



JANET NAPOLITANO
GOVERNOR

BETSEY BAYLESS
DIRECTOR

**ARIZONA DEPARTMENT OF ADMINISTRATION
OFFICE OF THE DIRECTOR**

100 NORTH 15th AVENUE • SUITE 401
PHOENIX, ARIZONA 85007
Phone: (602) 542-1500

January 16, 2004

The Honorable Janet Napolitano
Governor of the State of Arizona,
Members of the Legislature, Chief Justice of
the Supreme Court and Citizens and Taxpayers
of the State of Arizona

Ladies and Gentlemen:

It is our pleasure to transmit to you the Comprehensive Annual Financial Report (CAFR) of the State of Arizona for the fiscal year ended June 30, 2003. The CAFR has been presented in conformance with the Governmental Accounting Standards Board (GASB) statements 34 and 35. The objective of this new reporting model is to provide a clear picture of the government as a single, unified entity as well as providing traditional fund-based financial statements.

Responsibility for the accuracy of data, completeness and fairness of presentation, including all disclosures, rests with the State's management. The data presented in this report, to the best of our knowledge and belief, is accurate in all material respects and is reported in a manner which fairly presents the financial position and results of operations of the major and non-major funds of the State. All disclosures needed for the reader to gain a reasonable understanding of the State's financial activities have been included.

The report is presented in three sections: Introductory, Financial and Statistical.

The **Introductory Section** includes this Letter of Transmittal, the State's organizational chart and a list of principal State officials.

The **Financial Section** includes the State Auditor General's independent auditors' report, Management's Discussion and Analysis (MD&A) and the basic financial statements (which include the government-wide financial statements, the fund financial statements and the notes to the financial statements). The financial section also includes Required Supplementary Information (RSI), which includes budgetary comparison schedules, infrastructure condition and maintenance data, and retirement plans funding progress. In addition, the financial section includes other supplemental financial data, which includes combining financial statements.

The **Statistical Section** includes selected financial, economic, and demographic data.

U.S. generally accepted accounting principles require that management provides a narrative introduction, overview, and analysis to accompany the basic financial statements in the form of the MD&A. This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. The State's MD&A can be found immediately following the independent auditors' report.

FINANCIAL REPORTING ENTITY

The accompanying CAFR includes all funds of the State of Arizona (primary government), as well as its component units. Component units are legally separate entities for which the primary government is financially accountable.

Discretely presented component units are reported in a separate column in the government-wide financial statements to emphasize that they are legally separate from the primary government and to differentiate their financial position and results of operations from those of the primary government.

The criteria for inclusion in the reporting entity and its presentation are defined by the Codification of Governmental Accounting and Financial Reporting Standards, issued by the Governmental Accounting Standards Board, (Section 2100). Note 1.A of the Notes to the Financial Statements explains which units are included in the Financial Reporting Entity of the State.

ECONOMIC CONDITION AND OUTLOOK

The following economic summary, is excerpted from the Arizona Department of Economic Security's Arizona's Workforce, August 28, 2003.

Arizona's economy continues to add jobs in 2003. In fact, throughout most of 2003, Arizona was ranked in the top 10 fastest job growing states in the nation. However, in the most recent report for July, Arizona slipped to 13th. Notably, some states are gradually improving, while others are struggling with job losses. Global Insight forecasts the nation will show an average loss of jobs in 2003 and recover with modest job growth in 2004.

Arizona's Department of Economic Security, Research Administration (RA) expects Arizona's economy will continue growing, though at a slower pace in 2003 than earlier forecasted. This forecast update shows that Arizona's economy will add more than 82,000 jobs during the forecast period of 2003-04. While jobs grew at a slower than expected rate during the second quarter and most of the third quarter, momentum is expected to pick up for the remainder of 2003 and into 2004. Most of this stems from improving consumer optimism and business confidence and the expected gradual recovery extending through other geographic regions. Improving economic conditions, for example, are expected in Canada, Mexico, Japan, Europe, and especially Asia over this period.

Arizona's goods-producing industries are forecast to grow by 800 jobs over the two-year period. This group of industries shows a surprising endurance in job creation in the case of construction, while manufacturing shows a loss of industry share in its return to 1993-94 levels.

These two mostly cyclical industries have shown sharply different experiences over the recent couple of years. Construction is an industry serving mostly "home-grown" demand. Population growth in Arizona, among the fastest in the Mountain states region, helps to supply the demand for job growth, while the continued low interest rates add to the affordability and attraction of housing and other related products. Manufacturing, on the other hand, is an industry largely serving demand external to our State. With demand levels sharply curtailed in the recent couple of years from other regions, manufacturing firms have struggled to adjust by shedding plant, equipment, and jobs—a process generally referred to as consolidation. Increasingly, however, manufacturing and mining firms have also opted to close, relocate or prioritize their expansion efforts abroad.

During the forecast period, construction is forecast to add more than 11,000 jobs. Continued strong demand for housing has developers building new homes, homeowners expanding and remodeling, and cities and counties grappling with a great deal of infrastructure development such as the improvements of roads and highways. Additionally, continued attraction to rural regions from retirees and locals is forecast to incite economic planning and development groups to work hard in an effort to stay ahead of demand pressures.

Meanwhile, projected gains for construction are largely offset by the forecasted losses of nearly 10,000 jobs in manufacturing and loss of roughly 700 in mining. Computer and electronic manufacturing firms experienced the largest blow in the most recent downturn, and these related sectors are projected to show a prolonged struggle toward recovery.

Service-providing industries are forecast to add more than 81,000 jobs during 2003-04. This group of varied and diverse providers has been growing faster than the goods-producing industries, due to large sectors of the economy catering Arizona's fast growing population and industries serving tourists.

Health and education sectors are projected to show growth of more than 26,000 jobs. Forecasted annual growth rates are expected to average roughly 5.5 percent during 2003-04. Notably, health service jobs are forecast to outpace most all others during the next few years.

Professional and business services sectors are forecast to show increasing demand for labor over the next two years, growing by 1.7 percent in 2003 to more than 4 percent in 2004. This industry is forecast to add 18,600 jobs, accounting for more than 22% of the increase of jobs during the 2003-04 period. Projected to be one of the fastest growing sectors of this super sector, the employment services sector is already leading this group as it serves the growth in many other industries.

The combined trade, transportation, warehousing, and public utilities group is forecast to add almost 15,000 jobs during 2003-04. This represents nearly 18 percent of all jobs added during this two-year period. Trade is projected to be the fastest growing of this group, but losses in wholesale trade are expected to drag down improving retail sectors benefiting from rising and sustained levels of consumer optimism. Wholesale trade is expected to show losses in 2003 and contribute to growth in 2004. Warehousing and transportation job gains are expected to improve as economic activity stimulates commercial flows.

The information services sector is forecast to experience a difficult period toward recovery. Publishing and other information services are forecast to pare more than 3,000 jobs during 2003-04. This industry has been one of the hardest hit in the service-providing industries following the post-2000 economic downturn.

Arizona's leisure and hospitality industry is forecast to add 7,600 jobs during 2003-04, averaging roughly 1.5 percent over the two-year period. More than 9 percent of the total increase of jobs will come from this mostly tourism and entertainment group of sectors.

Financial services forecasts show a slight loss of jobs in 2003 with modest gains returning in 2004. Real estate is projected to be the source of continued growth, whereas the securities and commodities related sectors, along with the insurance sectors are forecast to experience some slight consolidations to cut costs and match lower demand.

Other services, a mix of service providing industries not elsewhere categorized, is forecast to add nearly 5,000 jobs. Growth rates of 2.3 percent and 3.3 percent are forecasted for 2003 and 2004, respectively.

Providing services to Arizona's growing population, government is forecast to add almost 11,000 jobs during the two-year period. Annual growth rates are expected to be modest and average less than 1.5 percent during the two-year period. Local education is projected to generate most of the jobs in government. Growth in federal government jobs stems from the demand for greater security and other services across the state. Fiscal pressures are expected to restrain job growth in state and local government to levels sharply lower than historical trend.

In conclusion, Arizona's economy continues to add jobs and the 2003-04 forecast calls for continued job growth with increasing momentum, which thus far has been absent from this growth phase. Sustained business confidence and higher levels of consumer optimism are expected to further invigorate Arizona's economy, especially as economies of other regions show improvement. While manufacturing job losses remain a concern, even these are expected to gradually slow. Continued job losses in this industry are anticipated to dampen an otherwise full economic recovery beyond the forecast 2003-04 period.

MAJOR INITIATIVES

When Governor Napolitano took office in January 2003, the State was facing an unprecedented fiscal crisis. The current year deficit was approximately \$300 million with 6 months left in the fiscal year, and the fiscal year 2004 deficit was projected to be \$1 billion, or 14% of projected expenditures. Arizona, like most other states, was experiencing dramatic revenue shortfalls, and projected 2.3% negative revenue growth in fiscal year 2003 after experiencing an 11.1% decline from fiscal year 2001 to fiscal year 2002. Of further concern was that there was no unified voice among economists on a future fiscal recovery. Under these circumstances, Governor Napolitano immediately began the task of resolving current year shortfalls and developing a plan to address the projected deficit. The Governor's approach was a multi-faceted one that examined all the key drivers of the State's budget. In addition, she established key principles that she deemed essential to the State's most vulnerable citizens and necessary for the State's prosperity when the inevitable economic recovery began. Outlined below are the actions taken and the principles specified by the Governor as the solution to the Fiscal year 2003 deficit was developed:

- **Examine the State's tax structure**
Development of any solution to the State's deficit required an examination of the drivers behind that deficit, including revenues. In January 2003, the Governor formed the Citizens' Finance Review Commission with the purpose of developing a series of recommendations to advise the Governor on a course to stimulate Arizona's economy for the long term. In particular, the Commission is to develop recommendations that address fiscal and tax policies that are simple, low and fair and support Arizona's growing economy.
- **Examine ways to reduce and avoid costs through improved government operations and efficiencies**
Upon taking office in January, the Governor instituted an Efficiency Review (ER) program designed to improve the performance and efficiency of State government. The ER's mission is to find practical and sensible ways for State agencies and State government, as a whole, to reduce costs, cut bureaucracy, eliminate duplication and improve customer service.

- **Protect funding for education**

The importance of excellence in education has ceased to be a viable option for debate. Virtually all responsible citizens who recognize their stake in the health of our society readily acknowledge the correlation between a well educated public and the critical goals of economic vitality, public safety, and a high quality of life. Throughout the resolution of the State’s deficit, the Governor’s actions reaffirmed the vital role of government in providing educational excellence for current and future Arizonans at all grade levels, starting with K-12 education.

- **Provide for Arizona’s neediest citizens**

Economic downturns hit all sectors of society, however the greatest pain is most often inflicted on citizens who live “on the bubble” - survival in good times, desperation in bad. A fiscal crisis raises far more than a fiscal dilemma, it also carries with it great issues of principle and priority. In resolving the fiscal year 2003 deficit, the Governor insisted that the critical support of Arizona’s children and families be maintained.

Based on these actions and principles, Governor Napolitano worked with the Legislature to resolve the fiscal year 2003 deficit. The success of her strategy is evidenced by the speedy resolution of the fiscal year 2003 shortfall and the sound fiscal position in which the State ended the fiscal year.

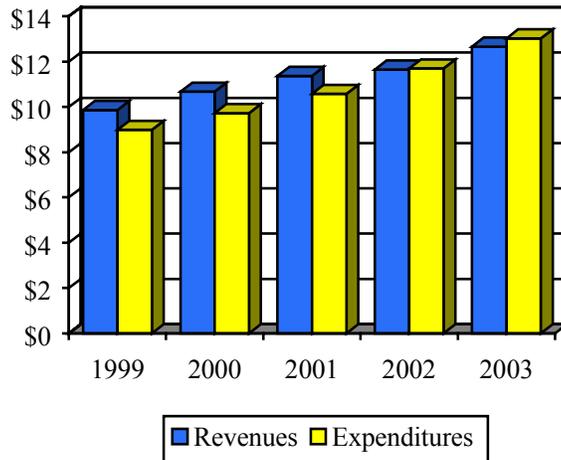
SERVICES PROVIDED BY THE STATE

The services provided by the State are administered through various agencies, departments, boards, commissions and institutions of higher learning. These services include: (1) General Government, (2) Health and Welfare, (3) Inspection and Regulation, (4) Education, (5) Protection and Safety, (6) Transportation and (7) Natural Resources.

GENERAL FUND BALANCE

Graph 1 details the General Fund Revenues and Expenditures for the last five fiscal years. This graph does not include transfer amounts relating to other fund types and other financing sources (uses), which affect the ending fund balance.

Graph 1
 General Fund Revenues and Expenditures
 for last 5 fiscal years
 (Dollars in billions)

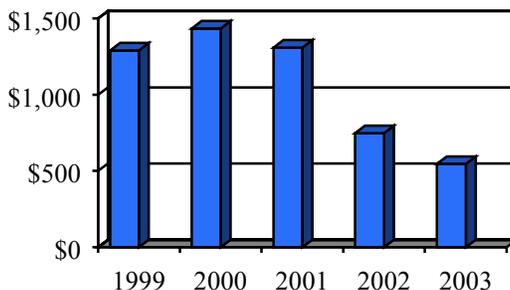


The General Fund ended the June 30, 2003, fiscal year with \$343.0 million in unreserved fund balance and a \$203.4 million reserved fund balance for a total fund balance of \$546.4 million. This compares to the previous year's restated total fund balance of \$748.3 million. Included in the \$203.4 million reserved fund balance is \$13.7 million for the Budget Stabilization Fund. The Budget Stabilization Fund is a form of "Rainy Day Fund" established by the Legislature in 1991.

Graph 2 details the General Fund Balance for the last five fiscal years:

Graph 2

General Fund Balance for last 5 fiscal years
(Dollars in millions)



BUDGETARY CONTROLS

Budgetary control is maintained through legislative appropriation and the executive branch allotment process. The Governor is required to submit an annual budget to the Legislature. The budget is legally required to be adopted through passage of appropriation bills by the Legislature and approval by the Governor. The appropriated funds are controlled by the executive branch through an allotment process. This process allocates the appropriation into quarterly allotments by legal appropriation level. The State also maintains an encumbrance accounting system to further enhance budgetary control. Encumbered amounts generally lapse as of the end of the fiscal year, with the exception of capital outlay items. Capital outlay appropriations and their encumbrances continue from year to year. The State's budgetary policies are explained in detail in the Required Supplementary Information (RSI).

INTERNAL CONTROLS

The State is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the State are protected from loss, theft or misuse and to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with U.S. generally accepted accounting principles. Internal accounting controls are designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived and (2) the valuation of costs and benefits requires estimates and judgments by management. In the opinion of management, the State's internal controls are adequate to provide reasonable assurance that these objectives are met.

CASH MANAGEMENT

The responsibility for cash management of the State is shared by the Office of the Treasurer (Treasurer) and the General Accounting Office of the Department of Administration, Financial Services Division (GAO). The Treasurer is responsible for the depository, custodial and investment functions of cash. The GAO is responsible for drawing down monies available for State functions and the expenditure or disbursement of those monies.

The State requires that Treasurer's deposits and investments with financial institutions be entirely covered by Federal depository insurance or alternatively collateralized with surety equal to 102% of the deposit or investment. Component units may have collateralization policies that differ from those of the Treasurer.

The Legislature has passed statutes authorizing State investments. Note 2.A. in the Notes to the Financial Statements describes these investments.

The Treasurer deposits receipts in accordance with applicable statutes and invests excess cash of the General Fund and various other funds. All interest, not otherwise apportioned by law, is deposited in the General Fund. Investment earnings for the General Fund totaled \$21.6 million for the fiscal year ended June 30, 2003.

PROPRIETARY OPERATIONS

The State's Enterprise Funds are comprised of governmental and quasi-governmental agencies that provide goods and services to the public on a fee for service basis. One of the largest Enterprise Funds is the Lottery Fund. The Lottery Fund generated \$322.6 million of operating revenues and \$59.6 million of income before contributions and transfers for fiscal year 2003. The Enterprise Funds ended fiscal year 2003 with total ending net assets of \$2.734 billion for the Primary Government and \$333.4 million for the Component Units. This does not include the State Compensation Fund's total policyholder's surplus of \$511.8 million.

The State has Internal Service Funds, which provide a variety of services to State agencies. These include risk management, computer services, telecommunications, transportation services, and employee benefits. The operating revenues for the Internal Service Funds were \$572.7 million for fiscal year 2003.

FIDUCIARY FUNDS

Fiduciary Funds are used to account for assets held by the State in a trustee capacity or as an agent for individuals, private organizations and other governments, including the four State Retirement Systems. See Note 5. in the Notes to the Financial Statements for more information on the four State Retirement Systems. The fiduciary activities are not included on the government-wide financial statements because the resources of these funds are not available to support the State's own programs.

RISK MANAGEMENT

The State purchases property and liability coverage whenever available on reasonable terms. The State is insured by a property insurer for claims in excess of \$3.5 million, but less than \$345 million, and liability claims in excess of \$2 million for the Universities and \$7 million for all other state agencies, but less than \$107 million. The State also maintains first dollar aircraft coverage up to \$200 million. Other purchased coverages include fidelity, foreign liability, medical malpractice (limited to the University of Arizona's medical professional staff), and employment practices. The State's self-insurance fund provides property and liability coverage for claims less than or in excess of this coverage, or whenever coverage, such as workers' compensation and medical malpractice for non-University of Arizona professional staff, is unavailable on reasonable terms.

The State pays self-insurance losses, defense costs, premiums and administrative costs from an appropriated fund which all of the State's agencies participate in. Total costs (excluding the cost of administering the program) have risen from approximately \$15.3 million in fiscal year 1988 to approximately \$78.1 million in fiscal year 2003. Yearly appropriations have also increased from approximately \$27.7 million in fiscal year 1988 to approximately \$96.2 million in fiscal year 2003 to meet rising losses and claims-related expenses. Although there are no assurances, historically the Legislature has appropriated sufficient funds to cover all costs.

INDEPENDENT AUDIT

In compliance with State statute, an annual financial audit of the "State Entity" is completed each year by the State of Arizona, Office of the Auditor General in conjunction with other audit firms. Their audit was conducted in accordance with U.S. generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Their report on the basic financial statements has been included in the financial section of this report. In addition, ARS §41-1279.03 requires at least a biennial single audit by the Office of the Auditor General. The Single Audit will be issued as a separate report at a later date.

ACKNOWLEDGMENTS

We wish to express our sincere appreciation to the many individuals whose dedicated efforts have made this report possible. The preparation of this report could not have been accomplished without the professionalism and dedication demonstrated by the financial and management personnel of each State agency, board, commission, institution of higher education and all other organizations within the reporting entity.


Betsy Bayless
Director


D. Clark Partridge
State Comptroller