

Management's Discussion and Analysis

As managers of the state of Washington, we offer this narrative overview and analysis of the financial activities for the fiscal year ended June 30, 2006. We present this information in conjunction with the information included in our letter of transmittal, which can be found preceding this narrative, and with the state's financial statements, which follow. All amounts, unless otherwise indicated, are expressed in thousands of dollars.

Financial Highlights

- Total assets of the state of Washington exceeded its liabilities by \$20.8 billion (reported as *net assets*). Of this amount, \$(2.7) billion was reported as "unrestricted (deficit) net assets." A negative balance indicates that no funds were available for discretionary purposes.
- The state of Washington's governmental funds reported combined ending fund balance of \$10.4 billion, an increase of 13 percent compared with the prior year.
- Unreserved fund balance for the General Fund was \$569 million, or 3.1 percent of total General Fund expenditures.
- The state's capital assets increased by \$1.3 billion while total bond debt increased by \$844 million during the current fiscal year.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the state of Washington's basic financial statements, which include three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. The focus is on both the state as a whole (government-wide) and the major individual funds. The dual perspectives allow the reader to address relevant questions, broaden a basis for comparison (year-to-year or government-to-government), and enhance the state's accountability.

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

The *Statement of Net Assets* presents information on all of the state of Washington's assets and liabilities, with the difference between the two reported as *net assets*. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the state of Washington is improving or deteriorating.

The *Statement of Activities* presents information showing how the state's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, *regardless of the timing of related cash flows*. Thus, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods (e.g., uncollected taxes and earned but unused vacation leave). The Statement of Activities is focused on both the gross and net cost of various activities (including governmental, business-type, and component unit). This is intended to summarize and simplify the reader's analysis of the revenues and costs of various state activities and the degree to which activities are subsidized by general revenues.

Both of these government-wide financial statements distinguish functions of the state of Washington that are principally supported by taxes and intergovernmental revenues (*governmental activities*) from other functions that are intended to recover all or a significant portion of their costs through user fees and charges (*business-type activities*). The governmental activities of the state of Washington include education, human services, transportation, natural resources, adult corrections, and general government. The business-type activities of the state of Washington include the workers' compensation, unemployment compensation, and health insurance programs, as well as various higher education student services such as housing and dining.

The government-wide financial statements can be found on pages C-17 through C-21 of this report.

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

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

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

Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures, and changes in fund balances for three major funds and an aggregate total for all non-major funds. The state's major governmental funds are the General Fund, Higher Education Special Revenue Fund, and the Higher Education Endowment Permanent Fund. Individual fund data for the state's non-major governmental funds are provided in the form of *combining statements* elsewhere in this report.

The governmental fund financial statements can be found on pages C-23 through C-27 of this report.

Proprietary Funds. The state of Washington maintains two different types of proprietary funds. *Enterprise funds* are used to report the same functions presented as *business-type activities* in the government-wide financial statements. *Internal service funds* represent an accounting device used to accumulate and allocate costs internally among the state of Washington's various functions. The state of Washington uses internal service funds to account for general services such as motor pool, central stores, data processing services, and printing services. Because internal service funds predominately benefit governmental rather than business-type functions, they have been included within *governmental activities* in the government-wide financial statements.

Proprietary fund financial statements provide the same type of information as the government-wide financial statements, but in greater detail. The proprietary fund financial statements provide separate information for the Workers' Compensation Fund, Unemployment Compensation Fund, and the Higher Education Student Services Fund, which are considered to be major funds, as well as an aggregated total for all non-major enterprise funds. The internal service funds are combined for presentation purposes. Individual fund data for the state's non-major proprietary funds are provided in the form of *combining statements* elsewhere in this report.

The proprietary fund financial statements can be found on pages C-28 through C-31 of this report.

Fiduciary Funds. Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are *not* reflected in the government-wide financial statement because the resources of those funds are *not* available to support the state of Washington's own programs. Washington's fiduciary funds include state administered pension plans. The accounting used for fiduciary funds is much like that used for proprietary funds. Individual fund data for the state's fiduciary funds are provided in the form of *combining statements* elsewhere in this report.

The fiduciary fund financial statements can be found on pages C-32 through C-33 of this report.

Component Units. Component units that are legally separate from the state and primarily serve or benefit those outside the state are discretely presented. They are either financially accountable to the state, or have relationships with the state such that exclusion would cause the state's financial statements to be misleading or incomplete. The state discretely reports one major component unit, the Washington State Public Stadium Authority, and four non-major component units. Refer to Note 1 on page C-37 for more detailed information. Individual fund data for the state's non-major component units are provided in the form of combining statements elsewhere in this report.

The financial statements for the state's component units can be found on pages C-34 through C-35 of this report.

Notes to the financial statements. The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages C-36 through C-111 of this report.

Other required information. In addition to this discussion and analysis, this report also presents required supplementary information on budgetary comparisons, pension plan funding, and infrastructure assets reported using the modified approach. Required supplementary information can be found on pages C-113 through C-135 of this report.

The combining statements referred to earlier are presented immediately following the required supplementary information. Combining and individual fund statements and schedules can be found on pages 159 through 213 of the *Comprehensive Annual Financial Report (CAFR)*.

Government-wide Financial Analysis

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. For the state of Washington, total assets exceed liabilities by \$20.8 billion at June 30, 2006 as compared to \$18.4 billion at June 30, 2005 (as restated).

The largest portion of the state's net assets (77.1 percent for Fiscal Year 2006 as compared to 84 percent for Fiscal Year 2005 (as restated)) reflects its investment in capital assets (e.g., land, buildings, machinery, and equipment), less any related debt used to acquire those assets that is still outstanding. The state of Washington uses these capital assets to provide services to citizens; consequently, these assets are *not* available for future spending. Although the state of Washington's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

State of Washington's Net Assets

(in millions of dollars)

	Governmental Activities		Business-type Activities		Total	
	2006	2005*	2006	2005	2006	2005
Current and other assets	\$ 15,537	\$ 14,210	\$ 18,297	\$ 17,281	\$ 33,834	\$ 31,491
Capital assets	24,174	22,903	1,587	1,525	25,761	24,428
Total assets	<u>39,711</u>	<u>37,113</u>	<u>19,884</u>	<u>18,806</u>	<u>59,595</u>	<u>55,919</u>
Current and other liabilities	3,510	3,744	1,962	2,091	5,472	5,835
Long-term liabilities outstanding	13,040	12,143	20,285	19,496	33,325	31,639
Total liabilities	<u>16,550</u>	<u>15,887</u>	<u>22,247</u>	<u>21,587</u>	<u>38,797</u>	<u>37,474</u>
Net assets:						
Invested in capital assets, net of related debt	15,434	14,975	605	510	16,039	15,485
Restricted	4,343	4,351	3,164	2,341	7,507	6,692
Unrestricted (deficit)	3,384	1,900	(6,132)	(5,632)	(2,748)	(3,732)
Total net assets	<u>\$ 23,161</u>	<u>\$ 21,226</u>	<u>\$ (2,363)</u>	<u>\$ (2,781)</u>	<u>\$ 20,798</u>	<u>\$ 18,445</u>

*Note: 2005 balances for Governmental Activities have been restated to reflect fund-type reclassifications and prior period error corrections.

A portion of the state of Washington's net assets (36.1 percent for Fiscal Year 2006 as compared to 36.3 percent for Fiscal Year 2005) represents resources that are subject to constitutional or external restrictions on how they may be used. The remaining balance represents *unrestricted (deficit) net assets*. A positive balance indicates that excess assets are available to meet the state's ongoing obligations to citizens and creditors. The state's overall negative balance is caused by the workers' compensation program that provides supplemental pension cost-of-living adjustments for time-loss and disability payments. For reporting purposes an actuarially determined liability has been recorded to comply with applicable accounting standards. However, by statute, these payments are funded on a pay-as-you-go basis.

State of Washington's Changes in Net Assets
(in millions of dollars)

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
Revenues:						
Program revenues:						
Charges for services	\$ 3,225	\$ 3,161	\$ 6,911	\$ 6,615	\$ 10,136	\$ 9,776
Operating grants and contributions	8,260	8,238	55	71	8,315	8,309
Capital grants and contributions	610	675	-	(2)	610	673
General revenues:						
Taxes	15,499	13,988	100	95	15,599	14,083
Interest and investment earnings	475	363	147	1,249	622	1,612
Total revenues	<u>28,069</u>	<u>26,425</u>	<u>7,213</u>	<u>8,028</u>	<u>35,282</u>	<u>34,453</u>
Expenses:						
General government	(1,320)	(1,260)	-	-	(1,320)	(1,260)
Education - K-12	(6,642)	(6,283)	-	-	(6,642)	(6,283)
Education - higher education	(4,804)	(4,455)	-	-	(4,804)	(4,455)
Human services	(10,082)	(9,852)	-	-	(10,082)	(9,852)
Adult corrections	(749)	(640)	-	-	(749)	(640)
Natural resources and recreation	(777)	(229)	-	-	(777)	(229)
Transportation	(1,526)	(1,457)	-	-	(1,526)	(1,457)
Interest on long-term debt	(533)	(505)	-	-	(533)	(505)
Workers' compensation	-	-	(2,267)	(2,407)	(2,267)	(2,407)
Unemployment compensation	-	-	(736)	(870)	(736)	(870)
Higher education student services	-	-	(1,254)	(1,170)	(1,254)	(1,170)
Health insurance programs	-	-	(1,244)	(1,138)	(1,244)	(1,138)
Other business-type activities	-	-	(1,042)	(988)	(1,042)	(988)
Total expenses	<u>(26,433)</u>	<u>(24,681)</u>	<u>(6,543)</u>	<u>(6,573)</u>	<u>(32,976)</u>	<u>(31,254)</u>
Excess (deficiency) of revenues over expenses before contributions to endowments, extraordinary loss, and transfers	1,636	1,744	670	1,455	2,306	3,199
Contributions to endowments	131	69	-	-	131	69
Extraordinary loss (asset impairment)	(84)	-	-	-	(84)	-
Transfers	252	184	(252)	(184)	-	-
Increase (decrease) in net assets	<u>1,935</u>	<u>1,997</u>	<u>418</u>	<u>1,271</u>	<u>2,353</u>	<u>3,268</u>
Net assets - July 1, as restated*	<u>21,226</u>	<u>19,842</u>	<u>(2,781)</u>	<u>(4,052)</u>	<u>18,445</u>	<u>15,790</u>
Net assets - June 30	<u>\$ 23,161</u>	<u>\$ 21,839</u>	<u>\$ (2,363)</u>	<u>\$ (2,781)</u>	<u>\$ 20,798</u>	<u>\$ 19,058</u>

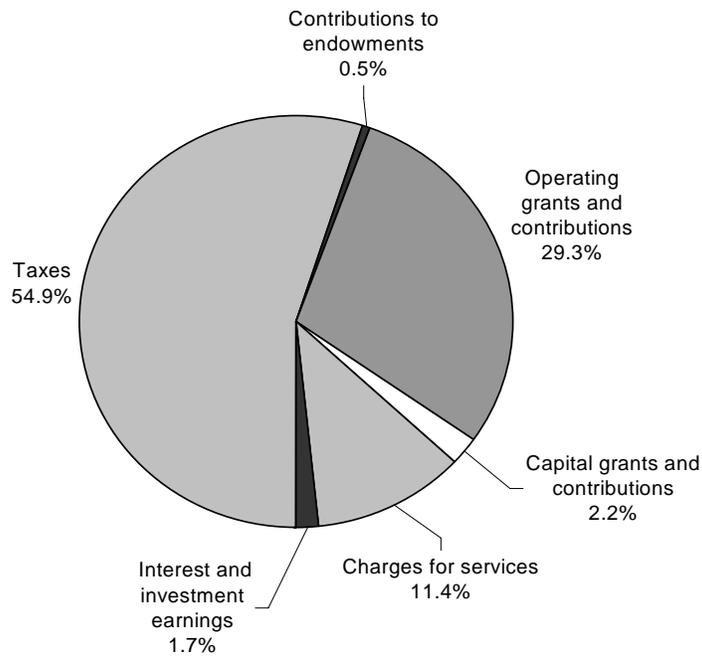
*Note: Governmental Activities net assets as of July 1, 2005, have been restated to reflect fund-type reclassification and prior period error corrections.

As previously mentioned, the state's activities are divided between governmental and business-type. The majority of support for governmental activities comes from taxes and intergovernmental grants, while business-type activities are supported primarily through user charges.

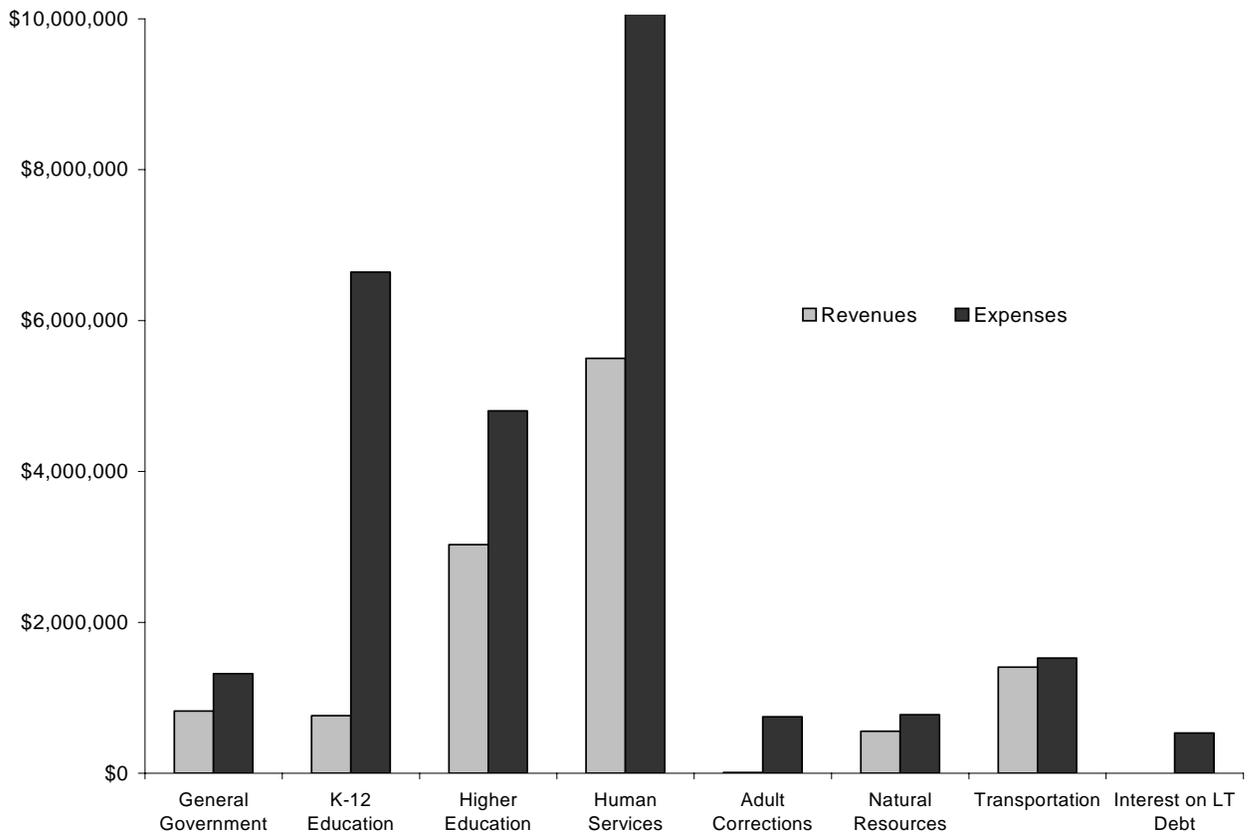
Governmental activities. Governmental activities resulted in an increase in the state of Washington’s net assets of \$1.9 billion. Key elements of this increase are as follows:

- Increases in tax revenues reflect strong economic and personal income growth during Fiscal Year 2006 as well as gains in employment.
- Strong growth in the housing sector due to low interest rates and an increase in disposable household income from home mortgage refinancing also resulted in increases in tax revenues.
- A series of revenue enhancements initiated by the state in Fiscal Years 2004 and 2005 continue to result in increased in tax revenues.

Revenues by Source – Governmental Activities



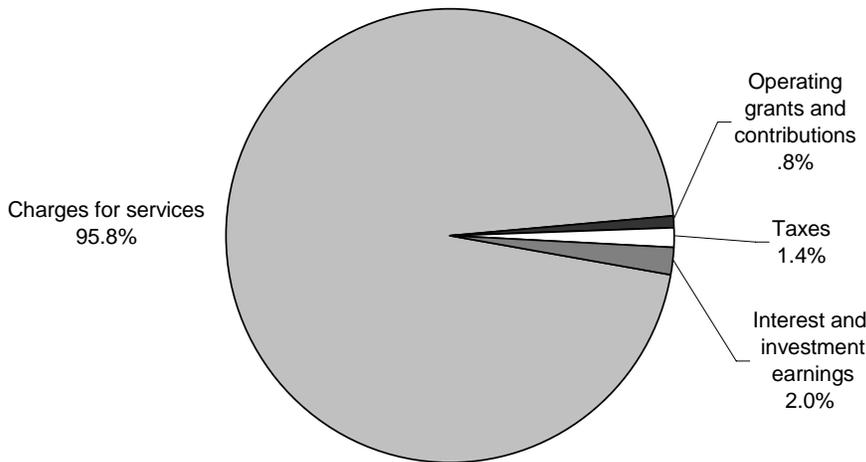
Program Revenues and Expenses - Governmental Activities



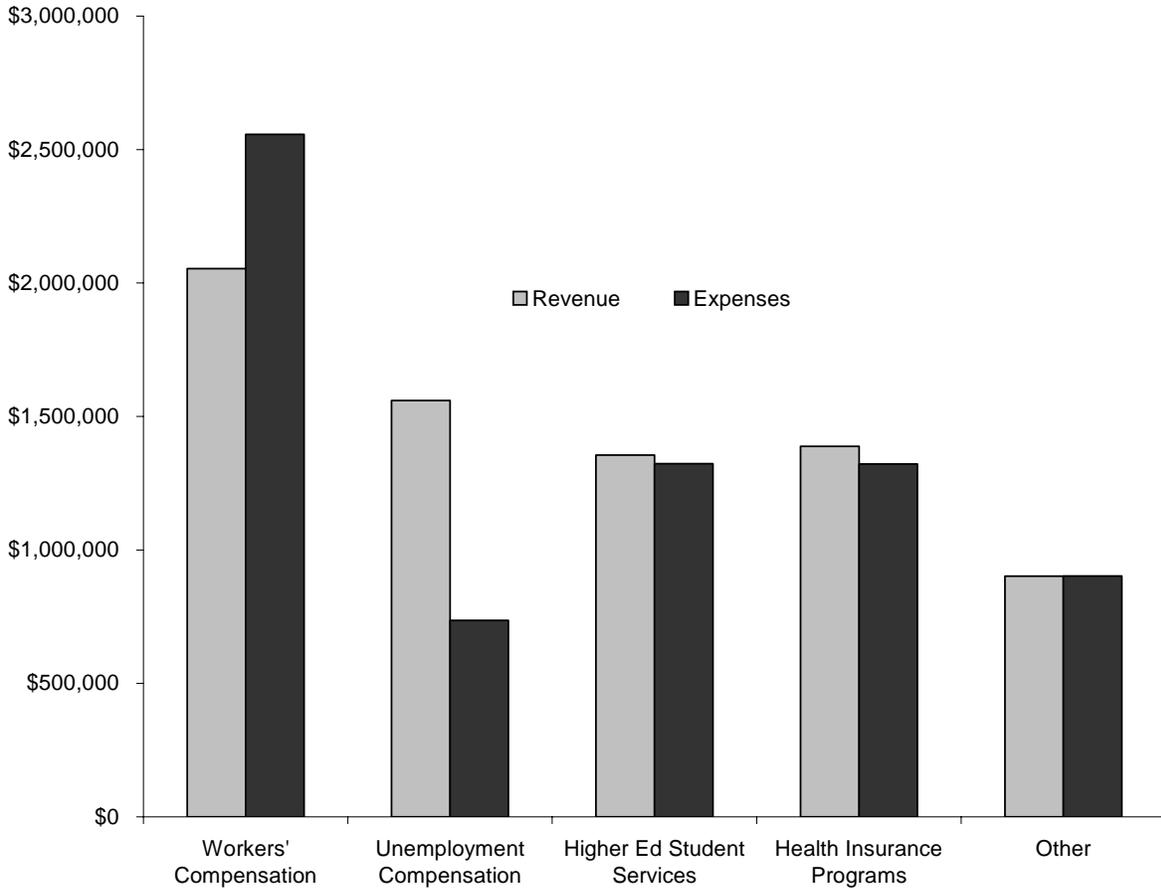
Business-type activities. Business-type activities increased the state of Washington’s net assets by \$418 million in spite of a \$503 million loss in the Workers’ Compensation Fund. Key factors contributing to the operating results of business-type activities are:

- Earnings on investments in the Workers’ Compensation Fund decreased by 103 percent in Fiscal Year 2006 compared to 2005. The decrease in earnings on investments is primarily due to unrealized losses on fixed income securities and was the significant contributing factor to the Workers’ Compensation Fund loss.
- The state’s economic recovery was reflected by a reduction in unemployment. Expenditures for unemployment compensation benefits decreased by 15 percent in Fiscal Year 2006 compared to 2005.

Revenues by Source – Business-type Activities



Program Revenues and Expenses – Business-type Activities



Financial Analysis of the Government's Funds

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

Governmental Funds. As discussed earlier, the focus of the state of Washington's *governmental funds* is to provide information on near-term inflows, outflows, and balances of *spendable* resources. Such information is useful in assessing the state of Washington's financing requirements. In particular, *unreserved fund balance* may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year.

The General Fund is the chief operating fund of the state of Washington. At the end of the fiscal year, total fund balance for the General Fund equaled \$1.9 billion. Unreserved fund balance, the amount considered available to spend, totaled \$569 million. \$1.1 billion of the General Fund fund balance relates to certain accrued revenues and has been designated for working capital purposes. It is not considered available to spend.

The fund balance of the state of Washington's General Fund decreased by \$92 million during the current fiscal year.

State of Washington's General Fund

(in millions of dollars)

	Fiscal Year		Difference Increase (Decrease)
	2006	2005	
Revenues			
Taxes	\$ 13,165	\$ 11,988	\$ 1,177
Federal grants	6,113	6,012	101
Investment revenue	73	36	37
Other	369	508	(139)
Total	<u>19,720</u>	<u>18,544</u>	<u>1,176</u>
Expenditures			
Human services	9,809	9,519	290
Education	7,407	7,243	164
Other	1,036	970	66
Total	<u>18,252</u>	<u>17,732</u>	<u>520</u>
Net transfers in (out)	(1,577)	(418)	(1,159)
Other financing sources	17	15	2
Net increase (decrease) in fund balance	<u>\$ (92)</u>	<u>\$ 409</u>	<u>\$ (501)</u>

The state's improving economy combined with state revenue enhancements measures are reflected in increased tax revenue collection. Expenditure growth continues to be limited to services and programs most vital to citizens – primarily health care, public education, and economic development. Overall revenues were up 6 percent while expenditures increased at a slower pace of 2.9 percent when compared to the prior year. The state took advantage of this opportunity to set aside resources to pay for health services, education, and pension funding in future years by transferring \$825 million from the General Fund to non-major governmental funds.

In addition to the General Fund, the state reports the Higher Education Special Revenue and Higher Education Endowment Funds as major governmental funds. The fund balance for the Higher Education Endowment Fund increased by \$282 million, which was consistent with the prior year's growth.

Non-major governmental fund revenue increased by \$275 million in Fiscal Year 2006 compared with Fiscal Year 2005 primarily related to growth in tax revenues. This revenue increase combined with the \$825 million in transfers from the General Fund noted above are primarily responsible for the increase in fund balance of \$1.2 billion.

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

The Workers' Compensation Fund, Unemployment Compensation Fund, and Higher Education Student Services Fund are major proprietary funds. The Workers' Compensation Fund reported a loss of \$503 million in Fiscal Year 2006. Workers' compensation claims expenses continued to exceed assessment revenue resulting in an operating loss which combined with a loss on investment activities to result in a decrease in net assets in Fiscal Year 2006. The Unemployment Compensation Fund reported income of \$823 million in Fiscal Year 2006 compared with an income of \$717 million in Fiscal Year 2005. This reflects the continuing reduction in the state's unemployment rate. Activity for the various non-major proprietary funds resulted in an increase to net assets of \$65 million.

General Fund Budgetary Highlights

Differences between the original budget of the General Fund and the final amended budget reflect adjustments related to changes in the state’s economy during the fiscal year ended June 30, 2006. During that year, significant changes to estimates are summarized as follows:

- Estimated tax revenues increased \$1.2 billion.
- Estimated revenues from federal grants-in-aid increased by \$399 million.
- Appropriated expenditure authority increased by \$1.5 billion.
-

The state did not overspend its legal spending authority for Fiscal Year 2006, the first year of the 2005-07 Biennium. Actual General Fund revenues and expenditures for Fiscal Year 2006 were approximately 50 percent of final budgeted revenues and appropriations for the 2005-07 Biennium.

Capital Assets, Infrastructure, Bond Debt Administration, and Economic Factors

Capital assets. The state of Washington’s investment in capital assets for its governmental and business-type activities as of June 30, 2006 amounted to \$25.8 billion (net of accumulated depreciation). This investment in capital assets includes land, infrastructure, museum and historical collections, buildings and other improvements, furnishings and equipment, as well as construction in progress.

Washington’s Fiscal Year 2006 investment in capital assets, net of current year depreciation, was \$1.3 billion, including increases to the state’s transportation infrastructure of \$874 million and buildings of \$527 million. The state’s construction in progress includes both new construction and major improvements to state infrastructure and facilities including state highway system, correctional facilities, ferry vessels and terminals, and buildings on the capitol and college and university campuses. Remaining commitments on these construction projects total \$3.2 billion.

Additional information on the state of Washington’s capital assets can be found in Note 6 beginning on page C-72 of this report.

State of Washington's Capital Assets
(net of depreciation)
(in millions of dollars)

	Governmental Activities		Business-type Activities		Total	
	2006	2005*	2006	2005	2006	2005
Land	\$ 1,238	\$ 1,207	\$ 92	\$ 87	\$ 1,330	\$ 1,294
Transportation infrastructure and other assets not depreciated	14,321	13,439	-	-	14,321	13,439
Buildings	5,247	4,737	1,183	1,166	6,430	5,903
Furnishings, equipment, and collections	1,362	1,353	115	135	1,477	1,488
Other improvements and infrastructure	942	921	59	53	1,001	974
Construction in progress	1,064	1,246	138	84	1,202	1,330
Total	\$ 24,174	\$ 22,903	\$ 1,587	\$ 1,525	\$ 25,761	\$ 24,428

*Note: 2005 balances for Governmental Activities have been restated to reflect prior period corrections.

Infrastructure. The state of Washington first reported infrastructure under the requirements of the Governmental Accounting Standards Board in Fiscal Year 2002. Transportation infrastructure reported includes the state highway system, emergency airfields, and a short rail line. While the rail line is reported net of depreciation, the state highway system and emergency airfields are reported using the modified approach. Under the modified approach, rather than recording depreciation, asset condition is reported.

The state highway system and emergency airfields continue to meet or exceed targeted condition levels and no significant changes in condition levels were noted. Amounts spent during Fiscal Year 2006 to maintain/preserve these infrastructure assets were not significantly different from estimated spending plans according to the biennial budget. The condition of these assets, along with the rating scales for pavement, bridges, rest areas, and airfields, and additional detail comparing budget to actual preservation and maintenance spending are available in the required supplementary information beginning on page C-126.

The Department of Transportation accomplished a net addition of 96 lane miles and 6 bridges in Fiscal Year 2006. The state transportation system asset value increased by \$874 million during the fiscal year. Fiscal Year 2007 commitments made for ongoing infrastructure projects that extend beyond the Fiscal Year 2006 amount to \$1.4 billion representing 766 projects.

Bond debt. At the end of Fiscal Year 2006, the state of Washington had general obligation bond debt outstanding of \$10.6 billion, an increase of 6 percent over Fiscal Year 2005. This debt is secured by a pledge of the full faith and credit of the state. Additionally, the state had authorized \$10.4 billion general obligation debt that remains unissued.

The state had revenue debt outstanding at June 30, 2006, of \$1.4 billion, an increase of \$203 million over Fiscal Year 2005. This increase is primarily related to revenue bonds issued by state colleges and universities. Revenue bond debt is secured by specific sources of revenue.

Four times during the year, the state issued general obligation debt, totaling \$1.6 billion for various capital and transportation projects as well as for refunding purposes. The state took advantage of the historically low interest rates that prevailed through Fiscal Year 2006 to refund outstanding bonds. This refunding will save taxpayers over \$36 million (net present value) in future interest payments. The state ranked 20th in a list of the top 100 issuers ranked by amount financed by municipal issuers in calendar year 2005, according to The Bond Buyer's 2006 Yearbook.

State of Washington's Bond Debt

(in millions of dollars)

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
General obligation (GO) bonds	\$ 10,464	\$ 9,842	\$ 120	\$ 138	\$ 10,584	\$ 9,980
Accreted interest on zero interest rate GO bonds	234	201	27	24	261	225
Revenue bonds	558	564	794	585	1,352	1,149
Total	\$ 11,256	\$ 10,607	\$ 941	\$ 747	\$ 12,197	\$ 11,354

The Washington State Constitution and the Revised Code of Washington limit the amount of general obligation (GO) debt that may be issued, the latter being the most restrictive. For the fiscal year ended June 30, 2006, the maximum GO debt authorized by constitutional limit was \$8.8 billion. The debt capacity remaining was \$1.5 billion. Specific bond issues and types that are not secured by general state revenues, such as motor fuel tax and reimbursable bonds, are excluded from the limitation.

By statutory provision, the State Finance Committee (SFC) is authorized to supervise and control the issuance of all state bonds, notes, or other evidences of indebtedness. The SFC is composed of the Governor, Lieutenant Governor and State Treasurer, the latter serving as chairman.

As of June 30, 2006, the state of Washington's general obligation debt was rated Aa1 by Moody's Investor Service, AA by Standard & Poor's Rating Group (S & P), and AA by Fitch Ratings.

Additional information on the state's bond debt obligations is presented in Note 7 beginning on page C-76 of this report. Additional information on the state's legal debt limit is presented in the statistical section beginning on page 234 of the CAFR.

Economic Factors and Next Year's Budgets and Rates

- Washington's outlook for Fiscal Year 2007 is for a continuation in the strong economic growth. It reflects the impact of the long awaited recovery at both the state and national levels.
- Revenue growth in the General Fund is expected to be even stronger in the 2005-07 Biennium than in the previous biennium.
- Overall, personal income and employment are expected to continue to grow in Fiscal Year 2007.

Legislative leaders and management will consider these factors in preparing the state's budget for future years.

Requests for Information

This financial report is designed to provide a general overview of the state of Washington's finances for all those with an interest in the government's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Office of Financial Management, PO Box 43113, Olympia, WA 98504-3113.

