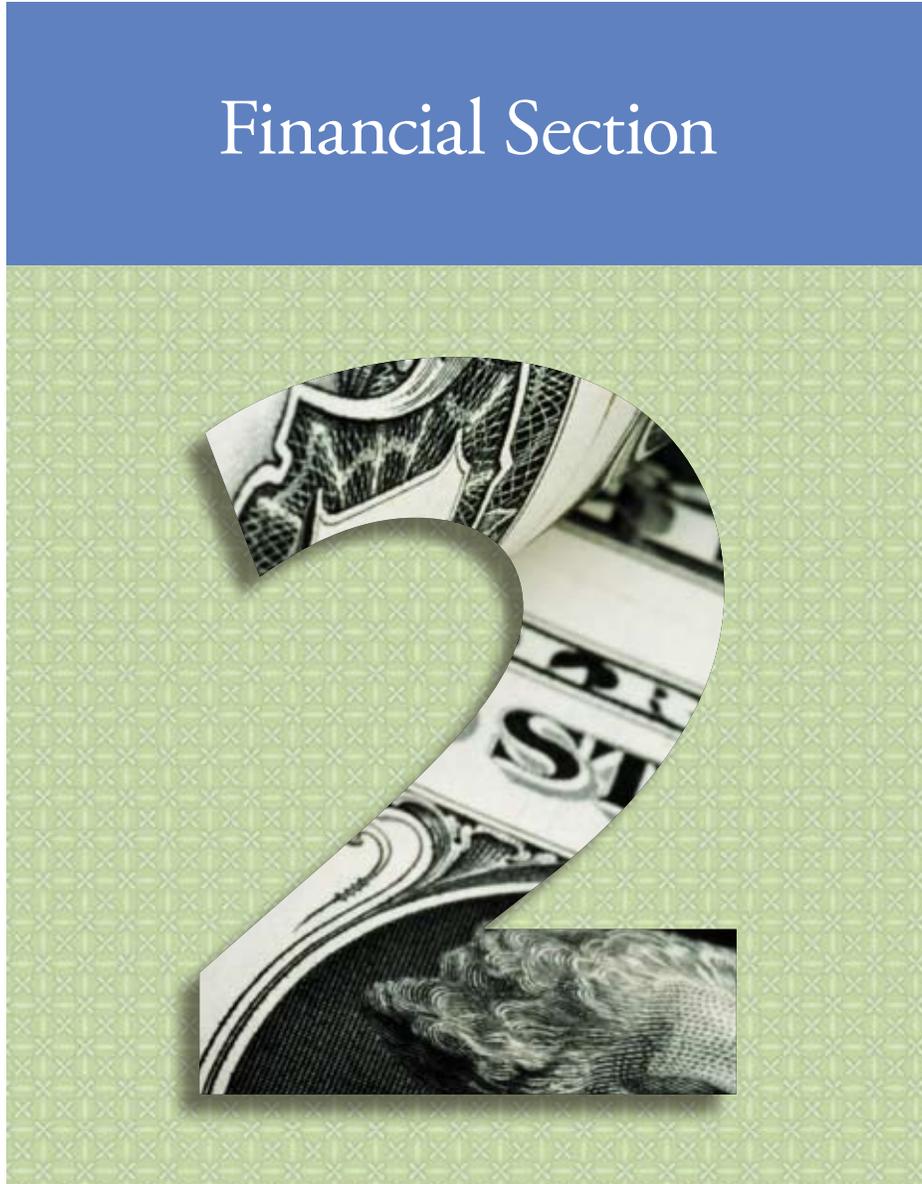


# Financial Section







## INDEPENDENT AUDITOR'S REPORT

The Honorable Rick Perry, Governor  
The Honorable Susan Combs, Comptroller of Public Accounts  
The Honorable David Dewhurst, Lieutenant Governor  
The Honorable Tom Craddick, Speaker of the House of Representatives  
and  
Members of the Legislature, State of Texas

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate discretely presented component unit and remaining fund information of the State of Texas as of and for the year ended August 31, 2007, which collectively comprise the State's basic financial statements as listed in the Table of Contents. These financial statements are the responsibility of the State Comptroller of Public Accounts. Our responsibility is to express opinions on these financial statements based on our audit.

We did not audit the financial statements of the following entities and fund:

- The University of Texas Investment Management Company (UTIMCO) and the University of Texas M.D. Anderson Cancer Center (UTMDACC), which constitute 59 and 8 percent, respectively, of the assets of Colleges and Universities, a major enterprise fund. UTIMCO and UTMDACC also constitute 43 and 6 percent, respectively, of the assets of the business-type activities.
- The Permanent School Fund, a major governmental fund, which constitutes 54 percent of the assets of the governmental activities.
- The Texas Local Governmental Investment Pool (TexPool), which constitutes 8 percent, of the assets of the aggregate discretely presented component unit and remaining fund information, which primarily consists of fiduciary funds.

The financial statements listed above were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for these entities and TexPool, is based on the reports of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of UTIMCO, UTMDACC, and TexPool were not audited in accordance with *Government Auditing Standards*. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting

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SAO No. 08-335

principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of other auditors provide a reasonable basis for our opinions.

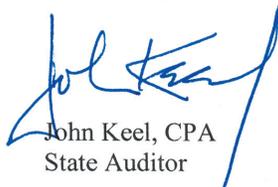
In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate discretely presented component unit and remaining fund information of the State of Texas as of August 31, 2007, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis, the budgetary comparison schedule, and the modified approach to reporting infrastructure assets are not required parts of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. This required supplementary information is the responsibility of the State Comptroller of Public Accounts. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the State's basic financial statements. The combining financial statements, as listed in the Table of Contents, are presented for purposes of additional analysis and are not a required part of the basic financial statements. These financial statements are also the responsibility of the State Comptroller of Public Accounts. This supplemental information has been subjected to the auditing procedures applied by us and the other auditors in the audit of the basic financial statements and, in our opinion, based on our audit and the reports of other auditors, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

We did not audit the introductory section or the statistical section and, accordingly, we express no opinion on them.

In accordance with *Government Auditing Standards*, we will issue a separate report on our consideration of the State's internal control over financial reporting and on our tests of the State's compliance with certain provisions of laws, regulations, contracts, and grants and on other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.



John Keel, CPA  
State Auditor

February 20, 2008



# Management's Discussion and Analysis



## Management's Discussion and Analysis

The following is a discussion and analysis of the state of Texas' financial performance for the fiscal year ended Aug. 31, 2007. Use this section in conjunction with the state's basic financial statements. Comparative data is available and presented for this 2007 report.

### Highlights Government-wide

#### Net Assets

The assets of the state of Texas exceeded its liabilities by \$141.2 billion as of Aug. 31, 2007, an increase of \$13.3 billion or 10.4 percent from fiscal 2006.

#### Fund Level

##### Governmental Funds

As of Aug. 31, 2007, the state's governmental funds reported a combined ending fund balance of \$42.4 billion, an increase of \$7.5 billion or 21.7 percent from fiscal 2006. The state reported a positive unreserved fund balance of \$11.2 billion in fiscal 2007.

#### Proprietary Funds

The proprietary funds reported net assets of \$42.9 billion as of Aug. 31, 2007, an increase of \$5.2 billion or 13.7 percent from fiscal 2006.

#### Long-Term Debt

The state's total bonds outstanding increased by \$3.1 billion or 15 percent during fiscal 2007 for governmental and business-type activities. This amount represents the net difference between net issuances, payments and refunding of outstanding bond debt. During the fiscal year, the state issued bonds totaling \$6.2 billion. More detailed information regarding the government-wide, fund level and long-term debt activities can be found in the debt administration section of this management's discussion and analysis (MD&A).

## Overview of the Financial Statements

The reporting focus of this report is on the state as a whole and on the major individual funds. The report presents a more comprehensive view of the state's financial activities and makes it easier to compare the performance of Texas state government to that of other governments.

The Financial Section of this annual report presents the state's financial activities and position in four parts-(1) MD&A (this part), (2) the basic financial statements, (3) required supplementary information other than MD&A and (4) other supplementary information presenting combining statements. The report also includes statistical and economic data.

The basic financial statements include government-wide financial statements, fund financial statements and notes to financial statements that provide more detailed information to supplement the basic financial statements.

### Reporting on the State as a Whole

The government-wide financial statements are designed to present an overall picture of the financial position of the state. These statements consist of the statement of net assets and the statement of activities, which are prepared using the economic resources measurement focus and the accrual basis of accounting. This means that all the current year's revenues and expenses are included, regardless of when cash is received or paid, producing a view of financial position similar to that presented by most private-sector companies.

The statement of net assets combines and consolidates the government's current financial resources with capital assets and long-term obligations. This statement includes all of the government's assets and liabilities.

Net assets, which are the difference between the state's assets and liabilities, represent one measure of the state's financial health.

Other indicators of the state's financial health include the condition of its roads and highways (infrastructure) and economic trends affecting the state's future tax revenues.

The statement of activities focuses on both the gross and net cost of various activities (governmental, business-

type and component units); these costs are paid by the state's general tax and other revenues. This statement summarizes the cost of providing (or the subsidy provided by) specific government services and includes all current year revenues and expenses.

The government-wide statement of net assets and the statement of activities divide the state's activities into three types.

### **Governmental Activities**

The state's basic services are reported here, including general government, education, employee benefits, teacher retirement benefits, health and human services, public safety and corrections, transportation, natural resources and recreation and regulatory services. Taxes, fees and federal grants finance most of these activities.

### **Business-Type Activities**

Activities for which the state charges a fee to customers to pay most or all of the costs of certain services it provides are reported as business-type activities. The state's colleges and universities are included as business-type activities.

### **Component Units**

Component units are legally separate organizations for which the state is either financially accountable or the nature and significance of their relationship with the state is such that exclusion would cause the state's financial statements to be misleading or incomplete. These entities are reported in a separate column in the government-wide financial statements. The state includes 15 separate legal entities in the notes to this report.

## **Reporting on the State's Most Significant Funds**

Fund financial statements provide additional detail about the state's financial position and activities. Some information presented in the fund financial statements differs from the government-wide statements due to the perspective and basis of accounting used. Funds are presented on the fund level statements as major or nonmajor based on criteria set by the Governmental Accounting Standards Board (GASB).

A fund is a separate accounting entity with a self-balancing set of accounts. The state uses funds to keep track of sources of funding and spending related to specific activities.

### **Governmental Funds**

A majority of the state's activities is reported in governmental funds. Reporting of these funds focuses on how money flows into and out of the funds and amounts remaining at year end for future spending.

Governmental funds are accounted for using the modified accrual basis of accounting, which measures cash and other assets that can be readily converted to cash. The governmental fund statements provide a detailed short-term view of the state's general governmental operations and the basic services it provides. This information should help determine the level of resources available for the state's programs. The reconciliation following the fund financial statements explains the differences between the government's activities, reported in the government-wide statement of net assets and the government-wide statement of activities, and the governmental funds. The general fund, state highway fund and permanent school fund are reported as major governmental funds.

### **Proprietary Funds**

When the state charges customers for services it provides, these activities are generally reported in proprietary funds. Services provided to outside (non-governmental) customers are reported in enterprise funds, a component of proprietary funds, and are accounted for using the economic resources measurement focus and the accrual basis of accounting. These are the same business-type activities reported in the government-wide financial statements, but are reported here to provide information at the fund level.

Services provided by one program of the state to another are reported in internal service funds, the other component of proprietary funds. The state's employees' life, accident and health insurance benefits fund is reported as the only internal service fund.

Colleges and universities, Texas Water Development Board funds and the Texas Department of Transportation Turnpike Authority are shown as major proprietary funds.

## Reporting on the State's Fiduciary Responsibilities

The state is the trustee or fiduciary for seven defined benefit plans and one defined contribution plan. It is also responsible for other assets that can be used only for trust beneficiaries. All state fiduciary activities are reported in separate statements of fiduciary net assets and changes in fiduciary net assets. The activities are reported separately from other financial activities because the state cannot use the assets to finance state operations. The state's fiduciary responsibilities include ensuring that the assets reported in these funds are used for their intended purposes.

## Financial Analysis of the State as a Whole

### Net Assets

Total assets of the state on Aug. 31, 2007, were \$197.2 billion, an increase of \$15.6 billion. Total liabilities as of

Aug. 31, 2007, were \$55.9 billion, an increase of \$2.3 billion or 4.2 percent. Net assets were affected by a number of factors. Cash and cash equivalents grew \$1.2 billion from fiscal 2006 and investments increased \$6.9 billion. Net capital assets increased \$4.9 billion, from additions to the state's highway system and college and university construction projects. The change in total liabilities is primarily in non-current liabilities with a net change in note and bond debt of \$2.4 billion. The net asset balance was \$141.2 billion in fiscal 2007, an increase of \$13.3 billion or 10.4 percent. Of the state's net assets, \$63.8 billion were invested in capital assets, net of related debt, while \$55.2 billion were restricted by statute or other legal requirements and were not available to finance day-to-day operations of the state. Unrestricted net assets were \$22.3 billion. The state's bonded indebtedness was \$24.2 billion, which included new issuances of \$6.4 billion in state bonds to finance new construction, housing, water conservation and other projects. Approximately \$3.2 billion in bonded debt was retired or refunded.

## Statement of Net Assets

August 31, 2007 and 2006 (Amounts in Thousands)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2007	2006	2007	2006	2007	2006
<b>ASSETS</b>						
Assets Other Than Capital Assets	\$ 59,609,496	\$ 53,920,494	\$ 57,302,088	\$ 52,234,597	\$ 116,911,584	\$ 106,155,091
Capital Assets	63,802,726	60,318,012	16,482,661	15,113,941	80,285,387	75,431,953
Total Assets	<u>123,412,222</u>	<u>114,238,506</u>	<u>73,784,749</u>	<u>67,348,538</u>	<u>197,196,971</u>	<u>181,587,044</u>
<b>LIABILITIES</b>						
Current Liabilities	15,627,216	17,951,094	11,521,853	9,875,245	27,149,069	27,826,339
Noncurrent Liabilities	9,434,902	6,125,253	19,364,288	19,734,021	28,799,190	25,859,274
Total Liabilities	<u>25,062,118</u>	<u>24,076,347</u>	<u>30,886,141</u>	<u>29,609,266</u>	<u>55,948,259</u>	<u>53,685,613</u>
<b>NET ASSETS</b>						
Invested in Capital Assets, Net of Related Debt	56,438,132	55,473,237	7,342,429	6,871,404	63,780,561	62,344,641
Restricted	29,346,612	25,992,910	25,815,068	22,812,284	55,161,680	48,805,194
Unrestricted	12,565,360	8,696,012	9,741,111	8,055,584	22,306,471	16,751,596
Total Net Assets	<u>\$ 98,350,104</u>	<u>\$ 90,162,159</u>	<u>\$ 42,898,608</u>	<u>\$ 37,739,272</u>	<u>\$ 141,248,712</u>	<u>\$ 127,901,431</u>

## Changes in Net Assets

The state earned program revenues of \$63.3 billion and general revenues of \$40.7 billion, for total revenues of \$104 billion, an increase of \$8.3 billion or 8.7 percent. The major components of this increase are taxes, which were up by \$3.1 billion, operating grants and contributions, up by \$2.8 billion and charges for services, which increased \$2.3 billion. Sales and use tax increased almost \$1.8 billion and cigarette and tobacco taxes increased \$778.7 million over the prior year.

The expenses of the state were \$90.5 billion, an increase of \$6.9 billion or 8.3 percent. The expense fluctuations in governmental activities are largely attributable to the health and human services function and education function, due to increased spending for urban and rural hospitals, teacher pay raises and high schools. In the business-type activities,

colleges and universities expenses were the largest increase. Other proprietary entities showed relatively stable activities between the prior and current years.

As a result of revenues exceeding expenses, the state's total net assets increased by \$13.3 billion, an increase of 10.4 percent. Revenues and expenses of the state's governmental and business-type activities are detailed on the following page.

Further discussion of results for improvement in the state's financial condition follows in the analysis of the state's funds. Economic strength through most of the year, plus legislative changes, brought higher tax revenues and fees. The largest benefactors were education, where teachers received pay raises, and health and human services, where urban and rural hospitals received additional state funding.

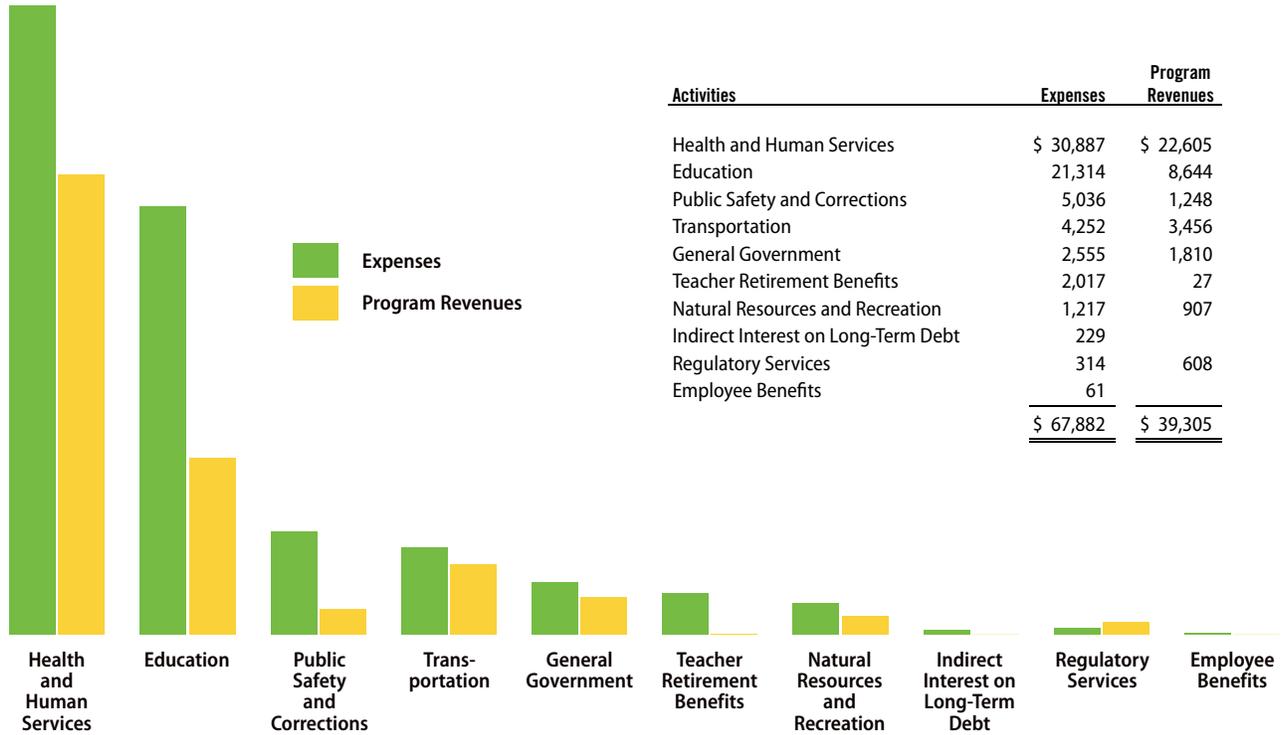
## Changes in Net Assets

For the Fiscal Years Ended August 31, 2007 and 2006 (Amounts in Thousands)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2007	2006	2007	2006	2007	2006
<b>REVENUES</b>						
Program Revenues:						
Charges for Services	\$ 7,485,972	\$ 6,080,506	\$ 14,831,991	\$ 13,934,320	\$ 22,317,963	\$ 20,014,826
Operating Grants and Contributions	29,995,409	28,979,226	9,001,427	7,200,099	38,996,836	36,179,325
Capital Grants and Contributions	1,823,686	2,803,006	197,731	155,541	2,021,417	2,958,547
Total Program Revenues	39,305,067	37,862,738	24,031,149	21,289,960	63,336,216	59,152,698
General Revenues:						
Taxes	37,071,589	33,993,845			37,071,589	33,993,845
Unrestricted Investment Earnings	941,938	760,207	245,977	55,150	1,187,915	815,357
Settlement of Claims	538,836	583,787	283	94	539,119	583,881
Gain on Sale of Capital Assets	3,942	2,762	13,363	276	17,305	3,038
Other General Revenues	1,627,330	1,071,679	266,722	91,017	1,894,052	1,162,696
Total General Revenues	40,183,635	36,412,280	526,345	146,537	40,709,980	36,558,817
Total Revenues	79,488,702	74,275,018	24,557,494	21,436,497	104,046,196	95,711,515
<b>EXPENSES</b>						
General Government	2,555,309	2,681,117	186,628	162,499	2,741,937	2,843,616
Education	21,313,526	18,025,550	17,165,602	15,982,582	38,479,128	34,008,132
Employee Benefits	61,171	56,718			61,171	56,718
Teacher Retirement Benefits	2,017,000	1,932,325	909,845	813,133	2,926,845	2,745,458
Health and Human Services	30,886,484	28,808,315	1,204,609	1,253,431	32,091,093	30,061,746
Public Safety and Corrections	5,035,761	5,084,923	75,305	73,775	5,111,066	5,158,698
Transportation	4,252,129	4,452,154	125,910	16,339	4,378,039	4,468,493
Natural Resources and Recreation	1,217,201	961,178	283,653	284,241	1,500,854	1,245,419
Regulatory Services	314,266	282,067			314,266	282,067
Indirect Interest on Long-Term Debt	229,354	54,121			229,354	54,121
Lottery			2,691,210	2,687,084	2,691,210	2,687,084
Total Expenses	67,882,201	62,338,468	22,642,762	21,273,084	90,524,963	83,611,552
Excess Before Contributions, Special Items and Transfers	11,606,501	11,936,550	1,914,732	163,413	13,521,233	12,099,963
Capital Contributions	309	1,449	1,364	3,874	1,673	5,323
Contributions to Permanent and Term Endowments			184,193	123,939	184,193	123,939
Special Items			(318,813)	(38,898)	(318,813)	(38,898)
Transfers	(3,383,910)	(3,513,639)	3,383,910	3,513,639	(318,813)	(38,898)
Change in Net Assets	8,222,900	8,424,360	5,165,386	3,765,967	13,388,286	12,190,327
Net Assets, Beginning Balance	90,162,159	81,677,916	37,739,272	33,909,713	127,901,431	115,587,629
Restatements	(34,955)	59,883	(6,050)	63,592	(41,005)	123,475
Net Assets, Beginning Balance, as Restated	90,127,204	81,737,799	37,733,222	33,973,305	127,860,426	115,711,104
Net Assets, Ending Balance	\$98,350,104	\$90,162,159	\$42,898,608	\$37,739,272	\$141,248,712	\$127,901,431

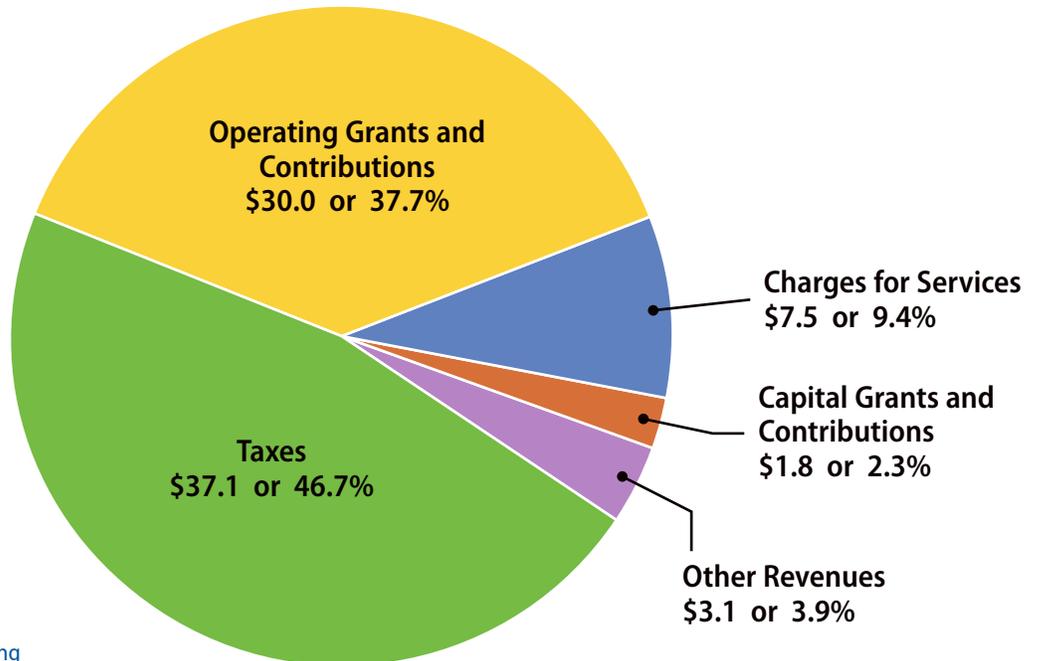
## Expenses and Program Revenues: Governmental Activities

For the Fiscal Year Ended August 31, 2007 (In Millions)



## Revenue by Source: Governmental Activities

For the Fiscal Year Ended August 31, 2007 (In Billions)\*

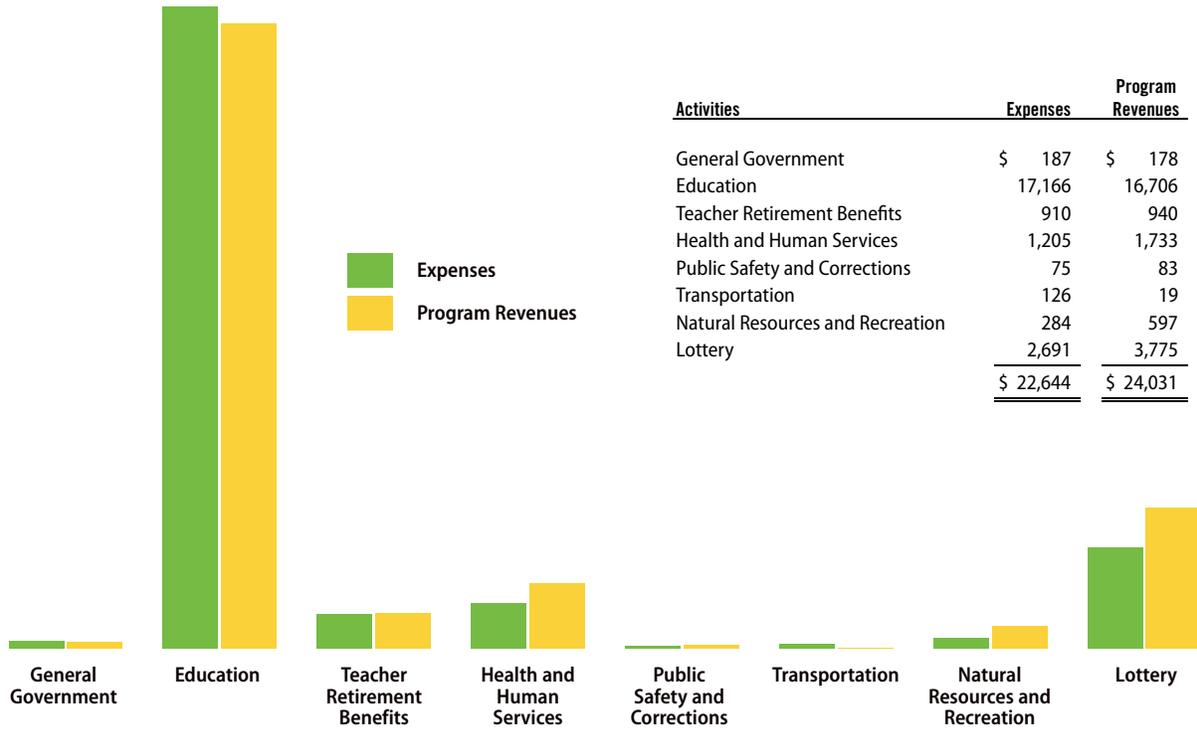


**Total = \$79.5 Billion**

\* Totals may not add due to rounding

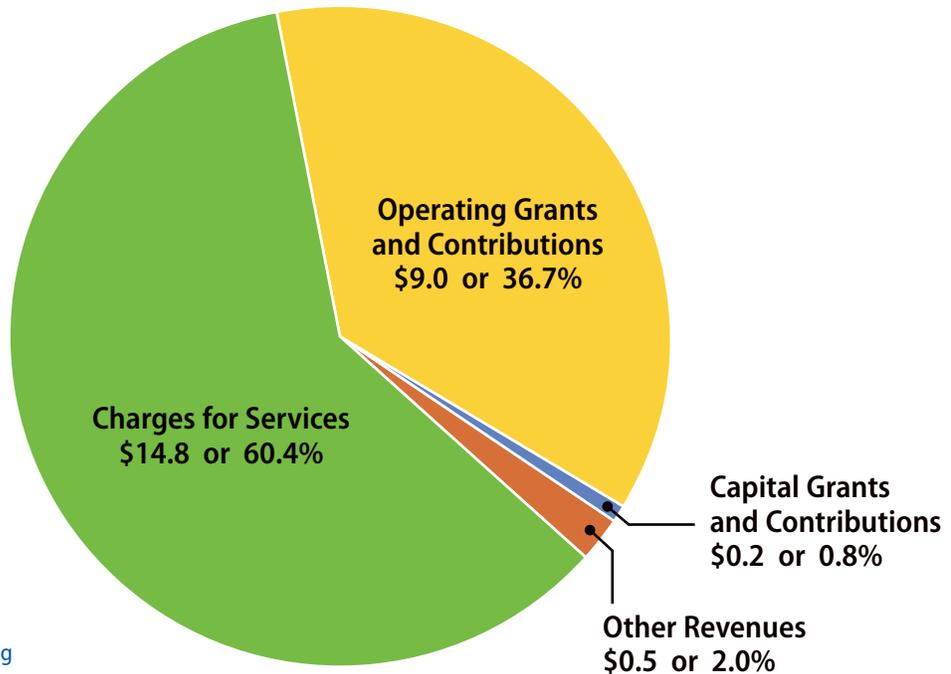
## Expenses and Program Revenues: Business-Type Activities

For the Fiscal Year Ended August 31, 2007 (In Millions)



## Revenue by Source: Business-Type Activities

For the Fiscal Year Ended August 31, 2007 (In Billions)\*



**Total = \$24.5 Billion**

\* Totals may not add due to rounding

## Governmental Activities

The governmental activities program revenue is \$39.3 billion, including charges for services of \$7.5 billion, operating grants and contributions of \$30 billion and \$1.8 billion reported in capital grants and contributions. The largest increase, \$1.4 billion, was for charges for services, which includes fee revenues and charges for goods and services. In addition, operating grants and contributions program revenues increased by \$1 billion. The largest changes in these two revenue sources were attributable to the health and human services function where there were increases in medical charges and with federal grants. Governmental activities expenses were \$67.9 billion, resulting in a net cost for governmental services of \$28.6 billion, an increase of \$4.1 billion or 16.8 percent above the cost of services from the prior year.

### Net Cost (Income) of the State's Governmental Activities

For the Fiscal Year Ended August 31, 2007 (Amounts in Thousands)

	Total Cost of Services	Net Cost (Income) of Services
General Government	\$ 2,555,309	\$ 744,949
Education	21,313,526	12,669,388
Employee Benefits	61,171	61,055
Teacher Retirement Benefits	2,017,000	1,990,339
Health and Human Services	30,886,484	8,281,873
Public Safety and Corrections	5,035,761	3,787,314
Transportation	4,252,129	796,200
Natural Resources and Recreation	1,217,201	310,404
Regulatory Services	314,266	(293,742)
Indirect Interest on Long-Term Debt	229,354	229,354
Total	<u>\$ 67,882,201</u>	<u>\$ 28,577,134</u>

### Net Cost (Income) of the State's Business-Type Activities

For the Fiscal Year Ended August 31, 2007 (Amounts in Thousands)

	Total Cost of Services	Net Cost (Income) of Services
General Government	\$ 186,628	\$ 8,543
Education	17,165,602	459,294
Teacher Retirement Benefits	909,845	(30,080)
Health and Human Services	1,204,609	(528,495)
Public Safety and Corrections	75,305	(7,474)
Transportation	125,910	106,996
Natural Resources and Recreation	283,653	(313,417)
Lottery	2,691,210	(1,083,754)
Total	<u>\$ 22,642,762</u>	<u>\$ (1,388,387)</u>

All functions of governmental activities in the government-wide statement of activities are in deficit except for the regulatory services function that reports a surplus. The regulatory services function consists mostly of professional licensing agencies, which are required to set professional license fees at a level sufficient to cover costs of operations. The tax collections of the state provide the primary source of funding, which added to program revenues, support payment for the governmental services.

## Business-Type Activities

Business-type activities generated program revenue of \$24 billion, including charges for services of \$14.8 billion, operating grants and contributions of \$9 billion and \$197.7 million reported in capital grants and contributions. The total expenses for business-type activities were \$22.6 billion. There was a total net gain from the government's business-type activities of \$5.2 billion. The largest positive change occurred in the college and university sector, which reduced the cost of education services by \$1.4 billion, offsetting higher costs with increased fees and improved returns from investment activity.

## Financial Analysis of the State's Funds

### Governmental Funds

As of Aug. 31, 2007, governmental funds reported fund balances of \$42.4 billion. Of this total amount, \$11.2 billion constitutes unreserved fund balances and \$31.2 billion reserved. The general fund reported a positive \$8.7 billion unreserved balance.

### General Fund

The fund balance for the general fund as of Aug. 31, 2007, was \$10.8 billion, an improvement of \$3.5 billion from the \$7.3 billion balance in fiscal 2006. As discussed in Budgetary Highlights, an increase in tax collections of \$2.1 billion was largely attributable to oil, gas and tobacco taxes. Revenues and expenses related to health care showed increases of \$1.2 billion and \$2.1 billion, respectively.

Education expenditures increased almost \$3 billion. A combination of factors accounted for this. These included the first year of impact for local property tax relief, a teacher pay raise and an increase in the allotment for high school spending.

### **State Highway Fund**

The fund balance for the state highway fund as of Aug. 31, 2007, was \$12.2 million, a decrease of \$243.5 million from \$255.7 million as of Aug. 31, 2006. Federal revenues dropped \$962.3 million from fiscal 2006. But, the Texas Department of Transportation was able to increase capital spending by \$417 million through the utilization of debt financing tools, by spending down equity and by increasing transfers from the Texas Mobility fund.

### **Permanent School Fund**

The fund balance for the permanent school fund (Fund) as of Aug. 31, 2007, totaled \$26.8 billion, an increase of \$2.9 billion since Aug. 31, 2006. Asset growth facilitated by income generation increased the fair value of investments from \$23.2 billion in fiscal 2006 to \$26 billion in fiscal 2007, an increase of \$2.8 billion. The Fund recognized \$3.6 billion in interest, investment and land income, an increase of \$1.2 billion above fiscal 2006. This increase was a combination of factors that included growth in equity and fixed income holdings, increased revenue from securities lending activity and expansion into emerging markets. Value in the fund provided \$843.1 million in transfers to provide funding for public education.

### **Proprietary Funds**

Proprietary funds reported net assets of \$42.9 billion as of Aug. 31, 2007, an increase of \$5.2 billion from fiscal 2006. Colleges and universities, Texas Water Development Board funds and the Texas Department of Transportation Turnpike Authority are discussed separately. In addition, the Texas Workforce Commission unemployment trust fund accounts realized a net asset increase of \$400.1 million as positive economic conditions continued to result in lower benefit payments. At the same time a \$318.8 million surplus

refund in tax credits was made to eligible employers by the Commission as explained in Note 23.

The Texas Prepaid Higher Education Tuition Board, reported a \$164.6 million unfunded liability for fiscal 2007, an increase in the unfunded amount by \$54.3 million from last year. Primary sources of the change were assumptions about the interest rates on investment returns and increases to tuition costs. On the positive side, actual investment performance was 4.3 percent higher than the assumed rate for fiscal 2007.

### **Colleges and Universities**

Colleges and universities net assets as of Aug. 31, 2007, totaled \$36.8 billion, an increase of \$4.4 billion from Aug. 31, 2006. The largest changes were increases in investments of \$4 billion and in net capital assets of \$1.1 billion. Fee revenues increased \$819.4 million and interest and investment income increased \$1.4 billion from the previous year. Tuition and fee increases and enrollment gains as well as investment successes account for much of the change. Capital additions are an indication of long-range plans for various new construction projects.

### **Texas Water Development Board Funds**

The Texas Water Development Board funds net assets totaled \$2.1 billion as of Aug. 31, 2007, an increase of \$300.2 million from \$1.8 billion as of Aug. 31, 2006. During fiscal 2007, federal revenues of \$237.4 million and investment income of \$191.5 million accounted for virtually all of the additions to the funds. The increase in net assets was primarily due to the close out of several underlying loans in clean water capitalization grants resulting from increased federal draws. Funds are primarily used to provide financial assistance to political subdivisions for water development, water quality enhancement and flood control projects.

### **Texas Department of Transportation Turnpike Authority**

Net assets for the Texas Department of Transportation Turnpike Authority totaled \$805.5 million as of Aug. 31, 2007, an increase of \$43.7 million from Aug. 31, 2006. The largest portion of the Turnpike Authority's total assets,

\$2.5 billion or 77.5 percent consists of completed highway projects or those under construction. Capital contributions from the state highway fund were discontinued in March 2007 once existing funds were determined to be sufficient for completion of current projects.

## **Fiduciary Funds**

Fiduciary funds report \$157 billion in net assets as of Aug. 31, 2007, an increase of \$18 billion from \$139 billion, in fiscal 2006.

### **Pension and Other Employee Benefit Trust Funds**

Total net assets for pension and other employee benefit trust funds were \$137.3 billion, an increase of \$13.8 billion from the \$123.5 billion in fiscal 2006. The majority of plan assets are held as investments for the pension funds. The overall financial condition of the pension fund retirement plans improved during fiscal 2007 due to the increased member, state and employer contributions, and appreciation in investment assets. The return for investments for the state's two largest pension systems, the Teacher Retirement System of Texas and the Employees Retirement System of Texas, was 14.4 percent and 13.9 percent, respectively, compared to the previous year's return percents of 9.7 and 8.8.

### **External Investment Trust Funds**

The external investment trust funds reported total net assets of \$16.5 billion in fiscal 2007, an increase of \$3.8 billion from the \$12.6 billion in fiscal 2006. The increase is due to additional investment contributions by participants, including 107 new clients in the Texas Government Investment Pool (TexPool) trust fund, and to higher interest income on larger investment asset balances.

### **Private-Purpose Trust Funds**

Total net assets for private-purpose trust funds were \$3.3 billion in fiscal 2007, an increase of \$385 million, or 13.3 percent from fiscal 2006. Increases to net assets were due to a combination of factors including higher rates of return on investments, an increase in interest rates on holdings, as well as increases to average monthly asset balances on which interest earnings were made.

## **Budgetary Highlights**

### **Variances for the General Fund**

The differences from original and final revenue budgets are due to both economic and legislative reasons. Actual results for tax revenues produced an additional \$1.6 billion above the final budget number. As strength in the state economy continued, sales tax collections increased by 9.5 percent. Tax collections for oil and gas were higher than budgeted as prices grew beyond forecasts. Finally, a 142.4 percent increase in cigarette and tobacco taxes was attributable to a tax rate hike of \$1.00 per pack of cigarettes.

Actual amounts exceed budgeted figures for both sales of goods and services revenues and for health and human expenditures. The variances of actual to budget were \$1.3 billion and \$680.7 million, respectively. Both were primarily attributable to large increases in intergovernmental receipts from urban and rural hospitals for the purpose of enhancing Medicaid reimbursements from federal matching funds. Increases in federal revenues for health care were offset by reductions in federal revenues for highway construction.

## **Capital Assets and Debt Administration**

### **Capital Assets**

As of Aug. 31, 2007, the state had \$80.3 billion in net capital assets, of which \$50.3 billion was infrastructure. This total represents an increase of \$4.9 billion in net capital assets or 6.4 percent from fiscal 2006. The state's capital assets include land and land improvements, infrastructure, construction in progress, buildings and building improvements, facilities and other improvements, furniture and equipment, vehicles, boats and aircraft and other capital assets. Details of capital assets are shown in Note 2.

### **Infrastructure Assets**

The value of the state's infrastructure assets is included in the governmental activities column of the government-wide statements.

The state accounts for its system of roads and highways using the modified approach allowed by GASB Statement

## Capital Assets – Net of Depreciation

August 31, 2007 and 2006 (Amounts In Thousands)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2007	2006	2007	2006	2007	2006
Land and Land Improvements	\$ 7,278,244	\$ 6,799,132	\$ 1,274,455	\$ 1,145,692	\$ 8,552,699	\$ 7,944,824
Infrastructure	48,397,641	45,927,273	1,900,120	296,607	50,297,761	46,223,880
Construction in Progress	4,623,788	4,020,789	2,041,057	3,419,532	6,664,845	7,440,321
Buildings and Building Improvements	2,542,910	2,629,379	8,545,156	7,745,073	11,088,066	10,374,452
Facilities and Other Improvements	84,117	83,551	613,234	521,876	697,351	605,427
Furniture and Equipment	255,122	263,590	1,251,007	1,173,396	1,506,129	1,436,986
Vehicles, Boats and Aircraft	389,098	366,697	50,029	50,764	439,127	417,461
Other Capital Assets	231,806	227,601	807,603	761,001	1,039,409	988,602
Total Capital Assets	<u>\$ 63,802,726</u>	<u>\$ 60,318,012</u>	<u>\$ 16,482,661</u>	<u>\$ 15,113,941</u>	<u>\$ 80,285,387</u>	<u>\$ 75,431,953</u>

No. 34. The Texas Department of Transportation (TxDOT) has developed a system of management, the Texas Maintenance Assessment Program (TxMAP), which is designed to maintain the service delivery potential of the state's roads and highways to near perpetuity.

The state's policy is to maintain its interstate highways at a condition level of 80 percent and its non-interstate highways (farm-to-market and other road systems) at a condition level of 75 percent. The condition assessment results for fiscal 2007 reflect condition levels of 84.1 percent (83.4 percent in fiscal 2006) for the interstate system and 79.5 percent (78 percent for fiscal 2006) for the non-interstate system.

In fiscal 2007, the estimated maintenance expenditures for interstate highways were \$438.5 million, compared to \$471.9 million actual maintenance expenditures. The estimated versus actual maintenance expenditures for non-interstate highways were \$1.7 billion and \$1.9 billion, respectively.

Additional information on the state's road and highway infrastructure is presented in the financial section's required supplementary information other than MD&A.

### Debt Administration

The state of Texas issues both general obligation bonds and revenue bonds. Each series of revenue bonds is backed by the pledged revenue source and restricted funds specified in the bond resolution. Most revenue bonds are designed to be self-supporting from a primary revenue source related to the program financed.

The state's general obligation bond issues are rated Aa1 by Moody's Investors Service, AA by Standard & Poor's Corporation and AA+ by Fitch, as of August 2007. During fiscal 2007, Texas' state agencies and universities issued \$6.2 billion in state bonds to finance new construction, housing, water conservation and treatment and other projects. General obligation debt accounted for \$2.8 billion of state bonds issued in fiscal 2007. This debt, which can only be authorized by a constitutional amendment, carries the full faith and credit of the state. The remaining \$3.6 billion is due to new issuances of revenue bonds, which are serviced by the revenue flows of individual entity projects. Bonds retired during the year were composed of \$362.7 million in general obligation bonds and \$838.6 million in revenue bonds. Also, \$158.1 million in general obligation bonds and \$1.8 billion in revenue bonds were refunded. The total outstanding general obligation debt of the state after new issuances, retirements and refundings as of Aug. 31, 2007, was \$9.5 billion. This represents an increase of \$2.3 billion or 32.1 percent from fiscal 2006. An additional \$3.8 billion of general obligation bonds have been authorized but have not been issued. Total revenue bonds outstanding were \$14.7 billion, which is an increase of \$918.4 million or 6.7 percent from fiscal 2006. \$2.2 billion of the net increase for general obligation bonds and \$931.7 of the net increase for revenue bonds are to finance highway projects in the state. Note 5 shows the details on the state's long-term liabilities and Note 6 provides detail information on the state's bond indebtedness.

## Outstanding Bonded Debt

August 31, 2007 and 2006 (Amounts in Thousands)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2007	2006	2007	2006	2007	2006
General Obligation Bonds Payable	\$ 6,756,893	\$ 4,478,891	\$ 2,775,467	\$ 2,738,685	\$ 9,532,360	\$ 7,217,576
Revenue Bonds Payable	2,030,739	1,152,483	12,304,358	12,378,384	14,335,097	13,530,867
<b>Total Bonds Payable</b>	<b>\$ 8,787,632</b>	<b>\$ 5,631,374</b>	<b>\$15,079,825</b>	<b>\$ 15,117,069</b>	<b>\$23,867,457</b>	<b>\$20,748,443</b>

### Cash Management

Funds deposited in the state Treasury are pooled for investment purposes. The Treasury is authorized to invest in fully collateralized time deposits, obligations of the United States, obligations of various federal credit organizations, direct security repurchase agreements, reverse repurchase agreements, bankers' acceptances, commercial paper and contracts written by the Comptroller which are commonly known as covered call options.

During fiscal 2007, the average investment portfolio consisted of the following.

### Average Investment Portfolio\*

For the Fiscal Year Ended August 31, 2007

Investment Type	Percent of Total	Average Amount Invested (Amounts in Millions)	Average Interest Rate
NOW Accounts	0.1 %	26.6	1.06 %
Time Deposits	0.1	15.0	3.77
BidTX	3.1	579.9	5.15
Repurchase Agreements	22.5	4,151.7	5.35
U.S. Treasury and Agency Securities	48.0	8,849.4	5.12
U.S. Treasury (Lottery)	3.2	586.4	**
Commercial Paper	21.7	4,007.4	5.36
Mutual Funds	2.4	438.4	5.18
Subtotal	<u>101.1</u>	<u>18,654.8</u>	
Reverse Repurchase Agreements	<u>(1.1)</u>	<u>(203.6)</u>	5.10
<b>Total</b>	<b><u>100.0 %</u></b>	<b><u>18,451.2</u></b>	5.22

\* The above numbers include all funds included in the state Treasury.  
 \*\* The yield for the lottery is not included in the average yield for the state since the investments are long-term and are held for lottery prize winners.

### Economic Condition and Outlook

Texas added more jobs than any other state in 2007, even adding more jobs than the combined job growth in the next two largest job gainers - Florida and California. Completing its fourth consecutive year of employment growth, Texas nonfarm employment advanced by 2 percent, or 204,400 jobs, from November 2006 to November 2007. Although growing almost twice as fast as the national average, Texas job growth slowed during the year, dropping nearly a percentage point from a 2.9 percent growth rate during the previous year. The state's economy was largely insulated from the nation's housing-induced slowdown, as average housing prices in Texas continued to increase. Higher oil and gas prices, although hurting consumers and most service-based industries, benefited the natural resources and mining sector, which is about five times as concentrated in Texas as the national average. The state's unemployment rate dropped to its best level in several years, standing at 4.2 percent in November 2007. During the year, Texas' unemployment rate fell below the nation's unemployment rate, standing a half percentage point lower than the national average in November.

Although comparatively stronger than the national economy, Texas' real gross domestic product growth slowed in 2007, advancing by an estimated 3.3 percent, when adjusted for inflation. Nominal personal income increased by an estimated 7.9 percent. The state's total personal income still exceeded the growth in population and inflation, resulting in real per capita personal income growth of 3.6 percent during the year.

The state revenue outlook continues to improve but there are many factors that preclude a forecasting of the same robust revenue growth seen in recent years. Fiscal 2007 finished strong with an ending balance of \$8.8 billion in general revenue-related funds after the required constitutional transfers to the economic stabilization fund. In November 2007, Comptroller Combs released the 2008-09 Certification Revenue Estimate and the state is expected to have sufficient revenue to support \$83.1 billion in general purpose spending for the biennium. Because of uncertainty in the U.S. and Texas economies, the Comptroller is forecasting slower revenue growth over the next two years. Sales tax, the state's largest source of the tax revenue, is only expected to grow at 3.1 percent in fiscal 2008 and 2.2 percent for fiscal 2009. Underpinning the lower rate of growth in the revenue estimate, Texas economic growth for the biennium is projected to decelerate to an average annual rate of 3 percent - down from the previous period's 3.7 percent

average annual growth. The state economy, though reasonably healthy, is entering into a period of uncertainty due to liquidity issues in credit markets and an ongoing correction in the housing market. While corrective measures have been implemented at the national level, the current situation requires extreme caution and prudence.

## **Contacting the State's Financial Management**

This financial report is designed to provide the state's citizens, taxpayers, customers, investors and creditors with a general overview of the state's finances and to demonstrate the state's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the Financial Reporting section of the Texas Comptroller of Public Accounts at 111 E. 17th Street, Austin, Texas 78774.

