

Management's Discussion and Analysis

(Unaudited)

The following is a discussion and analysis of the Commonwealth of Virginia's (the Commonwealth) financial performance, including an overview and analysis of the financial activities of the Commonwealth for the fiscal year ended June 30, 2012. Readers should consider this information in conjunction with the transmittal letter, which is located in the Introductory Section of this report, and the Commonwealth's financial statements, including the notes to the financial statements, which are located after this analysis.

Financial Highlights

Government-wide Highlights

The primary government's assets exceeded its liabilities at June 30, 2012, by \$19.7 billion. Net assets of governmental activities increased by \$1.4 billion and net assets of business-type activities increased by \$234.8 million. Component units reported an increase in net assets of \$438.0 million from June 30, 2011.

Fund Highlights

At the end of the fiscal year, the Commonwealth's governmental funds reported a combined ending fund balance of \$4.4 billion, an increase of \$1.0 billion in comparison with the prior year. Of this total fund balance, \$251.0 million represents nonspendable fund balance, \$1.6 billion represents restricted fund balance, \$3.4 billion represents committed fund balance, and \$11.8 million represents assigned fund balance. These amounts are offset by a negative \$820.9 million unassigned fund balance. The Enterprise Funds reported net assets at June 30, 2012, of \$359.0 million, an increase of \$237.7 million during the year which is primarily attributable to the Unemployment Compensation Fund. See page 33 for additional information.

The General Fund recognized higher fund assets, liabilities, revenues, and expenditures when compared to fiscal year 2011. See page 34 for additional information.

Long-term Debt

The Commonwealth's total debt rose during the fiscal year to \$36.1 billion, an increase of \$2.4 billion, or 7.1 percent. During the fiscal year, the Commonwealth issued new debt in the amount of \$1.8 billion for the primary government and \$5.5 billion for the component units. These debt issuances increased the debt balances to \$11.7 billion for the primary government and \$24.4 billion for component units.

Overview of the Financial Statements

This discussion and analysis is an introduction to the Commonwealth's basic financial statements, which include three components: 1) government-wide financial statements; 2) fund financial statements; and 3) notes to the financial statements. The report also contains additional required supplementary information and other information.

Government-wide Statements

The government-wide financial statements are designed to provide readers with a broad overview of the Commonwealth's finances in a manner similar to a private-sector business. The statements provide both short-term and long-term information about the Commonwealth's financial position which helps readers determine whether the Commonwealth's financial position has improved or deteriorated during the fiscal year. These statements include all non-fiduciary financial activity on the full accrual basis of accounting. This means that all revenue and expenditures are reflected in the financial statements even if the related cash has not been received or paid as of June 30.

The Statement of Net Assets (pages 40 and 41) presents information on all of the Commonwealth's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets may indicate whether the financial position of the Commonwealth is improving or deteriorating.

The Statement of Activities (pages 42 through 44) presents information showing how the Commonwealth's net assets changed during fiscal year 2012. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (e.g., uncollected taxes and earned but unused vacation leave).

Both the Statement of Net Assets and Statement of Activities report three separate activities. These activities are described as follows:

Governmental Activities – account for functions of the Commonwealth that are primarily supported by taxes and intergovernmental revenues. The majority of the Commonwealth’s basic services, such as education, individual and family services, transportation, resources and economic development, administration of justice, and general government, fall within this category.

Business-type Activities – account for functions that are intended to recover all or a significant portion of their costs through user fees and charges. The major business-type activities of the Commonwealth include the State Lottery, Virginia College Savings Plan, and Unemployment Compensation Fund.

Discretely Presented Component Units – account for functions of legally separate entities for which the Commonwealth is financially accountable. The Commonwealth has 27 non-higher education component units and 22 higher education institutions that are reported as discretely presented component units. Information regarding the individual financial statements of the component units is presented in the notes to the financial statements.

This report includes two schedules (pages 48 and 52) that reconcile the amounts reported on the governmental fund financial statements (modified accrual accounting) with governmental activities on the appropriate government-wide statements (full accrual accounting). The following indicates some of the reporting differences between the government-wide financial statements and the fund financial statements.

- Capital assets used in governmental activities are not reported on governmental fund statements.
- Long-term liabilities, unless due and payable, are not included in the fund financial statements. These liabilities are only included in the government-wide statements.
- Internal service funds are reported as governmental activities in the government-wide statements, but are reported as proprietary funds in the fund financial statements.
- Other long-term assets that are not available to pay for current period expenditures are deferred in the governmental fund statements, but not deferred in the government-wide statements.
- Capital outlay spending results in capital assets on the government-wide statements, but are reported as expenditures in the fund financial statements.
- Bond proceeds provide current financial resources on the fund financial statements, but are recorded as long-term liabilities in the government-wide financial statements.

Fund Financial Statements

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The Commonwealth, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All the Commonwealth’s funds can be divided into three categories: governmental, proprietary, and fiduciary. Each of these categories uses different accounting approaches. Fund financial statements begin on page 46 and provide detailed information about the major individual funds.

- **Governmental funds** – Most of the basic services provided by the Commonwealth are reported in the governmental funds. These statements provide a detailed, short-term view of the functions reported as governmental activities in the government-wide financial statements. The government-wide financial statements are reported using the full accrual basis of accounting, but the governmental fund financial statements are reported using the modified accrual basis of accounting. This allows the reader to focus on assets that can be readily converted to cash and determine whether there are adequate resources to meet the Commonwealth’s current needs.

Because the focus of governmental funds is more limited than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. This comparison can help readers better understand the long-term impact of the Commonwealth’s near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities. These reconciliations are presented on the page immediately following each governmental fund financial statement.

The Commonwealth reports 12 individual governmental funds. Information is presented separately in the governmental fund statements for the General, Commonwealth Transportation, Federal Trust, and Literary funds, which are all considered major funds. Data from the other 8 governmental funds are aggregated into a single column on the fund statements. Individual fund data for these nonmajor governmental funds is provided in the combining financial statements immediately following the required supplementary information.

- **Proprietary funds** – The Commonwealth maintains two different types of proprietary funds, enterprise and internal service. These funds report activities that operate more like those of private-sector business and use the full accrual basis of accounting. Enterprise funds report activities that charge fees for supplies or services to the general public like the State Lottery. Enterprise funds are reported as business-type activities on the government-wide financial statements.

The enterprise funds use the full accrual basis of accounting and the only differences between amounts reported on the government-wide statements and the enterprise fund statements are due to internal service fund activity (see reconciliations on pages 54 and 56). Internal service funds report activities that charge fees for supplies and services to other Commonwealth agencies, like Fleet Management. Internal service funds are reported as governmental activities in the government-wide statements because these types of services predominantly benefit governments rather than business-type functions.

The Commonwealth reports 22 individual proprietary funds. Information is presented separately in the proprietary fund statements for the State Lottery Department, Virginia College Savings Plan, and Unemployment Compensation Funds, all of which are considered major funds. Data from the other enterprise funds are aggregated into a single column on the fund statements. All internal service funds are aggregated into a single column on the fund statements. Individual fund data for all nonmajor proprietary funds is provided in the combining financial statements immediately following the required supplementary information.

- **Fiduciary funds** – These funds are used to account for resources held for the benefit of parties outside the government and use the full accrual basis of accounting. Fiduciary funds are excluded from the government-wide financial statements because the resources of these funds are restricted and cannot be used to finance the Commonwealth's operations. The Commonwealth's fiduciary activities are reported in separate Statements of Fiduciary Net Assets and Changes in Fiduciary Net Assets beginning on page 64.

The Commonwealth's fiduciary funds are the:

- Private Purpose Trusts, which reports the activities for 7 separate funds and accounts for transactions of trust arrangements in which the principal and income benefit individuals, private organizations, or other governments;
- Pension and Other Employee Benefit Trusts, which reports the activities of 12 separate pension and other employment retirement plans for employees;
- Investment Trust, which accounts for the activities of the external investment pool; and,
- Agency, which accounts for assets held on behalf of others in 20 separate funds.

Individual fund data for all fiduciary funds is provided in the combining financial statements immediately following the required supplementary information.

- **Component Units** – The government-wide financial statements report information for all component units aggregated in a single column. Information is provided separately in the component unit fund statements for the Virginia Housing Development Authority, Virginia Public School Authority, University of Virginia, Virginia Polytechnic Institute and State University, and Virginia Commonwealth University, all of which are considered major component units. Data from the other component units are aggregated into a single column on the fund statements. Individual fund data for all nonmajor component units is provided in the combining financial statements immediately following the required supplementary information.

Notes to the Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found immediately following the component unit fund financial statements.

Required Supplementary Information

The basic financial statements are followed by a section of required supplementary information. This section includes budgetary comparison schedules reconciling the statutory and generally accepted accounting principles fund balances at June 30. It also includes information concerning the Commonwealth's funding progress for pension and other postemployment benefits, as well as trend information for Commonwealth-managed risk pools.

Other Information

The combining statements referred to earlier in connection with nonmajor funds and component units can be found beginning on page 189 of this report. The individual fund information is aggregated into a single total on the combining financial statements, which carries forward to the fund financial statements.

Government-wide Financial Analysis

The primary government's assets exceeded its liabilities by \$19.7 billion during the fiscal year. The net assets of the governmental activities increased \$1.4 billion or 7.8 percent, primarily due to increases in current and other assets offset by increases in long-term liabilities. The asset increase is primarily due to unspent bond proceeds, and the long-term liabilities are discussed further on page 36. Business-type activities had an increase of \$234.8 million or 193.9 percent, primarily due to an increase for the Unemployment Compensation Fund. The government-wide beginning balance was restated for the correction of prior year errors to arrive at a restated beginning balance of \$18.1 billion.

Figure 11
Net Assets as of June 30, 2012 and 2011
(Dollars in Thousands)

| | Governmental Activities | | Business-type Activities | | Total | |
|---|-------------------------|----------------------|--------------------------|-------------------|----------------------|----------------------|
| | 2012 | 2011 as restated | 2012 | 2011 | 2012 | 2011 as restated |
| Current and other assets | \$ 10,607,730 | \$ 8,809,085 | \$ 3,161,983 | \$ 3,149,480 | \$ 13,769,713 | \$ 11,958,565 |
| Capital assets | 24,015,151 | 22,452,549 | 34,359 | 36,256 | 24,049,510 | 22,488,805 |
| Total assets | <u>34,622,881</u> | <u>31,261,634</u> | <u>3,196,342</u> | <u>3,185,736</u> | <u>37,819,223</u> | <u>34,447,370</u> |
| Long-term liabilities outstanding | 9,319,463 | 8,059,198 | 2,434,493 | 2,484,784 | 11,753,956 | 10,543,982 |
| Other liabilities | 5,980,535 | 5,273,348 | 405,905 | 579,825 | 6,386,440 | 5,853,173 |
| Total liabilities | <u>15,299,998</u> | <u>13,332,546</u> | <u>2,840,398</u> | <u>3,064,609</u> | <u>18,140,396</u> | <u>16,397,155</u> |
| Net assets: | | | | | | |
| Invested in capital assets, net of related debt | 19,891,265 | 18,353,426 | 33,910 | 35,338 | 19,925,175 | 18,388,764 |
| Restricted | 1,647,731 | 1,171,700 | 178,916 | 15,730 | 1,826,647 | 1,187,430 |
| Unrestricted | (2,216,113) | (1,596,038) | 143,118 | 70,059 | (2,072,995) | (1,525,979) |
| Total net assets | <u>\$ 19,322,883</u> | <u>\$ 17,929,088</u> | <u>\$ 355,944</u> | <u>\$ 121,127</u> | <u>\$ 19,678,827</u> | <u>\$ 18,050,215</u> |

The largest portion of the primary government's net assets reflects its investment in capital assets (e.g., land, buildings, equipment, infrastructure, construction-in-progress, and intangible assets including water rights, easements and software), less any related outstanding debt used to acquire those assets. These assets are recorded net of depreciation in the financial statements. The primary government uses these capital assets to provide services to citizens; therefore, these assets are not available for future spending. Although the primary government's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities (**Figure 11**). The investment in capital assets amount exceeds total net assets due to a negative unrestricted net asset amount unrelated to capital assets.

An additional portion of the primary government's net assets represents restricted net assets. These resources are subject to external restrictions or constitutional provisions specifying how they may be used. The remaining balance of (\$2.1 billion) is unrestricted net assets (**Figure 11**).

Approximately 52.4 percent of the primary government's total revenue came from taxes. While the primary government's expenses cover many services, the largest expenses are for education and individual and family services. General revenues normally fund governmental activities. For fiscal year 2012, governmental program and general revenues exceeded governmental expenses by \$725.3 million. Program revenues exceeded expenses from business-type activities by \$892.6 million. The following condensed financial information (**Figure 12**) was derived from the Government-wide Statement of Activities and provides detail regarding the change in net assets (see page 42).

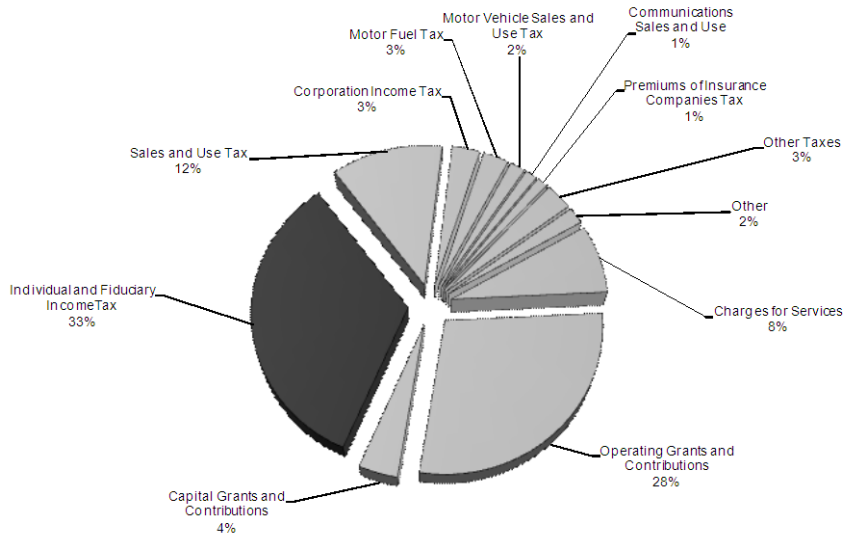
Figure 12
Changes in Net Assets for the Fiscal Years Ended June 30, 2012 and 2011
(Dollars in Thousands)

| | Governmental Activities | | Business-type Activities | | Total | |
|---|-------------------------|----------------------|--------------------------|-------------------|----------------------|----------------------|
| | 2012 | 2011 as restated | 2012 | 2011 | 2012 | 2011 as restated |
| Revenues: | | | | | | |
| Program Revenues: | | | | | | |
| Charges for Services | \$ 2,442,024 | \$ 2,352,638 | \$ 3,652,941 | \$ 3,601,117 | \$ 6,094,965 | \$ 5,953,755 |
| Operating Grants and Contributions | 9,178,384 | 9,950,314 | 447 | 575 | 9,178,831 | 9,950,889 |
| Capital Grants and Contributions | 1,266,700 | 1,324,192 | - | - | 1,266,700 | 1,324,192 |
| General Revenues: | | | | | | |
| Taxes: | | | | | | |
| Individual and Fiduciary Income | 10,813,550 | 10,050,404 | - | - | 10,813,550 | 10,050,404 |
| Sales and Use | 3,885,137 | 3,706,197 | - | - | 3,885,137 | 3,706,197 |
| Corporation Income | 978,690 | 851,630 | - | - | 978,690 | 851,630 |
| Motor Fuel | 900,199 | 903,108 | - | - | 900,199 | 903,108 |
| Motor Vehicle Sales and Use | 538,126 | 495,437 | - | - | 538,126 | 495,437 |
| Communications Sales and Use | 422,807 | 443,188 | - | - | 422,807 | 443,188 |
| Deeds, Contracts, Wills, and Suits | 370,620 | 335,526 | - | - | 370,620 | 335,526 |
| Premiums of Insurance Companies | 390,950 | 406,113 | - | - | 390,950 | 406,113 |
| Alcoholic Beverage Sales | 120,989 | 114,202 | - | - | 120,989 | 114,202 |
| Tobacco Products | 195,554 | 175,365 | - | - | 195,554 | 175,365 |
| Estate | 1,493 | 1,787 | - | - | 1,493 | 1,787 |
| Public Service Corporations | 114,972 | 113,260 | - | - | 114,972 | 113,260 |
| Beer and Beverage Excise | 43,659 | 43,873 | - | - | 43,659 | 43,873 |
| Wine and Spirits/ABC Liter | 24,297 | 22,924 | - | - | 24,297 | 22,924 |
| Bank Stock | 18,729 | 24,580 | - | - | 18,729 | 24,580 |
| Other Taxes | 73,613 | 76,592 | 9,141 | 9,141 | 82,754 | 85,733 |
| Unrestricted Grants and Contributions | 49,203 | 48,314 | - | - | 49,203 | 48,314 |
| Investment Earnings | 84,094 | 63,040 | 1,248 | 1,062 | 85,342 | 64,102 |
| Miscellaneous | 465,189 | 285,486 | 357 | 253 | 465,546 | 285,739 |
| Total Revenues | 32,378,979 | 31,788,170 | 3,664,134 | 3,612,148 | 36,043,113 | 35,400,318 |
| Expenses: | | | | | | |
| General Government | 2,877,588 | 2,838,981 | - | - | 2,877,588 | 2,838,981 |
| Education | 9,181,575 | 9,086,399 | - | - | 9,181,575 | 9,086,399 |
| Transportation | 3,030,002 | 2,817,764 | - | - | 3,030,002 | 2,817,764 |
| Resources and Economic Development | 984,557 | 1,002,189 | - | - | 984,557 | 1,002,189 |
| Individual and Family Services | 12,712,219 | 12,663,265 | - | - | 12,712,219 | 12,663,265 |
| Administration of Justice | 2,639,166 | 2,632,736 | - | - | 2,639,166 | 2,632,736 |
| Interest and Charges on Long-term Debt | 228,580 | 228,207 | - | - | 228,580 | 228,207 |
| State Lottery | - | - | 1,121,043 | 1,030,374 | 1,121,043 | 1,030,374 |
| Virginia College Savings Plan | - | - | 96,158 | 243,271 | 96,158 | 243,271 |
| Unemployment Compensation | - | - | 639,824 | 661,739 | 639,824 | 661,739 |
| Alcoholic Beverage Control | - | - | 507,180 | 479,393 | 507,180 | 479,393 |
| Risk Management | - | - | 13,169 | 8,360 | 13,169 | 8,360 |
| Local Choice Health Care | - | - | 266,719 | 229,545 | 266,719 | 229,545 |
| Virginia Industries for the Blind | - | - | 32,091 | 28,148 | 32,091 | 28,148 |
| Consolidated Laboratory | - | - | 6,964 | 6,642 | 6,964 | 6,642 |
| eVA Procurement System | - | - | 19,370 | 17,199 | 19,370 | 17,199 |
| Department of Environmental Quality Title V | - | - | 10,939 | 10,173 | 10,939 | 10,173 |
| Wireless E-911 | - | - | 40,761 | 38,415 | 40,761 | 38,415 |
| Museum and Library Gift Shops | - | - | 6,146 | 6,697 | 6,146 | 6,697 |
| Behavioral Health Canteen and Work Activity | - | - | 450 | 13 | 450 | 13 |
| Total Expenses | 31,653,687 | 31,269,541 | 2,760,814 | 2,759,969 | 34,414,501 | 34,029,510 |
| Excess before transfers | 725,292 | 518,629 | 903,320 | 852,179 | 1,628,612 | 1,370,808 |
| Transfers | 668,503 | 614,637 | (668,503) | (614,637) | - | - |
| Increase in net assets | 1,393,795 | 1,133,266 | 234,817 | 237,542 | 1,628,612 | 1,370,808 |
| Net assets (deficit), July 1, as restated | 17,929,088 | 16,795,822 | 121,127 | (116,415) | 18,050,215 | 16,679,407 |
| Net assets, June 30 | \$ 19,322,883 | \$ 17,929,088 | \$ 355,944 | \$ 121,127 | \$ 19,678,827 | \$ 18,050,215 |

Governmental Activities Revenues

Figure 13 is a graphical representation of the Statement of Activities revenues for governmental activities. Governmental activities revenues increased by \$590.8 million, or 1.9 percent. The net increase is mainly attributable to increases in the General Fund, which are discussed on page 34.

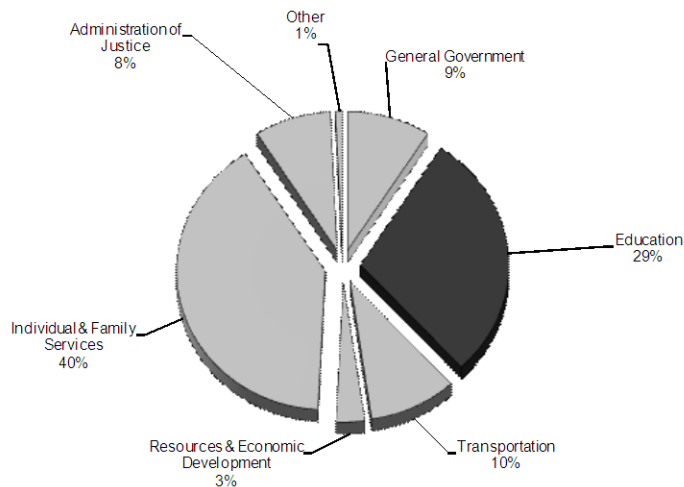
Figure 13
Revenues by Source – Governmental Activities
 Fiscal Year 2012



Governmental Activities Expenses

Figure 14 is a graphical representation of the Statement of Activities expenses for governmental activities. Governmental activities expenses increased by \$384.1 million or 1.2 percent. This change is primarily attributable to increases in all expense types with the exception of Resources and Economic Development. See pages 34 and 35 for additional information.

Figure 14
Expenses by Type – Governmental Activities
 Fiscal Year 2012



Net Assets of Business-type Activities

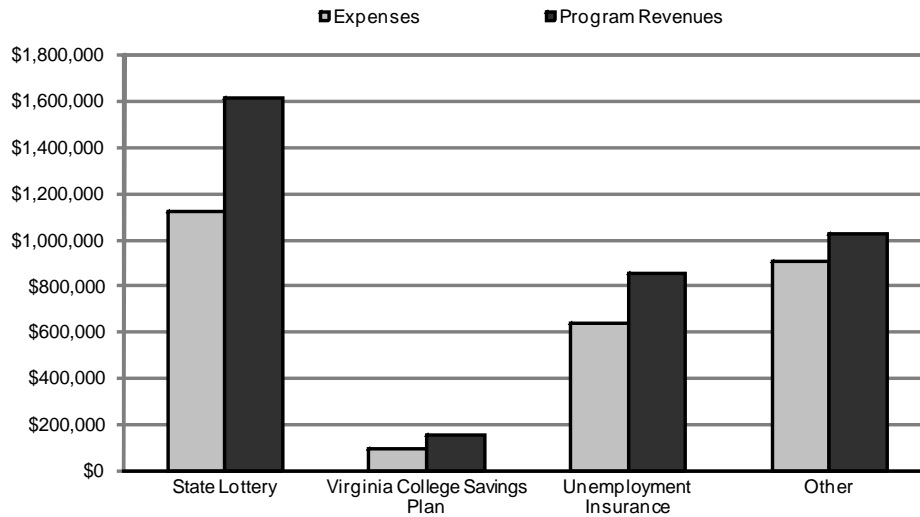
Net assets of business-type activities increased by \$234.8 million during the fiscal year. As shown in **Figure 15**, highlights of the changes in net assets for the major enterprise funds were as follows:

- Lottery sales were \$1.6 billion, an increase of \$133.3 million over the prior year. Net income was \$497.3 million, an increase of \$43.5 million (9.6 percent) from fiscal year 2011. Sales of scratch games increased by \$85.3 million (11.3 percent) and online sales increased by \$48.0 million (6.6 percent). This is offset by an increase of \$90.1 million (8.8 percent) in total expenses, primarily attributable to the cost of prizes and claims.
- Virginia College Savings Plan's net assets increased by \$63.3 million (863.4 percent). This change is primarily attributable to decreases in investment income and tuition benefits expense.
- Unemployment Compensation Fund net assets increased by \$202.6 million during fiscal year 2012, primarily as a result of an increase in the Employer Contribution rate for the Virginia Unemployment Trust Fund. Other factors adding to the fund were that it received a one-time \$68.0 million Federal Unemployment Tax credit and operating expenses decreased by \$21.9 million. These factors combined give the Trust Fund the large increase.

The Trust Fund became insolvent in October 2009, which required obtaining Federal repayable advances under Title XII of the Social Security Act totaling \$804.1 million during fiscal years 2010, 2011 and 2012. The advances enabled the Fund to continue benefit payments to claimants, and the Fund repaid the outstanding advance of \$445.8 million during fiscal year 2012. Additionally, the Fund received approval for a maximum of \$63.0 million in short-term Commonwealth Treasury Loans to meet cash flow needs and anticipates additional Federal advances in fiscal year 2013. See Note 37, "Subsequent Events," for additional information.

Over the one year period July 1, 2011 to June 30, 2012, the unemployment rate declined from 6.5 percent to 6.0 percent. Additionally, there were approximately 26,650 fewer initial unemployment claims filed than in the previous year. These declines were offset by increases in the average weekly benefit amounts from \$271.75 to \$280.60 and the average benefit duration from 14.8 weeks to 16.0 weeks in fiscal year 2012. These multiple influences led to a decrease in the total benefit payments of \$23.8 million over the prior year.

Figure 15
Business-type Activities
Program Revenues and Expenses
 For the Fiscal Year Ended June 30, 2012
 (Dollars in Thousands)



Fund Statements Financial Analysis

As of the end of the fiscal year, the primary government's governmental funds reported combined ending fund balances of \$4.4 billion, including a negative unassigned fund balance of \$820.9 million indicating that restricted and committed amounts exceed the available modified accrual basis fund balance. The remainder of fund balance is nonspendable, restricted or committed to indicate that it is not available for new spending.

General Fund Highlights

At the end of the fiscal year, the General Fund reported a combined ending fund balance of \$512.4 million, an increase of \$571.1 million in comparison with the prior year. Of this total fund balance, \$117.9 million represents nonspendable fund balance, \$729.3 million represents restricted fund balance, and \$486.1 million represents committed fund balance. These amounts are offset by a negative \$820.9 million unassigned fund balance.

Fiscal year 2012 General Fund revenues were 5.9 percent or \$971.6 million higher than fiscal year 2011 revenues. This revenue change results from increases of \$1.0 billion primarily attributable to individual and fiduciary income taxes (\$664.0 million), sales and use tax (\$129.3 million), and corporation income taxes (\$123.1 million) offset by decreases of \$68.5 million primarily attributable to premiums of insurance companies (\$28.3 million) and communication sales and use tax (\$17.5 million).

Fiscal year 2012 expenditures increased by \$864.4 million as compared to fiscal year 2011. This was primarily attributable to increases in individual and family services expenditures, education, and resources and economic development expenditures of \$625.5 million, \$211.6 million, and \$49.1 million, respectively, offset by decreases to general government expenditures of \$37.8 million. Net other financing sources and uses decreased by \$52.1 million which is primarily due to higher transfers out to nongeneral funds.

Budget Highlights

The General Fund began the year with an original revenue budget that was \$903.0 million or 5.7 percent higher than the final fiscal year 2011 revenue budget. Additionally, the final revenue budget was slightly higher (\$167.3 million or 1.0 percent) than the original budget. The change between the original and final budget was primarily attributable to increases in the final budget for individual and fiduciary income taxes of \$196.8 million offset by a decrease in the final budget for sales and use taxes of \$58.5 million. Total actual General Fund revenues were greater than final budgeted revenues by \$242.6 million.

Total final budget expenditures were less than original budget expenditures by \$14.9 million or 0.1 percent. This decrease was primarily attributable to general government expenditures of \$137.6 million and individual and family services expenditures of \$66.4 million offset by increases in education expenditures of \$95.0 million, administration of justice expenditures of \$58.9 million and resources and economic development expenditures of \$32.1 million.

The Commonwealth spent less than planned so actual expenditures were \$495.9 million or 2.9 percent lower than final budget expenditures.

Budget Outlook

In order to mitigate the effects of difficult economic conditions over the past several years, the Commonwealth adopted several temporary budget solutions such as, accelerated sales taxes, temporary pension funding strategy modifications (discussed further on the next page) and the continued receipt of additional federal funding. As a result of the Commonwealth's improving economy, these temporary budget solutions are being phased-out.

The economic indicators for fiscal year 2012 reflect a growing economy. Rising employment levels, faster income growth, higher consumer confidence, and the continued upward trends in the housing market drove growth in withholding, sales, and recordation taxes. During fiscal year 2012, the two General Fund revenue sources most closely tied to current economic activity – retail sales taxes and payroll withholding – experienced growth rates exceeding the annual estimate by \$55.5 million (1.8 percent) and \$33.7 million (0.3 percent), respectively. There is planned growth in the adopted budget for the 2012-2014 biennium (fiscal years 2013 and 2014). Based on the most recent General Fund revenue estimate, fiscal year 2013 revenue is projected to increase 2.9 percent over the fiscal year 2012 revenue collections.

While this revenue growth is expected to continue during the 2012-2014 biennium, pressures on the economic recovery persist due to the effect of federal budget uncertainties. In response to this uncertainty, the Commonwealth created the Federal Action Contingency Trust Fund and deposited \$30.0 million to assist in mitigating the potential effect of federal budget uncertainties on the Virginia economy. In addition the Governor instructed Cabinet Secretaries to prepare and submit plans for 4.0 percent reductions in General Fund spending for the fiscal year 2014. The Governor will release his final amendments to the 2012-2014 biennial budget on December 17, 2012.

Pension Funding

Effective for fiscal year 2012, the Commonwealth has approved a VRS contribution rate that is lower than the certified rate. VRS will receive contributions computed using the lower rate from all participating funds. In certain instances, the General Fund will receive the monetary differential between the certified and approved contribution rates. Additional information on all plans and the impact of funding rates on the Commonwealth's liability can be found in Note 14, "Retirement and Pension Systems."

Major Special Revenue Fund Highlights

The Commonwealth Transportation Fund ended the fiscal year with a fund balance of \$2.7 billion, an increase of \$312.1 million from the prior year. Approximately \$2.9 billion is contractually committed for various highway, public transportation, and rail preservation projects (see Note 19). The increase in fund balance was primarily due to the issuance of capital projects revenue bonds in the amount of \$897.6 million. Additionally, revenues and expenditures increased \$22.3 million, or 0.6 percent and \$603.8 million, or 15.5 percent, respectively. This increased activity is primarily due to expenditures for highway maintenance, acquisition and construction.

The Federal Trust Fund balance, as restated, increased by \$66.0 million, or 195.8 percent. A decrease in Federal Grants and Contracts revenue of approximately \$790.7 million, or 8.2 percent, was offset by a decrease in total expenditures of approximately \$863.0 million, or 8.9 percent. The decrease in Federal Grants and Contracts revenue was primarily due to the receipt of \$635.2 million in American Recovery and Reinvestment Act revenue which was \$947.5 million less than the previous fiscal year. Also contributing to the overall reduction were decreases of \$56.5 million for Medicaid funding and \$139.2 million for unemployment insurance. These decreases were offset by increases in food and home energy assistance programs of \$179.9 million and education grants of \$98.8 million.

The Literary Fund's fund balance decreased by \$22.0 million, or 18.4 percent, in fiscal year 2012 from fiscal year 2011. The decrease is the result of net disbursements exceeding net receipts by \$33.7 million, offset by a cash transfer in of \$11.3 million from the State Lottery representing unclaimed prizes.

Capital Asset and Long-term Debt

Capital Assets. The primary government's investment in capital assets for its governmental and business-type activities as of June 30, 2012, amounts to \$24.0 billion (net of accumulated depreciation totaling \$13.6 billion). This investment in capital assets includes land, buildings, improvements, equipment, infrastructure, construction-in-progress, and intangible assets including water rights, easements, and software. Infrastructure assets are items that are normally immovable such as roads, bridges, drainage systems, and other similar assets. As noted on page 30, increases in current and other assets coupled with increases in capital assets resulted in an increase in net assets of the governmental activities of \$1.4 billion or 7.8 percent. The increase in the primary government's investment in capital assets was primarily attributable to increases in infrastructure and buildings of \$940.5 million and \$263.0 million, respectively. These increases are primarily attributable to transportation. The primary government reports equipment with a value of \$50,000 or greater and an expected useful life of two or more years. The primary government capitalizes all land, buildings, infrastructure, and intangible assets that have a cost or value greater than \$100,000 and an expected useful life of two or more years. Additional information on the primary government's capital assets can be found in Note 12, "Capital Assets."

Figure 16
Capital Assets as of June 30, 2012
(Net of Depreciation)
(Dollars in Thousands)

| | <u>Governmental Activities</u> | <u>Business-type Activities</u> | <u>Total</u> |
|--------------------------|------------------------------------|-------------------------------------|----------------------|
| Land | \$ 2,612,758 | \$ 1,977 | \$ 2,614,735 |
| Buildings | 2,382,526 | 12,789 | 2,395,315 |
| Equipment | 469,082 | 17,238 | 486,320 |
| Water Rights/Easements | 48,449 | - | 48,449 |
| Infrastructure | 14,746,302 | - | 14,746,302 |
| Software | 210,282 | 1,621 | 211,903 |
| Construction-in-Progress | 3,545,752 | 734 | 3,546,486 |
| Total | \$ 24,015,151 | \$ 34,359 | \$ 24,049,510 |

Long-term Debt. The Commonwealth is prohibited from issuing general obligation bonds for operating purposes. At the end of the current fiscal year, the Commonwealth had total debt outstanding of \$36.1 billion, including total tax-supported debt of \$14.2 billion and total debt not supported by taxes of \$21.9 billion. Bonds backed by the full faith and credit of the government and tax-supported total \$1.8 billion. Debt is considered tax-supported if Commonwealth tax revenues are used or pledged for debt service payments. An additional \$801.4 million is considered moral obligation debt which is not tax-supported. The Commonwealth has no direct or indirect pledge of tax revenues to fund reserve deficiencies. However, in some cases, the Commonwealth has made a moral obligation pledge to consider funding deficiencies in debt service reserves that may occur. The remainder of the Commonwealth's debt represents bonds secured solely by specified revenue sources (i.e., revenue bonds).

During fiscal year 2012, the Commonwealth issued \$7.3 billion of new debt for various projects. \$1.8 billion of the new debt was for the primary government and \$5.5 billion for the component units. Additional information on the Commonwealth's outstanding debt can be found on page 145 in Note 25, "Long-Term Liabilities," as well as in the section entitled "Debt Schedules." The Commonwealth maintains a "triple A" bond rating for general obligation debt from the three rating agencies: Moody's Investors Service; Standard & Poor's Ratings Group, a division of The McGraw Hill Companies, Inc.; and Fitch, Inc.

State statutes limit the amount of general obligation debt the Commonwealth may issue for each specific type of debt. The 9(a) bonds, which may be issued to fund the defense of the Commonwealth; to meet casual deficits in revenue or in anticipation of the collection of revenues; or to redeem previous debt obligations, and are limited to 30 percent of 1.15 times the annual tax revenues for fiscal year 2012. The 9(b) bonds, which have been authorized by the citizens of Virginia through bond referenda to finance capital projects, are limited to 1.15 times the average of selected tax revenues for fiscal years 2010, 2011, and 2012. The 9(c) bonds, which have been issued to finance capital projects that will generate revenue upon their completion, are limited to 1.15 times the average of selected tax revenues for fiscal years 2010, 2011, and 2012. The current debt limitation for the Commonwealth is \$5.1 billion, \$15.2 billion, and \$15.1 billion, respectively, for the 9(a), 9(b), and 9(c) general obligation bond issues. These limits significantly exceed the Commonwealth's outstanding general obligation debt. Currently, there is no 9(a) debt outstanding.

Figure 17
Outstanding Debt as of June 30, 2012
General Obligation Bonds
(Dollars in Thousands)

| | <u>Primary Government</u> | | | <u>Component Units</u> |
|--------------------------|------------------------------------|-------------------------------------|-------------------|----------------------------|
| | <u>Governmental Activities</u> | <u>Business-type Activities</u> | <u>Total</u> | |
| General obligation bonds | | | | |
| 9(b) | \$ 831,148 | \$ - | \$ 831,148 | \$ - |
| 9(c) | 42,593 | - | 42,593 | 906,474 |
| Total | \$ 873,741 | \$ - | \$ 873,741 | \$ 906,474 |

Economic Factors and Review

In fiscal year 2012, the nation continued its slow recovery from what is considered the worst financial and economic downturn since the "Great Depression" of the 1930s. Economic data show that the upward trend continues to be better in the Commonwealth than at the national level. During the fiscal year, the Commonwealth's nonfarm employment growth rate improved slightly for the second year in a row, increasing by 1.6 percent as compared to 1.5 percent at the national level. The Commonwealth's personal income in current dollars also continued to increase, but only by 4.1 percent during the fiscal year. Unemployment in the Commonwealth and at the national level continued to decline during the fiscal year, reaching 6.0 percent and 8.5 percent, respectively. Total taxable sales in the Commonwealth experienced an increase of 4.7 percent over fiscal year 2011. Economic indicators show that the housing market in the Commonwealth and at the national level experienced increases of 10.6 percent and 19.7 percent, respectively, during fiscal year 2012. Following a small decline in 2011, fiscal year 2012 saw housing prices experience a very slight increase of 0.4 percent in the Commonwealth. However, this is better than the national level, which also improved, but which was still a negative 0.6 percent. Overall, the Commonwealth has continued to perform better than the nation in many areas of growth. This continuing positive trend is a good sign of the economic recovery. For a more in-depth discussion on the Commonwealth's economy see "Economic Review" beginning on page 8.

In August 2011, Moody's revised the Commonwealth's credit outlook to negative due to the Commonwealth's reliance on federal employment and procurement and uncertainties surrounding the federal budget. In response to this uncertainty, the Commonwealth created the Federal Action Contingency Trust Fund and deposited \$30.0 million to assist in mitigating the potential effect on the economy of the Commonwealth. Additionally, the Governor instructed Cabinet Secretaries to prepare and submit plans for 4.0 percent reductions in General Fund spending for the fiscal year 2014.

Requests for Information

This financial report is designed to provide a general overview of the Commonwealth's finances for all those with an interest in the government's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the State Comptroller's Office, Commonwealth of Virginia, P. O. Box 1971, Richmond, Virginia 23218. This report is also available for download at www.doa.virginia.gov.

The Commonwealth's component units issue their own separate financial statements. Contact information regarding each component unit is provided in Note 1.B.

