



Section One

Introductory
Section





February 22, 2013

To the Citizens of Texas, Governor Perry
and Members of the 83rd Texas Legislature:

The Comprehensive Annual Financial Report (CAFR) of the state of Texas for the fiscal year ended Aug. 31, 2012, is submitted herewith. Responsibility for both the accuracy of the data presented, as well as the completeness and fairness of the presentation, rests with the office of the Texas Comptroller of Public Accounts. To the best of my knowledge, the information presented is accurate in all material respects, and all disclosures necessary for a reasonable understanding of the state's financial activities are included.

The reporting approach established by the Governmental Accounting Standards Board (GASB) was utilized. The state also voluntarily follows the recommendations of the Government Finance Officers Association (GFOA) of the United States and Canada for the contents of government financial reports and participates in the GFOA's review program for the Certificate of Achievement for Excellence in Financial Reporting. The state auditor performed an audit, in accordance with generally accepted auditing standards, of the state's general-purpose financial statements. His opinion is presented in this report preceding the financial statements.

The state auditor contracted with KPMG to perform portions of the federal audit procedures necessary to meet the requirements of the federal Single Audit Act Amendments of 1996 and related Office of Management and Budget (OMB) Circular A-133. The federal portion of the Statewide Single Audit Report for the fiscal year ended Aug. 31, 2012, with the opinion expressed by KPMG, will be issued separately.

Profile of the Government

This report includes financial statements for the state of Texas reporting entity. Criteria for determining the reporting entity and presentation of the related financial data are established by GASB. The criteria include legal standing and financial accountability. Other organizations that would cause the financial statements to be misleading or incomplete if they were excluded are also included in the reporting entity. Note 1 of the notes to financial statements provides detail on the financial reporting entity. Note 19 provides a brief summary of the nature of significant component units and their relationship to the state of Texas.

All activities generally considered part of the state of Texas are included in this report. These activities provide a range of services in the areas of education; health and human services; public safety and corrections; transportation; natural resources and recreation; regulation; general government; employee benefits; and teacher retirement state contributions.

The management discussion and analysis (MD&A) in the financial section provides an overview of the state's financial activities, addressing both governmental and business-type activities reported in the government-wide financial statements.

Accounting System and Budgetary Controls

The state's internal accounting controls provide reasonable assurance regarding the safeguarding of assets against loss from unauthorized use or disposal and the reliability of financial records for preparing financial statements. The concept of reasonable assurance recognizes that the cost of a control should not exceed the resulting benefit.

Budgetary control is exercised through expenditure budgets for each agency. These budgets are entered into the statewide accounting system after the General Appropriations Act becomes law. The General Appropriations Act becomes law after passage by the Legislature, certification by my office that the amounts appropriated are within the estimated collections, and the signing of the bill by the governor. Controls are maintained first at the agency level, with additional control at the fund and appropriation level to ensure expenditures do not exceed authorized limits. Further detail on budgetary accounting for the state is found in the required supplementary information other than MD&A section.

Economic Outlook

Texas' relative job growth advantage over the national economy continues today, as it did before and during the most recent recession. Texas added 278,800 jobs over the 12 months ended in November 2012, and total nonfarm employment reached 10.9 million. The 2.6 percent job growth rate for Texas included increases that spanned all the major industries except information. This was the fastest rate of growth among the nation's largest states and was faster than all but two (North Dakota and Oklahoma) of the nation's 50 states. The comparable national job growth rate was 1.4 percent over the past year.

The average annual unemployment rate in Texas has remained more than one percentage point lower than the nation's unemployment rate in each year from 2009 to 2012. After three years of little improvement, the Texas unemployment rate has eased in recent months from 7.4 percent a year ago to 6.2 percent in November 2012, its lowest level since 2008. The rate of job growth, despite an expanding labor force, should be sufficient to allow continued mild improvement in the unemployment rate.

After a decline of 5.7 percent in 2009, Texas' total personal income rebounded substantially for three years, with average annual growth of 6 percent, boosted by hiring in the oil and natural gas exploration and production sectors. During these three years, the state's income growth rate was faster than the nation's by an average of 1.8 percentage points annually.

Underlying this personal income growth is a population that has been, and will continue to be, fueled by net migration and a relatively high birth rate. Recent estimates by the U.S. Bureau of the Census show that eight of the nation's 15 most rapidly growing large incorporated cities are in Texas. The state's comparatively positive economic picture in the face of a weak national recovery has encouraged interstate migration to Texas. The state population

grew by an estimated 379,000 in calendar 2012, with 202,000 due to net migration. According to the Census Bureau, Texas accounted for nearly 16 percent of the nation's total population growth during the past decade, nearly twice the share that would be expected from its population size.

Texas passed its 2008 pre-recession employment peak in December 2011. As of November 2012, Texas employment has increased by 685,000 from the low point in December 2009, resulting in 258,000 more jobs than those lost in the recession. Nationally, the employment rebound from the recession's low point has been 4.6 million, about half of the 8.8 million jobs lost.

The Job Picture by Industry

Of the eleven major industries of the Texas economy, all except information had net employment growth from November 2011 to November 2012. Goods-producing industries – mining, manufacturing and construction – expanded by 3 percent, exceeding growth in service-providing industries (2.6 percent) for the second year. Goods-producing industries' growth was spurred on by the strength of oil and natural gas exploration and the manufacturing of energy-related machinery and drilling rigs during the first half of the year.

In the 12 months ended in November 2012, the industry that added the most jobs was trade, transportation and utilities, at 69,600 jobs. The industry that had the fastest growth rate, at 6.7 percent, was construction. As in much of the nation, information was by far the weakest major private industry in the state, with a decline of 1.7 percent (3,400 jobs), primarily owing to cuts in the telecommunications sector, but also from another year of job declines among businesses engaged in printing and publishing. Professional and business services advanced because of robust hiring in administrative and support services, including employment services. This is a sector that often adds temporary and part-time jobs when the economy emerges from a recession,

as employers hire temporary employees before filling full-time positions. Leisure and hospitality services account for one-tenth of Texas' total nonfarm employment but provided 18 percent of the state's job growth over the past year, with a gain of 49,900 jobs.

Mining and logging employment was propelled by the effects of firmer market prices and improved oil and natural gas exploration technology, especially the extensive application of horizontal drilling and fracturing techniques. The number of Texas operating oil and natural gas drilling rigs in Texas averaged 899 rigs in 2012, eclipsing the recent low of 329 rigs in June 2009. Mining and logging, predominantly comprised of oil and natural gas activity in Texas, added 8,900 jobs over the past year, a 3.6 percent rate of growth. In November 2012, the state's mining and logging industry job count stood at 257,500 jobs.

The broader oil and natural gas industry – mining, petrochemicals, petroleum refining, and oil/natural gas-related manufacturing – accounted for an estimated 16 percent of Texas' gross state product (GSP) in 2012. It serves as a buttress for the overall state economy when increasing oil and natural gas prices hinder the business and household consumers of those energy sources.

After losing employment for three years, shedding 124,000 jobs from the pre-recession employment peak to the subsequent trough, the Texas construction industry substantially recovered in 2012 to become the state's fastest-growing industry. Construction employment bottomed out in December 2011 and has gained 39,700 jobs since then. Although residential construction remained muted in 2012, the industry benefited from heavy and civil engineering construction projects, which accounted for nearly half of the new construction jobs and was the fastest growing industrial subsector, at 19 percent job growth, over the past year. According to McGraw-Hill Construction and the Comptroller's econometric model, Texas' total nonresidential building area (offices, fabrication facili-

ties and warehouses) put in place in 2012 increased by 5.6 percent over the amount built in 2011, to 83.2 million square feet.

A positive sign for Texas construction is that the total number of single-family and multi-family residential building permits – although remaining well behind historical trends – was up by 41 percent in 2012, increasing from 90,000 units in the previous twelve months to nearly 127,000 units in the twelve months ended in November 2012. According to Multiple Listing Service data from the Texas A&M Real Estate Center, the median sale price for an existing Texas single-family home rose 8.3 percent, from \$146,900 in November 2011 to \$159,100 in November 2012. Without Texas' construction job growth in 2012, the national construction industry would have seen another year of job declines, as the national increase of 14,000 jobs was far less than Texas' gain of 37,400 jobs (a solid 6.7 percent growth rate). Total Texas construction employment was 594,400 in November 2012.

The value of Texas exports set a new record in 2012, increasing by 5.9 percent to reach \$266 billion, according to the World Institute for Strategic Economic Research (WISER) and Comptroller estimates for the last quarter. Texas is the nation's leading exporting state, as it has been since 2002, and exports represent more than 19 percent of the state's GSP. The value of Texas exports, which are predominately to non-European countries, has grown more quickly than the nation's, so that Texas exports now account for 17 percent of the total U.S. value.

With Texas economic activity swelled by the demand for the products and services of the energy industry, the economic value of Texas manufacturing increased in 2012 to an estimated \$201 billion, from \$192 billion in 2011. Productivity improvements and employment growth contributed to this increase. Durable goods manufacturing employment grew by 7,000 jobs (1.3 percent), but weakness still grips the nondu-

able goods sectors that are affected by outsourcing and technological changes, with ongoing erosion in printing, paper and food processing employment. Nondurable manufacturing sectors lost 4,400 jobs (down 1.5 percent) during the year. Manufacturing employment was 847,000 in November 2012.

Texas' service-providing industries, which account for more than 84 percent of the state's total nonfarm employment, had job growth of 2.6 percent from November 2011 to November 2012, following increases of 1.1 and 1.9 percent in 2010 and 2011. Services again underperformed the goods-producing industries in the rate of job growth, but still accounted for 82 percent of the jobs added during the year.

Employment expanded in the trade, transportation and utilities industry by 69,600 jobs; leisure and hospitality services by 49,900 jobs; education and health services by 45,700 jobs; and professional and business services by 37,400 jobs. Government gained 12,400 jobs and financial activities tacked on 9,300 jobs. With the delayed recovery of personal income growth, consumers have been wringing more years out of goods before replacing them, benefiting the repair sector, leading to job growth in other services of 9,000 jobs. Information, the smallest service-providing industry in Texas, has not added jobs in any year since the "dot.com" bust in 2000, losing another 3,400 jobs over the past year.

Texas consumer expenditures, based on sales tax collections in calendar year 2012, experienced solid growth, even in light of the nation's general economic uncertainty. The growth in sales tax receipts reached a six-year high in calendar 2012, up 12 percent, with much of the growth rooted in business spending related to oil and natural gas exploration. With more robust automobile and light truck sales, motor vehicle sales tax collections soared by a 19 percent increase during the calendar year. Texas consumer spending should continue expanding in 2013 and 2014.

Financial Policies

Fiscal soundness is an unwavering principle that guides the financial policies of the state. The Texas Constitution supports responsible governance by mandating several limitations on the budgeting process. In addition to the certification process requiring passage of a balanced budget in Article III, Section 49a, budget growth and indebtedness are also limited. According to Article VIII, Section 22, appropriations from state tax revenue not dedicated by the Texas Constitution cannot grow faster than state economic growth estimated by the Legislative Budget Board. Payments required for debt cannot exceed 5 percent of the previous three-year average of non-dedicated general revenue as provided in Article III, Section 49j.

The Economic Stabilization Fund (ESF), authorized in 1988 by the Texas Constitution, Article III, Section 49g, is yet another example of prudent governance. The Comptroller may transfer ESF amounts to the general revenue fund to prevent or eliminate temporary cash deficiencies. Any amounts transferred to general revenue shall be returned to the ESF as soon as practicable, but no later than Aug. 31 of each odd-numbered year. The Legislature may appropriate, by a three-fifths vote of the members present in each house, amounts in the ESF for spending that does not exceed the amount of any unanticipated deficit or revenue decline during a biennium. The Legislature may also appropriate any amount from the ESF for any purpose only if approved by at least two-thirds of the members present in each house. The ESF shall receive a transfer, not later than the 90th day of each biennium, from the general revenue fund for one-half of any unencumbered positive balance remaining in the general revenue fund on the last day of the preceding biennium. The ESF also receives transfers, not later than the 90th day of each fiscal year, from the general revenue fund for 75 percent of the prior fiscal year oil or natural gas production tax revenue that exceeds the amount of these collections in fiscal 1987. The balance in the fund

on Aug. 31, 2012 was \$6.1 billion. The ESF is also discussed in Note 13.

Major Initiatives

In recent years, Texas' budget-writing process has focused largely on short-term measures needed to close each successive budget gap. In recognition of this pattern, the Comptroller's office has inaugurated a series of programs designed to provide state policymakers with the information they need for effective, long-term financial planning.

Financial Allocation Study for Texas

For the 2012-13 biennium, the Texas Legislature appropriated about 42 percent of the state's non-dedicated general revenue for public education. Total spending by Texas school districts rose by nearly 64 percent from the 2000-01 through 2010-11 school years. Over the same period, enrollment rose by just 21 percent, roughly a third as fast as spending.

In response to a legislative directive to "identify school districts and campuses that use resource allocation practices that contribute to high academic achievement and cost-effective operations," the Comptroller's office created the Financial Allocation Study for Texas (FAST) to examine district and campus resource allocation – and the relationship between these allocations and student achievement. FAST allows school districts to identify ways to operate more efficiently without sacrificing student academic performance.

The FAST project was developed with the assistance of researchers at some of the state's top higher education institutions, Texas school superintendents, national experts and other stakeholders such as Texas school board members, professional education associations, education policy groups and business leaders. FAST ratings are provided to Texas school districts and campuses to identify those responsible for strong academic growth and cost-effective operations.

An accompanying web-based tool (www.fastexas.org) allows users to compare school districts and campuses on a multitude of academic and financial indicators. This first-of-its-kind tool is available to users free of charge.

The third annual edition of FAST, issued in 2012, gave 45 charter and school districts the highest rating of five stars. Of the 45 five-star districts, 27 held that rank in 2011 and 15 did so for three consecutive years.

The Cost of Federal Regulation

Excessive and poorly considered federal regulations can have a serious impact on Texas' economic health. The Comptroller's office has issued several recent reports addressing regulatory costs on our state.

In April 2012, the *Texas Business Attitudes Toward Federal Health Care Reform* report documented considerable opposition to federal health care reform among Texas businesses. Only 3.4 percent of the employers surveyed for the study believed the legislation will be good for their businesses.

Another area prone to federal regulatory overreach is environmental protection. More than 100 species found in Texas have received or are slated for federal endangered species review within the next five years, with potential consequences that could involve significant economic impacts on the state's landowners, businesses and communities.

To help policymakers stay abreast of rapidly evolving environmental regulation, in September 2011 the Comptroller's office debuted Keeping Texas First (www.keepingtexasfirst.com), a website that tracks proposed endangered species listings as well as air and water regulation, explains the federal rule-making process and provides detailed case studies outlining the financial impact of such regulation on the state economy.

One species found in the Permian Basin, for instance, was proposed for listing as an endangered species despite a lack of scientific data – in a region that provides 14 percent of the nation's oil and tens

of thousands of Texas jobs. The Comptroller's October 2012 *Endangered Economy: A Case Study of the Dunes Sagebrush Lizard and the West Texas Oil and Gas Industry* report discusses this case, which was resolved via a community-led, market-based program of voluntary conservation steps, without the severe land-use restrictions that follow listing under the Endangered Species Act.

The Comptroller spearheaded that effort as part of her role as the presiding officer of the state's Interagency Task Force on Economic Growth and Endangered Species. In January 2013, the task force released a report, *Update 2013: Task Force Activities in Response to Endangered Species Act Costs and Challenges*, detailing its work to head off onerous federal regulation while preserving the state's natural resources.

Tracking the Texas Economy

In February 2012, the Comptroller's office launched The Texas Economy website (www.thetexas-economy.org) – a comprehensive guide to the Texas economy and the industries, people and other factors that drive it – to help policymakers, businesses and taxpayers understand the complex forces shaping Texas. The regularly updated site provides a wide variety of data and analysis in an easy-to-understand and useful format, including information on:

- Key economic indicators
- Government revenue and spending
- Demographics
- Major industries
- Workforce trends
- Public education
- Career training
- Health care

The Texas Economy site also spotlights in-depth Comptroller research reports examining issues directly affecting state finances, such as reports on local government spending and bond debt.

Transparency

The Comptroller's office promotes openness in state and local governments and financial transparency at all levels. The agency's Texas Transparency website (www.texas Transparency.org) incorporates an Open Data Center that offers public access to machine-readable, platform-independent datasets on statewide contracts and bidders' lists, crude oil and natural gas industry data, tax receipts and more. A Texas EDGE Data Center provides data of interest to economic development officials, including population, employment, income, poverty, property values, sales activity and education information. Another feature, Where the Money Goes, allows the public to search the state check register and track state agency spending in detail.

A new feature added in November 2011, the Monthly State Revenue Watch (www.window.state.tx.us/finances/revenueWatch), presents detail on net state revenue collections by month of collection and type of revenue source, and allows its users to make side-by-side comparisons to prior year collections and the Comptroller's revenue estimate.

The Comptroller also encourages Texas local governments to open their books to the public by posting their budgets, annual financial reports and check registers online. Texas Transparency displays the progress local governments are making toward this goal, and gives users direct access to local government websites and their key financial documents.

As of Jan. 8, 2013, the Texas Transparency website listed all 254 Texas counties, 470 cities, 1,033 school districts and 32 special districts (including municipal utility districts, water districts, river authorities, toll road authorities and transit districts). More than 80 percent of these are posting at least one of the three recommended documents, giving taxpayers access to the data they need to see how their tax dollars are being spent. In calendar 2012, a total of 320 of these local governments earned the Comptroller's Leadership

Circle award for financial transparency, including 265 at the Gold level, 49 at the Silver level and six at the Bronze level.

Spotlighting Government Spending and Debt

Another major project springing from the Comptroller's transparency initiative is the *Texas, It's Your Money* series of reports released from August through December 2012. This series is intended to give Texans the tools they need to understand and hold accountable those responsible for government spending and debt. It also makes recommendations to improve the transparency of government finances and helps taxpayers exercise their fundamental right to control them.

The report series examines:

- The various local entities that add to Texans' tax bills – including cities, counties, special-purpose districts and transit authorities – and identifies trends in local taxation, including the proliferation of special taxing districts
- Trends in the issuance of bond debt, which local governments use for purposes such as hospital construction, water infrastructure and vehicle and technology purchases
- Bond indebtedness of public schools and higher education institutions, which supports the construction or renovation of educational facilities
- Public pension obligations in Texas

The *Texas, It's Your Money* series was accompanied by a suite of Web tools that will help Texans keep a closer eye on government finances, including interactive maps that provide a close-up view of the entities that assess property tax, collect sales tax revenues and issue public debt in each Texas county.

Protecting Texans' Health

Texas has been hard-hit by the national obesity epidemic, and this vital health issue is an economic risk

as well, costing Texas businesses \$9.5 billion annually. The 82nd Legislature asked the Comptroller to build a comprehensive collection of resources and information to help Texans address this problem.

In response to this charge, the Comptroller's office launched an online platform, Reshaping Texas (www.ReshapingTexas.org), in December 2012, to offer news and information about the obesity epidemic. Key topic areas include costs, Texas initiatives, success stories, research and maps. The site's features also include:

- Fitnessgram – aggregates fitness data collected by the Texas Education Agency to create geographic information system (GIS) maps showing where in Texas students are most at risk for obesity. These maps will help identify obesity “hot spots” in need of targeted interventions.
- Grants database – a regularly updated pool of funding opportunities for local nonprofits, schools and other organizations seeking resources to help fight obesity.
- Involvement information – step-by-step guidelines on how to get involved in the fight against obesity at the local level, including how to work with PTAs and School Health Advisory Councils.

Users are encouraged to share success stories and submit other relevant content.

Property Tax Value Limitations

In 2001, the 77th Legislature enacted House Bill 1200, creating the Texas Economic Development Act (Act). The Act allows school districts to attract new taxable property and assist in new job creation by offering a tax credit and an eight-year limitation on the appraised value of real and personal tangible property for the maintenance and operations portion of a school district's tax rate. In exchange for the appraised value limitation and tax credit, a property owner is required

to enter into an agreement with the school district to create a specific number of high-wage jobs and build or install specified types of real and personal property worth a certain amount.

To qualify, the property must be in a reinvestment zone and must be devoted to manufacturing, research and development, renewable energy generation, nuclear power generation, advanced clean energy projects or electric power generation using integrated gasification combined cycle technology. The amount of investment and the minimum amount of the value limitation varies according to whether the school district is considered a rural or non-rural district and according to the amount of taxable property value in the school district.

As of August 2012, a total of 84 school districts were parties to 128 value limitation agreements, with the bulk of projects involving manufacturing facilities and wind farms.

Awards and Acknowledgments

Certificate of Achievement

The Government Finance Officers Association (GFOA) of the United States and Canada awarded a Certificate of Achievement for Excellence in Financial Reporting to the state of Texas for its Comprehensive Annual Financial Report for the fiscal year ended August 31, 2011. The Certificate of Achievement is a prestigious national award that recognizes conformance with the highest standards for preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized Comprehensive Annual Financial Report whose contents conform 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. The state of Texas has received a Certificate of Achievement for the last 22 years (fiscal years ended August 1990 through 2011). We believe our current report continues to conform to the Certificate of Achievement Program requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

I will continue to maintain a highly qualified and professional staff to make this certification possible.

Acknowledgments

The preparation of this report requires the collective efforts of literally hundreds of financial personnel throughout state government, including the dedicated management and staff of the Comptroller's Financial Reporting section and Fiscal Management Division; the chief financial officers, chief accountants and staff at each agency; and the management and staff of the State Auditor's Office. I sincerely appreciate the dedicated efforts of all these individuals who continue to strive for improvements that will make Texas a national leader in quality financial reporting.

Sincerely,

A handwritten signature in black ink that reads "Susan Combs". The signature is fluid and cursive, with the first name "Susan" and last name "Combs" clearly legible.

Susan Combs

Certificate of Achievement for Excellence in Financial Reporting

Presented to

State of Texas

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
August 31, 2011

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



Christopher P. Moirrell

President

Jeffrey R. Emmer

Executive Director



State of Texas Comprehensive Annual Financial Report

State of Texas Elected State Officials

Executive Rick Perry
Governor

David Dewhurst
Lieutenant Governor

Susan Combs
Comptroller of Public Accounts

Greg Abbott
Attorney General

Jerry Patterson
Land Commissioner

Todd Staples
Commissioner of Agriculture

Christi Craddick
David J. Porter
Barry T. Smitherman
Railroad Commissioners

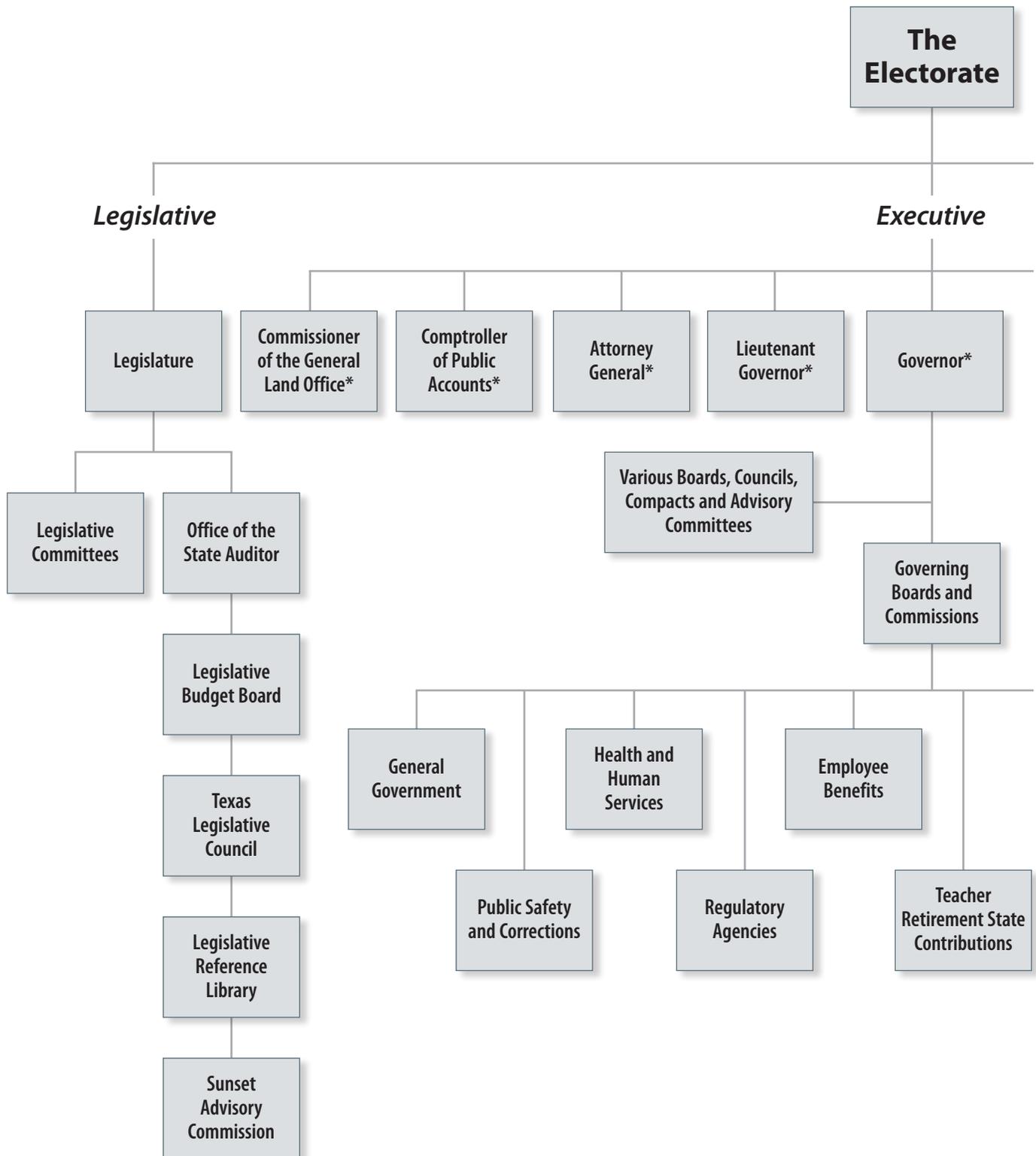
Legislative Lieutenant Governor David Dewhurst
President of the Senate

Joe Straus
Speaker of the House of Representatives

Judicial Wallace B. Jefferson
Chief Justice of the Supreme Court

Sharon Keller
Presiding Judge, Court of Criminal Appeals

Government Structure of Texas



* Elected Offices

