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May 25, 2007

The Honorable Janet Napolitano,  
Governor of the State of Arizona;  
Members of the Legislature;  
Chief Justice of the Supreme Court; and  
Citizens and Taxpayers of the State of Arizona

Ladies and Gentlemen:

It is our pleasure to transmit to you the Comprehensive Annual Financial Report (CAFR) of the State of Arizona for the fiscal year ended June 30, 2006. Responsibility for the accuracy of data, as well as the completeness and fairness of presentation, including all disclosures, rests with the State's management. The data presented in this report, to the best of our knowledge and belief, is accurate in all material respects and is reported in a manner which fairly presents the financial position and results of operations of the major and non-major funds of the State. All disclosures needed for the reader to gain a reasonable understanding of the State's financial activities have been included.

The report is presented in three sections: Introductory, Financial, and Statistical.

The **Introductory Section** includes this Letter of Transmittal, the State's organizational chart and a list of principal State officials.

The **Financial Section** includes the State Auditor General's Independent Auditors' Report, Management's Discussion and Analysis (MD&A) and the basic financial statements (which include the government-wide financial statements, the fund financial statements and the notes to the financial statements). The financial section also includes Required Supplementary Information (RSI), which includes budgetary comparison schedules, infrastructure condition and maintenance data, and agent retirement plans' funding progress. In addition, the financial section includes other supplemental financial data, which includes combining financial statements.

The **Statistical Section** includes five categories of information: Financial Trends, Revenue Capacity, Debt Capacity, Demographic and Economic Information, and Operating Information.

U.S. generally accepted accounting principles (GAAP) require that management provides a narrative introduction, overview, and analysis to accompany the basic financial statements in the form of the MD&A. This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. The State's MD&A can be found immediately following the Independent Auditors' Report.

**INTERNAL CONTROLS**

The State is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the State are protected from loss, theft or misuse and to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with U.S. GAAP. Internal accounting controls are designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived and (2) the valuation of costs and benefits requires estimates and judgments by management. In the opinion of management, the State's internal controls are adequate to provide reasonable assurance that these objectives are met.

## **INDEPENDENT AUDIT**

In compliance with State statute, an annual financial audit of the State Entity is completed each year by the State of Arizona, Office of the Auditor General in conjunction with other audit firms. Their audit was conducted in accordance with U.S. generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Their report on the basic financial statements has been included in the financial section of this report. In addition, ARS §41-1279.03 requires at least a biennial single audit by the Office of the Auditor General. The Single Audit will be issued as a separate report at a later date.

## **PROFILE OF THE GOVERNMENT**

The State of Arizona was admitted to the Union as the 48<sup>th</sup> state in 1912. Arizona is the sixth largest state, with 113,998 square miles. Arizona is known for the Grand Canyon, one of the Seven Wonders of the World, and its cacti and other desert landscape. A number of national forests, three national parks, eighteen national monuments, and Indian reservations are located in Arizona.

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

The services provided by the State are administered through various agencies, departments, boards, commissions, councils, administrations, offices and institutions of higher learning. These services include: (1) General Government, (2) Health and Welfare, (3) Inspection and Regulation, (4) Education, (5) Protection and Safety, (6) Transportation and (7) Natural Resources.

## **FINANCIAL REPORTING ENTITY**

The accompanying CAFR includes all funds of the State of Arizona (primary government), as well as its component units. Blended component units, although legally separate entities, are in substance part of a government's operations. Therefore, data from these units is combined with data of the primary government. Discretely presented component units are shown separately to emphasize that they are legally separate from the primary government and to differentiate their financial position and results of operations from those of the primary government. Discretely presented component units prepared in accordance with the Governmental Accounting Standards Board (GASB) are reported in a separate column in the government-wide financial statements. Discretely presented component units prepared in accordance with the Financial Accounting Standards Board are presented as separate financial statements immediately following the government-wide financial statements to emphasize that they are prepared in accordance with accounting standards other than those promulgated by the GASB.

The criteria for inclusion in the reporting entity and presentation are defined by the Codification of Governmental Accounting and Financial Reporting Standards, issued by the GASB, (Section 2100). Note 1 of the Notes to the Financial Statements explains which component units are included in the Financial Reporting Entity of the State.

## **BUDGETARY CONTROLS**

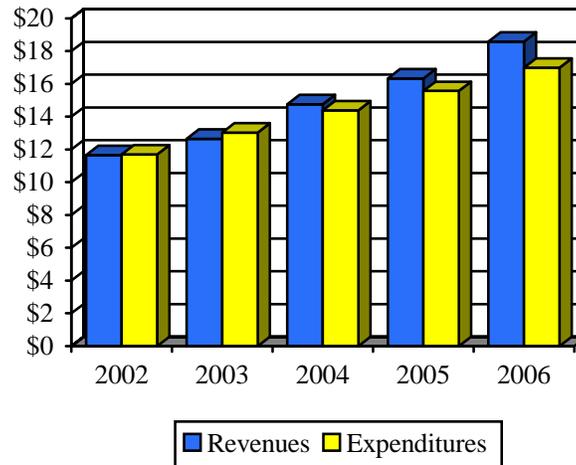
Budgetary control is maintained through legislative appropriation and the executive branch allotment process. The Governor is required to submit an annual budget to the Legislature. The budget is legally required to be adopted through passage of appropriation bills by the Legislature and approval by the Governor. The appropriated funds are controlled by the executive branch through an allotment process. This process generally allocates the appropriation into quarterly allotments by legal appropriation level. The State also maintains an encumbrance accounting system to further enhance budgetary control. Encumbered amounts generally lapse as of the end of the fiscal year, with the exception of capital outlay and other continuing appropriations. These appropriations and their encumbrances continue from year to year. The State's budgetary policies are explained in detail in the RSI.

## GENERAL FUND BALANCE

Graph 1 details the General Fund revenues and expenditures for the last five fiscal years. This graph does not include transfer amounts relating to other fund types and other financing sources (uses), which affect the ending fund balance.

Graph 1

General Fund Revenues and Expenditures  
for last 5 fiscal years  
(Dollars in billions)

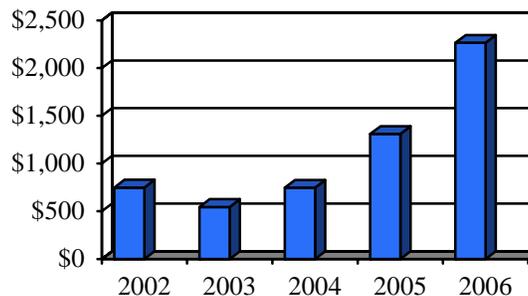


The General Fund ended the June 30, 2006, fiscal year with \$1.4 billion in unreserved fund balance and a \$831.332 million reserved fund balance for a total fund balance of \$2.3 billion. This compares to the previous year's total fund balance of \$1.3 billion. Included in the \$831.332 million reserved fund balance is \$651.020 million for the Budget Stabilization Fund. The Budget Stabilization Fund is a form of Rainy Day Fund established by the Legislature in 1991.

Graph 2 details the General Fund Balance for the last five fiscal years:

Graph 2

General Fund Balance for last 5 fiscal years  
(Dollars in millions)



## **RISK MANAGEMENT**

The State purchases property and liability coverage whenever available on reasonable terms. The State is insured by an approved property insurer for claims in excess of \$3.500 million, but less than \$450.000 million, and liability claims in excess of \$2.000 million for the Universities and the School for the Deaf and Blind and \$7.000 million for all other state agencies, but less than \$100.000 million. The State also maintains first dollar aircraft liability, hull, and airport liability coverage up to \$200.000 million. Other purchased coverages include fidelity, foreign liability, medical malpractice (limited to the University of Arizona's medical professional staff), nuclear property, nuclear liability, and employment practices. The State's self-insurance fund provides property and liability coverage for claims less than or in excess of this coverage, or whenever coverage, such as workers' compensation and medical malpractice for non-University of Arizona professional staff, is unavailable on reasonable terms.

The State pays self-insurance losses, defense costs, premiums and administrative costs from an appropriated fund which all of the State's agencies participate in. Total costs (excluding the cost of administering the program) have risen from approximately \$15.300 million in fiscal year 1988 to approximately \$79.900 million in fiscal year 2006. Yearly appropriations have also increased from approximately \$27.700 million in fiscal year 1988 to approximately \$85.700 million in fiscal year 2006 to meet rising losses and claims-related expenses. Annual funding is established for expected paid claims. The accrued insurance losses are not considered when determining funding for each fiscal year.

## **ECONOMIC CONDITION AND OUTLOOK**

*The following economic summary is excerpted from the Arizona Department of Economic Security's Arizona's Workforce, released on August 31, 2006.*

Arizona's economy is projected to grow at a faster rate than the nation in 2006 and 2007, according to the forecast update of the Arizona Department of Economic Security, Research Administration. Nonfarm jobs in the Grand Canyon State are forecast to increase at a rate of 4.90% in 2006 and then slow to 4.00% in 2007. Over the two-year period, nonfarm job growth is projected to add nearly 228,000 jobs in Arizona. Meanwhile, according to the most recent figures by Global Insight, the U.S. economy is forecast to have a slower pace of employment expansion, growing at a rate of 1.40% in 2006 and 1.10% in 2007.

Nonfarm payroll job data for July 2006, reported by the Bureau of Labor Statistics, showed Arizona as the second fastest growing state (4.80%) over the previous 12 months. Additionally, this report showed Arizona was ranked fourth in terms of the number of jobs added since July 2005. Population growth is a strong contributor to the State's faster-than-national pace of expansion.

In this updated forecast, job growth is projected in ten of eleven major industry groups, with information as the only industry slipping back into continuing job losses. The top five industries with the largest projected job gains are professional and business services, construction, trade, transportation and utilities, educational and health services, and leisure and hospitality.

Among Arizona's major industries, natural resources and mining is projected to have the fastest percentage growth at 28.50% in the forecast period. Professional and business services will grow at 15.20% during the same time period and will add over 58,000 jobs. Construction is forecast to continue its expansion by growing 17.60% in 2006 and 2007. Financial activities (growing at 8.80%) and education and health services (8.20%) round out Arizona's top five expanding industries during the forecast period.

Arizona factories are projected to add 6,400 jobs for a growth rate of 3.50% over the forecast period. Recent declines in the number of orders for new manufactured goods at the national level contributed to the downward revision of manufacturing job growth in the state. For example, the slowdown in the housing market has been impacting manufacturing orders.

Construction, one of the most rapidly growing industries, is forecast to increase employment by more than 40,000 jobs. Even with a cooling housing market, nonresidential construction continues to add jobs. However, higher costs and fewer projects are expected to slow the industry to a 6.50% rate of expansion in 2007.

Natural resources and mining, unlike all other industry groups, is projected to accelerate as new Arizona based mining operations are completed and existing facilities are expanded. Industrial output across the globe, including East Asia, North America and Europe, has increased the demand for many mined nonmetallic and metallic ores including copper. The rising demand and price has provided the incentive to many Arizona mining firms to increase their capacity to extract and process copper and other metallic ores. Publicly stated employment announcements by Arizona employers in the industry account for most of the increase for this industry. For 2006, this industry is forecast to add 1,600 jobs and 1,000 jobs in 2007.

Trade, transportation and utilities is forecast to have an increase of almost 40,000 jobs. Slower growth in consumer spending, due mostly from higher energy costs and sustained higher interest rates, will dampen job growth in this industry. In addition, heightened concerns over safety and costs are expected to weaken the air transportation sector.

Information is projected to lose slightly more than 1,000 jobs. Projected job losses are the result of continuing consolidation, outsourcing and automation.

Financial activities is forecast to add almost 16,000 jobs. Due to higher interest rates on mortgages and other customer and business loan products, growth is anticipated, although at a lower rate. This industry is nevertheless forecast to grow at 5.00% in 2006 and 3.80% in 2007.

Professional and business services sectors is forecast to have strong labor demand over the next two years, growing by 8.10% in 2006 and 7.10% in 2007. Since this industry is a major resource for the rest of the economy, it will follow the overall economic trend.

Education and health services is projected to show an increase of 23,000 jobs. Arizona's population is expected to grow at more than 2.5 times the rate of population growth for the rest of the U.S. for the same period, providing strength in this industry. Faster than national population growth in Arizona is driving the expansion in this industry.

Leisure and hospitality is projected to add almost 21,000 jobs over the 2006-07 period. Growth in this industry will be sustained by a growing economy. Sustained high fuel prices and greater air travel restrictions are expected to dampen some related tourist demand. Arizona activity is expected to be supported by domestic (local and U.S.) demand as an option to consumers traveling abroad.

Other services is forecast to follow the general trend of the overall economy and add almost 8,000 jobs.

Government is forecast to maintain its previously projected rate and have a gain of almost 16,000 jobs.

Arizona's forecast update shows continued, yet slowing, growth through 2006-07. Nevertheless, Arizona's job growth is expected to outpace the nation. This update includes an expectation of a slower second half of 2006, with further slowing in 2007. Ten of eleven major industries are predicted to add jobs in both 2006 and 2007. The greatest number of jobs will be added in professional and business services, while the fastest pace of growth among industries is expected in natural resources and mining. Arizona's economy remains generally strong, but the weakness forecast in job growth for 2006-07 is expected to be most evident in sectors closely associated with consumer spending and in housing.

## **MAJOR INITIATIVES**

The Governor's fiscal year 2006 Budget establishes key principles for nurturing the State's fiscal and human resources so that it is possible to compete in the 21<sup>st</sup> century economy. It recognizes that; (1) children are better able to develop and succeed if they are healthy; (2) families are strengthened when the children of working parents are in safe daytime environments; (3) Arizona must have a superior education system that offers each child the best chance to determine his or her path to growth and achievement; (4) our natural resources are not only a State treasure; they also contribute to a vibrant educational system and economy; and (5) public safety must be strengthened by recruiting and retaining the highest quality law enforcement and correctional officers.

Effectively managed and maximized through targeted initiatives, these factors will combine to produce a world-class economy in Arizona for years to come.

### **Strengthening Families**

*Department of Economic Security.* The FY 2006 Budget provided \$11.200 million for the Day Care Subsidy for child care caseload growth. This amount was sufficient to fund the new priority of ensuring that there was no need to institute a waiting list for child care services for the entire fiscal year. Child care subsidies are available for low-income families, families on cash assistance, families leaving cash assistance, and families in the Child Protective Services (CPS) system.

*Healthy Families.* The FY 2006 Budget provided \$13.750 million for the Healthy Families Program. In order to continue the advances made by the CPS since 2003, an additional \$8.800 million is provided to fund 173.9 caseworkers for families with children in need.

### **Healthcare**

*Arizona Health Care Cost Containment System (AHCCCS).* The FY 2006 Budget included \$12.200 million to increase inpatient reimbursement rates for qualifying rural hospitals. It also shortens the redetermination period from twelve to six months for most AHCCCS clients. This change was expected to reduce the AHCCCS client rolls, as many clients will no longer qualify for the program.

## **Education**

*Full Day Kindergarten.* The FY 2006 Budget provided \$17.000 million for the expansion of voluntary full day kindergarten from 136 schools to 282 schools serving approximately 24,000 students.

*AIMS Intervention.* High school students are required to pass the AIMS test in order to graduate beginning FY 2006. In order to best prepare these students; the FY 2006 Budget includes \$5.000 million for expanded AIMS tutoring.

*Community Colleges.* The FY 2006 Budget fully funded the Operating, Capital Outlay, and Equalization Aid funding formulas. Arizona's two year community colleges provide high school graduates with a variety of educational opportunities needed to allow these graduates to participate in Arizona's and the nation's new economy.

### *Universities.*

- A top-notch university system allows each person and business in Arizona to be a world-class competitor. Recognizing this, the FY 2006 Budget provides approximately \$22.000 million to fund the FY 2006 enrollment growth at the three State universities. Additionally, Arizona State University received \$1.000 million to create the Department of Biomedical Informatics. Finally, the University of Arizona received \$6.000 million for the Phoenix Medical Campus.
- The University of Arizona and Arizona State University began staffing and renovations for the new Phoenix Medical Campus, including the new Phoenix Campus of the University of Arizona Medical School. The first students are expected in July 2007. Also, during FY 2006, ASU became the largest University in the country.

## **Land and Water Management**

Environmental stewardship is necessary for maintaining Arizona's natural beauty and for enhancing the State's economic development.

*Water.* The FY 2006 Budget includes an increase of \$1.900 million to restore budget cuts made to the Department of Water Resources in previous budget years. The approved budget also provides an additional \$1.400 million for Rural Water Studies to assess local water use needs and to develop plans for sustainable future water supplies in rural areas outside the state's Active Management Areas.

*Forest Fires.* The drought has been a contributing factor in the forest fires that ravaged parts of the State in recent years. One response to those fires was to use crews of properly supervised inmates to help with fuel treatment and fire suppression in and around communities at risk. The FY 2005 Budget increased to 12 the number of crews, and this year's budget provides for three additional inmate fire crews consisting of 75 people. Additionally, the Budget provides an increase of \$1.200 million for fire-fighting training for the 15 inmate crews.

*Trust Lands.* Finally, a direct link can be drawn between the activities of the Land Department and the beneficiaries of the State Land Trust, particularly as it pertains to K-12 education. To maximize the earnings from the sale and lease of State lands, the Land Department needs sufficient resources for planning and other preparatory work. The FY 2006 Budget provides \$3.000 million for the Land Department to carry out this mission.

## **Economic Development**

*Arizona 21<sup>st</sup> Century Competitive Initiative Fund.* The FY 2006 Budget established the 21<sup>st</sup> Century Competitive Initiative Fund and provided \$35.000 million from the General Fund in seed money for this program. Under the Commerce and Economic Development Commission of the Department of Commerce, the 21<sup>st</sup> Century Competitive Initiative Fund will work to build, strengthen and promote medical, scientific and engineering research programs and infrastructure in areas of greatest strategic value to Arizona's competitiveness in the global economy with an emphasis in bioscience. The funds are to be used to attract world-class researchers to Arizona and support research into new products and technologies that can be commercialized and brought to the market.

## Public Safety

*Department of Public Safety.* Providing public safety officials with the resources necessary to serve a growing population continues to be a priority for Arizona. The FY 2006 Budget provides funding for initiatives designed to ensure that the public safety system is able to keep pace with population and traffic growth, while also directing funding to impede developing crime trends and keep our officers and citizens safe. The following initiatives helped accomplish these goals:

- An increase of \$3.900 million and 63.0 FTE positions from the General Fund for the Gang Intelligence Team Enforcement Mission.
- \$3.000 million from the General Fund for the purchase of protective safety equipment for DPS officers.
- \$3.000 million from the Highway User Reserve Fund (HURF) for sworn officer salary increases to bring DPS officer salaries closer to market level.
- \$3.500 million and 28.0 FTE from the HURF for additional highway patrol officers in an effort to keep staffing at pace with population and traffic growth.

*Department of Juvenile Corrections.* In response to a federal audit, 135 additional staff were added to enhance the mental health, education, and safety of juveniles.

## Statewide Transportation Acceleration Needs

The Governor worked with the State Legislature to ensure that additional funding was included in the State budget to speed up transportation projects. House Bills 2863 and 2865 were signed into law to establish the Statewide Transportation Acceleration Needs and provide \$301.000 million, including \$245.000 million from the General Fund, to enable the Arizona Department of Transportation and regional authorities to accelerate highway projects across the state.

## State Employees

Without question, State employees impact Arizona's citizens every hour of every day. Without their dedication and commitment, our highways would not be safe, our natural resources would be neglected, our roads would not be built and maintained, and our neediest citizens would not receive essential services and care. The FY 2006 Budget recognizes State employees' crucial role and provides adequate funding to offset increases in both retirement and health insurance costs. In addition, a \$1,650 salary adjustment and 2.50% performance adjustment were provided for each FTE effective March 11, 2006.

Initiatives such as those discussed above clearly illustrate the dynamic impact that can occur when State Government optimizes its existing resources for the benefit of the people it serves and makes the most prudent investments in its infrastructure.

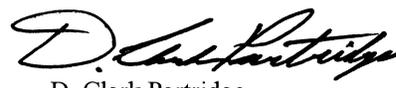
## AWARDS AND ACKNOWLEDGMENTS

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of Arizona for its CAFR for the year ended June 30, 2005. This was the second consecutive year that the government has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized CAFR. This report must satisfy both GAAP and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe that our current CAFR continues to meet the Certificate of Achievement Program's requirements, and we are submitting it to the GFOA to determine its eligibility for another certificate.

We wish to express our sincere appreciation to the many individuals whose dedicated efforts have made this report possible. The preparation of this report could not have been accomplished without the professionalism and dedication demonstrated by the financial and management personnel of each State agency, board, commission, council, administration, office, institution of higher education and all other organizations within the reporting entity.

  
William Bell  
Director

  
D. Clark Partridge  
State Comptroller