

STATE OF ARIZONA
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2007

Note 1. - Summary of Significant Accounting Policies

The accounting policies of the State of Arizona (State) are in conformity with Generally Accepted Accounting Principles (GAAP) as applicable to governmental units and are consistent with the Arizona Revised Statutes. Although accounts are separately maintained for each fund in the accompanying financial statements, funds that have similar characteristics have been combined into fund types. The following is a summary of the more significant accounting policies:

A. Fund Accounting

The accounts of the State are organized on the basis of funds and account groups, each of which is considered a separate accounting entity. The operations of each fund are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues, and expenditures or expenses. They are grouped into three broad fund categories as follows:

GOVERNMENTAL FUNDS

GENERAL FUND	A self-balancing set of accounts used to account for all financial resources except those required to be accounted for in another fund.
SPECIAL REVENUE FUNDS	A self-balancing set of accounts used to account for the proceeds of specific revenue sources (other than expendable trusts) that are legally restricted to expenditures for specified purposes.
OTHER GOVERNMENTAL FUNDS	A self-balancing set of accounts used to account for other government financial resources except those required to be accounted for in the General Fund or designated as Special Revenue Funds.

PROPRIETARY FUNDS

ENTERPRISE FUNDS	A self-balancing set of accounts used to account for operations that are financed and operated in a manner similar to private business enterprises.
INTERNAL SERVICE FUNDS	A self-balancing set of accounts used to account for the financing of goods and services provided by one department to other state departments of governments.

PERMANENT AND FIDUCIARY FUNDS

PERMANENT FUNDS	A self-balancing set of accounts used to account primarily for activity related to grants made to the State for schools and public institutions.
FIDUCIARY FUNDS	A self-balancing set of accounts used to account for assets held by the State in a trustee capacity or as an agent for individuals, private organizations and other governments.

B. Basis of Accounting

All Funds are reported on a cash basis of accounting in accordance with State law. Under the cash basis of accounting, revenues and expenditures are recognized when recorded in the State's central accounting system, the Arizona Financial Information System (AFIS). No allowance has been made to revenues or expenditures for unrecorded accounts receivable, accounts payable, deferred revenue or any other balance sheet item. Disbursements of appropriated monies, including related operating transfers, are reported as expenditures. The commitment for continuing appropriations is reported as a reservation of Fund Balance.

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Note 1. - Summary of Significant Accounting Policies (Continued)

C. Reporting Entity

The accompanying General Fund cash basis financial statements include transactions of the following funds and accounts:

General Fund - General Operations
Department of Revenue Excise and Transaction Privilege Tax Fund
Disproportionate Share Fund
Veterans' Nursing Home Fund
Tobacco Settlement Account
Budget Stabilization Fund
School Accountability Account (Proposition 301)
English Language Learner Account

D. Budgets and Appropriations Accounting

The State follows these procedures in establishing the budgetary data reflected in the financial statements:

1. Annually the Governor submits to the Legislature a proposed operating and capital outlay budget for the fiscal year commencing the following July 1. This document includes proposed expenditures and the means of financing them. Some agency budgets are approved for two fiscal years at a time on a biennial cycle.
2. Public hearings are then conducted during legislative sessions.
3. Prior to July 1, the budget is enacted through passage and approval of bills containing appropriations.
4. Appropriation accounting is then employed as a management tool to monitor the appropriated monies.

Note 2. - Description of Financial Statements

- A. The accompanying financial statements include a balance sheet and statements of revenues, expenditures, and changes in fund balance for the General Fund.
- B. The Statement of Expenditures - Appropriation to Actual, Budgetary (Legal) Basis is presented for all appropriations. The Capital Outlay Statement of Expenditures - Appropriation to Actual includes all capital appropriations for the General Fund and the Capital Outlay Stabilization Fund.
- C. Administrative Adjustments and Relief Bill line items are not included in this detailed schedule since they are authorized specifically by A.R.S. § 35-191 and would add undue complexity to the schedule. Administrative Adjustments are shown as Note 9 to the financial statements.
- D. The General Fund is presented prominently in the Annual Financial Report (AFR) due to its significance. The Statement of Revenues, Expenditures and Changes in Fund Balance is presented for all other funds accounted

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for on the AFIS. The statement includes beginning and ending balances for the current fiscal year as well as appropriated and non-appropriated activity in each fund. See Note 4 for additional detail on this Statement.

Note 3. - Description of Selected Columns

A. Supplemental Appropriations and Adjustments

The column titled Supplemental Appropriations, Mid-Year Reversions and Adjustments shown on the Statement of Expenditures - Appropriations to Actual includes the following:

Supplemental and Special Appropriations which are either the additional spending authority (appropriation) granted by the Legislature after an original appropriation is approved or other Session Law appropriations granted by the Legislature to a State agency or department for a specific program or purpose.

Transfers and adjustments which are the movements of monies or spending authority between funds, departments, programs and within programs in accordance with the Arizona Revised Statutes.

Mid-year reversions (when applicable) are the returning of spending authority (appropriation) originally granted to a State agency or department through the appropriation process prior to the completion of the granted spending period.

B. Lapsed Appropriations

In accordance with A.R.S. § 35-190, except as otherwise provided by law, all appropriations lapse after the close of the fiscal year. The unused spending authority (appropriation) which was originally granted to a State agency or department through the appropriation process expires. The term "reversion" is sometimes used in reference to these lapsed appropriations. The amount of lapsed appropriations from the General Fund for FY07 is \$161,966,228 from General Operations.

C. Continuing Appropriations

A continuing appropriation is a spending authority that, once established, is automatically renewed without further legislative action, period after period, until altered or revoked. In the State of Arizona, continuing appropriations are primarily for construction or other projects that take longer than one year to complete. The total General Fund continuing appropriations of \$132,881,630 includes \$87,971,861 from General Operations and \$44,909,769 from Capital Outlay.

D. Significant Transactions Subsequent to Fiscal Year End

Laws 2006, Second Regular Session, Chapter 344 (HB2863, Section 48) appropriated \$9,808,600 from the General Fund for deposit in the Budget Stabilization Fund. This transfer is reflected in the financial statements as a transfer out from the Budget Stabilization Fund and a transfer into the General Fund although the transfer did not occur prior to the close of the fiscal year. The transfer was completed in August 2007.

The Water Quality Assurance Revolving Fund (WQARF) received fees and corporate income tax revenues of \$19,029,619. Pursuant to A.R.S. § 49-282.B, the fund is to receive \$18 million each fiscal year. The excess revenues from Fiscal Year 2007 of \$1,029,619 were transferred to the General Fund in August of 2008.

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Note 3. - Description of Selected Columns (Continued)

E. Significant Transactions Related to Prior Fiscal Year End

The Department of Education received an appropriation for \$191,000,000 in Laws 2006, Second Regular Session, Chapter 353 (HB2874, Section 16). The bill did not contain an emergency clause, therefore, the appropriation was not effective until the general effective date of September 21, 2006. The FY06 appropriation was loaded on October 19, 2006 and the entire appropriation was expended by the end of November 2006.

The Department of Commerce received an appropriation for \$35,000,000 in Laws 2006, Second Regular Session, Chapter 334 (HB2477, Section 4). The bill did not contain an emergency clause, therefore the appropriation was not effective until the general effective date of September 21, 2006. The FY06 appropriation was loaded on October 10, 2006 and the entire appropriation was expended by the end of October 2006.

Note 4. – Statement of Revenues, Expenditures and Changes in Fund Balance

Laws 2005, 1st Regular Session, Chapter 331, Section 4, amending A.R.S. § 35-131.E, requires the AFR to include all appropriated and non-appropriated monies. The General Fund is presented prominently in the AFR due to its significance. In accordance with the revised statute, the Statement of Revenues, Expenditures and Changes in Fund Balance presents appropriated and non-appropriated activity for all other funds accounted for on the AFIS as well as beginning and ending balances for each fund. As required, this report includes non-appropriated activity in the same detail as the General Fund. The Statement includes appropriated activity when applicable for each fund, but summarized within a single line item labeled "Appropriated Activity."

During the course of the report compilation, a number of funds with negative balances were noted. No analysis of the accounts that comprise the negative balances was conducted as to the cause or the resolution. On the Fund Balance Report, the various balance sheet accounts culminating in the negative balance are listed only for those funds. The following funds were noted with negative balances:

OTHER GOVERNMENTAL FUNDS:

Federal Grant Fund - Governor's Office of Highway Safety (GHA2000)
Library, Archives and Public Records (LAA2000)
Department of Environmental Quality (EVA2000)
Inter-governmental and Interagency Service Agreement Fund - Office of Administrative Hearings (HGA2500)
Department of Environmental Quality (EVA2500)
Estate and Unclaimed Property Fund – Department of Revenue (RVA1520)
Developmental Disabilities Fund – Department of Economic Security (DEA3145)
Arizona Health Care Cost Containment System Fund – AHCCCS (HCA2120)
Special Program Payroll Trust Fund – Arizona Historical Society (HIA3159)

SPECIAL REVENUE FUNDS:

Southern Arizona Veterans' Cemetery Trust Fund – Department of Veterans' Services (VSA2499)
Arizona Wine Promotional Fund – Arizona Department of Agriculture (AHA2205)

ENTERPRISE FUNDS:

Arizona Exposition and State Fair Fund – AZ Exposition and State Fair Board (CLA4001)
Highway Expansion and Extension Loan Program Fund – Department of Transportation (DTA2417)

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FIDUCIARY FUNDS:

Statewide Payroll Fund – Department of Administration (AAA9200)
Administrative Fund – State Treasurer (TRA3736)
Local Transportation Assistance Fund – State Treasurer (TRA3747)
County Assistance Fund – State Treasurer (TRA3751)
Developmental Disabilities Fund – Department of Economic Security (DEA3146)
Racing Commission Bond Deposit Fund – Arizona Department of Racing (RCA3720)
Big Game Permit Fund – Arizona Game and Fish Department (GFA3712)

Note 4. – Statement of Revenues, Expenditures and Changes in Fund Balance (Continued)

For management reporting purposes, certain accrual adjustments are recorded in the AFIS. This activity is consistent with the statutory or legal basis upon which the AFR is prepared and has not been modified. Current year adjustments to prior year accruals, such as refunds of prior year's expenditures or adjustments to long-term debts or receivables, are reflected in the Fund Balance report as an adjustment to the beginning fund balance. Additionally, other entries are current year transactions and are shown as GAAP Revenue and GAAP Expenditure Offsets. Revenue offsets are frequently the result of adjustments to amounts recorded as due to other funds. Expenditure offsets are most commonly related to depreciation and adjustment of fixed assets. GAAP Revenue and GAAP Expenditure Offsets are recorded in the Fund Balance Report in their respective revenue and expenditure columns. Furthermore, a number of funds have year-end cash balances on the AFIS, but other balance sheet accounts off-set the cash resulting in a net fund balance of zero. This occurs most commonly with the Credit Card Clearing Fund.

Fund activity in the Fund Balance Report is shown on the statewide fund level. Some funds have activity with more than one agency and the report separates the activity within the fund by agency. Funds with activity in more than one section are listed in both sections and cross-referenced. For comparison purposes and consistency with the Statement of Expenditures – Appropriation to Actual, the Department of Economic Security Federal Grant Fund has not been combined on a statewide level. Detail is provided for each separate grant type.

Note 5. - Budget Stabilization Fund

A.R.S. § 35-144 established the Budget Stabilization Fund (BSF) in 1990. The BSF is sometimes referred to as the rainy day fund. The purpose of the BSF is to normalize (over time) the fluctuations of the State's high and low growth rates. The amount of cash transferred to or from the BSF and the General Fund - General Operations is established by statutory formula. No operating expenditures may occur in the BSF. Interest earned on pooled investments with the State Treasurer is the basic revenue source of the BSF.

Pursuant to Laws 2006, Chapter 344, Section 48.A.2., an additional \$9,808,600 was transferred from the General Operating Fund to the BSF. This amount represents the total amount transferred into the BSF for FY07 (as reported herein). The FY07 ending balance for the BSF is \$673.531 million. Pursuant to A.R.S. § 35-144.H, at the end of a fiscal year, the Budget Stabilization Fund shall not exceed 7% of the General Fund revenues for the fiscal year. The FY07 revenues were \$9,621.871 million. Therefore the statutory cap is \$673.531 million. The Budget Stabilization Fund exceeded the statutory cap (7% of GF revenues) by \$18.576 million and the surplus is included in the General Fund Unreserved Fund Balance as required by statute. The ending balance has been reflected as Restricted for Budget Stabilization Fund on the balance sheet, with a corresponding amount being included in Cash and Investments with the State Treasurer. Accordingly, the net increase to the BSF for FY07 was approximately \$22.5 million.

Laws 2000, Seventh Special Session, Chapter 1, Section 37 authorized transfers from the BSF to fund payments made for alternative fuel tax credits and alternative fuel cost reimbursements to consumers. Throughout the fiscal year, the Department of Revenue reported and the State Treasurer transferred from the BSF to the tax refund

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account of the General Fund the amount of verified alternative fuel related tax credits claimed in the preceding calendar month not used to offset income taxes under Title 43, Arizona Revised Statutes. The total transferred during FY07 for alternative fuel related tax credits was approximately \$7 thousand. This activity is included in the \$22.5 million net increase referred to above.

Note 6. – Tobacco Settlement Account

In a letter dated May 15, 2000, the State Treasurer was notified that state-specific finality as defined in the National Tobacco Litigation Master Settlement Agreement had occurred. In fiscal year 2000, the State of Arizona received approximately \$120 million from this settlement. These monies were deposited in a separate fund established under A.R.S. § 35-142 to segregate and account for tobacco settlement monies. This fund was treated as an account of the General Fund for financial reporting purposes beginning in FY00.

The 44th Legislature additionally appropriated \$78 million of tobacco settlement monies. In Laws 1999, First Regular Session, Chapter 313, \$8 million was appropriated to the Arizona Health Care Cost Containment System to reimburse healthcare group plans. Laws 2000, Fifth Special Session, Chapter 2 appropriated a combined total of \$70 million to the Department of Health Services, consisting of \$50 million to the Serious Mental Illness Services Fund and \$20 million for children's behavioral health services. This law was not affected by Proposition 204 of the 2000 General Election. At the end of fiscal year 2006, approximately \$69.84 million had been spent leaving a remaining balance of approximately \$160 thousand appropriated to the children's behavioral health services which was reflected as Reserved for Continuing Appropriations – Tobacco Settlement Account in the Fund Balance section of the FY06 balance sheet. The remaining \$160 thousand was spent in FY07 bringing the total expenditures from the Tobacco Settlement Account to \$70 million.

As a result of the 2000 General Election, Proposition 204 received voter approval to allocate all tobacco settlement monies to fund expanded AHCCCS eligibility, six public health programs, and subject to availability of monies, other legislature appropriated programs that benefit the health of Arizona residents, in that order. Proposition 204 added A.R.S. § 36-2901.02, which created the Arizona Tobacco Litigation Settlement Fund to receive all of Arizona's share of the tobacco settlement estimated at \$3.2 billion, payable in annual installments over the next 25 years. Accordingly, subsequent to the enactment of Proposition 204, tobacco settlement receipts have been deposited directly into this new non-appropriated fund and are not accounted for as a component of the General Fund.

Note 7. – ADOT Board Funding Obligations

Laws 1999, First Regular Session, Chapter 189, Section 12, authorized the Transportation Board to deliver non-negotiable Board funding obligations and required the State Treasurer to purchase the obligations. However, if operating monies in the State General Fund fall below an \$800 million average over the previous twelve consecutive months, the State Treasurer is not required to purchase Transportation Board funding obligations.

Laws 2001, First Regular Session, Chapter 238 amended the principal amount for FY06 to be not more than \$200 million that matures no later than four calendar years after delivery of the obligations. As of June 30, 2006, the total

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amount outstanding is \$200 million. The monies derived from the Board funding obligations are to be made available for the highway expansion and extension loan program pursuant to A.R.S. § 28-7676.

A.R.S. § 35-313 allows the State Treasurer to call the investment in the Transportation Board funding obligations if operating monies fall below \$200 million. The Transportation Board shall repay the obligations from its available resources and may reissue them under the same terms and conditions that they were originally issued.

Note 8. – Combining Financial Statements

The following schedules provide additional detail related to the combination of fund information for financial statement presentation. The General Operating Fund consists of five components: General Fund (General Operations); Department of Revenue Excise and Transaction Privilege Tax Fund; Disproportionate Share Fund; English Language Learner Account; and Veterans' Nursing Home Fund. The School Accountability (Proposition 301) Account is shown in a separate column.

STATE OF ARIZONA
GENERAL FUND
COMBINING BALANCE SHEET AND
COMBINING STATEMENT OF CHANGES IN FUND BALANCE
AS OF JUNE 30, 2007
(expressed in thousands)

	General Operating Fund	Tobacco Settlement Account	School Accountability Account (Prop. 301)	Budget Stabilization Fund	Total General Fund
ASSETS					
Cash With The State Treasurer	\$ 496,404	\$ -	\$ 14,425	\$ 673,531	\$ 1,184,360
Cash Not With The State Treasurer	243	-	-	-	243
TOTAL ASSETS	\$ 496,647	\$ -	\$ 14,425	\$ 673,531	\$ 1,184,603
FUND BALANCE					
Restricted:					
Budget Stabilization Fund	\$ -	\$ -	\$ -	\$ 673,531	\$ 673,531
School Accountability Account (Proposition 301) –					
Continuing Appropriations	-	-	14,425	-	14,425
Reserved For:					
Continuing Appropriations – General	118,457	-	-	-	118,457
Continuing Appropriations –					
Tobacco Settlement Account	-	-	-	-	-
Revolving Funds	243	-	-	-	243
Unreserved	377,947	-	-	-	377,947
TOTAL FUND BALANCE	\$ 496,647	\$ -	\$ 14,425	\$ 673,531	\$ 1,184,603
FUND BALANCE JULY 1, 2006	\$ 1,105,100	\$ 160	\$ 16,778	\$ 651,020	\$ 1,773,058

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CHANGES IN FUND BALANCE:

Revenues	\$ 9,448,624	\$ -	\$ 101,283	\$ 2,216	\$ 9,552,123
Expenditures	(10,135,592)	(160)	(103,636)	-	(10,239,388)
Other Financing Sources/Uses:					
Operating Transfers In	69,748	-	-	-	69,748
Budget Stabilization Fund					
Interest Earnings	-	-	-	29,069	29,069
Transfer from General Fund	(9,809)	-	-	9,809	-
Operating Transfer Out –					
Alternative Fuel Recovery	-	-	-	(7)	(7)
Excess Monies Over 7% Cap	18,576	-	-	(18,576)	-
TOTAL CHANGES IN FUND BALANCE	<u>\$ (608,453)</u>	<u>\$ (160)</u>	<u>\$ (2,353)</u>	<u>\$ 22,511</u>	<u>\$ (588,455)</u>
FUND BALANCE JUNE 30, 2007	<u>\$ 496,647</u>	<u>\$ -</u>	<u>\$ 14,425</u>	<u>\$ 673,531</u>	<u>\$ 1,184,603</u>

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Note 9. – Administrative Adjustments

The following expenditures were made in accordance with ARS § 35-191 during the fiscal year 2006-2007 for obligations incurred fiscal year 2005-2006 and, therefore related to the appropriations for fiscal year 2005-2006.

	Administrative Adjustments for Fiscal Year 2005-2006 <u>Appropriations</u>
<u>GENERAL GOVERNMENT</u>	
Department of Administration	\$ 222,968
Office of Equal Opportunity	2,132
Attorney General	73,125
Department of Commerce	2,429
Office of the Governor	67
Department of Revenue	13,615
Supreme Court	233,516
Court of Appeals	34,023
State Treasurer	300,334
State Board of Tax Appeals	<u>25</u>
TOTAL GENERAL GOVERNMENT	<u>\$ 882,234</u>
 <u>HEALTH AND WELFARE</u>	
Department of Economic Security	\$ 6,902,404
	45,852,50
Arizona Health Care Cost Containment System	0
Department of Health Services	4,720,104
Arizona Commission of Indian Affairs	4,005
Department of Veterans' Services	<u>4,426</u>
	57,483,43
TOTAL HEALTH AND WELFARE	<u>\$ 9</u>
 <u>INSPECTION AND REGULATION</u>	
Radiation Regulatory Agency	\$ 285
Department of Agriculture	7,039
Department of Financial Institutions	1,218
Corporation Commission	40
State Mine Inspector	46
Real Estate Department	24,363
Department of Weights and Measures	<u>2,779</u>
TOTAL INSPECTION AND REGULATION	<u>\$ 35,770</u>

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Note 9. – Administrative Adjustments (Continued)

	Administrative Adjustments for Fiscal Year 2005-2006 Appropriations
<u>EDUCATION</u>	
State Board for Charter Schools	\$ 11,899
Department of Education	5,172,815
Board of Medical Student Loans	1,176,852
Prescott Historical Society	25,221
Arizona State Schools for the Deaf and the Blind	818,947
Arizona Board of Regents	<u>2,312,568</u>
 TOTAL EDUCATION	 <u><u>\$ 9,518,302</u></u>
 <u>PROTECTION AND SAFETY</u>	
State Department of Corrections	\$ 6,351,021
Department of Juvenile Corrections	310,888
Arizona Criminal Justice Commission	183,255
Department of Emergency and Military Affairs	60,681
Board of Executive Clemency	169
Department of Public Safety	<u>199,535</u>
 TOTAL PROTECTION AND SAFETY	 <u><u>\$ 7,105,549</u></u>
 <u>NATURAL RESOURCES</u>	
Arizona Geological Survey	\$ 1,793
Department of Mines and Mineral Resources	4,196
Arizona Navigable Streams Adjudication Commission	259
Department of Water Resources	<u>73,944</u>
 TOTAL NATURAL RESOURCES	 <u><u>\$ 80,192</u></u>

SUMMARY

GENERAL GOVERNMENT	\$ 882,234
	57,483,43
HEALTH AND WELFARE	9
INSPECTION AND REGULATION	35,770
EDUCATION	9,518,302
PROTECTION AND SAFETY	7,105,549
NATURAL RESOURCES	<u>80,192</u>
	75,105,48
 TOTAL	 <u><u>\$ 6</u></u>