

State of South Carolina
Office of Comptroller General

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November 21, 2006

**To the Citizens, Governor and
Members of the South
Carolina General Assembly**

I am pleased to present to the citizens of South Carolina this Comprehensive Annual Financial Report for the State of South Carolina for the fiscal year ended June 30, 2006. The report provides financial information about the State's operations during the year and describes its financial position at the end of the year. For the convenience of users, we have divided the report into three sections as follows:

- The Introductory Section, containing this letter of transmittal; the Certificate of Achievement for Excellence in Financial Reporting that we recently received for our report as of June 30, 2005; a list of State officials; and an organizational chart of State government.
- The Financial Section, including the independent auditors' report, management's discussion and analysis, government-wide financial statements, fund financial statements, required supplementary information, other combining financial statements, and schedules.
- The Statistical Section, presenting comparative financial data and other non-financial data.

Management assumes full responsibility for the completeness and reliability of the information contained in this report, based upon a comprehensive framework of internal controls that was established for this purpose. Because the cost of internal controls should not exceed the anticipated benefits, the objective is to provide reasonable, rather than absolute, assurance that the financial statements are free of any material misstatements.

The State Auditor and Clifton Gunderson LLP, an independent certified public accounting firm, jointly performed an independent audit of the State's basic financial statements for the fiscal year ended June 30, 2006. The auditors have issued an unqualified opinion, the most favorable outcome of the audit process.

This letter of transmittal is designed to complement management's discussion and analysis that immediately follows the report of the independent auditors.

PROFILE OF THE GOVERNMENT

South Carolina stretches from the Atlantic Ocean to the Blue Ridge Mountains, containing over 30,000 square miles. Fortieth in geographic area among the fifty states, South Carolina ranks twenty-fifth in population with approximately four and a quarter million citizens.

As shown in the organization chart on page 15, State government is divided into three separate branches: legislative, executive, and judicial. The State's citizens elect the legislative and executive branch officials. The General Assembly elects certain members of the judicial branch, including the Supreme Court. The principal State officials currently in office are listed on page 14.

State government provides a full range of services to South Carolina's citizens including educational, health, social/human, transportation, public safety, regulatory, and conservation/natural resources services. In addition, the State provides grants and loans to assist local governments, including school districts, within its borders.

Certain legally separate entities are included in these financial statements because they function, in essence, as part of State government. The Governor appoints the governing boards for the Public Service Authority, a public utility company, and the State Ports Authority. The Connector 2000 Association, Inc. assists the State's Department of Transportation on a toll road project. The Lottery Commission transfers its net proceeds to the State for educational programs. Other entities benefit and support institutions of higher education, provide medical malpractice insurance, and address medical and educational needs of South Carolina's children. Additional information on these legally separate entities can be found in the notes to the financial statements.

South Carolina's annual Appropriation Act includes legally adopted budgets for the Budgetary General Fund and for Total Funds. The initial budget appears in the annual Appropriation Act. After the budget year begins, the State Budget and Control Board, comprised of five key executive and legislative officials, may order spending cuts if revenue collections fail to reach predicted levels. Departments and agencies may request transfers of appropriations among programs if the transfer request does not exceed 20% of the program budget. The Budget and Control Board has the authority to approve additional transfers of appropriations between personal service and other operating expense accounts. For additional information, see the notes to the required supplementary information—budgetary.

STATE ECONOMY

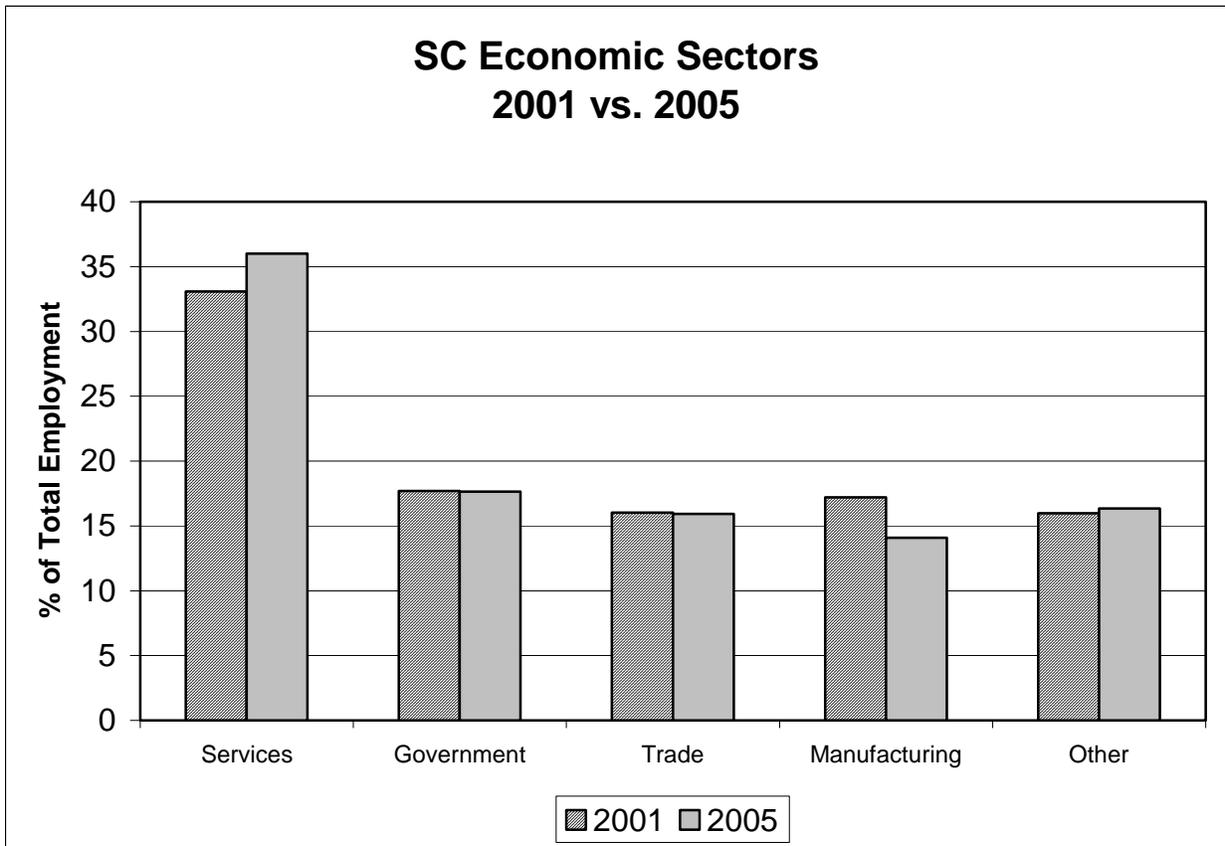
South Carolina historically has been a diverse manufacturing state; however, the State's economic base has undergone a gradual transition to other sectors such as trade, health care, services, and durable goods manufacturing. Businesses have migrated here from all over the world to take advantage of the State's skilled labor force, competitive wages, lower-priced land, excellent port facilities, accessibility to markets, and in recent years, substantial tax incentives.

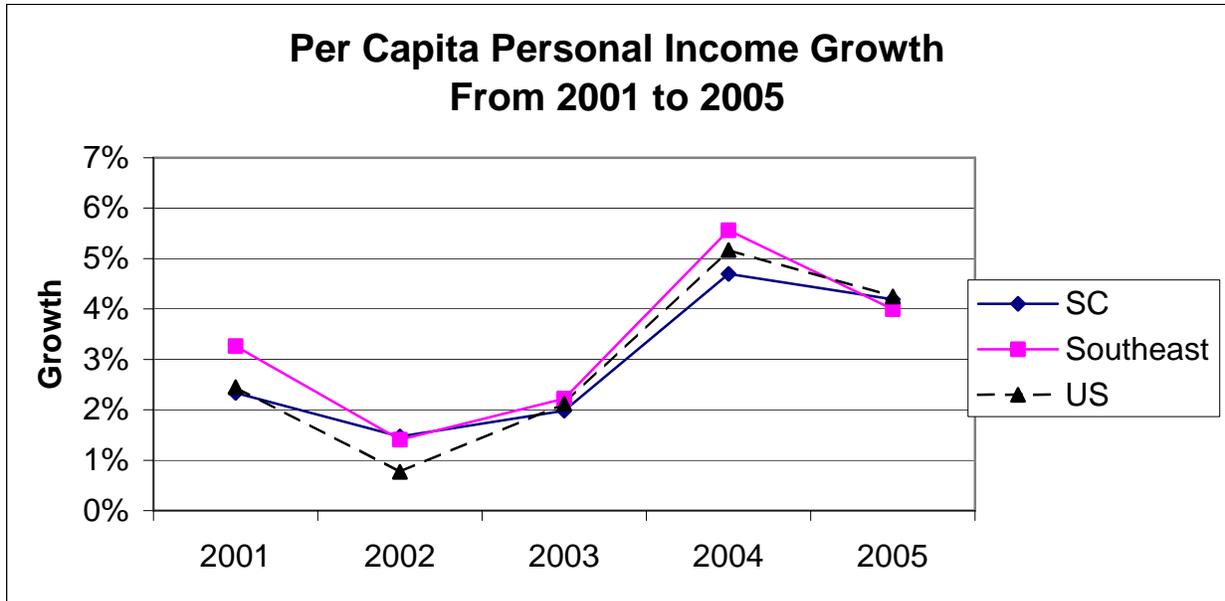
Overall, South Carolina's economy has improved following the recession of 2001, and is now enjoying a healthy expansion. The State's employment grew 1.4% in 2004 following employment declines in 2001 and 2002, with virtually no change in 2003. For the twelve-month period commencing in July 2005, total employment increased by 46,800 jobs, a gain of about 2.5%. South Carolina is currently creating jobs at the fastest pace since the late 1980's.

Although manufacturing still plays a big role in the State's economy, South Carolina's economic base has become more diversified since the 2001 recession. Employment in the State's manufacturing sector has been declining and now represents only about 14% of total employment versus 17% in 2001. Non-durable goods manufacturing, primarily related to the textile and apparel industry, has seen the greatest decline over the past five years. Accompanying these losses was growth in the manufacturing of other goods, such as the production of transportation equipment, fabricated

metals, and chemicals. During the past five years, the strongest employment gains have been in the State's service sector. This sector, fueled by tourism, educational, and healthcare industries has contributed to a more diversified overall employment base and improved income levels. This sector represented 36% of total employment in 2005, up from 33% in 2001. Similarly, the State's metropolitan areas are enjoying rapid job growth while rural areas, traditionally supported by textile industries, are struggling.

The State's unemployment rate was 6.8% for calendar year 2005, compared to the national rate of 5.1%. Part of the explanation underlying this higher State unemployment rate has been the rapid growth in the state's labor force. The size of the labor force had been growing at approximately the same pace as total employment, leading to a generally unchanging unemployment rate. In recent months, the State posted a decline in the size of the labor force coupled with a gain in employment that led to decline in the monthly unemployment rate to 6.2%. As long as the State continues to generate new jobs and the labor force growth rate slows, the State's unemployment rate will continue to decline steadily toward the national average.





South Carolina's per capita income for 2005 increased to \$28,212, or 4.2% over 2004. This increase matched the national growth rate and exceeded the 4.0% growth rate of the southeastern states. However, the State's 2005 level of per capita income was ranked forty-fourth among the states, representing only 82% of the national average and 91% of the southeastern region.

South Carolina's population at July 1, 2005, was 4.255 million. The State's rate of population growth is presently the thirteenth fastest in the nation.

For the calendar year 2005, the South Carolina Department of Commerce reported \$2.660 billion in new capital investments that are expected to create about 12,370 new jobs. The projected average wage for Commerce-assisted job creation was \$39,283, up 13% from 2004, and 139% of the State's per capita income. About 3,700 jobs were created in the State's rural areas. Manufacturing was the leading sector for investment (81%) and job creation (83%).

LONG-TERM FINANCIAL PLANNING

Beginning with fiscal year 2005–2006, State law requires agencies receiving 1% or more of the total annual General Fund appropriations to provide an estimate of general fund expenditures for the next three fiscal years. This data, in conjunction with the *State's Board of Economic Advisors* (BEA) long-term revenue estimate, is compiled by the State Budget Office. The three-year financial plan will assist the State in strategically assessing its future financial commitments. The plan must be updated annually and provided to the State's Budget and Control Board, the Speaker of the House of Representatives, and the President Pro Tempore of the Senate during the second quarter of each fiscal year.

Principal financial challenges facing South Carolina, as well as other state governments, include future spending increases for Medicaid, State retirement and health benefits (including post employment benefits), and elementary and secondary education.

Other management practices include a five-year capital improvement plan, which requires that first year funding be in place.

RELEVANT FINANCIAL POLICIES

The State's legislature is required to adopt a balanced budget annually based on revenue estimates provided by the State's BEA. State law requires the BEA to 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* is responsible for mandating spending cuts to keep the budget in balance. If the Board anticipates a year-end operating deficit, the Board must first reduce amounts set-aside in the Annual Appropriations Act for the 2% Capital Reserve. If the anticipated deficit is greater than the Reserve, then the Board must reduce agency appropriations evenly across-the-board. The State also is required to maintain a 3% General Reserve for eliminating a year-end operating deficit. If the State's budgetary General Fund experiences a year-end operating deficit after applying the actions described above, the Board is required to meet and address the deficit within sixty days of August 31.

The State has adopted legislation that beginning July 1, 2006, the Comptroller General shall suspend, to the extent necessary, any general or supplemental budgetary surplus appropriations, or Capital Reserve appropriations, if the State's GAAP-basis General Fund reports a negative unreserved fund balance.

Because of conservative budgeting and better than expected revenue collections, the State's General Fund experienced a budgetary operating surplus and a positive GAAP unreserved fund balance for the fiscal year ended June 30, 2006. Therefore, no appropriation reductions were necessary.

MAJOR INITIATIVES

Finance and Budgeting

The General Assembly has recently approved property tax relief that eliminates all school operating taxes on owner-occupied homes, funded by a one-cent increase on the sales tax. Other important legislation included in the 2006-2007 Appropriation Act (the Act) includes full funding of both the Education Finance Act and the State's rainy-day funds. The State's LIFE, HOPE and Palmetto Fellows Scholarship programs are also fully funded, providing tuition assistance for many of the State's higher education students.

The Act provides other tax relief by reducing the sales tax on food and creating a two-day sales tax holiday statewide. The Act also included a 3% raise for State employees and funding for the state employee and retiree health insurance program with no increase in premiums to subscribers or changes in benefits.

Business and Economic Development

The General Assembly has approved several significant economic development incentives. The *South Carolina Economic Development Incentive Act* and the *South Carolina Retail Facilities Revitalization Act* will encourage business expansion in the State.

Education

Education continued to be a legislative priority this year. The General Assembly included a provision in the Act establishing the South Carolina Child Development Education Pilot Program. This program will provide quality developmental and learning support for at-risk children.

Energy Conservation

The General Assembly approved several laws intended to encourage consumers to conserve energy, providing tax incentives for the production and use of alternative fuels and alternative fuel vehicles.

AWARDS AND ACKNOWLEDGMENTS

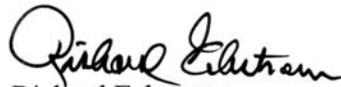
The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of South

Carolina for its comprehensive annual financial report (CAFR) for the fiscal year ended June 30, 2005. This was the eighteenth consecutive year that the State of South Carolina has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized CAFR. The report must satisfy both generally accepted accounting principles and applicable legal requirements.

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

Production of this report was made possible only by the support of all State agencies and component units that supplied GAAP closing data on a timely basis. We extend special appreciation to Mr. Larry Pearce, Director of Publications and Printing at the University of South Carolina, for providing the report's attractive cover.

Sincerely,



Richard Eckstrom
Comptroller General