

MANAGEMENT'S  
DISCUSSION  
AND  
ANALYSIS



## MANAGEMENT'S DISCUSSION AND ANALYSIS

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, 2004. 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 \$15.2 billion (reported as *net assets*). Of this amount, a \$496 million deficit for (*unrestricted net assets*) exists at fiscal year end, \$3.3 billion is restricted for specific purposes (*restricted net assets*), and \$12.4 billion is invested in capital assets, net of related debt.
- The State's total net assets increased in fiscal year 2004 by \$473 million. Net assets of governmental activities increased by \$680 million, while net assets of the business-type activities decreased by \$207 million.

#### Fund Level:

- As of the close of the fiscal year, the State's governmental funds reported combined ending fund balances of \$3.1 billion, an increase of \$443 million from the beginning of the year. Approximately 33% of the combined fund balances, \$1.0 billion 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 \$561 million, or 4%, of total General Fund expenditures.
- The enterprise funds reported net assets at year-end of \$2.5 billion, a decrease of \$205 million during the year.
- The Land Endowments Fund reported fund balance at year-end of \$1.4 billion, an increase of \$238 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 \$5.2 billion, an increase of \$1.0 billion (or 23%). During the year, the State issued revenue bonds and certificates of participation of \$689 million and \$550 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 statements:

**The Statement of Net Assets and the Statement of Financial Position (pages 38-40)** 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 42-44)** 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 University Medical Center, the Arizona Power Authority, and the Water Infrastructure Finance Authority are discretely presented component units reported by the State. Additionally, in fiscal year 2004, the State implemented the GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units*, an amendment to GASB Statement No. 14, *The Financial Reporting Entity*. Statement 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 university foundations and financing authorities whose financial statements are prepared in conformity with U.S. generally accepted accounting principles as adopted by the Financial Accounting Standards Board. These organizations include the ASU Foundation, the U of A Foundation, and other non-major foundations and financing authorities. Financial statements for these organizations are presented immediately following the government-wide statements to emphasize that they are prepared in accordance with accounting standards other than those promulgated by GASB, and include a statement of financial position (**page 40**) and a statement of activities (**page 44**). See **pages 63-65 and 107-121** for more information on discretely presented component units.

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

The fund financial statements begin on **page 45** 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 154** 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 46 and 48**) that reconcile the amounts reported on the governmental fund financial statements (modified accrual accounting) with governmental activities (accrual accounting) reported on the appropriate government-wide statement.

**Governmental fund financial statements can be found on pages 45 and 47 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 at the end of the financial statements on **pages 52-55**.

**Proprietary fund financial statements can be found on pages 50-59 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 60**. 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 60-61 of this report.**

#### **Notes to the Financial Statements**

The Notes to the 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 62 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 agent retirement plans’ funding progress schedules.

**Required supplementary information begins on page 125 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 154 of this report.**

### **GOVERNMENT-WIDE FINANCIAL ANALYSIS**

The State’s overall financial position and operations for the past year for the primary government are summarized as follows based on the information included in the government-wide financial statements. The fiscal year 2003 governmental activities net assets amount has been restated for the GASB Technical Bulletin No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues*. The fiscal year 2003 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 Note 4, capital assets, on **page 81** and Note 8, accounting changes and restatements, on **page 100** for additional restatement information.

State of Arizona-Primary Government  
Net Assets as of June 30, 2004 and 2003  
(expressed in thousands)

	Governmental Activities		Business-type Activities		Primary Government Total	
	2004	2003, as restated	2004	2003, as restated	2004	2003, as restated
Current assets	\$ 2,802,208	\$ 2,528,027	\$ 1,428,582	\$ 1,372,783	\$ 4,230,790	\$ 3,900,810
Capital assets	13,389,970	12,771,929	2,379,915	2,161,439	15,769,885	14,933,368
Other noncurrent assets	2,441,674	2,017,052	1,052,549	948,245	3,494,223	2,965,297
Total assets	<u>18,633,852</u>	<u>17,317,008</u>	<u>4,861,046</u>	<u>4,482,467</u>	<u>23,494,898</u>	<u>21,799,475</u>
Current liabilities	2,212,000	1,899,039	423,720	398,035	2,635,720	2,297,074
Noncurrent liabilities	3,728,379	3,404,396	1,932,727	1,372,754	5,661,106	4,777,150
Total liabilities	<u>5,940,379</u>	<u>5,303,435</u>	<u>2,356,447</u>	<u>1,770,789</u>	<u>8,296,826</u>	<u>7,074,224</u>
Net assets:						
Invested in capital assets, net of related debt	11,226,325	10,690,782	1,176,872	1,147,769	12,403,197	11,838,551
Restricted net assets	2,100,575	2,071,313	1,190,250	1,291,003	3,290,825	3,362,316
Unrestricted net assets	(633,427)	(748,522)	137,477	272,906	(495,950)	(475,616)
Total net assets	<u>\$ 12,693,473</u>	<u>\$ 12,013,573</u>	<u>\$ 2,504,599</u>	<u>\$ 2,711,678</u>	<u>\$ 15,198,072</u>	<u>\$ 14,725,251</u>

The largest portion of the State's net assets (82%) represents *capital assets, net of related debt* of \$12.4 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.

The State's net assets also include \$3.3 billion (22%) of 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 \$496 million (approximately 4%) represents *unrestricted net assets*, including restatements of beginning net assets.

The State's net assets increased by \$473 million during the current fiscal year. This increase is primarily caused by governmental activities increases for sales taxes, income taxes, capital assets, earnings on investments and trust land sales. Governmental Activities net asset increases were reduced by Business-type Activities reductions for the Unemployment Compensation Fund and the Industrial Commission Special Fund.

State of Arizona-Primary Government  
Changes in Net Assets for Fiscal Years Ended June 30, 2004 and 2003  
(expressed in thousands)

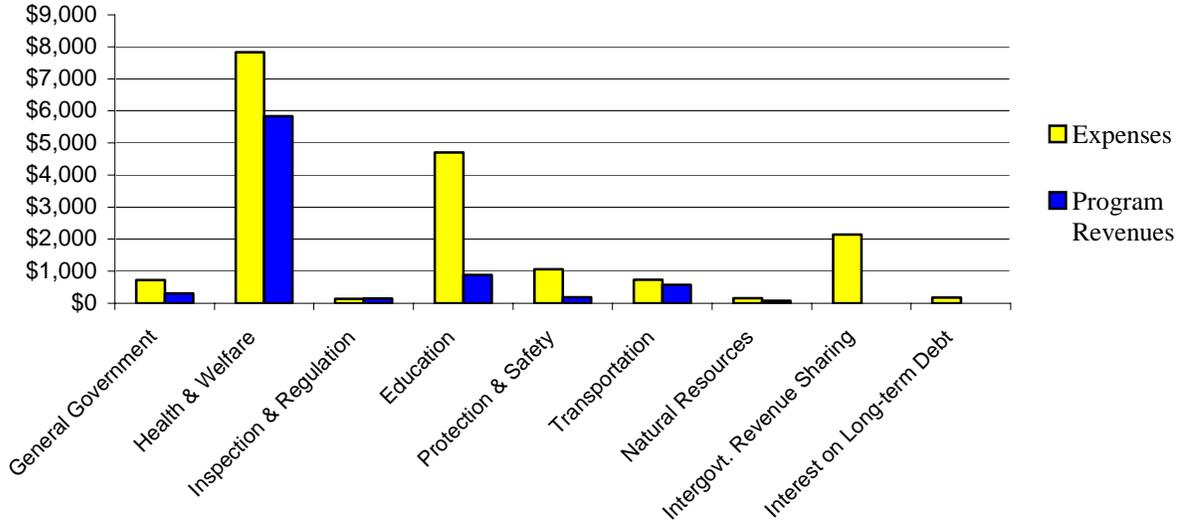
	Governmental Activities		Business-type Activities		Primary Government Total	
	2004	2003, as restated	2004	2003, as restated	2004	2003, as restated
Revenues:						
Program revenues:						
Charges for services	\$ 636,844	\$ 531,719	\$ 1,449,850	\$ 1,257,032	\$ 2,086,694	\$ 1,788,751
Operating grants and contributions	6,981,748	5,940,007	836,076	810,549	7,817,824	6,750,556
Capital grants and contributions	421,251	460,364	18,513	23,090	439,764	483,454
General revenues:						
Sales taxes	5,016,585	4,551,804	50,050	43,450	5,066,635	4,595,254
Income taxes	2,800,461	2,371,005	-	-	2,800,461	2,371,005
Tobacco taxes	223,804	-	-	-	223,804	-
Property taxes	50,455	37,470	-	-	50,455	37,470
Motor vehicle and fuel taxes	1,613,952	1,563,876	-	-	1,613,952	1,563,876
Other taxes	539,218	632,896	-	-	539,218	632,896
Unrestricted investment earnings	24,227	77,914	38,753	32,527	62,980	110,441
Unrestricted grants and contributions	8,502	7,222	-	3	8,502	7,225
Miscellaneous revenue	281,109	319,873	46,615	26,985	327,724	346,858
Gain on sale of trust land	319,517	137,563	-	-	319,517	137,563
Total revenues	18,917,673	16,631,713	2,439,857	2,193,636	21,357,530	18,825,349
Expenses:						
General government	726,525	694,173	-	-	726,525	694,173
Health and welfare	7,717,148	6,848,087	-	-	7,717,148	6,848,087
Inspection and regulation	138,281	141,673	-	-	138,281	141,673
Education	4,703,685	4,795,566	-	-	4,703,685	4,795,566
Protection and safety	1,059,047	982,839	-	-	1,059,047	982,839
Transportation	731,522	598,375	-	-	731,522	598,375
Natural resources	162,366	175,312	-	-	162,366	175,312
Intergovernmental revenue sharing	2,144,438	2,159,691	-	-	2,144,438	2,159,691
Interest on long-term debt	176,035	135,775	-	-	176,035	135,775
Universities	-	-	2,342,085	2,181,311	2,342,085	2,181,311
Unemployment compensation	-	-	397,657	455,685	397,657	455,685
Industrial Commission special fund	-	-	167,331	73,586	167,331	73,586
Lottery	-	-	303,996	263,321	303,996	263,321
Other business-type activities	-	-	109,944	107,740	109,944	107,740
Total expenses	17,559,047	16,531,491	3,321,013	3,081,643	20,880,060	19,613,134
Excess (deficiency) before contributions, special items and transfers	1,358,626	100,222	(881,156)	(888,007)	477,470	(787,785)
Contributions to permanent endowments	-	-	2,231	3,037	2,231	3,037
Special item – voluntary retirement program for faculty	-	-	(6,880)	-	(6,880)	-
Transfers	(678,726)	(665,004)	678,726	665,004	-	-
Change in net assets	679,900	(564,782)	(207,079)	(219,966)	472,821	(784,748)
Net assets - July 1, as restated	12,013,573	12,578,355	2,711,678	2,931,644	14,725,251	15,509,999
Net assets - June 30	\$ 12,693,473	\$ 12,013,573	\$ 2,504,599	\$ 2,711,678	\$ 15,198,072	\$ 14,725,251

**Change in Net Assets**

*Governmental Activities* – Net assets increased by \$680 million, or 6%. This increase is primarily attributed to the increases in earned general tax revenues. Reported sales tax and income tax revenue increased by \$465 million, or 10%, and \$429 million, or 18%, as compared to fiscal year 2003, respectively. Several key elements have led to this increase. The State has ranked in the top ten nationally in terms of annual percentage job growth for nearly two years as reported by Arizona’s Department of Economic Security, Research Administration. As a result, personal income growth has improved and consumer spending confidence is up. Furthermore, population inflows have continued to outpace outflows, fueling the expanding economy. Additionally, the State has improved its efforts in tax enforcement and exceeded its fiscal year 2003 collections by \$137 million. Another significant contributor to the net asset increase was record auction sales of \$320 million in State trust land, a \$182 million increase as compared to fiscal year 2003. Intense and competitive bidding in these auctions raised total sales prices approximately \$167 million above the appraised value of the land. Net asset increases were reduced by increases in long-term debt. The School Facilities Board issued revenue bonds in the amount of \$247 million and certificates of participation in the approximate amount of \$242 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 2004 and 2003.

	2004 Governmental Activities (expressed in thousands)	2003, as restated, Governmental Activities (expressed in thousands)
<b>Expenses, Net of Program Revenues:</b>		
General government	\$ (415,740)	\$ (452,184)
Health and welfare	(1,871,192)	(1,846,316)
Inspection and regulation	11,977	(16,142)
Education	(3,820,842)	(4,058,176)
Protection and safety	(870,240)	(830,114)
Transportation	(152,047)	6,548
Natural resources	(80,647)	(107,551)
Intergovernmental revenue sharing	(2,144,438)	(2,159,691)
Interest on long-term debt	(176,035)	(135,775)
Total Governmental Activities Expenses, Net of Program Revenues	<u>\$ (9,519,204)</u>	<u>\$ (9,599,401)</u>

**Expenses and Program Revenues  
Governmental Activities for Fiscal Year 2004  
(in millions of dollars)**



*Business-type Activities* – The net assets decreased by \$207 million, or 8%. The net assets reduction is primarily caused by the net losses of the Unemployment Compensation Fund and the Industrial Commission Special Fund of \$97 million and \$138 million, respectively. The Unemployment Compensation Fund’s fiscal year 2003 net loss amount was \$162 million. The declining rate of loss for the Unemployment Compensation Fund was primarily caused by an increase in employer assessments of \$34 million and a decrease in unemployment claims of \$58 million. The Industrial Commission’s net assets decreased \$138 million primarily due to workers’ compensation insurance carriers becoming insolvent during the year. The increase in insolvent insurers primarily increased the Industrial Commission’s expenses and long-term liabilities. As allowed by Title 23 of the Arizona Revised Statutes, the Industrial Commission has assessed the State Compensation Fund, privately owned insurance companies, and all self-insured plans that provide workers’ compensation insurance a two and one-half percent premium assessment for calendar year 2005, the largest amount currently authorized in Arizona law. The Industrial Commission had imposed no premium revenue assessments since calendar year 1992. For fiscal years 2005, 2006 and 2007 the Industrial Commission is projecting receipt of \$57 million from liquidated assets of insolvent carriers. 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 2003 and 2004.

	2004 Business-type Activities (expressed in thousands)	2003, as restated, Business-type Activities (expressed in thousands)
<b>Expenses, Net of Program Revenues:</b>		
Universities	\$ (815,629)	\$ (809,871)
Unemployment Compensation	(95,724)	(156,906)
Industrial Commission Special Fund	(162,189)	(73,586)
Lottery	62,586	58,946
Other	(5,618)	(9,555)
Total Business-Type Activities Expenses, Net of Program Revenues	<u>\$ (1,016,574)</u>	<u>\$ (990,972)</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, 2004, unreserved fund balance of the General Fund was \$561 million, while total fund balance closed the year at \$747 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 4% of total expenditures and other financing uses, while total fund balance represents 5% of the same amount.

The fund balance of the State's General Fund increased by \$200 million during the fiscal year. The primary source of the increase in fund balance is from the increase of sales tax and income tax revenues. Sales tax revenues increased approximately \$370 million from fiscal year 2003, an increase of approximately 10%. Sales taxes paid by retail stores, construction contractors, restaurants and bars and utility companies increased approximately \$150 million, \$80 million, \$27 million and \$24 million, respectively, when compared to fiscal year 2003 sales tax receipts. Receipts for the sales tax "amnesty" program not collected in fiscal year 2003 totaled approximately \$14 million. Income tax revenues increased approximately \$431 million, an increase of approximately 18%. Income taxes paid by individuals increased by approximately \$212 million when compared to fiscal year 2003 individual income tax receipts. Income taxes paid by businesses increased approximately \$136 million. Receipts for individual and business income tax "amnesty" programs not collected in fiscal year 2003 totaled approximately \$57 million.

Intergovernmental revenue and health and welfare expenditures increased by \$1.1 billion, or 20%, and \$1.1 billion, or 18%, as compared to fiscal year 2003, respectively. These increases are primarily due to the rising cost of health care programs for the State's indigent population, including Title XIX Medicaid and the Title XXI State Children's Health Insurance Program. Inflationary trends for health care costs are incorporated in the rate development process for the managed care organization capitation rates. Due to substantial increases in utilization and costs for pharmacy, outpatient/ER and inpatient, the capitation rates were increased by an average of 13% for the contract period of October 2003 to September 2004. The inflation rate is indicative of medical inflation including the rising cost of pharmaceuticals. The State received additional federal grants and county funding to cover a portion of these increased costs.

### 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 increased approximately \$52 million during fiscal year 2004. The fund balance increase was primarily caused by a \$20 million increase in sales taxes, a \$90 million increase in motor vehicle and fuel taxes and a \$27 million decrease in intergovernmental revenues. The fiscal year 2004 collections for both sales taxes and motor vehicle and fuel taxes recorded the highest year-over-year growth since fiscal year 1999 due mainly to the improved state and national economies and population growth. The sales tax growth was primarily attributable to a significant increase in registered vehicles (236 thousand) over fiscal year 2003. The motor vehicle and fuel tax growth was primarily attributable to the increase in population, which tends to follow job growth.

### 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 \$238 million during fiscal year 2004. Unrealized valuation increases for investments at fiscal year end, compared to the initial investment purchase price, were approximately \$102 million. This increase was primarily due to the rise in stock values of the S&P 500 and the S&P Mid Cap 400 Index Pools held by the State. Payments from the sale of trust land by the Land Department increased by approximately \$61 million, from \$88 million during fiscal year 2003 to \$149 million during fiscal year 2004. This increase is primarily the result of land contract payoffs that occurred for sales in prior fiscal years.

### **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. Budgetary Comparison Schedules for the major governmental funds are in the Required Supplementary Information section beginning on **page 125**. Differences between the original budget and the final amended budget resulted in a \$281 million increase in appropriations for the General Fund. The following comments summarize current year budgetary results:

- The General Fund appropriations increase of \$281 million is comprised primarily of 1) \$119 million of prior year obligations that are expended in the current year as allowed by §ARS 35-191; 2) \$69 million for the Department of Economic Security appropriations; 3) \$43 million for the Department of Education appropriations; 4) \$21 million for the Arizona Health Care Cost Containment System appropriations; 5) \$7 million for the Department of Health Services appropriations; and 6) a net original budget increase of \$22 million for all remaining general fund agencies. The original General Fund appropriation total was \$10.8 billion. The final General Fund appropriation total was \$11.1 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 \$311 million. Of this amount, approximately \$75 million will continue as legislative multiple fiscal year spending authority for fiscal year 2005 and beyond depending upon the budgetary guidelines of the Legislature. The remaining \$236 million represents the unused portion of the State's legislatively authorized annual operating budget.

**Additional budgetary information can be found on pages 143-144 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, 2004 totaled \$15.8 billion, net of accumulated depreciation. The total primary government increase in capital assets for the current period was 6%, with a 5% increase in capital assets used for governmental activities and a 10% increase for business-type activities. Depreciation charges of the governmental and business-type activities for the fiscal year totaled \$236 million.

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

- The universities' additions to capital assets totaled approximately \$378 million.
- The Department of Transportation started or completed roads and bridges totaling \$2.0 billion 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, 2004 are presented below (amounts in thousands):

	Governmental Activities		Business-type Activities		Total	
	2004	2003	2004	2003, as restated	2004	2003, as restated
Land	\$ 1,958,827	\$ 1,938,169	\$ 135,715	\$ 135,095	\$ 2,094,542	\$ 2,073,264
Buildings	1,488,193	1,196,997	2,488,685	2,232,616	3,976,878	3,429,613
Improvements other than buildings	140,029	129,035	2,493	2,478	142,522	131,513
Equipment	636,522	585,903	1,063,060	985,669	1,699,582	1,571,572
Collections (non-depreciable)	-	-	31,054	30,591	31,054	30,591
Infrastructure	8,597,975	7,571,377	246,791	279,494	8,844,766	7,850,871
Construction in progress	1,456,713	2,184,798	160,275	133,986	1,616,988	2,318,784
Less accumulated depreciation	(888,289)	(834,350)	(1,748,158)	(1,638,490)	(2,636,447)	(2,472,840)
Total	<u>\$ 13,389,970</u>	<u>\$ 12,771,929</u>	<u>\$ 2,379,915</u>	<u>\$ 2,161,439</u>	<u>\$ 15,769,885</u>	<u>\$ 14,933,368</u>

See Note 4, capital assets, beginning on **page 81** for additional capital asset data and Note 8, accounting changes and restatements, on **page 100** for information concerning Arizona State University raising its capitalization threshold to \$5,000 for equipment and collections.

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 6,912 centerline miles (18,391 travel lane miles) and 4,488 bridges (deck area of 41.2 million square feet) that the Department of Transportation (Department) is responsible for maintaining.

The Department 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 Department's serviceability rating goal is 3.23 for the overall system. The most recent assessment indicated that an overall rating of 3.8 was achieved for fiscal year end 2004.

The Department manages its bridges using the Arizona Bridge Information and Storage System (ABISS). The Department 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% or better. In fiscal year 2004, a CRI of 93.8% was obtained.

In addition to many smaller projects, each of the following major highway construction projects in excess of \$20 million were started during fiscal year 2004 (amounts in thousands):

<u>Project Description</u>	<u>Contract Start</u>	<u>Contract Amount</u>	<u>Current Year Expenditures</u>
Construction of new roadway on State Route Loop 202, from Elliot Road to Power Road in Maricopa County.	03/23/2004	\$ 54,114	\$ 7,445
Widening US 60 and constructing part of the State Route Loop 202 urban interchange, starting at Sossaman Road and ending west of Ellsworth Road in Maricopa County.	10/20/2003	\$ 40,952	\$ 31,462
Construction of new roadway on State Route Loop 202, from Elliot Road to Baseline Road in Maricopa County.	11/24/2003	\$ 39,463	\$ 18,703
Reconstruction of roadway to a 4 lane divided highway on the Burro Creek Section of US 93 in Mohave County.	12/23/2003	\$ 25,934	\$ 5,055
Construction of new roadway on State Route 188, from Resort Road to Devore Wash in Gila County.	09/05/2003	\$ 25,643	\$ 11,219
Construction of new roadway on State Route Loop 202, west of Higley Road to Power Road in Maricopa County.	01/20/2004	\$ 22,855	\$ 4,736

In addition to many smaller projects, the following major highway construction projects had expenditures in excess of \$15 million in fiscal year 2004:

<u>Project Description</u>	<u>Project Expenditures</u>
Construction of HOV lanes, roadway and drainage improvements on State Route 51, from Interstate 10 to Shea Boulevard in Maricopa County.	\$ 74,690
Construction of a bridge to by-pass the Hoover Dam on Interstate 93 in Mohave County.	\$ 50,041
Construction of new roadway at the interchange of State Route Loop 202 and Interstate 60 in Maricopa County.	\$ 36,479
Construction of new roadway on State Route Loop 202, from Gilbert Road to Higley Road in Maricopa County.	\$ 30,619
Construction of the roadway at the interchange of Interstate 10 and Interstate 19 in Pima County.	\$ 23,425
Construction of new roadway on State Route Loop 202, at Price Road in Maricopa County.	\$ 22,086
Construction of new roadway on State Route Loop 202, from Elliot Road to Baseline Road in Maricopa County.	\$ 20,470
Construction on Interstate 95 from McCulloch Boulevard to London Bridge Road in Mohave County.	\$ 19,194
Construction of new roadway on State Route Loop 202, from Dobson Road to Arizona Avenue in Maricopa County.	\$ 17,416
Construction of two overpasses on Grand Avenue (US 60): One at 43rd Ave. and Camelback Road and another at 51st Ave. and Bethany Home Rode in Maricopa County.	\$ 16,076
Construction on State Route 260 in Camp Verde area in Yavapai County.	\$ 15,166
Construction of new roadway on State Route Loop 202, from Price Road to Arizona Avenue in Maricopa County.	\$ 15,138

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

**More detailed information regarding capital assets are on pages 81 and 82.**

**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 \$251 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 \$115 million. The School Facilities Board issued \$247 million of revenue bonds to do school repairs at K through 12 public schools throughout the State.
- The Universities issued revenue bonds for \$191 million (including refunding bonds of \$9.8 million) primarily to fund the acquisition, construction or renovation of capital facilities, and information technology and telecommunications upgrade projects.
- The Department of Transportation issued \$200 million of grant anticipation notes to (i) pay costs of the projects (as specified), (ii) pay costs of issuing the notes, (iii) pay interest on the notes, and (iv) refund the 2000A Series Notes in the aggregate principal amount of \$26.255 million.
- The School Facilities Board issued \$242 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 leasehold improvements be reported as assets of the State government.
- Universities issued \$260 million of certificates of participation primarily for construction and building renewal projects and early redemption of certificates of participation prior to maturity.

State of Arizona-Primary Government  
Outstanding Bonded Long-Term Debt as of June 30, 2004  
(expressed in thousands)

	Governmental Activities		Business-type Activities		Total	
	2004	2003	2004	2003	2004	2003
Revenue Bonds	\$ 2,278,225	\$ 2,173,055	\$ 756,781	\$ 597,238	\$ 3,035,006	\$ 2,770,293
Grant Anticipation Notes	308,585	169,145	-	-	308,585	169,145
Certificates of Participation	845,804	582,511	641,315	429,144	1,487,119	1,011,655
Total	<u>\$ 3,432,614</u>	<u>\$ 2,924,711</u>	<u>\$ 1,398,096</u>	<u>\$ 1,026,382</u>	<u>\$ 4,830,710</u>	<u>\$ 3,951,093</u>

**More detailed information regarding long-term debt begins on page 87.**

## ECONOMIC CONDITION AND OUTLOOK

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.

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.

## 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 63**.