

MANAGEMENT'S
DISCUSSION
AND
ANALYSIS

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The following is a discussion and analysis of the State of Arizona's (the State's) financial performance, providing an overview of the activities for the fiscal year ended June 30, 2003. Please read it in conjunction with the transmittal letter at the front of this report and with the State's financial statements, which follow this section. The completeness and fairness of the following information is the responsibility of the State's officials and management.

FINANCIAL HIGHLIGHTS

Government-Wide:

- The assets of the State exceeded liabilities at the close of the fiscal year by \$14.7 billion (reported as *net assets*). Of this amount, a \$476 million deficit for (*unrestricted net assets*) exists at fiscal year end, \$3.3 billion is restricted for specific purposes (*restricted net assets*), and \$11.9 billion is invested in capital assets, net of related debt.
- The State's total net assets decreased in fiscal year 2003 by \$808 million. Net assets of governmental activities decreased by \$611 million, while net assets of the business-type activities decreased by \$198 million.

Fund Level:

- As of the close of the fiscal year, the State's governmental funds reported combined ending fund balances of \$2.7 billion, a decrease of \$614 million from the beginning of the year. Approximately 29 percent of the combined fund balances, \$787 million is available to meet the State's current and future needs (*unreserved fund balance*).
- As of the close of the fiscal year, unreserved fund balance for the General Fund was \$343 million, or 2.6 percent, of total General Fund expenditures.
- The enterprise funds reported net assets at year-end of \$2.7 billion, a decrease of \$195 million during the year.
- The Land Endowments Fund reported fund balance at year-end of \$1.1 billion, an increase of \$41 million during the year. The Land Endowments Fund is used to help finance public education within the State as required by the federal government and the State's Constitution.

Long-term Debt:

- The State's total long-term primary government debt rose during the fiscal year to \$4.2 billion, an increase of \$868 million (or 21%). During the year, the State issued revenue bonds and certificates of participation of \$823 million and \$489 million, respectively. More detailed information regarding the government-wide financial statements, fund level financial statements and long term debt activity can be found beginning on page 23.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is an introduction to the State's basic financial statements, which are comprised of three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. Required Supplementary Information and other supplementary information are included in addition to the basic financial statements.

Government-Wide Statements (Reporting the State as a Whole)

The government-wide financial statements provide a broad overview of the State of Arizona's finances in a manner similar to private sector business. The financial statements report information about the State, as a whole, and about its activities that should help answer this question: Is the State, as a whole, better or worse off as a result of this year's activities? These statements include all non-fiduciary assets and liabilities using the accrual basis of accounting. The current year's revenues and expenses are taken into account regardless of when cash is received or paid. The government-wide financial statements include the following two statements:

The Statement of Net Assets (pages 36 and 37) presents all of the State's assets and liabilities, with the difference between the two reported as "net assets". Over time, increases and decreases in net assets measure whether the State's financial position is improving or deteriorating.

The Statement of Activities (pages 40 and 41) presents information showing how the State's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying events giving rise to

the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in these statements 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 government-wide statements report three activities:

- *Governmental Activities* – Most of the State’s basic services are reported under this category. Taxes and intergovernmental revenues generally fund these services. The Legislature, the Judiciary and the general operations of the Executive departments fall within the governmental activities.
- *Business-type Activities* – The State charges fees to customers to help it cover all or most of the cost of certain services it provides. Lottery tickets, the State’s unemployment compensation services, Industrial Commission rehabilitation services, and the State’s three universities are examples of business-type activities.
- *Discretely Presented Component Units* – Component units are legally separate organizations for which the elected officials of the State are financially accountable. The State Compensation Fund, the University Medical Center, the Arizona Power Authority, and the Water Infrastructure Finance Authority are the State’s four organizations reported as discretely presented component units. See **page 65** for more information on discretely presented component units.

Fund Financial Statements (Reporting the State’s Major Funds)

The fund financial statements begin on **page 43** and provide detailed information about the major individual funds. A fund is a fiscal and accounting entity with a self-balancing set of accounts that the State uses to keep track of specific sources of funding and spending for a particular purpose. In addition to the major funds, **page 146** begins the individual fund data for the non-major funds. The State’s funds are divided into three categories – governmental, proprietary, and fiduciary – each category uses different accounting approaches.

- *Governmental funds* – Most of the State’s basic services are reported in the governmental funds, which focus on how money flows into and out of those funds and the balances left at year-end that are available for future spending. The governmental fund financial statements provide a detailed short-term view of the State’s general government operations and the basic services it provides. Governmental fund information helps determine whether there are more or fewer financial resources that can be spent in the near future to finance the State’s programs. These funds are reported using *modified accrual* accounting, which measures cash and all other financial assets that can readily be converted to cash. Governmental funds include the general, special revenue, capital projects, debt service, and permanent funds. Because the focus of governmental funds is narrower 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. By doing so, readers may better understand the long-term impact of the government’s near-term financing decisions. This report includes two schedules (**pages 44 and 46**) that reconcile the amounts reported on the governmental fund financial statements (modified accrual accounting) with governmental activities (accrual accounting) of the appropriate government-wide statement.

Governmental fund financial statements can be found on pages 43 and 45 of this report.

- *Proprietary funds* – When the State charges customers for the services it provides, whether to outside customers or to other agencies within the State, these services are generally reported in proprietary funds. Proprietary funds (enterprise and internal service) utilize accrual accounting; the same method used by private sector businesses. Enterprise funds report activities that provide supplies and services to the general public – such as the State Lottery Fund and Universities. Internal service funds report activities that provide supplies and services for the State’s other programs and activities – such as the State’s Risk Management Fund. Internal service fund operations primarily benefit governmental funds and are reported as governmental activities on the government-wide statements. The reconciliation between the government-wide financial statement business-type activities and the proprietary fund financial statements is presented **on pages 48-53**.

Proprietary fund financial statements can be found on pages 48-57 of this report.

- *Fiduciary funds* – The State acts as a trustee or fiduciary, for its employee pension plans. It is also responsible for other assets that, because of a trust arrangement, can be used only for the trust beneficiaries. The State’s fiduciary activities are reported in separate Statements of Fiduciary Net Assets and Changes in Fiduciary Net Assets beginning on **page 58**. These funds, which include pension, investment trust and agency funds are reported using accrual accounting. The government-wide statements exclude fiduciary fund activities and balances because these assets are restricted in purpose and do not represent discretionary assets of the State to finance its operations.

Fiduciary fund financial statements can be found on pages 58-59 of this report.

Notes to the Financial Statements

The Notes to the Basic Financial Statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements.

The notes can be found beginning on page 64 of this report.

Required Supplementary Information

Following the basic financial statements is additional Required Supplementary Information that further explains and supports the information in the financial statements. The Required Supplementary Information includes budgetary comparison schedules for the general fund and each major special revenue fund and a reconciliation of the schedules of statutory and U.S. generally accepted accounting principles (GAAP) expenditures for the fiscal year. This section also includes schedules of condition and maintenance data regarding certain portions of the State’s infrastructure and retirement plan funding progress schedules.

Required supplementary information begins on page 115 of this report.

Other Supplementary Information

Other supplementary information includes combining financial statements for non-major governmental, non-major enterprise, all internal service funds, and all fiduciary funds. These funds are added together, by fund type, and presented in single columns in the basic financial statements, but are not reported individually, as with major funds on the governmental funds and proprietary funds financial statements. Budgetary expenditure comparison schedules for the non-major governmental funds are also included.

Other supplementary information begins on page 146 of this report.

GOVERNMENT-WIDE FINANCIAL ANALYSIS

The State’s overall financial position and operation for the past year for the primary government are summarized as follows based on the information included in the government-wide financial statements. The 2002 governmental activities net assets amount has been restated for fund reclassifications and prior year error corrections. The 2002 business-type activities net assets amount has been restated due to increasing the capitalization threshold for capital assets of one of the Universities. These changes have not been audited and are provided to the reader for comparative purposes. See footnote 4, capital assets, on **page 82** and footnote 8, accounting changes and restatements, beginning on **page 102** for additional restatement information.

State of Arizona-Primary Government
Net Assets as of June 30, 2003
(expressed in thousands)

	Governmental Activities		Business-type Activities		Primary Government Total	
	2003	2002, as restated	2003	2002, as restated	2003	2002, as restated
Current assets	\$ 2,482,215	\$ 3,184,940	\$ 1,372,783	\$ 1,722,769	\$ 3,854,998	\$ 4,907,709
Long-term assets	2,017,052	1,746,159	948,245	1,059,024	2,965,297	2,805,183
Capital assets	12,771,929	11,942,142	2,183,534	2,058,219	14,955,463	14,000,361
Total assets	<u>17,271,196</u>	<u>16,873,241</u>	<u>4,504,562</u>	<u>4,840,012</u>	<u>21,775,758</u>	<u>21,713,253</u>
Current liabilities	1,899,039	1,523,221	398,035	461,077	2,297,074	1,984,298
Long-term liabilities	3,404,396	2,771,665	1,372,754	1,447,291	4,777,150	4,218,956
Total liabilities	<u>5,303,435</u>	<u>4,294,886</u>	<u>1,770,789</u>	<u>1,908,368</u>	<u>7,074,224</u>	<u>6,203,254</u>
Net assets:						
Invested in capital assets, net of related debt	10,690,782	10,043,985	1,169,864	1,159,647	11,860,646	11,203,632
Restricted net assets	2,025,501	2,124,499	1,291,003	1,473,311	3,316,504	3,597,810
Unrestricted net assets	(748,522)	409,871	272,906	298,686	(475,616)	708,557
Total net assets	<u>\$ 11,967,761</u>	<u>\$ 12,578,355</u>	<u>\$ 2,733,773</u>	<u>\$ 2,931,644</u>	<u>\$ 14,701,534</u>	<u>\$ 15,509,999</u>

The largest portion of the State's net assets (81 percent) *represents capital assets, net of related debt* of \$11.9 billion. The State uses these capital assets to provide services to citizens; consequently, these assets are *not* available for future spending. Although the State's investment in its capital assets is reported net of accumulated depreciation and 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.

Another significant portion of the State's net assets of \$3.3 billion (22 percent) represents resources that are subject to external restrictions on how they may be used. The largest restrictions are by the federal government and State constitution for basic education funded by the Land Endowment Earnings of the Permanent Funds and Unemployment Insurance Premiums from employers for funding the Unemployment Compensation Fund. Another major restriction is unspent debt instrument proceeds for the construction of additional capital assets.

The remaining negative balance of the State's net assets of \$476 million (3 percent) represents *unrestricted net assets*, including restatements of beginning net assets.

The State's net assets decreased by \$808 million during the current fiscal year. This decrease is primarily attributable to Medicaid income eligibility level increases, highway preservation expense increases, a reduction in unemployment grants, and statewide kindergarten through twelfth grade (K through 12) school building repairs and construction. The completion of roads and bridges increased capital assets approximately \$710 million. Medicaid income eligibility level increases, highway preservation expense increases and a reduction in unemployment grants reduced current assets by approximately \$488 million. Statewide K through 12 school building repairs and construction increased long-term liabilities approximately \$705 million. The fiscal year 2003 K through 12 basic State aid to education increased education expense approximately \$190 million.

State of Arizona-Primary Government
Changes in Net Assets for Fiscal Year Ended June 30, 2003
(expressed in thousands)

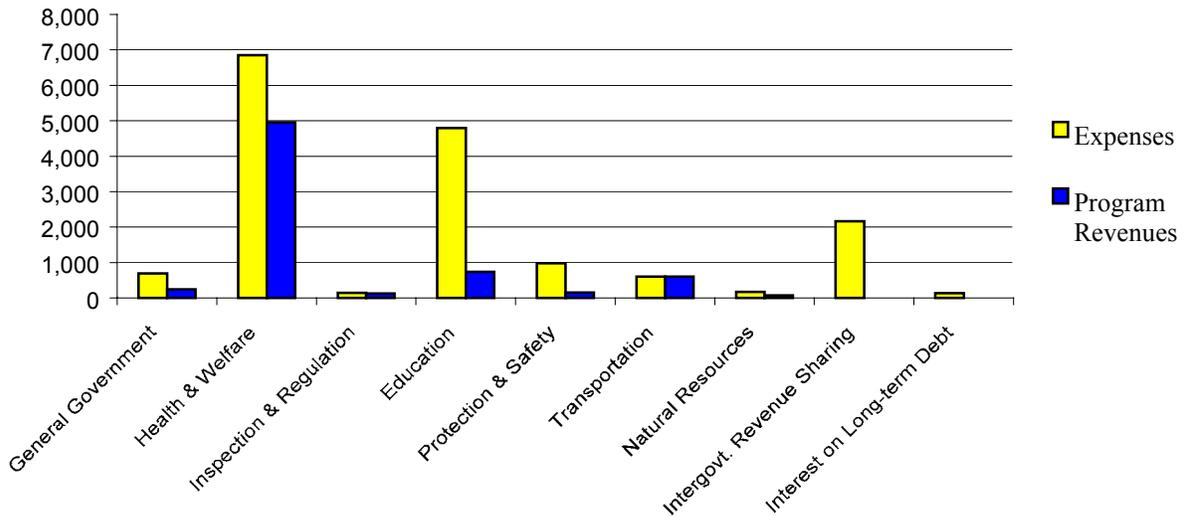
	Governmental Activities		Business-type Activities		Primary Government Total	
	2003	2002, as restated	2003	2002, as restated	2003	2002, as restated
Revenues:						
Program revenues:						
Charges for services	\$ 531,719	\$ 581,254	\$ 1,257,032	\$ 1,188,882	\$ 1,788,751	\$ 1,770,136
Operating grants and contributions	5,894,195	4,996,539	810,549	737,170	6,704,744	5,733,709
Capital grants and contributions	460,364	471,020	23,090	48,180	483,454	519,200
General revenues:						
Sales taxes	4,551,804	4,450,691	43,450	41,367	4,595,254	4,492,058
Income taxes	2,371,005	2,442,320	-	-	2,371,005	2,442,320
Property taxes	37,470	49,611	-	-	37,470	49,611
Motor vehicle and fuel taxes	1,563,876	1,493,259	-	-	1,563,876	1,493,259
Other taxes	632,896	544,514	-	-	632,896	544,514
Unrestricted investment earnings	77,914	116,614	32,527	29,327	110,441	145,941
Unrestricted grants and contributions	7,222	8,518	3	83,108	7,225	91,626
Miscellaneous revenue	319,873	186,917	26,985	12,447	346,858	199,364
Gain on sale of trust land	137,563	137,565	-	-	137,563	137,565
Total revenues	<u>16,585,901</u>	<u>15,478,822</u>	<u>2,193,636</u>	<u>2,140,481</u>	<u>18,779,537</u>	<u>17,619,303</u>
Expenses:						
General government	694,173	852,417	-	-	694,173	852,417
Health and welfare	6,848,087	5,960,399	-	-	6,848,087	5,960,399
Inspection and regulation	141,673	135,784	-	-	141,673	135,784
Education	4,795,566	4,277,635	-	-	4,795,566	4,277,635
Protection and safety	982,839	931,292	-	-	982,839	931,292
Transportation	598,375	411,108	-	-	598,375	411,108
Natural resources	175,312	152,772	-	-	175,312	152,772
Intergovernmental revenue sharing	2,159,691	2,190,160	-	-	2,159,691	2,190,160
Interest expense	135,775	131,206	-	-	135,775	131,206
Universities	-	-	2,159,216	2,039,832	2,159,216	2,039,832
Unemployment compensation	-	-	455,685	406,406	455,685	406,406
Industrial Commission	-	-	73,586	57,503	73,586	57,503
Lottery	-	-	263,321	239,648	263,321	239,648
Other business-type activities	-	-	107,740	95,164	107,740	95,164
Total expenses	<u>16,531,491</u>	<u>15,042,773</u>	<u>3,059,548</u>	<u>2,838,553</u>	<u>19,591,039</u>	<u>17,881,326</u>
Excess (deficiency) before contributions and transfers	54,410	436,049	(865,912)	(698,072)	(811,502)	(262,023)
Contributions to permanent endowments	-	-	3,037	2,723	3,037	2,723
Transfers	(665,004)	(709,916)	665,004	709,916	-	-
Change in net assets	(610,594)	(273,867)	(197,871)	14,567	(808,465)	(259,300)
Net assets - July 1, as restated	12,578,355	12,852,222	2,931,644	2,917,077	15,509,999	15,769,299
Net assets - June 30	<u>\$ 11,967,761</u>	<u>\$ 12,578,355</u>	<u>\$ 2,733,773</u>	<u>\$ 2,931,644</u>	<u>\$ 14,701,534</u>	<u>\$ 15,509,999</u>

Change in Net Assets

Governmental activities – Net assets decreased by \$611 million, or 5%. The School Facilities Board issued revenue bonds in the amount of \$332 million and certificates of participation in the approximate amount of \$373 million. The debt instruments are being issued to construct or repair K through 12 schools throughout the State. Although the debt instruments are obligations of the State, the constructed and improved schools are the capital assets of the school districts, which are separate and sovereign governmental entities. For each dollar of debt proceeds expended on construction and repair of schools, the State’s governmental activities net assets are reduced by one dollar. A comparison of the cost of services by function, net of program revenues, for the State’s governmental activities is shown below for fiscal years 2002 and 2003.

	2003 Governmental Activities (expressed in thousands)	2002, as restated, Governmental Activities (expressed in thousands)
Expenses, Net of Program Revenues:		
General government	\$ (452,184)	\$ (710,810)
Health and welfare	(1,892,128)	(1,620,216)
Inspection and regulation	(16,142)	(9,362)
Education	(4,058,176)	(3,737,181)
Protection and safety	(830,114)	(744,198)
Transportation	6,548	228,870
Natural resources	(107,551)	(79,697)
Intergovernmental revenue sharing	(2,159,691)	(2,190,160)
Interest expense	<u>(135,775)</u>	<u>(131,206)</u>
Total Governmental Activities Expenses, Net of Program Revenues	<u>\$ (9,645,213)</u>	<u>\$ (8,993,960)</u>

**Expenses and Program Revenues
Governmental Activities
(in millions of dollars)**



Business-type activities – The net assets decreased by \$198 million, or 7%. The decrease in net assets is primarily caused by a one-time lump sum distribution by the U.S. Department of Labor during fiscal year 2002 of Reed Act funding for the unemployment compensation fund in the approximate amount of \$145 million. During fiscal year 2003, the unemployment compensation fund received additional federal grant funding of approximately \$44 million due to significant increases of unemployment claims from government entities, non-profit organizations and the airline industry. These funding changes for the State’s unemployment program primarily reduced operating grant revenue and current assets. The Industrial Commission’s net assets decreased \$54 million primarily due to medical insurance carriers becoming insolvent during the year. The increase in insolvent medical insurers primarily increased the Industrial Commission’s expenses and long-term liabilities. A comparison of the cost of services by business-type, net of program revenues, for the State’s business-type activities is shown below for fiscal years 2002 and 2003.

	2003 Business-type Activities (expressed in thousands)	2002, as restated, Business-type Activities (expressed in thousands)
Expenses, Net of Program Revenues:		
Universities	\$ (787,776)	\$ (864,113)
Unemployment Compensation	(156,906)	5,368
Industrial Commission	(73,586)	(52,233)
Lottery	58,946	55,200
Other	<u>(9,555)</u>	<u>(8,543)</u>
Total Business-Type Activities Expenses, Net of Program Revenues	<u>\$ (968,877)</u>	<u>\$ (864,321)</u>

FINANCIAL ANALYSIS OF THE STATE’S FUNDS

The State uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental funds – The general government functions are contained in the General, Special Revenue, Debt Service, Capital Projects and Permanent Funds. The focus of the State’s governmental funds is to provide information on near-term inflows, outflows, and balances of *spendable* resources. Such information is useful in assessing the State’s financing requirements. In particular, *unreserved fund balance* may serve as a useful measure of a government’s net resources available for spending at the end of the fiscal year.

General Fund

The general fund is the chief operating fund of the State. At June 30, 2003, unreserved fund balance of the general fund was \$343 million, while total fund balance closed the year at \$546 million. As a measure of the general fund’s liquidity, it may be useful to compare both unreserved fund balance and total fund balance to total fund expenditures and other financing uses. Unreserved fund balance represents 2 percent of total expenditures and other financing uses, while total fund balance represents 4 percent of the same amount.

The fund balance of the State’s general fund decreased by \$202 million during the fiscal year. Most of the decline in fund balance is due to an increase in the Medicaid income eligibility limit approved by a voter initiative in the November 2000 general election. The initiative increased the indigent health care maximum income eligibility limit to 100% of the Federal Poverty Level. The increase of the State’s Medicaid population, due to passage of the November 2000 initiative, increased indigent health care entitlement matching by approximately \$129 million. General tax revenues of \$858 million were appropriated and \$109 million came from Tobacco Litigation Settlement receipts. Voters identified the Tobacco Litigation Settlement receipts as the funding source for expanded Medicaid coverage authorized by the initiative passed in the November 2000 general election. If litigation receipts do not cover the State’s share of the expanded coverage, the initiative requires general tax dollars to provide the remaining resources. The State’s Medicaid program provides healthcare services to 17 percent of Arizona’s population.

The education expenditure line item increase of approximately \$212 million results primarily from a \$191 million increase in basic State aid to education for K through 12 grades. The annual basic State aid to education funding requirements of K through 12 is determined by formula prescribed within Arizona law. The average daily attendance for K through 12 schools increased approximately 55 thousand students during 2003. The “student growth” component of the basic State aid formula for fiscal year 2003 was approximately \$248 million above fiscal year 2001 estimated growth amounts.

Transportation and Aviation Planning, Highway Maintenance and Safety Fund

The transportation and aviation planning, highway maintenance and safety fund is responsible for repair and maintenance of existing roads, paying the debt service for roads that are built from the issuing of revenue bonds, and providing technical assistance with road construction provided by contractors hired by the Arizona Department of Transportation. Total fund balance declined approximately \$88 million during fiscal year 2003. The fund balance decrease was primarily caused by two non-operating categories of transactions. Debt service funding of long-term obligations, secured by revenue collections, increased approximately \$30 million during fiscal year 2003, from approximately \$292 million in fiscal year 2002 to approximately \$322 million in fiscal year 2003. Payments to other State agencies increased approximately \$110 million in fiscal year 2003, from approximately \$80 million in fiscal year 2002 to approximately \$190 million in fiscal year 2003. These two transaction categories are reported as “transfers out” on the Statement of Revenues, Expenditures, and Changes in Fund Balances on **page 45**.

Land Endowments Fund

The fund was established when the federal government granted Statehood. Both the State constitution and the federal government require that the land grants given to the State be maintained indefinitely, and the earnings from the land grants should be used for public education, primarily K through 12 grades. The land endowments fund total fund balance increased \$41 million during fiscal year 2003. Unrealized valuation increase for investments at fiscal year end, compared to the initial investment purchase price, is approximately \$9 million. Proceeds from the sale of trust land by the Land Department increased by approximately \$37 million, from \$51 million during fiscal year 2002 to \$88 million during fiscal year 2003.

Proprietary funds

The business-type activities discussion for the fund level financial statements of the State’s enterprise funds provide the same type of information found in the government-wide financial statements analysis on **page 27**.

GENERAL FUND BUDGETARY HIGHLIGHTS

During the fiscal year, the original budget was amended by various supplemental appropriations and appropriation revisions. Budget to Actual Schedules for the major governmental funds are in the Required Supplementary Information section beginning on **page 115**. Differences between the original budget and the final amended budget resulted in a \$245 million increase in appropriations for the General Fund. The following comments summarize current year budgetary results:

- The General Fund appropriations increase of \$245 million is comprised primarily of 1) \$114 million of prior year obligations that are expended in the current year as allowed by ARS §35-191; 2) \$161 million of intra fund cash transfers mandated by the legislature; and 3) a net original budget reduction of \$30 million for all general fund agencies. The original General Fund appropriation total was \$9.6 billion. The final General Fund appropriation total was \$9.8 billion. No State agency’s budget was either increased or decreased a significant amount.
- The difference between the final budget and actual expenditures was approximately \$327 million. Of this amount, approximately \$87 million will continue as legislative multiple fiscal year spending authority for fiscal year 2004 and beyond depending upon the budgetary guidelines of the legislature. The remaining \$240 million represents the unused portion of the State’s legislatively authorized annual operating budget. Agencies not spending significant amounts of their annual operating legislative budgets were the State’s Indigent Health Care Agency (AHCCCS) (approximately \$143 million), the Department of Economic Security (approximately \$44 million) and the Department of Environmental Quality (approximately \$10 million).

Additional budgetary information can be found on pages 136-137 of this report.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital assets:

The State's investment in capital assets for its governmental and business-type activities as of June 30, 2003 totaled \$15.0 billion, net of accumulated depreciation. The total primary government increase in capital assets for the current period was 7 percent, with a 7 percent increase in capital assets used for governmental activities and a 6 percent increase for business-type activities. Depreciation charges of the governmental and business-type activities for the fiscal year totaled \$248 million.

Major capital assets activity during the current fiscal year included the following:

- The universities' additions to capital assets totaled approximately \$279 million.
- The department of transportation started or completed roads and bridges totaling \$835 million during the fiscal year.

For government-wide financial statement presentation, all depreciable assets, except infrastructure using the modified approach, were depreciated from acquisition date to the end of the current fiscal year. Governmental fund financial statements record capital asset purchases as expenditures.

Capital assets for the governmental and business-type activities as of June 30, 2003 are presented below (amounts in thousands):

	Governmental Activities		Business-type Activities		Total	
	2003	2002, as restated	2003	2002, as restated	2003	2002, as restated
Land	\$ 1,938,169	\$ 1,814,708	\$ 135,095	\$ 133,523	\$ 2,073,264	\$ 1,948,231
Buildings	1,196,997	1,063,937	2,232,616	2,100,782	3,429,613	3,164,719
Improvements Other than Buildings	129,035	115,837	2,478	36,920	131,513	152,757
Equipment	585,903	587,084	1,041,291	1,004,226	1,627,194	1,591,310
Collections (non-depreciable)	-	-	33,144	32,528	33,144	32,528
Infrastructure	7,571,377	7,468,539	279,494	213,301	7,850,871	7,681,840
Construction in Progress	2,184,798	1,676,519	133,986	98,572	2,318,784	1,775,091
Less Accumulated Depreciation	(834,350)	(784,482)	(1,674,570)	(1,561,633)	(2,508,920)	(2,346,115)
Total	\$ 12,771,929	\$ 11,942,142	\$ 2,183,534	\$ 2,058,219	\$ 14,955,463	\$ 14,000,361

See footnote 4, capital assets, beginning on **page 82** for additional capital asset data and footnote 8, accounting changes and restatements, beginning on **page 102** for information concerning the University of Arizona's raising its capitalization threshold to \$5,000.

As provided by GASB 34, the State has elected to record its infrastructure assets using the modified approach. Assets accounted for under the modified approach include approximately 6,801 centerline miles (18,129 travel lane miles) and 4,463 bridges that the State is responsible for maintaining.

The State manages its roads using the Present Serviceability Rating (PSR), which measures the condition of the pavement and its ability to serve the traveling public. The PSR uses a five-point scale (5 excellent, 0 poor) to characterize the condition of the roadway. The State's serviceability rating goal is 3.23 for the overall system. The most recent assessment indicated that an overall rating of 3.6 was achieved for fiscal year end 2003.

The State manages its bridges using the Arizona Bridge Information and Storage System (ABISS). The State determines the condition rating based on standards developed by the Federal Highway Administration and additional internal criteria. It is the policy of the State to maintain a Condition Rating Index (CRI) of 92.5 percent or better. In fiscal year 2003 a CRI of 93.9 percent was obtained.

In addition to many smaller projects, the following major highway construction projects in excess of \$20 million, were started during fiscal year 2003 (amounts in thousands):

Project Description	Contract Start Date	Contract Amount
Construction on State Route 260 in the vicinity of Camp Verde	10/24/2002	\$ 23,376
Construction of a four lane divided highway on the Kohl's Ranch section of State Route 260	5/13/2003	\$ 22,785
Construction of two overpasses on Grand Avenue (US 60); one at 43rd Avenue and Camelback Road and another at 51 st Avenue and Bethany Home Road	12/24/2002	\$ 20,180
Construction of the Santan Freeway (Loop 202) from Dobson Road to Arizona Avenue	6/25/2003	\$ 31,919
Construction of HOV lanes, roadway and drainage improvements on SR 51, from Interstate 10 to Shea Boulevard	1/22/2003	\$ 84,925

Capital assets financed by debt instruments do not generate funds to repay the debt instruments.

More detailed information regarding capital assets are on pages 82 and 83.

Long-term debt:

The State issues no general obligation debt instruments. The Arizona Constitution, under Article 9 Section 5, provides that the State may contract debts not to exceed \$350 thousand. This provision has been interpreted to restrict the State from pledging its credit as a sole payment for debts incurred for the operation of the State government. As a result, the State pledges either dedicated revenue streams or the constructed building or equipment acquired as security for the repayment of long-term debt instruments.

Major long-term debt activity during the current fiscal year included the following:

- The Department of Transportation issued revenue bonds for \$422 million to acquire land for future construction of controlled access roads, statewide road construction and early redemption of revenue bonds prior to maturity in the amount of approximately \$102 million. The School Facilities Board issued \$332 million of revenue bonds to do school repairs at K through 12 public schools throughout the State.
- The School Facilities Board issued \$373 million of certificates of participation to acquire and construct leasehold interests in new schools. The schools will be subleased to county school districts. At no time during the construction and sublease of the schools will the lease hold improvements be reported as assets of the State government.

State of Arizona-Primary Government
Outstanding Bonded Long Term Debt as of June 30, 2003
(expressed in thousands)

	Governmental Activities		Business-type Activities		Total	
	2003	2002	2003	2002	2003	2002
Revenue Bonds	\$ 2,173,055	\$ 1,782,510	\$ 597,238	\$ 596,403	\$ 2,770,293	\$ 2,378,913
Grant Anticipation Notes	169,145	182,295	-	-	169,145	182,295
Certificates of Participation	582,511	231,904	429,144	422,010	1,011,655	653,914
Total	<u>\$ 2,924,711</u>	<u>\$ 2,196,709</u>	<u>\$ 1,026,382</u>	<u>\$ 1,018,413</u>	<u>\$ 3,951,093</u>	<u>\$ 3,215,122</u>

See footnote 6, long-term obligations, beginning on **page 88** for both narrative and numeric detail information of the State's long-term debt transactions for fiscal year 2003.

More detailed information regarding long-term debt begins on page 88.

ECONOMIC CONDITION AND OUTLOOK

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.

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.

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.

CONTACTING THE STATE COMPTROLLER'S OFFICE

This financial report is designed to provide citizens, taxpayers, customers, investors, and creditors with a general overview of the State's finances and to demonstrate the State's accountability for the money it receives. If you have any questions about this report or need additional financial information, contact the Department of Administration, General Accounting Office, Financial Reporting Section at (602) 542-5405. You may also access and print this report at <http://www.gao.state.az.us/financials/>.

The State's component units issue their own separately issued audited financial statements. These statements may be obtained by directly contacting the component unit. Contact information regarding the component units begins on **page 65**.

