INTRODUCTORY SECTION

INTRODUCTORY SECTION

JANET NAPOLITANO
GOVERNOR

WILLIAM BELL
DIRECTOR

ARIZONA DEPARTMENT OF ADMINISTRATION
OFFICE OF THE DIRECTOR
100 NORTH 15th AVENUE • SUITE 401
PHOENIX, ARIZONA 85007
Phone: (602) 542-1500

March 31, 2006

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, 2005. Responsibility for the accuracy of data, as well as the 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 (GAAP) 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.

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. GAAP. 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.

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.

PROFILE OF THE GOVERNMENT

The State of Arizona was admitted to the Union as the 48th state in 1912. Arizona is the sixth largest state, with 113,909 square miles. Arizona is known for the Grand Canyon, one of the Seven Wonders of the World, and its cacti and other desert landscape. A number of national forests, three national parks, eighteen national monuments, and Indian reservations are located in the State.

The State has three branches of government, Executive, Legislative, and Judicial. The Executive branch is headed by a governor elected for a four-year term. Arizona's Legislative branch is bicameral, consisting of a thirty-member Senate and a sixty-member House of Representatives. Legislators are elected for two-year terms. The Judicial branch consists of the Arizona Supreme Court, Court of Appeals (with two divisions), superior courts, justice of the peace courts and municipal courts. The Supreme Court is the highest court in the State and is an appellate court comprised of five justices.

The services provided by the State are administered through various agencies, departments, boards, commissions, councils, administrations, offices 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.

FINANCIAL REPORTING ENTITY

The accompanying CAFR includes all funds of the State of Arizona (primary government), as well as its component units. Blended component units, although legally separate entities, are in substance part of a government's operations. Therefore, data from these units is combined with data of the primary government. 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 the Governmental Accounting Standards Board (GASB) are reported in a separate column in the government-wide financial statements. Discretely presented component units prepared in accordance with the Financial Accounting Standards Board (FASB) 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 the 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 GASB, (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.

BUDGETARY CONTROLS

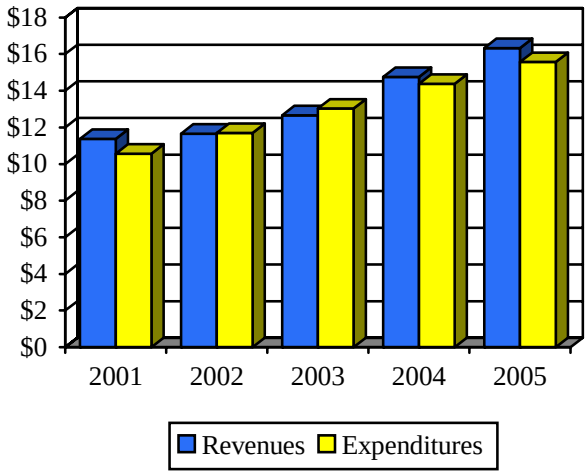
Budgetary control is maintained through legislative appropriation and the executive branch allotment process. The Governor is required to submit an annual budget to the Legislature. The budget is legally required to be adopted through passage of appropriation bills by the Legislature and approval by the Governor. The appropriated funds are controlled by the executive branch through an allotment process. This process generally 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 and other continuing appropriations. These appropriations and their encumbrances continue from year to year. The State's budgetary policies are explained in detail in the Required Supplementary Information (RSI).

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*)

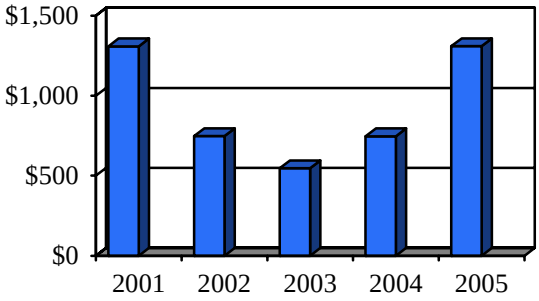


The General Fund ended the June 30, 2005, fiscal year with $986.2 million in unreserved fund balance and a $324.2 million reserved fund balance for a total fund balance of $1.310 billion. This compares to the previous year's total fund balance of $746.6 million. Included in the $324.2 million reserved fund balance is $160.9 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*)



RISK MANAGEMENT

The State purchases property and liability coverage whenever available on reasonable terms. The State is insured by an approved 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 the School for the Deaf and Blind and $7 million for all other state agencies, but less than $107 million. The State also maintains first dollar aircraft liability, hull, and airport liability coverage up to $200 million. Other purchased coverages include fidelity, foreign liability, medical malpractice (limited to the University of Arizona's medical professional staff), nuclear property, nuclear liability, 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 $86.7 million in fiscal year 2005. Yearly appropriations have also increased from approximately $27.7 million in fiscal year 1988 to approximately $93.9 million in fiscal year 2005 to meet rising losses and claims-related expenses. Annual funding is established for expected paid claims. The accrued insurance losses are not considered when determining funding for each fiscal year.

ECONOMIC CONDITION AND OUTLOOK

The following economic summary is excerpted from the Arizona Department of Economic Security's Arizona's Workforce, released on September 1, 2005.

In comparison to the original forecast released in April 2005, the economy in Arizona is projected to grow at a faster rate over the forecast period from 2004 to 2006. For 2005, the projected growth rate has been increased to 4.6 percent and, for 2006, the projected pace of expansion is 3.7 percent. The revised nonfarm job increase for 2004 to 2006 is 202,200 jobs, in comparison to the original forecast, with a gain of 191,300 jobs. Not only is the overall economy anticipated to grow at a faster rate, as demonstrated in the nonfarm job figures, but most industries are projected to grow at a more rapid pace.

The projections are being revised upwards because of stronger than anticipated strength in the Arizona economy. Strong population growth in the State has bolstered major industries such as construction, trade, financial activities, leisure and hospitality, educational and health services and government. Economic growth in the rest of the nation and other parts of the world has also helped to strengthen the State's economy. Productivity enhancements from automation and information technology have contributed to this overall economic improvement. An improving domestic economy has persuaded businesses to increase their spending. This increased spending has also contributed to accelerating the economy. Rapid economic growth in other parts of the world such as China has increased demand for many globally traded commodities such as copper and, therefore, has resulted in rising prices. Higher copper prices have resulted in expansion in the metal ores sector of the natural resources and mining industry. Continued U.S. military operations abroad have bolstered employment in the aerospace products and parts sector of durable goods manufacturing. Strong construction activity has bolstered another durable goods manufacturing sector, fabricated metal products.

The economy will continue to grow over the forecast period despite rising costs for energy, health care and interest rates because incomes are expected to increase at a faster rate than costs. Rising interest rates will make consumer debt service more expensive and home mortgages less affordable. The removal of equity from the refinancing of home mortgages with rising housing prices has placed more money in the hands of consumers and has contributed to continued growth of consumer spending. However, housing price growth is expected to slow as interest rates rise and, therefore, slow equity removal and mortgage refinance activity. Higher health care and energy costs will absorb consumer disposable income and leave less money to be spent on other goods and services. These rising costs will slow, rather than stop, the current economic expansion.

The current economic expansion could potentially be halted if the costs of interest rates, energy and health care increase past a certain point where they absorbed a majority of consumer disposable income while not leaving enough funds to be spent on other items. Rising interest rates, a special concern, will make servicing high levels of consumer and federal government debt more expensive and crowd out other types of spending.

Construction is now projected to have an increase of 39,800 jobs over the forecast period. The revised projected growth rate for 2005 is 11 percent, which slows to 9 percent for 2006. In contrast, the original set of projections had a gain of 24,800 jobs. Population growth and the corresponding need to expand infrastructure are expected to drive growth in construction.

Manufacturing is forecast to add 4,800 jobs for an expansion rate of 1.5 percent for 2005 and 1.2 percent for 2006. The increasing pace of expansion is the result of an anticipated increase in defense contracts. In contrast, the original set of projections had a gain of 3,900 jobs.

Natural resources and mining has a projected gain of 1,700 jobs, or a growth rate of 11 percent for 2005 and 9 percent for 2006. The previous forecast called for a gain of 500 jobs.

Trade is forecast to have an increase of 37,000 jobs from 2004 to 2006 with a growth rate of 5.6 percent for 2005 and 3.8 percent for 2006. Retail is anticipated to add 33,700 jobs while wholesale employment is projected to gain 3,300 jobs.

Financial activities is forecast to add 11,700 jobs in 2005 and 2006 for an expansion rate of 4 percent in 2005 and 3 percent in 2006. The original projections set called for an increase of 9,700 jobs.

Transportation, warehousing and utilities is a part of the economy where rising energy costs have caused a downward revision to growth in comparison to the original forecast. The revised set of projections has this sector adding 2,400 jobs for a growth rate of 1.8 percent in 2005 and 1.2 percent in 2006. However, the original forecast called for an increase of 2,800 jobs. The primary reason for the reduced growth rate, especially in transportation, is higher than originally anticipated fuel prices.

Information is following the trend of transportation, warehousing and utilities with downwardly revised forecast figures. The revised job losses have deepened to 4,300 jobs over the two-year period in contrast to a much smaller loss of 200 jobs in the original forecast. The reason for the downward revision is a deeper and longer than anticipated consolidation process in the telecommunications sector.

Professional and business services is expected to add 37,300 jobs, an expansion rate of 6 percent in 2005 and 4.9 percent in 2006. The original set of projection figures called for an increase of 37,700 jobs. Growth was revised downward for this industry group because of greater projected losses in the sector of business support services.

Leisure and hospitality is forecast to have an increase of 18,200 jobs, a growth rate of 4.3 percent for 2005 and 3.1 percent for 2006. The original projections set had an increase of 18,400 jobs.

Government is projected to have a gain of 19,300 jobs, or a rate of growth of 2.6 percent in 2005 and 2.2 percent in 2006. The original forecast called for an increase of 21,900 jobs.

The projected rate of expansion in educational and health services has been revised downward. This industry is now projected to have an increase of 29,500 jobs, or a pace of expansion of 6.0 percent in 2005 and 5.1 percent in 2006. The original forecast set the expansion to be an increase of 32,200 jobs. Growth projections for health care have been decreased because of the dampening effects of rapidly rising health care costs and shortages of workers in skilled occupations, while the slowing growth of the school age population, especially children in the primary and secondary school categories, has reduced the growth pace in educational and social services.

The revised projections for other services are unchanged from the original with an addition of 4,800 jobs for a growth rate of 2.8 percent in 2005 and 2.5 percent in 2006.

Overall, the remainder of 2005 and 2006 will be good for Arizona's economy with strong job growth in most industries. Information is the only exception with anticipated, accelerating losses. The factors of concern are rising interest and energy costs because if these two costs increase fast enough, then they have the potential to significantly slow down the State's economy.

MAJOR INITIATIVES

To fully appreciate the challenges and opportunities of the 2004 legislative session and the development of the FY 2005 State budget, it is essential to examine what transpired in the year prior when a newly elected Governor and a bumper crop of first-time Legislators were welcomed into office by arguably the most daunting fiscal crisis in State history. While state governments across the United States were reeling from the nationwide recession, the projected $1 billion General Fund deficit for FY 2004, when viewed as a percentage of the total budget, ranked Arizona among the nation's most fiscally troubled states.

The process of arriving at a balanced budget was predictable and inevitably contentious. Along the way, both the Executive and Legislative branches realized that despite the enormity of the task before them, they could resolve the State's fiscal crisis without draconian cuts in vital programs, without dismantling and then reconstituting State Government, and without raising taxes. The collective wisdom of employing temporary fiscal measures to address temporary, albeit severe, economic pressures has been affirmed in the last two years as the rebounding economy and sound decision-making in both the Legislative and Executive branches have sparked a return to fiscal health.

The Governor's Fiscal Year 2005 budget reflected a commitment to phase-in initiatives that respect the State's fiscal situation to shape an environment in which Arizonans of all ages receive an excellent education, pursue a life of prosperity and abundance, live in peace and safety, and enjoy Arizona's precious natural resources.

Education

Full Day Kindergarten. The FY 2005 Budget provided $25 million for classroom teachers and new facilities as the first step in a five-year phase-in of voluntary Full Day Kindergarten.

Community Colleges. The FY 2005 Budget fully funded the Operating, Capital Outlay, and Equalization Aid funding formulas. Arizona's two-year community colleges provide high school graduates with a variety of educational opportunities, including technical education needed to participate in Arizona's and the nation's new economy.

Universities. A top-notch university system allows each person and business in Arizona to be a world-class competitor. Recognizing this, the FY 2005 Budget provided full funding for FY 2005 enrollment growth at the three State universities. Additionally, funding for faculty retention was provided to the University of Arizona and Northern Arizona University. Finally, to help alleviate Arizona's shortage of nurses, over $1 million was provided for the nursing school at Northern Arizona University.

Health and Welfare

Human infrastructure investments that were adopted in the FY 2005 Budget included additional funding for the Division of Children, Youth and Families (DCYF) in the Department of Economic Security. Of the $35.6 million requested by the Governor, $28.8 million and 235 full-time equivalent (FTE) positions in FY 2004 supplemental appropriations were provided for a variety of Child Protective Services issues as well as other DCYF services such as Adoption Services, Permanent Guardianship subsidies, and out-of-home placements for foster children.

Additionally, the budget provided $13.75 million to double the Healthy Families program in FY 2005. The program provides contracted services to children under five years of age and members of their families. It is designed to prevent child abuse or neglect, as well as promote child development and wellness.

Public Safety

Keeping the State's physical infrastructure in quality condition also requires continued investment. With the continued growth in population and attendant growth in Arizona's network of highways comes the requirement to build more roads and maintain them for the safety of motorists.

Department of Public Safety. A major part of highway safety is having an adequate law enforcement presence. The FY 2005 Budget contained approximately $1.9 million for new Highway Patrol officers to increase visibility on the highways and address increased workloads due to traffic accidents and motorist assists. The FY 2005 budget also provided $4.3 million sworn officer salary adjustments.

Forest Protection. Arizona forests have suffered from the wilderness equivalent of the perfect storm: unrelenting drought, forest overgrowth stemming from years of policy decisions, and a major infestation of bark beetles. The result: unprecedented fire danger, putting people and property at risk.

The FY 2005 Budget provided $782,900 and 14 FTE positions to the State Land Department in inmate fire crews, which provided training for twelve inmate fire crews. The crews were used for fuel treatment and fire suppression in and around at-risk communities. The Budget also provided for $804,300 and 18 FTE positions in the Department of Corrections to fund 18 security positions for the newly added inmate fire crews.

Given the tremendous loss of property and the threat to the residents of more than 120 forest communities, it was a wise investment and one the State was dedicated to make.

Economic Development

Combining the human, physical and financial resources of the State of Arizona to drive economic development is the job of the Department of Commerce.

The Governor's Task Force recommended the largest initiative for military facilities. Military bases provide 83,000 jobs and an economic impact of $5.7 billion annually in Arizona. Laws 2004, Chapter 235 provided an annual $5 million appropriation for military installation preservation and enhancement projects. Another executive initiative for economic development adopted in the FY 2005 Budget included $295,400 for rural community economic health, including direct technical assistance to help those communities find resources that will allow them to upgrade their physical and human infrastructure.

These initiatives, combined with the ongoing activities of the Department of Commerce, are the force that pulls together and expands Arizona's physical, human and financial capital so that Arizona is not just *among* the best places to live and work, but it is *the* best.

State Employees

Any investment in human capital is not complete without investing in the people who deliver the services: the employees of the State of Arizona. The FY 2005 budget provided a $1,000 pay increase for State employees.

AWARDS AND ACKNOWLEDGMENTS

The Government Finance Officers Association (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of Arizona for its CAFR for the year ended June 30, 2004. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized CAFR whose content satisfies both GAAP and applicable legal requirements. A Certificate of Achievement is valid for a period of one year only. We believe our current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to the GFOA to determine its eligibility for another certificate.

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, council, administration, office, institution of higher education and all other organizations within the reporting entity.

William Bell
Director

D. Clark Partridge
State Comptroller

Certificate of Achievement for Excellence in Financial Reporting

Presented to

State of Arizona

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2004

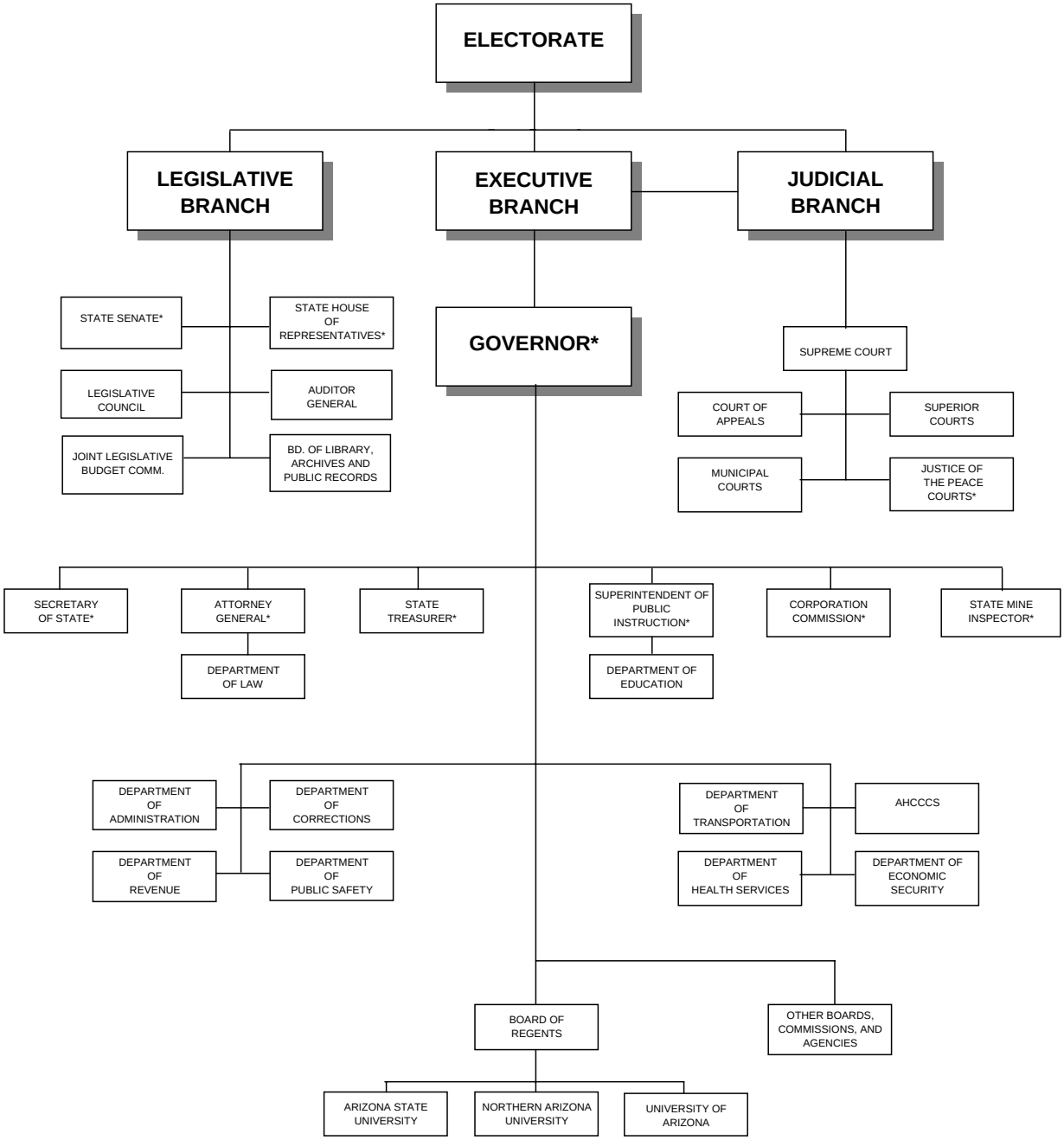
A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.

President

Executive Director

(This page intentionally left blank)

ARIZONA STATE GOVERNMENT ORGANIZATION



* ELECTED OFFICIALS

STATE OF ARIZONA
PRINCIPAL STATE OFFICIALS
JUNE 30, 2005

ELECTED OFFICIALS

Janet Napolitano, Governor

Senator Ken Bennett, President of the Senate

Representative James P. Weiers, Speaker of the House

Janice K. Brewer, Secretary of State

Terry Goddard, Attorney General

Douglas K. Martin, State Mine Inspector

David A. Petersen, State Treasurer

Tom Horne, Superintendent of Public Instruction

Jeff Hatch-Miller, Chairman - Corporation Commission

William A. Mundell, Commissioner - Corporation Commission

Kristin K. Mayes, Commissioner - Corporation Commission

Mike Gleason, Commissioner - Corporation Commission

Marc L. Spitzer, Commissioner - Corporation Commission

APPOINTED OFFICIALS

Executive Officials

William Bell, Director – Department of Administration – current

Betsey Bayless, Director - Department of Administration – through September, 2005

Dora B. Schriro, Director - Department of Corrections

David A. Berns, Director - Department of Economic Security

Gale Garriott, Director - Department of Revenue

Roger Vanderpool, Director - Department of Public Safety

Susan Gerard, Director - Department of Health Services

Anthony D. Rodgers, Director - Arizona Health Care Cost Containment System

Victor Mendez, Director - Department of Transportation

Judicial Officials

Ruth V. McGregor, Chief Justice - Supreme Court

Legislative Officials

Michael E. Braun, Executive Director - Legislative Council

Richard Stavneak, Director - Joint Legislative Budget Committee

Debra K. Davenport, CPA, Auditor General - Office of the Auditor General

Gladys Ann Wells, Director - Board of Library, Archives and Public Records

University Officials

Michael M. Crow, President - Arizona State University

Dr. John D. Haeger, President - Northern Arizona University

Peter W. Likins, President - University of Arizona