NOTES TO THE FINANCIAL STATEMENTS

INDEX

	Page
Note 1. Summary of Significant Accounting Policies	67
A. Reporting Entity	67
B. Basis of Presentation	70
C. Measurement Focus and Basis of Accounting	72
D. Deposits and Investments	72
E. Taxes Receivable	73
F. Inventories	74
G. Property Tax Calendar	74
H. Capital Assets	74
I. Investment Earnings	75
J. Scholarship Allowances	75
K. Deferred Revenue	75
L. Compensated Absences	75
M. Long-Term Obligations	75
N. New Accounting Pronouncements	76
Note 2. Deposits and Investments	76
A. Deposits and Investment Policies	76
B. Custodial Credit Risk – Deposits and Investments	77
C. Interest Rate Risk	78
D. Credit Risk	82
E. Concentration of Credit Risk	83
F. Foreign Currency Risk	84
G. Unemployment Compensation	85
H. Securities Lending	85
I. Derivatives	86
J. State Treasurer's Separately Issued Financial Statements	87
Note 3. Receivables/Deferred Revenue	88
A. Taxes Receivable	88
B. Deferred Revenue	89
Note 4. Capital Assets	90
Note 5. Retirement Plans	91
A. Plan Descriptions	91
B. Summary of Significant Accounting Policies	92
C. Funding Policy	92
D. Annual Pension Cost	93
E. Trend Information	93
F. Universities' Retirement Plans	93
G. Post-Employment Benefits	94
Note 6. Long-Term Obligations	95
A. Revenue Bonds	95
B. Grant Anticipation Notes	98
C. Certificates of Participation	99
D. Leases and Installment Purchases	103
E. Litigation	105
F. Compensated Absences	105
G. Changes in Long-Term Obligations	106
Note 7. Interfund Transactions	107
Note 8. Fund Deficit	108
A. Industrial Commission Special Fund	108
B. Healthcare Group	108
C. Risk Management Fund	109
D. Retiree Accumulated Sick Leave Fund	109
Note 9. Joint Venture	109
Note 10. Commitments, Contingencies, and Compliance	109
A. Risk Management Insurance Losses	109
B. Litigation	111
C. Accumulated Sick Leave	112
D. Unclaimed Property	112
E. Construction Commitments	113
F. Arizona State Lottery	113
Note 11. Tobacco Settlement	113
Note 12. Public-Private Partnership	113
Note 13. Conduit Debt	113
Note 14. Subsequent Events	114
Note 15. Summary of Significant Accounting Policies-Component Units	114
A. Financial Reporting Policies	114
B. Deposits and Investments	116
C. Program Loans	119
D. Pledges Receivable	120
E. Direct Financing Lease Agreement	120
F. Capital Assets	121
G. Long-Term Obligations	121
H. Related Party Transactions	126

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of the State of Arizona (the State) conform to U.S. Generally Accepted Accounting Principles (GAAP) applicable to governmental units adopted by the Governmental Accounting Standards Board (GASB).

A. REPORTING ENTITY

The State is a general purpose government. The accompanying financial statements present the activities of the State (the primary government) and its component units. Component Units' footnote disclosures are presented in Note 15 – *Summary of Significant Accounting Policies – Component Units.*

Component Units

Component units are legally separate entities for which the State is considered to be financially accountable, or organizations that raise and hold economic resources for the direct benefit of the State. 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 of the State, except for component units affiliated with the State's Universities, are reported in a separate column in the government-wide financial statements to emphasize they are legally separate from the State. Because the component units affiliated with the Universities follow Financial Accounting Standards Board (FASB) statements, these financial statements have been reported on separate pages following the respective counterpart financial statements of the State. For financial reporting purposes, only the statement of financial position and the statement of activities for component units affiliated with the Universities are included in the State's financial statements as required by the GASB.

The GASB has set forth criteria to be considered in determining financial accountability. These criteria include appointing a voting majority of an organization's governing body and (1) the ability of the State to impose its will on that organization or (2) the potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the State.

In addition, GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units* (GASB 39) requires that legally separate, tax-exempt entities that meet *all* of the following criteria should be discretely presented as component units: (1) The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents, (2) The primary government, or its component units, is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate organization, and (3) The economic resources received or held by an *individual organization* that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government.

The State reports the following blended component units:

The Arizona State Retirement System (ASRS) is a cost-sharing, multiple-employer, defined benefit pension plan that benefits employees of the State, its political subdivisions, and public schools. The ASRS is governed by a nine-member board that is appointed by the Governor and approved by the Senate to serve three-year terms.

The Public Safety Personnel Retirement System (PSPRS) is an agent, multi-employer, public employee retirement system that benefits fire fighters and police officers employed by the State and its political subdivisions. The PSPRS is jointly administered by the Fund Manager and 203 local boards. The Fund Manager is a five-member board appointed by the Governor. All members serve a fixed three-year term. Each eligible group participating in the system has a five-member local board. All members serve a fixed four-year term.

The Elected Officials' Retirement Plan (EORP) is a cost-sharing, multi-employer, public employee retirement plan that benefits all State and county elected officials and judges and certain elected city officials. The EORP is administered by a five-member board appointed by the Governor. All members serve a fixed three-year term.

The Corrections Officer Retirement Plan (CORP) is an agent, multi-employer, public employee retirement plan that benefits county detention officers and certain employees of the State's Department of Corrections and Department of Juvenile Corrections. The CORP is jointly administered by the Fund Manager of the PSPRS and 20 local boards. Each employer member participating in the CORP has a five-member local board. All members serve a fixed four-year term.

The State reports the following discretely presented component units:

University Medical Center (UMC) – The UMC is the primary teaching hospital for the College of Medicine, the College of Nursing, the College of Pharmacy, the College of Public Health, and the School of Health Related Professions of the University of Arizona (U of A). The UMC was created in 1984 when the State Legislature passed a bill that allowed the Arizona Board of Regents (ABOR) to convey the UMC to a private, not-for-profit, tax-exempt corporation. Although an autonomous entity was created, the teaching missions and research alliances with the U of A and the State remained. The ABOR confirms all members of the UMC's Board of Directors, and must approve all amendments to the UMC's articles of incorporation and bylaws. Complete financial statements may be obtained from the UMC's administrative offices at 655 East River Road, Tucson, Arizona 85704, (520) 694-2700.

Arizona Power Authority (APA) – The APA purchases the State's allocation of power produced at the federally owned Boulder Canyon Project hydropower plant and resells it to Arizona entities that are eligible purchasers under federal and state laws. The APA is governed by a commission of five members appointed by the Governor and approved by the Senate. The term of office of each member is six years and the members select a chairman and vice-chairman from among their membership for a term of two years. All revenue bonds issued by the APA must be approved by the State Certification Board. Complete financial statements may be obtained from the APA's administrative offices at 1810 West Adams Street, Phoenix, Arizona 85007-2697, (602) 542-4263.

Water Infrastructure Finance Authority (WIFA) – The WIFA is authorized to administer the Clean Water Revolving Fund. The Clean Water Revolving Fund was created pursuant to the Federal Water Pollution Control Act, which required the State to establish the Clean Water Revolving Fund to accept federal capitalization grants for publicly owned wastewater treatment projects. The WIFA has also entered into an agreement with the Environmental Protection Agency to administer the Drinking Water Revolving Fund pursuant to the Safe Drinking Water Act. The WIFA is governed by a twelve-member board of directors. The ten Governor appointed directors serve staggered terms of five years and serve at the pleasure of the Governor. Complete financial statements may be obtained from the WIFA's administrative offices at 1100 West Washington, Suite 290, Phoenix, Arizona 85007, (602) 364-1310.

Component units of the State affiliated with the Universities are legally separate, tax-exempt organizations controlled by separate Boards of Directors that meet the criteria established in GASB 39, with the exception of the Collegiate Golf Foundation and Campus Research Corporation (CRC). The Collegiate Golf Foundation is included because it is a legally separate organization that the State believes would be misleading to exclude due to its financial relationship to the State. The CRC is included because the U of A appoints a majority of the board of directors and approves the budget; the U of A can thus impose its will on the CRC.

The following discretely presented component units affiliated with the Universities are reported as *major* component units of the State:

Arizona State University Foundation (ASU Foundation) – The ASU Foundation's resources are disbursed at the discretion of the Foundation's independent board of trustees, in accordance with donor directions and Foundation policy.

Arizona Capital Facilities Finance Corporation (ACFFC) - The ACFFC provides facilities for either the use by students of ASU or ASU itself.

University of Arizona Foundation (U of A Foundation) - The U of A Foundation supports the U of A through various fund-raising activities and contributes funds to the U of A in support of various programs.

The following discretely presented component units affiliated with the Universities are reported as *non-major* component units of the State:

Arizona State University Alumni Association, Sun Angel Foundation, and Sun Angel Endowment - These three foundations receive funds primarily through donations and dues, and contribute funds to ASU for support of various programs.

Arizona State University Research Park, Inc. (ASU Research Park) - ASU Research Park is developing a research park to promote and support research activities in coordination with ASU.

Mesa Student Housing, LLC – Mesa Student Housing, LLC provides facilities for either the use by students of ASU or ASU itself.

Collegiate Golf Foundation - This foundation operates an ASU-owned golf course.

University of Arizona Alumni Association (U of A Alumni Association) - The U of A Alumni Association was established to serve the U of A and its graduates, former students, and friends by attracting, organizing, and encouraging them to advance the U of A's missions - teaching, research, and public service.

University of Arizona Law College Association (Law Association) - The Law Association was established to provide support and financial assistance to the College of Law at the U of A. The Law Association funds provide support to the College on many levels, from endowed student scholarships to named faculty professorships.

University of Arizona Campus Research Corporation (CRC) - The CRC was established to assist the U of A in the acquisition, improvement, and operation of the U of A Science and Technology Park (Park) and related properties. The CRC currently leases from the U of A the remaining 32.00% of building space of the Park not leased to the Arizona Research Park Authority. The CRC is responsible for assisting in the development of the presently undeveloped portions of the Park and for subleasing unoccupied space, newly developed space, and space now occupied by IBM or its subtenants once the current subleases expire. The U of A is responsible for payment of operational expenses associated with the space occupied by the U of A departments, offices, and programs.

Northern Arizona University Foundation, Inc. (NAU Foundation) - The NAU Foundation receives gifts and bequests, administers and invests securities and property, and disburses payments to and on behalf of the NAU for advancement of its mission.

Northern Arizona Capital Facilities Finance Corporation (NACFFC) - The NACFFC was established for the purpose of acquiring, developing, constructing, maintaining and operating student housing and other capital facilities and equipment for the use and benefit of the NAU's students.

Complete financial statements for each of the aforementioned component units, except for the U of A Foundation, may be obtained at the following addresses:

ASU Foundation, ASU Alumni Association, Sun Angel Foundation, Sun Angel Endowment, ASU Research Park, Inc., Collegiate Golf Foundation, ACFFC, and Mesa Student Housing, LLC - Arizona State University, Financial Services, P.O. Box 875812, Tempe, Arizona 85287-5812 or (480) 965-3601

The U of A Alumni Association - P.O. Box 210109, Tucson, Arizona 85721-0109

Law College Association of the U of A - P.O. Box 210176, Tucson, Arizona 85721-0176

CRC - University of Arizona Science and Technology Park, 9040 South Rita Road, Suite 1400, Tucson, Arizona 85747

NAU Foundation and NACFFC - Northern Arizona University, Comptroller's Office, P.O. Box 4069, Flagstaff, Arizona 86011

The financial statements of the U of A Foundation are not publicly available. For information regarding the U of A Foundation's financial statements, contact the U of A Comptroller at the following address: University of Arizona, Financial Services, P.O. Box 3310, Tucson, Arizona 85722-3310.

Related Organizations

Related organizations are legally separate entities for which the State is not considered to be financially accountable, and that do not meet the criteria established by GASB 39. The State's accountability for these organizations does not extend beyond making the appointments, nor are the economic resources accessible to the State. As a result, financial activity for the organizations described below is not included in the State's financial statements.

Arizona Health Facilities Authority (the Authority) – Arizona Revised Statutes (ARS) §36-482 established the Authority to issue tax-exempt bonds and loans for the purpose of reducing health care costs and improving health care for Arizona residents by providing less expensive financing for health care institutions. Proceeds from bond issues are loaned to various qualifying nonprofit health care institutions. The health care institutions reimburse the Authority for expenses for issuance of the bonds, pay fees of the Authority, and make payments under the loans for the benefit of the holders of the bonds. The Authority is governed by a seven-member board of directors that is appointed by the Governor and approved by the Senate. The directors serve staggered terms of seven years, and can be removed for cause or at will by the Governor with the consent of the Senate.

Arizona International Development Authority (the Authority) – ARS §41-1553.01 established the Authority to facilitate the development of international trade or commerce between Arizona and other countries. The Authority is governed by a seven-member board of directors appointed by the Governor and approved by the Senate for five-year terms, and can be removed only for cause.

Arizona Tourism and Sports Authority (the Authority) – ARS §5-802 established the Authority to construct, finance, maintain, improve, operate, market, and promote the use of a multipurpose facility and do all things necessary to accomplish those purposes. The Authority may issue revenue bonds in such principal amounts to accomplish the above stated purposes. The Authority is governed by a nine-member board of directors of which five are appointed by the Governor and approved by the Senate and two members each by the President of the Senate and the Speaker of the House. The directors serve terms of five years, and may be re-appointed for one full subsequent term, and can be removed only for cause.

Arizona Housing Finance Authority (the Authority) – ARS §41-3902 established the Authority to issue bonds for residential dwelling units and multifamily residential rental projects in rural areas. The Authority may also establish mortgage credit certificate programs to finance residential dwelling units in rural areas. The Authority is required to notify and obtain written consent from the governing bodies of any city, town, county, tribal government, or existing corporation for any multifamily residential rental projects planned for their jurisdiction. The Authority is governed by a seven-member board of directors that is appointed by the Governor and approved by the Senate. The directors serve terms of seven years, and can be removed only for cause.

State Compensation Fund (the Fund) – ARS §23-981 established the Fund to provide insurance to employers for workers' compensation, occupational disease compensation, and medical, surgical, and hospital benefits. The Fund is governed by a board of directors that consists of five members appointed by the Governor for staggered terms of five years, and can be removed only for cause. Annually, the Governor appoints a chairman from among the board members.

Joint Ventures

As described in Note 9, the U of A participates in a joint venture. In accordance with U.S. GAAP, the financial activities of this joint venture are not included in the State's financial statements.

B. BASIS OF PRESENTATION

The basic financial statements include both government-wide statements and fund financial statements. The government-wide statements focus on the State as a whole, while the fund financial statements focus on major funds. Each presentation provides valuable information that can be analyzed and compared between years and between governments to enhance the usefulness of the information.

Government-wide statements - provide information about the primary government and its component units. The statements include a statement of net assets and a statement of activities. These statements report the financial activities of the overall government, except for fiduciary activities. They also distinguish between the governmental and business-type activities of the State and between the State and its discretely presented component units. Governmental activities generally are financed through taxes and intergovernmental revenues. Business-type activities are financed in whole or in part by fees charged to external parties.

The **Statement of Net Assets** presents the State's non-fiduciary assets and liabilities, with the difference reported as net assets. Net assets are reported in three categories:

> **Invested in capital assets, net of related debt** consist of capital assets, net of accumulated depreciation and reduced by outstanding balances for bonds, notes, and other debt that are attributed to the acquisition, construction, or improvement of those assets.
>
> **Restricted net assets** result when constraints placed on net asset use are either externally imposed by creditors, grantors, contributors, and the like, or imposed by law through constitutional provisions or voter initiative.

Unrestricted net assets consist of net assets which do not meet the definition of the two preceding categories. Unrestricted net assets often have constraints on resources, which are imposed by management, but can be removed or modified.

The **Statement of Activities** presents a comparison between direct expenses and program revenues for each function of the State's governmental activities, and its different business-type activities. Direct expenses are those that are specifically associated with a program or function and, therefore, are clearly identifiable to a particular program or function.

The State does not allocate indirect expenses to programs or functions. Program revenues include:

- charges to customers or applicants for goods, services, privileges provided, and fines or forfeitures,
- operating grants and contributions, and
- capital grants and contributions, including special assessments.

Revenues that are not classified as program revenues, including internally dedicated resources and all taxes, are reported as general revenues.

Interfund balances have been eliminated from the government-wide financial statements to the extent that they occur within either the governmental or business-type activities. Balances between governmental and business-type activities are presented as internal balances and are eliminated in the total column. Revenues and expenses associated with reciprocal transactions within governmental or within business-type activities have not been eliminated.

Fund financial statements - provide information about the State's funds, including fiduciary funds. Separate statements are presented for the governmental, proprietary, and fiduciary fund categories. The emphasis of fund financial statements is on major governmental and enterprise funds, each displayed in a separate column. All remaining governmental and enterprise funds are aggregated and reported as non-major funds. Fiduciary funds are aggregated and reported by fund type.

Proprietary fund operating revenues, such as charges for services, result from exchange transactions associated with the principal activity of the fund. Exchange transactions are those in which each party receives and gives up essentially equal values. Operating expenses include the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

The State reports the following major governmental funds:

The General Fund - is the State's primary operating fund. It accounts for all financial resources of the general government, except those required to be accounted for in another fund.

The Transportation and Aviation Planning, Highway Maintenance and Safety Fund - accounts for all financial transactions applicable to the general operations of the Arizona Department of Transportation (ADOT). The ADOT builds and maintains the State's highway system and the Grand Canyon Airport.

The Land Endowments Fund - holds lands granted to the State by the Federal government for the benefit of public schools and other public institutions. Principal is maintained intact and investment earnings and lease revenues are distributed to beneficiaries in accordance with State statute.

The State reports the following major enterprise funds:

The Universities - account for transactions of the State's three universities, which comprise the State's university system.

Unemployment Compensation - pays claims for unemployment to eligible recipients from employer contributions and reimbursements.

The Industrial Commission Special Fund – accounts for deposits not to exceed 2.50% of all premiums received by the State Compensation Fund and private insurance carriers during the preceding calendar year. These monies are used to provide additional awards as necessary to enable injured employees to accept the benefits of any law for promotion of vocational rehabilitation of persons disabled in industry. In addition, benefits may be paid for workers' compensation claims filed by employees of non-insured employers. The Industrial Commission (Commission) then pursues against the non-insured employer for reimbursement of all benefits paid, including assessed penalties.

The Lottery - accounts for the activities of the Arizona State Lottery.

Additionally, the State reports the following fund types:

Internal Service Funds - account for insurance coverage, employee benefits, automotive maintenance and operation, highway equipment rentals, and data processing and telecommunication services provided to State agencies on a cost-reimbursement basis. It is the policy of the State to classify immaterial proprietary fund activities in governmental funds. This policy helps to reduce the number of funds reported in the financial statements to the minimum amount needed. These funds allocate a fixed rate payroll processing charge among all agencies, allocate postage and mailing costs among all agencies, and arrange for the sale of the State's office equipment and motorized vehicles at public auctions.

Pension Trust Funds - account for the activities of the ASRS, the PSPRS, the EORP, and the CORP, for which the State acts as a trustee. These retirement plans accumulate resources to pay pension benefits of State employees and employees of other governmental entities participating in the plans.

Investment Trust Funds - account for transactions by local governments and political subdivisions that elect to participate in the State Treasurer's investment pools. The Treasurer acts as trustee for the original deposits made into the investment pools.

Agency Funds - account for the receipt and disbursement of various taxes, deposits, deductions, and property collected by the State, where the State acts as an agent for distribution to other governments and organizations.

C. MEASUREMENT FOCUS AND BASIS OF ACCOUNTING

The government-wide, proprietary fund, and fiduciary fund financial statements are presented using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flows take place. Grants and donations are recognized as revenues as soon as all eligibility requirements the provider imposed have been met.

Governmental funds in the fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Under this method, revenues are recognized when measurable and available. The State considers all revenues reported in the governmental funds to be available if the revenues are collected within 31 days after year-end. Those revenues susceptible to accrual are federal reimbursements, highway user revenue tax, and state sales tax. Expenditures are recorded when the related fund liability is incurred, except for principal and interest on long-term debt, claims and judgments, and compensated absences, which are recognized as expenditures to the extent they are due and payable. General capital asset acquisitions are reported as expenditures in governmental funds. Proceeds of long-term debt and acquisitions under capital leases are reported as other financing sources.

Under the terms of grant agreements, the State funds certain programs through a combination of grants and general revenues. Therefore, when program expenses are incurred, there are both restricted and unrestricted resources available to finance the program. The State's policy regarding whether to first apply restricted or unrestricted resources is made on a case-by-case basis.

The State's business-type activities and enterprise funds follow Financial Accounting Standards Board (FASB) Statements and Interpretations issued on or before November 30, 1989; Accounting Principles Board Opinions; and Accounting Research Bulletins, unless those pronouncements conflict with GASB pronouncements. The State has chosen the option not to follow FASB Statements and Interpretations issued after November 30, 1989.

D. DEPOSITS AND INVESTMENTS

1. Cash and Cash Equivalents

On the Statement of Cash Flows, the amount reported as "Cash and Cash Equivalents" is equal to the total of the amounts on the Statement of Net Assets "Cash", "Cash with U.S. Treasury", "Cash and pooled investments with State Treasurer", "Cash held by trustee" and "Collateral investment pool" (for the Industrial Commission Special Fund). For purposes of the Statement of Cash

Flows, the State considers only those highly liquid debt instruments with an original maturity of ninety days or less to be cash equivalents.

- *Cash (not with State Treasurer)* – cash includes undeposited receipts, petty cash, bank accounts, non-negotiable certificates of deposit, and demand deposits with banking institutions other than the State Treasurer.

- *Cash with U.S. Treasury* – consists of unemployment compensation contributions from Arizona employers that are deposited in a trust fund maintained by the United States Treasury.

- *Cash and pooled investments with State Treasurer* – the State Treasurer maintains a centralized management of most State cash resources. From the perspective of the various State funds, the pool functions as both a cash management pool and a demand deposit account. The operations and investments of the State Treasurer's pooled investments are described in Note 2.

- *Cash held by trustee* – consists of certificates of participation (COPs) proceeds that primarily are invested in government money market mutual funds to be used for capital projects.

- *Collateral investment pool* – consists of cash received as collateral on securities lending transactions and investments made with that cash. The State records the collateral received as an asset. A corresponding liability is also recorded for such securities lending transactions.

2. Investment Valuation

Investments maintained by the State Treasurer are reported at fair value using Bank of New York (BONY) prices, as determined by independent, industry leading data vendors whose values are either exchange provided or matrix based on similar securities. Equities are priced utilizing the primary market close price. In the absence of a closed price, the mid, bid or ask price will be utilized. All bonds are priced using an evaluated price, the closing exchange price or the most recent exchange or quoted bid. The official price is normally the last traded price. Short-term instruments such as certificates of deposit and commercial paper are based on an internal model which uses primarily a vendor price. Equity prices are compared to Bloomberg's Index Alert. Any differences in prices are researched and generally Bloomberg's end of day price is used over BONY's price. All investments with a remaining maturity of 90 days or less, that have no price available, are priced using amortized cost (amortizing premium/accreting discount on a straight-line to maturity method).

The ASRS investments are reported at fair value determined by the custodial agents, except for real estate and commercial mortgages. The agent's determination of fair values includes, among other things, using pricing services or prices quoted by independent brokers at current exchange rates. The fair value of real estate investments is based on independent appraisals or estimated value. Commercial mortgages have been valued on an amortized cost basis, which approximates fair value. No allowance for loan loss has been provided as all loans are considered by the ASRS to be fully collectible. Short-term investments are reported at cost plus accrued interest, which approximates fair value. For investments where no readily ascertainable fair value exists, the ASRS, in consultation with its investment advisors, has determined the fair values for the individual investments based on anticipated maturity dates and current interest rates commensurate with the investment's degree of risk. Security transactions and any resulting gains or losses are accounted for on a trade date basis. Net investment income includes net appreciation (depreciation) in the fair value of investments, interest income, dividend income, and total investment expense, which includes investment management and custodial fees and all other significant investment related costs.

For the PSPRS, the EORP, and the CORP, investments are reported at fair value. Marketable securities (stocks and bonds), traded on public exchanges are priced by PSPRS's custodian Wells Fargo Bank N.A. using third party pricing services. Equity securities are valued at the last reported sales price. Fixed income securities are generally valued using the last reported sales price or thinly traded bonds are reported at fair value using estimates. Short term and alternative investments are reported at cost. Investment income is recognized as earned.

E. TAXES RECEIVABLE

Taxes receivable include amounts owed by taxpayers for the 2005 and prior calendar years including assessments for underpayments, penalties, and interest. In the government-wide financial statements, a corresponding amount is recorded as revenue using the accrual basis of accounting. In the governmental fund financial statements, revenue is recorded using the modified accrual basis of accounting. The remainder is recorded as deferred revenues.

The income tax receivable is composed of individual and corporate estimated payments, withholding payments, and payments with final returns and assessments that relate to income earned through June 30, 2006. Sales and motor vehicle and fuel tax receivables represent amounts that are earned by the State in the fiscal period ended June 30, 2006, but not collected until the following month.

F. INVENTORIES

Inventories consist of expendable supplies held for consumption in all funds and merchandise intended for sale to customers in the Proprietary Funds. Inventories are stated at cost using the first-in, first-out method, weighted average, or lower of cost or market. In the Governmental Funds, inventories are accounted for using the consumption method. Under this method, inventories are recorded as expenditures as they are used.

G. PROPERTY TAX CALENDAR

Real property taxes are levied on or before the third Monday in August and become due and payable in two equal installments. The first installment is due on the first day of October and becomes delinquent after the first business day of November. The second installment is due on the first day of March of the next year and becomes delinquent after the first business day of May. A lien attaches on the first day of January preceding assessment and levy.

H. CAPITAL ASSETS

Capital assets are stated at cost at the date of acquisition or, if donated, at the estimated fair market value at the date received. Interest incurred during the construction of capital assets is only capitalized in the Proprietary Funds.

Most capital assets are depreciated over their useful life. However, the State utilizes an alternative accounting treatment for most infrastructure assets in which costs to maintain and preserve these assets are expensed and no depreciation expense is recorded. This approach is discussed further in the Required Supplementary Information portion of this report. The State has adopted a general policy for capitalization thresholds, depreciation, and estimated useful lives of capital assets. In addition, the State has approved alternative policies for some State agencies.

Depreciable capital assets are depreciated on a straight-line basis. Capitalization thresholds (the dollar values at which asset acquisitions are added to the capital asset accounts) and estimated useful lives of capital assets being depreciated in the government-wide financial statements and the Proprietary Funds are as follows:

	General State Policy		Other Authorized Agency Policies	
Asset Category	Capitalization Threshold	Estimated Useful Life (yrs)	Capitalization Threshold	Estimated Useful Life (yrs)
Land	All capitalized	Not depreciated	All capitalized	Not depreciated
Buildings	All capitalized	25-40	$0-$100,000	10-50
Improvements other than buildings	$5,000	15	$5,000-$100,000	20-50
Equipment	$5,000	3-15	$0-$5,000	3-25
Infrastructure	All capitalized	Not depreciated	$0-$100,000	20-100

The State is trustee for approximately 9.3 million acres of land acquired through U.S. Government land grants in the early 1900's. The State acquired a substantial portion of this land at no cost and its fair market value at acquisition has not been reliably estimated. Accordingly, this land is not reported in the accompanying financial statements. A portion of the land that the State is trustee for has been sold and the buyers of the land have defaulted on the loans. The value of this land has been recorded at the sales price and properly included in the financial statements.

The State has interest in and maintains significant special collections, works of art, and historical treasures. All special collections, works of art, and historical treasures which are held for financial gain are capitalized at fair market value at the date of acquisition or donation. Those special collections, works of art, and historical treasures which are held for educational, research, or public exhibition purposes are not capitalized, as they are not subject to disposal for financial gain or encumbrance. Such items are inventoried for property control purposes.

Additional disclosures related to capital assets and assets acquired through capital leases are provided in Notes 4 and 6, respectively.

I. INVESTMENT EARNINGS

Investment earnings are composed of interest, dividends, and net changes in fair value of applicable investments.

J. SCHOLARSHIP ALLOWANCES

Student tuition and fee revenues, and certain other revenues earned by the three State Universities are reported net of scholarship discounts and allowances in the Statement of Revenues, Expenses and Changes in Fund Net Assets. A scholarship discount and allowance is the difference between the stated charge for goods and services provided and the amount that is paid by the student or third party making payment on behalf of the student. Accordingly, some types of student financial aid such as Pell grants and scholarships awarded by the Universities are considered to be scholarship allowances. These allowances are netted against applicable revenues in the Statement of Revenues, Expenses and Changes in Fund Net Assets.

K. DEFERRED REVENUE

Deferred revenue consists of payments to the State for goods and services, not yet rendered, or taxes, grants, and other non-exchange transactions for which related resources are not available to pay current liabilities. In the government-wide and proprietary fund financial statements, revenue is deferred when cash, receivables, or other assets are received prior to their being earned. In the governmental fund financial statements, revenue is deferred when that revenue is unearned or unavailable.

L. COMPENSATED ABSENCES

In the government-wide and proprietary fund financial statements, the State accrues liabilities for compensated absences as required by the GASB. In the governmental fund financial statements, liabilities for compensated absences are not accrued, because they are not considered due and payable.

In general, State employees accrue vested annual leave at a variable rate based on years of service. Except for University employees, an employee forfeits accumulated annual leave in excess of 240 hours at the end of a calendar year, unless the Director of the Department of Administration authorizes an exception. University employees may accumulate up to 264 hours of vacation, and any vacation hours in excess of the maximum amount that are unused at December 31 are forfeited. Except for University employees, an employee who separates from State service is paid for all unused and unforfeited annual leave at the employee's rate of pay at the time of separation. University employees, upon termination of employment, are paid all unused vacation benefits not exceeding 176 hours (annual accrual amount), depending on years of service and full-time equivalent employment status.

Some employees accumulate compensatory leave for time worked over 40 hours per week. An employee may accumulate up to 240 hours of compensatory leave (480 if working in a public safety activity or an emergency response activity). An employee who separates from State service is paid for all unused compensatory leave at either the employee's average base salary during the last three years of employment or final base salary, whichever is higher.

Sick leave includes any approved period of paid absence granted an employee due to illness, injury, or disability. Most State employees accrue sick leave at the rate of eight hours per month without an accumulation limit. Because sick leave benefits do not vest with employees, a liability for sick leave is not accrued in the financial statements. However, State employees are eligible to receive payment for an accumulated sick leave balance of 500 hours or more, with a maximum of 1,500 hours, upon retirement directly from State service (See Note 10.C).

M. LONG-TERM OBLIGATIONS

In the government-wide and proprietary fund financial statements, long-term debt and long-term liabilities are reported as liabilities. Amounts due within one year are reported as current liabilities, and amounts due thereafter are reported as non-current liabilities. Premiums and discounts on revenue bonds and COPs are deferred and amortized over the life of the debt instrument using the straight-line method. Bonds and COPs are reported net of the applicable premium or discount. Bond issuance costs and deferred gains or losses on debt refundings are charged to expense in the period incurred unless those costs are deemed to be material to the State's financial statements by management, in which case, they are deferred and amortized using either the straight-line method or the effective interest method.

In the fund financial statements, governmental fund types recognize proceeds from revenue bonds, COPs, and premiums and discounts on revenue bonds and COPs as other financing sources and uses in the current period. Long-term liabilities are more fully described in Note 6.

N. NEW ACCOUNTING PRONOUNCEMENTS

GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries.* This Statement establishes accounting and financial reporting standards for impairment of capital assets. A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. This Statement also clarifies and establishes accounting requirements for insurance recoveries. The requirements of this Statement are effective for periods beginning after December 15, 2004. The State has implemented the requirements of this standard, but they had no material effect on the financial statements.

GASB Statement No. 43, *Financial Reporting for Postemployment Benefits Plans Other Than Pension Plans.* This Statement establishes uniform financial reporting standards for OPEB plans and supersedes the interim guidance included in Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans.* The requirements of this Statement for OPEB plan reporting are effective for periods beginning after December 15, 2005. The ASRS has early implemented the requirements of this standard, but they had no material effect on the financial statements.

GASB Statement No. 44, *Economic Condition Reporting: The Statistical Section – an amendment of NCGA Statement.* This Statement improves the understandability and usefulness of the information presented as supplementary information in the statistical section. The provisions of this Statement are effective for statistical sections prepared for periods beginning after June 15, 2005. The State has implemented the requirements of this standard.

GASB Statement No. 46, *Net Assets Restricted by Enabling Legislation – an amendment of GASB Statement No. 34.* This Statement enhances the usefulness and compatibility of net asset information reported by clarifying the meaning of the phrase *legally enforceable* as it applies to restrictions imposed on net asset use by enabling legislation and by specifying the accounting and financial reporting requirements for those restricted net assets. The requirements of this Statement are effective for periods beginning after June 15, 2005. The State has implemented the requirements of this standard, but did not have any restricted net assets that are covered by this statement.

GASB Statement No. 47, *Accounting for Termination Benefits.* This Statement provides guidance to governmental employers for measuring, recognizing, and reporting liabilities and expenses/expenditures related to *all* termination benefits, without limitation as to the period of time during which the benefits are offered, and involuntary termination benefits. This Statement is effective for periods beginning after June 15, 2005. The State has implemented the requirements of this standard, but did not have any current benefits that are covered by this statement.

NOTE 2. DEPOSITS AND INVESTMENTS

A. DEPOSITS AND INVESTMENT POLICIES

The State's deposits and investments are primarily under the control of the State Treasurer, the Retirement Systems, the Universities, and the Commission. These entities maintain the majority of the deposits and investments of the primary government. The investment policies of these organizations are defined according to State statutes or a governing board or both and are described below.

The ARS §35-312, §35-313, and §35-314 authorize the State Treasurer to invest operating, trust, and permanent endowment fund monies. Monies deposited with the State Treasurer by State agencies are invested by the State Treasurer in a pooled fund. Any interest earned is allocated monthly into each respective fund based on average daily cash balances. There is no income from investments associated with one fund that is assigned to another fund.

The State statutes and the State Treasurer's investment policies designed to administer these statutes restrict investments to obligations of the U.S. Government and its agencies, obligations or other evidence of indebtedness of the State and certain local government divisions, negotiable certificates of deposit, bonds, debentures and notes issued by U.S. corporations, commercial paper issued by entities organized and doing business in the United States, bankers acceptances, collateralized repurchase agreements, money market mutual funds, domestic equities, and other securities. The State Treasurer is not allowed to invest in foreign investments.

The State Treasurer maintains external investment pools [the Local Government Investment Pool (LGIP), Local Government Investment Pool-Government, and the Central Arizona Water Conservation District]. The pools are not required to register (and are not registered) with the Securities and Exchange Commission under the 1940 Investment Advisors Act. The activity and performance of the pools are reviewed monthly by the State Board of Investment in accordance with ARS §35-311. The fair value of investments is measured on a monthly basis. Participant shares are purchased and sold based on the Net Asset Value (NAV) of the shares. The NAV is determined by dividing the fair value of the portfolio by the total shares outstanding. The State Treasurer does not contract with an outside insurer in order to guarantee the value of the portfolio or the price of shares redeemed.

State statutes authorize the retirement systems to make investments in accordance with the "Prudent Person" rule. This rule imposes the responsibility of making investments with the judgment and care that persons of ordinary prudence would exercise in the management of their own affairs when considering both the probable safety of their capital and the probable income from that capital.

The ASRS invests in U.S. government and government agency obligations, real estate, commercial mortgages, corporate bonds, and equity obligations. Per ARS §38-719, no more than 80.00% of the ASRS' total assets may be invested at any given time in corporate stocks or equity equivalents, based on cost value of the stocks or equity equivalents irrespective of capital appreciation. No more than 5.00% of the voting stock of any one corporation may be owned. No more than 20.00% of the ASRS' assets may be invested in foreign equity securities, and those investments shall be made only by investment managers with demonstrated expertise in such investments. No more than 10.00% of the ASRS' assets may be invested in bonds or other evidences of indebtedness of those multinational development banks in which the U.S. is a member nation, including the International Bank for Reconstruction and Development, the African Development Bank, the Asian Development Bank, and the Inter-American Development Bank. No more than 1.00% of ASRS' assets may be invested in economic development projects authorized as eligible for such investment by the Arizona State Department of Commerce. The ASRS Board has not formally adopted more restrictive policies for the various types of risks.

Per ARS §38-848, the PSPRS, the EORP, and the CORP may not invest more than 70.00% in corporate stocks, based on cost value of such stocks irrespective of capital appreciation, and shall be restricted to stocks that, except for bank and insurance stocks, are either: 1) listed or approved on issuance for listing on an exchange registered under the Securities Exchange Act of 1934, as amended, 2) designated or approved on notice of issuance for designation on the national market system of a national securities association registered under the Securities Exchange Act of 1934, as amended, 3) listed or approved on issuance for listing on an exchange registered under the laws of this State or any other State, or 4) listed or approved on issuance for listing on an exchange registered of a foreign country with which the U.S. is maintaining diplomatic relations at the time of purchase, except that no more than 10.00% may be invested in foreign equity securities on these exchanges, based on the cost value of the stocks irrespective of capital appreciation. Not more than 5.00% of the voting stock of any one corporation shall be owned.

The Board of Regents governs the investment policies of the Universities. The Universities may invest operating funds and capital projects funds in collateralized certificates of deposits and repurchase agreements with commercial banks, U.S. Treasury securities and other Federal agency securities, or in the Local Government Investment Pool administered by the State Treasurer. For endowment investments, donor restrictions for these investments will be applied, if any. In addition, the Board of Regents has authorized the Universities to establish investment committees to make investment policies and investment decisions. The Board of Regents' policies guide the investment committees' decisions and constitute each University's investment policy.

Per ARS §23-1065, the Commission's investment committee is responsible for defining, developing, and implementing investment objectives, policies and restrictions and supervising the investment activities of the Commission. The Commission requires that their investment policy be responsive to the unpredictable nature of the incidence and severity of claims, the long periods over which losses may be paid, and the effect on both claims and losses of increases in treatment and rehabilitation costs. The investment committee may invest in any legal investment authorized under ARS §38-719.

B. CUSTODIAL CREDIT RISK – DEPOSITS AND INVESTMENTS

Custodial credit risk for deposits is the risk that, in the event of the failure of a depository financial institution, the deposits or collateral securities may not be recovered from an outside party. The State Treasurer, the Retirement Systems, and the Universities' deposits with financial institutions are required by State statutes to be entirely covered by the Federal Depository Insurance

Corporation (FDIC) or, alternatively, collateralized for amounts in excess of the amount insured. The Commission's deposits are not required to be insured or collateralized. Surety collateral for the Universities, the ASRS, the PSPRS, the EORP, and the CORP must be equal to at least 100.00% of the bank balance required to be collateralized (102.00% for the State Treasurer). Beyond this requirement, these organizations do not have a formal policy specifically addressing custodial credit risk on deposits, except for the State Treasurer. The State statutes require surety collateral for the State Treasurer to consist of U.S. Government obligations, State obligations, and obligations of counties and municipalities within the State. As of June 30, 2006, $3.050 million was uncollateralized and uninsured and $2.408 million was collateralized with securities held by the pledging financial institution or its trust department/agent, but not in the State's name.

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the value of the investment or collateral securities that are in the possession of an outside party may not be recovered. The State does not have a formal policy in regards to custodial credit risk for investments. As of June 30, 2006, the State had $58.442 million in securities that were uninsured, not registered in the State's name and held by a counterparty or a counterparty's trust department or agent but not in the State's name.

C. INTEREST RATE RISK

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The State manages interest rate risk using the segmented time distribution, weighted average maturity, and duration methods.

The State Treasurer manages interest rate risk by incorporating ARS §35-323, which states that the State Treasurer will invest public monies in securities with a maximum maturity of five years and operating fund monies shall not be invested for a duration of longer than three years, into their investment policy and setting forth various thresholds or parameters in accordance with each investment pool's portfolio structure. The State Treasurer's policy provides either maturity or duration limitations for the various investment pools. The interest rate risk inherent in the portfolio is monitored monthly by measuring the weighted average maturity and/or duration.

The ASU manages interest rate risk by a policy for operating funds that limits the maximum maturity of any fixed rate issue to three years. The capital projects funds portfolio is not limited as to the overall maturity of its investments, with funds invested per the financing indentures to coincide with capital spending needs and debt service requirements, which are typically less than three years, with the additional limitation that certificates of deposit and commercial paper have maximum maturities of 360 days and 270 days, respectively.

The Commission manages interest rate risk by setting different goals of yield periods or duration of maturities for each individual investment segment within the Commission. Beyond this requirement, the Commission does not have a formal policy specifically addressing interest rate risk.

The following table presents the State Treasurer's, the ASU's, and the Commission's weighted average maturity in years by investment type (expressed in thousands):

Investment Type	Fair Value	Weighted Average Maturity (in years)
Bond mutual funds	$ 8,453	2.70
Certificate of deposit	4,932	1.09
Commercial mortgage – backed securities	2,881	29.77
Commercial paper	2,600,877	0.03
Corporate asset backed securities	7,094	5.72
Corporate collateralized mortgage obligations	70,835	20.51
Corporate notes & bonds	1,039,428	1.94
Government bonds	16,438	11.16
Government mortgage backed securities	11,767	19.04
Index linked government bonds	4,792	6.97
Money market mutual funds	78,915	0.30
Repurchase agreements	1,745,625	0.01
U.S. Agency Securities	2,914,780	0.76
U.S. Agency Mortgage Backed Securities	654,076	19.39
U.S. Treasury Securities	660,170	1.19
Other	6,803	6.55
Total Debt Securities	$ 9,827,866	2.03

The ASRS does not have a formal policy in regards to interest rate risk, but does manage interest rate risk using effective duration. Effective duration measures the expected change in value of a fixed income security for a given change in interest rate. This method takes into account the likely timing and amounts of variable cash flows for bonds with call options and prepayment provisions. The following table presents ASRS' effective duration by investment type (expressed in thousands):

Investment Type	Fair Value	Effective Duration
Domestic Fixed Income Securities		
Asset backed securities	$ 253,388	1.66
Bond funds	36,043	8.53
CMO's of government sponsored entities	423,889	3.86
Commercial mortgage backed securities	390,780	3.91
Commercial paper	157,443	0.03
Corporate bonds	1,043,042	4.27
Dollar denominated debt of foreign companies	55,906	6.86
Dollar denominated debt of foreign countries	45,329	6.54
Fixed income strips	37,434	7.88
GNMA pools	116,187	3.45
Government sponsored entity debt	311,866	4.21
Indexed linked government bond funds	1,092,671	0.00
Indexed linked treasury bonds	16,337	4.73
Municipal bonds	1,260	14.89
Non-government backed CMO's	168,515	2.36
Pools of government sponsored entities	1,414,300	4.11
Short term investments	1,697,024	0.08
U.S. Treasury Debt	630,702	4.20
Total Domestic Debt Securities	7,892,116	3.28
Foreign Debt Securities		
Corporate bonds	849	6.77
Government bonds	6,172	0.33
Provincial bonds	3,307	6.77
Margin accounts	1,605	0.08
Total Foreign Debt Securities	11,933	2.54
Total Debt Securities	$ 7,904,049	

The PSPRS, the EORP, the CORP, and the NAU do not have a formal policy in regards to interest rate risk. The U of A's investment policy limits its operating funds to having a portfolio comprised of a significant proportion of authorized securities with maturities of one year or less, and requires that a maximum maturity of any fixed rate issue may not exceed three years and the final maturity of any floating rate issue may not exceed five years. The U of A capital projects and endowment funds have no such limitations. The following table presents the interest rate risk for the PSPRS, the EORP, the CORP, the NAU, the U of A, and other State agencies utilizing the segmented time distribution (expressed in thousands):

		Investment Maturities (in years)					
Investment Type	**Fair Value**	**Less than 1**	**1-5**	**6-10**	**11-15**	**16-20**	**More than 20**
Corporate bonds	$ 714,644	$ 17,872	$ 111,536	$ 135,240	$ 78,116	$ 59,377	$ 312,503
Corporate bond funds	1,368	-	855	384	129	-	-
Collateralized bond obligations (CBO's)	52,434	-	-	7,800	15,813	-	28,821
Collateralized debt obligations (CDO's)	4,120	-	-	-	-	-	4,120
Commercial paper	293,862	293,862	-	-	-	-	-
Indexed treasury bond fund	1,220	-	-	-	1,220	-	-
International fixed income fund	8,443	2,406	2,438	1,996	1,603	-	-
Money market mutual funds	140,185	140,185	-	-	-	-	-
Municipal bonds	1,679	-	149	311	1,219	-	-
Repurchase agreements	94,202	94,202	-	-	-	-	-
Securities lending pool	21,567	21,567	-	-	-	-	-
U.S. Agency Securities	635,721	143,611	32,700	187,126	135,294	47,795	89,195
U.S. Treasury Securities	459	-	83	65	311	-	-
Other investments	7,769	708	3,049	3,892	120	-	-
Total Debt Securities	$ 1,977,673	$ 714,413	$ 150,810	$ 336,814	$ 233,825	$ 107,172	$ 434,639

The following table presents the State's investments at fair value that are considered to be highly sensitive to interest rate changes (expressed in thousands):

Interest Rate Terms	Corporate Bonds	U.S. Agency Securities	Total
U.S. LIBOR plus/minus fixed point variable monthly to semi-annually	$ 750,013	$ 180,360	$ 930,373
Mortgage backed securities - when interest rates fall, mortgages are refinanced and paid off early and the reduced stream of future interest payments diminish fair value.	-	673,863	673,863
Callable step-up notes - where on certain specified dates, the issuer can call the security. If the security is not called, the interest rate is increased by a specified amount. Prevailing interest rates may go up faster than this increase in the coupon interest rate.	-	127,307	127,307
Other securities with sensitivity to rate changes	-	128,200	128,200
Total	$ 750,013	$ 1,109,730	$ 1,859,743

D. CREDIT RISK

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations to the holder of the investment.

The State statutes and the State Treasurer's investment policy require that commercial paper must be rated P1 by Moody's Investor Service (Moody's) or A1 or better by Standard and Poor's Ratings Service (S & P). Corporate bonds, debentures, and notes must carry a minimum Baa or better rating of Moody's or a BBB or better rating of S & P. For investments not rated by Moody's, Fitch rating information is used. There is no statute or investment policy on ratings or credit quality for obligations issued by the U.S. Government or its agencies or repurchase agreements. The underlying securities for repurchase agreements must be explicitly guaranteed by the U.S. Government.

The ASRS has not adopted a formal policy with respect to credit risk.

The PSPRS, the EORP, and the CORP's investment policy is specific as to permissible credit quality ranges, exposure levels within individuals' quality tiers, and the average credit quality of the overall portfolios. The fixed income portfolio must have a minimum weighted average quality rating of A3 by Moody's and A- by S & P. Fixed income investments must have a minimum quality rating of Baa3 by Moody's and BBB- by S & P at the time of purchase. Commercial paper must have a minimum quality rating of P1 by Moody's and A1 by S & P at the time of purchase. The portion of the bond portfolio in investments rated Baa3 through Baa1 by Moody's and BBB- through BBB+ by S & P must be 20.00% or less of the fair value of the fixed income portfolio.

The Universities each have a different policy regarding credit risk. The ASU's policy requires that certificates of deposit have a minimum credit rating of A1/P1, commercial paper have a minimum credit rating of A1+/P1 and money market funds have a credit rating of AAAm or better, all rated by S & P. The U of A's policy requires that for endowment funds, corporate bonds and notes should be rated Baa or higher by Moody's at the time of purchase. The NAU does not have a formal policy with respect to credit risk.

The Commission's investment policy requires that fixed income investments be rated Ba or better by Moody's or BB or better by S & P at the time of purchase. Fixed income managers hired to manage funds in a specialized manner (high yield) are exempted from this requirement. Purchases of high yield fixed income investments will consist of a diversified portfolio of holdings which will maintain in the aggregate a minimum credit rating of Ba3 by Moody's and BB by S & P.

The following table presents the State's investments which were rated by S & P and/or an equivalent national rating organization as of June 30, 2006. The ratings are presented using S & P's rating scale (expressed in thousands):

Investment Type	**Fair Value**	**AAA**	**AA**	**A**	**BBB**	**BB**	**B**	**A1**	**Not Rated**
Alternative investments	$ 200,705	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 200,705
Asset backed securities	260,866	235,778	5,498	5,328	1,574	-	1,079	-	11,609
Bond funds	45,864	36,043	1,368	-	-	-	-	-	8,453
Certificates of deposit	4,932	-	4,932	-	-	-	-	-	-
CBO's	52,435	7,355	-	37,280	1,794	6,006	-	-	-
CDO's	77,823	73,703	-	-	4,120	-	-	-	-
CMO's of government sponsored entities	423,889	96,392	-	-	-	-	-	-	327,497
Commercial mortgage backed securities	393,661	351,449	1,121	277	-	-	-	-	40,814
Commercial paper	3,052,182	157,443	-	-	-	-	-	2,894,739	-
Corporate bonds	2,784,409	211,348	447,466	1,254,968	481,497	69,069	53,475	-	266,586
Dollar denominated debt of foreign companies	55,906	809	3,759	27,291	22,753	1,294	-	-	-
Dollar denominated debt of foreign countries	45,329	23,740	2,638	2,573	16,378	-	-	-	-
Fixed income strips incl US strips	37,434	37,434	-	-	-	-	-	-	-
Foreign corporate bonds	849	849	-	-	-	-	-	-	-
Foreign government bonds	6,172	5,894	-	-	278	-	-	-	-
Foreign margin accounts	1,605	-	-	-	-	-	-	-	1,605
Foreign provincial bonds	3,307	-	3,307	-	-	-	-	-	-
GNMA pools	116,187	116,187	-	-	-	-	-	-	-
Government bonds	22,175	22,175	-	-	-	-	-	-	-
Government mortgage backed securities	11,767	11,767	-	-	-	-	-	-	-
Government sponsored entity debt	311,866	291,446	20,420	-	-	-	-	-	-
Indexed linked government bond funds	1,092,671	-	-	-	-	-	-	-	1,092,671
Indexed linked treasury bonds	17,557	17,557	-	-	-	-	-	-	-
International fixed income fund	8,443	6,713	168	768	401	234	159	-	-
Money market mutual funds	219,099	126,078	-	-	-	-	-	-	93,021
Mortgages	10,599	10,599	-	-	-	-	-	-	-
Municipal bonds	2,939	1,369	1,570	-	-	-	-	-	-
Non-government backed CMO's	168,515	164,493	-	41	-	-	-	-	3,981
Pools of government sponsored entities	1,414,300	1,414,300	-	-	-	-	-	-	-
Securities lending pool	21,567	-	-	-	-	-	-	-	21,567
Short term money markets	1,697,024	-	-	-	-	-	-	-	1,697,024
U.S. Agency Securities	3,998,267	2,827,299	25,169	-	-	-	-	1,145,710	89
Other investments	13,440	-	-	-	-	-	-	-	13,440
Total	$ 16,573,784	$6,248,220	$517,416	$1,328,526	$528,795	$76,603	$54,713	$4,040,449	$3,779,062

E. CONCENTRATION OF CREDIT RISK

Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer. The State Treasurer's, the ASRS', the U of A's, and the Commission's investment policies state that no more than 5.00% of their investments may be invested in securities issued by any one institution, agency, or corporation, other than securities issued as direct obligations of or are fully guaranteed by the U.S. Government or mortgage backed securities and agency debentures issued by federal agencies. The PSPRS, the EORP, and the CORP's investment policy states that no more than 5.00% of their investments may be invested in securities issued by any one institution, agency, or corporation, other than securities issued as direct obligations of or are fully guaranteed by the U.S. Government. The ASU and the NAU have no formal policy in regards to the concentration of credit risk. At June 30, 2006, more than 5.00% of the Governmental Activities' total investments were held in the following single issuers (expressed in thousands):

Issuer Description	Fair Value	Percentage
Federal Home Loan Mortgage Corporation	$ 1,199,482	18.96%
Federal Home Loan Bank	862,745	13.64%
Federal National Mortgage Association	624,781	9.88%

At June 30, 2006, more than 5.00% of the Business-type Activities' total investments were held in the following single issuers (expressed in thousands):

Issuer Description	Fair Value	Percentage
Federal National Mortgage Association	$ 125,568	5.04%

F. FOREIGN CURRENCY RISK

Foreign currency risk is the risk that changes in the foreign exchange rate will adversely impact the fair value of an investment or deposit. The State does not have a policy regarding foreign currency risk. The ASRS is the primary State agency that has foreign currency risk. Per ARS §38-719, no more than 20.00% of the ASRS assets may be invested in foreign equity securities and those investments shall be made only by investment managers with demonstrated expertise in those investments. The ASRS Board has not adopted a formal policy that is more restrictive. The following table summarizes the State's foreign currency risk as of June 30, 2006 (expressed in thousands):

	Foreign Currency Risk by Investment Type at Fair Value				
Currency	**Short Term**	**Fixed Income**	**Equities**	**Real Estate**	**Total**
Australian Dollar	$ 628	$ -	$ 53,308	$ -	$ 53,936
British Pound Sterling	(938)	-	572,484	-	571,546
Canadian Dollar	106	-	16,131	-	16,237
Danish Krone	1,898	-	21,434	-	23,332
Euro Currency	6,346	5,894	1,071,646	45	1,083,931
Hong Kong Dollar	352	-	72,859	-	73,211
Indonesian Rupiah	-	-	4,284	-	4,284
Japanese Yen	17,091	-	688,921	-	706,012
New Mexican Peso	296	278	-	-	574
New Taiwan Dollar	-	-	21,650	-	21,650
New Zealand Dollar	488	3,307	10,947	-	14,742
Norwegian Krone	22	-	7,660	-	7,682
Singapore Dollar	135	-	65,094	19	65,248
South Korean Won	-	-	28,050	-	28,050
Swedish Krona	577	-	30,421	-	30,998
Swiss Franc	538	-	268,992	-	269,530
Thailand Baht	-	-	4,293	-	4,293
Other	3,252	9,434	52,094	-	64,780
Total	$ 30,791	$ 18,913	$2,990,268	$ 64	$3,040,036

G. UNEMPLOYMENT COMPENSATION

The ARS §23-703 requires that unemployment compensation contributions from Arizona employers be deposited in an unemployment trust fund account with the Secretary of the Treasury of the United States that is established and maintained pursuant to Section 1104 of the Social Security Act. The cash on deposit in the trust fund account is pooled and invested. Interest earned from investments purchased with such pooled monies is deposited in the trust fund account. The Unemployment Compensation Fund, reported as a major Enterprise Fund, has been established for this purpose.

H. SECURITIES LENDING

Cash received as collateral on securities lending transactions and investments made with that cash are reported as assets. A corresponding liability is also recorded for such securities lending transactions.

1. Industrial Commission

State statutes and the Commission's policies permit the Commission to enter into securities lending transactions with its custodial bank. There were no significant violations of legal or contractual provisions, and there were no borrower or lending agent default losses to the securities lending agent. The custodial bank, Northern Trust, manages the securities lending operations through a contractual agreement with the Commission and splits the fees received with the Commission. There was no credit risk (i.e., lender's exposure to the borrowers of its securities) related to the securities lending transactions at June 30, 2006. Northern Trust's indemnification responsibilities include performing appropriate borrower and collateral investment credit analysis, demanding adequate types and levels of collateral, and complying with applicable Department of Labor and Federal Financial Institutions Examinations Council regulations concerning securities lending. Securities are loaned for collateral that may include cash, U.S. Government securities, and irrevocable letters of credit. Domestic securities are loaned for collateral valued at 102.00% of the market value of securities loaned plus accrued interest. International securities are loaned for collateral valued at 105.00% of the market value of securities loaned plus accrued interest. The market value at June 30, 2006 for loaned securities collateralized by cash and non-cash collateral was $48.935 million and $5.207 million, respectively. As part of the securities lending transactions, Northern Trust received cash and non-cash collateral valued at $49.750 million and $5.295 million, respectively at June 30, 2006. Non-cash collateral cannot be pledged or sold unless the borrower defaults. Deposit and investment risk disclosures are only reported for collateral received on securities lent.

All securities loans can be terminated on demand by either the lender or the borrower. The average term of the loans is 80 days and cash open collateral is invested in a short-term investment pool, the Core USA Collateral Section, which had an average weighted maturity of 41 days as of June 30, 2006. Cash collateral may also be invested separately in term loans, in which case the investments match the loan term. Cash open loans can be terminated on demand by either lender or borrower and there were no dividends or coupon payments owing on securities lent. Securities lending earnings are credited to participating clients on approximately the fifteenth day of the following month. Investments made with cash collateral received are classified as an asset on the Statement of Net Assets. A corresponding liability is recorded as the Commission must return the cash collateral to the borrower upon expiration of the loan. At June 30, 2006, the Commission had $49.750 million outstanding as payable for securities lending.

2. Arizona State Retirement System

The ASRS is permitted by ARS §38-715(D) (3), to enter into securities lending transactions. The ASRS' custodial bank enters into agreements with counterparts to loan securities and have the same securities redelivered at a later date. All securities are eligible for loan (U.S. fixed income securities, U.S. equities, and international equities) with a higher percentage of U.S. Treasuries on loan than most other security types. It is the policy of the ASRS to receive as collateral at least 102.00% of the market value of the loaned securities and maintain collateral at no less than 100.00% for the duration of the loan. At year-end, the ASRS has no credit risk exposure to borrowers because the amount the ASRS owes the borrowers exceeds the amount the borrowers owe the ASRS. The ASRS records the collateral received as an asset and the same amount as an obligation for securities on loan. Any cash collateral received is invested in short-term investments. The maturities of the investments are closely matched to those of the security loans to avoid interest rate exposure. The ASRS receives a spread for its lending activities. Investments made with cash collateral received are classified as an asset on the Statement of Fiduciary Net Assets. A corresponding liability is recorded as the ASRS must return the cash collateral to the borrower upon expiration of the loan. At June 30, 2006, the ASRS had $2.3 billion outstanding as payable for securities on loan.

3. Public Safety Personnel Retirement System, Elected Officials' Retirement Plan and Corrections Officer Retirement Plan

The EORP, the PSPRS, and the CORP are permitted by ARS Title 38, Chapter 5, Articles 3, 4, and 6, respectively, to enter into securities lending transactions. The PSPRS, the EORP, and the CORP are parties to securities lending agreements with a bank. The bank, on behalf of the PSPRS, the EORP, and the CORP, enters into agreements with brokers to loan securities and have the same securities returned at a later date. The loans are fully collateralized, primarily by cash. Collateral is marked-to-market on a daily basis. Non-cash collateral can be sold only upon borrower default. The PSPRS, the EORP, and the CORP require collateral of at least 102.00% of the fair value of the loaned U.S. Government or corporate security. Securities on loan are carried at fair value. As of June 30, 2006, the fair values of securities on loan were (expressed in millions):

PSPRS	$ 891.375
EORP	70.380
CORP	134.101

4. University of Arizona

During the fiscal year, the U of A engaged in securities lending transactions within its endowment funds, as authorized by the Board of Regents. The U of A entered into an agreement with Wells Fargo, the U of A's custodian, to carry out these transactions. The custodian enters into agreements with brokers to loan securities and have the same securities returned at a later date. It is the policy of the U of A to receive as collateral at least 102.00% of the market value of the loaned securities and accrued interest, and maintain collateral at no less than 100.00% for the duration of the loan. At year-end, the U of A had no credit risk to borrowers because the U of A was holding more collateral than the amount of loaned securities outstanding.

The U of A records the collateral received as an asset, which is offset by an obligation recorded under securities lending. During the fiscal year ended June 30, 2006, there were no violations of legal or contractual provisions, and there were no borrower or lending agent default losses. Wells Fargo does indemnify the U of A against losses due to borrower defaults. Collateral can be received in the form of U.S. Government securities, letters of credit, or cash. As of June 30, 2006, the custodian has received only cash collateral. This collateral may be invested in U.S. Treasury and sponsored agency obligations, repurchase agreements, bankers' acceptances, commercial paper, mortgage backed securities, municipal securities, and corporate bonds or in a cash collateral investment pool, which invests in similar securities. At June 30, 2006, cash collateral received from borrowers was invested in the cash collateral investment pool and corporate bonds, which had a weighted average maturity of 3 days and 377 days, respectively, and represented 78.00% and 22.00% of cash collateral investments, respectively. The relationship between the maturities of the cash collateral investment pool and the U of A's securities loans is affected by the maturities of the securities loans made by other entities that use the custodial bank's pool, which the U of A cannot determine. However, the U of A or the borrower can terminate securities loans on demand. Other cash collateral investments are made such that their maturities will match those of the related securities loans. Such matching existed at year-end. At June 30, 2006, cash collateral investments totaled $27.916 million with a corresponding market value of securities on loan of $27.270 million. Securities lent for cash collateral included corporate stocks, corporate bonds, agency notes, agency bonds, government notes, and government bonds. The U of A cannot sell or pledge securities received as collateral unless the borrower defaults. The U of A earns a negotiated fee for participating in securities lending activities.

I. DERIVATIVES

A derivative instrument is a financial instrument or other contract with all three of the following characteristics:

- It has (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements, and in some cases whether or not a settlement is required.
- It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- Its terms require or permit net settlement, it can readily be settled net by means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

The principal categories of derivatives employed and their uses during the year were as follows:

Category	**Purpose**
Currency forward contracts	Hedge currency risk of investments denominated in foreign currencies.
Futures contracts	Reduce transaction costs; obtain market exposure; enhance returns.

Derivatives are reported at fair value. The fair value of currency forward contracts is determined by interpolating the spot rate and the forward rates based upon number of days to maturity. The interpolated rate is used to determine the unrealized gain/loss at the valuation date. The fair value of futures contracts is determined by calculating the difference between the closing Bloomberg market price on valuation date and the original futures trade price. Futures are settled daily.

Generally, derivatives are subject to both interest rate risk and credit risk. The derivatives utilized by ASRS internal investment managers typically have no greater interest rate risk than their physical counterparts, and in many cases are offset by exposure elsewhere in the portfolio. As of June 30, 2006, the ASRS had $1.2 billion in temporary investments held as collateral for equity and fixed income derivatives which may have a positive or negative notional value.

The ASRS believes that it is unlikely that any of the derivatives used by its internal investment managers could have a material adverse effect on the financial conditions of the System.

J. STATE TREASURER'S SEPARATELY ISSUED FINANCIAL STATEMENTS

The State Treasurer issues a separately published Annual Financial Report. The report provides additional information relating to the State Treasurer's total investing activities, including the Investment Trust Funds. A copy of the State Treasurer's Office Annual Financial Report can be obtained from their office location at:

State Treasurer's Office
1700 W. Washington
Phoenix, Arizona 85007-2812

The Treasurer's financial statements are audited by the Office of the Auditor General.

NOTE 3. RECEIVABLES/DEFERRED REVENUE

A. TAXES RECEIVABLE

The following table summarizes taxes receivable at June 30, 2006 (expressed in thousands):

Type of Tax	General Fund	Transportation & Aviation Planning, Highway Maintenance & Safety Fund	Unemployment Compensation Fund	Industrial Commission Special Fund	Non-Major Governmental Funds	Government-Wide Total
Sales	$ 400,429	$ -	$ -	$ -	$ 3,055	$ 403,484
Income – individual and corporate	132,015	-	-	-	-	132,015
Motor vehicle and fuel	-	70,212	-	-	-	70,212
Luxury	8,842	-	-	-	16,537	25,379
Unemployment	-	-	67,287	-	-	67,287
Other	-	-	-	4,658	-	4,658
Gross taxes receivable	541,286	70,212	67,287	4,658	19,592	703,035
Allowance for uncollectible taxes	(110,084)	-	-	-	-	(110,084)
Net Taxes Receivable	$ 431,202	$ 70,212	$ 67,287	$ 4,658	$ 19,592	$ 592,951

B. DEFERRED REVENUE

At June 30, 2006, the components of deferred revenue, in terms of revenue unavailable and unearned, were as follows (expressed in thousands):

Current Deferred Revenue for Governmental Funds:	**Unavailable**	**Unearned**	**Total Deferred Revenue**
General Fund:			
Delinquent sales tax	$ 94,113	$ -	$ 94,113
Delinquent income tax	72,212	-	72,212
Tobacco settlement	42,907	-	42,907
Child support administrative reimbursements	4,894	-	4,894
Advance insurance premiums	-	41,752	41,752
Advance land lease payments	-	291	291
Public assistance overpayments	1,601	-	1,601
Vaccine & commodity food supplement	-	9,272	9,272
Advanced county Medicaid payments	-	20,675	20,675
Federal grants	185,882	-	185,882
Tribal reimbursements	124	-	124
Transportation & Aviation Planning, Highway Maintenance & Safety Fund:			
Notes receivable for real estate mortgage loans	9,464	-	9,464
Land Endowments Fund:			
Land sales receivable	757,430	-	757,430
Land leases receivable	3,144	-	3,144
Advance land lease payments	-	31,621	31,621
Non-Major Funds:			
Public assistance overpayments	1,389	-	1,389
Advance payments for Hawaii/Arizona PMMIS Alliance	-	906	906
Other	-	53	53
Total Current Deferred Revenue for Governmental Funds	1,173,160	104,570	1,277,730
Noncurrent Deferred Revenue for Governmental Funds:			
General Fund:			
Advance land lease payments	-	6,006	6,006
Total Noncurrent Deferred Revenue for Governmental Funds	-	6,006	6,006
Total Current and Noncurrent Deferred Revenue for Governmental Funds	$ 1,173,160	$ 110,576	$ 1,283,736

Current Deferred Revenue for Proprietary Funds:	**Unearned**
Universities:	
Unexpended cash advances received	$ 31,138
Auxiliary sales and services	5,985
IBM lease related to acquisition of research park	4,900
Student tuition and fees	34,526
Other deferred revenue	3,759
Deposits	1,497
Non-Major Funds:	
Policyholders' advance premiums	8,097
Magazine subscriptions	3,592
Total Current Deferred Revenue for Proprietary Funds	$ 93,494
Noncurrent Deferred Revenue for Proprietary Funds:	
Universities:	
IBM lease related to acquisition of research park	34,770
Total Noncurrent Deferred Revenue for Proprietary Funds	$ 34,770

NOTE 4. CAPITAL ASSETS

Capital asset activities for the fiscal year ended June 30, 2006 were as follows (expressed in thousands):

	Primary Government				
	Beginning Balance	Additions	Retirements	Adjustments & Reclassifications	Ending Balance
Governmental Activities:					
Non-depreciable capital assets:					
Land	$ 1,980,978	$ 257,668	$ (10,864)	$ -	$ 2,227,782
Construction in progress	1,785,351	654,666	(389,869)	(13,954)	2,036,194
Infrastructure	8,863,628	516,176	(48)	(1)	9,379,755
Total Non-depreciable Capital Assets	12,629,957	1,428,510	(400,781)	(13,955)	13,643,731
Depreciable capital assets:					
Buildings	1,515,343	5,659	(434)	7,428	1,527,996
Improvements other than buildings	142,563	1,471	(12,733)	2,323	133,624
Equipment	666,417	63,273	(39,613)	6,042	696,119
Infrastructure	6,604	-	-	5	6,609
Total Depreciable Capital Assets	2,330,927	70,403	(52,780)	15,798	2,364,348
Less accumulated depreciation for:					
Buildings	(420,573)	(38,536)	47	689	(458,373)
Improvements other than buildings	(59,556)	(4,048)	-	55	(63,549)
Equipment	(463,763)	(65,836)	36,036	1,140	(492,423)
Infrastructure	(4,162)	(97)	-	-	(4,259)
Total Accumulated Depreciation	(948,054)	(108,517)	36,083	1,884	(1,018,604)
Total Depreciable Capital Assets, Net	1,382,873	(38,114)	(16,697)	17,682	1,345,744
Total Governmental Activities Capital Assets, Net	$ 14,012,830	$ 1,390,396	$ (417,478)	$ 3,727	$ 14,989,475

	Beginning Balance	Additions	Retirements	Adjustments & Reclassifications	Ending Balance
Business-type Activities:					
Non-depreciable capital assets:					
Land	$ 143,195	$ 4,187	$ (3,908)	$ 113	$ 143,587
Construction in progress	284,181	194,134	(112,103)	(203,182)	163,030
Collections	33,130	1,107	(78)	-	34,159
Total Non-depreciable Capital Assets	460,506	199,428	(116,089)	(203,069)	340,776
Depreciable capital assets:					
Buildings	2,709,694	208,084	(12,173)	195,826	3,101,431
Improvements other than buildings	3,600	-	-	1	3,601
Equipment	1,108,706	88,749	(30,578)	(1)	1,166,876
Infrastructure	289,215	10,332	(816)	7,244	305,975
Total Depreciable Capital Assets	4,111,215	307,165	(43,567)	203,070	4,577,883
Less accumulated depreciation for:					
Buildings	(1,035,505)	(92,120)	4,623	(44)	(1,123,046)
Improvements other than buildings	(2,092)	(170)	10	1	(2,251)
Equipment	(769,387)	(68,475)	25,768	(193)	(812,287)
Infrastructure	(86,935)	(9,728)	539	(1)	(96,125)
Total Accumulated Depreciation	(1,893,919)	(170,493)	30,940	(237)	(2,033,709)
Total Depreciable Capital Assets, Net	2,217,296	136,672	(12,627)	202,833	2,544,174
Total Business-type Activities Capital Assets, Net	$ 2,677,802	$ 336,100	$ (128,716)	$ (236)	$ 2,884,950

Depreciation expense was charged to governmental functions as follows (expressed in thousands):

General government	$	26,762
Health and welfare		19,027
Inspection and regulation		1,575
Education		1,132
Protection and safety		37,557
Transportation		15,311
Natural resources		7,153
Total Governmental Activities	$	108,517

Depreciation expense was charged to business-type activities as follows (expressed in thousands):

Lottery	$	215
Industrial Commission Special Fund		1,157
Universities		166,799
Other		2,322
Total Business-type Activities	$	170,493

NOTE 5. RETIREMENT PLANS

The State contributes to the four plans described below. The four plans are considered part of the State's financial reporting entity and are included in the State's financial statements as Pension Trust Funds.

A. PLAN DESCRIPTIONS

The State participates in the ASRS, the PSPRS, the EORP, and the CORP. Benefits are established by State statutes and provide retirement, death, long-term disability, survivor, and health insurance premium benefits to State employees, public school employees and employees of counties, municipalities, and other State political subdivisions.

The **ASRS** is a cost-sharing, multiple-employer defined benefit pension plan that benefits employees of the State, its political subdivisions, and public schools. The ASRS is governed by the Arizona State Retirement System Board according to the provisions of ARS Title 38, Chapter 5, Article 2. In addition, the ASRS administers the Health Benefit Supplement Fund (HBS) and the Long-Term Disability Fund, which are benefit cost-sharing, multiple-employer post-employment benefit plans. Although the assets of the HBS plan are commingled with assets of the Retirement Fund, each plan's assets may be used only for the payment of benefits to the members of the plan, in accordance with terms of the plan.

The **PSPRS** is an agent, multiple-employer defined benefit pension plan that benefits public safety employees of the State or certain local governments. The PSPRS, acting as a common investment and administrative agent, is governed by a five-member board, known as the Fund Manager, and 203 local boards according to the provisions of ARS Title 38, Chapter 5, Article 4.

The **EORP** is a cost-sharing, multiple-employer defined benefit pension plan that benefits all elected State and county officials and judges and certain elected city officials. The EORP is governed by the Fund Manager of the PSPRS according to the provisions of ARS Title 38, Chapter 5, Article 3.

The **CORP** is an agent, multiple-employer defined benefit pension plan that benefits town, city, and county detention officers; and certain employees of the Arizona Department of Corrections and the Arizona Department of Juvenile Corrections. The CORP is governed by the Fund Manager of the PSPRS and 20 local boards according to the provisions of ARS Title 38, Chapter 5, Article 6.

Each plan issues a publicly available financial report that includes its financial statements and required supplementary information. A report may be obtained by writing or calling the applicable plan.

Arizona State Retirement System
P.O. Box 33910
Phoenix, Arizona 85067-3910
(602) 240-2000 or (800) 621-3778

Public Safety Personnel Retirement System, Elected Officials' Retirement Plan or the Corrections Officer Retirement Plan
3010 East Camelback Road, Suite 200
Phoenix, Arizona 85016
(602) 255-5575

The number of participating government employers as of June 30, 2006 is shown below:

Employer	ASRS	PSPRS	EORP	CORP
Cities and towns	74	130	19	-
Counties and county agencies	15	24	15	13
State	1	1	1	1
Special districts	81	48	-	-
School districts	235	-	-	-
Charter schools	180	-	-	-
Community college districts	10	-	-	-
Dispatchers	-	-	-	6

B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

As part of the Pension Trust Funds, the financial statements are prepared using the accrual basis of accounting under which expenses are recorded when the liability is incurred and revenues are recorded in the accounting period in which they are earned and become measurable. Employee contributions are recognized in the period in which contributions are due. Employer contributions are recognized when due and the employer has made a formal commitment to provide the contributions. Contributions from employees and employers for service through June 30 are accrued. These contributions are considered to be fully collectible and, accordingly, no allowance for uncollectible receivables is reflected in the financial statements.

Benefit and refund payments are recognized when due and payable in accordance with the terms of the retirement health benefit supplement and long-term disability plan.

C. FUNDING POLICY

The contribution requirements of plan members and the State are established by Title 38, Chapter 5 of the Arizona Revised Statutes. These contribution requirements may be amended by the Arizona State Legislature.

Cost-sharing plans – For the year ended June 30, 2006, active ASRS members and the State were each required by statute to contribute at the actuarially determined rate of 7.40% (6.90% retirement and 0.50% long-term disability) of the members' annual payroll. The State's contributions to ASRS for the years ended June 30, 2006, 2005, and 2004 were $128.575, $93.148, and $87.657 million, respectively, for the primary government which were equal to the required contributions for these years.

In addition, active EORP members were required by statute to contribute 7.00% of the members' annual covered payroll. The State was required to contribute a designated portion of certain fees collected by the Supreme Court plus additional contributions of 20.54% of the members' annual covered payroll, as determined by actuarial valuation. The State's contributions to EORP for the years ended June 30, 2006, 2005, and 2004 were $2.140 million, $1.010 million, and $987 thousand, respectively, which were equal to the required contributions for the year.

Agent plans – For the year ended June 30, 2006, active PSPRS members were required by statute to contribute 7.65% of the members' annual covered payroll and the participating State agencies were required to contribute at actuarially determined rates of 7.52 – 28.99%. Active CORP members were required by statute to contribute 8.50% of the members' annual covered payroll and the participating State agencies were required to contribute at actuarially determined rates of 5.51 – 5.56%.

D. ANNUAL PENSION COST

The State's annual pension cost and related actuarial data for each of the agent, multiple-employer defined benefit pension plans for the year ended June 30, 2006, is as follows (expressed in thousands):

	PSPRS	CORP
Contribution rates:		
State	7.52 – 28.99%	5.51 – 5.56%
Plan members	7.65%	8.50%
Annual pension cost	$15,878	$17,472
Contributions made	$15,878	$17,472
Actuarial valuation date	6/30/04	6/30/04
Actuarial cost method	entry age	entry age
Actuarial assumptions:		
Investment rate of return	8.75%	8.75%
Projected salary increases	6.25 – 9.25%	6.25 – 9.25%
includes inflation at	5.25%	5.25%
Cost-of-living adjustments	None	None
Amortization method	level percent open	level percent open
Remaining amortization	20 years	20 years
Asset valuation method	smoothed market value	smoothed market value

E. TREND INFORMATION

Information for each of the agent, multiple-employer defined benefit plans as of the most recent actuarial valuations is as follows (expressed in thousands):

Contributions Required and Contributions Made				
	Fiscal Year Ended	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation
PSPRS	6/30/06	$15,878	100%	$ 0
	6/30/05	6,442	100%	0
	6/30/04	6,299	100%	0
CORP	6/30/06	17,472	100%	0
	6/30/05	12,754	100%	0
	6/30/04	11,900	100%	0

F. UNIVERSITIES' RETIREMENT PLANS

Faculty, academic professional, and administrative officers at the three universities (the ASU, the NAU, and the U of A) may select one of six retirement plans: the Teachers Insurance Annuity Association/College Retirement Equities Fund (TIAA/CREF), Variable Annuity Life Insurance Company (VALIC), Fidelity Investments Tax-Exempt Services Company (Fidelity), Aetna Life Insurance and Annuity Company (Aetna), The Vanguard Group (Vanguard), or the ASRS. The ASRS is a defined benefit plan (described above) and the other five plans are defined contribution plans. The five defined contribution plans are administered by independent insurance and annuity companies approved by the ABOR. In addition, the U of A employees hired before July 1, 1972, have the option to participate in the defined contribution plan administered by the ASRS. Eligible classified staff belong to the ASRS. In a defined contribution plan, benefits depend solely on amounts contributed to the plan plus investment earnings.

The Arizona State Legislature establishes and may amend active plan members' and the Universities' contribution rates. For the year ended June 30, 2006, plan members and the three Universities were each required by statute to contribute an amount equal to 7.00% of an employee's compensation, except for an 8.13% contribution for the ASRS defined contribution plan.

Contributions to these plans for the year ended June 30, 2006, were as follows (expressed in thousands):

Plan	University Contributions	Employee Contributions	Total Contributions
TIAA/CREF	$ 27,572	$ 27,572	$ 55,144
VALIC	3,169	3,169	6,338
Fidelity	8,455	8,455	16,910
Aetna	209	209	418
Vanguard	1,139	1,139	2,278
ASRS	108	93	201

G. POST-EMPLOYMENT BENEFITS

In addition to the pension benefits described, the ASRS offers the Retiree Group Insurance Program and the Health Insurance Premium Benefit Program to eligible retired and disabled members. A retired member is defined as a member actively receiving an annuity benefit and a disabled member is defined as a member receiving a Long-Term Disability (LTD) benefit through the LTD program administered by the ASRS or through their former member employer's group LTD plan.

Pursuant to ARS §38-782, the Retiree Group Insurance Program makes available group health insurance coverage to eligible retired and disabled members and their dependents. Retired and disabled members of the ASRS, University Optional Retirement Plans, the PSPRS, the EORP, and the CORP may participate if they are no longer eligible for health insurance benefits through their former employer. More than 48,000 coverage agreements currently exist for retired and disabled members and their dependents.

Pursuant to ARS §38-783, retired and disabled members with at least five years of credited service are eligible to participate in the Health Insurance Premium Benefit (subsidy) Program. This assistance is provided to those members who elect group coverage through either the Retiree Group Insurance Program or their former member employer.

The ASRS offers a monthly subsidy to decrease the cost of group healthcare insurance offered to all retired and disabled persons of the ASRS, the PSPRS, the CORP, and the EORP that is provided by the primary government of the State. The amount of the subsidy provided to retired or disabled participants is dependent upon the number of years of credited service; whether the participant is eligible for Medicare coverage; if the participant elects group insurance coverage for spouse or dependents; and if the participant lives in an isolated or rural location of the State. The amount of the monthly subsidy paid on a member's and their dependents' behalf toward the cost of group health insurance by the ASRS ranges from $50 to $470. The ASRS reimbursed approximately $80.800 million and $89.600 million towards the cost of group health insurance coverage for the years ended June 30, 2006 and June 30, 2005, respectively. Employment functions of the retired and disabled members eligible for the subsidy are teachers, State employees, and political subdivision employees.

The subsidy was enacted by the State Legislature as part of the enabling and operating laws of the ASRS (ARS §38-782 and §38-783). The actuarial calculation of the ASRS plan liabilities used to assess the annual required contribution rate to all participating employers includes an actuarial dollar amount of $904.119 million for fiscal year 2006 (3.20% of the total actuarial liabilities) to fund the health insurance subsidy program. The total annual required contribution rate for both employers and employees during fiscal year 2006 was 6.40%. The participating ASRS employers and employees make no other contributions for funding the health insurance subsidy benefit enacted by the State Legislature.

Total actuarial liabilities of the ASRS, including funding for the healthcare insurance subsidy, are determined on a projected unit-credit basis. As the ASRS is a cost-sharing plan, the number of subsidy participants and amount contributed for the subsidy by each participating employer is not available. Total Net Assets available to pay the subsidy for all participants at June 30, 2006, is $969.746 million.

The State Legislature in ARS §38-783 has made the payment of the healthcare subsidy to retired and disabled participants subordinate to the payment of normal retirement benefits.

During the November 1998 general election, voters added Article XXIX to the State of Arizona Constitution. Article XXIX is titled Public Retirement Systems. Article XXIX provided for the following actions:

1. Public retirement systems shall be funded with contributions and investment earnings using actuarial methods and assumptions that are consistent with generally accepted actuarial standards.

2. The assets of the State's public retirement systems, including investment earnings and contributions, are separate and independent trust funds and shall be invested, administered, and distributed as determined by law solely in the interests of the members and beneficiaries of the public retirement systems.

3. Membership in a public retirement system is a contractual relationship that is subject to Article II, Section 25 of the State's constitution, and public retirement system benefits shall not be diminished or impaired.

Article II, Section 25 of the State's constitution indicates that no law impairing the obligation of a contract shall ever be enacted.

NOTE 6. LONG-TERM OBLIGATIONS

A. REVENUE BONDS

Governmental Activities

1. Arizona Department of Transportation

The ADOT issued Senior and Subordinated Highway Revenue Bonds to provide funds for acquisition of right-of-way and construction of federal, state, and local highways. The original amount of Highway Revenue Bonds issued in prior years and outstanding at the start of the fiscal year was $1.2 billion. During the year, Highway Revenue Bonds totaling $265.650 million were issued to (i) finance portions of the Transportation Board's Five Year Transportation Facilities Construction Program, (ii) pay interest on any bonds issued for highway purposes, (iii) pay costs of issuing the bonds, and (iv) refund portions of the Board's outstanding Senior Series 1999 Bonds ($13.985 million), Senior Series 2001 Bonds ($86.170 million), and Senior Series 2002 B Bonds ($48.595 million).

The Highway Revenue Bonds are secured by a prior lien on and a pledge of motor vehicle and related fuel fees and taxes. Arizona Revised Statutes restrict the total principal amount of Arizona Highway Revenue Bonds that may be outstanding at any time, excluding refunded bonds, from exceeding $1.3 billion.

The Maricopa County Regional Area Road Bond Fund is used to record all payments of principal and interest for Transportation Excise Tax Revenue Bonds issued by ADOT. The Bonds are secured by transportation excise taxes collected by the Arizona Department of Revenue on behalf of Maricopa County. The original amount of Transportation Excise Tax Revenue Bonds issued in prior years and outstanding at the start of the fiscal year was $80.375 million.

The bond resolution adopted by the Transportation Board on July 25, 1986 established a debt service reserve requirement equal to the maximum annual interest due in the current year or future years on any series of outstanding Transportation Excise Tax Revenue Bonds. The Second Supplemental Transaction Excise Tax Revenue Bond Resolution adopted by the Board on September 22, 1988, gives the Board the option, which it has elected, of acquiring debt service reserve insurance policies in lieu of the debt service reserve requirement. Accordingly, no debt service reserve is reported in the accompanying financial statements. The policies were issued by Financial Guaranty Insurance Company, except for the 1993 Series Subordinated Bonds policies, which were issued by MBIA Insurance Corporation, and the 1995 Series A and Series B Subordinated Bonds policies, which were issued by AMBAC Assurance Corporation. These policies are non-cancelable and insure payment, up to the policy amount, of the bond interest on their respective payment dates. The policies terminated on July 1, 2005. The premiums on these insurance policies are recorded as expenditures in the year of payment. There are no Transportation Excise Tax Revenue Bonds outstanding as of June 30, 2006.

In prior fiscal years, the ADOT refinanced various bond issues through advance-refunding arrangements. Under the terms of the refunding bond issues, sufficient assets to pay all principal, redemption premium, if any, and interest on the refunded bond issues have been placed in irrevocable trust accounts at commercial banks and invested in U.S. Government securities which, together with interest earned thereon, will provide amounts sufficient for future payment of principal and interest of the issues refunded. The assets, liabilities, and financial transactions of these trust accounts and the liability for the defeased bonds are not reflected in the accompanying financial statements. Refunded bonds for the ADOT at June 30, 2006 totaled $212.880 million.

ADOT advance-refunded a portion of the Highway Revenue Bonds Series 1999 Bonds ($13.985 million), a portion of the Highway Revenue Bonds Series 2001 Bonds ($86.170 million), and a portion of the Highway Revenue Bonds Series 2002B Bonds ($48.595 million) to reduce its total debt service payments by $7.833 million and to obtain an economic gain (difference between the present values of the debt service payments on the old and new debt) of $5.848 million. The payment to the refunded bond escrow agent totaled $161.726 million, representing principal of $148.750 million and interest of $12.976 million.

2. School Facilities Board

On August 18, 2005, the Arizona School Facilities Board (SFB) issued State School Improvement Revenue Refunding Bonds, Series 2005 for $448.760 million. The 2005 Bonds include $448.760 million of serial bonds with interest rates ranging from 3.00% to 5.00% and maturity dates ranging from 2007 to 2021. The 2005 Bonds maturing on or after July 1, 2015, are subject to optional redemption prior to maturity without premium. The SFB realized net proceeds from the 2005 Bonds of $484.963 million after receipt of $37.304 million net reoffering premium and payment of $1.101 million for issuance costs. The SFB net proceeds were used to advance-refund a portion of School Improvement Revenue Bonds Series 2001, 2002, and 2003 with a total outstanding principal balance of $446.680 million. The advance-refunding resulted in a debt service savings of $24.494 million and a net present value benefit of $14.907 million (difference between the present values of the old debt and new debt service payments) for the SFB. The advance-refunding resulted in a difference between the reacquisition price and the net carrying amount of the old debt of $21.398 million. The loss on refunding is being amortized using the straight line method as a charge to interest expense. The refunded Bonds Series 2001, 2002, and 2003 will be paid by investments held in an irrevocable trust with a fair value of $484.963 million. As a result, the refunded debt is considered to be defeased and is not included in the State's financial statements. Refunded Bonds for the SFB at June 30, 2006 totaled $446.680 million.

Business-Type Activities

3. Universities

a. University of Arizona

The U of A's bonded debt consists of various issues of system revenue bonds that are generally callable with interest payable semi-annually. Bond proceeds are used to pay for acquiring or constructing capital facilities and infrastructure. Bond proceeds are also used for refunding obligations from previously issued bonds. Payment of principal and interest on bonds is secured by a pledge of tuition and fees, sales and services, auxiliary enterprises, and other charges.

On September 13, 2005, the U of A sold System Revenue Bonds Series 2005A (2005A Bonds) for $35.570 million dated September 1, 2005. The 2005A Bonds include $25.255 million of serial bonds with interest rates ranging from 3.00% to 5.00% and maturity dates ranging from 2007 to 2025. The 2005A Bonds also include two term bonds consisting of $4.785 million with an interest rate of 5.00% due June 1, 2028, and $5.530 million with an interest rate of 5.00% due June 1, 2031. The 2005A Bonds with maturity on or after June 1, 2016, are subject to optional redemption without premium. The 2005A Bonds with maturity on June 1, 2028 and June 1, 2031, are subject to mandatory sinking fund redemption without premium pursuant to the debt documents. The 2005A Bonds sold at a premium of $1.372 million and had accrued interest of $119 thousand. The U of A realized net proceeds of $36.647 million after payment of $414 thousand for issuance costs, underwriter discounts, and bond insurance. The net proceeds were used to finance the Architecture Building Expansion Project, the Poetry Center Project, the Residence Life Building Renewal Phase II Project, the Deferred Renovation - Building Renewal and Infrastructure Project, and to pay the December 1, 2005 interest payments on the U of A's System Revenue Bonds Series 1992A, 1998, 2002, 2003, 2004A, and 2004B. The interest payments from the net proceeds provided budget relief to assist the U of A with implementing a budget stabilization plan.

On May 9, 2006, the U of A sold System Revenue Bonds Series 2006A (2006A Bonds) for $17.645 million dated May 1, 2006. The 2006A Bonds include $17.645 million of serial bonds with an interest rate of 5.00% and maturity dates ranging from 2016 to 2020. The 2006A Bonds with maturity on or after June 1, 2017, are subject to optional redemption without premium. The 2006A Bonds sold at a premium of $993 thousand. The U of A realized net proceeds of $18.477 million after payment of $303 thousand for issuance costs, underwriter discounts, and bond insurance and a U of A Contribution of $142 thousand. The net proceeds were used to pay the June 1, 2006 principal and interest payments on the U of A's System Revenue Bonds Series 1992A, 1998, 2002, 2003, 2004A, and 2004B. This provided budget relief to assist the U of A with implementing a budget stabilization plan.

In fiscal year 2003, the U of A refunded, in advance of maturity, a portion of outstanding System Revenue Bonds Series 2000A. At June 30, 2006, the outstanding principal balance of the refunded bonds was $4.330 million, which will be paid by investments held in an irrevocable trust with a fair value of $4.364 million. Accordingly, the trust account assets and liability for these defeased bonds are not included in the U of A's financial statements.

In fiscal year 2005, the U of A refunded, in advance of maturity, a portion of outstanding System Revenue Bonds Series 1998 and the remaining portion of System Revenue Bonds Series 2000A. At June 30, 2006, the total outstanding principal balance of the refunded bonds was $28.285 million, which will be paid by investments held in an irrevocable trust with a total fair value of $29.859 million. Accordingly, the trust account assets and liability for these defeased bonds are not included in the U of A's financial statements.

b. Northern Arizona University

On October 19, 2005, the NAU sold System Revenue Bonds Series 2005 for $15.255 million dated November 1, 2005. The 2005 Bonds include $6.280 million of serial bonds with interest rates ranging from 3.00% to 4.50% and maturity dates ranging from June 1, 2007 to June 1, 2026. The 2005 Bonds also include $8.975 million of term bonds, with interest rates ranging from 4.60% to 5.125% and maturing on June 1, 2030, 2035, and 2040. The 2005 Bonds were sold with net original issue discount of $11 thousand. NAU realized net proceeds of $15.000 million after payment of $244 thousand for issuance costs, underwriter discounts, and bond insurance. The costs associated with this issue were recorded in the current fiscal year. The net proceeds of $15.000 million are being used to finance a new parking garage and enclosed pedestrian bridge on the NAU's Mountain Campus.

In prior years, the NAU defeased certain revenue bonds by either placing the proceeds of new bonds, or cash and investments accumulated in the sinking fund, in an irrevocable trust to provide for all future debt service payments on the refunded bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included in the NAU's financial statements. At June 30, 2006, $25.425 million of such bonds outstanding are considered defeased.

c. Arizona State University

At June 30, 2006, the ASU held a combination of fixed and variable rate bonds. The ASU's fixed rate bonded debt consists of various issues of system revenue bonds that are generally callable at a prescribed date with interest payable semi-annually. In prior years, certain system revenue bonds of the ASU were defeased through advance-refunding by depositing sufficient U.S. Government securities to pay all future debt service in an irrevocable trust. Accordingly, the liabilities for these defeased bonds are not included in the ASU's financial statement. The principal amount of all such bonds outstanding June 30, 2006 was $46.900 million.

The ASU had outstanding two series of variable rate demand system revenue bonds, Series 2003A and 2003B, totaling $103.000 million, with final maturities of July 1, 2034. Both series of bonds continue to bear interest at a weekly rate not to exceed 12.00% per annum based upon prevailing market conditions, as determined by the respective remarketing agents. The bonds are subject to conversion, at the option of the Arizona Board of Regents on behalf of the ASU, to a different or alternate adjustable rate mode, or a fixed rate pursuant to the bond indenture. The interest rate in effect at June 30, 2006 was 3.95% for the Series 2003A bonds and Series 2003B bonds.

The variable rate bonds are subject to purchase on the demand of the holder at a price equal to principal plus accrued interest on seven days' notice and delivery to the remarketing agents. If the remarketing agents are unable to resell the bonds, the ASU has a Standby Purchase Agreement with Bank of America, N.A. to extend credit through the purchase of the unremarketed bonds. Assuming all of the $51.500 million Series 2003A bonds and $51.500 million Series 2003B bonds are not resold within 90 days, the ASU would be responsible to make annual installment principal payments of $20.600 million over a five year period, plus interest to be calculated as established in the Standby Purchase Agreement. The ASU has agreed to pay Bank of America, N.A. an annual commitment fee of 0.18% on the outstanding principal for the Standby Purchase Agreement. The Standby Purchase Agreement is valid through October 15, 2008.

Securities and cash restricted for bond debt service held by the trustee at June 30, 2006 totaled $26.500 million.

Summary of Revenue Bonds

The following schedule summarizes revenue bonds outstanding at June 30, 2006 (expressed in thousands):

Revenue Bonds Outstanding	Dates Issued	Maturity Dates	Interest Rates	Outstanding Balance at June 30, 2006
Governmental Activities:				
Department of Transportation	1992-2006	2007-2025	3.40-6.00%	$1,223,425
School Facilities Board	2001-2006	2007-2021	.14-5.75%	883,275
Proprietary Funds:				
University Revenue Bonds	1969-2006	2007-2040	2.50-7.13%	802,600

Principal and interest debt service payments on revenue bonds outstanding at June 30, 2006 are as follows (expressed in thousands):

	Annual Debt Service					
	Governmental Activities			Business-Type Activities		
Fiscal Year	Total Principal	Total Interest	Total	Total Principal	Total Interest	Total
2007	$ 102,860	$ 105,615	$ 208,475	$ 42,435	$ 37,731	$ 80,166
2008	108,925	100,895	209,820	47,215	35,665	82,880
2009	114,715	95,301	210,016	44,255	33,463	77,718
2010	121,080	89,683	210,763	46,335	31,203	77,538
2011	127,520	83,171	210,691	48,425	28,869	77,294
2012-2016	683,110	314,651	997,761	213,950	111,319	325,269
2017-2021	691,865	128,726	820,591	140,810	65,254	206,064
2022-2026	156,625	14,900	171,525	95,660	38,993	134,653
2027-2031	-	-	-	74,460	18,949	93,409
2032-2036	-	-	-	45,875	4,595	50,470
2037-2040	-	-	-	3,180	417	3,597
Total	$ 2,106,700	$ 932,942	$ 3,039,642	$ 802,600	$ 406,458	$ 1,209,058

B. GRANT ANTICIPATION NOTES

Grant Anticipation Notes are issued by the Transportation Board and secured by revenues received from the Federal Highway Administration under a grant agreement and certain other federal-aid revenues. The original amount of Grant Anticipation Notes issued in prior years and outstanding at the start of the fiscal year was $363.970 million.

Grant Anticipation Notes currently outstanding are as follows (expressed in thousands):

Grant Anticipation Notes Outstanding	Dates Issued	Maturity Dates	Interest Rates	Outstanding Balance at June 30, 2006
Governmental Activities:				
Department of Transportation	2000-2005	2007-2016	2.50-5.25%	$ 325,430

Future debt service principal and interest payments on Grant Anticipation Notes issues for fiscal years ended June 30 are summarized below (expressed in thousands):

Annual Debt Service			
Governmental Activities			
Fiscal Year	Total Principal	Total Interest	Total
2007	$ 42,570	$ 14,578	$ 57,148
2008	36,565	13,300	49,865
2009	29,990	11,832	41,822
2010	31,350	10,468	41,818
2011	32,785	9,034	41,819
2012-2016	152,170	20,075	172,245
Total	$ 325,430	$ 79,287	$ 404,717

C. CERTIFICATES OF PARTICIPATION

Governmental Activities

1. Department of Administration

The State has issued COPs to finance construction or improvements of office buildings that are primarily leased to State agencies. The State's obligation to make lease payments and any other obligations of the State under the lease are subject to, and dependent upon, annual appropriations made by the State Legislature and annual allocations of such appropriations being made by the Department of Administration for such purpose. The Department of Administration agrees to use its best efforts to budget, obtain, allocate, and maintain sufficient appropriated monies to make lease payments. In the event any such appropriation and allocation is not made, the leases will terminate and there can be no assurance that the proceeds for the re-leasing or sale of the projects will be sufficient to pay principal and interest with respect to the then outstanding COPs. The scheduled payments of principal and interest with respect to the COPs are guaranteed under certificate insurance policies. The State's obligation to make lease payments does not constitute a debt or liability of the State within the meaning of any constitutional or statutory limitation. Neither the full faith and credit nor the general taxing power of the State is pledged to make payments of principal or interest due with respect to the COPs. Such payments will be made solely from amounts derived under the terms of the lease, including lease payments, and amounts from time to time on deposit under the terms of the declaration of trust.

2. School Facilities Board

In prior fiscal years, the SFB refinanced various COPs through advance-refunding arrangements. Under the terms of the refundings, sufficient assets to pay all principal, redemption premiums, if any, and interest on the refunded COPs have been placed in irrevocable trust accounts at commercial banks and invested in U.S. securities which, together with interest earned thereon, will provide amounts sufficient for future payment of principal and interest of the issues refunded. The assets, liabilities, and financial transactions of these trust accounts and the liability for the defeased COPs are not reflected in the accompanying financial statements. Refunded COPs for the SFB at June 30, 2006 totaled $311.130 million.

Business-Type Activities

3. University of Arizona

On November 16, 2005, the U of A issued Refunding COPs Series 2005D, 2005E, 2005F, 2005G, 2005H, 2005I (2005D-I) for $6.655 million, $3.555 million, $14.915 million, $2.245 million, $770 thousand, and $1.320 million, respectively, dated November 1, 2005 at a net premium of $202 thousand. The 2005D-I COPs include $29.460 million of serial certificates with interest rates ranging from 3.25% to 5.00% and maturity dates ranging from 2006 to 2025. The 2005D-I Certificates maturing on or after June 1, 2016, are subject to optional redemption prior to maturity without premium and there are also extraordinary redemption dates pursuant to the debt documents.

The U of A realized net proceeds from the 2005D-I COPs of $29.147 million after payment of $515 thousand for issuance costs, underwriters discount, and bond insurance. These net proceeds were used for the following:

- Pay the December 1, 2005 debt service interest payments on the COPs Series 1999A, 1999B, 1999, 2000A, 2001A, 2001B, 2002A, 2002B, 2003A, 2003B, and 2004A, which provided budget relief to assist the U of A with implementing a budget stabilization plan.

- Current-refund a $14.070 million principal portion of a variable rate COPs Series 2000A. At the time of the refunding, the effective rate of the refunded 2000A variable rate COPs was 3.05% and the maximum annual interest rate could not exceed 12.00%. Depending on what the future changes might have been in the variable rates of the refunded 2000A COPs, the difference in debt service payments resulting from changes in variable interest rates compared to the 2005F Certificates' average fixed interest rate of 4.30% over the next 19 years is ($2.130 million) to $15.417 million. The difference between the present value of the old and new debt service payments results in a range of an economic loss of $135 thousand to an economic gain of $974 thousand. The current refunding resulted in a difference between the reacquisition price and the net carrying amount of the old debt of $209 thousand. This difference, reported in the accompanying financial statements as a deduction of long-term debt, is being amortized to interest expense through the year 2025 using the straight-line method.

- Refund in advance of maturity a $6.555 million principal portion of the COPs Series 1999A and the $3.290 million principal balance of the Series 1999. The advance-refunding generated a combined net present value economic gain of $437 thousand (difference between the present values of the old debt and new debt service payments) for the U of A. The advance-refunding decreases the U of A's debt service by $260 thousand in year one, $43 thousand in year two, and by an average $27 thousand in years three through nine when the annual debt service increase by an average of $4 thousand from years ten through fifteen. The advance refunding resulted in a difference between the reacquisition price and the net carrying amount of the old debt of $654 thousand. This difference, reported in the accompanying financial statements as a deduction from long-term debt, is being amortized to interest expense through the year 2020 using the straight-line method. The refunded COPs Series 1999A and 1999 will be paid by investments held in an irrevocable trust with a combined fair value of $9.969 million. Accordingly, the trust account assets and liability for these defeased bonds are not included in the U of A's financial statements.

On May 9, 2006, the U of A issued Refunding COPs Series 2006A, 2006B, 2006C, 2006D, and 2006E (2006A-E) for $35.785 million, $12.395 million, $6.100 million, $1.285 million, and $3.085 million, respectively, dated May 1, 2006, at a net premium of $996 thousand. The 2006A-E COPs include $58.650 million of serial certificates with interest rates ranging from 3.60% to 5.00% and maturity dates ranging from 2007 to 2025. The 2006A-E COPs maturing on or after June 1, 2017, are subject to optional redemption prior to maturity without premium, and there are also extraordinary redemption dates pursuant to the debt documents.

The U of A realized net proceeds from the 2006A-E COPs of $58.824 million after payment of $913 thousand for issuance costs, underwriters discount, and bond insurance and the U of A contribution of $91 thousand. The net proceeds were used for the following:

- Pay the June 1, 2006 debt service principal and interest payments on the COPs Series 1999A, 2000A, 2001A, 2001B, 2002A, 2002B, 2003A, 2003B, and 2004A.

- Current-refund the variable rate COPs Series 1999B and the remaining portion of the variable rate COPs Series 2000A, with outstanding principal balances of $36.500 million and $11.530 million, respectively. At the time of the refunding, the effective rate of the refunded 1999B and 2000A variable rate COPs was 3.60% and the maximum annual interest rate could not exceed 12.00%. Depending on what the future changes might have been in the variable rates of the refunded 1999B and 2000A COPs, the difference in the combined debt service payments resulting from changes in variable interest rates compared to the 2006A Certificates' average fixed interest rate of 4.90% over the next 18 years is ($7.290 million) to $45.871 million. The difference between the present values of the old and new debt service payments results in a range of an economic loss of $486 thousand to an economic gain of $3.058 million. The current refunding resulted in a difference between the reacquisition price and the net carrying amount of the old debt of $629 thousand. This difference, reported in the accompanying financial statements as a deduction from long-term debt, is being amortized to interest expense through the year 2025 using the straight-line method.

On June 6, 2006, the U of A issued COPs Series 2006 for $18.240 million at a discount of $104 thousand dated June 1, 2006. The 2006 COPs include two term certificates consisting of $3.780 million with an interest rate of 4.50% due June 1, 2028, and $6.320 million with an interest rate of 4.50% due June 1, 2031. The 2006 COPs with maturity on or after June 1, 2017, are subject to optional redemption without premium. The 2006 COPs with maturity on June 1, 2028 and June 1, 2031, are subject to mandatory sinking fund redemption without premium pursuant to the debt documents. There are also extraordinary redemption dates pursuant to the debt documents. The U of A realized net proceeds of $17.807 million after payment of $329 thousand for issuance costs, underwriter discounts, and bond insurance. The net proceeds were used to finance the Arizona Biomedical Research Collaborative Building construction project.

The U of A has outstanding at June 30, 2006, variable rate COPs, Series 2004B, totaling $41.400 million. These certificates bear interest at a weekly rate, determined by J.P. Morgan Securities as remarketing agents, with a final maturity date of June 1, 2031. These certificates are subject to conversion, at the option of the Arizona Board of Regents, to an adjustable rate, an annual rate, or a term rate pursuant to the debt documents. If not converted, the 2004B COPs will bear interest at a weekly rate not to exceed 12.00% per annum determined under prevailing market conditions by the remarketing agent. The variable rate COPs are subject to purchase on the demand of the holder at a price equal to principal plus accrued interest on seven days' notice and delivery to the remarketing agents. If the remarketing agents are unable to resell the demand certificates, the U of A has Standby Purchase Agreements with Bayerische Landesbank to extend credit through the purchase of the un-marketed certificates. Assuming all of the $41.400 million COPs are not resold within 90 days, the U of A would be responsible to make annual installment principal payments of $8.280 million over a five year period, plus interest to be calculated as established in the Standby Purchase Agreements. Bayerische Landesbank charges the U of A an annual Standby Purchase Agreement commitment fee on the outstanding principal for the COPs for the Series 2004B. The fee is 0.19%. The Standby Purchase Agreement is valid through November 30, 2015.

In fiscal year 2003, the U of A refunded, in advance of maturity, a portion of outstanding COPs Series 2001B. At June 30, 2006, the outstanding principal balance for the COPs Series 2001B was $5.465 million, which will be paid by investments held in an irrevocable trust with a fair market value of $5.437 million. Accordingly, the trust account assets and liability for these defeased COPs are not included in the U of A's financial statements.

In fiscal year 2005, the U of A refunded, in advance of maturity, a portion of outstanding COPs Series 1999A, 1999, and 2001A. At June 30, 2006, the total outstanding principal balance for the COPs Series 1999A, 1999, and 2001A was $41.935 million, which will be paid by investments held in an irrevocable trust with a fair value of $43.283 million. Accordingly, the trust account assets and liability for these defeased COPs are not included in the U of A's financial statements.

4. Arizona State University

During fiscal year 2006, the ASU issued $15.810 million in certificates of participation to fund the Arizona Biomedical Research Collaborative Building in cooperation with the U of A and to provide additional funding for Biodesign Institute Building B. The 2006 COPs were issued in June 2006 at an average interest rate of 4.52%. The annual debt service for the 2004, 2005A, and 2006 COPs will be funded by state appropriations in the amount of $14.500 million annually beginning in fiscal 2008.

Securities and cash restricted for COP debt service held by the trustee at June 30, 2006 totaled $21.800 million.

5. Northern Arizona University

On July 27, 2005, the NAU issued COPs Series 2005 for $40.255 million dated August 1, 2005. The Series 2005 COPs included $31.455 million of serial certificates with interest rates ranging from 3.00% to 5.00% and maturity dates ranging from 2008 to 2029. The 2005 COPs also included $8.800 million of term certificates with interest rates ranging from 4.75% to 5.00% and maturing on September 1, 2020 and September 1, 2030. The 2005 COPs were issued at a premium of $1.158 million. NAU realized net proceeds of $40.763 million after payment of $650 thousand for issuance costs, underwriters discount, and bond insurance. The costs associated with this issue were recorded in the current fiscal year. The net proceeds are being used to finance the Laboratory Facility building and the North Campus Research Infrastructure project.

On June 7, 2006, the NAU issued COPs Series 2006 for $12.445 million dated June 1, 2006. The Series 2006 COPs included $9.390 million of serial certificates with interest rates ranging from 4.00% to 4.40% and maturity dates ranging from 2008 to 2027. The 2006 COPs also included a $3.055 million term certificate with an interest rate of 4.50% and maturing on September 1, 2030. The 2006 COPs were issued at a net discount of $169 thousand. NAU realized net proceeds of $12.004 million after payment of $272 thousand for issuance costs, underwriters discount, and bond insurance. The costs associated with this issue were recorded in the current fiscal year. The net proceeds are being used to finance the Arizona Western NAU Yuma Research Facility project and the Utility Infrastructure project.

A summary of the COPs issued as of June 30, 2006, is as follows (expressed in thousands):

Project	Issue Date	Final Maturity Date	Amount Authorized And Issued	Outstanding Balance	Interest Rates
Governmental Activities:					
Refunding Certificates of 92A, 92C, & 1091	2001	2011	$ 57,930	$ 34,700	4.00 – 5.25
Health Lab/HRIS	2002	2023	63,270	52,655	3.50 – 5.50
Refunding Certificates of 92B	2002	2011	75,295	62,765	2.90 – 5.50
School Facilities Board 2003A	2003	2018	372,730	154,270	2.50 – 5.00
School Facilities Board 2003B	2004	2019	194,610	115,170	2.25 – 5.25
School Facilities Board 2004A	2004	2019	47,160	44,405	2.00 – 5.00
ADOA Refunding Certificates of 93B	2004	2012	16,725	13,620	3.00 – 5.00
ADOA Series 2004B	2004	2019	31,965	30,260	3.00 – 5.25
School Facilities Board 2004B	2005	2020	190,040	131,155	3.50 – 5.25
School Facilities Board 2004C	2005	2020	47,585	47,585	3.00 – 5.00
SFB Refunding Certificates of 2003A	2005	2018	201,125	201,125	2.50 – 5.00
SFB Refunding Certificates of 2003B	2005	2019	80,055	80,055	2.50 – 5.00
SFB Refunding Certificates of 2004B	2005	2020	53,045	53,045	2.50 – 5.00
Total Governmental Activities:			$ 1,431,535	$ 1,020,810	
Business-Type Activities:					
Arizona State University:					
Towers Project	1991	2011	$ 4,500	$ 1,815	6.89
Downtown Center – 1999A	1999	2025	5,620	4,935	5.75
Downtown Center – 1999B	1999	2025	5,165	4,690	8.00
2002 Certificates of Participation	2002	2027	103,800	95,460	4.75
2004 West Campus – Refunding	2004	2010	22,495	22,495	2.36
2004 Certificates of Participation	2005	2031	80,275	80,275	4.89
2005A Certificates of Participation	2005	2031	110,115	110,115	4.36
2006 Certificates of Participation	2006	2031	15,810	15,810	4.52
University of Arizona:					
Fixed Student Union A	1999	2020	21,607	3,601	5.13 – 5.30
Parking Garage/Residence Hall	1999	2009	18,635	505	4.85 – 5.00
Park Student Union/Ln Svcs/6th St Gar	2001	2025	31,695	15,165	3.88 – 5.50
Gittings Bldg. Highland Infra. Life Sci.	2001	2022	21,425	13,385	4.00 – 5.13
Student Housing, Health Bldg., UA North	2002	2022	76,965	64,400	4.13 – 5.50
Meinel Bldg & Refund COPS 1994B	2002	2023	29,845	28,845	3.00 – 5.13
Refund COPS 1997 & Portion of Series 2001B	2003	2022	10,615	10,615	3.50 – 5.00
Med. Resh. Bldg./Biomed Sci./Tech. Infstr.	2004	2031	153,960	152,360	2.00 – 5.25
Chem.Bldg./Res.Life/Pkg.Garage/Rfnd.COPS	2004	2029	42,020	40,895	3.50 – 5.25
Chemical Building Expansion	2004	2031	41,400	41,400	Variable not to exceed 12
Refund COPS 1999A	2005	2024	12,660	12,660	4.00 – 5.00
Refund COPS 1999	2005	2024	14,825	14,825	5.00
Refund COPS 2001A	2005	2022	16,330	16,330	4.13 – 5.00
Refund COPS 1999, 1999A&B, 2000A, 2001A&B, 2002A&B, 2003A&B, 2004A	2006	2025	29,460	29,010	3.25 – 5.00
Refund COPS 1999A&B, 2000A, 2001A&B, 2002A&B, 2003A&B, 2004A	2006	2025	58,650	58,650	3.60 – 5.00
Biomed Rsch Collab Bldg Project	2006	2031	18,240	18,240	4.00 – 5.00
Northern Arizona University:					
2004 Certificates of Participation	2005	2030	37,585	37,585	2.50 – 5.13
2005 Certificates of Participation	2006	2031	40,255	40,255	3.00 – 5.00
2006 Certificates of Participation	2006	2031	12,445	12,445	4.00- 4.50
Total Business-Type Activities:			$ 1,036,397	$ 946,766	
Total Certificates of Participation			$ 2,467,932	$ 1,967,576	

Principal and interest debt service requirements on COPs outstanding at June 30, 2006, are as follows (expressed in thousands):

	Annual Debt Service					
	Governmental Activities			Business-type Activities		
Fiscal Year	Total Principal	Total Interest	Total Amount Required	Total Principal	Total Interest	Total Amount Required
2007	$ 60,945	$ 47,664	$ 108,609	$ 16,805	$ 43,755	$ 60,560
2008	63,215	45,202	108,417	30,160	43,139	73,299
2009	65,805	42,417	108,222	31,155	42,043	73,198
2010	68,580	39,425	108,005	32,120	40,715	72,835
2011	71,680	36,120	107,800	28,255	39,623	67,878
2012-2016	414,055	122,826	536,881	189,885	177,004	366,889
2017-2021	272,090	21,998	294,088	251,126	123,432	374,558
2022-2026	4,440	229	4,669	205,145	62,924	268,069
2027-2031	-	-	-	162,115	19,958	182,073
Total	$ 1,020,810	$ 355,881	$ 1,376,691	$ 946,766	$ 592,593	$ 1,539,359

D. LEASES AND INSTALLMENT PURCHASES

1. Leases

The total operating lease expenditures for the fiscal year ended June 30, 2006, were $32.576 million for governmental activities and $20.422 million for business-type activities. The future minimum lease payments for long-term operating leases as of June 30, 2006, are summarized below (expressed in thousands):

Fiscal Year	Governmental Activities	Business-type Activities	Total
2007	$ 24,926	$ 3,022	$ 27,948
2008	17,468	2,343	19,811
2009	13,462	919	14,381
2010	7,121	462	7,583
2011	2,051	227	2,278
2012-2016	794	-	794
Total Minimum Lease Payments	$ 65,822	$ 6,973	$ 72,795

Many operating leases are for buildings and land leased by State agencies. Although these leases are considered to be long-term, they are cancelable under certain circumstances.

- An agency must be able to cancel the lease if monies are not appropriated to cover the lease expenditures.
- If an agency is ordered to move into State-owned property and a 60-day notice is given, the lease can be canceled without penalty.
- In situations where the use of the leased property is dependent on the use of Federal monies, the lease must be cancelable in the event Federal monies are no longer available.

The State has entered into capital lease agreements for the acquisition of buildings, telephone systems, copy machines, and other equipment. Capital lease assets and liabilities are reported on the government-wide Statement of Net Assets. A lease is reported as a capital lease if one or more of the following criteria are met:

- Title to or ownership of the asset is transferred to the State at the end of the lease.
- The lease contains a bargain purchase option.

- The lease term is equal to 75.00% or more of the useful life of the leased asset. (This criteria does not apply if the beginning lease term falls within the last 25.00% of the total useful life of the asset.)

- The present value of the minimum lease payments at the inception of the lease, excluding executory costs, equals at least 90.00% of the fair market value of the leased asset. (This criterion does not apply if the beginning lease term falls within the last 25.00% of the total useful life of the asset.)

The future minimum lease payments for long-term capital leases as of June 30, 2006 are summarized below (expressed in thousands):

	Annual Debt Service	
Fiscal Year	Governmental Activities	Business-type Activities
2007	$ 14,963	$ 9,209
2008	15,217	9,521
2009	15,348	9,842
2010	14,323	8,907
2011	12,433	8,292
2012-2016	64,468	36,253
2017-2021	70,638	30,656
2022-2026	76,375	30,072
2027-2031	20,435	30,414
2032-2036	-	15,543
Total minimum lease payments	304,200	188,709
Less: amount representing interest	(76,254)	(75,321)
Less: amount representing executory costs	(98,138)	-
Obligations under capital leases	$ 129,808	$ 113,388

2. Installment Purchases

The State has installment purchase contracts payable for acquisitions of computer and other equipment. Installment purchases assets and liabilities are reported in the government-wide Statement of Net Assets.

The future minimum payments for long-term installment purchases as of June 30, 2006, are summarized below (expressed in thousands):

	Annual Debt Service	
Fiscal Year	Governmental Activities	Business-type Activities
2007	$ 2,530	$ 2,637
2008	2,270	2,255
2009	1,625	2,034
2010	754	1,600
2011	-	1,600
2012-2016	-	1,676
2017-2021	-	135
Total future minimum payments	7,179	11,937
Less: amount representing interest	(364)	(1,658)
Obligations under installment purchases	$ 6,815	$ 10,279

3. Capital Assets Financed through Capital Leases and Certificates of Participation

The following table summarizes the historical costs of assets acquired under capital leases and COPs (expressed in thousands):

	Governmental Activities	Business-type Activities
Land	$ 6,078	$ -
Construction in progress	24,747	-
Buildings	302,427	1,067,487
Improvements other than buildings	3,653	-
Equipment	64,308	56
	401,213	1,067,543
Less: Accumulated Depreciation	(118,486)	(72,218)
Carrying Value	$ 282,727	$ 995,325

E. LITIGATION

The amounts shown for the *Ladewig vs. Arizona Department of Revenue* and the *Kerr vs. Killian* settlements are further discussed in Note 10.B – *Litigation*. The State has typically paid for litigation from the General Fund.

F. COMPENSATED ABSENCES

Compensated absences are paid from various funds in the same proportion that those funds pay payroll costs. The compensated absence liability attributable to governmental activities will be liquidated primarily by the General Fund. During fiscal year 2006, the State paid for compensated absences as follows: 85.00% from the General Fund, 9.00% from other funds, and 6.00% from other major funds.

G. CHANGES IN LONG-TERM OBLIGATIONS

The following is a summary of changes in Long-Term Obligations (expressed in thousands):

	Balance July 1, 2005	Increases	Decreases	Reclassifications	Balance June 30, 2006	Due Within One Year	Due Thereafter
Governmental Activities:							
Long-term Debt:							
Revenue bonds	$ 2,170,845	$ 714,410	$ (778,555)	$	$ 2,106,700	$ 102,860	$ 2,003,840
Grant anticipation notes	363,970	-	(38,540)		325,430	42,570	282,860
Certificates of participation	1,054,677	-	(33,867)		1,020,810	60,945	959,865
Capital leases	126,676	8,752	(5,620)		129,808	5,699	124,109
Installment purchase contracts	6,926	2,091	(2,202)		6,815	2,342	4,473
Premiums and discounts on debt	197,479	59,711	(37,232)		219,958	19,947	200,011
Deferred amounts on refundings	-	(21,398)	3,566		(17,832)	(3,566)	(14,266)
Total Long-term Debt	3,920,573	763,566	(892,450)	-	3,791,689	230,797	3,560,892
Other Long-term Liabilities:							
Compensated absences	153,235	214,909	(233,798)		134,346	127,749	6,597
Ladewig vs. Arizona Department of Revenue Settlement	150,905	-	(74,789)		76,116	76,116	-
Kerr vs. Killian Settlement	-	15,000	-		15,000	15,000	-
Total Other Long-term Liabilities	304,140	229,909	(308,587)	-	225,462	218,865	6,597
Total Long-term Obligations	$ 4,224,713	$ 993,475	$ (1,201,037)	$ -	$ 4,017,151	$ 449,662	$ 3,567,489
Business-type Activities:							
Long-term Debt:							
Revenue bonds	$ 768,000	$ 68,470	$ (33,870)	$	$ 802,600	$ 42,435	$ 760,165
Certificates of participation	860,759	175,027	(89,020)		946,766	16,805	929,961
Capital leases	120,361	-	(6,973)		113,388	4,057	109,331
Installment purchase contracts	7,276	4,764	(1,761)		10,279	2,180	8,099
Notes payable	30	-	(30)		-	-	-
Premiums and discounts on debt	36,133	4,534	(3,723)	1,387	38,331	1,633	36,698
Deferred amounts on refundings	(20,821)	(1,492)	2,094	(1,387)	(21,606)	(1,688)	(19,918)
Total Long-term Debt	1,771,738	251,303	(133,283)	-	1,889,758	65,422	1,824,336
Other Long-term Liabilities:							
Compensated absences	55,819	72,134	(65,118)		62,835	10,622	52,213
Total Other Long-term Liabilities	55,819	72,134	(65,118)	-	62,835	10,622	52,213
Total Long-term Obligations	$ 1,827,557	$ 323,437	$ (198,401)	$ -	$ 1,952,593	$ 76,044	$ 1,876,549

The above long-term obligations relating to governmental activities include Internal Service Funds. Amounts for capital leases and compensated absences differ from those in the Reconciliation of the Governmental Funds Balance Sheet to the Statement of Net Assets because $11.130 million of capital leases and $12.346 million of compensated absences are attributable to Internal Service Funds. These amounts are included in the reconciliation as part of Internal Service Fund net assets.

NOTE 7. INTERFUND TRANSACTIONS

INTERFUND BALANCES AND TRANSFERS

Interfund Receivables/Payables

Interfund balances as of June 30, 2006 are as follows (expressed in thousands):

	Due To						
Due From	General Fund	Transportation & Aviation Planning, Highway Maintenance & Safety Fund	Land Endowments Fund	Non-Major Governmental Funds	Non-Major Enterprise Funds	Internal Service Funds	Total Due To
General Fund	$ -	$ -	$ 392	$ 42,695	$ 3	$ 1,694	$ 44,784
Transportation & Aviation Planning, Highway Maintenance & Safety Fund	66,822	-	-	2,861	131,307	-	200,990
Land Endowments Fund	2,247	-	-	10,859	-	1	13,107
Non-Major Governmental Funds	26,809	-	-	1,451	-	681	28,941
Unemployment Compensation Fund	3	-	-	755	-	-	758
Lottery Fund	16,135	-	-	1,041	-	-	17,176
Non-Major Enterprise Funds	150,559	20,000	-	-	-	1	170,560
Internal Service Funds	1,025	-	-	3	-	1,090	2,118
Total Due From	$ 263,600	$ 20,000	$ 392	$ 59,665	$ 131,310	$ 3,467	$ 478,434

Interfund balances represent (1) amounts due to and from the Internal Service Funds for goods and services rendered, and (2) cash transferred between funds for various interfund activities subsequent to the balance sheet date. The cash is recorded in the fund which initiated the transfer, and a corresponding liability is recorded. The receiving fund records an interfund receivable.

The following interfund balances are not expected to be repaid within one year (expressed in thousands):

	Due To						
Due From	General Fund	Transportation & Aviation Planning, Highway Maintenance & Safety Fund	Land Endowments Fund	Non-Major Governmental Funds	Non-Major Enterprise Funds	Internal Service Funds	Total Due To
Transportation & Aviation Planning, Highway Maintenance & Safety Fund	$ 64,518	$ -	$ -	$ -	$ 98,900	$ -	$ 163,418
Non-Major Enterprise Funds	150,494	-	-	-	-	-	150,494
Total Due From	$ 215,012	$ -	$ -	$ -	$ 98,900	$ -	$ 313,912

Interfund Transfers

Transfers for the year ended June 30, 2006 are as follows (expressed in thousands):

	Transferred To							
Transferred From	General Fund	Transportation & Aviation Planning, Highway Maintenance & Safety Fund	Land Endowments Fund	Non-Major Governmental Funds	Universities Fund	Industrial Commission Special Fund	Non-Major Enterprise Funds	Total Transfers Out
General Fund	$ -	$ 859	$ 131	$ 65,198	$ 851,304	$ -	$ -	$ 917,492
Transportation & Aviation Planning, Highway Maintenance & Safety Fund	32,383	-	-	425,474	-	-	-	457,857
Land Endowments Fund	1,524	-	-	47	-	-	-	1,571
Non-Major Governmental Funds	177,086	3,067	-	9,571	-	19,000	110	208,834
Unemployment Compensation Fund	17	-	-	2,550	-	-	-	2,567
Lottery Fund	65,193	-	-	27,174	-	-	-	92,367
Non-Major Enterprise Funds	988	-	-	-	-	-	-	988
Internal Service Funds	791	-	-	30	-	-	-	821
Total Transfers In	$ 277,982	$ 3,926	$ 131	$ 530,044	$ 851,304	$ 19,000	$ 110	$ 1,682,497

Interfund transfers represent legally authorized non-exchange transfers of funds. These transfers include: (1) Legislative appropriations from the General Fund, (2) other legislative transfers, (3) statutorily required transfers, (4) transfers related to the elimination of funds, and (5) transfers for debt service.

NOTE 8. FUND DEFICIT

A. INDUSTRIAL COMMISSION SPECIAL FUND

The Industrial Commission Special Fund deficit decreased in the amount of $83.116 million from $192.766 million to $109.650 million during fiscal year 2006. The main contributor to the Special Fund deficit continues to be the insolvent carrier liability, which was $263.212 million at June 30, 2006. The Special Fund is responsible for paying all current and future Arizona workers' compensation claims of insolvent insurance carriers and self-insured plans. Some of the claims expense will be recovered over a period of years as the Special Fund receives liquidation distributions from the insolvent companies. The 2006 calendar year assessments percentage for the State Compensation Fund and privately owned insurance companies that provide workers' compensation insurance is 2.50%, the largest amount currently authorized in Arizona law. In 2005, ARS §23-1081(B) was amended to permit surplus in the Industrial Commission Administrative Fund to be transferred to the Special Fund when the Special Fund is not actuarially sound. During fiscal year 2006, $19.000 million was transferred from the Administrative Fund to the Special Fund.

B. HEALTHCARE GROUP

The Healthcare Group (HCG) incurred an operating loss of $6.137 million in 2006 and $4.844 million in 2005 and at June 30, 2006 had a fund deficit of $3.696 million. Additionally, current liabilities exceeded current assets by $1.723 million at June 30, 2006.

Three factors were the primary contributors to the decrease in net assets in fiscal year 2006. The most significant were the $8.629 million stop-loss coverage reconciliation costs for the HMO model insurance contractors that are $4.000 million in excess of the premium revenue set aside for the HMO benefit plans' stabilization reserve. The second was PPO model benefit claims that have been incurred but not yet received or paid in excess of the premium based reserves collected for the purpose of paying medical claims. The third factor contributing to the decrease in net assets was a continuation from fiscal year 2005 of the startup costs associated with the introduction of the new PPO product.

In response to the decreases in net assets and liquidity concerns described above, HCG has started the following intensive initiatives:

- HCG will conduct an organization-wide review of operating expenditures and will implement a plan which could include elimination of personnel and reengineering of job assignments and duties.
- Premium increases were implemented in July, 2006 for new HMO members and in September, 2006 for renewing members. Analysis of fiscal year 2006 claims experience indicates that groups with 1 employee consume disproportionately more healthcare services than the larger groups. Therefore, HCG's pricing strategy includes the implementation of actuarially determined premium rates for groups with 1 employee which are designed to cover the costs of their disproportionate consumption of services. HCG began implementing this strategy for PPO "groups of 1" in Maricopa County in July, 2006. A second increase will be implemented in January, 2007 at which time the "group of 1" rate will be implemented across the State in both the HMO and the PPO.
- Beginning in January, 2007, co-payments associated with primary care, ambulatory care, and hospitalization will be increased.
- Amend the contracted health plan contracts, effective July 1, 2006 to include PPO and HCG HMO program administrative costs and PPO claim costs as authorized allocations from the HMO stabilization reserve monies on an as needed basis.
- In March, 2007, HCG will introduce a Point-of-Service plan and begin tiering its hospital network. When a member requires inpatient or outpatient care from a hospital provider, their co-insurance payment will be dependent upon the level or "tier" of the hospital they choose. Hospitals will be classified into tiers based on the discounts that they offer to HCG. Members will incur less out of pocket costs if they choose a Tier 1 hospital vs. a Tier 2 or Tier 3 hospital.

The HCG management represents that successful implementation of these operating improvements will provide sufficient cash to fund operating expenses. However, there can be no assurance that these operating improvements will occur or will provide sufficient cash to fund operating expenses. Additionally, if enrollment growth and across-the-board premium increases are not sufficient to fund the reserves for past losses and future stop-loss and claims experience costs, then the HCG will be required to scale back administrative expenditures to the level supported by actual enrollment and/or require a subsidy from the State General Fund to cover these operating costs. There can be no assurances that the Legislature will approve such a subsidy from the State General Fund. Accordingly, the accompanying financial statements have been prepared assuming that the HCG will continue as a going concern. The matters discussed above raise substantial doubt about the HCG's ability to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification of asset carrying amounts or the amount and classification of liabilities that might result should the HCG be unable to continue as a going concern.

C. RISK MANAGEMENT FUND

Risk Management Fund (RMF) - The RMF deficit of $330.819 million is primarily due to the RMF receiving annual funding only for expected paid claims (self-insured and excess insurance expenditures, legal and other claim related expenditures, and administrative expenditures), and not being funded for non-current accrued insurance losses. Accrued insurance losses of the RMF are not considered when determining funding for each fiscal year.

D. RETIREE ACCUMULATED SICK LEAVE FUND

The Retiree Accumulated Sick Leave pays retirees their accumulated sick leave upon retirement from State service when they meet certain criteria. When a retiree submits an application to receive their sick leave benefits, the entire liability is recorded in the fund. The retirees receiving benefits are paid in three equal annual installments; however, State agencies pay for only one year based on a .40% charge on gross payroll. The $3.263 million fund deficit is primarily due to the above funding mechanism.

NOTE 9. JOINT VENTURE

The U of A is a participant in the Large Binocular Telescope Corporation (LBT). The LBT was formally incorporated as a nonprofit corporation in August 1992, pursuant to a Memorandum of Understanding, as amended, executed on February 24, 1989, between the U of A and the Arcetri Astrophysical Observatory in Florence, Italy (Arcetri). The purpose of the joint venture is to design, develop, construct, own, operate, and maintain a binocular telescope currently being constructed in Arizona. The current members of the LBT are the U of A, Arcetri Research Corporation, Ohio State University and the LBT Beteiligungsgesellschaft.

The U of A has committed resources equivalent to 25.00% of the project's construction costs and the LBT's annual operating costs. As of June 30, 2006, the U of A has made cash contributions of $18.159 million toward the project's construction costs. The U of A's financial interest represents its future viewing/observation rights. Upon completion of construction, these rights will be divided among the participants in proportion to their contributions. According to the audited financial statements of the LBT for the year ended December 31, 2005, assets, liabilities, revenues, and expenses totaled $109.000 million, $2.000 million, $10.000 million, and $3.000 million, respectively.

The LBT's separate audited financial statements can be obtained from LBT Project Office, Steward Observatory, University of Arizona, Tucson, AZ 85721-0065.

NOTE 10. COMMITMENTS, CONTINGENCIES, AND COMPLIANCE

A. RISK MANAGEMENT INSURANCE LOSSES

The Department of Administration – Risk Management Section manages the State's property, environmental, liability, and workers' compensation losses. The State has determined that the management of these losses can be performed effectively and efficiently through the Risk Management Section. Consequently, all agencies and the State's three universities are required to participate in this program. The State's Risk Management Section evaluates the proper mix of purchased commercial insurance and self-insurance annually.

The Industrial Commission Special Fund provides payment of workers' compensation losses which are not covered by the State Compensation Fund, the Department of Administration – Risk Management Section, private insurance carriers, or self-insured employers. The workers' compensation claims paid by the Commission encompass losses against uninsured or underinsured employers and insolvent insurance carriers and would include payments for vocational rehabilitation, medical conditions incurred prior to 1973, apportionment claims for pre-existing industrial and non-industrial related physical impairments, and compensation for loss of earnings associated with the disability. The Commission is totally self-insured.

The State records claims liability when the reported loss is probable and reasonably estimated. On an annual basis, independent actuarial firms are engaged to estimate the State's total year-end outstanding claims liability, which takes into account recorded claims and related allocated claims adjustment expenditures, loss development factors, and an estimate for incurred but not reported claims.

The management and payment of these losses is accomplished through the funding mechanism of the Risk Management Fund (Internal Service Fund) and the Industrial Commission Special Fund (Enterprise Fund). As discussed in the above paragraph, an independent annual actuarial analysis is performed to evaluate the needed funding. The Risk Management Section will assess each agency an annual portion of the necessary funding for the Risk Management Fund based on their exposures and prior loss experience. Interest and dividend earnings of investments and assessments on gross premium revenues currently fund the Commission Special Fund. To provide funding for workers' compensation claims, the Commission may direct payment to the State Treasurer an amount not to exceed one and one-half percent of all premiums received by the State Compensation Fund, private carriers and self-insured plans during the immediately preceding calendar year. Beginning in calendar year 2004, a 1.50% assessment was levied under ARS §23-1065(A) because of a deficit net assets balance resulting from an increase in accrued insurance losses due to defunct insurance carriers.

The major reason for the decrease in insolvent carrier liabilities from July 1, 2005 through June 30, 2006 was the additional 12 months of workers' compensation case development without a significant number of new cases being assigned to the State Compensation Fund under ARS §23-966(A). The total of all three assessments for the Industrial Commission Special fund in 2006 is 2.50%. This includes the 1.50% assessment under ARS §23-1065(A), .50% assessment under ARS §23-966(D), based on the insolvent carrier losses, and .50% assessment under ARS §23-1065(F) based on the total apportionment liability. The Commission has filed pending proof of claim requests with ancillary receivers, liquidators holding deposits and surety bonds of several insolvent companies. Since the actual amount that will ultimately be received cannot be determined, the Commission will continue to recognize receipt of insolvent carrier deposits (no insurance settlement income) as revenue at the time received rather than recording a receivable.

Occasionally, the Risk Management Section agrees with claimants to purchase an annuity contract to settle specific claims when it is determined that it is in the best interest of the State to do so. In these instances, the State requires the claimant to sign an agreement releasing the State from any further obligation. As a result of these requirements, the likelihood that the State will be required to make future payments on these claims is remote.

There have been no significant reductions in the current fiscal year insurance coverage. There have been no settlements that have exceeded insurance premium coverage in the last three years.

The following table presents the changes in claims liabilities balances (short- and long-term combined) during fiscal years ended June 30, 2005 and June 30, 2006 (expressed in thousands):

Fiscal Year	Beginning Balance	Current Year Claims and Changes in Estimates	Claims Payments	Ending Balance
Risk Management Fund:				
2005	$ 243,128	$ 127,775	$ 69,303	$ 301,600
2006	301,600	135,364	69,764	367,200
Industrial Commission Special Fund:				
2005	384,936	101,395	24,733	461,598
2006	461,598	(36,513)	14,842	410,243

B. LITIGATION

In *Ladewig vs. Arizona Department of Revenue,* Ladewig is a class action tax refund case. The class members are seeking refunds for Arizona income tax paid on dividends received from corporations doing less than 50.00% of their business in Arizona during the years 1986 through 1989. The trial court held that such taxes violated the Commerce clause of the U.S. Constitution and certified the class. The class certification was upheld by the Arizona Supreme Court in 2001. The Tax Court approved a settlement in December 2002. The remaining issues concern the administration of the settlement. The Department moved to correct claim errors that were caused by computer and clerical mistakes and resulted in millions of dollars in overpayments on the first installment to approximately 3,250 class members. The Tax Court ruled in November 2005 that the Department could not recover amounts previously paid to class members, but could offset the overpayments against the amounts due for the remaining two installments. Accordingly, the State has recorded a liability in its financial statements in the amount of $76.116 million.

In *Kerr vs. Killian,* federal employees claimed an income tax refund on taxes paid on federal employee contributions. Prior to 1990, the Arizona statutes allowed state employees to deduct mandatory employee pension contributions, but did not provide a similar deduction for federal employees. After 1990, Arizona amended the statutes to just adopt federal adjusted gross income. Contributions that are deductible at the federal level are also deductible for Arizona tax purposes. The Arizona Supreme Court held that Arizona's tax statutes after 1990 did not discriminate against federal employees based on the source of income. The United States Supreme Court denied review. The Arizona Court of Appeals remanded the case for the earlier years to take a fresh look at the class certification issue. The parties then entered into a settlement agreement which the tax court has approved. Accordingly, the State has recorded a liability in its financial statements in the amount of $15.000 million.

In *Roosevelt Elementary School District No. 66 vs. State of Arizona*, the plaintiffs allege the State failed to fully fund the Building Renewal Fund established by the Students FIRST legislation. On October 13, 2000, the court held that the State did not violate the statutory provisions regarding funding of the Building Renewal Fund for fiscal year 1998-99. However, the court held that neither party was entitled to summary judgment regarding funding for fiscal year 1999-00, and that in order to prevail on that claim, the plaintiffs would have to demonstrate that they were injured by the alleged under funding. On February 21, 2002, the court granted the plaintiffs' motion to file an amended complaint, which included similar allegations regarding funding for fiscal year 2001-02. The parties both moved for summary judgment once again regarding the remaining claims in the case (fiscal years 1999-2000 and 2001-02), and on May 7, 2002, the trial court granted the plaintiffs' motion for summary judgment as to both years. The State timely appealed the decision to the Arizona Court of Appeals. On August 14, 2003, the Court of Appeals reversed the decision of the trial court and remanded the matter back to the trial court. Plaintiffs filed a petition for review in the Arizona Supreme Court, which was denied. The matter was remanded to the Superior Court. In 2006, the parties completed discovery and the State filed a Motion for Summary Judgment in mid-2006. One of the grounds for the Motion for Summary Judgment was the plaintiff school districts' failure to apply for funding under the Emergency Deficiencies Correction Fund (ARS §15-2022). The matter was set for trial in late October, 2006, but the Superior Court granted summary judgment in favor of the State based on the failure of the plaintiff districts to apply for emergency deficiency monies. However, because one of the plaintiffs had applied for emergency funding for some of its projects in July, 2006, and because another of the three plaintiffs submitted a request for emergency funding after the summary judgment ruling, the Superior Court has stayed the case pending the outcome of the emergency requests, and has indicated that the claims may be reinstated if the emergency requests are denied and the plaintiffs have used all their available state funding. The potential outcome is uncertain at this time. If this case were to have an unfavorable outcome, it is possible that the State could incur losses of approximately $88.000 million. However, at this time, the plaintiffs have suggested that they are only seeking a declaration that the Students FIRST legislation is unconstitutional as applied.

In the *Somerton Elementary School District No. 66 vs. State of Arizona*, the plaintiffs' claim is identical to that alleged in the *Roosevelt Elementary School District* case discussed above, except that it involves the level of State funding for the Building Renewal Fund for the fiscal year 2002-03. Because the issues raised in this case are identical to those raised in the *Roosevelt Elementary School District* case, it was assigned to the same trial court judge. The potential outcome is uncertain at this time. If this case were to have an unfavorable outcome, it is possible that the State could incur losses of approximately $90.000 million. However, at this time, the plaintiffs have suggested that they are only seeking a declaration that the Students FIRST legislation is unconstitutional as applied.

In *Smith vs. Winkelman* the plaintiffs have filed an action in Maricopa County Superior Court seeking an accounting, declaratory relief, and damages for breach of trust. Damages are for the value of land disposed of by the State Land Department between 1929 and 1967 for approximately 900 rights of way that were issued to governmental entities without appraisal or auction, and without the payment of any compensation. In January 2007, the court granted motions to dismiss on the ground that the plaintiffs' claims were barred by laches. Plaintiffs have announced their intention to appeal. One claim by the State against one grantee (the Flood Control District of Maricopa County) was settled in September 2006, and a separate action seeking approval of that settlement is pending. The lands at issue in that settlement comprise approximately one third of the total lands affected by the challenged right of way. Approval of the settlement is expected to significantly reduce the State's exposure to risk of damages. The State previously moved to dismiss on statute of limitations and for lack of standing and justiciability, but that motion was denied and the Court of Appeals declined to review the statute of limitations issue on a petition for special action. The State joined in the motions leading to the dismissal order. The State will probably defend that appeal and cross-appeal the denial of the previous motions to dismiss. The potential outcome is uncertain at this time. If this case were to have an unfavorable outcome, it is possible that the State would have to pay the Land Endowments Fund between $500.000 million and $1.0 billion.

In *Liquid Titan vs. Arizona Department of Weights and Measures, et al.*, the plaintiff alleges defamation against the Arizona Department of Weights and Measures (ADWM), the former director, and the current director. The complaint arises from a press release issued by the ADWM relating to fuel quality and record violations. The complaint has been served with discovery. The State is preparing its answer and has met with the ADWM to address answering the complaint and responding to discovery. The State's anticipated response is to admit the press release and deny allegations of wrongful intent and lack of basis for assertions in the press release. The potential outcome is uncertain at this time. If this case were to have an unfavorable outcome, the State could incur losses ranging from $9.200 million to $15.000 million.

The State has a variety of claims pending against it that arose during the normal course of its activities. Management believes, based on advice of legal counsel, losses, if any, resulting from settlement of these claims will not have a material effect on the financial position of the State. All losses for any unsettled litigation or contingencies involving workers' compensation, medical malpractice, construction and design, highway operations, employment practices, criminal justice, fidelity and surety, environmental property damage, general liability, environmental liability, building and contracts, auto liability, or auto physical damage are determined on an actuarial basis and included in the Accrued Insurance Losses of the Internal Service Funds and the Industrial Commission Special Fund.

C. ACCUMULATED SICK LEAVE

State employees are eligible to receive payment for an accumulated sick leave balance of 500 hours or more with a maximum of 1,500 hours upon retirement directly from State service. The benefit value is calculated by taking the State employee's hourly rate of pay at the retirement date, multiplied by the number of sick hours at the retirement date times the eligibility percentage. The eligibility percentage varies based upon the number of accumulated sick hours from 25.00% for 500 hours to a maximum of 50.00% for 1,500 hours. The maximum benefit value is $30 thousand. The benefit is paid out in annual installments over three years. The Retiree Accumulated Sick Leave Fund is accounted for on the financial statements as an Internal Service Fund and accounts for the retiree accumulated sick leave.

D. UNCLAIMED PROPERTY

The State of Arizona's Uniform Unclaimed Property Act requires deposit of certain unclaimed assets into a managed Agency Fund. ARS §44-313 requires a separate trust fund of not less than $100 thousand to be retained for prompt payment of claims. The excess amount, above that which is required to be retained, is required to be deposited to the General Fund where it is included as other revenue. Under ARS §46-731, unclaimed utility deposits are deposited in the Utility Assistance Fund to help low income people make utility deposits and repairs. Fifty-five and twenty percent of the remaining net cash collected, after refunds, is transferred to the Department of Commerce Housing Fund to be used for low-cost housing and the State Treasurer for distribution as provided for in ARS §5-113, respectively. The balance is to be deposited in the General Fund. Also, per Senate Bill 1524, 47th Legislature, 1st Regular Session, notwithstanding ARS §44-313, the Department of Revenue shall deposit any unclaimed property for fiscal year 2006 that is associated with the case of *Ladewig v. State of Arizona* in the General Fund. Ladewig unclaimed property in the amount of $3.705 million was deposited into the General Fund during fiscal year 2006. In addition, for fiscal year 2006, $856 thousand was deposited in the Utility Assistance Fund, $26.005 million was deposited in the Housing Fund, $9.456 million was deposited in the Racing Fund and $10.256 million was deposited in the General Fund. A total of approximately $417.074 million has been remitted since inception of the fund. The State is also holding securities valued at $47.951 million, and mutual funds of $4.791 million. The remittances to the General Fund and the holdings by the State represent contingencies, as claims for refunds can be made by the owners of the property. The GASB requires that a liability be reported to the extent that it is probable that escheat property will be reclaimed and paid to claimants. This liability is also reported as a reduction of revenue. This liability is reported in the General Fund because it is the fund to which the property ultimately escheats in Arizona. At June 30, 2006, this amount, reported as Due to Others in the General Fund, is $102.208 million.

E. CONSTRUCTION COMMITMENTS

The ADOT had outstanding commitments under construction contracts of approximately $692.381 million at June 30, 2006.

F. ARIZONA STATE LOTTERY

Annuities are purchased for all prizes over $400 thousand for which winners will receive the jackpot in annual installments for The Pick on-line game. These annuities are purchased from qualifying insurance companies which have the highest ratings from among A.M. Best Company, Standard & Poor's, Moody, Duff & Phelps, or Weiss. The Lottery remains contingently liable on all annuities. Aggregate future payments to prize winners on existing annuities totaled approximately $159.038 million at June 30, 2006. Approximately $118.072 million of the total aggregate future payments at June 30, 2006 relate to annuities purchased from five separate insurance companies, of which approximately $45.942 million relates to a single insurance company.

NOTE 11. TOBACCO SETTLEMENT

The State is one of many states participating in the settlement of litigation with the tobacco industry over the reimbursement of healthcare costs. The settlement money is intended to compensate the State for costs it has incurred in providing health and other services to its citizens that were necessitated by the use of tobacco products. The State expects to receive settlement payments through 2025.

The State recorded tobacco settlement revenue of $86.231 million and $84.333 million in the fund statements and the government-wide statements in fiscal year 2006, respectively. Future settlement payments are subject to several adjustments, but the amounts are not presently determinable. These adjustments include a volume adjustment, which could reflect any decreasing cigarette production under a formula that also takes into account increased operating income from sales. Other factors that might affect the amounts of future payments include ongoing and future litigation against the tobacco industry and the future financial health of the tobacco manufacturers. Because the net realizable value of the future settlement payments is not measurable and there is no obligation for the tobacco companies to make settlement payments until cigarettes are shipped, the State did not record a receivable for the future payments related to cigarette sales after June 30, 2006.

NOTE 12. PUBLIC-PRIVATE PARTNERSHIP

The State has entered into a partnership agreement with Accenture. The purpose of this partnership is to fund the Department of Revenue's technology needs. This agreement stipulates that Accenture will be paid 85.00% of the new revenue generated from the system enhancements, even if this amount is insufficient to cover the total contract cost. Accordingly, Accenture has created a system that increases the State's efficiency in collecting tax revenues. As of June 30, 2006, the State has paid Accenture $106.525 million towards the $136.673 million contract cost. Included in the $136.673 million contract cost is capitalized interest charges of $7.000 million and application support charges of $30.138 million.

NOTE 13. CONDUIT DEBT

During the year ended June 30, 2006, the Greater Arizona Development Authority (GADA) issued $64.100 million Infrastructure Revenue Bonds, Series 2005B for public infrastructure projects in the communities of the Town of Queen Creek, the City of Williams, the Drexel Heights Fire District, the City of Lake Havasu, and the Town of Superior. During the year ended June 30, 2006, the GADA issued $52.060 million Infrastructure Revenue Bonds, Series 2006A for public infrastructure projects in the communities of the Town of Queen Creek, the Town of Buckeye, the City of Stafford, and the Town of Sahuarita. The GADA's bond structure provides lower borrowing costs for Arizona's communities by diversifying the risk to investors and by sharing financing costs among several borrowers. The GADA Fund is leveraged when GADA issues its bonds, which maximizes loan capacity for communities. An intercept mechanism for intercepting state-shared revenues for loans to political subdivisions enhances the security of the GADA bonds even further.

In previous years, the State appropriated a total of $20.000 million to the GADA for the express purpose of securing bonds issued by the GADA. As of June 30, 2006, the remaining balance in the appropriations account was $17.302 million. The Series 2005B and 2006A bonds were issued by the GADA to make loans to the participants listed above and constitute special and limited obligations of the GADA. The principal of and interest on the bonds are payable solely from the funds which are held in Trust by the Trustee (the Trust Estate). The Trust Estate includes debt service payments required to be made by the respective participants in the Series 2005B and 2006A bond issues. The principal of and interest premium, if any, on the Series 2005B and 2006A bonds shall not constitute or give rise to a pecuniary liability on the part of the directors and officers of the GADA. The Series 2005B and 2006A bonds do not constitute a legal debt of the State and are not enforceable against the State. At June 30, 2006, the total outstanding face value of all bonds issued by the GADA was $233.785 million.

NOTE 14. SUBSEQUENT EVENTS

On September 21, 2006, House Bill 2206 became effective and eliminated the restriction that limited the principal amount of Highway Revenue Bonds for the ADOT that could be outstanding at one time to $1.3 billion. On September 26, 2006, the ADOT issued $325.000 million in Highway Revenue Bonds, Series 2006 to (i) finance portions of the ADOT's Five-Year Capital Program and (ii) pay costs of issuing the Series 2006 Bonds. The 2006 Bonds are due July 1, 2012 through July 1, 2026. Net proceeds totaled $350.727 million (after receipt of $26.201 million reoffering premium and payment of $967 thousand in underwriting fees and costs of issuance). Also on September 26, Standard & Poor's Ratings Services upgraded the rating on the ADOT's outstanding subordinate lien Highway Revenue Bonds from AA+ to AAA.

In November 2006, the GADA issued the infrastructure Revenue Bond Series 2006B. The principal amount of original issue was $36.520 million with interest rates of 4.00% to 5.00%. Maturity dates are from February 1, 2017 through February 1, 2037. Interest payment dates are February 1 and August 1 of each year. The GADA's contribution to the bond issuance costs are $200 thousand. In addition, the GADA will reclassify from unrestricted net assets to its restricted net assets the amount of $8.055 million for the pledged collateral reserve fund. The participants in this bond issue are the cities of Show Low and Somerton, Maricopa Fire District, Drexel Heights Fire District, the Town of Quartzite, and the Apache Fire Department in the amounts of $8.370 million, $6.885 million, $3.200 million, $1.350 million, $7.215 million, and $9.500 million, respectively.

NOTE 15. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – COMPONENT UNITS

The accounting policies of the State's component units conform to U.S. GAAP applicable to governmental units adopted by the GASB, except for those component units affiliated with the State's Universities. Because the component units affiliated with the Universities are not governmental entities, they follow FASB statements for not-for-profit organizations for financial reporting purposes. Each component unit has a June 30 year-end with the exception of the Law College Association, which has a May 31 year-end.

A. FINANCIAL REPORTING POLICIES

1. Measurement Focus and Basis of Accounting

The State's component units and component units affiliated with the Universities are presented using the economic resources measurement focus and the accrual basis of accounting. The State's component units follow FASB Statements and Interpretations issued on or before November 30, 1989; Accounting Principles Board Opinions; and Accounting Research Bulletins, unless those pronouncements conflict with GASB pronouncements. The State has chosen the option not to follow FASB Statements and interpretations issued after November 30, 1989, except for UMC, which has elected to apply the provisions of all relevant pronouncements of the FASB, including those issued after November 30, 1989, unless those pronouncements conflict or contradict GASB pronouncements.

2. Net Assets

Component units affiliated with the Universities classify net assets, revenues, expenses, gains and losses based on the existence or absence of donor-imposed restrictions. Accordingly, the net assets of the component units affiliated with the Universities and changes therein are classified and reported as follows:

- *Unrestricted net assets* include assets and contributions that are not restricted by donors or for which such restrictions have expired.

- *Temporarily restricted net assets* include contributions for which donor imposed restrictions have not been met (either by the passage of time or by actions of the Foundations), charitable remainder unitrusts, pooled income funds, gift annuities, and pledges receivable for which the ultimate purpose of the proceeds is not permanently restricted. Donor-restricted contributions are classified as temporarily restricted if the restrictions are satisfied in the same reporting period in which the contributions are received, except for the Foundations associated with ASU, which classify such contributions as unrestricted.

- *Permanently restricted net assets* include contributions, charitable remainder unitrusts, pooled income funds, gift annuities, and pledges receivable which require by donor restriction that the corpus be invested in perpetuity and only the board-approved payout be made available for program operations in accordance with donor restrictions.

3. Cash and Cash Equivalents

Cash and cash equivalents includes monies held in certificates of deposit, overnight money market accounts, and money market funds. Cash and cash equivalents are stated at cost, which approximates fair value.

4. Investments

Investments are recorded in accordance with Statements of Financial Accounting Standards (SFAS) No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*. Under SFAS No. 124, entities are required to report investments in equity securities that have readily determinable fair values, and all investments in debt securities at fair value. Equities, fixed income, and mutual funds are stated at fair market value based on quoted market prices. Investment securities, in general, are exposed to various risks, such as interest rate, credit, and overall market volatility. Investment income or loss (including realized and unrealized gains and losses on investments, interest, and dividends) is included in the excess of revenues over expenses in the Statement of Activities.

5. Income Taxes

The Foundations qualify as tax-exempt organizations under Section 501(c)(3) of the Internal Revenue Code and, accordingly, there is no provision for income taxes in the accompanying financial statements, except for the Collegiate Golf Foundation and the ACFFC. In addition, they qualify for the charitable contribution deduction and have been classified as organizations that are not private foundations. Any income determined to be unrelated business taxable income would be taxable. The ACFFC and NACFFC are exempt from taxes under the provisions of Section 501(c)(4) of the Internal Revenue Code. The ACFFC does not qualify for the charitable contribution deduction.

6. Annuities Payable and Other Trust Liabilities

Annuities payable and other trust liabilities for the U of A Foundation are stated at the actuarially computed present value of future payments to the annuitants. The excess of the fair values of assets received (classified according to their nature in the Statement of Financial Position) pursuant to annuity agreements over the actuarially computed annuities payable (using market rates in effect on the contribution date) is recorded as contributions in the year received.

7. Contributions

Contributions are recorded in accordance with SFAS No. 116, *Accounting for Contributions Received and Contributions Made.* Contributions received are recorded as unrestricted, temporarily restricted, or permanently restricted support depending on the existence and/or nature of any donor restrictions. All donor-restricted support is reported as an increase in temporarily or permanently restricted net assets depending on the nature of the restriction.

8. Net Assets Released from Restriction

Expenses are not incurred in the temporarily restricted or permanently restricted net asset categories. As the restrictions on these net assets are met, the assets are reclassified to unrestricted net assets. The total assets reclassified are reported as net assets released from restriction in the accompanying Statement of Activities.

9. Use of Estimates

The preparation of the Universities-affiliated component units' financial statements in conformity with U.S. GAAP required management to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

B. DEPOSITS AND INVESTMENTS

1. Component Units

A. Deposits and Investment Policies

The investments of the WIFA are stated at fair value, except guaranteed investment contracts, which are stated at cost since they are non-participating contracts. The investments of the UMC are stated at fair value.

B. Custodial Credit Risk - Deposits

Custodial risk for deposits is the risk that, in the event of the failure of a depository financial institution, the deposits or collateral securities may not be recovered from the outside party. The UMC holds deposits in excess of FDIC limits. At June 30, 2006, uninsured, uncollateralized deposits included in cash and cash equivalents were approximately $14.296 million.

C. Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The WIFA does not have a formal policy regarding interest rate risk. The following table presents the interest rate risk for the WIFA utilizing the segmented time distribution method as of June 30, 2006 (expressed in thousands):

		Investment Maturities (in years)			
Investment Type	**Fair Value**	**Less than 1**	**1-5**	**6-10**	**More than 10**
Commercial paper	$ 49,206	$ 49,206	$ -	$ -	$ -
Corporate asset backed securities	384	-	384	-	-
Corporate collateralized mortgage obligations	2,868	-	-	-	2,868
Corporate notes	14,934	14,934	-	-	-
Guaranteed investment contracts	80,896	-	13,577	67,319	-
Money market mutual funds	126,700	126,700	-	-	-
U.S. Agency Securities	57,104	57,104	-	-	-
U.S. Agency Mortgage Backed Securities	8,020	-	-	-	8,020
U.S. Treasury Securities	1,016	1,016	-	-	-
Total	$ 341,128	$ 248,960	$ 13,961	$ 67,319	$ 10,888

The UMC's investment policy limits the portfolio duration related to debt securities to the Lehman Brothers Intermediate Government/Credit Index. This is an index based on all publicly issued intermediate government and corporate debt securities with average maturities of four to five years. The following table presents the estimated maturities of the UMC's investments, utilizing the segmented time distribution method as of June 30, 2006 (expressed in thousands):

Investment Type	Fair Value	Investment Maturities (in years) Less than 1	1-5	6-10	More than 10
Commercial paper	$ 15,521	$ -	$ -	$ -	$ 15,521
Corporate bonds	5,900	-	5,900	-	-
Corporate fixed income	25,315	25,315	-	-	-
Guaranteed investment contracts	4,243	-	-	-	4,243
Managed futures	3,558	3,558	-	-	-
Money market mutual funds	14,582	14,582	-	-	-
U.S. Treasury Securities	127,987	7,663	120,324	-	-
Other	19,924	-	19,638	286	-
Total	$ 217,030	$ 51,118	$ 145,862	$ 286	$ 19,764

D. Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations to the holder of the investment. The WIFA does not have a formal policy regarding credit risk. The following table presents the WIFA's investments which were rated by S & P's and/or an equivalent national rating organization. The ratings are presented using S & P's rating scale as of June 30, 2006 (expressed in thousands):

Investment Type	Fair Value	AAA	AA	A	BB	A1	Not Rated
Commercial paper	$ 49,206	$ -	$ -	$ -	$ -	$ 49,206	$ -
Corporate securities	18,186	5,045	2,811	8,622	1,708	-	-
Guaranteed investment contracts	80,896	80,896	-	-	-	-	-
Money market mutual funds	126,700	-	-	-	-	-	126,700
U.S. Agency Securities	65,124	49,738	-	-	-	15,386	-
Total	$ 340,112	$ 135,679	$ 2,811	$ 8,622	$ 1,708	$ 64,592	$ 126,700

The UMC's investment policy establishes ranges which limit the level of investments held in domestic and international equities, fixed income securities, and alternative investment strategies. Investment in fixed income securities is limited to investment grade securities with a credit rating of BBB, or equivalent, or better. The portfolio must maintain an average rating of A or better at all times. The following table presents the UMC's investments which were rated by S & P's and/or an equivalent national rating organization. The ratings are presented using S & P's rating scale as of June 30, 2006 (expressed in thousands):

Security Description	Fair Value	AAA	AA	A	Not Rated
Commercial paper	$ 15,521	$ 15,521	$ -	$ -	$ -
Corporate bonds	5,900	-	-	-	5,900
Corporate fixed income	25,316	19,354	23	39	5,900
Federal agencies	43	43	-	-	-
Managed futures	3,558	-	-	-	3,558
Other	19,924	-	-	-	19,924
Totals	$ 70,262	$ 34,918	$ 23	$ 39	$ 35,282

E. Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer. The WIFA's investment policy contains no limitations on the amount that can be invested in any one issuer. As of June 30, 2006, an investment in Bayerische Landesbank (fair value of $40.586 million) was approximately 11.90% of the WIFA's total investments and an investment in AIG Matched Funding Corp. (fair value of $25.153 million) was approximately 7.37% of the WIFA's total investments.

F. Foreign Currency Risk

The UMC's investment policy permits it to invest a portion of its holdings in international equities and both international alternative and managed future investments. The UMC's current holdings in international securities totaled approximately $12.000 million or 4.99% of total investments. There is no one foreign currency that comprises a material amount of these holdings. The following table summarizes the UMC's foreign currency risk as of June 30, 2006 (expressed in thousands):

Foreign Currency Risk by Investment Type at Fair Value (Expressed in Thousands)

Currency	Fixed Income	Equities	Total
Argentina Peso	$ -	$ 154	$ 154
Australian Dollar	2	295	297
Brazil Real	8	2,993	3,001
British Pound Sterling	95	466	561
Canadian Dollar	81	2,867	2,948
Chilean Peso	1	109	110
Chinese Yuan	-	395	395
Czech Koruna	-	51	51
Euro	215	486	701
Hong Kong Dollar	-	327	327
Indonesia Rupiah	1	84	85
Israel Shekel	1	99	100
Japanese Yen	84	230	314
Mexican Peso	3	479	482
Norwegian Krone	17	234	251
Peruvian Nuevo Sol	-	161	161
Russian Ruble	6	75	81
South African Rand	4	893	897
South Korean Won	-	279	279
Thailand Baht	1	654	655
Other	64	86	150
Total	$ 583	$ 11,417	$ 12,000

2. Universities-Affiliated Component Units

A. Investment Summary

Investments of the Universities-affiliated component units are comprised of the following amounts at June 30, 2006. All investments are stated at fair value (expressed in thousands):

	ASU Foundation	ACFFC	U of A Foundation	NAU Foundation
Money market funds and cash equivalents	$ 21,781	$ 75,038	$ -	$ -
U.S. Government/Agency Obligations and Mutual Funds	-	-	69,428	12,732
Domestic/international equity securities and mutual funds	275,332	-	137,966	30,756
Fixed income	109,078	-	9,992	-
Corporate bonds	-	-	-	5,523
REIT fund, real estate and timber partnerships	-	-	14,818	-
Absolute return limited partnerships	-	-	64,628	-
Other investments	58,539	2,700	6,806	525
Total Investments	$ 464,730	$ 77,738	$ 303,638	$ 49,536

B. Endowment Trust Agreement

In March 2003, the ASU Foundation and the ASU entered into a trust agreement, appointing the ASU Foundation the trustee of selected ASU endowments. In accordance with the trust agreement, the ASU Foundation receives a management fee for providing these services. Unrealized and realized gains and losses, and interest and dividends, if any, are added to or subtracted from the recorded value of the invested trust assets managed by the ASU Foundation. The invested trust assets are separate from ASU Foundation investments, and a corresponding liability is presented for the fair value of the invested trust assets managed for the ASU.

C. PROGRAM LOANS

The WIFA has made loans to local governments and others in Arizona to finance various projects pursuant to the requirements of the Clean Water and Safe Drinking Water Acts. The loans are generally payable in semi-annual installments due January 1 and July 1 of each year, including interest. However, several loans are payable monthly or quarterly. Changes in the program loans during fiscal year 2006 are as follows (expressed in thousands):

	Beginning Balance	**Increases**	**Decreases**	**Ending Balance**
Clean Water Fund	$ 349,094	$ 89,222	$ (22,728)	$ 415,588
Drinking Water Fund	139,978	27,950	(8,581)	159,347
Total	$ 489,072	$ 117,172	$ (31,309)	$ 574,935

Repayment of these loans will be made from pledged property taxes, net revenues from the systems, transaction privilege taxes, or from special assessments. Most loans have a .30 to 4.00% annual administrative fee.

Some program loans require a monthly or quarterly payment into a debt service reserve to assure payments of the loans. The debt service reserve is a liability of the WIFA to the borrowers and interest on the reserve accrues to the borrowers.

D. PLEDGES RECEIVABLE

Unconditional promises to give are included in the accompanying financial statements as pledges receivable and revenue of the appropriate net asset category. Unconditional promises to give are recorded at their net realizable value using various yields as determined by the university foundations. The following summarizes unconditional promises as of June 30, 2006 (expressed in thousands):

	Universities-Affiliated Component Units Net Pledges Receivable
ASU Foundation	$ 64,907
U of A Foundation	29,230
Law Association	29,445

E. DIRECT FINANCING LEASE AGREEMENT

1. ASU Foundation

ASU Foundation leases a portion of the Fulton Center building (ASU Foundation's headquarters) to ASU under a direct financing lease. At the end of the lease, ASU Foundation and Affiliates will gift their portion of the building to ASU and ASU will receive title to the building.

The entire amount of the minimum Fulton Center lease payments receivable balance of $54.200 million will be used by ASU Foundation and Affiliates to service the principal and interest payments required for the Series 2003 Bonds. Accordingly, unearned interest will be amortized to lease revenue by the interest method using interest rates which correspond to the stated interest rates of the Series 2003 Bonds. Unearned interest at June 30, 2006 was $29.600 million. ASU Foundation's net investment in this direct financing lease is $24.600 million and is presented in the Component Unit's Statement of Financial Position.

2. ACFFC

Pursuant to a Sub-Lease Agreement, Nanotechnology Research, LLC, a wholly owned subsidiary of ACFFC, leases its interest in the Research Park to ASU, which will pay rent at times and in amounts sufficient to pay all principal and interest (after utilization of amounts held in the Capitalized Interest Accounts) on the Series 2004 Bonds, as well as all fees and expenses related to the Series 2004 Bonds. The Sublease Agreement is a net lease, and Nanotechnology is entitled to receive the rents and all other sums payable pursuant to the Sublease Agreement free from all taxes, charges, fees, and expenses, all of which will be paid by ASU.

The Sublease Agreement commenced on April 7, 2004, and continued until June 30, 2005, with successive automatic annual renewals for the period July 1 through June 30 of each year without action on the part of Nanotechnology or ASU, through the period ending March 31, 2034. The Sublease Agreement is subject to early termination by Nanotechnology or ASU upon payment in full of the Series 2004 Bonds.

Upon termination of or expiration of the Sublease Agreement, Nanotechnology's interest in the premises, including all buildings and improvements on the leased premises, transfers to ASU without further consideration. Therefore, the lease is classified as a direct financing capital lease.

Lease payments are based on a variable interest rate currently determined on a weekly basis. The average interest rate approximates 4.66% at June 30, 2006. Lease payments commence once the Capitalized Interest Accounts are fully utilized, which at present interest rates is expected to be in 2007. ACFFC's net investment in this direct financing lease is $35.000 million.

F. CAPITAL ASSETS

Capital asset activity for the UMC for the fiscal year ended June 30, 2006 was as follows (expressed in thousands):

		University Medical Center			
	Beginning Balance	Additions	Retirements	Adjustments & Reclassifications	Ending Balance
Non-depreciable capital assets:					
Land	$ 6,001	$ -	$ -	$ -	$ 6,001
Construction in progress	7,235	23,771	(160)	(775)	30,071
Total Non-depreciable Capital Assets	13,236	23,771	(160)	(775)	36,072
Depreciable capital assets:					
Buildings	149,885	550	(186)	470	150,719
Improvements other than buildings	881	-	-	(91)	790
Equipment	163,981	11,390	(56,153)	396	119,614
Total Depreciable Capital Assets	314,747	11,940	(56,339)	775	271,123
Less accumulated depreciation for:					
Buildings	(90,943)	(6,638)	161	(1)	(97,421)
Improvements other than buildings	(364)	-	13	-	(351)
Equipment	(131,521)	(11,938)	55,894	1	(87,564)
Total Accumulated Depreciation	(222,828)	(18,576)	56,068	-	(185,336)
Total Depreciable Capital Assets, Net	91,919	(6,636)	(271)	775	85,787
Total UMC Capital Assets, Net	$ 105,155	$ 17,135	$ (431)	$ -	$ 121,859

The capital asset summary for the Universities-affiliated component units for the fiscal year ended June 30, 2006 was as follows (expressed in thousands):

	ASU Foundation	ACFFC	CRC	NACFFC
Buildings and improvements	$ 17,183	$ 73,664	$ 12,571	$ -
Furniture, fixtures, and equipment	2,127	36,199	627	-
Construction in progress	-	91,384	-	17,201
Other property and equipment	-	509	-	-
Total cost or donated value	19,310	201,756	13,198	17,201
Less: Accumulated Depreciation	(1,247)	(9,789)	(1,820)	-
Property and Equipment, Net	$ 18,063	$ 191,967	$ 11,378	$ 17,201

G. LONG-TERM OBLIGATIONS

1. Component Units

A. Arizona Power Authority

In prior years, the APA defeased various issues of bonds by purchasing U.S. Government securities which were deposited in an irrevocable trust with an escrow agent to provide future debt service until the call dates. As a result, those bonds are considered to be defeased and the liability has been removed from the Hoover Uprating Fund. Accordingly, these trust account assets and related liabilities are not included in the accompanying financial statements.

B. University Medical Center

In November 2005, the UMC issued $140.000 million of Hospital Revenue Bonds (the "Series 2005 Bonds"). The Series 2005 Bonds were issued at a discount to yield an effective interest rate of 5.01% and are to be used for the construction of a new six-story bed tower, expansion of the emergency department, construction of a clinical decision unit, and to finance other capital needs of the UMC.

The UMC is subject to certain financial covenants under the Master Trust Indenture (the Indenture), with which the UMC is in compliance as of and for the year ended June 30, 2006. In addition, the Indenture places certain restrictions on the incurrence of additional indebtedness and the sale or acquisition of property.

The UMC has established and maintains separate funds as a bond reserve fund on outstanding bonds payable. These funds totaled $19.706 million at June 30, 2006 which are held by the trustee and are reflected as restricted investments held by trustee in the accompanying financial statements.

The bonds or other obligations of the UMC do not constitute general obligations of the Arizona Board of Regents, the U of A, the State, or any political subdivision thereof.

C. Water Infrastructure Finance Authority

The WIFA's bonds are callable and interest is payable semiannually. The bonds are special obligations of the WIFA payable solely from and secured by the WIFA's assets. The bonds are not obligations, general, specific, or otherwise, of the State or any other political subdivision thereof other than the WIFA.

In fiscal year 2006, the WIFA issued Water Quality Revenue Bonds, Series 2006A for $205.400 million, with interest rates ranging from 3.75% to 5.00% and maturity dates ranging from 2007 to 2026. The WIFA realized net proceeds of $215.156 million, after receipt of a reoffering premium of $11.094 million, and payment of underwriters' discount and issuance costs totaling $1.338 million. The net proceeds will be used to fund certain loans made by the WIFA to finance water quality projects.

In prior fiscal years, the WIFA refinanced various bond issues through advance-refunding arrangements. Under the terms of the refunding bond issues, sufficient assets to pay all principal, redemption premium, if any, and interest on the refunded bond issues have been placed in irrevocable trust accounts at commercial banks and invested in U.S. Government securities which, together with interest earned thereon, will provide amounts sufficient for future payment of principal and interest of the issues refunded. The assets, liabilities, and financial transactions of these trust accounts and the liability for the defeased bonds are not reflected in the accompanying financial statements. The amount outstanding on the refunded bonds for the WIFA at June 30, 2006 totaled $106.210 million.

The $8.034 million deferred amount on retirement of bonds is being amortized over the lives of the defeased bonds on a straight-line basis. Annual amortization is $401 thousand and $173 thousand for Clean Water Revolving and Drinking Water Revolving Funds, respectively. Amortization has been offset against interest expense.

Bond premiums are being amortized over the life of the bonds. The amortization for the year ended June 30, 2006, is $1.819 million. Further, bond issuance costs are amortized over the life of the bond and offset to interest expense. The amortization for the ended June 30, 2006, is $190 thousand.

Summary of Revenue Bonds

The following schedule summarizes revenue bonds outstanding at June 30, 2006 (expressed in thousands):

Revenue Bonds Outstanding	Dates Issued	Maturity Dates	Interest Rates	Outstanding Balance at June 30, 2006
Component Units:				
Arizona Power Authority	2001-2004	2007-2018	5.00-5.25%	$ 54,960
University Medical Center	1993-2006	2007-2036	4.82-5.53%	232,965
Water Infrastructure Finance Authority	1992-2006	2007-2027	2.00-6.10%	582,560

Principal and interest debt service payments on revenue bonds outstanding at June 30, 2006 are as follows (expressed in thousands):

	Annual Debt Service		
	Arizona Power Authority		
Fiscal Year	Principal	Interest	Total
2007	$ 2,825	$ 2,760	$ 5,585
2008	3,120	2,611	5,731
2009	3,450	2,447	5,897
2010	3,815	2,265	6,080
2011	4,220	2,064	6,284
2012-2016	25,405	6,647	32,052
2017-2021	12,125	645	12,770
Total	$ 54,960	$ 19,439	$ 74,399

	Annual Debt Service		
	University Medical Center		
Fiscal Year	Principal	Interest	Total
2007	$ 3,835	$ 11,689	$ 15,524
2008	4,040	11,491	15,531
2009	4,145	11,289	15,434
2010	4,295	11,082	15,377
2011	4,515	10,863	15,378
2012-2016	26,280	50,617	76,897
2017-2021	33,630	43,265	76,895
2022-2026	42,915	33,974	76,889
2027-2031	54,780	22,116	76,896
2032-2035	54,530	6,983	61,513
Total	$ 232,965	$ 213,369	$ 446,334

	Annual Debt Service		
	Water Infrastructure Finance Authority		
Fiscal Year	Principal	Interest	Total
2007	$ 25,110	$ 27,251	$ 52,361
2008	25,900	26,172	52,072
2009	27,420	25,007	52,427
2010	26,845	23,820	50,665
2011	28,020	22,579	50,599
2012-2016	157,895	90,454	248,349
2017-2021	155,520	51,694	207,214
2022-2026	119,100	16,274	135,374
2027-2031	16,750	367	17,117
Total	$ 582,560	$ 283,618	$ 866,178

D. Changes in Long-Term Obligations

The following is a summary of changes in long-term obligations for the component units (expressed in thousands):

	Balance July 1, 2005	Increases	Decreases	Balance June 30, 2006	Due Within One Year	Due Thereafter
Arizona Power Authority:						
Long-term Debt:						
Revenue bonds	$ 57,520	$ -	$ (2,560)	$ 54,960	$ 2,825	$ 52,135
Revenue bond premium and discounts	2,853	-	(379)	2,474	-	2,474
Deferred amounts, Net	(1,946)	-	258	(1,688)	-	(1,688)
Total Long-term Debt	58,427	-	(2,681)	55,746	2,825	52,921
Other Long-term Liabilities:						
Compensated absences	64	68	(64)	68	68	-
Total Other Long-term Liabilities	64	68	(64)	68	68	-
Total Long-term Obligations	$ 58,491	$ 68	$ (2,745)	$ 55,814	$ 2,893	$ 52,921
University Medical Center:						
Long-term Debt:						
Revenue bonds	$ 97,245	$ 140,000	$ (4,280)	$ 232,965	$ 3,835	$ 229,130
Revenue bond premium and discounts	(807)	(197)	(122)	(1,126)	-	(1,126)
Total Long-term Debt	96,438	139,803	(4,402)	231,839	3,835	228,004
Other Long-term Liabilities:						
Compensated absences	9,463	3,251	(1,838)	10,876	4,751	6,125
Other	4,423	-	(1,409)	3,014	-	3,014
Total Other Long-term Liabilities	13,886	3,251	(3,247)	13,890	4,751	9,139
Total Long-term Obligations	$ 110,324	$ 143,054	$ (7,649)	$ 245,729	$ 8,586	$ 237,143
Water Infrastructure Finance Authority:						
Long-term Debt:						
Revenue bonds	$ 405,675	$ 205,400	$ (28,515)	$ 582,560	$ 25,110	$ 557,450
Revenue bond premium	28,206	11,093	(1,820)	37,479	-	37,479
Deferred amounts, Net	(8,608)	-	574	(8,034)	-	(8,034)
Total Long-term Debt	425,273	216,493	(29,761)	612,005	25,110	586,895
Other Long-term Liabilities:						
Compensated absences	26	48	(15)	59	59	-
Total Other Long-term Liabilities	26	48	(15)	59	59	-
Total Long-term Obligations	$ 425,299	$ 216,541	$ (29,776)	$ 612,064	$ 25,169	$ 586,895

2. Universities-Affiliated Component Units

In August 2005, McAllister Academic Village, LLC, a wholly owned subsidiary of ACFFC issued Variable Rate Revenue Bonds, Series 2005A and 2005B in the aggregate original principal amount of $96.700 million, and $48.300 million, respectively, dated August 3, 2005, due at various intervals through July 2045. The interest is payable initially in monthly installments. The principal is payable in annual installments commencing July 1, 2008 and July 1, 2009 for the Series 2005A and 2005B Variable Bonds, respectively. Variable interest rate for the Series 2005A and 2005B Bonds was 3.97% and 3.95%, respectively at June 30, 2006. These bonds are secured by leasehold deeds of trust, assignment of leases and rents, security agreements, and fixture filings.

Bonds payable as of June 30, 2006 are summarized as follows (expressed in thousands):

	Final Maturity	Amount
ASU Foundation:		
Series 2003 Lease Revenue Term Bonds	2023	$ 20,400
Series 2003 Lease Revenue Term Bonds	2028	10,575
Series 2003 Lease Revenue Term Bonds	2034	16,625
Series 2004A Variable Rate Revenue Bonds	2034	22,420
Series 2004B Variable Rate Revenue Bonds	2022	11,690
ACFFC:		
Series 2005A Variable Rate Demand Revenue Bonds	2045	96,700
Series 2005B Variable Rate Demand Revenue Bonds	2045	48,345
Series 2005 Tax – Exempt Bonds	2035	16,005
Series 2004 Variable Rate Demand Revenue Bonds	2030	51,605
Series 2004A Variable Rate Demand Lease Revenue Bonds	2034	20,175
Series 2004B Variable Rate Demand Lease Revenue Bonds	2034	14,825
Series 2003 Serial and Term Bonds	2035	13,395
Series 2002 Bonds	2018	29,805
Series 2000 Serial and Term Bonds	2032	10,615
Unamortized bond premium		1,276
NACFFC:		
Variable Rate Demand Revenue Bonds, Series 2005	2033	35,805

Scheduled future maturities of Universities-affiliated component units' bonds payable are as follows (expressed in thousands):

Fiscal Year	ASU Foundation	ACFFC	NACFFC
2007	$ 415	$ 1,830	$ 460
2008	1,020	1,945	355
2009	1,070	3,060	400
2010	1,120	5,410	455
2011	1,170	6,025	510
Thereafter	76,915	284,476	33,625
Total	$ 81,710	$ 302,746	$ 35,805

H. RELATED PARTY TRANSACTIONS

The UMC and the U of A both provide and receive services from each other under various contracts. Payments to the U of A by the UMC include program support, resident and intern salaries, utilities, ground maintenance, mailroom operations, and various administrative functions. Amounts paid to the U of A for these services were approximately $21.618 million for the year ended June 30, 2006.

The UMC has entered into contractual agreements with the U of A to provide support for the academic mission of the U of A. Charges to the U of A for such services and facilities provided by the UMC were approximately $9.700 million for the year ended June 30, 2006. These amounts are included in other operating revenue in the accompanying combined financial statements.

University Physicians Healthcare (UPH) is a not-for-profit corporation whose members are physicians employed by the U of A and who practice at the UMC. The UMC has agreements with the UPH whereby the UPH provides physician, medical directorship, and other services to the UMC. The UMC and the UPH share certain services and facilities within the hospital. Examples include information systems, medical records, and patient scheduling. The UPH reimburses the UMC for these services pursuant to written agreements between the parties at amounts that approximate actual costs. Charges to the UPH for the above services provided by the UMC were approximately $2.900 million for the year ended June 30, 2006. These amounts are included in other operating revenue in the accompanying combined financial statements.

The UMC also has an agreement to provide healthcare services to members of an AHCCCS health plan owned by the UPH called University Familicare (UFC). The UFC, an AHCCCS funded HMO, manages approximately 15,000 members. The UMC provides healthcare services to the UFC members in the normal course of business. The UMC operates under a contract with the UFC at rates that are substantially the same as rates received from other unaffiliated AHCCCS HMOs. Such rates are generally at or below the maximum rates established by the AHCCCS. Net patient service revenue includes $8.636 million in 2006 from this payor, based on negotiated rates.

Effective July 1, 2003, the UMC became the region's sole Level I Trauma Center and entered into an arrangement with the UPH to pay trauma physician call pay. Funding for the physician call pay was derived primarily from funds designated by the State to cover trauma readiness costs. During 2006, amounts incurred for these services totaled $3.631 million. As of June 30, 2006, accrued expenses include approximately $300 thousand payable to the UPH for these services.