

MANAGEMENT'S
DISCUSSION
AND
ANALYSIS

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following is a discussion and analysis of the State of Arizona's (the State's) financial performance, providing an overview of the activities for the fiscal year ended June 30, 2006. Please read it in conjunction with the transmittal letter at the front of this report and with the State's financial statements, which follow this section. The completeness and fairness of the following information is the responsibility of the State's officials and management.

FINANCIAL HIGHLIGHTS

Government-Wide:

- The assets of the State exceeded liabilities at the close of the fiscal year by \$20.0 billion (reported as *net assets*). Of this amount, \$985.535 million is unrestricted, \$5.0 billion is restricted for specific purposes (*restricted net assets*), and \$14.0 billion is invested in capital assets, net of related debt.
- The State's total net assets increased in fiscal year 2006 by \$3.1 billion. Net assets of governmental activities increased by \$2.9 billion, while net assets of the business-type activities increased by \$241.135 million.

Fund Level:

- As of the close of the fiscal year, the State's governmental funds reported combined ending fund balances of \$5.6 billion, an increase of \$1.4 billion from the beginning of the year. Approximately 38% of the combined fund balances, or \$2.1 billion, is available to meet the State's current and future needs (*unreserved fund balance*).
- As of the close of the fiscal year, unreserved fund balance for the General Fund was \$1.4 billion, or 8%, of total General Fund expenditures.
- The enterprise funds reported net assets at year end of \$2.8 billion, an increase of \$258.185 million during the year.
- The Land Endowments Fund reported fund balance at year end of \$2.0 billion, an increase of \$326.494 million during the year. The Land Endowments Fund is used to help finance public education within the State as required by the federal government and the State's Constitution.

Long-term Debt:

- The State's total long-term primary government debt decreased during the fiscal year to \$5.7 billion, a slight decrease of \$10.864 million (less than 1%). Changes during the year included the addition of revenue bonds and certificates of participation of \$782.880 million and \$175.027 million, respectively. Also, the State retired \$812.425 million of revenue bonds, \$38.540 million of grant anticipation notes, and \$122.887 million of certificates of participation.

More detailed information regarding the government-wide financial statements, fund level financial statements and long-term debt activity can be found beginning on **page 26**.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is an introduction to the State's basic financial statements, which are comprised of three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. Required Supplementary Information and other supplementary information are included in addition to the basic financial statements.

Government-Wide Statements (Reporting the State as a Whole)

The government-wide financial statements provide a broad overview of the State of Arizona's finances in a manner similar to private sector business. The financial statements report information about the State, as a whole, and about its activities that should help answer this question: Is the State, as a whole, better or worse off as a result of this year's activities? These statements include all non-fiduciary assets and liabilities using the accrual basis of accounting. The current year's revenues and expenses are taken into account regardless of when cash is received or paid. The government-wide financial statements include the following:

The Statement of Net Assets and the Statement of Financial Position (pages 38-40) present all of the State's assets and liabilities, with the difference between the two reported as net assets. Over time, increases and decreases in net assets measure whether the State's financial position is improving or deteriorating.

The Statements of Activities (pages 42-44) present information showing how the State's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in these statements for some items that will only result in cash flows in future fiscal periods (e.g., uncollected taxes and earned, but unused vacation leave).

Both government-wide statements report three activities:

- *Governmental Activities* – Most of the State's basic services are reported under this category. Taxes and intergovernmental revenues generally fund these services. The Legislature, the Judiciary, and the general operations of the Executive departments fall within the governmental activities.
- *Business-type Activities* – The State charges fees to customers to help it cover all or most of the cost of certain services it provides. Lottery tickets, the State's unemployment compensation services, Industrial Commission rehabilitation services, and the State's three universities are examples of business-type activities.
- *Discretely Presented Component Units* – Component units are legally separate organizations for which the elected officials of the State are financially accountable. The University Medical Center, the Arizona Power Authority, and the Water Infrastructure Finance Authority are discretely presented component units reported by the State. Based on GASB Statement No. 39, the State has added university foundations and financing authorities whose financial statements are prepared in conformity with U.S. generally accepted accounting principles as adopted by the Financial Accounting Standards Board. These organizations include the ASU Foundation, Arizona Capital Facilities Finance Corporation, the U of A Foundation, and other non-major foundations and financing authorities. Financial statements for these organizations are presented immediately following the government-wide statements to emphasize that they are prepared in accordance with accounting standards other than those promulgated by GASB, and include a statement of financial position (**page 40**) and a statement of activities (**page 44**). See **pages 67-69 and 114-126** for more information on discretely presented component units.

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

The fund financial statements begin on **page 45** and provide detailed information about the major individual funds. A fund is a fiscal and accounting entity with a self-balancing set of accounts that the State uses to keep track of specific sources of funding and spending for a particular purpose. In addition to the major funds, **page 160** begins the individual fund data for the non-major funds. The State's funds are divided into three categories – governmental, proprietary, and fiduciary – each category uses different accounting approaches.

- *Governmental funds* – Most of the State's basic services are reported in the governmental funds, which focus on how money flows into and out of those funds and the balances left at year end that are available for future spending. The governmental fund financial statements provide a detailed short-term view of the State's general government operations and the basic services it provides. Governmental fund information helps determine whether there are more or fewer financial resources that can be spent in the near future to finance the State's programs. These funds are reported using modified accrual accounting, which measures cash and all other financial assets that can readily be converted to cash. Governmental funds include the general, special revenue, capital projects, debt service, and permanent funds. Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. This report includes two schedules (**pages 46 and 48-49**) that reconcile the amounts reported on the governmental fund financial statements (modified accrual accounting) with governmental activities (accrual accounting) reported on the appropriate government-wide statement.

Governmental fund financial statements can be found on pages 45 and 47 of this report.

- *Proprietary funds* – When the State charges customers for the services it provides, whether to outside customers or to other agencies within the State, these services are generally reported in proprietary funds. Proprietary funds (enterprise and internal service) utilize accrual accounting; the same method used by private sector businesses. Enterprise funds report activities that provide supplies and services to the general public – such as the State Lottery Fund and Universities. Internal service funds report activities that provide supplies and services for the State’s other programs and activities – such as the State’s Risk Management Fund. Internal service fund operations primarily benefit governmental funds and are reported as governmental activities on the government-wide statements. The reconciliation between the government-wide financial statement business-type activities and the proprietary fund financial statements is presented at the end of the financial statements on **pages 52-55**.

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

- *Fiduciary funds* – The State acts as a trustee or fiduciary for its employee pension plans. It is also responsible for other assets that, because of a trust arrangement, can be used only for the trust beneficiaries. The State’s fiduciary activities are reported in separate Statements of Fiduciary Net Assets and Changes in Fiduciary Net Assets beginning on **page 60**. These funds, which include pension trust, investment trust, and agency funds are reported using accrual accounting. The government-wide statements exclude fiduciary fund activities and balances because these assets are restricted in purpose and do not represent discretionary assets of the State to finance its operations.

Fiduciary fund financial statements can be found on pages 60-61 of this report.

Notes to the Financial Statements

The Notes to the Financial Statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements.

The notes can be found beginning on page 67 of this report.

Required Supplementary Information

Following the basic financial statements is additional Required Supplementary Information that further explains and supports the information in the financial statements. The Required Supplementary Information includes budgetary comparison schedules for the general fund and each major special revenue fund and a reconciliation of the schedules of statutory and U.S. GAAP expenditures for the fiscal year. This section also includes schedules of condition and maintenance data regarding certain portions of the State’s infrastructure and agent retirement plans’ funding progress schedules.

Required supplementary information begins on page 129 of this report.

Other Supplementary Information

Other supplementary information includes combining financial statements for non-major governmental, non-major enterprise, all internal service funds, all fiduciary funds, and non-major universities – affiliated component units. These funds are added together, by fund type, and presented in single columns in the basic financial statements, but are not reported individually, as are major funds on the governmental funds and proprietary funds financial statements. A budgetary expenditure comparison schedule for the non-major special revenue funds is also included.

Other supplementary information begins on page 160 of this report.

GOVERNMENT-WIDE FINANCIAL ANALYSIS

The State's overall financial position and operations for the past year for the primary government are summarized, as follows, based on the information included in the government-wide financial statements.

State of Arizona-Primary Government
Net Assets as of June 30, 2006 and 2005
(expressed in thousands)

	Governmental Activities		Business-type Activities		Primary Government Total	
	2006	2005	2006	2005	2006	2005
Current assets	\$ 4,723,241	\$ 3,503,360	\$ 1,804,687	\$ 1,516,254	\$ 6,527,928	\$ 5,019,614
Capital assets	14,989,475	14,012,830	2,884,950	2,677,802	17,874,425	16,690,632
Other non-current assets	3,555,772	2,955,282	937,469	1,063,599	4,493,241	4,018,881
Total Assets	23,268,488	20,471,472	5,627,106	5,257,655	28,895,594	25,729,127
Current liabilities	2,157,620	2,069,865	539,784	484,636	2,697,404	2,554,501
Non-current liabilities	3,887,329	4,049,808	2,341,478	2,268,310	6,228,807	6,318,118
Total Liabilities	6,044,949	6,119,673	2,881,262	2,752,946	8,926,211	8,872,619
Net assets:						
Invested in capital assets, net of related debt	12,878,151	11,825,961	1,144,374	1,166,954	14,022,525	12,992,915
Restricted net assets	3,560,868	2,938,288	1,400,455	1,232,016	4,961,323	4,170,304
Unrestricted net assets	784,520	(412,450)	201,015	105,739	985,535	(306,711)
Total Net Assets	\$ 17,223,539	\$ 14,351,799	\$ 2,745,844	\$ 2,504,709	\$ 19,969,383	\$ 16,856,508

The largest portion of the State's net assets (70%) represents *capital assets, net of related debt* of \$14.0 billion. The State uses these capital assets to provide services to citizens; consequently, these assets are *not* available for future spending. Although the State's investment in its capital assets is reported net of accumulated depreciation and related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

The State's net assets also include \$5.0 billion (25%) of resources that are subject to external restrictions on how they may be used. The largest restrictions are by the State's Constitution for basic education funded by the earnings of the Land Endowments Fund and by federal regulations for unemployment insurance premiums from employers for funding the Unemployment Compensation Fund. Another major restriction is unspent debt instrument proceeds primarily for the acquisition and construction of federal, state, and local highways.

The remaining balance of the State's net assets of \$985.535 million (5%) represents *unrestricted net assets*.

The State's net assets increased \$3.1 billion during the current fiscal year. This increase was primarily caused by governmental activities increases for sales taxes, income taxes, gains on the sale of trust land, and capital assets. Additionally, net assets were further increased by business-type activities' increases for the Universities Fund, the Unemployment Compensation Fund, and the Industrial Commission's Special Fund.

State of Arizona-Primary Government
Changes in Net Assets for Fiscal Years Ended June 30, 2006 and 2005
(expressed in thousands)

	Governmental Activities		Business-type Activities		Primary Government Total	
	2006	2005	2006	2005	2006	2005
Revenues:						
Program revenues:						
Charges for services	\$ 721,759	\$ 617,659	\$ 1,906,465	\$ 1,701,249	\$ 2,628,224	\$ 2,318,908
Operating grants and contributions	7,941,223	7,544,370	852,788	834,421	8,794,011	8,378,791
Capital grants and contributions	388,646	497,140	30,056	19,774	418,702	516,914
General revenues:						
Sales taxes	6,322,311	5,421,949	54,550	57,584	6,376,861	5,479,533
Income taxes	4,548,843	3,562,916	-	-	4,548,843	3,562,916
Tobacco taxes	248,122	237,430	-	-	248,122	237,430
Property taxes	43,035	46,148	-	-	43,035	46,148
Motor vehicle and fuel taxes	1,857,293	1,758,950	-	-	1,857,293	1,758,950
Other taxes	575,946	493,501	-	-	575,946	493,501
Unrestricted investment earnings	172,311	106,362	49,050	40,311	221,361	146,673
Unrestricted grants and contributions	12,293	11,624	-	5	12,293	11,629
Miscellaneous revenue	235,610	387,269	58,816	26,017	294,426	413,286
Gain on sale of trust land	567,364	288,483	-	-	567,364	288,483
Total Revenues	23,634,756	20,973,801	2,951,725	2,679,361	26,586,481	23,653,162
Expenses:						
General government	781,542	646,452	-	-	781,542	646,452
Health and welfare	9,057,733	8,494,206	-	-	9,057,733	8,494,206
Inspection and regulation	159,766	149,238	-	-	159,766	149,238
Education	5,304,555	4,853,458	-	-	5,304,555	4,853,458
Protection and safety	1,279,129	1,171,340	-	-	1,279,129	1,171,340
Transportation	386,777	589,966	-	-	386,777	589,966
Natural resources	187,947	184,538	-	-	187,947	184,538
Intergovernmental revenue sharing	2,658,636	2,335,828	-	-	2,658,636	2,335,828
Interest on long-term debt	172,439	182,852	-	-	172,439	182,852
Universities	-	-	2,759,142	2,540,193	2,759,142	2,540,193
Unemployment compensation	-	-	226,171	292,127	226,171	292,127
Industrial Commission special fund	-	-	(18,300)	106,295	(18,300)	106,295
Lottery	-	-	377,104	317,226	377,104	317,226
Other business-type activities	-	-	136,894	120,629	136,894	120,629
Total Expenses	19,988,524	18,607,878	3,481,011	3,376,470	23,469,535	21,984,348
Excess (deficiency) before contributions, special items and transfers	3,646,232	2,365,923	(529,286)	(697,109)	3,116,946	1,668,814
Contributions to permanent endowments	-	-	3,803	2,955	3,803	2,955
Special item - intergovernmental transfer of Sundome Center for the Performing Arts	-	-	(7,874)	-	(7,874)	-
Transfers	(774,492)	(707,597)	774,492	707,597	-	-
Change in Net Assets	2,871,740	1,658,326	241,135	13,443	3,112,875	1,671,769
Net Assets - July 1	14,351,799	12,693,473	2,504,709	2,491,266	16,856,508	15,184,739
Net Assets - June 30	\$ 17,223,539	\$ 14,351,799	\$ 2,745,844	\$ 2,504,709	\$ 19,969,383	\$ 16,856,508

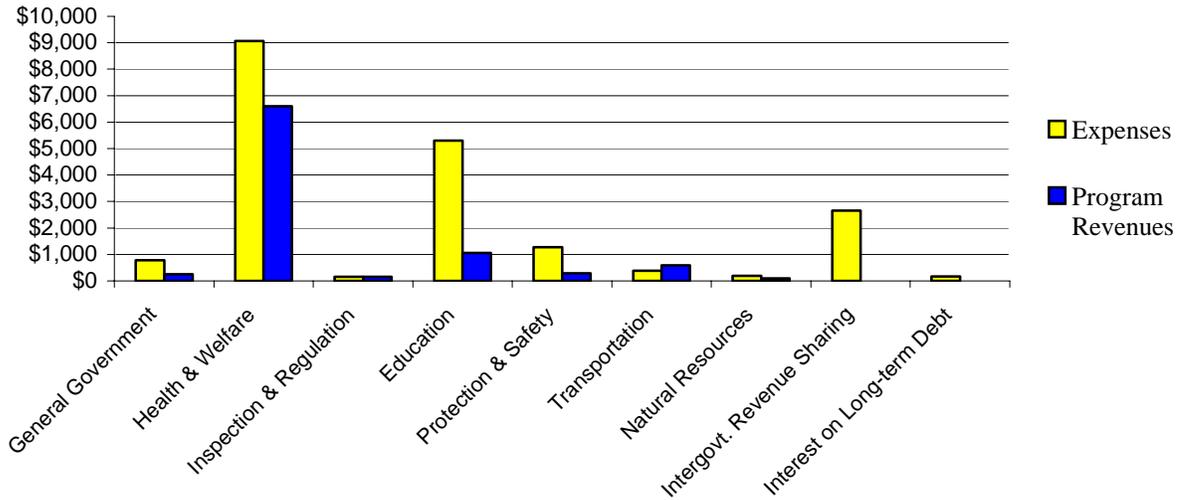
Change in Net Assets

Governmental Activities – Net assets increased by \$2.9 billion, or 20%. This increase was primarily attributed to the increases in earned general tax revenues. Reported sales tax and income tax revenue increased by \$900.362 million, or 17%, and \$985.927 million, or 28%, as compared to fiscal year 2005, respectively. Several key elements have led to this increase. The State ranked fourth, nationally, in terms of the number of jobs added during fiscal year 2006, as reported by Arizona’s Department of Economic Security, Research Administration. Furthermore, annual estimates of the U.S. Census Bureau show that Arizona led the nation in population growth, with a 3.5% increase, during fiscal year 2006. Additionally, during fiscal year 2006, personal income growth in Arizona, as reported by the U.S. Bureau of Economic Analysis, increased 7.8%, ranking Arizona sixth among all states in percentage change. Additionally, the State’s improved efforts in tax enforcement resulted in the collection of \$530.00 million for fiscal year 2006 (an increase of \$74.436 million from the prior fiscal year). Another significant contributor to the net asset increase was record auction sales of 3,426 acres in State trust land for gross sales of \$544.330 million. In many of these auctions there was intense, competitive bidding which raised the total sales price by approximately 10.5% above the appraised value. Furthermore, net assets were increased by the capitalization of \$302.375 million of capital assets that were previously recorded as transportation expenses.

A comparison of the net cost (income) of services by function for the State’s governmental activities is shown below for fiscal years 2006 and 2005. Net cost (income) is the total cost less revenues generated by the activities and shows the financial burden placed upon the State’s taxpayers by each of these functions.

Functions/Programs:	Governmental Activities (expressed in thousands)			
	Total Cost of Services		Net Cost (Income) of Services	
	2006	2005	2006	2005
General government	\$ 781,542	\$ 646,452	\$ 525,480	\$ 367,749
Health and welfare	9,057,733	8,494,206	2,454,326	2,190,654
Inspection and regulation	159,766	149,238	(678)	1,262
Education	5,304,555	4,853,458	4,247,978	3,881,306
Protection and safety	1,279,129	1,171,340	985,492	924,270
Transportation	386,777	589,966	(200,657)	(43,964)
Natural resources	187,947	184,538	93,880	108,752
Intergovernmental revenue sharing	2,658,636	2,335,828	2,658,636	2,335,828
Interest on long-term debt	172,439	182,852	172,439	182,852
Total Governmental Activities	<u>\$19,988,524</u>	<u>\$18,607,878</u>	<u>\$ 10,936,896</u>	<u>\$ 9,948,709</u>

**Expenses and Program Revenues
Governmental Activities for Fiscal Year 2006
(in millions of dollars)**



Business-type Activities – The net assets increased by \$241.135 million, or 10%. This increase was primarily caused by the net increase of the Unemployment Compensation Fund of \$129.536 million; a net increase in the Universities Fund of \$48.523 million; and a decrease in the Industrial Commission’s Special Fund deficit of \$83.116 million. The increase in net assets from the Unemployment Compensation Fund was primarily caused by an increase in employer assessments (wages subject to unemployment tax rose 11% during the 12 months ending December 31, 2005) and a decline in the cost of sales and benefits (the amount of unemployment benefits paid decreased 23% during fiscal year 2006). The increase in net assets for the Universities Fund was primarily attributed to increases in non-operating revenues, including gains on sale of land, increased State appropriations, investment income, and gifts and donations. The Industrial Commission’s Special Fund deficit decreased primarily due to a decrease in insolvent carrier liabilities. Insolvent carrier liability decreased during fiscal year 2006, because there was an insignificant number of new workers’ compensation cases being assigned to the State Compensation Fund under ARS §23-966. In addition, during fiscal year 2006, \$19.000 million was transferred from the Industrial Commission’s Administrative Fund to the Special Fund.

A comparison of the net cost (income) of services by function for the State’s business-type activities is shown below for fiscal years 2006 and 2005. Net cost (income) is the total cost less revenues generated by the activities and shows the financial burden placed upon the State’s taxpayers by each of these functions.

Functions/Programs:	Business-type Activities (expressed in thousands)			
	Total Cost of Services		Net Cost (Income) of Services	
	2006	2005	2006	2005
Universities	\$ 2,759,142	\$ 2,540,193	\$ 957,929	\$ 871,465
Unemployment Compensation	226,171	292,127	(132,076)	(25,969)
Industrial Commission Special Fund	(18,300)	106,295	(52,394)	49,248
Lottery	377,104	317,226	(91,593)	(80,335)
Other	136,894	120,629	9,836	6,617
Total Business-type Activities	\$ 3,481,011	\$ 3,376,470	\$ 691,702	\$ 821,026

FINANCIAL ANALYSIS OF THE STATE'S FUNDS

The State uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental funds – The general government functions are contained in the general, special revenue, debt service, capital projects and permanent funds. The focus of the State's governmental funds is to provide information on near-term inflows, outflows, and balances of *spendable* resources. Such information is useful in assessing the State's financing requirements. In particular, *unreserved fund balance* may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year.

General Fund

The General Fund is the chief operating fund of the State. At June 30, 2006, unreserved fund balance of the General Fund was \$1.4 billion, while total fund balance closed the year at \$2.3 billion. As a measure of the General Fund's liquidity, it may be useful to compare both unreserved fund balance and total fund balance to total fund expenditures and other financing uses. Unreserved fund balance represents 8% of total expenditures and other financing uses, while total fund balance represents 13% of the same amount.

The fund balance of the State's General Fund increased by \$955.736 million during the fiscal year. The primary source of the increase in fund balance is from the increase of sales tax and income tax revenues. Sales tax revenues increased \$881.221 million from fiscal year 2005, an increase of 19%. Sales taxes paid by retail stores and construction contractors increased approximately \$387.765 million and \$253.975 million, respectively, when compared to fiscal year 2005 sales tax receipts. Income tax revenues increased \$1.0 billion, an increase of 29%. Income taxes paid by individuals increased by approximately \$812.594 million, when compared to fiscal year 2005 individual income tax receipts. In addition, income taxes paid by corporations increased approximately \$194.338 million during the same period.

Health and welfare expenditures and intergovernmental revenue increased by \$568.922 million, or 7%, and \$399.100 million, or 6%, as compared to fiscal year 2005, respectively. Overall program enrollment in the State's various healthcare programs declined .2%. However, the cost of healthcare programs, including the Social Security Act Titles XIX (Medicaid) and XXI (State Children's Health Insurance Program), were major contributing factors to an increase in health and welfare expenditures during fiscal year 2006. Utilization and inflationary trends for health care costs are incorporated into a rate development process for the managed care organization capitation rates. The capitation rates were increased by a weighted average of 8% for the contract period of October 2005 to September 2006, primarily due to pharmacy, physician, and inpatient costs. The State received additional intergovernmental revenue (including federal grants and county funding) to cover a major portion of these increased costs.

Education expenditures increased \$379.944 million, or 9%, compared to fiscal year 2005. The increase can be primarily attributed to an increase of approximately \$216.000 million in State assistance for kindergarten through twelfth grade (K-12) operating expenditures largely to support an increase of 40,543 student enrollments and a 3.2% inflation adjustment. In addition, expenditures for full day kindergarten increased approximately \$22.000 million and programs supported by federal grant aid increased by approximately \$57.000 million during fiscal year 2006.

Transportation and Aviation Planning, Highway Maintenance and Safety Fund

The Transportation and Aviation Planning, Highway Maintenance and Safety Fund is responsible for the repair and maintenance of existing roads, paying the debt service for roads that are built from the issuance of revenue bonds, and providing technical assistance with road construction provided by contractors hired by the Arizona Department of Transportation. Total fund balance increased \$52.124 million during fiscal year 2006. Fund balance increased primarily due to a \$98.361 million increase in motor vehicle and fuel tax revenues and a \$39.365 million increase in licenses, fees, and permits due to increased population, which tends to follow job growth. Also, distributions to other State agencies were \$118.000 million less than fiscal year's 2005 distributions due to 2004 Senate Bill 1314, which required an additional \$118.000 million to be transferred from vehicle license tax revenues to the State's General Fund in fiscal year 2005. Fund balance increases were offset, in part, due to a \$103.952 million increase in distributions to Arizona counties and cities, as a result of increased motor vehicle and fuel tax collections, and a \$91.407 million decrease in intergovernmental revenues.

Land Endowments Fund

The fund was established when the federal government granted Arizona statehood. Both the State's Constitution and the federal government require that the land grants given to the State be maintained indefinitely, and the earnings from the land grants should be used for public education, primarily K-12. The Land Endowments Fund total fund balance increased \$326.494 million during fiscal year 2006. Permanent fund endowment investments increased \$311.657 million, at fiscal year end, due to record receipts from State Trust land sales and a net increase in the fair value of investments of \$71.006 million.

Proprietary funds

The business-type activities discussion for the fund level financial statements of the State's enterprise funds provide the same type of information found in the government-wide financial statements analysis on **page 29**.

GENERAL FUND BUDGETARY HIGHLIGHTS

During the fiscal year, the original budget was amended by various supplemental appropriations and appropriation revisions. Budgetary Comparison Schedules for the major governmental funds are in the Required Supplementary Information section beginning on **page 129**. Differences between the original budget and the final amended budget resulted in a \$657.075 million increase in appropriations for the General Fund, before adjustments. The following comments summarize current year budgetary results:

- Some of the primary reasons for the General Fund appropriations \$657.075 million increase were 1) \$192.021 million of prior fiscal year obligations that were paid in the current fiscal year per ARS §35-191; 2) \$191.294 million for the Department of Education's deferral of Basic State Aid and Additional State Aid payments to school districts; 3) \$16.163 million supplemental appropriation for the Arizona Health Care Cost Containment System's Disproportionate Share Hospital program; 4) \$38.050 million to the Department of Education for full-day kindergarten funding; 5) \$16.564 million to the Department of Education, primarily for increases to Basic State Aid Entitlement and achievement testing; 6) \$20.000 million for the Parks Board Growing Smarter transfer to the Land Conservation Fund per ARS §41-511.23; 7) \$39.854 million for a 2.5% performance pay adjustment and increase of \$1,650 for each full-time equivalent position beginning March 11, 2006. The original General Fund appropriation total was \$13.2 billion, before adjustments. The final General Fund appropriation total was \$13.9 billion, before adjustments.
- The difference between the final budget and actual expenditures was \$543.405 million, after adjustments. Of this amount, \$69.861 million will continue as legislative multiple fiscal year spending authority for fiscal year 2007 and beyond, depending upon the budgetary guidelines of the Legislature. The remaining \$473.544 million represents the unused portion of the State's legislatively authorized annual operating budget.

Additional budgetary information can be found on pages 149-150 of this report.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital assets:

The State's investment in capital assets for its governmental and business-type activities as of June 30, 2006 totaled \$17.9 billion, net of accumulated depreciation. The total primary government increase in capital assets for the current period was 7%, with a 7% increase in capital assets used for governmental activities and an 8% increase for business-type activities. Depreciation charges of the governmental and business-type activities for the fiscal year totaled \$279.010 million.

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

- The Universities' additions to capital assets totaled approximately \$501.933 million and included increased investments in instruction and research facilities.

- The Department of Transportation started or completed roads and bridges totaling \$1.4 billion during the fiscal year.

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

Capital assets for the governmental and business-type activities as of June 30, 2006 are presented below (expressed in thousands):

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
Land	\$ 2,227,782	\$ 1,980,978	\$ 143,587	\$ 143,195	\$ 2,371,369	\$ 2,124,173
Buildings	1,527,996	1,515,343	3,101,431	2,709,694	4,629,427	4,225,037
Improvements other than buildings	133,624	142,563	3,601	3,600	137,225	146,163
Equipment	696,119	666,417	1,166,876	1,108,706	1,862,995	1,775,123
Collections (non-depreciable)	-	-	34,159	33,130	34,159	33,130
Infrastructure	9,386,364	8,870,232	305,975	289,215	9,692,339	9,159,447
Construction in progress	2,036,194	1,785,351	163,030	284,181	2,199,224	2,069,532
Less accumulated depreciation	(1,018,604)	(948,054)	(2,033,709)	(1,893,919)	(3,052,313)	(2,841,973)
Total	<u>\$ 14,989,475</u>	<u>\$ 14,012,830</u>	<u>\$ 2,884,950</u>	<u>\$ 2,677,802</u>	<u>\$ 17,874,425</u>	<u>\$ 16,690,632</u>

See Note 4, capital assets, beginning on **page 90** for additional capital asset data.

As provided by GASB Statement 34, the State has elected to record its infrastructure assets, that the Department of Transportation is responsible for maintaining, using the modified approach. Assets accounted for under the modified approach include 6,922 center lane miles (18,668 travel lane miles) and 4,676 bridges.

The State manages its roads using the Present Serviceability Rating (PSR), which measures the condition of the pavement and its ability to serve the traveling public. The PSR uses a five-point scale (5 excellent, 0 impassable) to characterize the condition of the roadway. The State's serviceability rating goal is 3.23 for the overall system. The most recent assessment indicated that an overall rating of 3.52 was achieved for fiscal year 2006.

The State manages its bridges using the Arizona Bridge Information and Storage System (ABISS). The State determines the condition rating based on standards developed by the Federal Highway Administration and additional internal criteria. It is the policy of the State to maintain a Condition Rating Index (CRI) of 92.5% or better. In fiscal year 2006, a CRI of 93.8% was obtained.

In addition to many smaller projects, each of the following major highway construction projects in excess of \$20.000 million were started during fiscal year 2006 (expressed in thousands):

<u>Project Description</u>	<u>Contract Start Date</u>	<u>Contract Amount</u>	<u>Current Year Expenditures</u>
Widen roadway on US 60 from Gilbert Road to Power Road within the City of Mesa, in Maricopa County.	09/23/05	\$ 73,705	\$ 37,153
Construction of State Route Loop 202 from Power Road to University Drive within the City of Mesa, in Maricopa County.	12/19/05	195,340	34,091
Construction of State Route Loop 202 from University Drive to Southern Avenue within the City of Mesa, in Maricopa County.	10/24/05	67,415	24,065
Reconstruct roadway to a four lane divided highway on US 93, in Yavapai County.	09/23/05	25,472	10,302
Reconstruction of the intersection of US 89 and I-40B within the City of Flagstaff, in Coconino County.	11/22/05	30,480	6,398
Reconstruction at the intersection of I-40 and North Park Drive within the City of Winslow, in Navajo County.	10/25/05	20,629	5,578

In addition to many smaller projects, the following major highway construction projects had expenditures in excess of \$15.000 million in fiscal year 2006 (expressed in thousands):

<u>Project Description</u>	<u>Project Expenditures</u>
Construction at the interchange of State Route Loop 202 and US 60, in Maricopa County.	\$ 50,944
Construction of State Route Loop 202 from Power Road to University Drive, in Maricopa County.	43,694
Construction of State Route Loop 202 from Frye Road to Power Road, in Maricopa County.	43,013
Widen roadway on US 60 from Gilbert Road to Power Road, in Maricopa County.	40,130
Construction of State Route Loop 202 from Gilbert Road to Frye Road, in Maricopa County.	36,549
Construction of State Route Loop 202 from University Drive to Southern Avenue, in Maricopa County.	26,088
Construction on US 93 north of Wickenburg, in Mohave County.	22,912
Construction on US 60 at 59 th Avenue and Glendale Avenue, in Maricopa County.	21,306
Construction of State Route Loop 202 from Power Road to Elliot Road, in Maricopa County.	20,162

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

More detailed information regarding capital assets are on pages 90 and 91.

Long-term debt:

The State issues no general obligation debt instruments. The Arizona Constitution, under Article 9, Section 5, provides that the State may contract debts not to exceed \$350 thousand. This provision has been interpreted to restrict the State from pledging its credit as a sole payment for debts incurred for the operation of the State government. As a result, the State pledges either dedicated revenue streams or the constructed building or equipment acquired as security for the repayment of long-term debt instruments.

Major long-term debt activity during the current fiscal year included the following:

- The Department of Transportation issued revenue bonds for \$265.650 million to (i) finance portions of the Transportation Board’s Five Year Transportation Facilities Construction Program, (ii) pay the costs of issuing the bonds, (iii) pay interest on any bonds issued for highway purposes, and (iv) advance refund portions of previously issued revenue bonds with a total outstanding principal balance of \$148.750 million.

- The School Facilities Board issued \$448.760 million of revenue bonds to advance refund portions of previously issued revenue bonds with a total outstanding principal balance of \$446.680 million.
- The Universities issued revenue bonds for \$68.470 million to fund the acquisition, construction or renovation of capital facilities and infrastructure. Furthermore, proceeds were used to pay principal and/or interest payments on the University of Arizona's previously issued revenue bonds.
- The Universities issued \$175.027 million of certificates of participation to (i) fund building and infrastructure projects, (ii) current-refund previously issued certificates of participation with a total outstanding principal of \$62.100 million, (iii) refund previously issued certificates of participation with a total outstanding principal of \$9.845 million in advance of maturity, and (iv) pay principal and/or interest payments on some of the University of Arizona's previously issued certificates of participation.

State of Arizona-Primary Government
Outstanding Major Long-Term Debt as of June 30, 2006
(expressed in thousands)

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
Revenue bonds	\$ 2,106,700	\$ 2,170,845	\$ 802,600	\$ 768,000	\$ 2,909,300	\$ 2,938,845
Grant anticipation notes	325,430	363,970	-	-	325,430	363,970
Certificates of participation	1,020,810	1,054,677	946,766	860,759	1,967,576	1,915,436
Total	<u>\$ 3,452,940</u>	<u>\$ 3,589,492</u>	<u>\$ 1,749,366</u>	<u>\$ 1,628,759</u>	<u>\$ 5,202,306</u>	<u>\$ 5,218,251</u>

More detailed information regarding long-term debt begins on page 95.

ECONOMIC CONDITION AND OUTLOOK

Arizona's economy outpaced the nation in fiscal year 2006, with solid growth in labor markets, population, and personal income. As previously mentioned, the State ranked fourth, nationally, in terms of the number of jobs added during fiscal year 2006, as reported by Arizona's Department of Economic Security, Research Administration. Furthermore, annual estimates of the U.S. Census Bureau show that Arizona led the nation in population growth, with a 3.5% increase, during fiscal year 2006. Additionally, during fiscal year 2006, personal income growth in Arizona, as reported by the U.S. Bureau of Economic Analysis, increased 7.8%, ranking Arizona sixth among all states in percentage change.

Arizona's economy is projected to see a moderation of growth in 2007. Job growth was expected to slow in the second half of 2006, with further slowing in 2007, as the housing market and growth in consumer spending slows down. Nevertheless, Arizona's economy was 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.

CONTACTING THE STATE COMPTROLLER'S OFFICE

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

The State's component units issue their own separately issued audited financial statements. These statements may be obtained by directly contacting the component unit. Contact information regarding the component units begins on **page 68**.