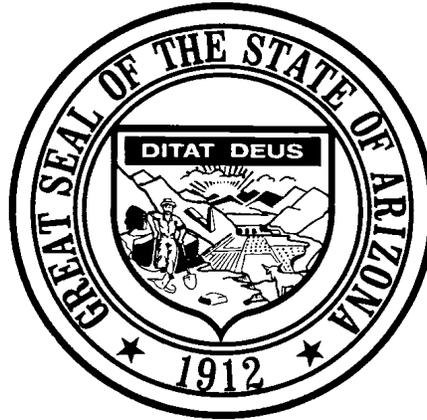


# ARIZONA FINANCIAL HIGHLIGHTS

## A REPORT TO THE CITIZENS OF THE STATE FOR FISCAL YEAR 2007

Prepared by the Arizona Department of Administration, General Accounting Office  
July 23, 2008

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**Janet Napolitano**  
Governor

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## **ARIZONA FINANCIAL HIGHLIGHTS**

### **INTRODUCTION**

*Arizona Financial Highlights* is intended to present certain basic financial information about the State of Arizona (State) in a simplified format. The financial information presented is prepared by the Arizona Department of Administration, General Accounting Office (GAO).

This report is not intended to take the place of other, more detailed accounting reports and records and should not be relied on by those seeking to buy or sell bonds or other obligations of the State. The State's Comprehensive Annual Financial Report (CAFR), provides audited, detailed information. The CAFR is prepared in accordance with U.S. generally accepted accounting principles and is independently audited by the Office of the Auditor General. Much of the information in the CAFR is necessarily technical and complex. As a result, the full financial statements may not be as useful to the citizens of the State who wish to better understand State government finances.

*Arizona Financial Highlights* represents the ongoing effort of State officials to keep Arizonans informed about the State finances and to be accountable in all respects for the receipt and expenditure of public funds.

State government reports its finances on the basis of a *fiscal year* that starts on July 1 and ends the following June 30. All information in this report is for the fiscal year 2007 that began on July 1, 2006, and ended on June 30, 2007, and includes financial information pertaining to the State's primary government, exclusive of the State's component units and fiduciary funds. Financial information regarding the State's component units and fiduciary funds may be found in the CAFR.

This report and other financial reports, such as the CAFR, can be found on the GAO web site at [www.gao.state.az.us](http://www.gao.state.az.us).

### **THE ARIZONA ECONOMY**

*The following economic summary is excerpted from the Arizona Department of Economic Security's Arizona's Workforce, released on September 6, 2007.*

The Arizona Department of Economic Security, Research Administration's (RA's) forecast update for 2007-08 shows Arizona's economy is expected to continue adding jobs over the two-year period. This forecast update calls for growth of 113,700 nonfarm jobs, with growth rates of 2.40% in 2007 and 1.70% in 2008. This suggests that the economy is slowing more than RA's earlier forecasts had predicted. RA's forecast in April was 3.70% for 2007 and 3.00% for 2008.

Arizona's economy is nevertheless expected to perform better than the national economy over the two-year period. Global Insight forecasts that the nation's nonfarm jobs will grow by 1.40% in 2007 and by 1.10% in 2008.

Economic expansion outside of the United States helps maintain growth in Arizona industries dependent on exports, such as natural resources and mining and tourism-related industries. Arizona's population growth is expected to continue at about the same pace of 6.10% over two years, according to RA's Population Statistics Unit.

While job growth rates are projected to decrease during 2007-08, Arizona's economy is expected to experience improving growth trends as some of the affects subside in the housing and finance (mortgage)

## **ARIZONA FINANCIAL HIGHLIGHTS**

industries. Population growth will eventually remove the surplus of unsold homes on the current market and provide the impetus of increasing demand for housing.

Natural resources and mining is projected to continue its strong growth, with 13.30% in 2007 and 6.00% in 2008. Almost 2,000 new jobs are expected to be added in Arizona's fastest growing industry. Demand for copper and other natural resource material is expected to remain strong in both the United States and abroad. In Arizona's rural areas and smaller urban counties, mining activity is projected to bolster other parts of the local economy.

Construction is projected to lose 2,400 jobs in 2007 and 12,100 jobs in 2008. The slowdown in the housing market and a tightening lending market hastens the construction employment losses. Much of the recent impacts from the sub-prime lending and adjustable-rate mortgage loans are expected to cause various private sector driven adjustments to lending practices.

Manufacturing forecasts call for a loss of about 900 jobs in 2007 and 300 in 2008. At six-tenths of one percent of its overall employment, manufacturing's losses over the two-year forecast period are relatively small. Recent losses in this sector have been the result of Arizona factory closures and consolidations in the computer and electronic parts sector. Continued military demand is expected to support aerospace product and parts and fabricated metal job growth.

Trade, transportation, and utilities employment is expected to have lower job growth than forecast in April 2007 as a result of the reduction in the growth rate of consumer spending and wavering consumer confidence. Despite this slowdown, trade, transportation, and utilities is forecast to add the largest number of jobs of any major industry group —27,000 during the forecast period. As has been the case for several earlier years, higher fuel and energy process are expected to continue to challenge transportation companies and consumers.

Information is forecast to lose slightly more than 600 jobs in 2007 and then gain 300 jobs in 2008. Recent employment trends in this industry have begun to shift away from several years of losses.

Job growth in the financial activities industry is projected to slow in 2007 as the financial industry adjusts with credit tightening and restructuring. In 2008, economic and population growth is forecast to bolster this industry despite weakness in the housing market. The financial activities group is forecast to add 2,200 jobs this year and 3,300 jobs in 2008.

Professional and business services is forecast to add 24,400 jobs, with 3.90% growth in 2007 and 2.20% next year. The slowing rates of growth are a result of the overall slowdown in the economy. Job growth is expected to be fairly good in professional, scientific, and technical services, while the other sectors will bear more of the brunt of the economic slowdown.

Educational and health services is projected to gain 23,000 jobs during the forecast period. The forecast for this industry is only slightly below that of the April 2007 figures. New health care facilities and schools continue to need staffing and will be necessary to meet population demands.

Leisure and hospitality is forecast to add more than 21,500 jobs. This industry is projected to do well from the domestic traveler seeking to explore Arizona and the Southwest, and from travelers from foreign markets taking advantage of the lower value of the U.S. dollar. This industry reached new record highs in 2006 and 2007, despite drought-related weather conditions in the Southwest.

## ARIZONA FINANCIAL HIGHLIGHTS

Other services is projected to add almost 8,700 jobs during the forecast period and represents the second largest percentage gain of any major industry group with increases of 5.10% in 2007 and 3.30% in 2008.

Government job growth is projected to slow slightly, as demand for public services continues from a growing population. Government is forecast to add more than 17,500 jobs over the forecast period.

In conclusion, Arizona's economy showed considerable job growth in 2006 — the fastest job growth state in the nation at 5.40%. However, considerable signs of a slowing national and local economy have caused RA's forecast update to show downward revisions to growth in 2007 and 2008. Regardless, over the forecast period, Arizona's economy is expected to outpace the national economy, which is expected to grow by 1.40% in 2007 and 1.10% in 2008, compared to Arizona's 2.50% and 1.70% growth, respectively.

### FINANCIAL INFORMATION

#### A. GOVERNMENT-WIDE ACTIVITIES

The State's government-wide financial statements report information about its financial position and operating results, taken as a whole. These government-wide statements include assets, liabilities, and operating results, using accounting practices that are similar to the ones used in the private sector. Additionally, the government-wide statement of activities separately presents revenues and expenses associated with specific government programs from general revenues not associated with these programs. This presentation allows for financial statement readers to quickly see the extent to which general revenues support specific government programs. These statements do *not* include fiduciary assets, such as pension funds, because those monies belong to participating members and not the State. Unless otherwise indicated, all tables and graphs in this report reflect the modified accrual basis of accounting. Major differences between **government-wide** financial statements (using *full accrual* accounting) and **fund-level** financial statements (using *modified accrual* accounting) include:

- Revenues are recognized when earned, regardless of when collected for government-wide reporting.
- Expenses for which goods or services have been received by the State, but not expected to be paid with current financial resources are reported in the government-wide financial statements.
- Certain expenses that are not recorded in the fund-level statements, such as depreciation expense and the amortization of bond premiums and discounts, are recorded in the government-wide statements.
- Certain transactions that resulted in revenues and expenditures in the fund-level statements have been reversed and recorded as assets and liabilities in the government-wide statements. Examples include bond proceeds (reported as additions to liabilities at the government-wide level) and capital outlay (reported as additions to capital assets at the government-wide level). Similarly, principal payments on long-term obligations are reported as reductions in long-term liabilities for government-wide reporting instead of debt service expenditures for fund-level reporting.

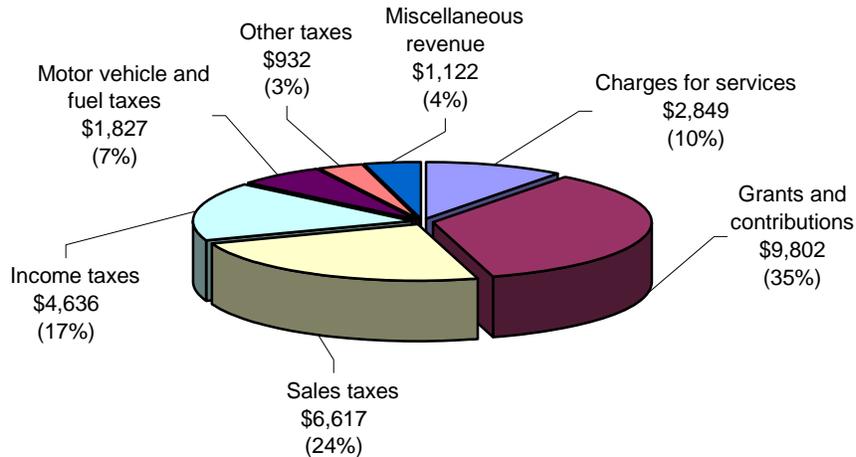
As of June 30, 2007, the State (excluding discretely presented component units) had government-wide assets of \$31.5 billion and liabilities of \$9.5 billion, resulting in net assets of \$22.0 billion. Of the total net assets, \$14.7 billion represents amounts invested in capital assets (infrastructure, land, buildings, and equipment, net of outstanding debt to finance these assets) and another \$6.3 billion is legally restricted to be spent on specific programs. The remaining surplus of \$992.3 million is unrestricted net assets, which do not meet the definition of "restricted" or "invested in capital assets, net of related debt."

## ARIZONA FINANCIAL HIGHLIGHTS

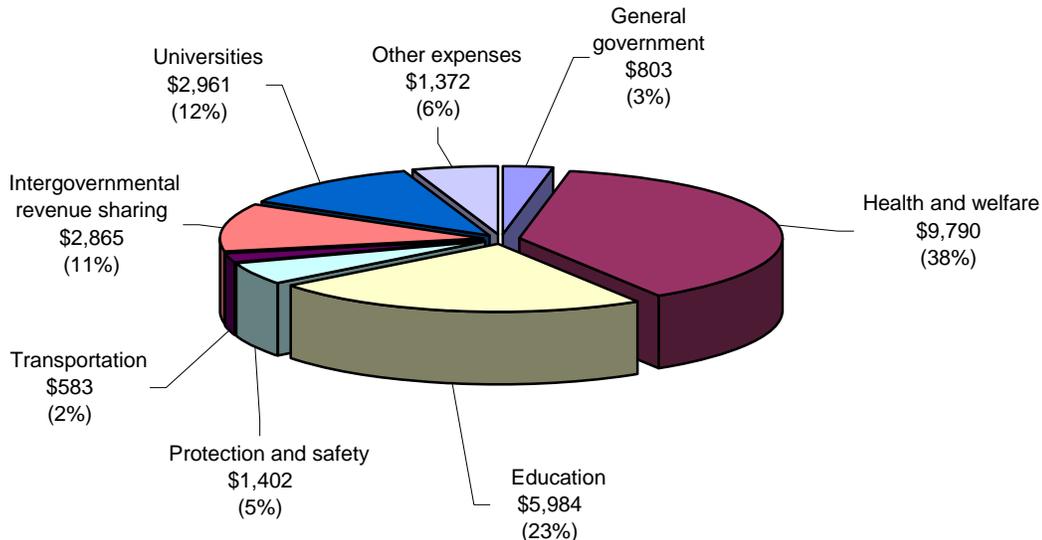
Unrestricted net assets often have limitations on their use, imposed by management, which may be removed or modified.

On a government-wide basis, the State (excluding discretely presented component units) had revenues of \$27.8 billion and expenses of \$25.8 billion during the fiscal year ending June 30, 2007.

### **Government-Wide Revenues Full Accrual Basis For the Fiscal Year Ended June 30, 2007 (in millions)**



### **Government-Wide Expenses Full Accrual Basis For the Fiscal Year Ended June 30, 2007 (in millions)**



**ARIZONA FINANCIAL HIGHLIGHTS**

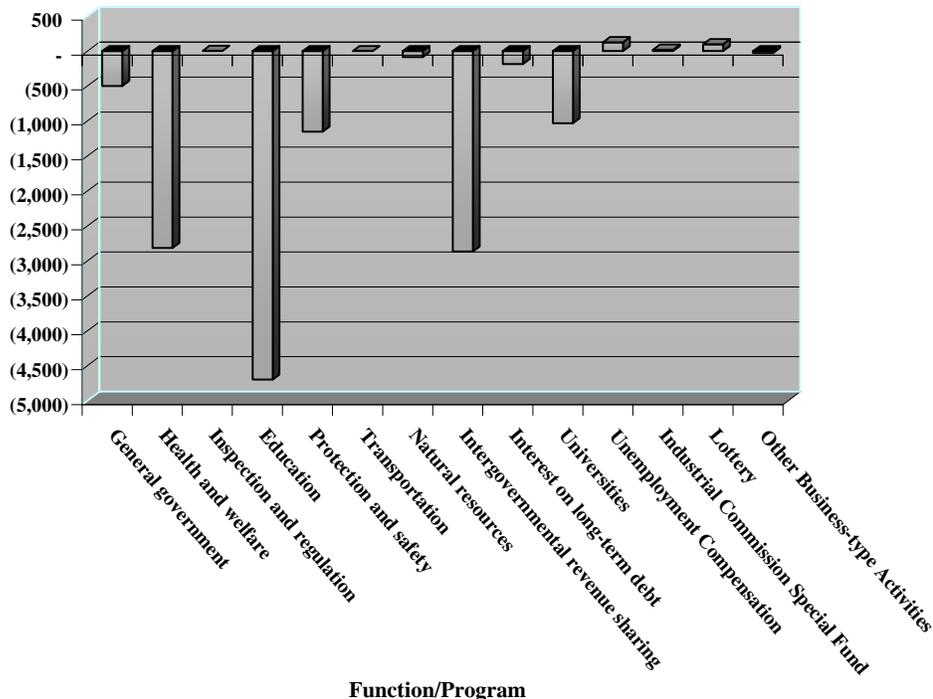
The primary government is further classified into Governmental Activities and Business-type Activities. Governmental activities include governmental programs such as Education and Health and Welfare programs, which are primarily financed by general revenues of the State, which include taxes, investment earnings, sales of State trust land, and other revenues. These programs are also directly financed by Federal Grants. Business-type Activities consist of entities which are primarily self-financed through charges for services rendered, similar to private sector businesses. An exception to the self-financing mechanism discussed for Business-type Activities is the Universities, whose operations are partially financed by general revenues of the State, in addition to direct charges to users, such as tuition.

For Governmental Activities, expenses totaled \$22.0 billion. Of the \$22.0 billion of expenses, \$9.7 billion, or 44%, was financed by direct charges for services rendered or intergovernmental grants. The remaining \$12.3 billion, or 56%, was financed by general revenues of the State. Although Education is the second largest expenditure of the governmental programs, it is most dependent upon General Revenues for financing its operations, followed by Health and Welfare. This is because the Health and Welfare function receives a larger percentage of its financing from Federal Grants which are specifically designated for these programs.

For Business-type Activities, expenses totaled \$3.8 billion. Of the \$3.8 billion of expenses, \$3.0 billion, or 79%, was financed by direct charges for services rendered. The remaining \$800.0 million was financed by general revenues of the State. With the exception of the Universities, all Business-type Activities are substantially self-financed.

The following graph depicts the State’s net program (expenses) revenues of its individual functions and the extent to which a function is self-financing or draws from the general revenues of the government:

**Government-wide Net (Expenses) Revenues  
Full Accrual Basis  
For the Fiscal Year Ended June 30, 2007  
(in millions)**



## ARIZONA FINANCIAL HIGHLIGHTS

### B. FUND LEVEL FINANCIAL STATEMENT INFORMATION

The State accounts for its revenues and expenditures within various *funds*. The largest fund supporting the operation of State government is the General Fund, which accounts for the majority of receipts from sales and income taxes. Other important funds include: the Transportation & Aviation Planning, Highway Maintenance & Safety Fund, which receives revenues from gasoline taxes, vehicle registration fees and a portion of sales taxes; and the Universities, which account for the financial activity of the three State universities.

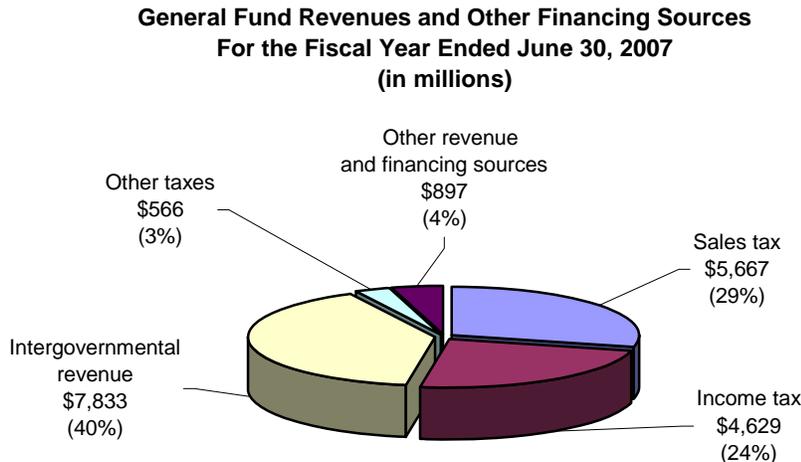
The State reports its revenues and expenditures under two different methods of accounting. Legally, the State accounts for its activities on a cash basis. This means that receipts are recognized when cash is received and expenditures are recognized essentially when cash is paid out. Cash basis accounting is easily verifiable and, therefore, is used to demonstrate State agencies' compliance with State laws.

The other method of accounting used in the State is accrual accounting. This method of accounting provides more detailed and comprehensive financial information. Therefore, the information presented in this report is on the accrual basis of accounting, unless otherwise stated. A *modified accrual* basis of accounting is used to present most **fund-level** financial statement information below (as opposed to a full accrual basis of accounting that was used to present government-wide information, in the previous section, and the Universities, below).

### GENERAL FUND

#### **Modified Accrual Basis:**

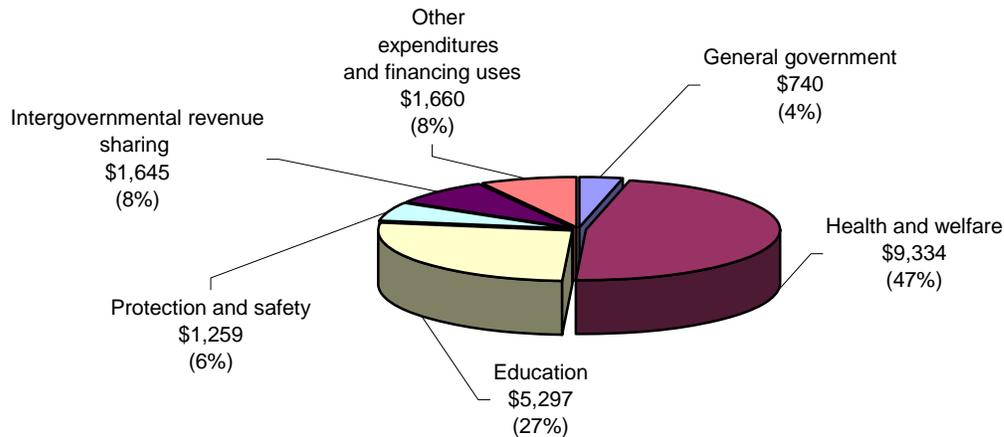
The General Fund has three major revenue sources: sales taxes, income taxes, and intergovernmental revenues. The General Fund had \$19.6 billion in total revenues and other financing sources during fiscal year 2007. Other financing sources include transfers from other State funds and proceeds from capital leases totaling \$282.5 million.



## ARIZONA FINANCIAL HIGHLIGHTS

General Fund expenditures and other financing uses, for fiscal year 2007, totaled \$19.9 billion. Other financing uses consist of transfers to other State funds in the amount of \$1.3 billion.

**General Fund Expenditures and Other Financing Uses  
For the Fiscal Year Ended June 30, 2007  
(in millions)**

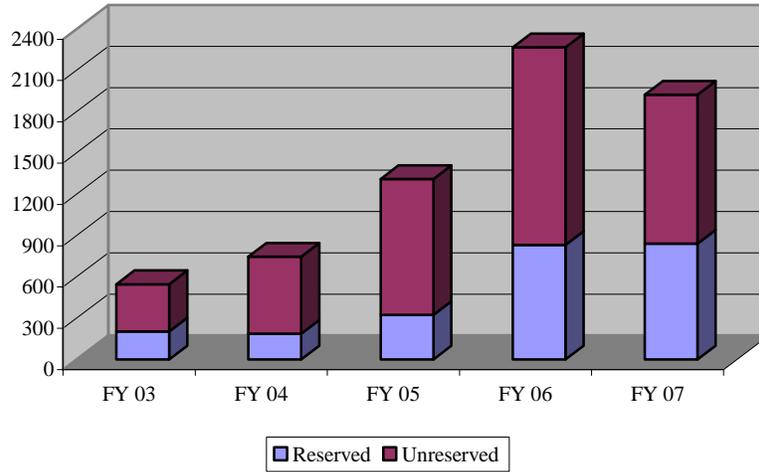


General Fund expenditures and other financing uses exceeded revenues and other financing sources by \$343.0 million in fiscal year 2007. The fiscal year deficit of \$343.0 million, when added to the \$2.3 billion beginning balance, produced a General Fund total fund balance, as of June 30, 2007, of \$1.9 billion. The primary causes of the 2007 fiscal year deficit were as follows:

- Revenue increased at a slower rate during fiscal year 2007 than expenditures. Revenue increased by \$732.3 million, or approximately 4% compared to fiscal year 2006. However, expenditures increased by \$1.7 billion, or approximately 10%, representing a 58% decrease in net revenues.
- Transfers out from the General Fund increased \$369.9 million from fiscal year 2006, an increase of 40%. The increase is primarily due to the transfer of \$245.0 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.

**ARIZONA FINANCIAL HIGHLIGHTS**

**General Fund - Fund Balance  
For the Last Five Fiscal Years  
(in millions)**



The balances shown in the above chart are described as either reserved or unreserved. At the end of fiscal year 2007, the General Fund had a reserved fund balance of \$841.4 million and an unreserved fund balance of \$1.1 billion. Balances are reserved if legal restrictions on the assets exist or if the amounts have already been appropriated for use in subsequent years. One such reservation is for the Budget Stabilization Fund (BSF), also known as the Rainy Day Fund, which was established in 1990. The BSF is a separate account administered by the State Treasurer, who is responsible for transferring General Fund money into and out of the BSF as required by law. This fund is designed to set revenues aside during times of economic growth and to spend these savings during times of an economic downturn. It is intended to stabilize the fiscal resources of the State through the business cycle. At the end of fiscal year 2007, the restricted balance in the BSF increased to \$673.5 million, compared to \$651.0 million at the end of fiscal year 2006. This increase is due to statutory required transfers from the General Fund as noted above.

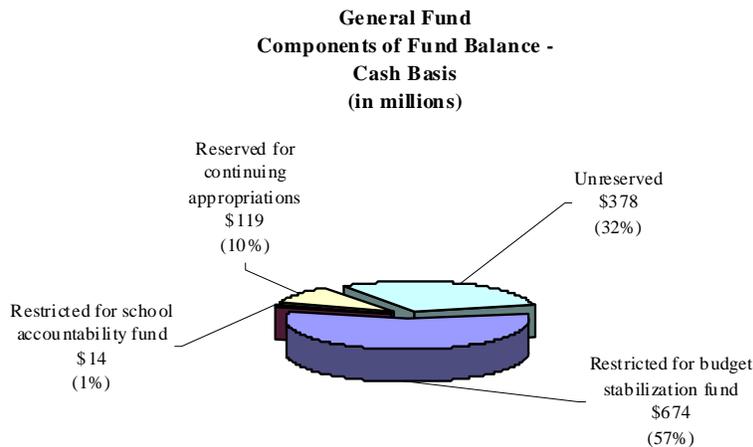
**ARIZONA FINANCIAL HIGHLIGHTS**

**Cash Basis:**

The State prepares its operating budget on the cash basis of accounting. On the cash basis of accounting, the General Fund had a fund balance of \$1.2 billion, as of June 30, 2007. This compares to a fund balance of \$1.8 billion for June 30, 2006. The following financial statements show the total assets, fund balance, and changes in the General Fund balance for the fiscal year 2007.

<b>General Fund Balance Sheet - Cash Basis</b>	
For the Fiscal Year Ended June 30, 2007 (in millions)	
<b>ASSETS:</b>	
Cash	\$ 1,185
<b>TOTAL ASSETS</b>	<b><u>\$ 1,185</u></b>
<b>FUND BALANCE:</b>	
Restricted:	
Budget stabilization fund	\$ 674
School accountability fund	14
Reserved For:	
Continuing appropriations	119
Unreserved	378
<b>TOTAL FUND BALANCE</b>	<b><u>\$ 1,185</u></b>

<b>Statement of Revenues, Expenditures and Changes in General Fund Balance - Cash Basis</b>	
For the Fiscal Year Ended June 30, 2007 (in millions)	
<b>REVENUES:</b>	
Sales and use taxes	\$ 4,539
Income taxes	4,090
Insurance premium taxes	398
Other taxes	95
Other revenues	430
<b>TOTAL REVENUES</b>	<b><u>\$ 9,552</u></b>
<b>EXPENDITURES:</b>	
Education	\$ 5,713
Health and welfare	2,481
Protection and safety	1,075
General government	843
Other expenditures	127
<b>TOTAL EXPENDITURES</b>	<b><u>\$ 10,239</u></b>
<b>REVENUES (UNDER)EXPENDITURES</b>	<b>\$ (687)</b>
<b>OTHER FINANCING SOURCES</b>	
Interest earnings	29
Transfers from other funds	70
<b>TOTAL OTHER FINANCING SOURCES</b>	<b><u>\$ 99</u></b>
<b>NET CHANGE IN FUND BALANCE</b>	<b>\$ (588)</b>
<b>FUND BALANCE, JULY 1, 2006</b>	<b><u>1,773</u></b>
<b>FUND BALANCE, JUNE 30, 2007</b>	<b><u>\$ 1,185</u></b>

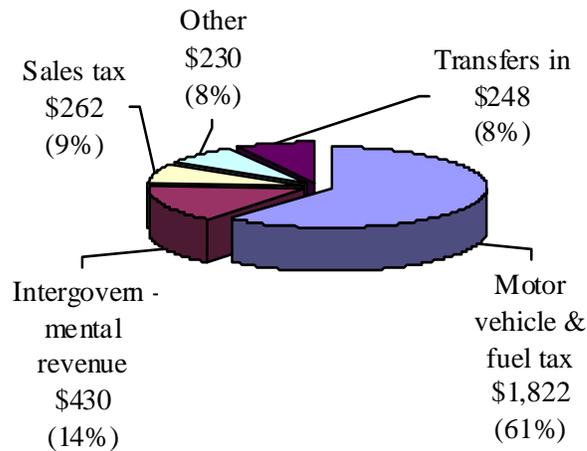


**ARIZONA FINANCIAL HIGHLIGHTS**

**TRANSPORTATION & AVIATION PLANNING, HIGHWAY MAINTENANCE & SAFETY FUND**

The Transportation & Aviation Planning, Highway Maintenance and Safety Fund pays for planning, developing, maintaining and operating facilities for the efficient movement of people and goods by surface and air throughout the State. Transportation & Aviation Planning, Highway Maintenance and Safety Fund revenue sources include the tax on motor fuel, vehicle registration fees, intergovernmental revenue, and driver licensing fees. Also, since 1986, one-half cent of the State's sales tax collected within Maricopa County is deposited into the Maricopa Regional Area Road Fund for construction of State highways within Maricopa County.

**Transportation & Aviation Planning, Highway Maintenance & Safety Fund  
Revenue and Other Financing Sources  
For the Fiscal Year Ended June 30, 2007  
(in millions)**



During fiscal year 2007, the Transportation & Aviation Planning, Highway Maintenance and Safety Fund had revenues and other financing sources of \$3.0 billion and expenditures and other financing uses of \$2.6 billion. Total fund balance increased \$379.5 million during fiscal year 2007. The fund balance increase was primarily due to the receipt of \$245.0 million of State General Fund monies in order to accelerate certain critical projects on the State highway system. Also, distributions to other State agencies were \$49.6 million less than fiscal year's 2006 distributions due to Laws 2005, 1<sup>st</sup> Regular Session, Chapter 286, Section 80, which required an additional \$49.6 million to be transferred from the Highway User Revenue Fund to the Department of Public Safety in fiscal year 2006.

At the end of fiscal year 2007, the following construction activity was planned:

- In June 2007, the Transportation Board approved a \$6.6 billion Highway Construction Program as part of the Five-Year Transportation Facilities Construction Program for fiscal years 2008 through 2012. This program provides funding for highway facilities on the National Highway System and the statewide system, as well as the new Maricopa County Regional Transportation Plan and the completion of the Maricopa Regional Freeway System Life Cycle Program. Altogether (including Maricopa County) the program includes \$4.9 billion for system improvements, \$538.0 million for system management, and \$1.1 billion for system preservation. As part of the Five-Year Transportation Facilities Construction Program, the State Transportation Board also adopted a \$760.6 million Five-Year Airport Development Program that includes 946 projects at general aviation and air carrier airports located throughout the State.

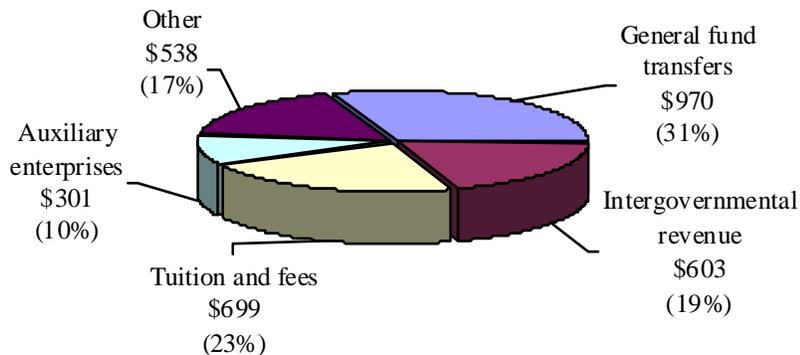
## ARIZONA FINANCIAL HIGHLIGHTS

- The Five-Year Transportation Facilities Construction Program includes approximately \$3.9 billion for the Maricopa Regional Transportation Plan and the completion of the Maricopa Regional Freeway System Life Cycle program of freeway construction in Maricopa County, funded in large part from the Maricopa County Regional Area Road Fund. The soon to be completed Maricopa Regional Freeway System Life Cycle Program will complete the construction of approximately 137 miles of new freeways. Currently, 132.3 miles have been opened to traffic and 4.7 more miles are under construction.
- Beginning in fiscal year 2006, the ADOT began to experience an unfavorable trend in the cost of many of its construction projects. Material and labor price increases, and in some cases shortages, resulted in materially higher bid prices than those estimated by the ADOT. How long this trend will continue, and the potential impact this trend may have on the Board's Five-Year Transportation Facilities Construction Program, cannot yet be determined. However, over the past few months, the ADOT has begun to see a softening in the rate of increase of material and labor prices.

### UNIVERSITIES

The Universities include the operations of the State's three public universities: Arizona State University (ASU), Northern Arizona University (NAU) and the University of Arizona (U of A). In fiscal year 2007, Arizona's universities had revenues, contributions, and transfers from other funds of \$3.1 billion, including a \$969.9 million transfer from the State's General Fund. This compares with fiscal year 2006 revenues, contributions, and transfers from other funds of \$2.8 billion, including an \$851.3 million transfer from the State's General Fund.

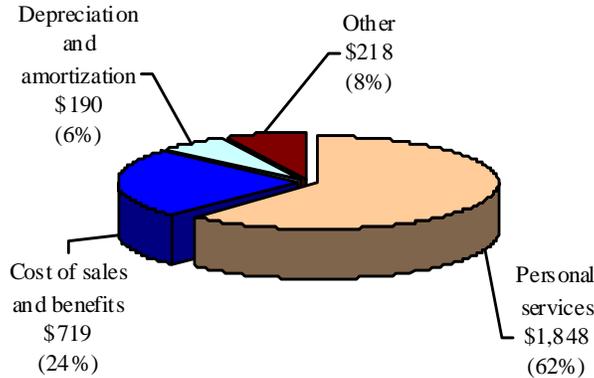
**Universities - Revenue Sources**  
**Full Accrual Basis**  
**For the Fiscal Year Ended June 30, 2007**  
**(in millions)**



Revenues are derived from numerous sources including student tuition and fees, grants, private gifts, contracts, share of State sales tax, and sales and services through the auxiliary enterprises. Auxiliary enterprises include the operations of substantially self-supporting activities such as housing, bookstore, student unions, and intercollegiate athletics. Revenues from auxiliary enterprises for fiscal year 2007 were \$300.8 million, net of scholarship allowances of \$9.3 million. Revenues from student tuition and fees for fiscal year 2007 were \$698.6 million, net of scholarship allowances of \$192.0 million. The Universities had expenses of \$3.0 billion during fiscal year 2007, compared with \$2.7 billion in fiscal year 2006.

## ARIZONA FINANCIAL HIGHLIGHTS

### **Universities - Expenses Full Accrual Basis For the Fiscal Year Ended June 30, 2007 (in millions)**



#### Other university highlights:

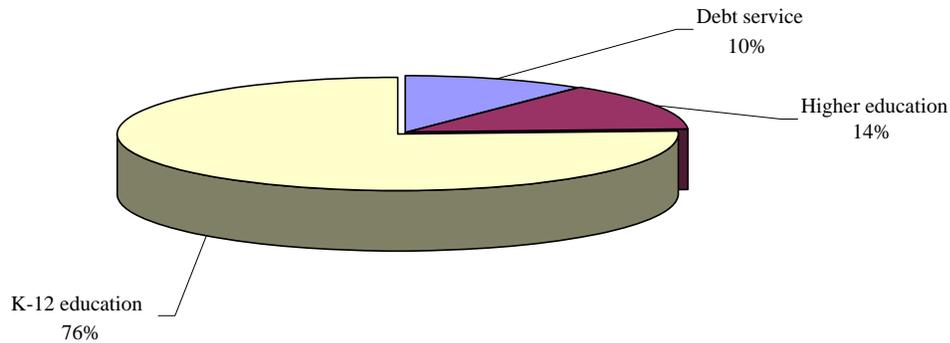
- Arizona's universities have \$3.0 billion in infrastructure, land, buildings, equipment, and other, net of accumulated depreciation, as of June 30, 2007.
- Total full-time equivalent enrollment continued to grow in fiscal year 2007. Enrollment for fall semester 2006 was 59,068 for ASU, 17,489 for NAU, and 34,023 for U of A, totaling 110,580 on a statewide basis.

#### **C. EDUCATION**

In fiscal year 2007, K-12 education was the second largest component of the State's expenditures. In November 2000, Arizona voters approved Proposition 301 that provided much needed financial resources to Arizona elementary and secondary public schools. Through a dedicated funding source, consisting of a 6/10<sup>th</sup> of a percent increase in the transaction privilege tax, school districts and charter schools realized additional funding for increased school days, school safety, character education, school accountability programs, and teacher salaries. This tax expires on June 30, 2021. In fiscal year 2007, approximately \$508.6 million of dedicated tax revenue was collected and allocated to K-12 schools and \$90.4 million was allocated to higher education. An additional \$65.8 million was allocated for debt service on revenue bonds used to finance deficiency corrections as discussed below.

## ARIZONA FINANCIAL HIGHLIGHTS

### Allocation of Proposition 301 Sales Tax Revenue for Fiscal Year 2007



As part of Proposition 301, the voters also authorized up to \$820.0 million in revenue bonding authority to cover the estimated \$1.3 billion cost of correcting school building deficiencies as required by Students FIRST legislation. Additionally, the Legislature passed Laws 2003, 1st Regular Session, Chapter 264, Section 22 giving the State an additional revenue bonding authority of \$247.1 million for correcting school building deficiencies. As of June 30, 2007, all of the proceeds arising from the bond issuances have been used in the State's deficiency correction program.

State law required that all deficiencies in existing public school buildings (excluding public charter schools) be corrected prior to July 2004. However, the Glendale Union School District and the Tucson Unified School District were not able to complete their deficiency corrections within the allotted time frame. As such, Laws 2005, 1st Regular Session, Chapter 287, Sections 6 and 7 (House Bill 2769) extended the deadline for completing these projects until June 30, 2006. As of June 2007, all deficiency correction projects (7,594 in total) were completed.

Finally, the State Land Department continues to generate significant revenue that benefits education through State land trust sales. The State Land Department holds a competitive bidding process for the sale of State trust land authorized by A.R.S. 37-231. State financed purchase contracts are awarded to the highest bidder. Executed Certificates of Purchase are recorded by the State at the close of escrow on these contracts for government-wide reporting, regardless of when the contract is settled. For fund level reporting, land sales revenue is recognized when contract payments are received by the State, or if the buyer has external financing to settle the contract in full at the time of purchase. The State had land auction sales in fiscal year 2007 of 4,262 acres of trust land for gross sales of \$453.7 million. This amount is reported in the government-wide financial statements. In many of these auctions there was intense, competitive bidding which raised the total sales price by approximately 14% above the appraised value.

At the fund level, the Land Endowments Fund total fund balance increased \$411.0 million during fiscal year 2007. Permanent fund endowment investments increased \$455.3 million at fiscal year end due to receipts from State Trust land sales and a net increase in the fair value of investments of \$253.2 million.

**ARIZONA FINANCIAL HIGHLIGHTS**

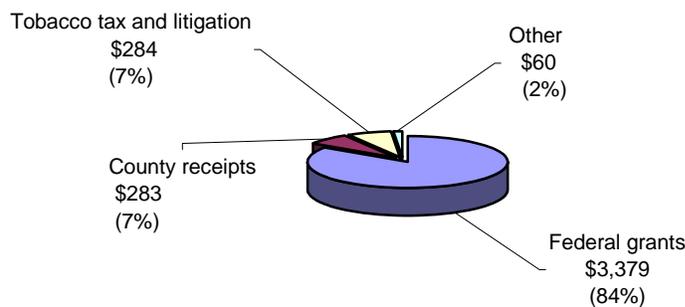
**D. HEALTH CARE SERVICES**

The State administers a variety of health care related programs through three major State agencies: The Arizona Department of Health Services, the Arizona Health Care Cost Containment System (AHCCCS), and the Arizona Department of Economic Security. The major programs administered by these agencies include Medicare and Medicaid, Behavioral Health, and Acute and Long-term Care for Arizona’s population which is in need of financial assistance for medical care. Health care services for the State are funded by a combination of Federal, State, and County funds.

The AHCCCS provides long-term and acute health care to eligible residents of the State. Eligible residents include those who qualify under Section 1931(b) of the Social Security Act, individuals who are aged, blind or disabled, children who meet certain age requirements from families receiving food stamps, and pregnant women and children whose household income levels meet eligibility requirements. Other low-income persons may qualify by meeting certain income and resource criteria as certified by their county eligibility office. Additionally, proposition 204, passed in November 2000, increased the indigent health care maximum income eligibility limit to 100% of the Federal Poverty Level. For the fiscal year ended June 30, 2007, the AHCCCS had revenue and other financing sources of \$4.0 billion, and expenditures and other financing uses of \$4.0 billion. This compares to revenues and other financing sources of \$3.8 billion, and expenditures and other financing uses of \$3.8 billion for the fiscal year ended June 30, 2006. These increases are due to utilization and inflationary trends for health care costs being incorporated into the rate development process for the managed care organization capitation rates. Due to increases in utilization and costs for pharmacy, physician, and inpatient costs, the capitation rates were increased by an average of 5.6% for the contract period of October 2006 to September 2007. The State received additional federal grants and county funding to cover a major portion of these increased costs.

The following graph shows relative percentages of funding sources for the AHCCCS:

**AHCCCS Revenue Sources  
For the Fiscal Year Ended June 30, 2007  
(in millions)**



## ARIZONA FINANCIAL HIGHLIGHTS

### **E. DEBT SERVICE AND CAPITAL PROJECTS FUNDING**

The State historically provides funding for capital projects on a “pay-as-you-go” basis, and limits them to those necessary for services to its citizens. However, due to budgetary constraints, the State will finance certain major capital projects. Essential major projects are being financed with revenue bonds, grant anticipation notes (GANs), and some lease purchase transactions.

Revenue bonds are associated with specific State functions and are funded by dedicated revenue sources. Revenue bonds have been issued for highway construction, which are funded primarily by gasoline taxes; building construction at the universities, which are funded by certain gross revenues; and statewide school deficiency corrections, which are funded by Education Transaction Privilege Taxes and approved by the voters under Proposition 301 on November 7, 2000, as well as State School Trust Revenues distributable pursuant to Arizona Revised Statutes, Section 37-521. Gross revenues for universities include revenues derived from fees, tuition, rentals and other charges from students, faculty, staff members and others being served by university facilities.

GANs are an innovative financing mechanism secured by revenues received from the Federal Highway Administration under a grant agreement and certain other federal-aid revenues. The State has issued GANs to help pay for the costs of acquiring right-of-way for design and construction of certain controlled-access highways within Maricopa County.

Lease purchase transactions are principally funded by certificates of participation (COPs). The State has used COPs primarily to construct prisons and to purchase and construct other buildings for State government operations. Additionally, the State has issued COPs to finance new school facilities approved by voters under Proposition 301.

Revenue bonds totaling \$474.5 million were issued and \$186.4 million were retired during fiscal year 2007. COPs totaling \$171.1 million were issued and \$243.7 million were retired during fiscal year 2007. In addition to funding capital projects with new debt, the State periodically assesses the interest rates on outstanding debt. When economically viable, the State refinances existing debt to take advantage of lower interest rates currently prevailing. The State refinanced two outstanding revenue bond issues and five outstanding COP issues during the fiscal year ended June 30, 2007. Both existing revenue bonds were partially refinanced, and four of the five refinanced COP issues were partial refundings. In general, the decision to partially refinance certain issuances is based upon a comparison of the present value cost of future debt service for existing serial bonds outstanding relative to the proposed debt service requirements of the new bond issuance. Occasionally, bonds or COPs are refunded for cash management purposes, even though the net present value cost of the new debt service is higher than the existing debt service cost. The above refinancing resulted in an economic gain to the State of approximately \$6.5 to \$9.9 million (a range of gain is calculated because variable rate debt was refinanced during fiscal year 2007, and future interest rates on variable rate debt are unknown). The following table shows amount of debt issued by project and debt instrument used to finance such projects during fiscal year 2007 (amounts in millions).

<b>Project</b>	<b>Revenue Bonds</b>	<b>COPs</b>
Highway construction	\$ 325.0	\$ -
Refinancing	42.2	171.1
Universities' capital facilities	107.3	-
Total issued in fiscal year 2007	\$ 474.5	\$ 171.1

**ARIZONA FINANCIAL HIGHLIGHTS**

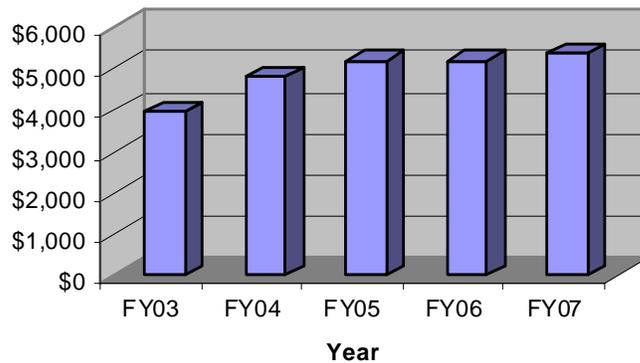
The outstanding revenue bonds, GANs and COPs for the primary government are as follows:

**State of Arizona  
Major Long-Term Obligations Outstanding  
As of June 30, 2007  
(in millions)**

Revenue bonds	\$3,197
Grant anticipation notes	283
Certificates of participation	<u>1,895</u>
<b>Total Major Long-Term Obligations</b>	<b><u>\$5,375</u></b>

The following graph shows the trend in major long-term obligations outstanding for the past five fiscal years. Major outstanding long-term obligations remained stable during fiscal year 2007 compared to fiscal year 2006 due to the substantial completion of school deficiency corrections financed by revenue bonds, and the change in method of financing new schools from COP financing to direct appropriation from the General Fund.

**Major Long-Term Obligations Outstanding  
For the Last Five Fiscal Years  
(in millions)**



**F. LITIGATION**

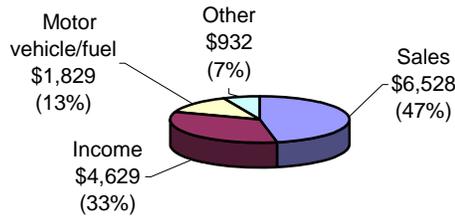
The State is a defendant in a number of lawsuits relating to various issues. The State recognizes a liability for the estimated amount the State is expected to pay as a result of an unfavorable outcome on any given litigation if (1) the amount to be paid can be reasonably estimated, and (2) it is probable that the outcome of such litigation would be unfavorable to the State. As of June 30, 2007, the State is not reporting an accrued liability for any pending litigation. The Ladewig vs. the Arizona Department of Revenue and Kerr vs. Killian settlements were fully paid during fiscal year 2007.

**ARIZONA FINANCIAL HIGHLIGHTS**

**G. TRENDS IN TAX REVENUE**

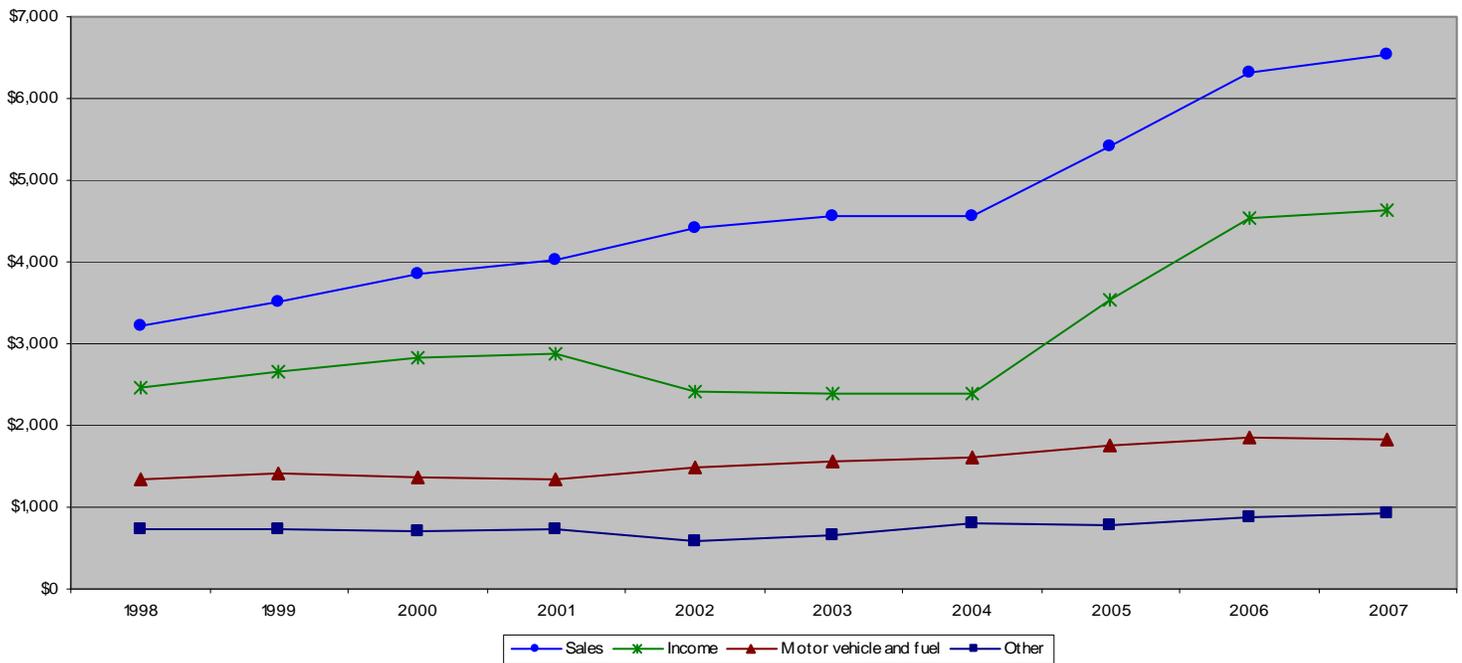
The State derives approximately 58% of its total revenues from taxes. The following graph shows the relative percentage of the different taxes earned by the State's governmental funds.

**Tax Revenues  
For the Fiscal Year Ended June 30, 2007  
(in millions)**



The following graph and table show the trend in tax revenue by type of tax. Included in other taxes are property tax, unemployment tax (through FY 2001 only), tobacco tax, and miscellaneous taxes collected by the State.

**Tax Revenue Trends  
For the Last Ten Fiscal Years  
(in millions)**



Tax Type	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Sales	\$ 3,210	\$ 3,508	\$ 3,854	\$ 4,020	\$ 4,425	\$ 4,556	\$ 4,985	\$ 5,410	\$ 6,313	\$ 6,528
Income	2,461	2,648	2,821	2,879	2,410	2,387	2,819	3,529	4,536	4,629
Motor vehicle and fuel	1,332	1,413	1,360	1,333	1,493	1,564	1,614	1,759	1,857	1,829
Other	723	738	719	732	593	670	814	777	867	932
<b>Total Tax Revenues</b>	<b>\$ 7,726</b>	<b>\$ 8,307</b>	<b>\$ 8,754</b>	<b>\$ 8,964</b>	<b>\$ 8,921</b>	<b>\$ 9,177</b>	<b>\$ 10,232</b>	<b>\$ 11,475</b>	<b>\$ 13,573</b>	<b>\$ 13,918</b>