

Section One

Introductory Section





February 29, 2016

To the Citizens of Texas, Governor Abbott
and Members of the 84th Texas Legislature:

The Comprehensive Annual Financial Report (CAFR) of the state of Texas for the fiscal year ended Aug. 31, 2015, 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's Office performed an audit, in accordance with generally accepted auditing standards, of the state's general-purpose financial statements. Their opinion is presented in this report preceding the financial statements.

The State Auditor's Office 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, 2015, 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. All governmental funds are appropriated for a biennium, except for appropriations related to construction, which are appropriated for five years. 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, other than the MD&A section, is found in the required supplementary information.

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 nondedicated general revenue as provided in Article III, Section 49j.

The economic stabilization fund (ESF), commonly called the "rainy day fund," 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 with interest 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 received transfers, not later than the 90th day of fiscal 2015, from the general revenue fund for 50 percent of the 75 percent of the prior fiscal year oil or natural

gas production tax revenue that exceeded the amount of collections in fiscal 1987. The remaining 50 percent was transferred to the state highway fund as directed by the passage of a constitutional amendment known as Proposition 1 in the November 2014 election. The amendment did not create any new taxes or fees.

The balance in the fund on Aug. 31, 2015, was \$9.6 billion. The ESF is also discussed in Note 13.

Economic Outlook

Texas possesses advantages such as relatively low living costs, an attractive business climate, a central Sunbelt location, and a balanced mix of industries that have enabled it to grow faster than the nation in most years. However, the recent fall in oil and natural gas prices, and the resulting reduction in related economic activity, is expected to slow the rate of growth of the Texas economy in 2016. After 5.2 percent growth in 2014, the Texas economy, as measured by real Gross State Product (GSP), is estimated to have grown by 2.2 percent in 2015 and is projected to grow by a further 2.2 percent in 2016.

After increasing by 6 percent in 2014, Texas personal income is estimated to have grown by 4.2 percent in 2015 and is projected to grow by a further 4 percent in 2016. Underlying this income growth is growth in Texas population. Recent estimates by the U.S. Census Bureau show that eight of the nation's 15 most rapidly growing large incorporated cities are in Texas, where total state population is expected to grow by 1.7 percent in 2016, to 27.9 million.

The Texas unemployment rate has improved substantially over the year, from an average of 5 percent in 2014 to 4.3 percent in 2015. However, the rate has been climbing in recent months and is projected to average 4.5 percent in 2016.

Total Texas nonfarm employment grew by 3.1 percent in 2014 and is estimated to have grown by 2.3

percent in 2015. In 2016, Texas nonfarm employment growth is projected to be 1.8 percent.

Growth in Texas' GSP, personal income and employment will all be in line with the nation as a whole, but will be significantly slower than during the rebound from the Great Recession. Texas' unemployment rate will, however, continue to be below that of the U.S.

Texas Industry Performance

Goods-producing industries' employment declined by 3 percent over the past 12 months, while employment in service-producing industries grew by 2.4 percent. Employment declines in the goods-producing industries were led by manufacturing (down 36,000 jobs) and mining and logging (down 30,300 jobs), while employment growth in the service-providing industries was led by education and health services (up 63,800 jobs) and leisure and hospitality (up 55,000 jobs). The industry that saw the largest employment growth rate was leisure and hospitality (4.5 percent), while the mining and logging industry had the greatest rate of decline (-9.6 percent).

Manufacturing

According to the U.S. Census Bureau, the value of Texas exports in 2014 was a record \$289 billion, an increase of 3.3 percent from 2013. Those exports provided a substantial boost to Texas manufacturing, notably for companies producing chemicals, computers and electronics, petroleum products, industrial machinery and transportation equipment. Texas is the nation's leading exporting state, a position held since 2002. However, through November 2015, Texas exports had fallen by 13 percent from the corresponding period of 2014, hurt by falling oil prices and a stronger dollar.

Construction

Despite the fall in sector employment, housing activity has increased over the past year. Total single-family building permits issued in the year ending November 2015 were up 3.4 percent from the year ending November 2014, while multi-family building permits were up 4.3 percent. According to Multiple Listing Service data from the Texas A&M Real Estate Center, the median sales price for an existing Texas single-family home rose 4.8 percent over the last year, from \$184,600 in November 2014 to \$193,500 in November 2015. The inventory of existing homes for sale in November 2015 was only 3.4 months, up slightly from 3.3 months a year ago, but a substantial improvement from the recent high of 8.2 months in mid-2011.

Mining and Logging

Texas oil production peaked more than 40 years ago in 1972, when calendar year production reached 1,263 million barrels. After a decades-long decline in production volumes, reaching a low of 343 million barrels in calendar 2007, the trend reversed its course. Production reached 1,035 million barrels in 2015 largely due to the development of the Eagle Ford Shale in South Texas. In addition to the substantial exploration and production activities within the state and in the Gulf of Mexico, Texas is the headquarters for many of the nation's largest oil and natural gas refining and distribution companies, and has a large number of energy-related jobs in other industries associated with those activities. The recent fall in oil and gas prices has had significant negative effects on those industries as well.

Major Legislative Initiatives

The 2015 session of the Texas Legislature enacted a variety of new laws affecting state revenues and finances. Legislation in the following areas is expected to have significant revenue implications.

Property Tax Relief

Relief from school property taxes was provided by increasing the amount of the residence homestead exemption. Property value that can be excluded from tax increased from \$15,000 to \$25,000. Thus a school district would tax a residence appraised at \$200,000, for instance, at a value of \$175,000 which is additional 5 percent reduction from the previous exemption. Since the amount of the exemption is established in the state constitution, Texas voters approved an amendment making the change in November 2015. The state is required to supplement the difference in funding to school districts, which rely heavily on property tax revenues. As a result, the state will provide local districts with supplemental funding of \$1.2 billion in the next two years, and more thereafter.

Franchise Tax

The state reduced the franchise or "margin" tax rate by 25 percent. This change could save businesses across the state up to \$1.3 billion in fiscal 2016. The franchise tax accounted for approximately 9.3 percent of all Texas tax collections in 2014, or more than \$4.7 billion. This change will reduce state revenues by approximately \$2.6 billion in the 2016-2017 biennium, mostly from the state's Property Tax Relief Fund.

Tax Repeals

In the 2015 session, the Legislature repealed several outdated tax laws. These were identified by the Comptroller and recommended for repeal to ease the tax burden on businesses and make tax administration more efficient. The tax laws repealed are as follows:

- service fee on alcoholic beverages served on commercial planes and trains
- bingo gross rentals tax
- controlled substances tax
- state inheritance tax

- regulatory tax and fee assessment on the production of crude oil
- sulphur production tax
- fireworks tax
- liquefied gas tax (*compressed and liquefied natural gas delivered directly to vehicle fuel tanks remain taxable*)

The minor taxes and fees repealed represent a revenue cost of only about \$17.4 million in the 2016-2017 biennium, an amount that will be more than made up by redeploying Comptroller resources to enforce other Texas taxes.

Prekindergarten Grants

The High Quality Prekindergarten Grant Program was established to provide up to \$130 million in 2016 and 2017 for state grants to support pre-k programs in public schools and open-enrollment charter schools. School districts and charters can receive this funding for students who are four years of age as of September 1 of each year. The grant amounts, to be determined by the state's commissioner of education, can reach up to \$1,500 per student per school year.

The grant program is funded only for the 2016-2017 biennium. Additional appropriations would be needed to continue the program in 2018 and beyond. The Legislative Budget Board's estimate for this assumes complete use of the grant funding in 2016 and 2017 as well as the expenditure of some administrative costs, for a total cost of about \$131.2 million.

State Contracts

Several measures were passed to enhance state contracting reporting and data collection inside the Comptroller's office and other oversight agencies.

The first measure concerns the Texas Comptroller's vendor performance tracking system, which collects agency feedback on vendors after contract completion or termination. The Comptroller will be required to

assign vendor "grades," based on agency input, ranging from A to F. The Comptroller's office is establishing rules on how a vendor's rating will affect its eligibility to continue contracting with state agencies. The performance tracking system and new rating information will be made available to the public on the Comptroller's website.

The second measure changes the data collection process for the state's centralized accounting and payroll/personnel system (CAPPS). Agencies are now required to provide specific contract data to CAPPS, including statements of work, financial information and summaries of the processes used to award each contract. By the end of fiscal 2017, the Comptroller's office anticipates that about 50 agencies will be using CAPPS for their financial system, accounting for 87 percent of all state agency spending.

Also included in the measures is the requirement for the State Auditor's Office to consider auditing Health and Human Services Commission contracts that exceed \$100 million annually. Other measures include required posting of contract information on state agency websites for transparency purposes; increased ethics training; and a two-year prohibition on any vendor employment of former state workers who participated in purchases made with that vendor. The Comptroller's office and the Governor's office will work together to study the feasibility of consolidating state purchasing functions and reducing the number of vendors that work with the state.

Although the Legislative Budget Board cannot provide a definitive cost due to the sheer number of state contracts and vendors in Texas, it does estimate that the higher administrative costs for the revised vendor performance tracking system and additional legal assistance at the Comptroller's office, as well as additional agency costs associated with posting contract information online will be about \$4.3 million in the next two years.

Transportation

A constitutional amendment approved by Texas voters in November 2015 will dedicate some state sales tax and motor vehicle sales tax revenues to the state highway fund. In fiscal 2018 and thereafter, the Comptroller will credit to the fund up to \$2.5 billion annually from the net sales tax revenue that exceeds the first \$28 billion of revenue collected.

Beginning in fiscal 2020, the Comptroller will also transfer to the fund 35 percent of each year's net revenue from the motor vehicle sales tax that exceeds the first \$5 billion of revenue collected. The funds transferred must be used for building and maintaining public roadways, acquiring rights of way or repaying bonds issued for highway improvement projects.

There is no significant impact in the 2016 and 2017 biennium. Thereafter, it will reduce the general revenue fund balance but produce an equivalent gain to the state highway fund.

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, 2014. 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 25 years (fiscal years ended August 1990 through 2014). 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,



Glenn Hegar



State of Texas Comprehensive Annual Financial Report

State of Texas Elected State Officials

Executive

Greg Abbott
Governor

Dan Patrick
Lieutenant Governor

Glenn Hegar
Comptroller of Public Accounts

Ken Paxton
Attorney General

George P. Bush
Land Commissioner

Christi Craddick
David J. Porter
Ryan Sitton
Railroad Commissioners

Sid Miller
Commissioner of Agriculture

Legislative

Lieutenant Governor Dan Patrick
President of the Senate

Joseph R. Straus, III
Speaker of the House of Representatives

Judicial

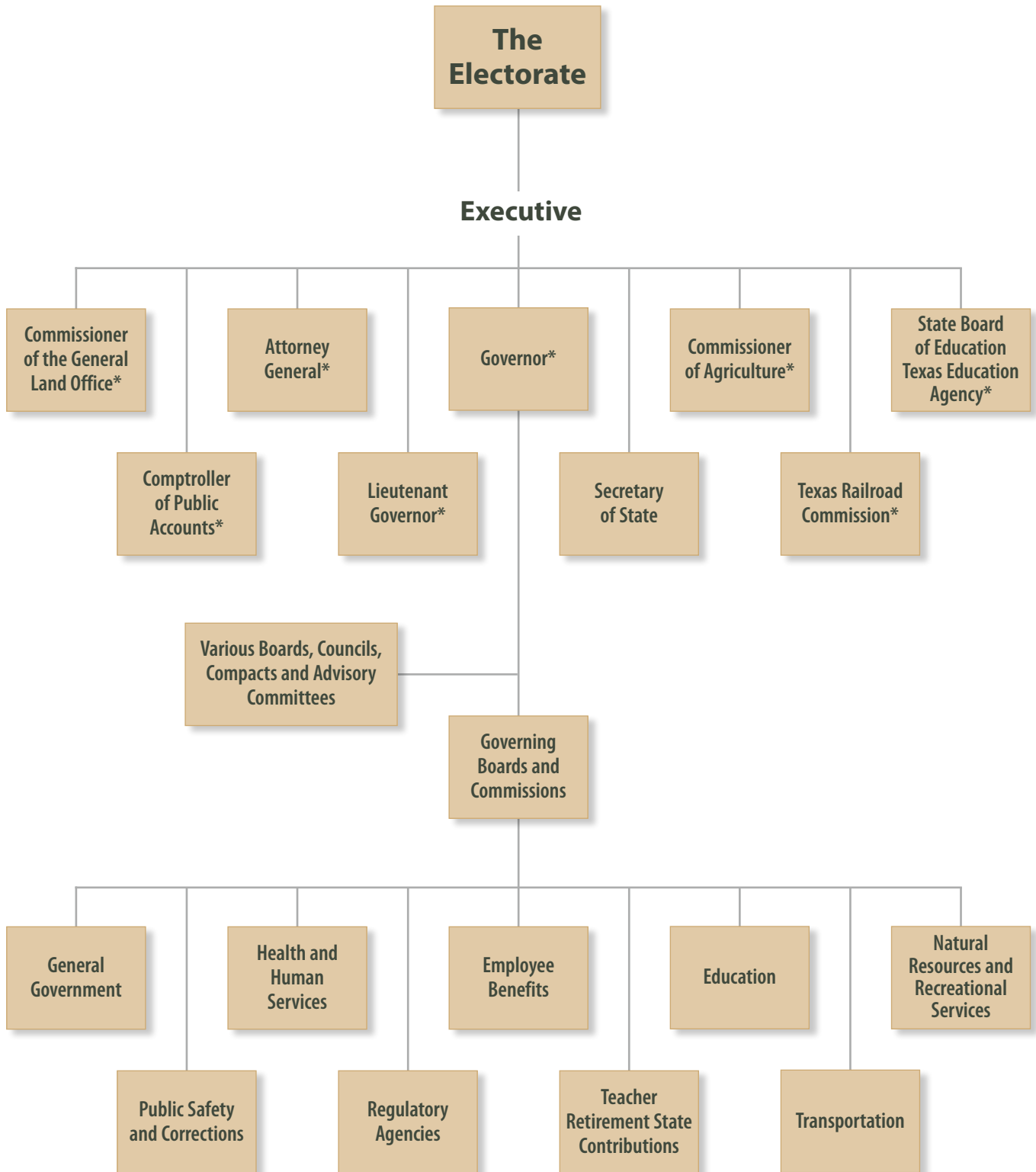
Supreme Court of Texas

Nathan L. Hecht, Chief Justice
Jeff Brown, Justice
Jeffrey S. Boyd, Justice
John Devine, Justice
Paul Green, Justice
Eva M. Guzman, Justice
Phil Johnson, Justice
Debra Lehrmann, Justice
Don R. Willett, Justice

Court of Criminal Appeals

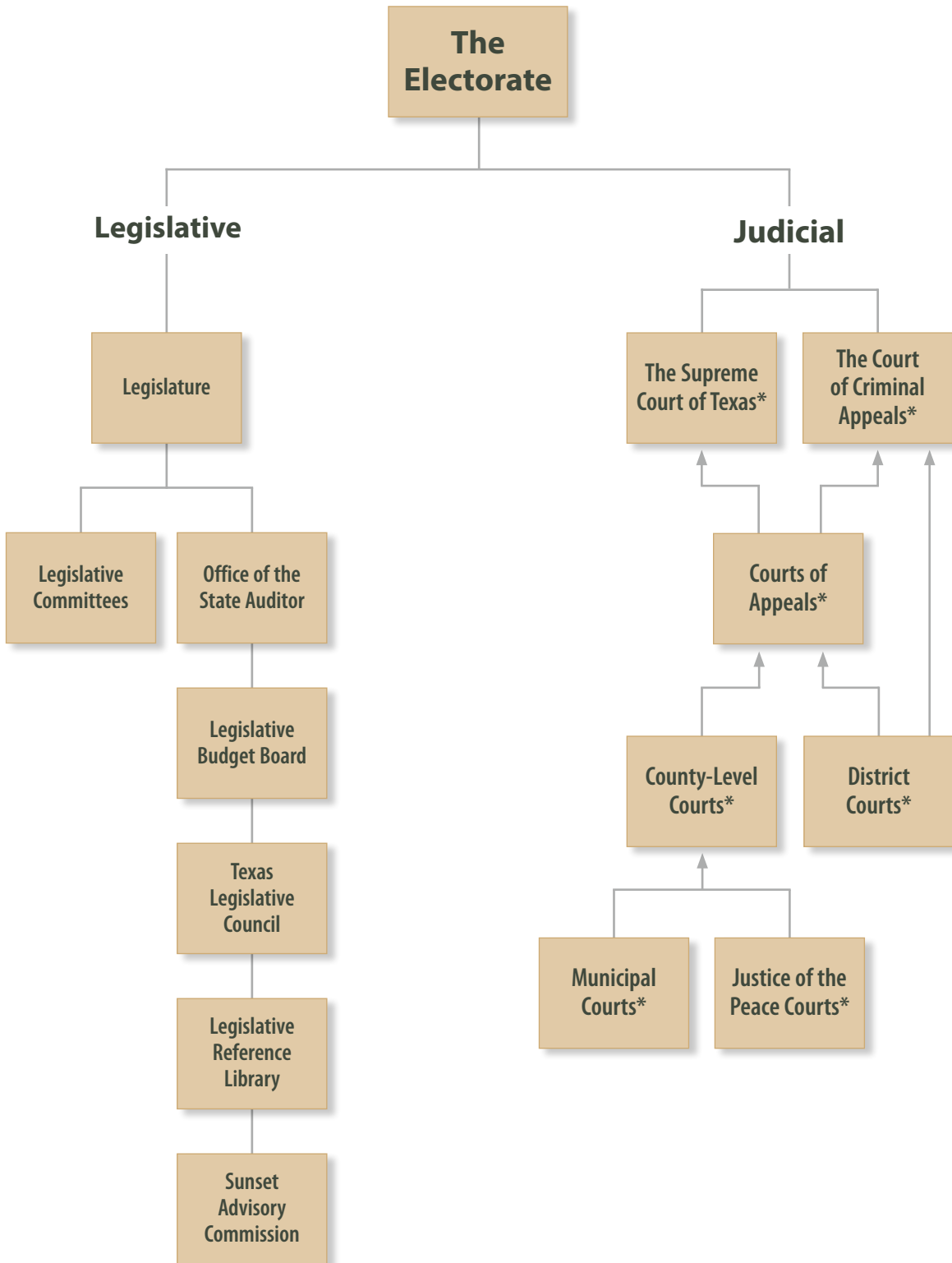
Sharon Keller, Presiding Judge
Elsa Alcala, Judge
Barbara Parker Hervey, Judge
Cheryl Johnson, Judge
Michael E. Keasler, Judge
Lawrence E. Meyers, Judge
David Newell, Judge
Bert Richardson, Judge
Kevin Yeary, Judge

Government Structure of Texas



* Elected Offices

Government Structure of Texas (continued)



* Elected Offices



Government Finance Officers Association

**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, 2014

Executive Director/CEO