

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, 2007. 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 \$22.0 billion (reported as *net assets*). Of this amount, \$992.255 million is unrestricted, \$6.3 billion is restricted for specific purposes (*restricted net assets*), and \$14.7 billion is invested in capital assets, net of related debt.
- The State's total net assets increased in fiscal year 2007 by \$2.0 billion. Net assets of governmental activities increased by \$1.7 billion, while net assets of the business-type activities increased by \$330.948 million.

Fund Level:

- As of the close of the fiscal year, the State's governmental funds reported combined ending fund balances of \$6.3 billion, an increase of \$756.846 million from the beginning of the year. Approximately 30% of the combined fund balances, or \$1.9 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 \$1.1 billion, or 6%, of total General Fund expenditures.
- The enterprise funds reported net assets at year end of \$3.1 billion, an increase of \$316.864 million during the year.
- The Land Endowments Fund reported fund balance at year end of \$2.5 billion, an increase of \$410.968 million during the year. The Land Endowments Fund is used to help finance public education within the State as required by the federal government and the State's Constitution.

Long-term Debt:

- The State's total long-term primary government debt increased during the fiscal year to \$6.0 billion, an increase of \$348.796 million (less than 6%). Changes during the year included the addition of revenue bonds and certificates of participation of \$474.530 million and \$171.146 million, respectively. Also, the State retired \$186.425 million of revenue bonds, \$42.570 million of grant anticipation notes, and \$243.730 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). Additionally, long-term assets and liabilities are reported regardless of when these assets are expected to be converted to cash, or when the liability is expected to be liquidated (e.g., capital assets and bonded debt).

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 67-70 and 110-122** 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 158** begins the individual fund data for the non-major funds. The State’s funds are divided into three categories – governmental, proprietary, and fiduciary – each category uses different accounting approaches.

- *Governmental funds* – Most of the State’s basic services are reported in the governmental funds, which focus on how money flows into and out of those funds and the balances left at year end that are available for future spending. The governmental fund financial statements provide a detailed short-term view of the State’s general government operations and the basic services it provides. Governmental fund information helps determine whether there are more or fewer financial resources that can be spent in the near future to finance the State’s programs. These funds are reported using modified accrual accounting, which measures cash and all other financial assets that can readily be converted to cash. Governmental funds include the general, special revenue, capital projects, debt service, and permanent funds. Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government’s near-term financing decisions. This report includes two schedules (**pages 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 pensions and other employee benefit trust funds, 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 125 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 158 of this report.

GOVERNMENT-WIDE FINANCIAL ANALYSIS

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

State of Arizona-Primary Government
Net Assets as of June 30, 2007 and 2006
(expressed in thousands)

	Governmental Activities		Business-type Activities		Primary Government Total	
	2007	2006	2007	2006, as restated	2007	2006, as restated
Current assets	\$ 4,742,906	\$ 4,723,241	\$ 1,979,651	\$ 1,804,687	\$ 6,722,557	\$ 6,527,928
Capital assets	15,812,417	14,989,475	3,094,701	2,881,535	18,907,118	17,871,010
Other non-current assets	4,781,778	3,555,772	1,065,324	937,469	5,847,102	4,493,241
Total Assets	25,337,101	23,268,488	6,139,676	5,623,691	31,476,777	28,892,179
Current liabilities	2,287,944	2,157,620	637,782	539,784	2,925,726	2,697,404
Non-current liabilities	4,131,458	3,887,329	2,428,517	2,341,478	6,559,975	6,228,807
Total Liabilities	6,419,402	6,044,949	3,066,299	2,881,262	9,485,701	8,926,211
Net assets:						
Invested in capital assets, net of related debt	13,500,218	12,878,151	1,180,518	1,140,959	14,680,736	14,019,110
Restricted net assets	4,742,094	3,560,868	1,575,991	1,400,455	6,318,085	4,961,323
Unrestricted net assets	675,387	784,520	316,868	201,015	992,255	985,535
Total Net Assets	\$ 18,917,699	\$ 17,223,539	\$ 3,073,377	\$ 2,742,429	\$ 21,991,076	\$ 19,965,968

The largest portion of the State's net assets (67%) represents *capital assets, net of related debt* of \$14.7 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. Refer to page 103 for explanation of Business-type Activities restatement.

The State's net assets also include \$6.3 billion (29%) 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 \$992.255 million (4%) represents *unrestricted net assets*.

The State's net assets increased \$2.0 billion during the current fiscal year. This increase was primarily caused by gains on sale of trust land and increases for sales taxes, tobacco taxes, unrestricted investment earnings, fair value of endowment investments, and capital assets for governmental activities. 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, 2007 and 2006
(expressed in thousands)

	Governmental Activities		Business-type Activities		Primary Government Total	
	2007	2006	2007	2006, as restated	2007	2006, as restated
Revenues:						
Program revenues:						
Charges for services	\$ 798,332	\$ 721,759	\$ 2,050,461	\$ 1,906,465	\$ 2,848,793	\$ 2,628,224
Operating grants and contributions	8,536,030	7,941,223	883,373	852,788	9,419,403	8,794,011
Capital grants and contributions	354,255	388,646	27,981	30,056	382,236	418,702
General revenues:						
Sales taxes	6,537,584	6,322,311	79,223	54,550	6,616,807	6,376,861
Income taxes	4,636,447	4,548,843	-	-	4,636,447	4,548,843
Tobacco taxes	358,205	248,122	-	-	358,205	248,122
Property taxes	43,736	43,035	-	-	43,736	43,035
Motor vehicle and fuel taxes	1,826,893	1,857,293	-	-	1,826,893	1,857,293
Other taxes	529,629	575,946	-	-	529,629	575,946
Unrestricted investment earnings	261,099	172,311	103,362	49,050	364,461	221,361
Unrestricted grants and contributions	11,711	12,293	-	-	11,711	12,293
Miscellaneous revenue	212,253	235,610	77,841	58,816	290,094	294,426
Gain on sale of trust land	451,501	567,364	-	-	451,501	567,364
Total Revenues	24,557,675	23,634,756	3,222,241	2,951,725	27,779,916	26,586,481
Expenses:						
General government	802,659	781,542	-	-	802,659	781,542
Health and welfare	9,789,699	9,057,733	-	-	9,789,699	9,057,733
Inspection and regulation	175,609	159,766	-	-	175,609	159,766
Education	5,984,196	5,304,555	-	-	5,984,196	5,304,555
Protection and safety	1,401,513	1,279,129	-	-	1,401,513	1,279,129
Transportation	583,304	386,777	-	-	583,304	386,777
Natural resources	193,862	187,947	-	-	193,862	187,947
Intergovernmental revenue sharing	2,864,543	2,658,636	-	-	2,864,543	2,658,636
Interest on long-term debt	191,674	172,439	-	-	191,674	172,439
Universities	-	-	2,960,790	2,762,557	2,960,790	2,762,557
Unemployment Compensation	-	-	248,111	226,171	248,111	226,171
Industrial Commission Special Fund	-	-	23,669	(18,300)	23,669	(18,300)
Lottery	-	-	363,508	377,104	363,508	377,104
Other business-type activities	-	-	176,486	136,894	176,486	136,894
Total Expenses	21,987,059	19,988,524	3,772,564	3,484,426	25,759,623	23,472,950
Excess (deficiency) before contributions, special items and transfers	2,570,616	3,646,232	(550,323)	(532,701)	2,020,293	3,113,531
Contributions to permanent endowments	-	-	4,815	3,803	4,815	3,803
Special item - intergovernmental transfer of Sundome Center for the Performing Arts	-	-	-	(7,874)	-	(7,874)
Transfers	(876,456)	(774,492)	876,456	774,492	-	-
Change in Net Assets	1,694,160	2,871,740	330,948	237,720	2,025,108	3,109,460
Net Assets - July 1, as restated	17,223,539	14,351,799	2,742,429	2,504,709	19,965,968	16,856,508
Net Assets - June 30	\$ 18,917,699	\$ 17,223,539	\$ 3,073,377	\$ 2,742,429	\$ 21,991,076	\$ 19,965,968

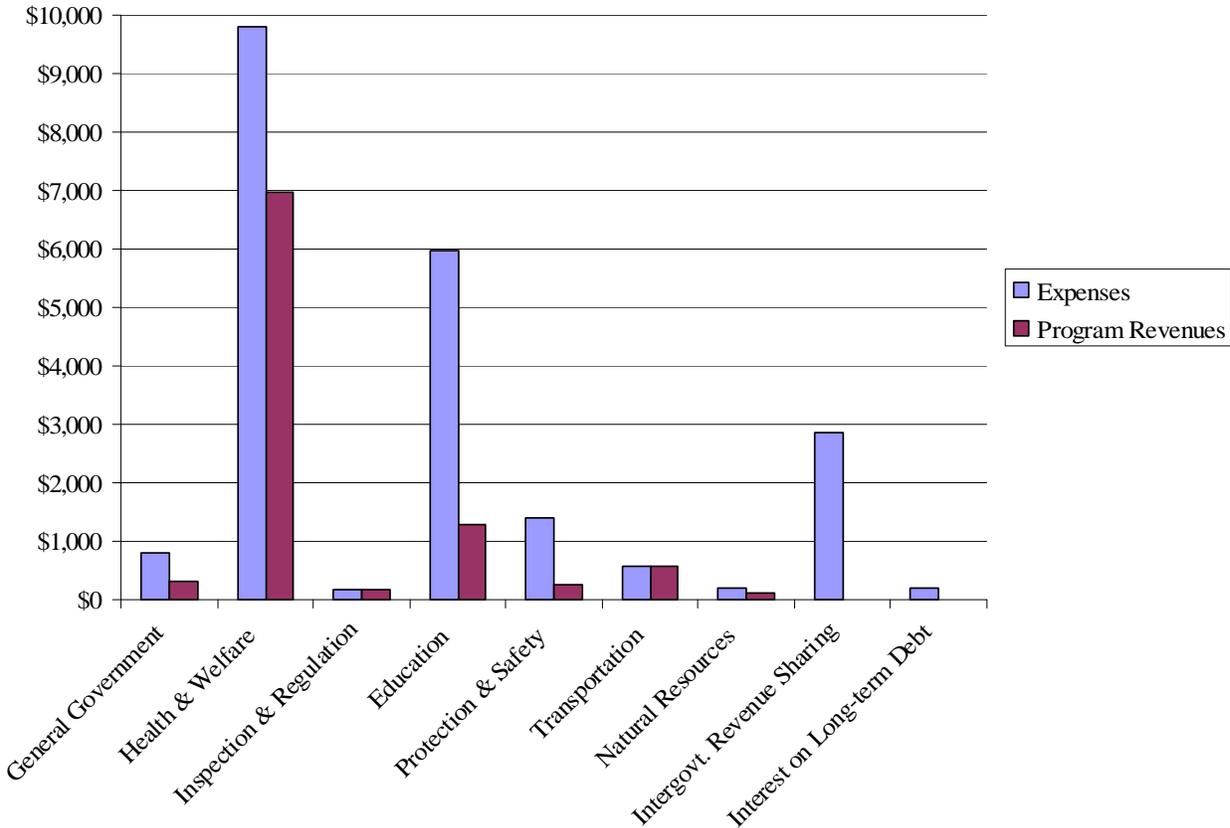
Change in Net Assets

Governmental Activities – Net assets increased by \$1.7 billion, or 10%. This increase was partially attributed to the increases in earned general tax revenues in excess of related expenses. However, some revenues were used to purchase capital assets, which will be expensed over time. The State recorded \$622.067 million of additional capital assets, net of any related debt used to acquire those assets, for governmental activities during the fiscal year. Reported sales tax and tobacco tax revenue increased by \$215.273 million, or 3%, and \$110.083 million, or 44%, as compared to fiscal year 2006, respectively. Several key elements have led to this increase. The State ranked second, nationally, in terms of the number of jobs added during fiscal year 2007, as reported by Arizona’s Department of Economic Security, Research Administration. Furthermore, annual estimates of the U.S. Census Bureau show that Arizona ranked second, nationally, in population growth, with a 2.7% increase, during fiscal year 2007. Additionally, during fiscal year 2007, personal income growth in Arizona, as reported by the U.S. Bureau of Economic Analysis, increased 6.4%, ranking Arizona tenth among all states in percentage change. Also, in December of 2006, proposition 203 increased the tobacco tax on cigarettes by \$0.039 per cigarette, which creates and funds the Early Childhood Development and Health Fund. The increase in the tobacco tax from proposition 203 created revenue of \$74.445 million, or 30% more tobacco tax revenue, as compared to fiscal year 2006. Additionally, the State’s improved efforts in tax enforcement resulted in the collection of \$585.930 million for fiscal year 2007 (an increase of \$55.929 million from the prior fiscal year). Another significant contributor to the net asset increase was auction sales of 4,262 acres in State trust land for gross sales of \$453.655 million. In many of these auctions there was intense, competitive bidding which raised the total sales price by approximately 14% above the appraised value. In addition, unrestricted investment earnings increased \$88.788 million, or 52%, compared to fiscal year 2006.

A comparison of the net cost (income) of services by function for the State’s governmental activities is shown below for fiscal years 2007 and 2006. 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.

	Governmental Activities (expressed in thousands)			
	Total Cost of Services		Net Cost (Income) of Services	
	2007	2006	2007	2006
Functions/Programs:				
General Government	\$ 802,659	\$ 781,542	\$ 497,769	\$ 525,480
Health and Welfare	9,789,699	9,057,733	2,809,369	2,454,326
Inspection and regulation	175,609	159,766	(2,167)	(678)
Education	5,984,196	5,304,555	4,698,423	4,247,978
Protection and safety	1,401,513	1,279,129	1,154,915	985,492
Transportation	583,304	386,777	382	(200,657)
Natural resources	193,862	187,947	83,534	93,880
Intergovernmental revenue sharing	2,864,543	2,658,636	2,864,543	2,658,636
Interest on long-term debt	191,674	172,439	191,674	172,439
Total Governmental Activities	<u>\$ 21,987,059</u>	<u>\$ 19,988,524</u>	<u>\$ 12,298,442</u>	<u>\$ 10,936,896</u>

Expenses and Program Revenues
Governmental Activities for Fiscal Year 2007
(in millions of dollars)



Business-type Activities – The net assets increased by \$330.948 million, or 12%. This increase was primarily caused by the net increase of the Unemployment Compensation Fund of \$125.119 million; a net increase in the Universities Fund of \$135.459 million; and a decrease in the Industrial Commission’s Special Fund deficit of \$71.123 million. The increase in net assets from the Unemployment Compensation Fund resulted from the collection of more unemployment assessments than benefits paid during the fiscal year as well as interest earnings on cash deposited with the U.S. Treasury. The increase in net assets for the Universities Fund was primarily attributed to increases in non-operating revenues; including an increased share of state sales tax revenues, increased State appropriations (transfers in), investment income, and gain on sale of capital assets. The Industrial Commission’s Special Fund deficit decreased primarily due to an increase in investment income. In addition, during fiscal year 2007, \$8.000 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 on the next page for fiscal years 2007 and 2006. 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.

	Business-type Activities (expressed in thousands)			
	Total Cost of Services		Net Cost (Income) of Services	
	2007	2006, as restated	2007	2006, as restated
Functions/Programs:				
Universities	\$ 2,960,790	\$ 2,762,557	\$ 1,031,059	\$ 961,344
Unemployment Compensation	248,111	226,171	(127,137)	(132,076)
Industrial Commission				
Special Fund	23,669	(18,300)	(19,072)	(52,394)
Lottery	363,508	377,104	(98,692)	(91,593)
Other	176,486	136,894	24,591	9,836
Total Business-type Activities	<u>\$ 3,772,564</u>	<u>\$ 3,484,426</u>	<u>\$ 810,749</u>	<u>\$ 695,117</u>

FINANCIAL ANALYSIS OF THE STATE'S FUNDS

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

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

General Fund

The General Fund is the chief operating fund of the State. At June 30, 2007, unreserved fund balance of the General Fund was \$1.1 billion, while total fund balance closed the year at \$1.9 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 5% of total expenditures and other financing uses, while total fund balance represents 10% of the same amount.

The fund balance of the State's General Fund decreased \$343.039 million during the fiscal year. The primary source of the decrease in fund balance is from the increase in transfers out. Transfers out from the General Fund increased \$369.864 million from fiscal year 2006, an increase of 40%. The increase is primarily due to the transfer of \$245.000 million to the Transportation and Aviation Planning, Highway Maintenance and Safety Fund in order to accelerate the construction of certain critical projects on the State highway system.

Another explanation of the decrease in fund balance is that expenditures increased by \$1.7 billion, while revenues only increased by \$732.290 million. In particular, sales tax revenues only increased \$239.267 million from fiscal year 2006, an increase of 4%. Sales taxes paid by retail stores and construction contractors increased approximately \$71.913 million and \$75.240 million, respectively, when compared to fiscal year 2006 sales tax receipts.

Health and welfare expenditures and intergovernmental revenue (including federal grants and county funding) increased by \$676.098 million, or 8%, and \$300.542 million, or 4%, as compared to fiscal year 2006, respectively. Overall program enrollment in the State's various healthcare programs increased 1.2%. Further, 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 2007. Utilization and inflationary trends for healthcare 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 5.6% for the contract period of October 2006 to September 2007, primarily due to pharmacy, physician, and inpatient costs. Additionally, utilization and inflationary trends of the Arizona Long Term Care System (ALTCS) contributed to an increase in health and welfare expenditures. The ALTCS capitation rate increased by 5.7% due to utilization and inflation adjustments for contract year July 2006 through June 2007. The resulting rate was subsequently increased an additional 3% to implement a legislated 4.1% provider rate increase. Additionally, the ALTCS caseload grew by approximately 6.5% during this period.

Education expenditures increased \$582.863 million, or 12%, compared to fiscal year 2006. The increase can be primarily attributed to an increase in State assistance for kindergarten through twelfth grade (K-12) operating expenditures largely to support an increase of 21,960 student enrollments and a 4.4% inflation adjustment. Additionally, programs supported by federal grant aid increased by approximately \$25.000 million during fiscal year 2007.

Protection and safety expenditures increased \$129.588 million, or 11%, compared to fiscal year 2006. The increase can primarily be attributed to a one-time expenditure of \$97.800 million from the General Fund to reduce the Highway User Revenue Fund and State Highway Fund monies for Highway Patrol to their respective \$10.000 million statutory caps.

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 (ADOT). Total fund balance increased \$379.530 million during fiscal year 2007. The fund balance increase was primarily due to the transfer of \$245.000 million of General Fund monies in order to accelerate the construction of certain critical projects on the State highway system. Also, distributions to other State agencies were \$49.600 million less than fiscal year's 2006 distributions due to 2005 Senate Bill 1513, Chapter 286, which required an additional \$49.600 million to be transferred from the Highway User Revenue Fund to the Department of Public Safety in fiscal year 2006.

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 \$410.968 million during fiscal year 2007. Endowment investments increased \$455.304 million, net of payable for securities purchased, at fiscal year end, due to receipts from land sales and a net increase in the fair value of investments of \$253.150 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 125**. Differences between the original budget of \$15.2 billion and the final amended budget of \$16.9 billion resulted in a \$1.7 billion increase in appropriations for the General Fund, before adjustments. Some of the primary reasons for the General Fund appropriations \$1.7 billion increase were:

1. \$251.162 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 Basic State Aid and Additional State Aid payments to school districts which was deferred in prior fiscal years
3. \$118.050 million to the Department of Education for full-day kindergarten funding
4. \$191.000 million to the Department of Education to payoff K-12 rollover that shifted from the FY06 appropriation
5. \$100.000 million to the Department of Education for the additional 2.4% above the minimum inflation factor required by Proposition 301
6. \$215.200 million to the Department of Education for Basic State Aid because the county equalization assistance rate did not exceed 8 cents

7. \$20.000 million for the Parks Board Growing Smarter transfer to the Land Conservation Fund per ARS §41-511.23
8. \$86.284 million to the School Facilities Board for the Building Renewal Fund
9. \$62.066 million to the Department of Corrections primarily for increased correctional officers' salaries and employee related expenses, and inmate healthcare costs
10. \$35.000 million to the Department of Commerce for the purpose of strengthening medical, scientific, and engineering research programs and infrastructure to promote statewide economic development
11. \$50.000 million that was appropriated in advance to the School Facilities Board by Laws 2005, Chapter 287, and not included in the FY 2007 General Appropriation Act.

The difference between the final budget and actual expenditures was \$746.835 million, after adjustments. Of this amount, \$162.657 million will continue as legislative multiple fiscal year spending authority for fiscal year 2008 and beyond, depending upon the budgetary guidelines of the Legislature. The remaining \$584.178 million represents the unused portion of the State's legislatively authorized annual operating budget.

Additional budgetary information can be found on pages 147-148 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, 2007 totaled \$18.9 billion, net of accumulated depreciation. The total primary government increase in capital assets for the current period was 6%, with a 5% increase in capital assets used for governmental activities and a 7% increase for business-type activities. Depreciation charges of the governmental and business-type activities for the fiscal year totaled \$314.941 million.

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

- The Universities' additions to capital assets totaled \$414.238 million and included increased investments in instruction, research, student housing, and campus police facilities.
- The ADOT started or completed roads and bridges totaling \$1.2 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 fund-level financial statements as expenditures.

Capital assets for the governmental and business-type activities as of June 30, 2007 are presented below (expressed in thousands):

	Governmental Activities		Business-type Activities		Total	
	2007	2006	2007	2006, as restated	2007	2006, as restated
Land	\$ 2,368,725	\$ 2,227,782	\$ 153,038	\$ 143,587	\$ 2,521,763	\$ 2,371,369
Buildings	1,677,197	1,527,996	3,431,338	3,101,431	5,108,535	4,629,427
Improvements other than buildings	138,329	133,624	3,600	3,601	141,929	137,225
Equipment	732,690	696,119	1,209,996	1,143,858	1,942,686	1,839,977
Collections (non-depreciable)	-	-	35,311	34,159	35,311	34,159
Infrastructure	9,861,750	9,386,364	326,218	305,975	10,187,968	9,692,339
Construction in progress	2,121,158	2,036,194	100,398	163,030	2,221,556	2,199,224
Less accumulated depreciation	(1,087,432)	(1,018,604)	(2,165,198)	(2,014,106)	(3,252,630)	(3,032,710)
Total	<u>\$ 15,812,417</u>	<u>\$ 14,989,475</u>	<u>\$ 3,094,701</u>	<u>\$ 2,881,535</u>	<u>\$ 18,907,118</u>	<u>\$ 17,871,010</u>

As provided by GASB Statement 34, the State has elected to record its infrastructure assets, that the ADOT is responsible for maintaining, using the modified approach. Assets accounted for under the modified approach include 6,817 center lane miles (18,573 travel lane miles) and 4,648 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 3.87 was achieved for fiscal year 2007.

The State manages its bridges using the Arizona Bridge Information and Storage System. 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 2007, a CRI of 93.6% 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 2007 (expressed in thousands):

<u>Project Description</u>	<u>Contract Start Date</u>	<u>Contract Amount</u>	<u>Current Year Expenditures</u>
Construction on Interstate 10 from Price Road to 29 th Street within the City of Tucson in Pima County.	09/18/06	\$ 200,300	\$ 28,463
Construction of State Route Loop 179 south of Sedona in Coconino and Yavapai Counties.	07/24/06	30,352	12,066
Construction of two traffic interchanges and related bridge work on Interstate 17 within the City of Phoenix in Maricopa County.	03/23/07	35,778	1,559
Construction of HOV lanes on State Route Loop 101 and State Route 51 within the City of Phoenix in Maricopa County.	04/23/07	40,207	989
Construction on Interstate 10 north of Tucson in Pima and Pinal Counties.	06/19/07	21,893	-
Construction on US 60 east of Apache Junction in Pinal County.	06/22/07	40,530	-

In addition to many smaller projects, the following major highway construction projects had expenditures in excess of \$15.000 million in fiscal year 2007 (expressed in thousands):

<u>Project Description</u>	<u>Project Expenditures</u>
State Route Loop 202 from Power Road to University Drive within the City of Mesa in Maricopa County.	\$ 91,392
US 60 from Gilbert Road to Power Road within the City of Mesa in Maricopa County.	44,977
State Route Loop 202 from University Drive to Southern Avenue within the City of Mesa in Maricopa County.	43,008
Interstate 10 from Price Road to 29 th Street within the City of Tucson in Pima County.	31,392
State Route Loop 101 and Interstate 17 interchange in Maricopa County.	28,866
State Route 179 south of Sedona in Coconino and Yavapai Counties.	26,147
State Route Loop 202 and US 60 interchange within the City of Mesa in Maricopa County.	23,591
Intersection of Interstate 40 and North Park Drive within the City of Winslow in Navajo County.	17,316

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

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

Long-term debt:

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

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

- The ADOT issued revenue bonds for \$325.000 million to finance portions of the Transportation Board’s Five Year Transportation Facilities Construction Program and pay the costs of issuing the bonds.
- The Universities issued revenue bonds for \$149.530 million to fund the acquisition, construction, or renovation of capital facilities and infrastructure. Furthermore, proceeds were used to refund the Northern Arizona University’s previously issued revenue bonds with a total outstanding balance of \$41.130 million.
- The Universities issued \$171.146 million of certificates of participation to current-refund previously issued certificates of participation with a total outstanding principal of \$41.400 million and refund previously issued certificates of participation with a total outstanding principal of \$124.595 million in advance of maturity.

State of Arizona-Primary Government
Outstanding Major Long-Term Debt as of June 30, 2007
(expressed in thousands)

	Governmental Activities		Business-type Activities		Total	
	2007	2006	2007	2006	2007	2006
Revenue bonds	\$ 2,328,840	\$ 2,106,700	\$ 868,565	\$ 802,600	\$ 3,197,405	\$ 2,909,300
Grant anticipation notes	282,860	325,430	-	-	282,860	325,430
Certificates of participation	959,865	1,020,810	935,127	946,766	1,894,992	1,967,576
Total	\$ 3,571,565	\$ 3,452,940	\$ 1,803,692	\$ 1,749,366	\$ 5,375,257	\$ 5,202,306

More detailed information regarding long-term debt begins on page 91.

ECONOMIC CONDITION AND OUTLOOK

Arizona’s economy continued to outpace the nation in fiscal year 2007, with growth in labor markets, population, and personal income. As previously mentioned, the State ranked second, nationally, in terms of the number of jobs added during fiscal year 2007, as reported by Arizona’s Department of Economic Security, Research Administration. Furthermore, annual estimates of the U.S. Census Bureau show that Arizona ranked second, nationally, in population growth, with a 2.7% increase, during fiscal year 2007. Additionally, during fiscal year 2007, personal income growth in Arizona, as reported by the U.S. Bureau of Economic Analysis, increased 6.4%, ranking Arizona tenth among all states in percentage change.

Arizona’s economy is projected to continue adding jobs in fiscal year 2007. However, job growth is expected to slow in the second half of 2007 with further slowing in 2008 as a result of a slowdown in the housing market and tightening credit markets. Nevertheless, Arizona’s economy was projected to grow at a faster rate than the nation in 2007 and 2008, 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**.