



STATE OF WASHINGTON

OFFICE OF FINANCIAL MANAGEMENT

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November 2, 2017

The Honorable Jay Inslee, Governor
Honorable Members of the Legislature
Citizens of the State
State of Washington
Olympia, WA 98504

In accordance with Revised Code of Washington 43.88.027, the Office of Financial Management has prepared this Comprehensive Annual Financial Report (CAFR) of the state of Washington for the fiscal year ended June 30, 2017. Full responsibility for the completeness and reliability of the information contained in this report, based upon a comprehensive framework of internal control established for this purpose, rests with the state. Because the cost of internal control should not exceed 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 has issued an unmodified (“clean”) opinion on the Washington state financial statements for the fiscal year ended June 30, 2017. The independent auditor’s report is located at the front of the financial section of this report.

Management’s Discussion and Analysis (MD&A) immediately follows the independent auditor’s report and provides a narrative introduction, overview and analysis of the basic financial statements. The MD&A complements this letter of transmittal and should be read in conjunction with it.

Following the MD&A are the basic financial statements, including the government-wide financial statements, the fund financial statements and the notes to the financial statements. The required supplementary information, combining financial statements, individual fund schedules and the statistical section complete the CAFR.

Profile of Washington State

Washington state was created in 1889 by an enabling act of Congress. The state is located on the Pacific Coast, in the northwestern corner of the continental United States, and comprises 71,303 square miles. Its current population is 7.3 million. Washington is famous for its breathtakingly beautiful scenery and sharp contrasts. On the west side of the state, high mountains rise above coastal waters. The forests of the Olympic Peninsula are among the world’s rainiest places.

The state's coastline features hundreds of bays and inlets that make excellent harbors, while in the eastern part, flat semi-desert land stretches for long distances without a single tree.

Washington's location makes it a gateway for land, sea, and air travel to Alaska and Pacific Rim countries. Ships from all parts of the world dock at Washington ports. Costco Wholesale Corporation, headquartered in Issaquah, operates an international chain of membership warehouses. Microsoft, a global leader in the computer software industry, makes its home in Redmond. Amazon.com, a major internet retailer, Starbucks, a worldwide renowned coffee company, and Weyerhaeuser Company, a major producer of wood and related products, are headquartered in Seattle.

East of the Cascade Mountain range, farmers raise livestock and grow a variety of crops such as wheat, potatoes, and tree fruits. Washington leads the nation in apple and hops production, makes world-class wine, and produces large amounts of lumber, pulp, paper, and other wood products. Western Washington's mild, moist climate makes that region excellent for dairy farming and the production of flower bulbs.

GOVERNMENTAL STRUCTURE

As established in the state Constitution, Washington state has Executive, Legislative, and Judicial branches of government. The Executive Branch is composed of nine elected officials: the Governor, Lieutenant Governor, Secretary of State, State Treasurer, State Auditor, Attorney General, Superintendent of Public Instruction, Insurance Commissioner, and Commissioner of Public Lands. Thirty-nine agency heads are appointed by, and report to, the Governor. Seventy-eight agency heads report to boards appointed, in whole or in part, by the Governor. The Legislative Branch is composed of the Senate (with 49 members) and the House of Representatives (with 98 members). The Judicial Branch is composed of the State Supreme Court, the highest court in the state, which has nine Justices. Every two years, three Justices are elected for six-year terms. A Chief Justice is chosen from among the most senior Justices. The Judicial Branch also includes the state's superior courts, justices of the peace, and such inferior courts as the Legislature may provide.

TYPES OF SERVICES PROVIDED AND REPORTING ENTITY

The state provides a wide range of services that include education, transportation, environment and natural resource protection, and social and health services.

The accompanying report includes all funds and subsidiary accounts of the primary government, Washington state as legally defined, as well as its component units. Component units are legally separate entities for which the primary government is financially accountable or ones that have relationships with the state such that exclusion would cause the state's financial statements to be misleading or incomplete. The determination of "financial accountability" is based on criteria established in Governmental Accounting Standards Board Statements No. 14 and No. 61. Note 1.A to the financial statements explains more fully component units which are included in the reporting entity.

THE BUDGET CYCLE

Washington enacts budgets for a two-year cycle, beginning on July 1 of each odd-numbered year. By law, the Governor must propose a biennial budget in December, the month before the

Legislature convenes in regular session. The biennial budget enacted by the Legislature can be modified in any legislative session through changes to the original appropriations. Since the inception of annual legislative sessions in 1979, it has become common for the Legislature to enact annual revisions to the state's biennial budget. These revisions are referred to as supplemental budgets.

Operating appropriations are generally made at the fund/account and agency level; however, in a few cases, appropriations are made at the fund/account and agency/program level. Operating appropriations cover either the entire biennium or a single fiscal year in the biennium. Capital appropriations are biennial and are generally made at the fund/account, agency and project level. The legal level of budgetary control is at the fund/account, agency and appropriation level, with administrative controls established at lower levels of detail in certain instances.

Washington State's Economy and Revenue Outlook

Washington's economy has continued to outpace the nation during this period of expansion. Recent economic performance has narrowed that gap somewhat, but Washington should outperform the nation in job and income growth during the next several years.

Washington's jobless rate moved above the national rate during the past two years after having mirrored the national figures for much of the economic recovery. Washington's rate has traditionally been higher than the national norm due to the state's outsized share of seasonal industries and its attractiveness to in-migrants searching for opportunity and the Northwest experience. More recent figures show Washington's jobless rate remaining above the national average, likely the result of an increase in workforce participation. In fundamental ways, that reflects an increase in workers' confidence in finding gainful employment. By the end of the next biennium (2019-21), Washington's unemployment rate is projected to fall to 4.3 percent, down from the current 4.6 percent.

Personal income in Washington is expected to make above-average gains over the next biennium. Real personal income should gain 3.5 percent in fiscal year 2019 and 3.7 percent in fiscal year 2020, measurably higher than projections for the nation. On a per-capita basis, Washington's real personal income should reach \$51,551 at the end of fiscal year 2020, more than \$4,600 above the U.S. average.

These gains in Washington's personal income will occur notwithstanding declines in aerospace employment, which is expected to fall by 2.4 percent in fiscal year 2019 and 1.6 percent in fiscal year 2020. Though this places a drag on overall nonfarm employment growth, Washington is still projected to net a 1.9 percent increase in total payroll jobs in fiscal year 2019 and a 1.5 percent increase in fiscal year 2020, again measurably better than projections for the nation.

Construction activity in Washington is expected to increase at a healthy rate in fiscal years 2019-20. While multi-family construction growth was prompted by demand for rental units in the aftermath of the recession, income gains have renewed demand for single-family housing. Building permits should reach 42,400 in fiscal year 2019 and 41,800 in fiscal year 2020. As a result, construction employment should jump by 1.5 percent and 0.6 percent, respectively. That should boost construction jobs to 6 percent of total nonfarm employment, a bit above historic averages yet reflective of a strong housing and commercial building market.

General Fund-State revenues are forecasted to grow at a 6.6 percent pace in fiscal year 2019 and 3.9 percent in fiscal year 2020, compared to the 6.2 percent gain in fiscal year 2017 and the 6.0 percent increase in fiscal year 2018. The expanding economy, strong gains in hiring and robust housing markets have had a positive effect on revenue growth. Further economic growth, continued job gains, and sustained expansion in the housing and commercial building markets should keep revenues growing at a sound pace.

Major Initiatives

In recent years, Governor Jay Inslee and the Legislature approved historic spending increases on several fronts.

The 2015-17 operating budget included an additional \$1.3 billion to meet the state's kindergarten-through-12th grade basic education obligation; made another large investment in early learning; cut tuition and expanded financial aid for students at public colleges and universities; added child protective and child welfare service workers; and made important investments in mental health services.

The Legislature also approved a \$16 billion transportation investment package to address critical statewide maintenance and safety needs, relieve congestion, and improve freight mobility. And lawmakers approved a \$3.9 billion capital budget that was projected to support 21,000 jobs and included more than \$800 million for school construction and kindergarten-through-third grade class-size reduction.

Even with those investments, however, the state faced enormous fiscal and policy challenges heading into the current two-year budget cycle (2017–19). During the 2017 legislative session, Governor Inslee and lawmakers once again made significant progress, especially with investments in K-12 education and mental health services.

EDUCATION

Under the state Supreme Court's 2012 *McCleary v. State of Washington* decision, the state is under court order to meet its constitutional obligation to adequately fund basic education. The state made progress in both the 2013-15 and 2015-17 budgets toward meeting this obligation, but not enough progress to satisfy the court. In September 2014, the court found the state in contempt for failing to produce a long-term basic education funding plan and threatened sanctions if such a plan was not in place by the end of the 2015 legislative session.

To continue meeting the state's obligations under the *McCleary* decision, the Governor and the Legislature increased funding for basic education by about \$1.3 billion for the 2015–17 biennium. The state's two-year budget provided full funding for materials, supplies and operating costs; expanded full-day kindergarten to all students in the 2016-17 school year; and reduced class sizes in kindergarten through third grade.

But again, the court was not satisfied with the outcomes of the 2015 legislative session, and in August 2015, imposed penalties of \$100,000 per day until the Legislature adopted a complete plan for complying with the state's constitutional obligation.

In 2016, Governor Inslee signed Senate Bill 6195 to ensure continuing bipartisan collaboration on fully funding basic education and to commit the Legislature to adopting measures in the 2017 legislative session that finish the job of fully funding basic education. The bipartisan Education Funding Task Force analyzed methods to eliminate dependence on local levies that have been paying for a portion of basic education and to prepare recommendations on competitive compensation that help school districts recruit and retain educators.

After holding a hearing in September 2016, the Supreme Court issued an order the following month acknowledging progress made in the 2015-17 biennial budget but maintaining the \$100,000 per day penalty, pending legislative action in the 2017 session.

On June 30, 2017, the Governor signed a biennial budget that adds \$1.8 billion for basic education. The two-year budget — along with House Bill 2242 — provides funding beginning this biennium and a plan to complete these investments in the 2019-20 school year:

- \$1.1 billion to increase educator compensation allocations and provide health insurance benefits through a statewide system. Among other changes, the new law eliminates the salary grid for certificated staff to provide districts flexibility in salary levels, implements a regional compensation factor based on housing costs, and raises the minimum teacher salary to \$40,000. Districts will begin offering health insurance benefits through the state program in January 2020 to all staff who work at least 630 hours annually.
- \$383.0 million for other basic education enhancements to increase services for students not meeting academic standards, highly capable instruction, transitional bilingual instruction, special education students, and career and technical education programs.
- \$165.0 million for higher costs of the Local Effort Assistance program. The funds will lower local maintenance and operations (M&O) levy authority in 2019 to reflect the increase in state funding for compensation. The local M&O levy is limited to provide only “enrichment” and “supplementation” to basic education.
- \$23.0 million more for teacher mentoring and student support programs.

When fully implemented, new funding for school districts will total \$5.6 billion during the next four years.

Aside from more funding for McCleary, the 2017-19 biennial budget also invested \$46 million in early learning, including \$25 million to add 1,800 spaces in the Early Childhood Education and Assistance Program, the state’s preschool program for children from low-income families.

In addition, the two-year budget included \$49 million for the State Need Grant program to hold students harmless from tuition increases, expand the grant to 875 students annually and boost the grant award for students attending private, nonprofit four-year colleges and universities.

Under current law, tuition increases are capped at the average annual percentage growth in the median hourly wage. Public baccalaureate universities and colleges, and community and technical colleges may increase tuition by up to 2.2 percent in the first year of the biennium and 2.0 percent in the second year of the biennium.

MENTAL HEALTH

The 2017-19 budget provides more than \$100.0 million in state funds (\$177.0 million total funds) for improvements to the state's mental health system, informed by recommendations from outside experts. This includes investments to address challenges at Western State Hospital and to expand resources to serve people in community settings where the chances of successful treatment are much greater. New investments include:

- \$61.0 million to fund improvements at Western State Hospital based upon consultant and federal Centers for Medicare and Medicaid Services recommendations, and add 200 more full-time equivalent employees.
- \$11.0 million for 96 new beds to provide crisis stabilization and intervention services that will help reduce psychiatric hospital admissions.
- \$16.5 million to increase forensic capacity for court-ordered placements.
- \$66.0 million to build capacity for civil commitments in the community instead of the public mental health hospitals, including higher payment rates for community hospitals.
- \$32.0 million to enlarge discharge placement capacity in the community, including more adult family homes, skilled nursing facilities, shared supportive housing and state-operated living alternatives. This will help hard-to-place individuals transition from the state hospitals into the community.

DEPARTMENT OF CHILDREN, YOUTH AND FAMILIES

Governor Inslee signed House Bill 1661 in July 2017, creating the Department of Children, Youth, and Families (DCYF). The new agency will restructure how the state serves at-risk children and youth, with the goal of producing better outcomes in all Washington communities.

DCYF, after a yearlong transition period that began after the bill was passed, will oversee several services now offered through the state Department of Social and Health Services (DSHS) and the Department of Early Learning (DEL). These include all programs from the Children's Administration in DSHS, such as Child Protective Services (including the Family Assessment Response program), licensed foster care and adoption support, as well as all DEL services, including the Early Childhood Education and Assistance Program for preschoolers and Working Connections Child Care for low-income families.

Starting in July 2019, the new department will also administer programs offered by the Juvenile Rehabilitation Administration and the Office of Juvenile Justice in DSHS. Those programs include juvenile rehabilitation institutions, community facilities and parole services for youth.

The creation of the new department follows the suggestions of the bipartisan Blue Ribbon Commission on the Delivery of Services to Children and Families convened by the Governor in February 2016 to recommend a state system that focuses more clearly on preventing harm to children and youth, rather than reacting once harm has occurred.

HEALTH CARE

Access to health care has increased dramatically in Washington since the 2010 passage of the federal Patient Protection and Affordable Care Act (ACA), which gave Washingtonians the unprecedented opportunity to choose affordable, high-quality health insurance coverage. More than 170,000 people have been enrolled for private insurance through the state's health insurance exchange, the Washington Healthplanfinder. Washington also opted to expand its Medicaid program under the ACA. These actions have provided coverage to more than 750,000 people in the state. As a result, the percentage of Washington residents without health insurance has fallen from 16 percent to 5 percent.

Besides improving access to health care, the state endeavors to make health care more affordable. To that end, Washington has undertaken a number of initiatives to drive down costs and improve the health of its citizens.

For example, the state's Plan for a Healthier Washington will transform health care so people experience better health by receiving better care right when they need it and finding care that is more accessible and affordable. As part of this effort, the state is integrating mental health and substance abuse treatment with primary medical care. And, under legislation passed in 2014, the state is operating an all-payer claims database that will significantly improve the transparency of health care costs and quality, which will help purchasers and patients make more informed health care choices.

A new state-federal partnership will bolster efforts to improve the physical and mental health of Washington families and transform the state's Apple Health (Medicaid) program to control costs. The partnership is the result of an agreement in principle on a five-year Medicaid demonstration waiver to continue implementing the Governor's Healthier Washington plan. Among other aims, the initiative is expected to:

- Reduce use of high-cost services such as acute care hospitals, psychiatric hospitals, and nursing home facilities.
- Improve health for Apple Health clients by focusing on prevention and proactive management of diabetes and cardiovascular disease, pediatric obesity, smoking, mental illness, and substance abuse.
- Accelerate Medicaid payment reform to pay providers for better health outcomes, not just services rendered.
- Bend the Medicaid cost curve below the national trend.

In 2016, Governor Inslee issued Executive Order 16-09 to respond to the opioid use public health crisis. The order coordinates efforts by state agencies and other private and public partners to implement the comprehensive state opioid response plan. The plan has a four-part focus: to prevent the next generation from becoming addicted to opioids in the first place; treat people with opioid use disorder and link them to support services, including housing; intervene in opioid overdoses to prevent death; and use data more effectively to detect opioid misuse and abuse, monitor serious conditions and overdoses, and evaluate interventions to respond more effectively. The Legislature funded many of these activities and passed major legislation in 2017 to implement the order.

The Governor also continued his Healthiest Next Generation initiative, a public-private partnership launched in 2014 that has developed strategies to ensure healthy weight in children through such actions as promoting breastfeeding, supporting child care providers and schools by providing more nutritious meal and drink options, and encouraging children to be more active. The initiative also supports youth substance use prevention and education efforts such as regulating e-cigarettes. In fact, Washington was the first state in the nation to pass legislation to comprehensively regulate e-cigarettes. Governor Inslee has also continued a focus on employee wellness, launching the program SmartHealth, with online access to health improvement and wellness tools.

The Governor convened an Aging Summit to help the state prepare for the needs of an aging population. The summit generated a number of policy recommendations, such as the need for investments in long-term care and nursing homes. The summit also resulted in the formation of a joint legislative and executive branch committee, as well as legislation to implement the Community First Choice Option and develop an Alzheimer's disease plan for Washington. The Governor recently announced a private-public partnership to implement a more affordable small business retirement marketplace. AARP recently ranked Washington as number one in the nation for long-term care.

ENVIRONMENT AND ENERGY

The Governor continues to tackle the issue of carbon pollution, a cornerstone of his agenda.

At his urging, the 2015-17 budget included \$40.4 million for programs to support research institutions, utilities, and businesses as they develop, demonstrate, and deploy new renewable, clean energy, and energy-efficiency programs. The sum of \$25 million was provided for grants to state agencies, school districts, universities, and local governments to improve the energy efficiency of public facilities and street lighting, and to install solar energy systems to cut energy demand and costs.

In September 2016, the state Department of Ecology issued rules to limit carbon pollution from major polluters in the state. Under the Clean Air Rule, businesses that are responsible for 100,000 metric tons of carbon pollution annually will be required to cap and then gradually reduce their emissions. Natural gas distributors, petroleum fuel producers and importers, power plants, metal manufacturers, waste facilities, and state and federal facilities are included under the rule and need to reduce their emissions by an average of 1.7 percent a year starting in 2017. A total of \$4.5 million was provided by the Legislature to implement this rule in the 2017-19 biennium.

Rising safety and environmental risks associated with rapid changes in how crude oil is transported through rail corridors and over waters are affecting the state. As petroleum shipments from Alaska decline, transport of crude oil from the Bakken region via rail is increasing. To address these risks, Governor Inslee sponsored House Bill 1449, later signed into law, which expands the state oil spill tax to oil transported by rail. This bill provides additional oil spill prevention and preparedness funding, advanced notice and reporting requirements for oil transported by rail and pipelines, enhanced authority of safety inspections at rail crossings, and stronger oil spill contingency planning requirements.

Washington faced its largest wildfire season in 2015 when 1.1 million acres burned statewide. Last year, however, 308,000 acres burned, still a considerable toll. In response to these dramatic fire seasons, the Governor secured an additional \$8.7 million in the 2016 supplemental budget to

improve the ability of state and local fire districts to respond to and prevent wildfires and to improve forest health.

TRANSPORTATION

In 2017, the Governor and the Legislature continued implementation of the transportation revenue package passed in 2015, which will support more than 200,000 family-wage jobs across the state. The 2017-19 state transportation budget includes more funding for several high-priority projects around the state, including \$64.0 million for the North Spokane corridor, \$15.0 million to add capacity on Interstate 5 near Seattle, \$73.0 million for I-90 improvements at Snoqualmie Pass, and \$110.0 million for regional and rural mobility grants.

RESULTS WASHINGTON

Washington is a recognized national leader in adapting proven private-sector principles to improve state government. Governor Inslee's innovative Results Washington initiative, launched in 2013, uses data and multi-agency teams to spur improvements in education, the economy, the environment, health, safety, and effective government. More than half of Results Washington's nearly 200 measures are on track to meet or beat their targets.

In addition, state agencies have launched hundreds of improvement projects of their own. This work has led to faster services, easier-to-use documents, fewer errors, slashed backlogs, and millions of dollars in cost avoidance.

Underlying much of this work are the principles of Lean management, which has proven highly effective at driving customer-focused improvements in health care, aerospace, retail, and other industry sectors. Today, Lean principles are increasingly being put to use in the public sector. Lean emphasizes root-cause problem solving and cycles of improvement led by frontline staff, all with the goal of increasing quality and value to the customer.

A key tenet of this effort is transparency and accountability. The Governor meets regularly with teams of state agency directors to discuss progress, new data, challenges, and next steps. These meetings are open to the public and streamed live over the Internet. Goals, improvement strategies and current data are also posted online at www.results.wa.gov.

Awards and Acknowledgements

The Government Finance Officers Association (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to Washington state for its CAFR for the fiscal year that ended June 30, 2016. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

To be awarded a Certificate of Achievement, a governmental unit must publish an easily readable and efficiently organized CAFR, with contents conforming to program standards. Such reports must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. Washington state has received a Certificate of Achievement for the past 30 years. The Office of Financial Management considers this report to be in conformity with the Certificate of Achievement Program requirements, and will submit it to the GFOA.

The preparation of this report could not have been accomplished without the professionalism and dedication demonstrated by the financial and management personnel of each state agency and the Office of Financial Management. This CAFR reflects the Governor's commitment to the Legislature, the citizens of Washington state, and the financial community to maintain financial statements in conformance with the highest standards of financial accountability.

Sincerely,

A handwritten signature in black ink, appearing to read 'D. Schumacher', with a long horizontal flourish extending to the right.

David Schumacher
Director