



STATE OF WASHINGTON
OFFICE OF FINANCIAL MANAGEMENT

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December 21, 2005

The Honorable Christine Gregoire, Governor
Members of the Legislature
Citizens of the State
State of Washington
Olympia, Washington 98504

In accordance with Chapter 43.88.027 of the Revised Code of Washington, the Office of Financial Management (OFM) has prepared this Comprehensive Annual Financial Report (CAFR) of the state of Washington for the fiscal year that ended June 30, 2005. Full responsibility for the completeness and reliability of the information contained in this report, based upon a comprehensive framework of internal control that has been 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 unqualified (“clean”) opinion on the Washington State financial statements for the year ended June 30, 2005. 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.

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



Profile of Washington State

The state of Washington was created by an enabling act of Congress in 1889. The state is located on the Pacific Coast in the northwestern corner of the continental United States. Washington comprises 68,139 square miles and currently has a population of 6.3 million. Washington is famous for its scenery of breathtaking beauty 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 rainiest places in the world. Washington's coastline has hundreds of bays and inlets that make excellent harbors. In the eastern part of the state, the 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 the 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 leader in the computer software industry, makes its home in Redmond. The Weyerhaeuser Company, a major producer of wood and related products, is headquartered in Federal Way.

East of the Cascade Mountain Range, farmers raise livestock and wheat on large ranches. Washington leads the nation in apple production. The state produces large amounts of lumber, pulp, paper, and other wood products. The mild moist climate in western Washington makes the region excellent for dairy farming and the production of flower bulbs.

Governmental Structure

As established in the State Constitution, the state consists of three branches of government: the Executive Branch, Legislative Branch, and Judicial Branch. The Executive Branch has nine elected officials as follows: the Governor, Lieutenant Governor, Secretary of State, State Treasurer, State Auditor, Attorney General, Superintendent of Public Instruction, Commissioner of Public Lands, and Insurance Commissioner. Thirty-nine agency heads are appointed by, and report to, the Governor. Ninety agency heads report to a board appointed in whole or in part by the Governor. The Legislative Branch consists of two legislative bodies: the Senate with forty-nine members, and the House of Representatives with ninety-eight members. The Judicial Branch consists of the State Supreme Court, which is the highest court in the state comprised of nine justices. Every two years, three justices are elected for six-year terms. A Chief Justice is chosen from among the most senior justices.

Types of Services Provided and Reporting Entity

The state provides a wide range of services. These 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, the state of Washington as legally defined, as well as all of its component units. Component units are legally separate entities for which the primary government is financially accountable. The determination of "financial accountability" is based on criteria established in Governmental Accounting Standards Board Statement No. 14. Note 1.A to the financial statements explains more fully which organizations 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 within 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

Summary

Since the economic recovery began in the fourth quarter of 2001, Washington has gained more than 100,000 jobs, or about 3.7 percent growth. Although the state job recovery started slowly, it picked up strength in Fiscal Year 2005. A turnaround in the aerospace industry, a strong growth in the housing sector due to low interest rates, and an increase in disposable household income from home mortgage refinancing have aided the state recovery.

The relative strength of the state's recovery reflects the underlying strengths of the state economy, which includes a vital export base, the presence of knowledge-based industries such as business, professional, health, and financial services, and a high quality of life that continues to support strong population growth.

After two years of decline and one year of growth below 1 percent, Washington State's non-farm payroll employment grew by a robust 2.4 percent in Fiscal Year 2005. Personal income grew at a rate of 7.8 percent that fiscal year. While this was a significant improvement over growth rates of 1.7 percent in Fiscal Year 2003 and 3.6 percent in Fiscal Year 2004, about 3 percentage points of the increase in Fiscal Year 2005 was due to Microsoft's special dividend paid in November 2004. The aerospace industry turned around in Fiscal Year 2005 and posted a modest but positive employment increase of 2 percent after six fiscal years of decline. Total manufacturing employment grew by 1.5 percent, breaking the trend of falling employment in that sector. In Fiscal Year 2005, Washington's unemployment rate receded to 5.7 percent, significantly lower than the 6.9 percent rate for Fiscal Year 2004 and only slightly above the national unemployment rate of 5.3 percent in Fiscal Year 2005.

Washington's outlook for Fiscal Year 2006 is for a continuation in the strong economic activity. Non-farm payroll employment in Washington is forecast to increase in Fiscal Year 2006 by 2.5 percent, the strongest growth since Fiscal Year 2000. Personal income growth is also predicted to grow by 3.8 percent in Fiscal Year 2006. This lower growth rate of Washington personal income is artificially low due to the effects of Microsoft's special dividend in November 2004. General Fund-State revenues are forecast to grow at an even stronger 12.6 percent rate in the 2005-07 Biennium, compared to the increase of 10.6 percent in the 2003-05 Biennium.

Economic Condition in Fiscal Year 2005

Washington's non-farm payroll employment grew by 2.4 percent in Fiscal Year 2005, a significantly faster rate than the 1.6 percent increase in U.S. non-farm payroll employment. Washington's non-farm payroll employment increased by almost 65,000 during Fiscal Year 2005. Personal income in Washington grew more rapidly than U.S. personal income, 7.8 percent in Washington compared to 6.4 percent for the U.S. However, about 3 percentage points of the increase for Washington in Fiscal Year 2005 was due to Microsoft's special dividend in November 2004. Without the dividend, Washington personal income growth would have been below U.S. personal income growth. Real per capita income growth was up in Washington by 5.0 percent over the same period, compared to 3.6 percent for the nation as a whole. Again, Microsoft's special dividend significantly affected Washington's growth rate.

Aerospace employment and manufacturing employment provided some modest bright spots for Washington's employment growth. After adding more than 15,000 employees in Fiscal Year 1998, employment in the aerospace industry fell by nearly 50,000 in Fiscal Years 1999 through 2004. Aerospace employment made a modest comeback in Fiscal Year 2005, increasing by 1,200. Manufacturing employment other than aerospace also grew, rising by 1.3 percent. All durable manufacturing industries except one also experienced higher employment in Fiscal Year 2005 compared to Fiscal Year 2004. Employment in most nondurable manufacturing industries continued to decline in Fiscal Year 2005.

Employment in durable manufacturing other than aerospace grew by 3.5 percent in Fiscal Year 2005 (an increase of 4,100 jobs) while employment in durable manufacturing nationally inched up by 0.9 percent. Employment increased in all durable manufacturing industries in Washington during Fiscal Year 2005, except the computer and electronic products industry where employment was down 1.1 percent (loss of 300 jobs). Employment in electrical equipment, appliances and components grew by 4.9 percent and employment in other transportation equipment (transportation equipment other than aerospace) increased by 8.4 percent. Employment in wood products rose by 6.1 percent, and employment in fabricated metal products rose by 4.3 percent in Fiscal Year 2005. Machinery manufacturing experienced growing employment at the rate of 6.8 percent. The smallest percentage increases in employment in the durable manufacturing sector during Fiscal Year 2005 occurred in other durable manufacturing, up by 1.7 percent, and the primary metals industry, up only 0.2 percent (an increase of fewer than 100 jobs).

Non-durable manufacturing employment in Washington decreased by 1.8 percent in Fiscal Year 2005, a loss of 1,500 jobs. Nationally, non-durable manufacturing employment declined by 1.5 percent. In Washington, all non-durable manufacturing industries experienced employment

losses in Fiscal Year 2005, except petroleum products, which rose by 1.1 percent. The largest percentage losses in employment occurred in food manufacturing, a 2.4 percent decline, and paper and paper products manufacturing, a 3.9 percent loss. Employment in printing decreased by 2.1 percent.

Washington's non-manufacturing employment grew by 2.2 percent during Fiscal Year 2005, with construction employment growing by 6.4 percent, services employment increasing by 2.5 percent, and employment in the natural resources industry rising at a rate of 5.8 percent. Wholesale trade employment rose by 3.5 percent, retail trade employment grew by 2.1 percent, and transportation, warehousing and utilities employment increased by 3.4 percent. Employment in the information sector rose by 0.6 percent and employment in the financial activities industry increased by 0.4 percent. State and local government employment grew by 1.0 percent, but federal government civilian employment declined by 0.2 percent in Fiscal Year 2005.

Economic Outlook

The economic forecast for Washington State for Fiscal Year 2006 reflects the impact of the long-awaited recovery at both the state and national levels. According to the November 2005 forecast by the state Economic and Revenue Forecast Council, growth in Washington's non-farm payroll employment is predicted to increase by 2.5 percent in Fiscal Year 2006, a rate closer to the state's long-term average employment growth and significantly higher than the expected national growth rate of 1.5 percent for non-farm payroll employment in Fiscal Year 2006.

Washington's personal income growth will slow in Fiscal Year 2006 with growth of only 3.8 percent, but this is a statistical artifact created by Microsoft's special dividend in Fiscal Year 2004. U.S. personal income growth is predicted to be 5.8 percent in Fiscal Year 2006. Without the data anomaly caused by the Microsoft special dividend, Washington's personal income would be forecast to grow faster than U.S. personal income in Fiscal Year 2006.

Manufacturing employment in Washington is projected to continue growing in Fiscal Year 2006. Aerospace employment is expected to grow strongly in Fiscal Year 2006, by 8.6 percent. Other manufacturing sectors are also expected to show some increase in employment, adding about 1,500 jobs (0.8 percent increase) in Fiscal Year 2006. Most sectors of durable manufacturing besides aerospace are expected to increase in employment. The fastest employment growth in non-aerospace manufacturing is expected in machinery, 4.8 percent; electrical equipment, appliances and components, 4.1 percent; and other transportation equipment, 5.5 percent. Most sectors of non-durable manufacturing are expected to continue declining in Fiscal Year 2006. Employment in food manufacturing is forecast to fall by 3.2 percent, and employment in paper and paper products manufacturing will decline by 0.9 percent. Employment in printing should grow by 1.5 percent in Fiscal Year 2006.

In the non-manufacturing sectors, the strongest growth is predicted to occur in software publishing and the construction sector. Employment in software publishing is predicted to increase by 5.3 percent and construction employment is forecast to grow by 5.1 percent in Fiscal Year 2006. Information employment and wholesale trade employment growth are also expected to be bright spots in the continuing recovery. Employment in those sectors should grow by a relatively robust 3.1 percent and 3.5 percent, respectively, in Fiscal Year 2006.

With the exception of federal government civilian employment and natural resources, all other non-manufacturing sectors are expected to increase employment. Retail trade employment is forecast to show slightly positive growth of 1.8 percent, and services employment is expected to increase by 2.8 percent in Fiscal Year 2006. Employment in transportation, warehousing and utilities is predicted to grow by 2.4 percent, and employment in financial activities is expected to increase by only 1.0 percent. After significant budget cuts in previous years, state and local government employment is expected to grow by 1.2 percent in Fiscal Year 2006.

A few Washington industries will continue to experience no growth going into Fiscal Year 2006. Federal government civilian employment is forecast to fall in Fiscal Year 2006 by 0.6 percent. The poorest growth performance among the non-manufacturing sectors is predicted to occur in the natural resources industry. The natural resources industry is forecast to drop by 1.1 percent in Fiscal Year 2006.

General Fund-State Revenues

General Fund-State revenues for the 2003-05 Biennium were \$23.4 billion, an increase of 10.6 percent in nominal terms over the previous biennium. Revenue growth is expected to be even stronger in the 2005-07 Biennium. General Fund-State collections are forecast to increase by 12.6 percent during that two-year period, generating revenue of \$26.3 billion. Based on the November 2005 revenue forecast, Washington will have an estimated reserve of \$1.453 billion by the end of the 2005-07 Biennium, up slightly from \$853 million in the previous biennium. These projected reserves assume no further changes in appropriations for the 2005-07 Biennium.

Major Initiatives

Washington State made progress in 2005 to strengthen its transportation system and improve educational opportunities for secondary and higher education students. Steps were taken to nurture the state's recovering economy, improve its health care system for children, protect its natural environment, and make state government more efficient.

Transportation

Newly elected Governor Christine Gregoire and the Legislature approved a transportation improvement package of \$8.5 billion to be spent over 16 years to address congestion and safety on critical roads and bridges across Washington, and to strengthen mass transit systems. The package is financed by an additional 9.5-cent tax on a gallon of gasoline. The tax is phased in over four years. One penny of the new tax – \$602 million – goes to cities and counties for local transportation needs. Other transportation fees in the package buy public transportation and rail improvements. The gasoline tax was challenged by a citizen initiative, but voters in the November 2005 election upheld the tax.

Public Education

The Governor and Legislature used proceeds from increases in tobacco and liquor taxes, along with partial restoration of an estate tax, to establish and finance an Education Legacy Trust Fund. The fund provides \$138 million in the next biennium to reinstate financing for smaller class sizes

in public schools, a step approved by citizen passage of Initiative 728 in 2000. Teacher pay Initiative 732, passed in 2000, also was reinstated, providing cost-of-living increases for public school staff at a cost of \$139 million to the General Fund. The Governor and Legislature took additional actions to improve public schools in 2005, including approval of a program to provide classroom help for struggling high school students, and funding to launch an 18-month study of the state's entire education system from early learning through higher education.

Higher Education

To meet growing enrollment demand in the state's system of higher education, Governor Gregoire and the Legislature provided \$74.1 million from the new Education Legacy Trust Fund to create 7,900 new enrollment slots at state colleges and universities, bringing the number of full-time, state-subsidized enrollments to more than 224,000. The new enrollments will enable the state to keep up with the projected demand for access to the state's higher education system in the next biennium. The Governor and Legislature also agreed to allow institutions of higher education to increase tuition by set limits in order to increase spending to attract and retain high-quality faculty and to help finance financial aid for students from lower-income families.

Economic Development

To further nurture Washington's recovering economy, the Legislature and Governor balanced competing demands and agreed on a \$26 billion biennial state budget without raising general consumer and business taxes. In addition, the Legislature approved Governor Gregoire's proposal to move Washington into leading-edge medical research and improve the quality and yield of farm crops through a new \$1 billion Life Sciences Discovery Fund. Bonus money from the tobacco settlement – \$350 million – will be used as seed money to attract public and private contributions for research over 10 years to create new jobs and commerce in the next 10 to 15 years. The Legislature also approved the Governor's proposal that clarifies rules governing research scientists and companies, as well as public resources in order to more easily move research findings into commercial development. Other steps taken to strengthen Washington's economy included passage of a \$3.3 billion public works budget to provide much-needed facilities for higher education, public schools and local communities.

Environment

Significant steps were taken in 2005 to reduce global warming emissions. Governor Gregoire and the Legislature adopted most of California's tough vehicle emissions standards for new cars sold in Washington beginning with the 2009 model year. Also signed into law was the nation's most aggressive green buildings legislation, requiring all major public agency facilities exceeding 5,000 square feet, including school buildings receiving state funding, to meet the green building council's Leadership in Energy and Environmental Design (LEED) standards. Meeting the standards will save energy, water and natural resources while producing considerable savings in operating costs. The Governor and Legislature also provided funding to better guard against oil spills in Washington waters and to reduce toxic and wastewater pollution.

Government Efficiency

Governor Gregoire and the Legislature took big steps to make Washington's government more efficient and accountable. They reduced the ranks of middle management by 1,000 positions and

redeployed the \$50 million in savings to better deliver services. The Legislature also authorized performance audits of state government operations, and established the Governor's Government Management Accountability and Performance (GMAP) program to require that state agencies present clear goals and data with which to measure progress in meeting the goals. In addition, state government launched a program to leverage its purchasing power for cheaper products – and in a way that reduces the need for costly warehouse space and inventory control.

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, 2004. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

In order 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 last eighteen 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 institution of higher education, and the Office of Financial Management. This CAFR reflects the commitment of the Governor to the Legislature, the citizens of Washington State, and the financial community to maintain financial statements in conformance with the highest professional standards.

Sincerely,



Victor A. Moore
Director