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December 12, 2003



David A. Von Moll, CPA, CGFM
Comptroller
Post Office Box 1971
Richmond, Virginia 23218

The Honorable Mark R. Warner
Governor of the Commonwealth of Virginia
State Capitol
Richmond, Virginia 23219

Dear Governor Warner:

It is my pleasure to present the Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2003, in accordance with Section 2.2-813 of the *Code of Virginia*.

This report consists of management's representations concerning the Commonwealth of Virginia's finances. Management assumes full responsibility for the completeness and reliability of all information presented. This report reflects my commitment to you, to the citizens of the Commonwealth, and to the financial community to maintain our financial statements in conformance with accounting principles generally accepted in the United States of America (GAAP) as established by the Governmental Accounting Standards Board (GASB). Data presented in this report is believed to be accurate in all material respects, and all disclosures that are necessary to enable the reader to obtain a thorough understanding of the Commonwealth's financial activities have been included.

The 2003 CAFR is presented in three sections. The Introductory Section includes a financial overview, discussion of the Virginia economy, and organization charts for State government. The Financial Section includes the State auditor's report, management's discussion and analysis (MD&A), audited government-wide and fund financial statements and notes thereto, required supplementary information other than MD&A, and the underlying combining and individual fund financial statements and supporting schedules. The Statistical Section sets forth selected unaudited economic, financial trend, and demographic information for the Commonwealth on a multi-year basis.

In accordance with Section 30-133 of the *Code of Virginia*, the Auditor of Public Accounts has audited the Commonwealth's financial statements for the year ended June 30, 2003. The audit was conducted in accordance with auditing standards generally accepted in the United States of America and Government Auditing Standards issued by the Comptroller General of the United States. The auditor's opinion is included in the Financial Section of this report. Audit testing for compliance with the Federal Single Audit Act Amendments of 1996 and the related OMB Circular A-133 is performed at the statewide level. The Commonwealth's Single Audit Report will be issued at a later date. I would like to acknowledge the Auditor of Public Accounts' staff for their many contributions to the preparation of this report.

It should be noted that GAAP requires the MD&A mentioned above to include a narrative introduction, overview, and analysis to accompany the basic financial statements. This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. The Commonwealth's MD&A can be found immediately following the independent auditor's report on page 31.

The Government Finance Officers Association of the United States and Canada (GFOA) awarded the Certificate of Achievement for Excellence in Financial Reporting to the Commonwealth for its CAFR for the fiscal year ended June 30, 2002. 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 that conforms to program standards. Such reports must satisfy both accounting principles generally accepted in the United States of America and all applicable legal requirements.

A Certificate of Achievement is valid for a period of one year. The Commonwealth has received a Certificate of Achievement for the last seventeen consecutive years (fiscal years 1986-2002). I believe that this year's report continues to conform to the Certificate of Achievement program requirements and we are submitting it to GFOA.

This report could not have been prepared without the full cooperation of all State agencies within the Executive Branch, the Legislature, the Judiciary, the Component Units, and especially the dedication and professionalism of the financial reporting staff in the Department of Accounts.

Respectfully submitted,

David A. Von Moll

Comptroller of the Commonwealth of Virginia

Financial Overview

General Fund Condition – Overall

Virginia uses the cash basis of accounting for budgetary purposes. Revenues and expenditures are recorded at the time cash is actually received or disbursed according to the provisions of the Appropriation Act. The basis of budgeting financial activity of the General Fund is presented as Required Supplementary Information on page 158 in the Financial Section.

Figure 1 shows the General Fund ending fund balances on a basis of budgeting since fiscal year 1999. All of the \$554.8 million ending fund balance at June 30, 2003, was reserved or designated, including \$247.5 million for the Revenue Stabilization Reserve Fund, \$65.7 million for the Payroll Reserve, and \$241.6 million designated for reappropriation, appropriation, or transfer in fiscal year 2004. **Figure 2** shows the General Fund ending fund balances since fiscal year 1999, using the modified accrual basis of accounting. Additional data for general fund balances are located on page 282 in the Statistical Section.

General Fund Revenues, Expenditures, and Other Financing Sources (Uses)

Figure 3 presents a detailed analysis of General Fund revenue on a basis of budgeting for the year ended June 30, 2003. Prior year data is shown for comparison purposes. Overall, revenue and transfers in increased by 3.6 percent and is mainly attributable to an overall increase in tax revenue collections and transfers in.

Figure 4 shows General Fund expenditures by function on a basis of budgeting for the year ended June 30, 2003. Overall, expenditures and transfers out decreased by 0.6 percent during fiscal year 2003.

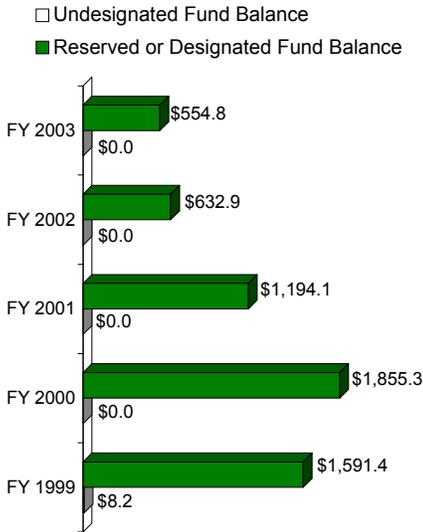
General Fund Condition - Modified Accrual Basis

Although the Commonwealth budgets and manages its financial affairs using the basis of budgeting, GAAP requires that states use the modified accrual basis of accounting to prepare fund financial statements. The modified accrual basis of accounting recognizes revenues when they become both measurable and available to finance operations throughout the fiscal year or to liquidate liabilities at the end of the fiscal year. Expenditures are recognized when a liability occurs. The accruals recorded on the financial statements for the fiscal year ended June 30, 2003, reflect cash that will not be received or disbursed until fiscal year 2004.

Accruals of revenues and expenditures required by the modified accrual basis of accounting resulted in a decrease of \$491.2 million from the \$554.8 million basis of budgeting General Fund balance (**Figure 5**). Starting in fiscal year 2002 with the implementation of GASB Statement No. 34, Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments (GASB Statement No. 34), full accrual data is also required. Please refer to the Management Discussion and Analysis on page 31 in the Financial Section for additional analysis.

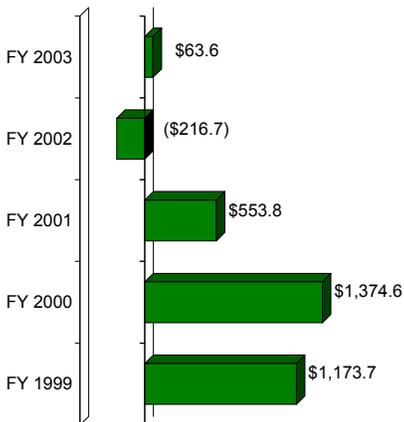
General Fund Balance – Basis of Budgeting Highlighting the Undesignated Fund Balance

(Dollars in Millions) *Figure 1*



General Fund Balance – GAAP Basis

(Dollars in Millions) *Figure 2*



Analysis of General Fund Revenues and Other Financing Sources

(Basis of Budgeting)

(Dollars in Thousands)

Figure 3

	FY 2003	FY 2002	Increase (Decrease)	FY 2003 % of Total
Taxes:				
Individual and Fiduciary Income	\$ 6,775,746	\$ 6,710,772	\$ 64,974	1.0
Sales and Use	2,335,958	2,429,845	(93,887)	(3.9)
Corporation Income	343,319	290,215	53,104	18.3
Public Service Corporations	91,247	77,152	14,095	18.3
Premiums of Insurance				
Companies	333,004	292,702	40,302	13.8
Other	574,051	487,826	86,225	17.7
Subtotal - Taxes	<u>10,453,325</u>	<u>10,288,512</u>	<u>164,813</u>	1.6
Other Revenue	<u>537,673</u>	<u>454,505</u>	<u>83,168</u>	18.3
Total Revenues	<u>10,990,998</u>	<u>10,743,017</u>	<u>247,981</u>	2.3
Other Financing Sources:				
Transfers and Other Sources	<u>987,096</u>	<u>820,518</u>	<u>166,578</u>	20.3
Total Revenues and Other Financing Sources	<u>\$ 11,978,094</u>	<u>\$ 11,563,535</u>	<u>\$ 414,559</u>	3.6

Analysis of General Fund Expenditures By Function and Other Financing Uses

(Basis of Budgeting)

(Dollars in Thousands)

Figure 4

	FY 2003	FY 2002	% Increase (Decrease)	FY 2003 % of Total
General Government	\$ 1,367,126	\$ 1,350,940	1.2	11.3
Education	5,441,934	5,542,589	(1.8)	45.1
Transportation	36	16,002	(99.8)	0.0
Resources and Economic				
Development	206,743	251,856	(17.9)	1.7
Individual and Family Services	2,769,780	2,550,020	8.6	23.0
Administration of Justice	1,867,835	1,910,280	(2.2)	15.5
Capital Outlay	<u>19,752</u>	<u>119,046</u>	<u>(83.4)</u>	<u>0.2</u>
Total Expenditures	<u>11,673,206</u>	<u>11,740,733</u>	<u>(0.6)</u>	<u>96.8</u>
Other Financing Uses:				
Transfers and Other Uses	<u>383,066</u>	<u>383,940</u>	<u>(0.2)</u>	<u>3.2</u>
Total Expenditures and Transfers	<u>\$ 12,056,272</u>	<u>\$ 12,124,673</u>	<u>(0.6)</u>	<u>100.0</u>

Analysis of General Fund Balance

Basis of Budgeting versus Modified Accrual Basis

(Dollars in Millions)

Figure 5

	FY 2003	FY 2002	Variance
Fund Balance, Budgetary Basis (1)	\$ 554.8	\$ 632.9	\$ (78.1)
Receivables, Inventory and Accrued Revenues:			
Sales Tax Receivable	87.1	85.4	1.7
Other Tax Receivable	281.5	280.5	1.0
Other Receivables (2)	85.4	89.1	(3.7)
Inventory	37.1	34.8	2.3
Other Accrued Items (3)	46.1	55.2	(9.1)
Total Accrued Receivables, Inventory and Other	537.2	545.0	(7.8)
Payables and Accrued Expenditures:			
Tax Refunds Payable	217.9	226.5	(8.6)
Deferred Taxes (4)	168.1	501.8	(333.7)
Medicaid Claims Payable	160.4	184.3	(23.9)
Sales Tax Due to Localities	143.9	145.0	(1.1)
Other Accrued Items (5)	338.1	337.0	1.1
Total Payables and Accrued Expenditures	1,028.4	1,394.6	(366.2)
Receivables and Accrued Revenues Under			
Payables and Accrued Expenditures	(491.2)	(849.6)	358.4
Fund Balance, Modified Accrual Basis	\$ 63.6	\$ (216.7)	\$ 280.3

- (1) The FY 2003 amount is \$2.4 million less than the amount reported in the August 15, 2003, Preliminary (Unaudited) Annual Report of the Comptroller. The difference is due to ABC audit adjustments.
- (2) This includes Accounts Receivable, Interest Receivable, and Other Taxes Receivable. An additional \$284.2 million and \$138.8 million in Receivables offset by Deferred Revenue are reported in the General Fund for FY 2003 and FY 2002, respectively. These additional Receivables will be collected after August 31; therefore, the revenue is only reported on the Government-wide Statement of Activities.
- (3) This includes Lottery and ABC Profit Transfers, Increase of Investments to Fair Value which must be recorded in accordance with GASBS No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, Due From Other Funds, and accelerated sales tax overpayments. Accelerated sales overpayments of \$6.1 million and \$9.7 million for FY 2003 and FY 2002, respectively, are included as a reduction to Other Accrued Items.
- (4) Prior to FY 2003, Deferred Taxes were reported as Deferred Credit. Also, prior to FY 2003, the estimated underpayments of corporate and individual income taxes were not included in the estimation of the Deferred Credit amount. For additional information describing the calculation of Deferred Taxes, see footnote 1.P.
- (5) This includes Accounts Payable, ABC Profits Due to Localities, Other Payments Due to Other Governments, Car Tax Refund Payable, and Due To Other Funds.

Proprietary Fund Operations of the Primary Government

Section 58.1-4022(D) of the *Code of Virginia* requires that the State Lottery Department transfer to the General Fund the audited balances of the State Lottery Fund, net of established reserves. The Auditor of Public Accounts has certified \$375.2 million for transfer to the General Fund for fiscal year 2003. Section 3-1.01.G1 of Chapter 1042, 2003 Acts of Assembly, requires that the Comptroller transfer estimated lottery balances to the General Fund prior to the end of the fiscal year. In accordance with Article X, Section 7-A of the Constitution of Virginia, lottery proceeds must be distributed to the Commonwealth's localities and the school divisions to be expended for the purposes of public education.

Debt Administration

Virginia is one of only seven states in the nation with 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. These ratings reflect the Commonwealth’s long-standing record of sound fiscal management, its diversified economic base, and low debt ratios.

The total debt of the Commonwealth, as of June 30, 2003, was \$17.8 billion. Of that amount, \$5.3 billion (30 percent) was tax-supported debt. Debt is considered tax supported if State tax revenues are used or pledged for debt service payments. This includes all debt issued pursuant to Article X, Sections 9(a), 9(b) and 9(c) of the Constitution of Virginia, as well as selected Section 9(d) debt issues and other long-term obligations.

Outstanding general obligation debt backed by the full faith and credit of the Commonwealth totaled \$917.1 million at June 30, 2003. Included is Section 9(b) debt totaling \$410.7 million for Public Facilities, and \$43.7 million for Transportation Facilities. In 2002, Virginia voters approved two general obligation bond referenda authorizing \$1,014.5 million in new capital projects for educational and park and recreational facilities of the Commonwealth. In June 2003, \$50.4 million in general obligation bonds were sold, representing the first issuance under this authorization. Principal and interest payments on Public Facilities Section 9(b) debt were less than one-tenth of one percent of total General Fund expenditures in fiscal year 2003.

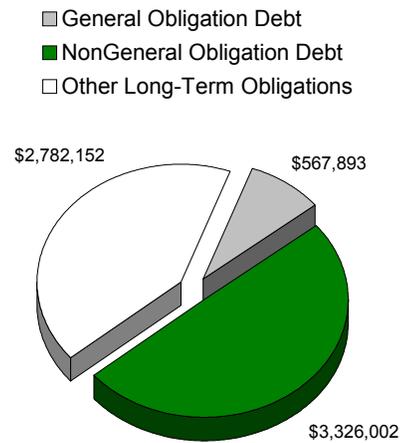
The balance of general obligation debt of \$462.7 million, also backed by the full faith and credit of the Commonwealth, consisted of Section 9(c) bonds. Revenue-producing capital projects, primarily auxiliary enterprises of colleges and universities and transportation toll facilities, service these bond payments. Holders of Section 9(c) bonds have a legal claim to general tax revenues of the Commonwealth should revenues prove to be insufficient to meet principal and interest payments. Such claims on general tax revenue have not been made.

The remaining \$4.4 billion in tax-supported debt is made up of selected Section 9(d) bonded debt and other long-term obligations. Tax-supported Section 9(d) debt totaling \$2.8 billion includes transportation debt, as well as the Virginia Port Authority, Virginia Public Building Authority, Innovative Technology Authority, Virginia Biotechnology Research Park Authority, and certain Virginia College Building Authority bonds payable. Other tax-supported long-term obligations include capital leases, certain appropriation supported bonds, installment purchases, notes payable, pension liability, IDA obligations, Virginia Public Broadcasting Board Notes, and compensated absences.

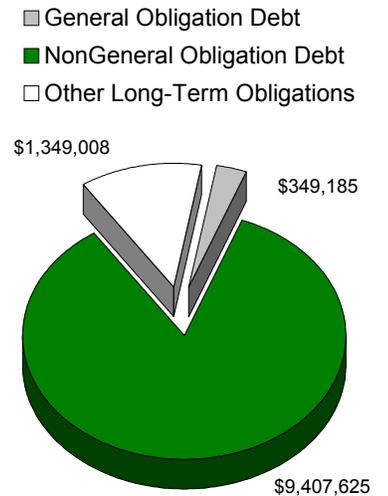
None of the remaining debt of the Commonwealth, which totals \$12.5 billion, is supported by tax revenues. The Commonwealth has no direct or indirect pledge of tax revenues to fund reserve deficiencies. However, in some cases, the Commonwealth has made a moral obligation pledge to consider funding deficiencies in debt service reserves that may occur. At June 30, 2003, \$2.0 billion, or 16 percent, of debt not supported by taxes was considered moral obligation debt.

A detailed summary of all the debt issues may be found in Note 18, as well as in the section entitled “Debt Schedules.”

**Total Outstanding Debt
Primary Government**
June 30, 2003
(Dollars in Thousands) **Figure 6**



**Total Outstanding Debt
Component Units**
June 30, 2003
(Dollars in Thousands) **Figure 7**



Investment Policy

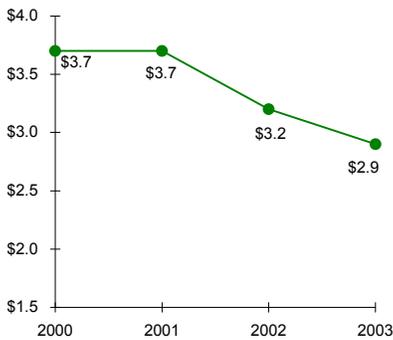
The Commonwealth's primary investment objectives are safety of principal, maintenance of needed liquidity, and attaining a market rate of return throughout budgetary and economic cycles. Accordingly, investments are made in compliance with the *Code of Virginia*, with adherence to specific guidelines adopted by the Treasury Board, and with consideration given to the prevailing investment environment.

The general account of the Commonwealth is a pool of investments representing assets of a number of funds, including the general fund, various higher education operating funds, and the Commonwealth Transportation Trust Fund. These monies are invested in a variety of high quality securities including U.S. Treasury and agency securities, corporate debt securities of domestic corporations, asset-backed securities, mortgage-backed securities, AAA-rated dollar obligations of foreign governments, bankers acceptances, negotiable certificates of deposit and bank notes, repurchase agreements, and money market funds. The general account portfolio is divided into two pools, the primary liquidity pool and the total return pool. The primary liquidity pool is internally managed by Treasury staff and is the major source for disbursement requirements and operational needs of the Commonwealth. The objective of the total return pool, which is externally managed, is to generate higher total returns over a market cycle than would be generated by the primary liquidity pool. Treasury's allocation target for the overall general account asset mix is currently 75 percent for the primary liquidity pool and 25 percent for the total return pool.

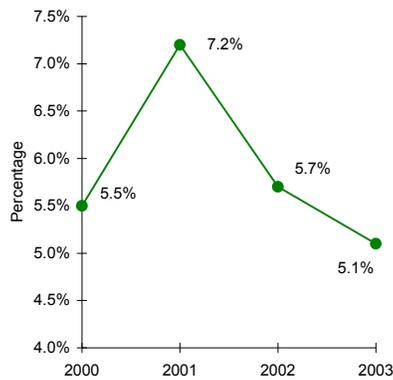
The average daily invested balance (**Figure 8**) for the fiscal year ended June 30, 2003, was \$2.9 billion, down \$300 million from the fiscal year 2002 average. The average yield or return (**Figure 9**) of 5.1 percent for fiscal year 2003 was below the 5.7 percent return for fiscal year 2002. Lower invested balances and lower interest rates combined to reduce fiscal year 2003 earnings to \$147.2 million (**Figure 10**) versus fiscal year 2002 earnings of \$178.5 million. During this fiscal year, the Federal Reserve lowered interest rates another 75 basis points. The targeted federal funds rate at June 30, 2003 was 1.00 percent with expectations that it will remain at this level for some time.

In addition to the general account of the Commonwealth, the Department of the Treasury manages or sponsors a number of individual customized investment programs and two special purpose investment pools. The Local Government Investment Pool (LGIP) is a special purpose money market-like fund managed by Treasury staff for the benefit of public entities of the Commonwealth in the investment of their short-term funds. The LGIP enables participants to maximize their return on investments by providing a fund where monies can be commingled for investment purposes in order to realize the economies of large-scale investing and professional funds management. The State Non-Arbitrage Program (SNAP) is a program providing comprehensive investment management, accounting, and arbitrage rebate calculations for proceeds of tax-exempt financings of Virginia bond issuers. The Treasury Board contracts with an outside manager for administration of the SNAP program. The Treasury Board has adopted investment guidelines for both the LGIP and SNAP, authorizing them to invest in certain high-quality, short-term securities appropriate for money market funds. LGIP shareholder balances averaged \$2.2 billion for fiscal year ended June 30, 2003, with year-end balances of \$2.8 billion. SNAP shareholder balances averaged \$2.1 billion for the fiscal year with year-end balances of \$2.2 billion.

Average Daily Invested Balance
By Fiscal Year
(Dollars in Billions) *Figure 8*



Average Yield on Investments
By Fiscal Year
Figure 9



Net Earnings on Investments
By Fiscal Year
(Dollars in Millions) *Figure 10*



Risk Management

The Commonwealth maintains self-insurance programs for employee health, general (tort) liability, medical malpractice, workers' compensation, property, and automobile liability insurance. These are reported in the Internal Service Funds. The Commonwealth assumes the full risk for claims filed under the employee health insurance program and the workers' compensation program. For the other programs, the risk assumed is limited to certain amounts per occurrence.

The Commonwealth also provides employee health, errors and omissions liability, commuter rail liability, and law enforcement professional liability insurance for local governmental units throughout the Commonwealth. These programs are accounted for in the Enterprise Funds. Additional information on all risk management programs is presented in Note 15 to the Financial Statements.

Retirement Systems

The Commonwealth provides a variety of retirement plans for its employees. The majority of employees participate in one of the four defined benefit plans administered by the Commonwealth. These defined benefit plans are the Virginia Retirement System, the State Police Officers' Retirement System, the Judicial Retirement System, and the Virginia Law Officers Retirement System. Certain employees may elect to participate in selected defined contribution pension plans. Further information on the state's participation in the retirement systems can be found in Note 10 to the financial statements.

Reporting Entity

For financial reporting purposes, the Commonwealth's reporting entity consists of (1) the primary government, (2) component unit organizations for which the primary government is financially accountable (blended component units), and (3) other component unit organizations for which the nature and significance of their relationship with the primary government is such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete (discrete component units). The funds and accounts of all agencies, boards, commissions, foundations, and authorities that have been identified as the primary government or a component unit have been included.

Section 2100 of the *GASB Codification of Governmental Accounting and Financial Reporting Standards* (GASB Codification) describes the criteria for determining which organizations, functions, and activities should be considered part of the Commonwealth for financial reporting purposes. The basic criteria include appointing a voting majority of an organization's governing body, as well as the Commonwealth's ability to impose its will on that organization, or the potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the Commonwealth.

Internal Controls

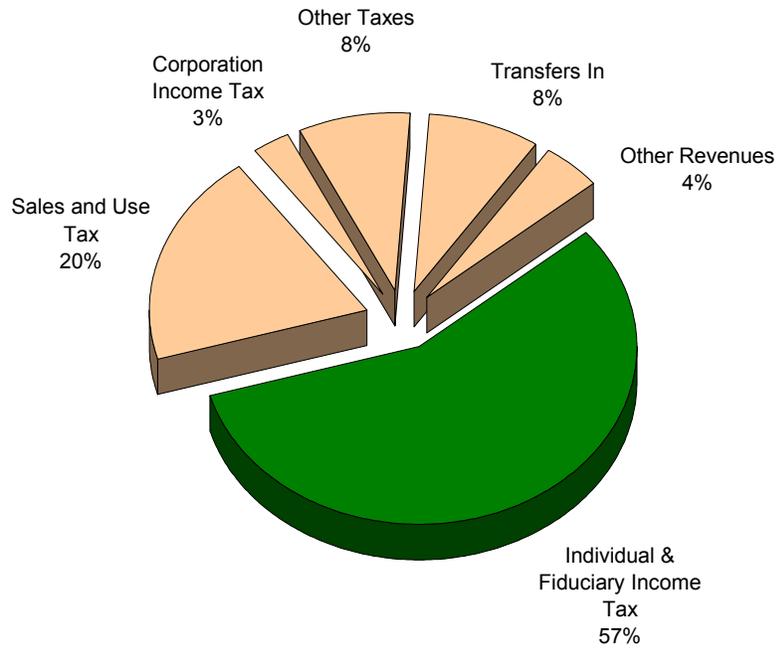
The Commonwealth's management is responsible for the establishment and maintenance of internal accounting controls that ensure assets are safeguarded and financial transactions are properly recorded and adequately documented. To ensure that the costs of controls do not exceed the benefits obtained, management is required to use estimates and judgments to attain reasonable assurance as to the adequacy of such controls. The Commonwealth's established internal controls fulfill these requirements.

Certain budgetary controls also are maintained to ensure compliance with the legal provisions of the Commonwealth's Appropriation Act, which reflects the General Assembly's approval of a biennial budget. The financial transaction process begins with development and approval of the budget, after which budgetary control is maintained through a formal appropriation and allotment system. The budgeted amounts reflected in the accompanying financial statements represent summaries of agency budgets.

Financial Highlights

General Fund

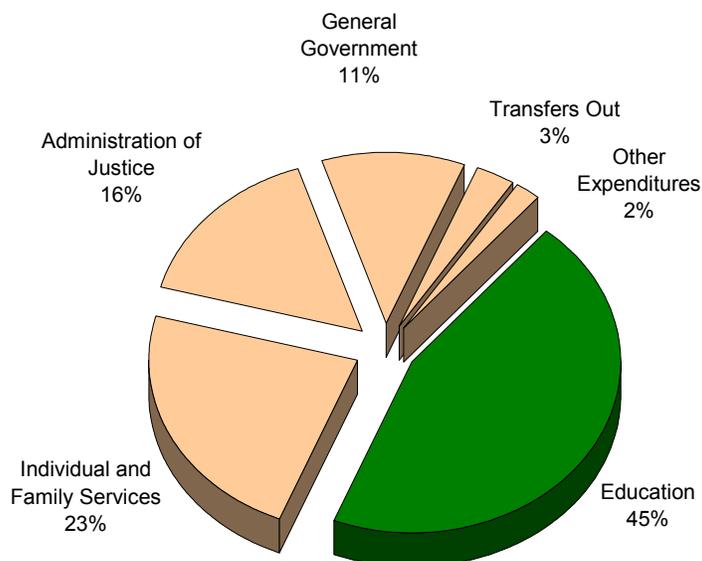
Figure 11
Revenue Dollar
 Fiscal Year 2003
 (Basis of Budgeting)



<u>Revenues and Other Financing Sources</u>	<u>FY 2003</u>	<u>FY 2002</u>
Individual & Fiduciary Income Tax	57%	58%
Sales and Use Tax	20%	21%
Corporation Income Tax	3%	3%
Other Taxes	8%	7%
Transfers In	8%	7%
Other Revenues	4%	4%
Total	<u>100%</u>	<u>100%</u>

General Fund

Figure 12
Expenditure Dollar
 Fiscal Year 2003
 (Basis of Budgeting)



<u>Expenditures and Other Financing Uses</u>	<u>FY 2003</u>	<u>FY 2002</u>
Education (1)	45%	46%
Individual and Family Services	23%	21%
Administration of Justice	16%	16%
General Government (2)	11%	11%
Transfers Out	3%	3%
Other Expenditures (3)	2%	3%
Total	<u>100%</u>	<u>100%</u>

- (1) Includes fiscal year 2003 and fiscal year 2002 transfers out to higher education institutions, 10% and 11%, respectively, of Total Expenditures and Other Financing Uses.
- (2) Includes payments to localities pursuant to the Personal Property Tax Relief Act of 1998, totaling \$856.7 million and \$826.2 million and 63% and 61% of the fiscal year 2003 and fiscal year 2002, respectively, total General Government expenditures.
- (3) Includes Transportation, Resources and Economic Development, and Capital Outlay expenditures.

Certificate of Achievement for Excellence in Financial Reporting

Presented to

Commonwealth of Virginia

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2002

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



President

Executive Director