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December 10, 1999

The Honorable Jane Dee Hull  
Governor of the State of Arizona,  
Members of the Legislature, Chief Justice of  
the Supreme Court and Citizens and Taxpayers  
of the State of Arizona

Ladies and Gentlemen:

In accordance with Section §35-131 of the Arizona Revised Statutes (ARS), it is our pleasure to transmit to you the Comprehensive Annual Financial Report (CAFR) of the State of Arizona for the fiscal year ended June 30, 1999. Responsibility for the accuracy of data, completeness and fairness of presentation, including all disclosures, rests with the State's management. The data presented in this report, to the best of our knowledge and belief, are accurate in all material respects and are reported in a manner which fairly presents the financial position and results of operations of the various funds and account groups of the State. All disclosures needed for the reader to gain a reasonable understanding of the State's financial activities have been included.

The report is presented in three sections: Introductory, Financial and Statistical.

- The **Introductory Section** includes this Letter of Transmittal, Financial Highlights, the State's organizational chart and a list of principal State officials.
- The **Financial Section** begins with the State Auditor General's Independent Auditors' report and contains the General Purpose Financial Statements, Combining Financial Statements by Fund Type and Account Group, and other schedules.
- The **Statistical Section** includes selected financial, economic and demographic data.

**FINANCIAL REPORTING ENTITY**

The accompanying CAFR includes all funds and account groups of the State of Arizona (primary government), as well as its component units. Component units are legally separate entities for which the primary government is financially accountable.

Discretely presented component units are reported in a separate column in the combined financial statements to emphasize that they are legally separate from the primary government and to differentiate their financial position, results of operations and cash flows from those of the primary government.

The criteria for inclusion in the reporting entity and its presentation are defined by the Codification of Governmental Accounting and Financial Reporting Standards, issued by the Governmental Accounting Standards Board, (Section 2100). Note 1.B of the Notes to the Financial Statements explains which units are included in the Financial Reporting Entity of the State.

**ECONOMIC CONDITION AND OUTLOOK**

*The following economic summary is excerpted from the Arizona Department of Economic Security's Arizona's Workforce, September 2, 1999.*

The Arizona Department of Economic Security, Research Administration (RA) forecasts that the Grand Canyon State's economy will grow by more than 127,000 jobs during the 1999-2000 period. With the exception of

mining, all other industries are expected to expand their workforces. Generally, this forecast translates into a growth of 13,800 jobs in the goods producing industries and 113,600 jobs in the service producing industries. Based on this forecast, the decade of the 1990s will have shown Arizona's economy to have grown by nearly 668,000 nonfarm jobs – an expansion of almost 50 percent.

Arizona's economy for 1999 is forecast to show 12-month average growth of nearly 73,000 jobs, representing an annual growth rate of 3.5 percent. Nationally, jobs are forecast to grow 1.9 percent in 1999 and four-tenths of one percentage point in 2000.

Job growth is forecast to continue in Arizona's economy in 2000. The first year of the new millenium is expected to show the economy creating 54,600 jobs. While construction is expected to experience its first loss since 1991, all other industries are forecast to add jobs – again, except mining.

Back in January 1992, Arizona's mining industry represented more than 2.1 percent of all nonfarm jobs in the State. With the layoffs occurring this year, the remaining employment in the mining industry represents less than one half of one percent of all jobs. While mining, especially for copper, has represented a valuable industry for the State, clearly the trend over time has been one of declining economic significance.

Economic conditions abroad are expected to improve during the forecast period, as the latest indicators have already been suggesting. As Arizona moved into the 1990s, the economic industry mix became more diversified and increasingly developed international dependencies. This has been especially the case for manufacturing in the Phoenix area, an economy still experiencing some of the lagging effects of the Asian economic crisis.

Arizona has become known as a great place to live and to conduct business. The latest registration data from the Department of Motor Vehicles suggest that the inflow of people to the State has not abated much in the last couple of years, even showing a slight increase in 1999. In an economic environment where interest rates are still at modestly low levels, Arizona's construction activity in recent years has been nothing short of blazing. While permit data show nonresidential activity is slowing, residential construction has continued to grow at a rather brisk pace.

Overall, Arizona's economy has performed exceptionally well throughout the 1990s. The RA remains convinced that the national and Arizona economies are slowing, but not at risk structurally. National policy moves have thus far been aimed at managing growth within acceptable bounds of inflationary stimulation. Arizona's economy is forecasted to see continued growth as all of us now prepare to take that grand step across the threshold into the new millennium.

## **MAJOR INITIATIVES**

**Tax Policy.** The Governor has committed to reducing the tax burden associated with the Vehicle License Tax (VLT) and to provide targeted reductions that stimulate the economy by attracting higher paying jobs. The Governor recommended and the Legislature agreed to reduce the VLT by 16 percent as part of the Fiscal Year 1999 budget. Over the Fiscal Year 2000/Fiscal Year 2001 biennium, these reductions continue. The biennial budget includes a VLT reduction of \$20 million in Fiscal Year 2000 and \$40 million in Fiscal Year 2001. Further, if revenues exceed predetermined levels, additional VLT reductions will go into effect. These reductions continue to hold cities, counties and transportation funding harmless in the quest to slash this onerous tax.

The adopted budget also includes further reductions in the corporate income tax rate and to expand the research and development tax credit.

**Quality of Life.** The budget for Fiscal Years 2000 and 2001 provides \$20 million in Fiscal Year 2001 to implement the voter-approved Growing Smarter initiative. Those funds are part of the State Parks Board budget and will be dedicated for the next 11 years. The initiative dedicates the funds to conserving open spaces on or near urban areas that are experiencing high growth pressures.

The adopted budget includes an additional \$3 million to support Arizona's Clean Water and Safe Drinking Water Revolving Funds. This funding represents the Federally required 20% match for the \$21.7 million allocation provided to the State under the Clean Water Act. Monies in those funds will provide to Arizona communities assistance and low-cost loans necessary for the construction and maintenance of basic environmental infrastructures and the protection of public health.

**Education.** State government faces no greater opportunity to secure Arizona's future than to enhance public education, in terms of both operational excellence and meeting school districts' capital needs. The adopted budget identifies and provides for \$391.8 million in new Maintenance and Operation (M&O) funding, from a variety of sources, for K-12 schools over the course of the biennium.

The increase includes: \$174.1 million for required formula spending, \$177.4 million for additional M&O funding, an estimated \$20 million in extracurricular activities funding associated with tax credits, \$17.5 million in Federal funding for additional teachers and \$1.7 million for implementation of State standards.

The State's University system continues to provide a wide range of quality academic programs at an extremely reasonable cost for Arizona citizens. Undergraduate tuition rates are the third lowest among senior public universities in the U.S.



The 9.3% increase in Sales Taxes reflects the increased economic growth occurring in the State. Sales Taxes have consistently outpaced both the prior year collections and the current year forecasts.

The 7.6% increase in Income Taxes reflects the increase in job growth, wage earnings and corporate income tax collections.

The 6.0% increase in Motor Vehicle and Fuel Taxes resulted from an increase in the number of motor vehicles being utilized in the State.

The 4.6% decrease in Property Taxes resulted from a reduction in property tax collections in the General Fund.

The 11.8% increase in Intergovernmental Revenues resulted from the increase in Federal funding for health and welfare and transportation programs.

The 7.9% increase in Licenses, Fees and Permits resulted primarily from the increase in license, fees and permit activity related to regulatory and motor vehicle licensing.

The 10.8% decrease in Earnings on Investments was the result of a decrease in the fair value of investments and the reversal of the prior year's accrual.

The 10.6% increase in Other Taxes and Revenues resulted primarily from an increase in insurance premium taxes, fines, forfeitures, penalties and other revenues.

General Governmental expenditures totaled \$11.64 billion for the fiscal year ended June 30, 1999, an increase of 10.5% over 1998. State Government expenditures and the changes from last year are shown below in Table 2.

The total expenditures increase of \$1.10 billion or 10.5% was the result of the factors described below.

The 11.5% increase in General Government expenditures resulted primarily from the increase in the cost of operating

State government and the increase in intergovernmental revenue sharing. These amounts are recorded as General Government expenditures on the State's financial statements.

The 7.5% increase in Health and Welfare expenditures resulted primarily from an increase in expenditures related to the Arizona Department of Economic Security and the Arizona Health Care Cost Containment System programs. In addition there was an increase in the expenditures related to the Tobacco Tax funded programs.

The 6.9% increase in Inspection and Regulation expenditures resulted from the increased growth in providing inspection and regulatory services.

The 9.2% increase in Education expenditures resulted from additional funding for increased student growth and increased Basic State Aid to public and charter schools. The increase also includes over \$100 million sent to the counties for new school facilities and the rehabilitation of existing school facilities.

The 13.0% increase in Protection and Safety expenditures resulted primarily from an increase in the prison population and the opening of 1,200 adult prison beds at the Lewis Complex correctional facility.

The 16.6% increase in Transportation expenditures resulted from the increases in expenditures related to highway construction and an increase in intergovernmental revenue sharing. These amounts are recorded as Transportation expenditures on the State's financial statements.

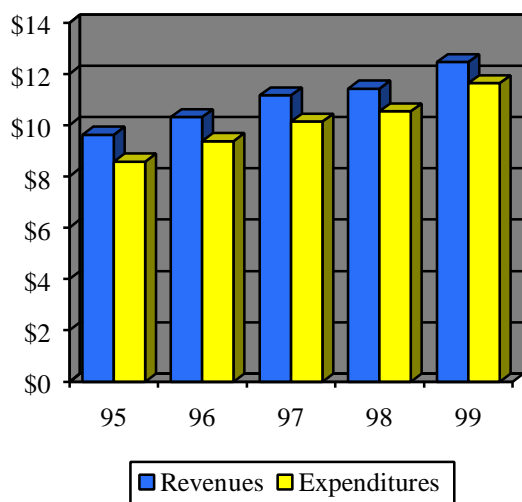
The 35.0% increase in Capital Outlay expenditures resulted primarily from the increase in expenditures for highway construction within Maricopa County.

The 4.9% increase in Debt Service expenditures resulted primarily from the increase in principal payments for revenue bonds for the Maricopa Regional Area Road Fund.

<b>Table 2</b> <b>GENERAL GOVERNMENTAL EXPENDITURES</b> (Expressed in Thousands)				
<u><b>Expenditure Function</b></u>	<u><b>Amount</b></u>	<u><b>Percent of Total</b></u>	<u><b>Increase / (Decrease) From 1998</b></u>	
			<u><b>Amount</b></u>	<u><b>Percent</b></u>
General Government-----	\$ 1,375,368	11.8%	\$ 141,391	11.5%
Health and Welfare-----	4,125,781	35.5	286,351	7.5
Inspection and Regulation-----	104,825	0.9	6,784	6.9
Education-----	2,827,148	24.3	238,106	9.2
Protection and Safety-----	775,480	6.7	89,172	13.0
Transportation-----	1,748,482	15.0	248,931	16.6
Natural Resources-----	93,099	0.8	(2,815)	(2.9)
Capital Outlay-----	319,134	2.7	82,747	35.0
Debt Service-----	269,457	2.3	12,596	4.9
<b>Total</b>	<b><u>\$11,638,774</u></b>	<b><u>100.0%</u></b>	<b><u>\$1,103,263</u></b>	<b><u>10.5%</u></b>

Graph 1 details the General Governmental Revenues and Expenditures for the last five fiscal years:

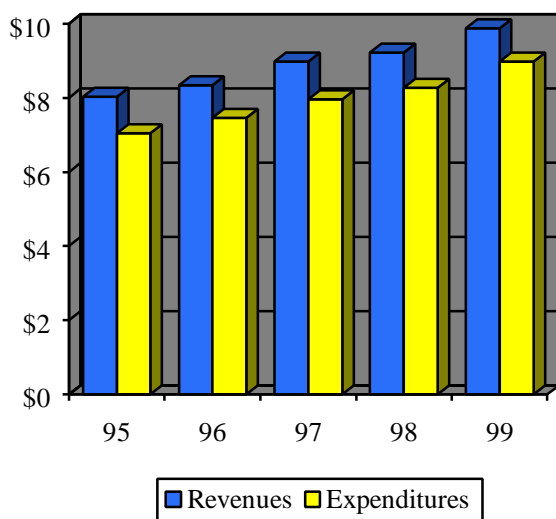
Graph 1  
General Governmental Revenues and Expenditures  
for last 5 fiscal years  
(Dollars in billions)



### GENERAL FUND BALANCE

Graph 2 details the General Fund Revenues and Expenditures for the last five fiscal years. This graph does not include operating transfer amounts relating to other fund types and other financing sources (uses), which affect the ending fund balance.

Graph 2  
General Fund Revenues and Expenditures  
for last 5 fiscal years  
(Dollars in billions)

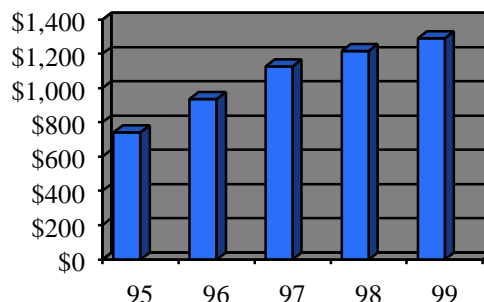


The General Fund ended the June 30, 1999, fiscal year with \$818.8 million in unreserved fund balance and a \$472.1 million reserved fund balance for a total fund balance of \$1.291 billion. This compares to the previous

year total fund balance of \$1.215 billion. Included in the \$472.1 million reserved fund balance is \$386.8 million for the Budget Stabilization Fund. The Budget Stabilization Fund is a form of "Rainy Day Fund" established by the Legislature in 1991.

Graph 3 details the General Fund Balance for the last five fiscal years:

Graph 3  
General Fund Balance for last 5 fiscal years  
(Dollars in millions)



### BUDGETARY CONTROLS

Budgetary control is maintained through legislative appropriation and the executive branch allotment process. The Governor is required to submit an annual budget to the Legislature. The budget is legally required to be adopted through passage of appropriation bills by the Legislature and approval by the Governor. The appropriated funds are controlled by the executive branch through an allotment process. This process allocates the appropriation into quarterly allotments by legal appropriation level. The State also maintains an encumbrance accounting system to further enhance budgetary control. Encumbered amounts generally lapse as of the end of the fiscal year, with the exception of capital outlay items. Capital outlay appropriations and their encumbrances continue from year to year.

The State's budgetary policies and procedures, fund accounting structure and basis of accounting are explained in detail in Note 1. of the Notes to the Financial Statements.

## **INTERNAL CONTROLS**

The State is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the State are protected from loss, theft or misuse and to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. Internal accounting controls are designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived and (2) the valuation of costs and benefits requires estimates and judgments by management. In the opinion of management, the State's internal controls are adequate to provide reasonable assurance that these objectives are met.

## **CASH MANAGEMENT**

The responsibility for cash management of the State is shared by the Office of the Treasurer (Treasurer) and the General Accounting Office of the Department of Administration, Financial Services Division (GAO). The Treasurer is responsible for the depository, custodial and investment functions of cash. The GAO is responsible for drawing down monies available for State functions and the expenditure or disbursement of those monies.

The State requires that Treasurer's deposits and investments with financial institutions be entirely covered by Federal depository insurance or alternatively collateralized with surety equal to 102% of the deposit or investment. Component units may have collateralization policies that differ from those of the Treasurer.

The Legislature has passed statutes authorizing State investments. Note 3.A. in the Notes to the Financial Statements describes the types of investments made by the State.

The Treasurer deposits receipts in accordance with applicable statutes and invests excess cash of the General Fund and various other funds. All interest, not otherwise apportioned by law, is deposited in the General Fund. Investment earnings for the General Fund totaled \$94.8 million for the fiscal year ended June 30, 1999.

## **PROPRIETARY OPERATIONS**

The State's Enterprise Funds are comprised of governmental and quasi-governmental agencies that provide goods and services to the public on a fee for service basis. One of the largest Enterprise Funds is the Lottery Fund. The Lottery Fund generated \$269.2 million of operating revenues and \$44.7 million of income before transfers for fiscal year 1999. The Enterprise Funds ended

fiscal year 1999 with a combined equity of \$156.8 million for the Primary Government and \$101.0 million for the Component Units (GAAP basis). The State Compensation Fund's Policyholders' Surplus was \$320.4 million (Non-GAAP basis).

The State has Internal Service Funds which provide a variety of services to State agencies. These include risk management, computer services, telecommunications, transportation services, printing services and other services. The operating revenues for the Internal Service Funds were \$159.3 million for fiscal year 1999.

## **TRUST AND AGENCY FUNDS**

Trust and Agency Funds are used to account for assets held by the State in a trustee capacity or as an agent for individuals, private organizations and other governments, including the four State Retirement Systems. The Trust and Agency Funds for the Primary Government reported a year-end equity of \$33.13 billion as compared to the previous year end of \$29.20 billion. See Note 7. in the Notes to the Financial Statements for more information on the four State Retirement Systems. The Fiduciary Fund Type Component Unit reported a year-end equity of \$126.9 million.

## **DEBT ADMINISTRATION**

The Arizona Constitution, under Article 9 Section 5, provides that the State may contract debts not to exceed \$350,000. This provision has been interpreted to restrict the State from pledging its credit as a sole payment for debts incurred for the operation of State government. As a result, the State, including the Enterprise Funds and the University Funds, finances most of its major capital needs by lease purchase transactions and by issuing revenue bonds. Lease purchase transactions are funded by Certificates of Participation (COPs). Revenue bonds are associated with specific State functions and are funded by dedicated revenue sources.

The State first issued COPs in 1984 to acquire and construct a building for the Industrial Commission. Since that time, additional issues have been transacted for the construction and purchase of buildings and other structures, as well as telecommunication systems for two of the Universities. The State issued COPs during fiscal year 1992 which provide for the sale and leaseback of prison facilities in Florence, Arizona. The proceeds were used to reimburse the General Fund for the expenditures incurred in purchasing the ENSCO Hazardous Waste Facility. In all cases, the Attorney General determined that the issuance of the COPs was in accordance with the provisions of the Constitution.

The State did not issue any new COPs and retired \$33.3 million during the fiscal year ended June 30, 1999. The State had \$326.9 million in COPs outstanding at year end. Principal and interest are covered by lease payments out of current revenues or appropriations from the fund responsible for utilization of the specific buildings.

The State has issued revenue bonds primarily to finance the construction of highways. They have also been issued for the construction of buildings and other facilities. The State's senior lien highway revenue bonds currently carry an Aa1/AAA rating from Moody's Investor Service, Inc. and Standard and Poor's Rating Service. The State issued \$178.3 million of revenue bonds and retired \$211.3 million during the fiscal year ended June 30, 1999. The State had \$2.1 billion in bonds outstanding at year-end, an increase of \$116.8 million from fiscal year 1998. This increase was primarily the result of the Water Infrastructure Finance Authority being added to the reporting entity. The Arizona Department of Transportation Highway Revenue Bonds accounted for \$1.257 billion of the total bonds outstanding. See Note 9.A. and 9.B. in the Notes to the Financial Statements for additional information on revenue bonds and COPs.

### **RISK MANAGEMENT**

The State purchases property and liability coverage whenever available on reasonable terms. The State is insured by an approved property insurer for claims in excess of \$100 thousand but less than \$350 million and liability claims in excess of \$1 million for the Universities and \$4 million for all other state agencies but less than \$79 million. The State also maintains an excess workers' compensation policy for claims in excess of \$1 million and first dollar aircraft coverage up to \$200 million. Other purchased coverages include fidelity, crop, foreign liability, workers' compensation and medical malpractice. The State's self-insurance fund provides property and liability coverage for claims less than or in excess of this coverage or whenever coverage is unavailable on reasonable terms.

The State pays self-insurance losses from a fund to which monies are appropriated each year by the Legislature.

(Original Signed by)  
J. Elliott Hibbs  
Director

Monies remaining at the end of a fiscal year carry over to the next fiscal year, but are part of the appropriation made for that fiscal year to pay expected losses and costs. Self-insurance losses and claims-related expenses (excluding the cost of administering the program) have risen from approximately \$15.3 million in fiscal year 1988 to approximately \$79.9 million in fiscal year 1999. Yearly appropriations have also increased from approximately \$27.7 million in fiscal year 1988 to approximately \$82.0 million in fiscal year 1999 to meet such rising losses and claims-related expenses. Although there are no assurances, historically the Legislature has appropriated sufficient funds to cover all costs.

### **INDEPENDENT AUDIT**

In compliance with State statute, an annual financial audit of the "State Entity" is completed each year by the State of Arizona, Office of the Auditor General in conjunction with other audit firms. Their audit was conducted in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Their report on the general purpose financial statements has been included in the financial section of this report. In addition, ARS §41-1279.03 requires at least a biennial single audit by the Office of the Auditor General. The Single Audit will be issued as a separate report at a later date.

### **ACKNOWLEDGMENTS**

We wish to express our sincere appreciation to the many individuals whose dedicated efforts have made this report possible. The preparation of this report could not have been accomplished without the professionalism and dedication demonstrated by the financial and management personnel of each State agency, board, commission and institution of higher education.

Robert Rocha  
State Comptroller