

MANAGEMENT'S
DISCUSSION
AND
ANALYSIS

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The following is a discussion and analysis of the State of Arizona's (the State's) financial performance, providing an overview of the activities for the fiscal year ended June 30, 2005. 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 \$16.856 billion (reported as *net assets*). Of this amount, a \$306.711 million deficit for *unrestricted net assets* exists at fiscal year end, \$4.170 billion is restricted for specific purposes (*restricted net assets*), and \$12.993 billion is invested in capital assets, net of related debt.
- The State's total net assets increased in fiscal year 2005 by \$1.671 billion. Net assets of governmental activities increased by \$1.658 billion, while net assets of the business-type activities increased by \$13.443 million.

Fund Level:

- As of the close of the fiscal year, the State's governmental funds reported combined ending fund balances of \$4.202 billion, an increase of \$1.082 billion from the beginning of the year. Approximately 37% of the combined fund balances, or \$1.561 billion, is available to meet the State's current and future needs (*unreserved fund balances*).
- As of the close of the fiscal year, unreserved fund balance for the General Fund was \$986.168 million, or 6%, of total General Fund expenditures.
- The enterprise funds reported net assets at year end of \$2.522 billion, an increase of \$28.279 million during the year.
- The Land Endowments Fund reported fund balance at year end of \$1.718 billion, an increase of \$355.422 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 increased during the fiscal year to \$5.692 billion, an increase of \$483.034 million, or 9%. During the year, the State issued revenue bonds and certificates of participation of \$574.700 million and \$843.799 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 25**.

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:

The Statement of Net Assets and the Statement of Financial Position (pages 40-42) 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 44-46) 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. Based on GASB Statement No. 39, 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, Arizona Capital Facilities Finance Corporation, 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 42**) and a statement of activities (**page 46**). See **pages 65-67 and 111-124** for more information on discretely presented component units.

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

The fund financial statements begin on **page 47** 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 158** 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 48 and 50**) 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 47 and 49 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 54-57**.

Proprietary fund financial statements can be found on pages 52-61 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 62**. These funds, which include pension trust, 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 62-63 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 65 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. 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 127 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 are 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 158 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 2004 business-type activities net assets amount has been restated due to changing a method of calculating depreciation on research buildings to a componentized method based on the estimated useful life of the building components. See Note 4, capital assets, on **page 87** and Note 8, accounting changes and restatements, on **page 105** for additional restatement information.

State of Arizona-Primary Government
Net Assets as of June 30, 2005 and 2004
(expressed in thousands)

	Governmental Activities		Business-type Activities		Primary Government Total	
	2005	2004	2005	2004, as restated	2005	2004, as restated
Current assets	\$ 3,503,360	\$ 2,802,208	\$ 1,516,254	\$ 1,428,582	\$ 5,019,614	\$ 4,230,790
Capital assets	14,012,830	13,389,970	2,677,802	2,366,582	16,690,632	15,756,552
Other non-current assets	2,955,282	2,441,674	1,063,599	1,052,549	4,018,881	3,494,223
Total assets	<u>20,471,472</u>	<u>18,633,852</u>	<u>5,257,655</u>	<u>4,847,713</u>	<u>25,729,127</u>	<u>23,481,565</u>
Current liabilities	2,069,865	2,212,000	484,636	423,720	2,554,501	2,635,720
Non-current liabilities	4,049,808	3,728,379	2,268,310	1,932,727	6,318,118	5,661,106
Total liabilities	<u>6,119,673</u>	<u>5,940,379</u>	<u>2,752,946</u>	<u>2,356,447</u>	<u>8,872,619</u>	<u>8,296,826</u>
Net assets:						
Invested in capital assets, net of related debt	11,825,961	11,226,325	1,166,954	1,163,539	12,992,915	12,389,864
Restricted net assets	2,938,288	2,100,575	1,232,016	1,190,250	4,170,304	3,290,825
Unrestricted net assets	(412,450)	(633,427)	105,739	137,477	(306,711)	(495,950)
Total net assets	<u>\$ 14,351,799</u>	<u>\$ 12,693,473</u>	<u>\$ 2,504,709</u>	<u>\$ 2,491,266</u>	<u>\$ 16,856,508</u>	<u>\$ 15,184,739</u>

The largest portion of the State's net assets (77%) represents *capital assets, net of related debt* of \$12.993 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 \$4.170 billion (25%) of resources that are subject to external restrictions on how they may be used. The largest restrictions are by the State's Constitution for basic education funded by the earnings of the Land Endowments Fund and unemployment insurance premiums from employers for funding the Unemployment Compensation Fund. Another major restriction is unspent debt instrument proceeds, primarily for the acquisition and construction of federal, state, and local highways.

The remaining negative balance of the State's net assets of \$306.711 million (2%) represents *unrestricted net assets*, including restatements of beginning net assets.

The State's net assets increased by \$1.671 billion during the current fiscal year. This increase is primarily caused by governmental activities increases for sales taxes, income taxes, capital assets, and sale of trust land. Additionally, net assets were further increased by business-type activities increases for the Universities and the Unemployment Compensation Funds.

State of Arizona-Primary Government
Changes in Net Assets for Fiscal Years Ended June 30, 2005 and 2004
(expressed in thousands)

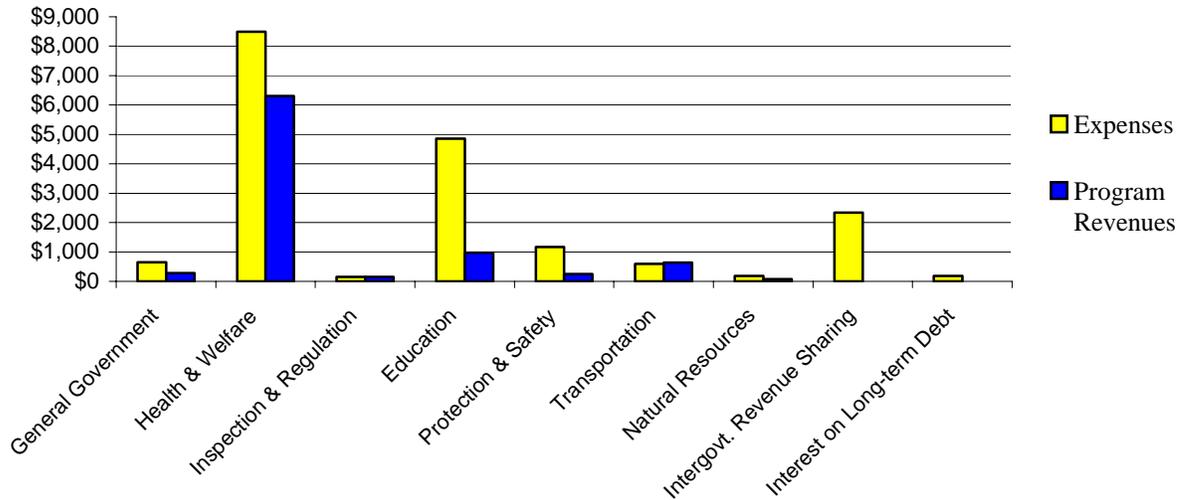
	Governmental Activities		Business-type Activities		Primary Government Total	
	2005	2004	2005	2004, as restated	2005	2004, as restated
Revenues:						
Program revenues:						
Charges for services	\$ 617,659	\$ 636,844	\$ 1,701,249	\$ 1,449,850	\$ 2,318,908	\$ 2,086,694
Operating grants and contributions	7,544,370	6,981,748	834,421	836,076	8,378,791	7,817,824
Capital grants and contributions	497,140	421,251	19,774	18,513	516,914	439,764
General revenues:						
Sales taxes	5,421,949	5,016,585	57,584	50,050	5,479,533	5,066,635
Income taxes	3,562,916	2,800,461	-	-	3,562,916	2,800,461
Tobacco taxes	237,430	223,804	-	-	237,430	223,804
Property taxes	46,148	50,455	-	-	46,148	50,455
Motor vehicle and fuel taxes	1,758,950	1,613,952	-	-	1,758,950	1,613,952
Other taxes	493,501	539,218	-	-	493,501	539,218
Unrestricted investment earnings	106,362	24,227	40,311	38,753	146,673	62,980
Unrestricted grants and contributions	11,624	8,502	5	-	11,629	8,502
Miscellaneous revenue	387,269	281,109	26,017	46,615	413,286	327,724
Gain on sale of trust land	288,483	319,517	-	-	288,483	319,517
Total revenues	20,973,801	18,917,673	2,679,361	2,439,857	23,653,162	21,357,530
Expenses:						
General government	646,452	726,525	-	-	646,452	726,525
Health and welfare	8,494,206	7,717,148	-	-	8,494,206	7,717,148
Inspection and regulation	149,238	138,281	-	-	149,238	138,281
Education	4,853,458	4,703,685	-	-	4,853,458	4,703,685
Protection and safety	1,171,340	1,059,047	-	-	1,171,340	1,059,047
Transportation	589,966	731,522	-	-	589,966	731,522
Natural resources	184,538	162,366	-	-	184,538	162,366
Intergovernmental revenue sharing	2,335,828	2,144,438	-	-	2,335,828	2,144,438
Interest on long-term debt	182,852	176,035	-	-	182,852	176,035
Universities	-	-	2,540,193	2,355,418	2,540,193	2,355,418
Unemployment compensation	-	-	292,127	397,657	292,127	397,657
Industrial Commission special fund	-	-	106,295	167,331	106,295	167,331
Lottery	-	-	317,226	303,996	317,226	303,996
Other business-type activities	-	-	120,629	109,944	120,629	109,944
Total expenses	18,607,878	17,559,047	3,376,470	3,334,346	21,984,348	20,893,393
Excess (deficiency) before contributions, special items and transfers	2,365,923	1,358,626	(697,109)	(894,489)	1,668,814	464,137
Contributions to permanent endowments	-	-	2,955	2,231	2,955	2,231
Special item – voluntary retirement program for faculty	-	-	-	(6,880)	-	(6,880)
Transfers	(707,597)	(678,726)	707,597	678,726	-	-
Change in net assets	1,658,326	679,900	13,443	(220,412)	1,671,769	459,488
Net assets - July 1, as restated	12,693,473	12,013,573	2,491,266	2,711,678	15,184,739	14,725,251
Net assets - June 30	\$ 14,351,799	\$ 12,693,473	\$ 2,504,709	\$ 2,491,266	\$ 16,856,508	\$ 15,184,739

Change in Net Assets

Governmental Activities – Net assets increased by \$1.658 billion, or 13%. This increase is primarily attributed to the increases in earned general tax revenues. Reported sales tax and income tax revenue increased by \$405.364 million, or 8%, and \$762.455 million, or 27%, as compared to fiscal year 2004, respectively. Several key elements led to this increase. The State ranked in the top five nationally in terms of annual percentage job growth as reported by Arizona’s Department of Economic Security, Research Administration. Aggregate personal income growth in Arizona, as reported by the Bureau of Economic Analysis, is vibrant, with growth in 2005 averaging about 9% on a year-over-year basis. Furthermore, population inflows have continued to outpace outflows, fueling the expanding economy. Additionally, the State’s improved efforts in tax enforcement resulted in the collection of \$455.000 million for fiscal year 2005. Another significant contributor to the net asset increase was record auction sales of approximately 2,000 acres in State trust land for \$288.483 million. Intense and competitive bidding of 18 land sale auctions raised total sales prices approximately \$74.176 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 \$246.600 million and certificates of participation in the amount of \$571.850 million. The debt instruments are being issued to construct or repair K through 12 schools throughout the State and refund previously issued debt. 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 2005 and 2004.

	2005 Governmental Activities (expressed in thousands)	2004 Governmental Activities (expressed in thousands)
Expenses, Net of Program Revenues:		
General government	\$ (367,749)	\$ (415,740)
Health and welfare	(2,190,654)	(1,871,192)
Inspection and regulation	(1,262)	11,977
Education	(3,881,306)	(3,820,842)
Protection and safety	(924,270)	(870,240)
Transportation	43,964	(152,047)
Natural resources	(108,752)	(80,647)
Intergovernmental revenue sharing	(2,335,828)	(2,144,438)
Interest on long-term debt	(182,852)	(176,035)
Total Governmental Activities Expenses, Net of Program Revenues	<u>\$ (9,948,709)</u>	<u>\$ (9,519,204)</u>

Expenses and Program Revenues
Governmental Activities for Fiscal Year 2005
(in millions of dollars)



Business-type Activities – The net assets increased by \$13.443 million, or 1%. This increase is primarily caused by the net increase of the Unemployment Compensation Fund of \$24.264 million; a net increase in the Universities Fund of \$32.367 million; and a decrease in the Industrial Commission’s Fund of \$30.156 million. The increase in net assets from the Unemployment Compensation Fund was primarily caused by an increase in employer assessments, or higher contribution rates, and a decline in the unemployment rate. In addition, the increase in net assets for the Universities Fund was primarily attributed to an increase in the fair market value of endowments, student fees, new gifts, and state appropriations. Net asset increases were reduced by the Industrial Commission’s net assets decrease that resulted from workers’ compensation claims from insolvent insurance carriers during the year. The increase in insolvent insurers increased the Industrial Commission’s 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. 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 2004 and 2005.

	2005 Business-type Activities (expressed in thousands)	2004, as restated, Business-type Activities (expressed in thousands)
Expenses, Net of Program Revenues:		
Universities	\$ (871,465)	\$ (828,962)
Unemployment Compensation	25,969	(95,724)
Industrial Commission Special Fund	(49,248)	(162,189)
Lottery	80,335	62,586
Other	(6,617)	(5,618)
Total Business-type Activities Expenses, Net of Program Revenues	<u>\$ (821,026)</u>	<u>\$ (1,029,907)</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, 2005, unreserved fund balance of the General Fund was \$986.168 million, while total fund balance closed the year at \$1.310 billion. 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 6% of total expenditures and other financing uses, while total fund balance represents 8% of the same amount.

The fund balance of the State's General Fund increased by \$563.764 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 \$344.843 million from fiscal year 2004, an increase of 8%. Sales taxes paid by retail stores, construction contractors, restaurants and bars, and out-of-state companies increased approximately \$155.000 million, \$111.000 million, \$29.000 million and \$21.000 million, respectively, when compared to fiscal year 2004 sales tax receipts. Income tax revenues increased \$709.789 million, an increase of 25%. Income taxes paid by individuals increased by approximately \$530.000 million when compared to fiscal year 2004 individual income tax receipts. In addition, income taxes paid by businesses increased approximately \$180.000 million during the same period.

Health and welfare expenditures and intergovernmental revenue increased by \$640.612 million, or 9%, and \$477.182 million, or 7%, as compared to fiscal year 2004, respectively. Overall program enrollment growth of 11% in the State's various healthcare programs, most significantly Title XIX Medicaid and the Title XXI State Children's Health Insurance Program, was the main contributing factor to the growth in expenditures in fiscal year 2005. Additionally, increased expenditures resulted from rising cost of health care programs. 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 (37%), physician (21%), and transportation and inpatient (14%), the capitation rates were increased by an average of 6% for the contract period of October 2004 to September 2005. The State received additional federal grants and county funding to cover a major portion of these increased costs.

Education expenditures increased \$305.888 million, or 8%, compared to fiscal year 2004. The increase is primarily attributed to an increase in statewide enrollment of 41,000 from fiscal year 2004.

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 \$77.484 million during fiscal year 2005. The fund balance increase was primarily caused by a \$28.206 million increase in sales taxes, a \$145.258 million increase in motor vehicle and fuel taxes, and a \$79.531 million increase in intergovernmental revenues. Fund balance was reduced by the 2004 Senate Bill 1413 which required an additional \$118.000 million to be transferred from fuel tax revenues to the State's General Fund. Further, there was also a \$64.243 million increase in the distributions to Arizona counties and cities due to the increase in motor vehicle and fuel taxes. The fiscal year 2005 collections for sales taxes recorded the highest year-over-year growth since fiscal year 1996. The growth in sales taxes and motor vehicle and fuel taxes is due primarily 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's 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 \$355.422 million during fiscal year 2005. The net increase in the fair value of investments at fiscal year end was approximately \$76.000 million. This increase was primarily due to the rise in stock values of the S&P 500 and 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 \$125.126 million, from \$149.001 million during fiscal year 2004 to \$274.127 million during fiscal year 2005. 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 29**.

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 127**. Differences between the original budget and the final amended budget resulted in a \$774.395 million increase in appropriations for the General Fund. The following comments summarize current year budgetary results:

- Some of the primary reasons for the General Fund appropriations \$774.395 million increase are 1) \$10.611 million of prior year obligations that are expended in the current year as allowed by §ARS 35-191; 2) \$191.294 million for the Department of Education's deferral of Basic State Aid and Additional State Aid payments to school districts; 3) \$199.554 million for the Arizona Health Care Cost Containment System's enrollment growth of 11% for the Acute Base and Proposition 204 capitation costs programs; 4) \$88.056 million for the Department of Health Services' increased expenditure authorizations for Behavioral Health and Children Rehabilitative Services programs; and 5) \$75.000 million for the School Facilities Board's Deficiencies Correction Fund adjustment. The original General Fund appropriation total was \$12.268 billion. The final General Fund appropriation total was \$13.043 billion.
- The difference between the final budget and actual expenditures was \$368.821 million. Of this amount, \$55.727 million will continue as legislative multiple fiscal year spending authority for fiscal year 2006 and beyond, depending upon the budgetary guidelines of the Legislature. The remaining \$313.094 million represents the unused portion of the State's legislatively authorized annual operating budget.

Additional budgetary information can be found on pages 146-147 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, 2005 totaled \$16.691 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 13% increase for business-type activities. Depreciation charges of the governmental and business-type activities for the fiscal year totaled \$268.327 million.

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

- The Universities' additions to capital assets totaled approximately \$490.038 million and included increased investment in research facilities.

- The Department of Transportation started or completed roads and bridges totaling \$894.854 million during the fiscal year.

For government-wide financial statement presentation, all depreciable assets were depreciated from acquisition date to the end of the current fiscal year. Capital asset purchases of the governmental funds are reported in the fund financial statements as expenditures.

Capital assets for the governmental and business-type activities as of June 30, 2005 are presented below (amounts in thousands):

	Governmental Activities		Business-type Activities		Total	
	2005	2004	2005	2004, as restated	2005	2004, as restated
Land	\$ 1,980,978	\$ 1,958,827	\$ 143,195	\$ 135,715	\$ 2,124,173	\$ 2,094,542
Buildings	1,515,343	1,488,193	2,709,694	2,488,685	4,225,037	3,976,878
Improvements other than buildings	142,563	140,029	3,600	2,493	146,163	142,522
Equipment	666,417	636,522	1,108,706	1,063,060	1,775,123	1,699,582
Collections (non-depreciable)	-	-	33,130	31,054	33,130	31,054
Infrastructure	8,870,232	8,597,975	289,215	246,791	9,159,447	8,844,766
Construction in progress	1,785,351	1,456,713	284,181	160,275	2,069,532	1,616,988
Less accumulated depreciation	(948,054)	(888,289)	(1,893,919)	(1,761,491)	(2,841,973)	(2,649,780)
Total	<u>\$ 14,012,830</u>	<u>\$ 13,389,970</u>	<u>\$ 2,677,802</u>	<u>\$ 2,366,582</u>	<u>\$ 16,690,632</u>	<u>\$ 15,756,552</u>

See Note 4, capital assets, beginning on **page 87** for additional capital asset data and Note 8, accounting changes and restatements, on **page 105** for information concerning Arizona State University changing its depreciation method to a componentized method.

As provided by GASB 34, the State has elected to record its infrastructure assets, that the Department of Transportation is responsible for maintaining, using the modified approach. Assets accounted for under the modified approach include approximately 6,816 center lane miles (18,424 travel lane miles) and 4,608 bridges (approximate total deck area of 42.0 million square feet).

The State manages its roads using the Present Serviceability Rating (PSR), which measures the condition of the pavement and its ability to serve the traveling public. The PSR uses a five-point scale (5 excellent, 0 impassable) to characterize the condition of the roadway. The State 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 2005.

The State manages its bridges using the Arizona Bridge Information and Storage System (ABISS). The State determines the condition rating based on standards developed by the Federal Highway Administration and additional internal criteria. It is the policy of the State to maintain a Condition Rating Index (CRI) of 93% or better. In fiscal year 2005, a CRI of 94% 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 2005 (amounts in thousands):

<u>Project Description</u>	<u>Contract Start</u>	<u>Contract Amount</u>	<u>Current Year Expenditures</u>
Construction of State Route Loop 202 from Frye Road to Power Road in Maricopa County.	09/20/2004	\$ 58,869	\$ 21,747
Construction of State Route Loop 202 from Gilbert Road to Frye Road in Maricopa County.	11/10/2004	\$ 50,458	\$ 17,461
Construction on Interstate 60 at 59 th Avenue and Glendale Avenue in Maricopa County.	11/22/2004	\$ 25,996	\$ 5,005
Construction at the interchange of State Route Loop 202 and Interstate 60 in Maricopa County.	04/18/2005	\$ 71,375	\$ 3,848

In addition to many smaller projects, the following major highway construction projects had expenditures in excess of \$15 million in fiscal year 2005 (amounts in thousands):

<u>Project Description</u>	<u>Project Expenditures</u>
Construction of State Route Loop 202 from Power Road to Elliot Road in Maricopa County.	\$ 34,236
Construction on State Route Loop 202 from Arizona Avenue to Gilbert Road in Maricopa County.	\$ 32,571
Construction of State Route Loop 202 from Frye Road to Power Road in Maricopa County.	\$ 28,601
Construction on State Route Loop 202 from Elliot Road to Baseline Road in Maricopa County.	\$ 24,317
Construction of State Route Loop 202 from Gilbert Road to Frye Road in Maricopa County.	\$ 23,689
Construction on State Route 85 to add a parallel road between Gila Bend and Interstate 10 to improve capacity and safety in Maricopa County.	\$ 23,319
Construction on State Route Loop 202 from Dobson Road to Arizona Avenue in Maricopa County.	\$ 20,601
Construction on State Route Loop 202 west of Higley Road to Power Road in Maricopa County.	\$ 19,690
Construction at the interchange of State Route Loop 202 and Interstate 60 in Maricopa County.	\$ 17,818
Construction on the Burro Creek Section of US 93 in Mohave County.	\$ 16,898
Construction on State Route 51 from Interstate 10 to Shea Boulevard in Maricopa County.	\$ 15,453

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

More detailed information regarding capital assets are on pages 87 and 88.

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 \$188.260 million to (i) finance portions of the Transportation Board’s Five Year Transportation Facilities Construction Program, (ii) pay costs of issuing the bonds, and (iii) pay interest on any bonds issued for highway purposes.
- The School Facilities Board issued \$246.600 million of revenue bonds for school repairs at K through 12 public schools throughout the State, to refund previously issued debt, and pay the cost of issuing the bonds.
- The Universities issued revenue bonds for \$139.840 million primarily to fund the acquisition, construction or renovation of capital facilities, and information technology and telecommunications upgrade projects. Further, proceeds were used to refund previously issued debt with a total outstanding principal balance of \$100.440 million.
- The Department of Transportation issued \$104.385 million of grant anticipation notes to (i) pay costs of the projects (as specified), (ii) pay costs of issuing the notes, and (iii) pay interest on the notes.
- The School Facilities Board issued \$571.850 million of certificates of participation to acquire and construct leasehold interests in new schools. The schools will be subleased to various 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. Further, proceeds were used to refund previously issued debt with a total outstanding principal balance of \$332.020 million, pay the cost of issuing the certificates of participation, and pay capitalized interest.
- Universities issued \$271.800 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 Long-Term Debt as of June 30, 2005
(expressed in thousands)

	Governmental Activities		Business-type Activities		Total	
	2005	2004	2005	2004	2005	2004
Revenue Bonds	\$ 2,170,845	\$ 2,278,225	\$ 768,000	\$ 756,781	\$ 2,938,845	\$ 3,035,006
Grant Anticipation Notes	363,970	308,585	-	-	363,970	308,585
Certificates of Participation	1,054,677	845,804	860,759	641,315	1,915,436	1,487,119
Total	<u>\$ 3,589,492</u>	<u>\$ 3,432,614</u>	<u>\$ 1,628,759</u>	<u>\$ 1,398,096</u>	<u>\$ 5,218,251</u>	<u>\$ 4,830,710</u>

More detailed information regarding long-term debt begins on page 92.

ECONOMIC CONDITION AND OUTLOOK

The Arizona Department of Economic Security Research Administration’s forecast update calls for Arizona’s economy to continue expanding through the forecast period of 2005-06. Arizona’s non-farm jobs are forecast to grow by 5% in 2005 and 4% in 2006. Over the two-year period, non-farm job growth is forecast to total more than 202,000 jobs.

During the forecast period, some issues will continue to capture attention and restrain the growth of the State’s economy. Potentially, slower expansion could be the result of higher-than-anticipated energy costs that have eroded consumer purchasing power and elevated business costs. Also, 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.

CONTACTING THE STATE COMPTROLLER'S OFFICE

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

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

