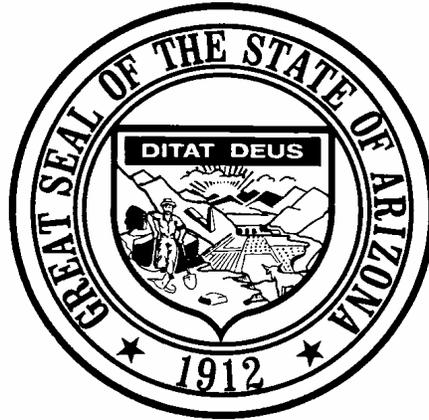


# ARIZONA FINANCIAL HIGHLIGHTS

## A REPORT TO THE CITIZENS OF THE STATE FOR FISCAL YEAR 2006

Prepared by the Arizona Department of Administration, General Accounting Office  
July 26, 2007

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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 2006 that began on July 1, 2005, and ended on June 30, 2006, 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 August 31, 2006.*

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

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

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

## **ARIZONA FINANCIAL HIGHLIGHTS**

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

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

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

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

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

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

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

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

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

Leisure and hospitality is projected to add almost 21,000 jobs over the 2006-2007 period. Growth in this industry will be sustained by a growing economy. Sustained high fuel prices and greater air travel restrictions

## ARIZONA FINANCIAL HIGHLIGHTS

are expected to dampen some related tourist demand. Arizona activity is expected to be supported by domestic (local and U.S.) demand as an option to consumers traveling abroad.

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

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

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

### 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, 2006, the State (excluding discretely presented component units) had government-wide assets of \$28.895 billion and liabilities of \$8.926 billion, resulting in net assets of \$19.969 billion. Of the total net assets, \$14.022 billion represents amounts invested in capital assets (infrastructure, land, buildings, and equipment, net of outstanding debt to finance these assets) and another \$4.961 billion is legally restricted to

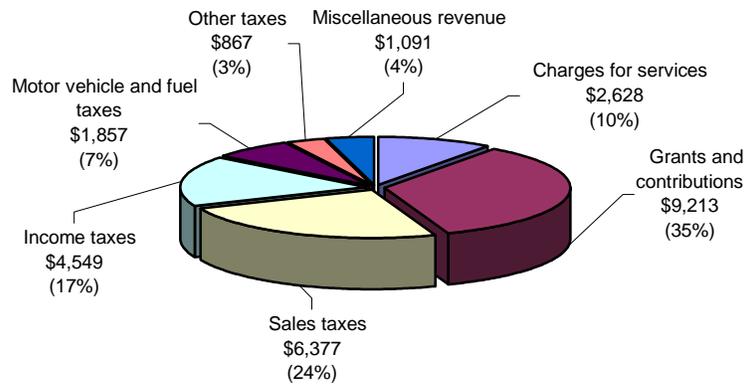
**ARIZONA FINANCIAL HIGHLIGHTS**

be spent on specific programs. The remaining surplus of \$986 million is unrestricted net assets, which do not meet the definition of “restricted” or “invested in capital assets, net of related debt.”

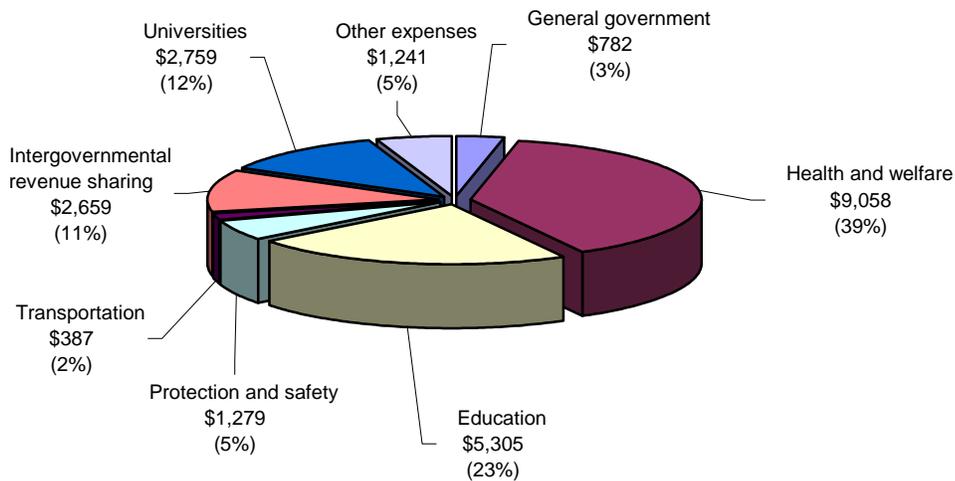
Unrestricted net assets often have limitations on their use, imposed by management, which may be removed or modified.

On a government-wide basis, the State (excluding discretely presented component units) had revenues of \$26.582 billion and expenses of \$23.470 billion during the fiscal year ending June 30, 2006.

**Government-Wide Revenues  
Full Accrual Basis  
For the Fiscal Year Ended June 30, 2006  
(in millions)**



**Government-Wide Expenses  
Full Accrual Basis  
For the Fiscal Year Ended June 30, 2006  
(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.

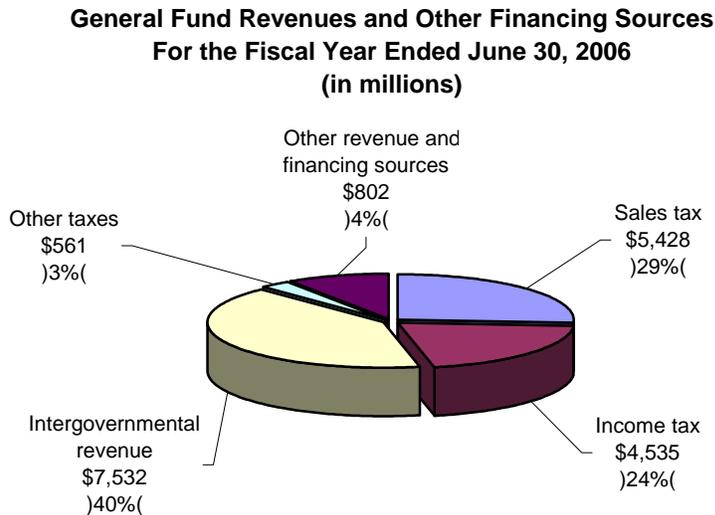
The other method of accounting used in the State is accrual accounting. This method of accounting provides more detailed and comprehensive financial information. Therefore, the information presented in this report is on the accrual basis of accounting, unless otherwise stated. A *modified accrual* basis of accounting is used to present **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:**

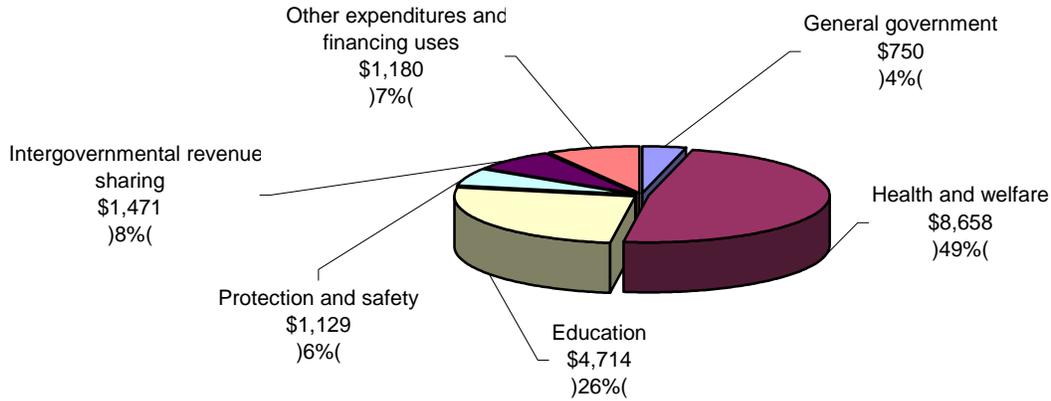
The General Fund has three major revenue sources: sales taxes, income taxes, and intergovernmental revenues. The General Fund had \$18.858 billion in total revenues and other financing sources during fiscal year 2006. Other financing sources include transfers from other State funds and proceeds from capital leases totaling \$282 million.

General Fund expenditures and other financing uses, for fiscal year 2006, totaled \$17.902 billion. Other financing uses consist of transfers to other State funds in the amount of \$917 million.



**ARIZONA FINANCIAL HIGHLIGHTS**

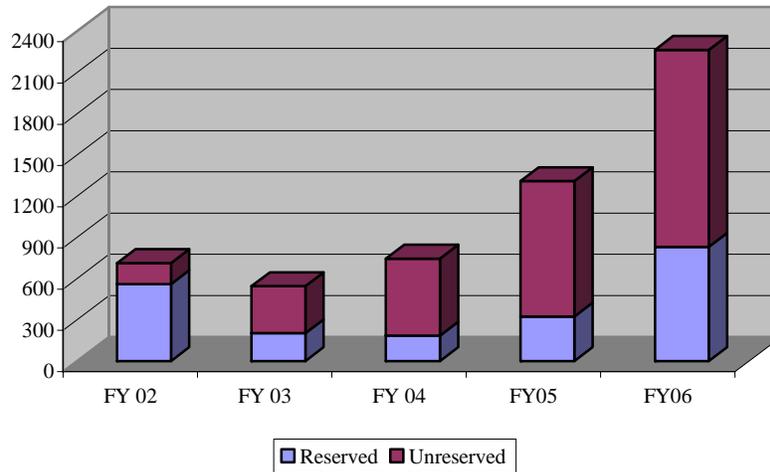
**General Fund Expenditures and Other Financing Uses  
For the Fiscal Year Ended June 30, 2006  
(in millions)**



General Fund revenues and other financing sources exceeded expenditures and other financing uses by \$956 million in fiscal year 2006. The fiscal year excess of \$956 million, when added to the \$1.310 billion beginning balance, produced a General Fund fund balance, as of June 30, 2006, of \$2.266 billion. The primary source of the increase in fund balance is from the increase of sales tax and income tax revenues. Sales tax revenues increased \$881 million from fiscal year 2005, an increase of 19%. Sales taxes paid by retail stores and construction contractors increased approximately \$388 million and \$254 million, respectively, when compared to fiscal year 2005 sales tax receipts. Income tax revenues increased \$1.0 billion, an increase of 29%. Income taxes paid by individuals increased by approximately \$813 million, when compared to fiscal year 2005 individual income tax receipts. In addition, income taxes paid by corporations increased approximately \$194 million during the same period.

## 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 2006, the General Fund had a reserved fund balance of \$831 million and an unreserved fund balance of \$1.435 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), 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 2006, the restricted balance in the BSF increased to \$651 million, compared to \$161 million at the end of fiscal year 2005. 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 \$1.773 billion, as of June 30, 2006. This compares to a fund balance of \$861 million for June 30, 2005. The following financial statements show the total assets, fund balance, and changes in the General Fund balance for the fiscal year 2006.

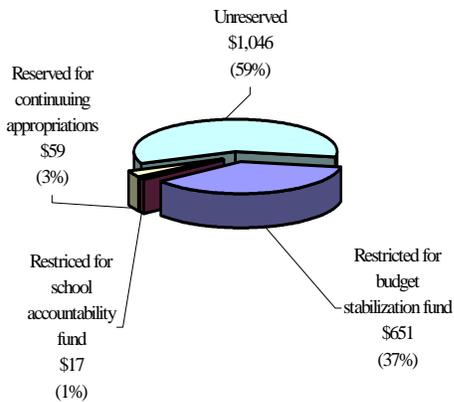
**General Fund Balance Sheet -  
Cash Basis**  
For the Fiscal Year Ended June 30, 2006

(in millions)	
<b>ASSETS:</b>	
Cash	\$ 1,733
<b>TOTAL ASSETS</b>	<u>\$ 1,773</u>
<b>FUND BALANCE:</b>	
Restricted:	
Budget stabilization fund	\$ 651
School accountability account	17
Reserved For:	
Continuing appropriations	59
Unreserved	<u>1,046</u>
<b>TOTAL FUND BALANCE</b>	<u>\$ 1,773</u>

**Statement of Revenues, Expenditure and Changes in  
General Fund Balance**  
**Cash Basis**  
For the Fiscal Year Ended June 30, 2006

(in millions)	
<b>REVENUES:</b>	
Sales and use taxes	\$ 3,955
Income taxes	4,090
Insurance premium taxes	374
Other taxes	109
Other revenues	364
<b>TOTAL REVENUES</b>	<u>\$ 8,892</u>
<b>EXPENDITURES:</b>	
Education	\$ 4,416
Health and welfare	2,157
Protection and safety	842
General government	504
Other expenditures	115
<b>TOTAL EXPENDITURES</b>	<u>\$ 8,034</u>
<b>REVENUES OVER EXPENDITURES</b>	\$ 858
<b>OTHER FINANCING SOURCES</b>	
Interest earnings	9
Transfers from other funds	45
<b>TOTAL OTHER FINANCING SOURCES</b>	<u>\$ 54</u>
<b>NET CHANGE IN FUND BALANCE</b>	\$ 912
<b>FUND BALANCE, JULY 1, 2005</b>	<u>861</u>
<b>FUND BALANCE, JUNE 30, 2006</b>	<u>\$ 1,773</u>

**General Fund  
Cash Basis  
Components of Fund Balance  
(in millions)**



**ARIZONA FINANCIAL HIGHLIGHTS**

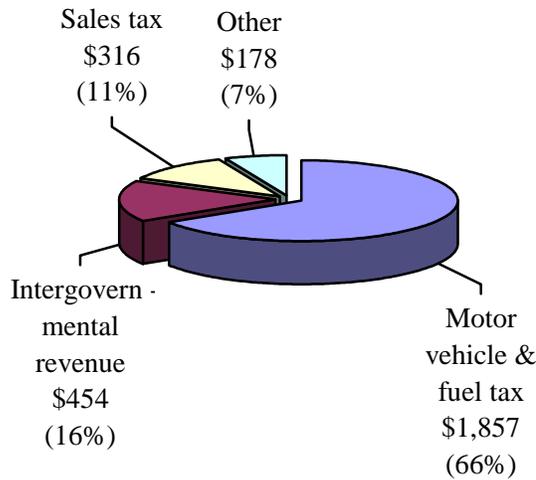
**TRANSPORTATION & AVIATION PLANNING, HIGHWAY MAINTENANCE & SAFETY FUND**

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 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.

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**Transportation & Aviation Planning, Highway Maintenance & Safety Fund  
Revenue and Other Financing Sources  
For the Fiscal Year Ended June 30, 2006  
(in millions)**

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During fiscal year 2006, the Transportation & Aviation Planning, Highway Maintenance and Safety Fund had revenues and other financing sources of \$2.805 billion and expenditures and other financing uses of \$2.753 billion. Total fund balance increased \$52 million during fiscal year 2006. Fund balance increased primarily due to a \$98 million increase in motor vehicle and fuel tax revenues and a \$39 million increase in licenses, fees, and permits due to increased population, which tends to follow job growth. Also, transfers to other State agencies were \$118 million less than fiscal year's 2005 transfers due to 2004 Senate Bill 1314, which required an additional \$118 million to be transferred from vehicle license tax revenues to the State's General Fund in fiscal year 2005. Fund balance increases were offset, in part, due to a \$104 million increase in distributions to Arizona counties and cities, as a result of increased motor vehicle and fuel tax collections, and a \$91 million decrease in intergovernmental revenues.

At the end of fiscal year 2006, the following construction activity was planned:

- In June 2006, the Transportation Board approved a \$5.8 billion highway construction program as part of the Five-Year Transportation Facilities Construction Program for fiscal years 2007 through 2011; \$4.3 billion for system improvements, \$537 million for system management and \$988 million for system preservation. 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 Association of Governments (MAG) Life Cycle Program. The Five-Year Transportation Facilities Construction Program includes approximately \$3.2 billion for freeway and expressway construction in Maricopa County, funded in large part from the Maricopa County Regional Area Road Fund. As part of the Five-Year Transportation Facilities Construction Program, the

## ARIZONA FINANCIAL HIGHLIGHTS

Transportation Board also adopted a \$717 million Five-Year Airport Development Program that includes 1,025 projects at general aviation and air carrier airports located throughout the State.

- The Regional Freeway Program in Maricopa County began in 1986 and will ultimately open 137 miles of new freeway. Currently, 130 miles have been opened to traffic and 7 more miles are under construction.
- Since the beginning of the fiscal year 2006, the ADOT has seen an unwelcome trend in the cost of many of its construction 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.

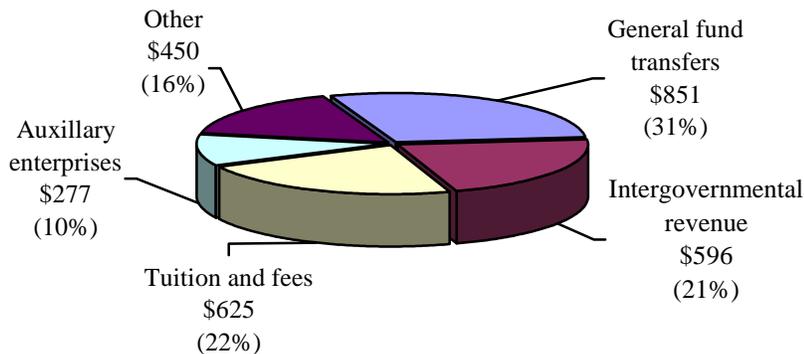
### UNIVERSITIES

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 2006, Arizona's universities had revenues, contributions, and transfers from other funds of \$2.799 billion, including an \$851 million transfer from the State's General Fund. This compares with fiscal year 2005 revenues, contributions, and transfers from other funds of \$2.558 billion, including a \$787 million transfer from the State's General Fund.

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**Universities - Revenue Sources**  
**Full Accrual Basis**  
**For the Fiscal Year Ended June 30, 2006**  
**(in millions)**

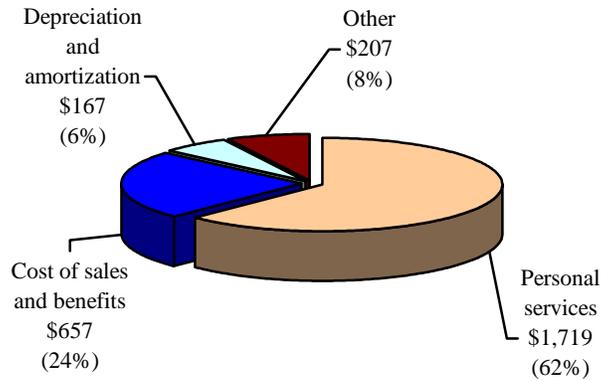
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Revenues are derived from numerous sources including student tuition and fees, grants, private gifts, contracts and sales and services through the auxiliary enterprises. Auxiliary enterprises include the operations of substantially self-supporting activities such as housing, bookstore, student unions and intercollegiate athletics. Revenues from auxiliary enterprises for fiscal year 2006 were \$277 million, net of scholarship allowances of \$7 million. Revenues from student tuition and fees for fiscal year 2006 were \$625 million, net of scholarship allowances of \$176 million. The universities had expenses of \$2.750 billion during fiscal year 2006, compared with \$2.526 billion in fiscal year 2005.

**ARIZONA FINANCIAL HIGHLIGHTS**

**Universities - Expenses  
Full Accrual Basis  
For the Fiscal Year Ended June 30, 2006  
(in millions)**



Other university highlights:

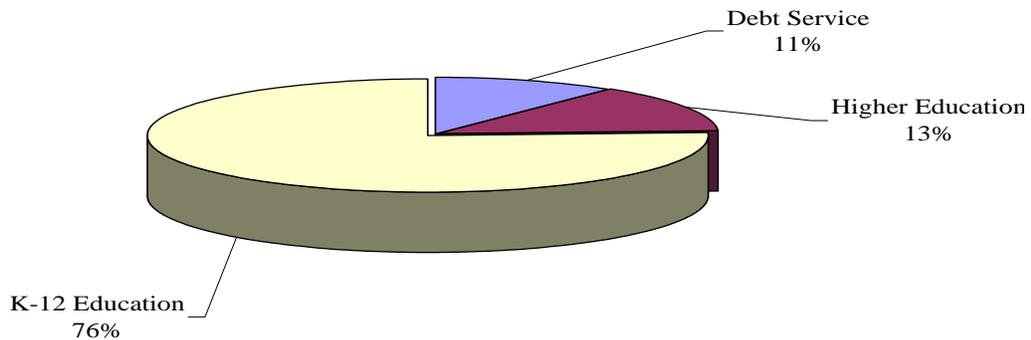
- Arizona's universities have \$2.839 billion in infrastructure, land, buildings and equipment, net of accumulated depreciation as of June 30, 2006.
- Total full-time equivalent enrollment continued to grow in fiscal year 2006. Enrollment for fall semester 2006 was 59,068 for ASU, 17,489 for NAU, and 34,023 for U of A, totaling 110,580 on a statewide basis.

**C. EDUCATION**

In fiscal year 2006, 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. In fiscal year 2006, approximately \$556 million of dedicated tax revenue was collected and allocated to K-12 schools and higher education. An additional \$66 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 2006



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 Legislature passed Laws 2003, 1st Regular Session, Chapter 264, Section 22 giving the State an additional revenue bonding authority of \$247 million for correcting school building deficiencies. Of this amount, \$482 million in bonds were issued in June 2001, \$6 million were issued in December 2001, and the remaining \$332 million of bonds were issued in fiscal year 2003. Additionally, in October, 2003, the Arizona School Facilities Board issued \$247 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. During fiscal year 2006, the State partially refinanced the School Facilities Board Series 2001, 2002, and 2003 revenue bonds. This refinancing resulted in a debt service savings of \$24 million and a net present value benefit of \$15 million.

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, 1<sup>st</sup> 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 2006, all deficiency correction projects (7,593 in total) were completed except one in Glendale Union School District remained outstanding.

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 record land auction sales in fiscal year 2006, of 3,426 acres of trust land for gross sales of \$567 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 10.5% above the appraised value.

## ARIZONA FINANCIAL HIGHLIGHTS

At the fund level, the Land Endowments Fund total fund balance increased \$326 million during fiscal year 2006. Permanent fund endowment investments increased \$312 million at fiscal year end due to record receipts from State Trust land sales and a net increase in the fair value of investments of \$71 million.

### 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.

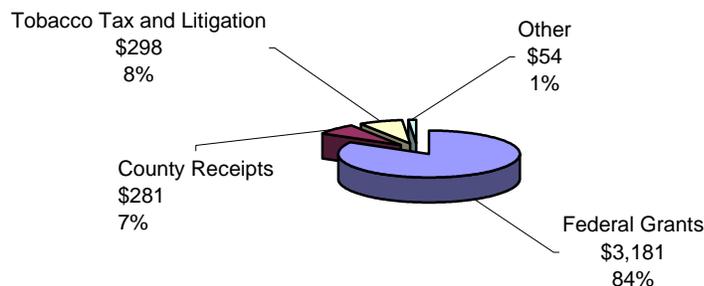
The AHCCCS provides long-term and acute health care to eligible residents of the State. Eligible residents include those who receive Temporary Assistance for Needy Families, Supplemental Security Income, children who meet certain age requirements from families receiving food stamps, and pregnant women 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 year ended June 30, 2006, the AHCCCS had revenue and other financing sources of \$3.8 billion, and expenditures and other financing uses of \$3.8 billion. This compares to revenues and other financing sources of \$3.7 billion, and expenditures and other financing uses of \$3.7 billion for the fiscal year ended June 30, 2005. 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, physician, and inpatient costs, the capitation rates were increased by an average of 8% for the contract period of October 2005 to September 2006. 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:

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**AHCCCS Revenue Sources**  
**For the Fiscal Year Ended June 30, 2006**  
**(in millions)**

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## 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 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 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 \$783 million were issued and \$812 million were retired during fiscal year 2006. COPs totaling \$175 million were issued and \$123 million were retired during fiscal year 2006. 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 four outstanding COP issues during the fiscal year ended June 30, 2006. All six existing revenue bonds were partially refinanced, and two of the four 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 \$20 to \$25 million (a range of gain is calculated because variable rate debt was refinanced during fiscal year 2006, 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 2006 (amounts in millions).

<b>Project</b>	<b>Revenue Bonds</b>	<b>COPs</b>
Highway construction	\$ 117	\$ -
Refinancing	598	88
Universities' capital facilities	68	87
Total issued in fiscal year 2006	\$ 783	\$ 175

## ARIZONA FINANCIAL HIGHLIGHTS

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

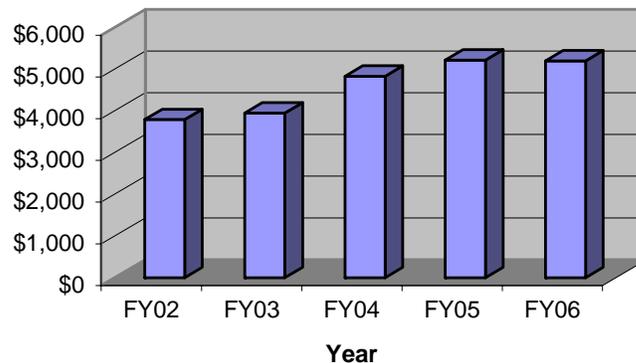
**State of Arizona**  
**Long-Term Obligations Outstanding**  
**As of June 30, 2006**  
**(in millions)**

Revenue bonds	\$2,909
Grant anticipation notes	325
Certificates of participation	<u>1,968</u>

**Total Long-Term Obligations**     **\$5,202**

The following graph shows the trend in long-term obligations outstanding for the past five fiscal years. Outstanding long-term obligations remained stable during fiscal year 2006 compared to fiscal year 2005 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.

**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.

In *Ladewig vs. Arizona Department of Revenue*, Ladewig 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 50.00% 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 settlement in December 2002. The remaining issues concern the administration of the settlement. The Department moved to correct claim errors that were caused by computer and clerical mistakes and resulted in millions of dollars in overpayments on the first installment to approximately 3,250 class members. The Tax Court ruled in November 2005 that the Department could not recover amounts previously paid to class members, but could offset the overpayments

## ARIZONA FINANCIAL HIGHLIGHTS

against the amounts due for the remaining two installments. The State initially estimated this litigation to result in a liability to the State of \$350 million. However, that estimate was revised in fiscal years 2004, 2005, and 2006. The final total amount of the Ladewig settlement is \$275 million, of which \$76 million remains unpaid as of June 30, 2006. This remaining liability is reflected in the State's financial Statements, and is expected to be paid in fiscal year 2007.

In *Kerr vs. Killian*, federal employees claimed an income tax refund on taxes paid on federal employee contributions. Prior to 1990, the Arizona statutes allowed state employees to deduct mandatory employee pension contributions, but did not provide a similar deduction for federal employees. After 1990, Arizona amended the statutes to just adopt federal adjusted gross income. Contributions that are deductible at the federal level are also deductible for Arizona tax purposes. The Arizona Supreme Court held that Arizona's tax statutes after 1990 did not discriminate against federal employees based on the source of income. The United States Supreme Court denied review. The Arizona Court of Appeals remanded the case for the earlier years to take a fresh look at the class certification issue. The parties then entered into a settlement agreement which the tax court has approved. Accordingly, the State has recorded a liability in its financial statements in the amount of \$15 million.

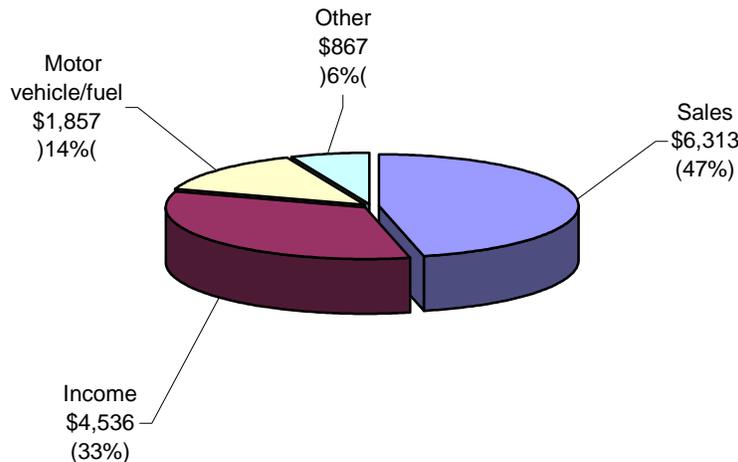
### G. TRENDS IN TAX REVENUE

The State derives approximately 59% of its total revenues from taxes. The following graph shows the relative percentage of the different taxes earned by the State's governmental funds.

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**Tax Revenues**  
**For the Fiscal Year Ended June 30, 2006**  
**(in millions)**

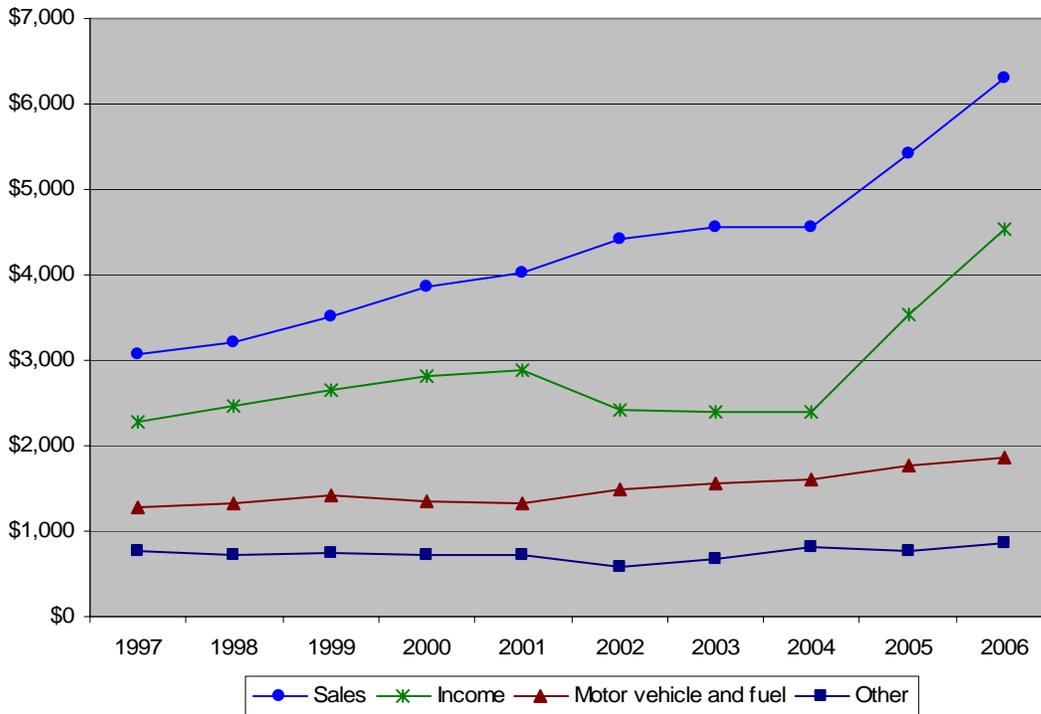
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**ARIZONA FINANCIAL HIGHLIGHTS**

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)**



<b>Tax Type</b>	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Sales	\$ 3,060	\$ 3,210	\$ 3,508	\$ 3,854	\$ 4,020	\$ 4,425	\$ 4,556	\$ 4,985	\$ 5,410	\$ 6,313
Income	2,290	2,461	2,648	2,821	2,879	2,410	2,387	2,819	3,529	4,536
Motor vehicle and fuel	1,288	1,332	1,413	1,360	1,333	1,493	1,564	1,614	1,759	1,857
Other	764	723	738	719	732	593	670	814	777	867
<b>Total Tax Revenues</b>	<b>\$ 7,402</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>