



**REPORT
 HIGHLIGHTS**
 FINANCIAL STATEMENT AUDIT

Subject

The State of Arizona issues a Comprehensive Annual Financial Report. The State is responsible for preparing financial statements, maintaining strong internal controls, and demonstrating accountability for its use of public monies. As the auditors, our job is to determine whether the State has met its responsibilities.

Our Conclusion

The information in the State's financial statements is fairly stated in accordance with U.S. generally accepted accounting principles in all material respects, and the financial statements can be relied on. Our audit covers all state operations with the exception of agencies and departments that are audited by public accounting firms. The Department of Transportation, Arizona Health Care Cost Containment System, State Lottery, the retirement plans, and component units are audited by other auditors. Our conclusion is based, in part, on the work of those auditors.



2005

Year Ended June 30, 2005

**General Fund Financial
 Condition Improves**

During fiscal year 2005, General Fund revenues and other financing sources totaled approximately \$17.3 billion, and expenditures and other financing uses totaled approximately \$16.8 billion. As a result, the fund balance of the State's General Fund increased \$563 million from the prior year. This represents an increase of approximately 75.5 percent.

General Fund revenues and other financing sources increased \$2.0 billion, or 13.1 percent, between fiscal years 2004 and 2005, primarily as a result of the following:

- Income tax revenues increased by approximately \$710 million, or 25.2 percent. Taxes paid by individuals increased by approximately \$530 million, and taxes paid by businesses increased approximately \$180 million.
- Intergovernmental revenues increased \$477 million, or 7.2 percent, due mainly to an increase in monies received for health and welfare programs from the federal and local governments.
- Sales tax revenues increased approximately \$345 million, or 8.2 percent, because of an improving economy and increasing population. The majority of this increase (\$316 million) was from sales taxes paid by retail stores, construction contractors, restaurants and bars, and out-of-state companies.

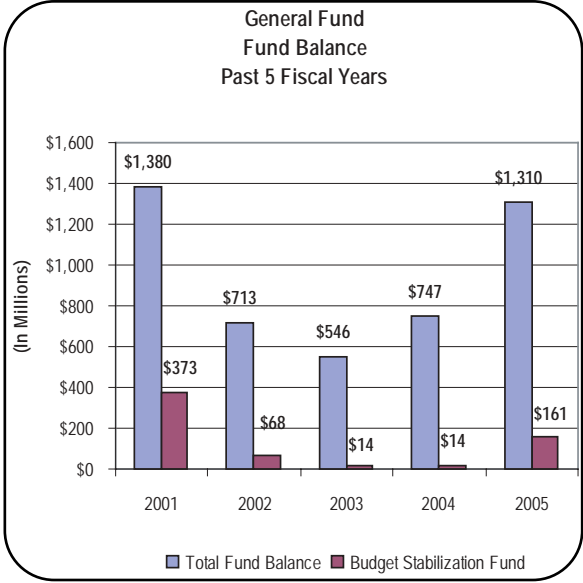
General Fund expenditures and other financing uses increased \$1.6 billion, or 10.9 percent, between fiscal years 2004 and 2005, primarily as a result of the following:

- Health and welfare expenditures increased \$641 million, or 8.6 percent, mainly because of growth in Title XIX

and XXI programs and inflationary factors.

- Education expenditures increased \$306 million, or 7.6 percent, due to rising student enrollment, which resulted in increased state aid to schools, costs incurred for building new schools, and increased federal aid passed through to schools.

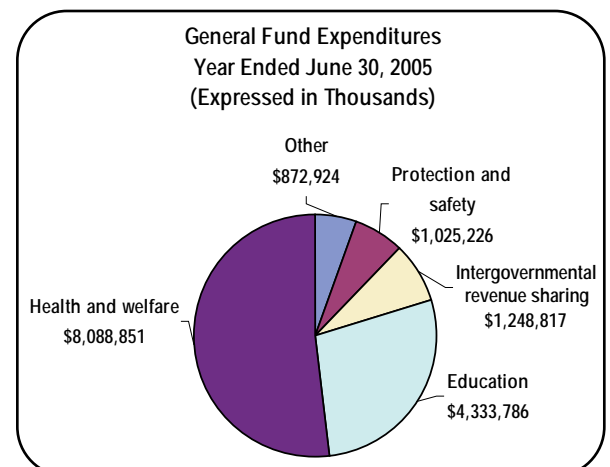
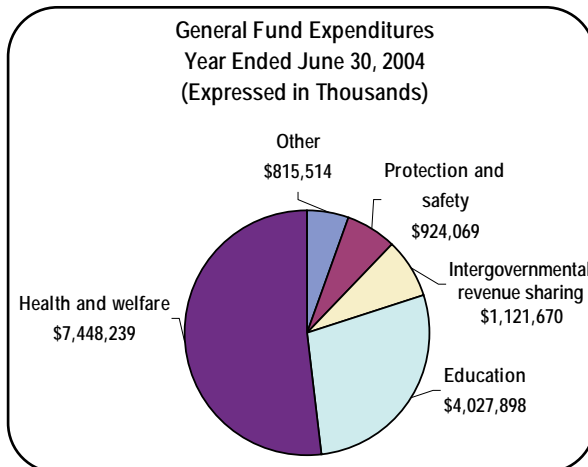
As shown in the graph below, from June 30, 2001 through June 30, 2003, the General Fund's fund balance had declined by approximately \$834 million. However, from June 30, 2003 through June 30, 2005, the fund balance increased by approximately \$764 million, ending with \$986 million in unreserved fund balance and a \$324 million reserved fund balance for a total fund balance of \$1.3 billion. Included in the \$324 million reserved fund balance is \$161 million for the Budget Stabilization Fund. The Budget Stabilization Fund is a form of "Rainy Day Fund" established by the Legislature in 1991.



Summary of General Fund Expenditures

For fiscal year 2005, education, health and welfare, protection and safety, and intergovernmental revenue sharing expenditures accounted for 94.4

percent of General Fund expenditures. The graphs below detail General Fund expenditures for fiscal years 2004 and 2005.



State Implements New Financial Reporting Standard

During fiscal year 2005, the State implemented Governmental Accounting Standards Board (GASB) Statement No. 40, *Deposit and Investment Risk Disclosures*.

This reporting standard requires the State to disclose its investment and deposit policies as well as risks related to credit risk, custodial credit risk, concentration of credit risk, interest rate risk, and foreign currency risk.

Credit risk: This is the risk that an issuer of a debt security will not fulfill its obligations.

Custodial credit risk: This is the risk that a government will not be able to recover

deposits if a depository financial institution fails, or recover the value of an investment in the possession of an outside party if the transaction fails.

Concentration of credit risk: This is the risk of loss attributed to the magnitude of a government's investment in a single issuer.

Interest rate risk: This is the risk that changes in interest rates will adversely affect the value of an investment in debt securities.

Foreign currency risk: This is the risk that changes in exchange rates will adversely affect the fair value of a deposit or investment.

Summary of the State's Government-wide Financial Data

The State's government-wide financial statements are designed to provide readers with a broad overview of the State's finances in a manner similar to private-sector businesses. These statements report the financial activities of the overall government, except for fiduciary activities.

The tables below present a summarized version of the government-wide Statement of Net Assets and Statement of Activities

reported in the Comprehensive Annual Financial Report for the State's primary government, (which include all governmental and business-type activities) excluding component units.

The Statement of Net Assets presents information on all state assets and liabilities, with the difference between the two reported as net assets. The Statement of Activities presents information showing how net assets changed during the most recent fiscal year.

Statement of Net Assets June 30, 2005 (Expressed in Thousands)

	<u>Total Governmental and Business-type Activities</u>
Current and other assets	\$ 9,038,495
Capital assets	<u>16,690,632</u>
Total assets	<u>25,729,127</u>
Current liabilities	2,554,501
Noncurrent liabilities	<u>6,318,118</u>
Total liabilities	<u>8,872,619</u>
Net assets	
Invested in capital assets, net of related debt	12,992,915
Restricted net assets	4,170,304
Unrestricted net assets	<u>(306,711)</u>
Total net assets	<u>\$16,856,508</u>

Statement of Activities Year Ended June 30, 2005 (Expressed in Thousands)

	<u>Total Governmental and Business-type Activities</u>
Program revenues:	
Governmental activities	\$ 8,659,169
Business-type activities	2,555,444
General and other revenues:	
Governmental activities	11,607,035
Business-type activities	<u>834,469</u>
Total revenues	<u>23,656,117</u>
Expenses:	
Governmental activities	18,607,878
Business-type activities	<u>3,376,470</u>
Total expenses	<u>21,984,348</u>
Change in net assets	1,671,769
Net assets—beginning, as restated	<u>15,184,739</u>
Net assets—ending	<u>\$16,856,508</u>

State Begins Self-Funded Health Benefits Program

In October 2004, the State implemented a self-funded health benefits program, referred to as Arizona Benefit Options. The program was developed with the intent to limit increases in healthcare costs and to broaden the employee's choice of healthcare providers. Currently, it serves over 62,000 active employees from over 100 state agencies, boards, and commissions, and 3 state universities and approximately 9,000 retirees.

Under the program, the State contracts directly with vendors to provide healthcare services and pays for the services using premiums it receives from employees, retirees, and state employers. The State's program includes both integrated and nonintegrated plans. The integrated plans, including United Health Care and PacifiCare, are used to provide hospital and

provider networks, payment authorization, and claims processing. The nonintegrated plan uses the following four networks to provide medical services: Arizona Foundation, Beech Street, Schaller Anderson, and RAN+AMN (HMA). A third party administrator, Harrington, is responsible for customer service and paying claims to the four nonintegrated networks. The State also contracts with Walgreen's Health Initiative to provide a national network of pharmacies, mail order services, and specialty services for all healthcare providers.

Health benefits program expenses are recorded in the State's Employee Benefits Fund. Total expenses for fiscal year 2005, including 3 months under the State's prior contract with CIGNA and 9 months under the new self-funded health benefits program, were \$497 million.

TO OBTAIN MORE INFORMATION

A copy of the full report can be obtained by calling
(602) 553-0333



or by visiting
our Web site at:
www.azauditor.gov

Contact person for
this report:
Rick Meyer