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February 11, 2005

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, 2004. 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 agent 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. In fiscal year 2004, the State implemented the Governmental Accounting Standards Board (GASB) Statement No. 39, *Determining Whether Certain Organizations Are Component Units*, an amendment to GASB Statement No. 14, *The Financial Reporting Entity*. Statement No. 39 provides additional guidance in determining whether certain organizations for which the primary government is not financially accountable should be reported as component units, based on the nature and significance of their relationship with the primary government. Based on this guidance, the State has added component units affiliated with Universities (i.e., foundations and financing authorities) that prepare financial statements in conformity with U.S. generally accepted accounting principles as adopted by the Financial Accounting Standards Board (FASB).

Discretely presented component units are shown separately 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. Discretely presented component units prepared in accordance with GASB standards are reported in a separate column in the government-wide financial statements. Discretely presented component units prepared in accordance with FASB standards are presented as separate financial statements immediately following the government-wide financial statements to emphasize that they are prepared in accordance with accounting standards other than those promulgated by GASB.

The criteria for inclusion in the reporting entity and presentation are defined by the Codification of Governmental Accounting and Financial Reporting Standards, issued by the Governmental Accounting Standards Board, (Section 2100). Note 1 of the Notes to the Financial Statements explains which component 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, September 2, 2004.

Arizona's Department of Economic Security, Research Administration's forecast update calls for Arizona's economy to continue expanding through the forecast period of 2004-05. Essentially unchanged from the original forecast, Arizona's non-farm jobs are forecast to grow by 2.4% in 2004 and 3.0% in 2005. Over the two-year period, non-farm job growth is forecast to total more than 125,000.

Meanwhile, the national economy is forecast to show continued improvement during the 2004-05 period. According to Global Insight, non-farm jobs at the national level are forecast to grow at annual rates of 1.0% in 2004 and 1.7% in 2005.

During the forecast period, some issues will continue to capture attention and restrain the growth of the economy. Slower expansion is the result of, first, higher-than-anticipated energy costs that have eroded consumer purchasing power and elevated business costs. Second, firms have been reluctant to hire new workers because of the continued upward spiral of health care costs and advances in productivity. Third, real growth in wages has been slow because of weak hiring that has maintained slack labor markets.

While the overall economy in Arizona is expected to grow at essentially the same pace as forecasted in April, some industries are projected to expand at a more rapid rate. Construction has the largest upward revision with a projected increase of more than 28,000 jobs over the forecast period as compared to an original increase of 9,000 jobs. A rising population level, coupled with affordable housing and low interest rates, has provided a stronger-than-expected stimulus to construction job growth.

Educational and health services are also forecast to have slightly larger job gains with a projected increase of more than 29,000 jobs over the forecast period. Growth in Arizona's communities is driving the employment increases in this industry.

Natural resources and mining is now projected to have fewer job reductions, a loss of only 100 jobs, with the revised forecast. Gradual improvements in global demand for industrial materials and rising energy costs have increased the need to use local sources of raw materials.

However, the forecast update has decreased the rate of employment growth for most other industries in the State. Job losses deepened in manufacturing to a total decrease of 4,500 jobs over the two-year period while only 600 jobs were lost in the earlier forecast.

Trade, transportation and utilities are projected to gain more than 19,000 jobs. Higher energy prices and stagnant wages have limited the ability of consumers to increase their spending. Rising consumer spending would have generated greater levels of demand required to have higher rates of job growth in this industry group.

Projected losses in information technology have increased to a total of more than 3,300 jobs. The original forecast had a recovery beginning in 2005. However, revised projections have losses in both years. The factors of outsourcing, overcapacity and enhanced productivity are expected to continue limiting job growth in this industry.

Financial activities is forecast to have fewer jobs created as a result of a slower pace of expansion in the overall economy. Some of the fast-growing sectors related to mortgage financing and real estate are expected to have more consolidation over this period.

Professional and business services are projected to add more than 23,000 jobs. The attempt of firms to control rising costs with the outsourcing of many functions, especially labor, is expected to create new jobs in this industry group.

Job gains in leisure and hospitality are expected to number more than 10,000 according to the forecast update. Despite stretched budgets, consumers and businesses are still expected to spend on travel, dining-out and recreation. Improvement in this tourism-related industry is anticipated in Arizona as the economies of other states continue to expand.

Employment growth in other services is projected to increase by more than 3,600 jobs.

Government is forecast to gain more than 13,000 jobs as a result of an increasing population creating greater demand for public services such as education, police and fire.

In conclusion, Arizona's economy has been adding jobs for nearly two years at a rate that ranks it among the top ten states in the nation, in terms of annual percentage growth. While the nation has shown six consecutive months of over-the-year increases, not all states have yet realized job creation. For those states now adding jobs, the pace of recovery has been slow. Research Administration is convinced that Arizona's economy will continue on a path of modest growth that will accelerate well into 2005.

MAJOR INITIATIVES

When Governor Napolitano took office in January 2003, the State was facing an unprecedented fiscal crisis. The FY2004 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 FY2003, after experiencing an 11.1% decline from FY2001 to FY2002. 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 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 FY2004 deficit was developed:

- Preserve the core functions of State government and continue the commitment to excellence in the quality of essential services and the manner in which they are provided.

- Apply spending reductions with specificity, agency by agency, program by program. The FY2004 Executive Budget only considered specific operating budget reductions, not across-the-board cuts.

- Programs and services that directly benefit children – including, but not limited to K-12 education – are immune to spending reductions. A degradation of services to children would only give rise to future societal burdens that will confound future planning.

- Universities and community colleges are crucial to economic development – a key ingredient to fiscal health – and are protected from spending cuts.

- Make appropriate use of accepted cost-shifting methods to address immediate needs until the current fiscal crisis has passed.

- Take full advantage of federal funds available to the State.

SERVICES PROVIDED BY THE STATE

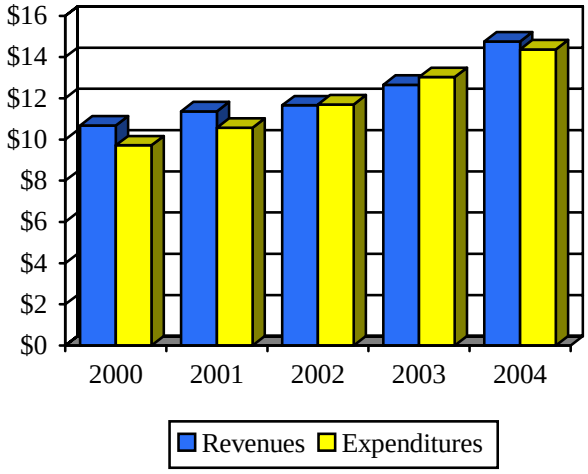
The services provided by the State are administered through various agencies, departments, boards, commissions and institutions of higher learning. These services include: (1) General Government, (2) Health and Welfare, (3) Inspection and Regulation, (4) Education, (5) Protection and Safety, (6) Transportation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

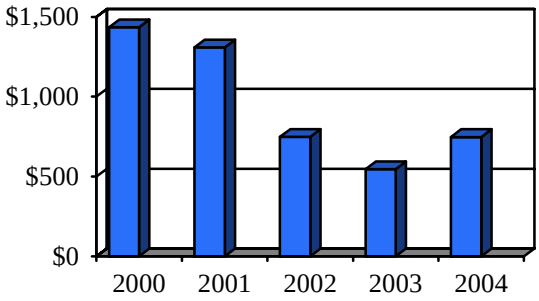


The General Fund ended the June 30, 2004, fiscal year with $561.0 million in unreserved fund balance and a $185.6 million reserved fund balance for a total fund balance of $746.6 million. This compares to the previous year's total fund balance of $546.4 million. Included in the $185.6 million reserved fund balance is $13.5 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 $9.5 million for the fiscal year ended June 30, 2004.

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 $366.7 million of operating revenues and $63.0 million of income before contributions and transfers for fiscal year 2004. The Enterprise Funds ended fiscal year 2004 with total ending net assets of $2.507 billion for the Primary Government.

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 $622.0 million for fiscal year 2004.

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 $450 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 $71.6 million in fiscal year 2004. Yearly appropriations have also increased from approximately $27.7 million in fiscal year 1988 to approximately $88.6 million in fiscal year 2004 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.

Betsey Bayless
Director

D. Clark Partridge
State Comptroller