ARIZONA FINANCIAL HIGHLIGHTS

A REPORT TO THE CITIZENS OF THE STATE
FOR FISCAL YEAR 2005

Prepared by the Arizona Department of Administration, General Accounting Office
June 16, 2006

Janet Napolitano
Governor

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 2005 that began on July 1, 2004, and ended on June 30, 2005, 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.

THE ARIZONA ECONOMY

The following economic summary is excerpted from the Arizona Department of Economic Security's Arizona's Workforce, released on September 1, 2005.

In comparison to the original forecast released in April 2005, the economy in Arizona is projected to grow at a faster rate over the forecast period from 2004 to 2006. For 2005, the projected growth rate has been increased to 4.6 percent and, for 2006, the projected pace of expansion is 3.7 percent. The revised nonfarm job increase for both years for 2004 to 2006 is 202,200 jobs, in comparison to the original forecast, with a gain of 191,300 jobs. Not only is the overall economy anticipated to grow at a faster rate, as demonstrated in the non-farm job figures, but most industries are projected to grow at a more rapid pace.

The projections are being revised upwards because of stronger than anticipated strength in the Arizona economy. Strong population growth in the State has bolstered major industries such as construction, trade, financial activities, leisure and hospitality, educational and health services and government. Economic growth in the rest of the nation and other parts of the world has also helped to strengthen the State's economy. Productivity enhancements from automation and information technology have contributed to this overall economic improvement. An improving domestic economy has persuaded businesses to increase their spending. This increased spending has also contributed to accelerating the economy. Rapid economic growth in other parts of the world such as China has increased demand for many globally traded commodities such as copper and, therefore, has resulted in rising prices. Higher copper prices have resulted in expansion in the metal ores sector of the natural resources and mining industry. Continued U.S. military operations abroad have bolstered employment in the aerospace products and parts sector of durable goods manufacturing. Strong construction activity has bolstered another durable goods manufacturing sector, fabricated metal products.

The economy will continue to grow over the forecast period despite rising costs for energy, health care and interest rates because incomes are expected to increase at a faster rate than costs. Rising interest rates will make consumer debt service more expensive and home mortgages less affordable. The removal of equity from the refinancing of home mortgages with rising housing prices has placed more money in the hands of consumers and has contributed to continued growth of consumer spending. However, housing price growth is expected to slow as interest rates rise and, therefore, slow equity removal and mortgage refinance activity. Higher health care and energy costs will absorb consumer disposable income and leave less money to be spent on other goods and services. These rising costs will slow, rather than stop, the current economic expansion.

The current economic expansion could potentially be halted if the costs of interest rates, energy and health care increase past a certain point where they absorbed a majority of consumer disposable income while not leaving enough funds to be spent on other items. Rising interest rates, a special concern, will make servicing high levels of consumer and federal government debt more expensive and crowd out other types of spending.

Construction is now projected to have an increase of 39,800 jobs over the forecast period. The revised projected growth rate for 2005 is 11 percent, which slows to 9 percent for 2006. In contrast, the original set of projections had a gain of 24,800 jobs. Population growth and the corresponding need to expand infrastructure are expected to drive growth in construction.

Manufacturing is forecast to add 4,800 jobs for an expansion rate of 1.5 percent for 2005 that accelerates to 1.2 percent for 2006. The increasing pace of expansion is the result of an anticipated increase in defense contracts. In contrast, the original set of projections had a gain of 3,900 jobs.

Natural resources and mining has a projected gain of 1,700 jobs, or a growth rate of 11 percent for 2005 and 9 percent for 2006. The previous forecast called for a gain of 500 jobs. The current labor dispute with the ASARCO mining company has resulted in a temporary decrease in natural resources and mining employment, especially in the sector of metal ore mining. The unknown duration of the strike has increased the level of uncertainty for projecting employment levels in this industry.

Trade is forecast to have an increase of 37,000 jobs from 2004 to 2006 with a growth rate of 5.6 percent for 2005 and 3.8 percent for 2006. Retail is anticipated to add 33,700 jobs while wholesale employment is projected to gain 3,300 jobs.

Financial activities is forecast to add 11,700 jobs in 2005 and 2006 for an expansion rate of 4 percent in 2005 and 3 percent in 2006. The original projections set called for an increase of 9,700 jobs.

Transportation, warehousing and utilities is a part of the economy where rising energy costs have caused a downward revision to growth in comparison to the original forecast. The revised set of projections has this sector adding 2,400 jobs for a growth rate of 1.8 percent in 2005 and 1.2 percent in 2006. However, the original forecast called for an increase of 2,800 jobs. The primary reason for the reduced growth rate, especially in transportation, is higher than originally anticipated fuel prices.

Information is following the trend of transportation, warehousing and utilities with downwardly revised forecast figures. The revised job losses have deepened to 4,300 jobs over the two-year period in contrast to a much smaller loss of 200 jobs in the original forecast. The reason for the downward revision is a deeper and longer than anticipated consolidation process in the telecommunications sector.

Professional and business services is expected to add 37,300 jobs, an expansion rate of 6 percent in 2005 and 4.9 percent in 2006. The original set of projection figures called for an increase of 37,700 jobs. Growth was revised downward for this industry group because of greater projected losses in the sector of business support services.

Leisure and hospitality is forecast to have an increase of 18,200 jobs, a growth rate of 4.3 percent for 2005 and 3.1 percent for 2006. The original projections set had an increase of 18,400 jobs.

Government is projected to have a gain of 19,300 jobs, or a rate of growth of 2.6 percent in 2005 and 2.2 percent in 2006. The original forecast called for an increase of 21,900 jobs.

The projected rate of expansion in educational and health services has been revised downward. This industry is now projected to have an increase of 29,500 jobs, or a pace of expansion of 6.0 percent in 2005 and 5.1 percent in 2006. The original forecast set the expansion to be an increase of 32,200 jobs. Growth projections for health care have been decreased because of the dampening effects of rapidly rising health care costs and shortages of workers in skilled occupations, while the slowing growth of the school age population, especially children in the primary and secondary school categories, has reduced the growth pace in educational and social services.

The revised projections for other services are unchanged from the original with an addition of 4,800 jobs for a growth rate of 2.8 percent in 2005 and 2.5 percent in 2006.

Overall, the remainder of 2005 and 2006 will be good for Arizona's economy with strong job growth in most industries. Information is the only exception with anticipated, accelerating losses. The factors of concern are rising interest and energy costs because if these two costs increase fast enough, then they have the potential to significantly slow down the State's economy.

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. 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 collection is made.
- Expenses are recorded for long-term obligations, such as accrued vacation time, regardless of when the payment is made.
- 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).

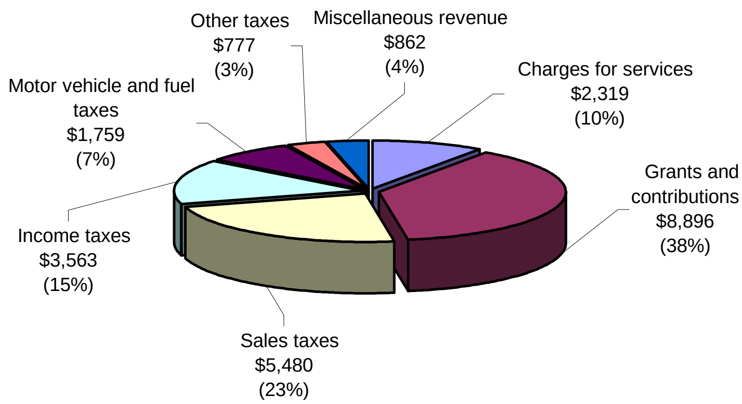
At June 30, 2005, the State (excluding fiduciary funds and discretely presented component units) had government-wide assets of $25.729 billion and liabilities of $8.873 billion, resulting in net assets of $16.856 billion. Of the total net assets, $12.993 billion represents amounts invested in capital assets (infrastructure, land, buildings, and equipment, net of outstanding debt to finance these assets) and another $4.170 billion is legally restricted to be spent on specific programs. The remaining deficit of ($307) million is unrestricted net assets, which do not meet the definition of "restricted" or "invested in capital assets, net of related debt." The unrestricted net assets deficit is primarily due to the financing method used to fund the construction and repair of Kindergarten through Twelfth grade (K-12) schools throughout the State. This financing method involves the State issuing bonded debt instruments, and entering into long-term lease-purchase agreements to fund the above referenced construction and repair. All assets related to the construction and repair of the K-12 school facilities belong to the school districts. However, since it is a State-financed obligation, the State reports the related liabilities in their financial statements. The outstanding balance of these K-12 school facility obligations at June 30, 2005 was $1.768 billion.

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

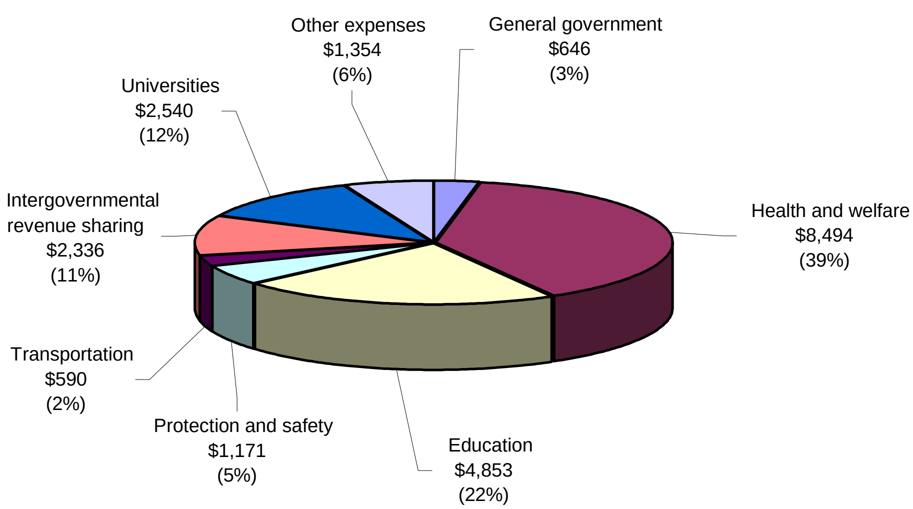
On a government-wide basis, the State (excluding fiduciary funds and discretely presented component units) earned $23.656 billion and spent $21.984 billion during the fiscal year ending June 30, 2005.

ARIZONA FINANCIAL HIGHLIGHTS

Government-Wide Revenues
Full Accrual Basis
For the Fiscal Year Ended June 30, 2005
(in millions)



Government-Wide Expenses
Full Accrual Basis
For the Fiscal Year Ended June 30, 2005
(in millions)



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 Fund, 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 **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).

GENERAL FUND

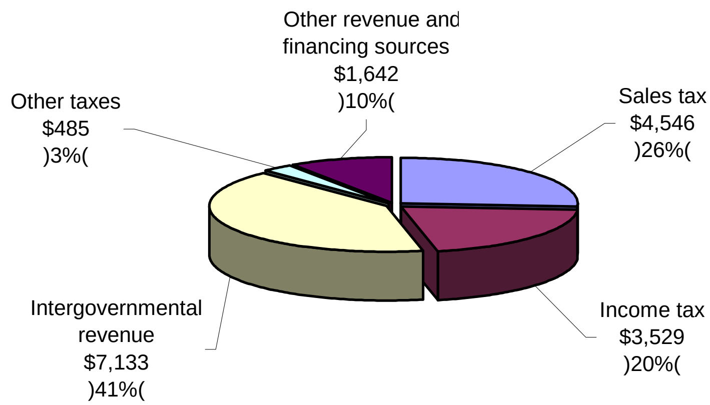
Modified Accrual Basis:

The General Fund has three major revenue sources: sales taxes, income taxes, and intergovernmental revenues. The General Fund had $17.335 billion in total revenues and other financing sources during fiscal year 2005. Other financing sources include transfers from other State funds and proceeds from issuance of long-term debt totaling $1.002 billion.

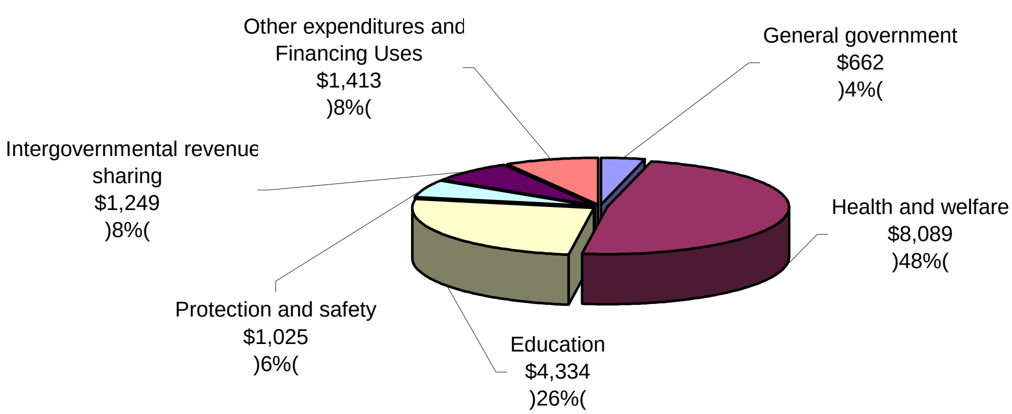
General Fund expenditures and other financing uses, for fiscal year 2005, totaled $16.772 billion. Other financing uses consist of payments to retire refunded debt and transfers to other State funds in the amount of $1.202 billion.

ARIZONA FINANCIAL HIGHLIGHTS

General Fund Revenues and Other Financing Sources
For the Fiscal Year Ended June 30, 2005
(in millions)

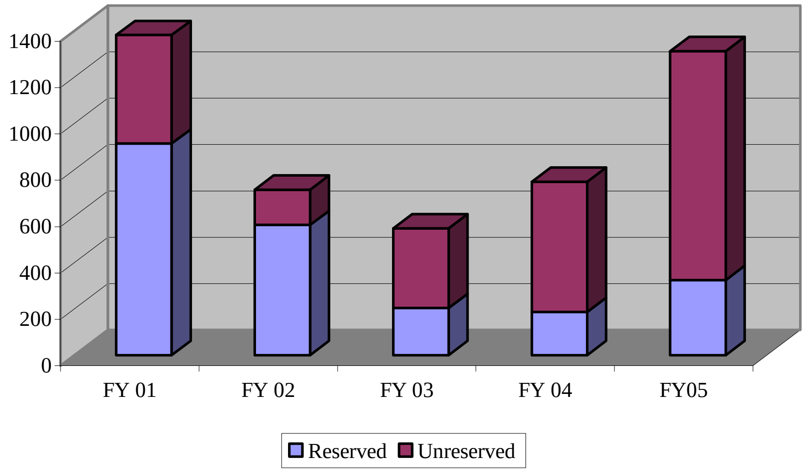


General Fund Expenditures and Other Financing Uses
For the Fiscal Year Ended June 30, 2005
(in millions)



General Fund revenues and other financing sources exceeded expenditures and other financing uses by $563 million in fiscal year 2005. The fiscal year excess of $563 million, when added to the $747 million beginning balance, produced a General Fund fund balance, as of June 30, 2005, of $1.310 billion. The increase in fund balance is due primarily to the increase of sales tax and income tax revenues. Sales tax revenues increased $345 million from fiscal year 2004, an increase of 8%. Sales taxes paid by retail stores, construction contractors, restaurants and bars, and out-of-state companies increased approximately $155 million, $111 million, $29 million and $21 million, respectively, when compared to fiscal year 2004 sales tax receipts. Income tax revenues increased $710 million, an increase of 25%. Income taxes paid by individuals increased by approximately $530 million when compared to fiscal year 2004 individual income tax receipts. In addition, income taxes paid by businesses increased approximately $180 million during the same period.

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



The balances shown in this chart are described as either reserved or unreserved. At the end of fiscal year 2005, the General Fund had a reserved fund balance of $324 million and an unreserved fund balance of $986 million. 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). The BSF 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 downtrend. It is intended to stabilize the fiscal resources of the State through the business cycle. At the end of fiscal year 2005, the restricted balance in the BSF increased to $161 million, compared to $14 million at the end of fiscal year 2004. This increase is due to statutory required transfers from the General Fund as noted above.

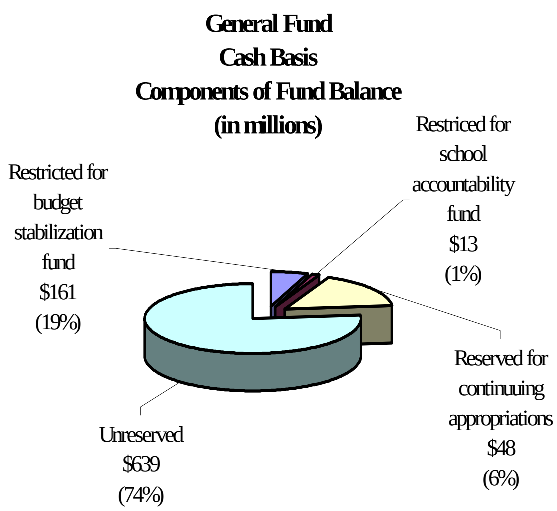
ARIZONA FINANCIAL HIGHLIGHTS

Cash Basis:

The State prepares its operating budget on a cash basis of accounting. On a cash basis of accounting, the General Fund had a fund balance of $861 million, as of June 30, 2005. This compares to a fund balance of $413 million for June 30, 2004. The following financial statements show the total assets and fund balance and changes in the General Fund balance for the fiscal year 2005.

General Fund Balance Sheet - Cash Basis
For the Fiscal Year Ended June 30, 2005

(in millions)	
ASSETS:	
Cash	$ 861
TOTAL ASSETS	$ 861
FUND BALANCE:	
Restricted:	
Budget Stabilization Fund	$ 161
School Accountability Account	13
Reserved For:	
Continuing Appropriations	48
Unreserved	639
TOTAL FUND BALANCE	$ 861



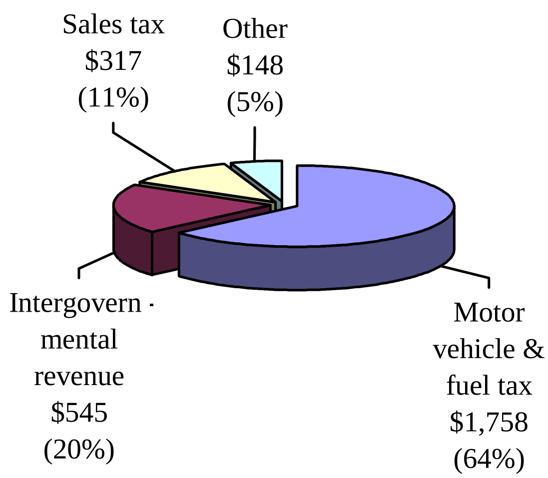
Statement of Revenues, Expenditure and Changes in General Fund Balance
Cash Basis
For the Fiscal Year Ended June 30, 2005

(in millions)	
REVENUES:	
Sales and Use Taxes	$ 3,609
Income Taxes	3,172
Insurance Premium Taxes	358
Other Taxes	126
Other Revenues	459
TOTAL REVENUES	$ 7,724
EXPENDITURES:	
Education	$ 4,226
Health and Welfare	1,885
Protection and Safety	744
General Government	627
Other Expenditures	96
TOTAL EXPENDITURES	$ 7,578
REVENUES OVER EXPENDITURES	$ 146
OTHER FINANCING SOURCES	
Transfers from Other Funds	$ 302
TOTAL OTHER FINANCING SOURCES	$ 302
NET CHANGE IN FUND BALANCE	$ 448
FUND BALANCE, JULY 1, 2004	413
FUND BALANCE, JUNE 30, 2005	$ 861

TRANSPORTATION & AVIATION PLANNING, HIGHWAY MAINTENENACE & 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 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, 2005
(in millions)



During fiscal year 2005, the Transportation & Aviation Planning, Highway Maintenance and Safety Fund had revenues and other financing sources of $2.768 billion and expenditures and other financing uses of $2.691 billion. Total fund balance increased $77 million during fiscal year 2005. The fund balance increase was primarily caused by a $28 million increase in sales taxes, a $145 million increase in motor vehicle and fuel taxes, and a $79 million increase in intergovernmental revenues. Fund balance was reduced by Laws 2004, 2nd Regular Session, Chapter 282, Section 5 (Senate Bill 1413) which required an additional $118 million to be transferred from fuel tax revenues to the State's General Fund. Further, there was also a $64 million increase in the distributions to Arizona counties and cities due to the increase in motor vehicle and fuel taxes. The fiscal year 2005 collections for sales taxes recorded the highest year-over-year growth since fiscal year 1996. The growth in sales taxes and motor vehicle and fuel taxes is due primarily to the increase in population, which tends to follow job growth. At the end of fiscal year 2005, the following construction activity was planned:

- In June 2005, the Transportation Board approved a $5.1 billion highway construction program as part of the Five-Year Transportation Facilities Construction Program for fiscal years 2006 through 2010. This program provides funding for highway facilities on both the National Highway System and the statewide system, as well as the new Maricopa County Regional Transportation Plan and the completion of the Maricopa Association of Governments (MAG) Life Cycle Program. The Five-Year Transportation Facilities Construction Program includes approximately $2.8 billion for freeway and expressway construction in Maricopa County (funded in large part from the Maricopa County Regional Area Road Fund), and $2.3 billion for statewide projects. Programmatically, the Arizona Department of

Transportation (ADOT) expects to spend 3.8 billion for system improvements, $526 million for system management and $837 million for system preservation. As part of the Five-Year Transportation Facilities Construction Program, the Transportation Board also adopted a $665 million Five-Year Airport Development Program that includes 1,049 projects at general aviation and air carrier airports located throughout the State.

- The current Regional Freeway Program in Maricopa County will have opened 138 miles of new freeways by the end of fiscal year 2008. Currently, 114 miles have been opened to traffic since 1995, 16 more miles are under construction and 8 miles are planned.

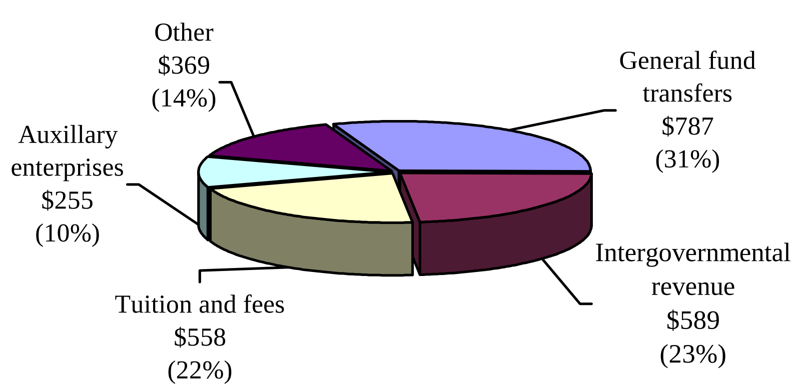
- On November 2, 2004, Maricopa County voters approved Proposition 400 which extends the one-half cent sales tax for another 20 years through December 31, 2025. The sales tax extension will be used for construction of new freeways, widening of existing freeways, improvements to the arterial street system, regional bus service and other special transportation services, and high capacity transit services such as light rail, and rapid transit and express buses.

- Since the end of the fiscal year, the ADOT has begun to see a disturbing trend in the cost of recently-bid construction projects. For a number of such projects, material and labor price increases, and in some cases shortages, have 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.

UNIVERSITY FUNDS

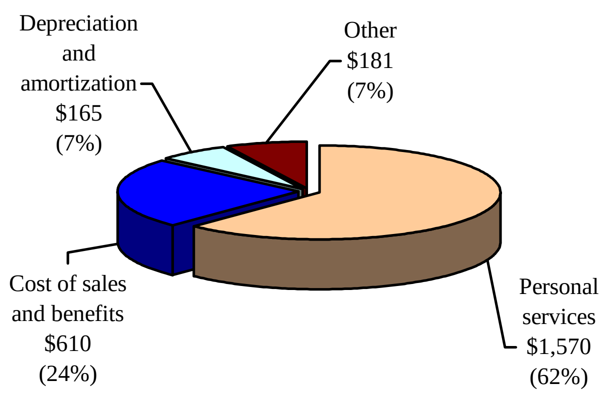
The University Funds include the operations of the State's three public universities: Arizona State University (ASU), Northern Arizona University (NAU) and the University of Arizona (U of A). In fiscal year 2005, Arizona's universities had revenues, contributions, and transfers from other funds of $2.558 billion, including a $787 million transfer from the State's General Fund. This compares with fiscal year 2004 revenues, contributions, and transfers from other funds of $2.377 billion, including a $741 million transfer from the State's General Fund.

University Funds Revenue Sources
Full Accrual Basis
For the Fiscal Year Ended June 30, 2005
(in millions)



Revenues are derived from numerous sources including student tuition and fees, grants, private gifts, contracts 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 2005 were $255 million, net of scholarship allowances of $6 million. Revenues from student tuition and fees for fiscal year 2005 were $558 million, net of scholarship allowances of $161 million. The universities had expenses of $2.526 billion during fiscal year 2005, compared with $2.346 billion in fiscal year 2004.

University Funds Expenses
Full Accrual Basis
For the Fiscal Year Ended June 30, 2005
(in millions)



Other university highlights:

- Arizona's universities have $2.632 billion in infrastructure, land, buildings and equipment, net of accumulated depreciation as of June 30, 2005.

- Total full-time equivalent enrollment continued to grow in fiscal year 2005. Enrollment for Fall semester 2005 was 56,900 for ASU, 16,628 for NAU, and 34,237 for U of A, totaling 107,765 on a statewide basis.

C. EDUCATION

In fiscal year 2005, 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 6/10th 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. In fiscal year 2005, approximately $532 million of dedicated tax revenue was collected and allocated to higher education and K-12 schools.

As part of Proposition 301, the voters also authorized up to $820 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 State legislature passed Laws 2003, 1st Regular Session, Chapter 264, Section 22 (House Bill 2534) giving the State an additional revenue bonding authority of $247 million for correcting school building deficiencies. Of this amount, $482.150 million in bonds were issued in June 2001, $6.350 million were issued in December 2001, and the remaining $331.5 million of bonds were issued in fiscal year 2003. Additionally, in October, 2003, the Arizona School Facilities Board issued $247.125 million of State School Trust Revenue Bonds, to finance the costs of correcting existing deficiencies in school facilities. These State School Trust Revenue Bonds were subsequently refinanced in fiscal year 2005 to a fixed interest rate structure. State law required that all deficiencies in existing public school buildings (excluding public charter schools) be corrected prior to July 2004, however, two school districts (Tucson Unified and Glendale Union) were not able to complete their deficiency corrections within the allotted time frame. Accordingly, 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 2005, 98% of all deficiency correction projects (5,548 in total) were under construction or complete. Although in prior fiscal years new school construction was still financed on a cash-basis, new legislation established the lease purchase program, a new long-term financing plan for new school construction. Accordingly, in prior fiscal years, $614.500 million of lease purchase agreements (Certificates of Participation) were issued. An additional $571.850 million of Certificates of Participation were issued in fiscal year 2005. Of the $571.850 million, $237.625 was issued to finance new school construction. The remaining $334.225 was issued to refinance existing variable rate Certificates of Participation, to fixed rate Certificates of Participation, thus reducing the State's exposure to unfavorable interest rate fluctuations. Laws 2005, Chapter 287 mentioned above prohibits the School Facilities Board from issuing more Certificates of Participation. Future new school construction will be financed directly from the General Fund. Further details of the State's debt financing activity are discussed in a separate section later in this report.

Finally, the State Land Department continues to generate significant revenue that benefits education through State land trust sales. Land sales in fiscal year 2005 totaled approximately $288 million. The Land Endowments Fund total fund balance increased $355 million during fiscal year 2005. Unrealized valuation increases for investments at fiscal year end, compared to the initial investment purchase price, were approximately $76 million. This increase was primarily due to the rise in stock values of the S&P 500 and S&P Mid Cap 400 Index Pools held by the State. Payments from the sale of trust land by the Land Department increased by approximately $125 million, from $149 million during fiscal year 2004 to $274 million during fiscal year 2005. This increase is primarily the result of land contract payoffs that occurred for sales in prior fiscal years.

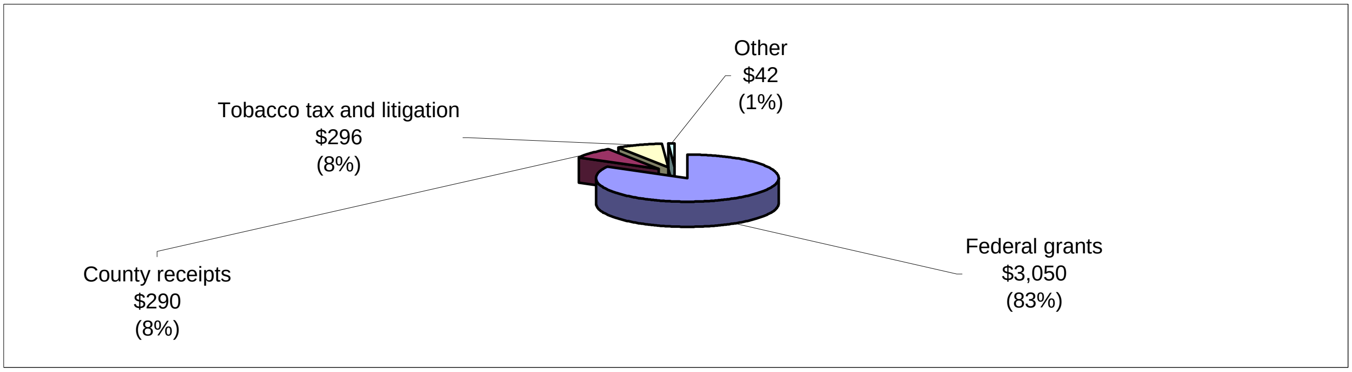
D. HEALTH CARE SERVICES

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 medically needy population. 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 receive Temporary Assistance for Needy Families, Supplemental Security Income, 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 the year ended June 30, 2005, the AHCCCS had revenue and other financing sources of $3.7 billion, and expenditures and other financing uses of $3.7 billion. This compares to revenues and other financing sources of $3.3 billion, and expenditures and other financing uses of $3.3 billion for the fiscal year ended June 30, 2004. These increases are due to inflationary trends for health care costs being incorporated into the rate development process for the managed care organization capitation rates. Due to substantial increases in utilization and costs for pharmacy (37%), physician (21%), and transportation and inpatient (14%), the capitation rates were increased by an average of 6% for the contract period of October 2004 to September 2005. The inflation rate is indicative of medical inflation. 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 Fiscal Year Ended June 30, 2005
(in millions)



E. DEBT SERVICE AND CAPITAL PROJECTS FUNDING

The State historically financed capital projects on a "pay-as-you-go" basis. However, due to budgetary constraints, the State has significantly limited 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 gross revenues, and statewide school deficiency corrections, which are funded by Education Transaction Privilege Taxes, approved by the voters under Proposition 301 on November 7, 2000, as well as State School Trust Revenues distributable pursuant to Arizona Revised Statues, 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 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 $574.7 million were issued and $670.9 million were retired during fiscal year 2005. COPs totaling $843.8 million were issued and $415.5 million were retired during fiscal year 2005. 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 six outstanding revenue bond issues and six outstanding COP issues during the fiscal year ended June 30, 2005. Of the six revenue bond refundings, two existing revenue bonds were fully refinanced, while four existing revenue bonds were partially refinanced. All six of the 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 COP's 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 $12 million. The following table shows amount of debt issued by project and debt instrument used to finance such projects during fiscal year 2005 (amounts in millions).

Project	Revenue Bonds	COPs	GAN's
Highway construction	$ 188.3	$ -	$ 104.4
School facilities construction and improvements	22.3	237.6	-
Refinancing	327.1	378.2	-
Universities' capital facilities	37.0	228.0	-
Total issued in fiscal year 2005	$ 574.7	$ 843.8	$ 104.4

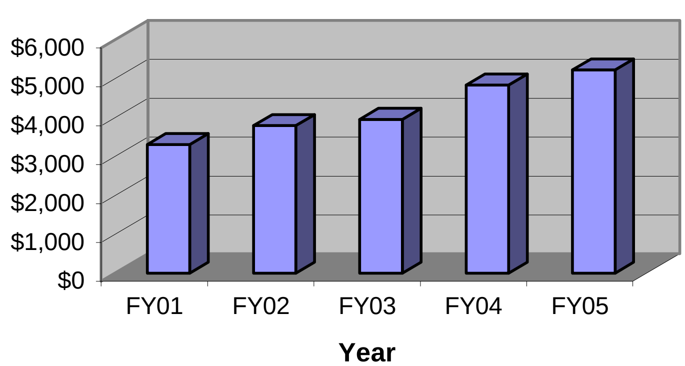
The outstanding revenue bonds, GANs and COPs for the primary government are as follows.

State of Arizona
Long-Term Obligations Outstanding
As of June 30, 2005
(in millions)

Revenue bonds	$2,938.8
Grant anticipation notes	364.0
Certificates of participation	1,915.4
Total Long-Term Obligations	**$5,218.2**

The following graph shows the trend in long-term obligations outstanding for the past five fiscal years. The increase in long-term obligations from fiscal 2004 to fiscal year 2005 is primarily due to revenue bonds and COPs being issued to finance school facilities improvements and construction, higher education research facilities and housing, and highway construction being financed through the issuance of revenue bonds.

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



F. LITIGATION

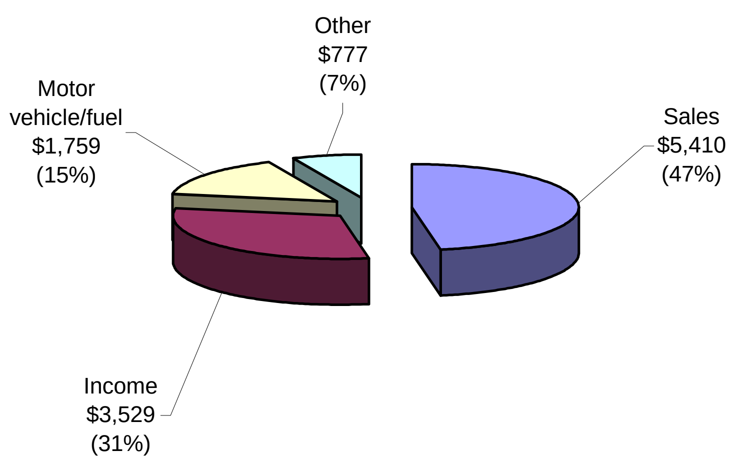
The State is a defendant in a number of lawsuits relating to various issues. The State recognizes a liability for the estimated amount the State is expected to pay as a result of an unfavorable outcome on any given litigation if (1) the amount to be paid can be reasonably estimated, and (2) it is probable that the outcome of such litigation would be unfavorable to the State. This amount is included in the State's financial statements regardless of when amounts are expected to be paid.

Ladewig vs. Arizona Department of Revenue, is a class action tax refund case. The class members are seeking refunds for Arizona Income tax paid on dividends received from corporations doing less than 50% of their business in Arizona during the years 1986 through 1989. The trial court held that such taxes violated the Commerce clause of the U.S. Constitution and certified the class. The class certification was upheld by the Arizona Supreme Court in 2001. The Tax Court approved a proposed settlement in December 2002. The State initially estimated this litigation to result in a liability to the State of $350 million. However, that estimate has been revised in fiscal year 2004 to $308 million. The estimated total liability was again revised in fiscal year 2005 to approximately $300 million. During fiscal year 2005, the State paid approximately $133.1 million, leaving an estimated remaining liability of $150.9 million. This estimated remaining liability is reflected in the State's financial Statements.

G. TRENDS IN TAX REVENUE

The State derives approximately 56% of its total revenues from taxes. The following graph shows the relative percentage of the different taxes earned by the State's governmental funds.

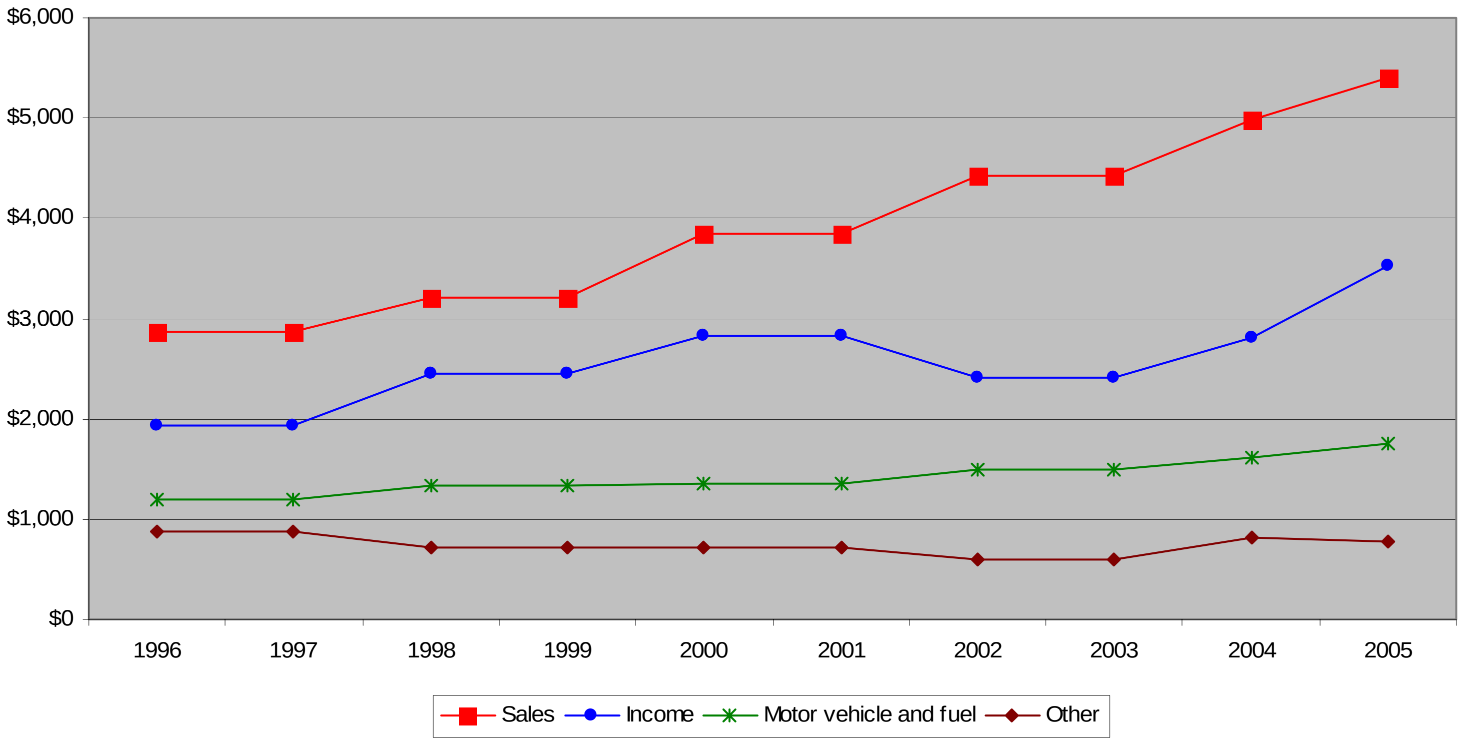
Tax Revenues
For Fiscal Year Ended June 30, 2005
(in millions)



ARIZONA FINANCIAL HIGHLIGHTS

The following graph and table shows 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	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Sales	$ 2,868	$ 3,060	$ 3,210	$ 3,508	$ 3,854	$ 4,020	$ 4,425	$ 4,556	$ 4,985	$ 5,410
Income	1,934	2,290	2,461	2,648	2,821	2,879	2,410	2,387	2,819	3,529
Motor vehicle and fuel	1,197	1,288	1,332	1,413	1,360	1,333	1,493	1,564	1,614	1,759
Other	883	764	723	738	719	732	593	670	814	777
Total Tax Revenues	$ 6,882	$ 7,402	$ 7,726	$ 8,307	$ 8,754	$ 8,964	$ 8,921	$ 9,177	$ 10,232	$ 11,475