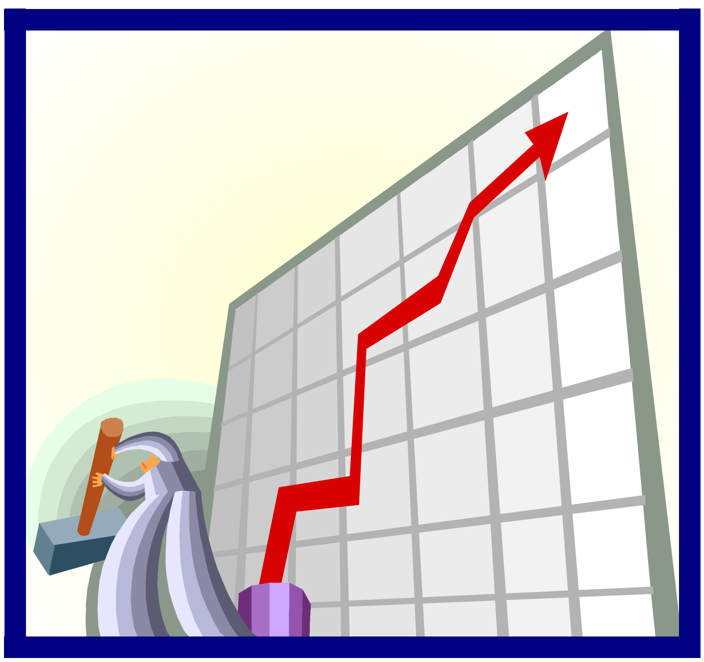
Internal Audit Department

Financial Condition Report

Fiscal Year 2002

June 2003



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June 30, 2003

Fulton Brock, Chairman, Board of Supervisors
Don Stapley, Supervisor, District II
Andrew Kunasek, Supervisor, District III
Max W. Wilson, Supervisor, District IV
Mary Rose Wilcox, Supervisor, District V

We have completed this FY 2002 edition of the Maricopa County Financial Condition Report. This work, which is part of our Board-approved audit plan, provides important information on County financial conditions and trends over the past five to ten years. New accounting guidelines delayed distribution of the County financial statements until February 2003, which in turn delayed issuance of the Financial Condition Report.

Overall, the County's financial condition and trends were favorable through the end of FY 2002. This is especially noteworthy given the slow economy, growing service demands, and increasingly negative impact the state budget crisis is likely to have on Maricopa County. Maintaining a balance between fiscal health and optimum service levels is a difficult task even in a strong economy. A special section of this report analyzes the important issue of health system net income and liquidity as portrayed in County financial statements.

Evaluating a jurisdiction's financial condition is a complex process, especially during uncertain economic times. Many variables are difficult to isolate and quantify. We believe, however, that a routine assessment of the past provides insight for the future, allowing us to make informed decisions in critical times. Additionally, a comparison to benchmarks broadens our perspective. This type of financial analysis alerts County officials to potential concerns and facilitates the Board's governance of Maricopa County.

Sincerely,

Ross L. Tate

Ross L. Tate
County Auditor

Financial Condition Report Awards

National Association of Local Government Auditors Award Winner 2001

National Association of Counties Achievement Award Winner 2001

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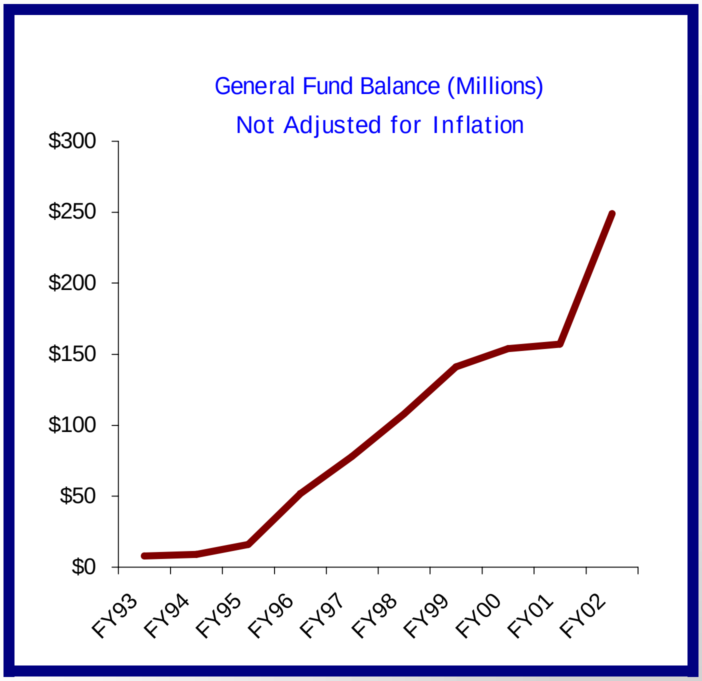
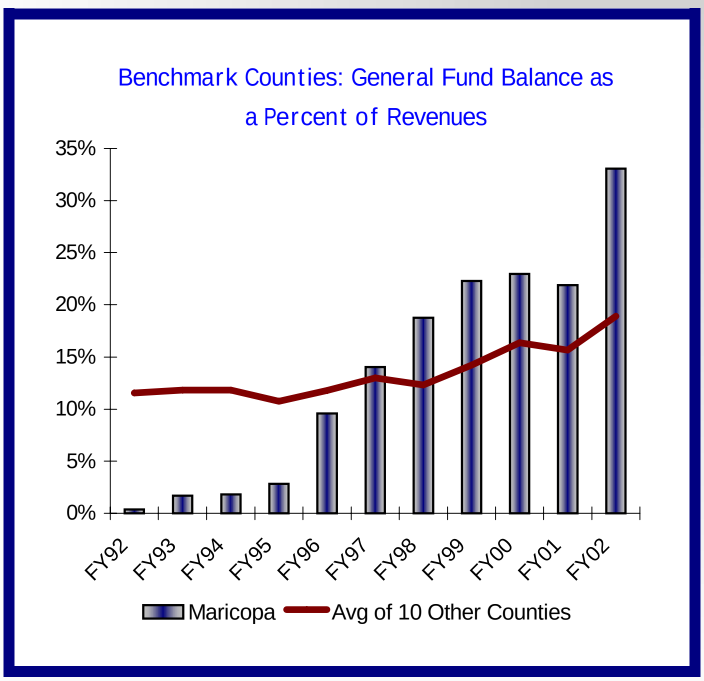
General Fund Accelerates Equity Growth



Conservative budget strategies have resulted in healthy General Fund balance increases.

The fund balance did not grow in FY01 because the County set money aside to fully fund several construction projects.

The fund balance rose sharply in FY02 because additional money budgeted to fund construction projects was kept in the General Fund. County management determined that such funds may be needed for worsening economic conditions and potential cost shifting by the state.



Since FY96, Maricopa's General Fund has achieved a healthy fund balance in relation to its revenues. Since FY97, Maricopa has significantly surpassed the average of ten benchmark counties for this financial measure.

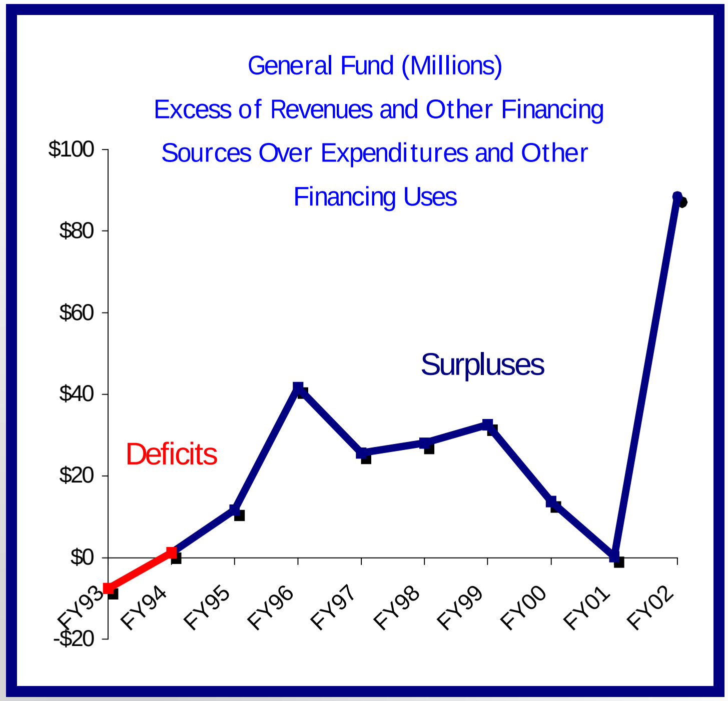
Strong General Fund equity will serve the County's citizens during current and future financial challenges.

General Fund Surpluses and Strong Liquidity

Since FY95, the General Fund has consistently spent less than it takes in, causing fund balance growth and increased cash availability for paying obligations.

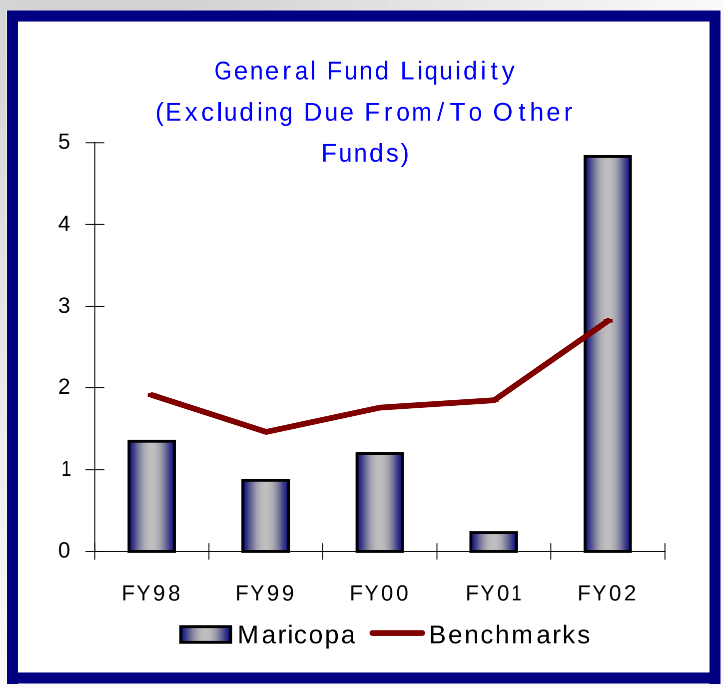
The FY01 dip reflects the transfer of money to fund construction projects.

The FY02 upward spike reflects deferred construction projects and a decision to keep additional money in the General Fund for future operating needs.



Liquidity measures the number of dollars available to pay each dollar of liability. Liquidity levels above 1 are desirable.

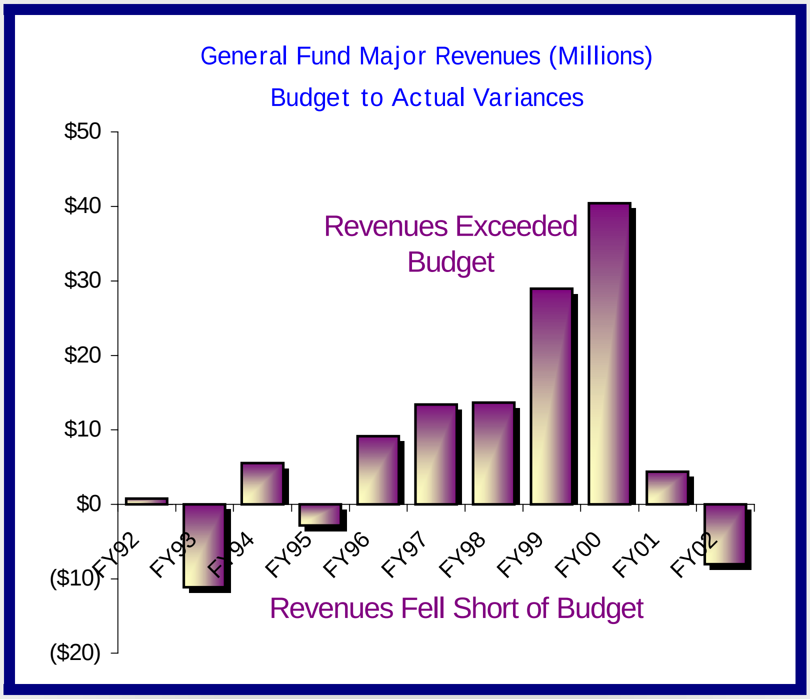
Although the General Fund shows a strong liquidity ratio in FY02, the General Fund will face fiscal challenges from the effects of ongoing budget shortfalls at the state. Maricopa County's conservative fiscal policy places us in a better position to meet these challenges.



General Fund Key Revenue Budgets

After FY94, conservative budget techniques led to actual revenues being larger than budgeted revenues. However, the FY01 and FY02 economic downturn eliminated this trend.

The chart below shows the combined General Fund major revenues budget-to-actual variance (property tax, sales tax, and vehicle license tax):



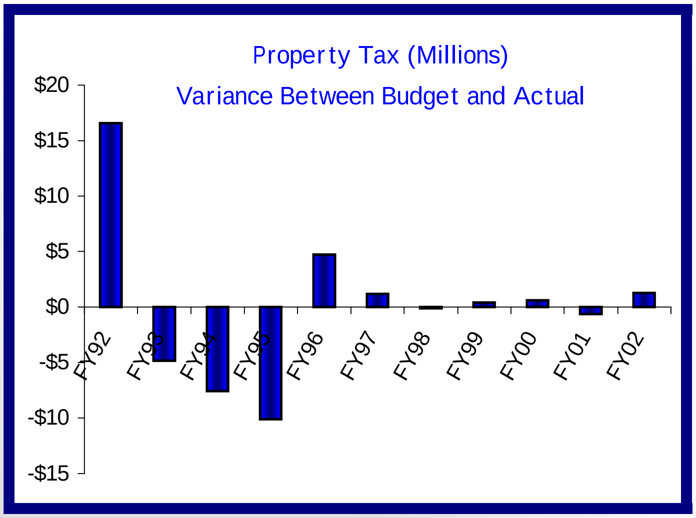
Property tax forecasting accuracy is evident by small budget-to-actual variances (top chart at right).

Sales tax revenues (middle chart at right) did not meet even conservative budget forecasts in FY02. These declines caused positive revenue budget variances to decline.

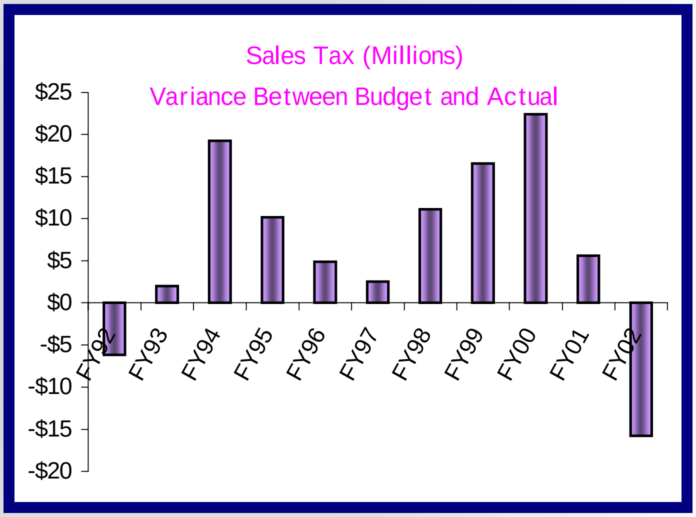
Vehicle License Tax (VLT chart bottom right) shows large budget-to-actual variances. VLT is difficult to forecast because the public can choose to pay the tax annually or biannually. It is difficult to forecast the public's payment preference year to year.

Sales Tax Below FY 02 Expectations / VLT Positive

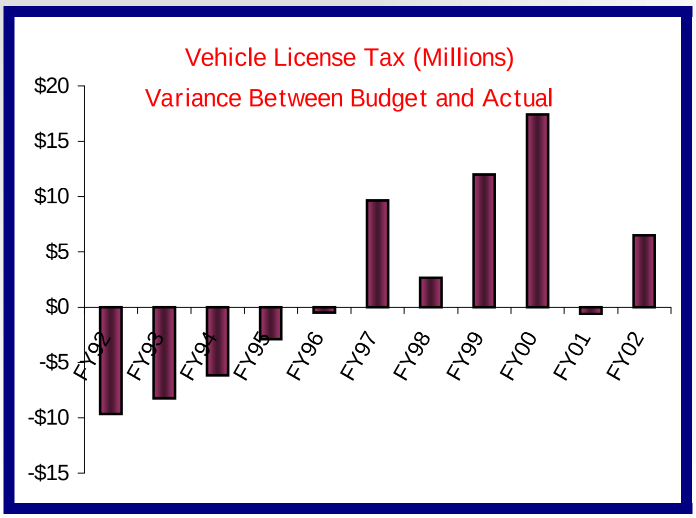
Anticipated property tax revenues are more predictable than sales tax or vehicle license revenues.



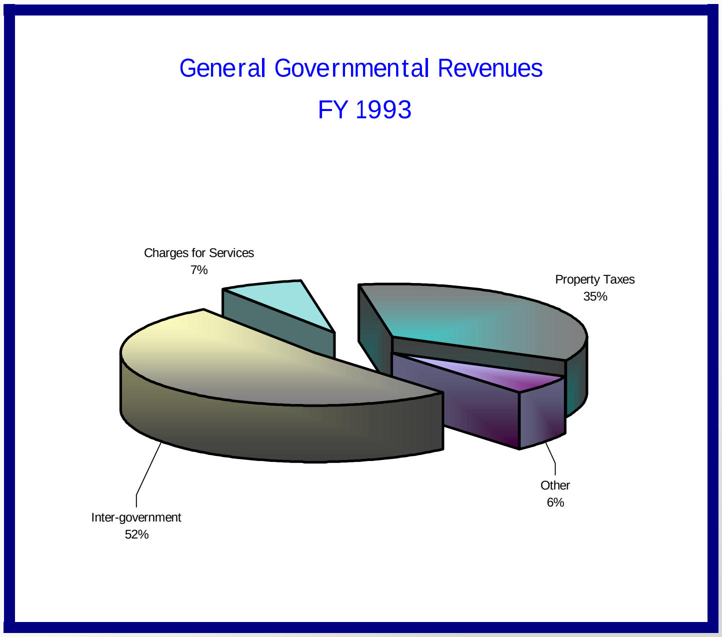
Sales tax revenues can be volatile and more difficult to predict. FY02 sales taxes revenues were lower than the most conservative forecasts.



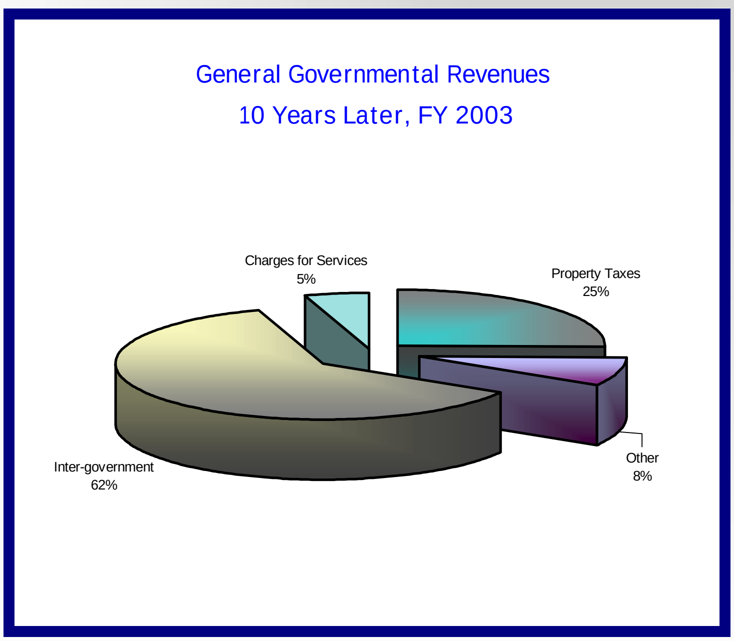
Vehicle license tax revenues are also difficult to predict. Citizens can opt to prepay these taxes for one or two years.



Sales Tax Overtakes Property Tax

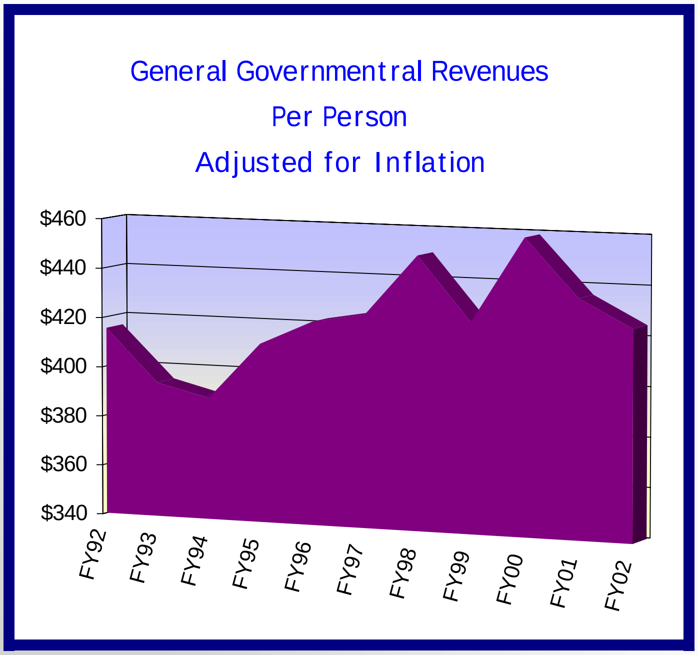


Over the past ten years the importance of intergovernmental revenues (primarily sales tax and vehicle license tax) has grown. Sales tax and property tax revenues have traded places as the largest contributor to General Fund revenues (bottom page 6). As shown on page 4, sales taxes are volatile and more difficult to forecast.



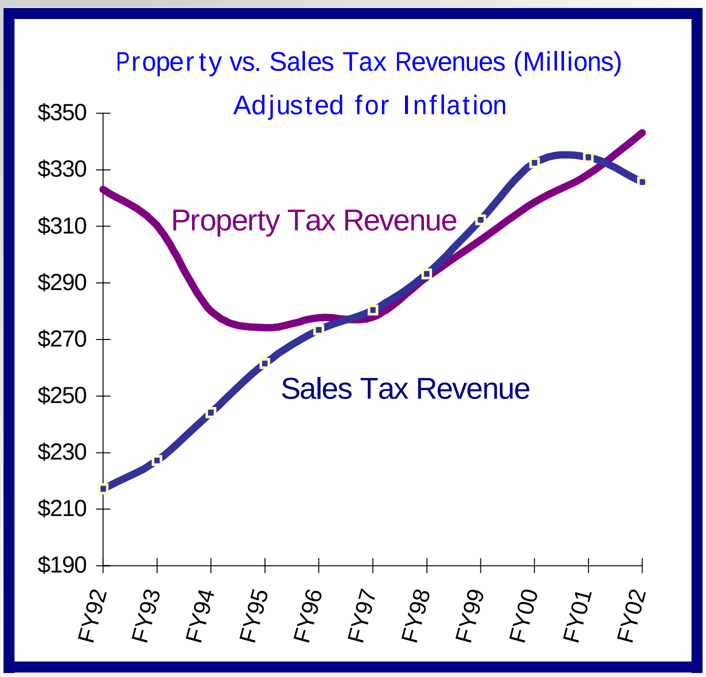
Inflation and Declining Sales Hurt Revenue Trend

In recent years, General Government Revenues have not kept up with population growth and inflation. Even though governmental revenues may increase in dollars, revenues (adjusted for inflation and population) actually declined. However, the County fund balance is healthy (page 1) which indicates that although revenues are down, spending is under control.

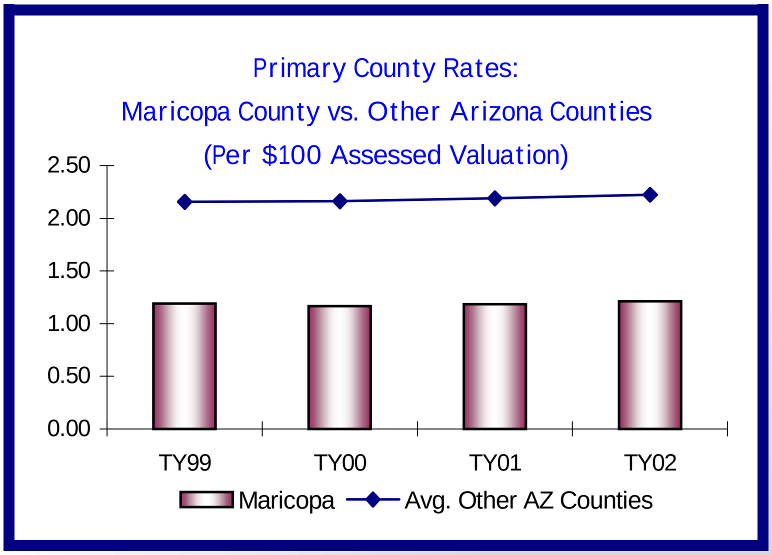


Although sales tax revenues have become relatively more important in recent years, the upward trend of inflation-adjusted sales tax reversed in FY02.

As Maricopa County has increased its reliance on sales taxes to support services, it has been more directly affected by economic trends.



Property Tax Rates are Comparatively Low

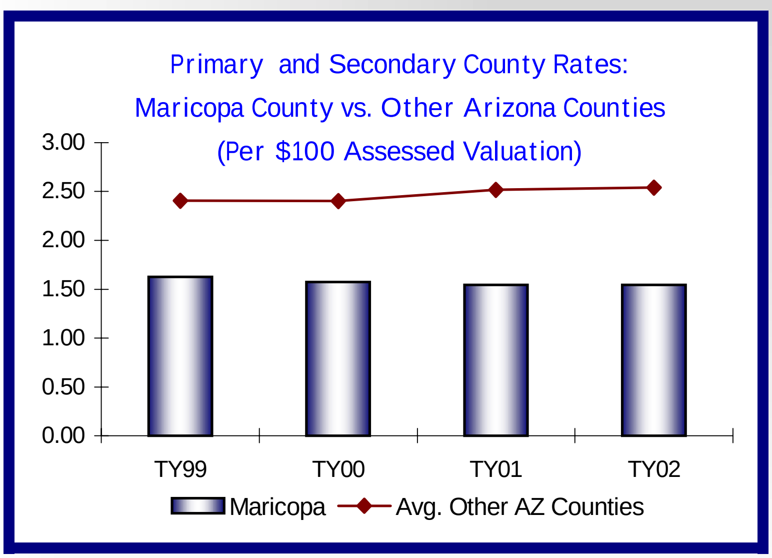


Primary Tax Rate
(Per $100 Assessed Valuation)
TY02 (Tax Year)

Maricopa	$1.21
Benchmark Average	$2.22

Primary property tax revenues help fund County maintenance and operation budgets.

Maricopa County tax rates are lower than the average of all other Arizona counties.



Combined Primary and
Secondary Tax Rate,
(Per $100 Assessed Valuation)
TY02 (Tax Year)

Maricopa	$1.54
Benchmark Average	$2.53

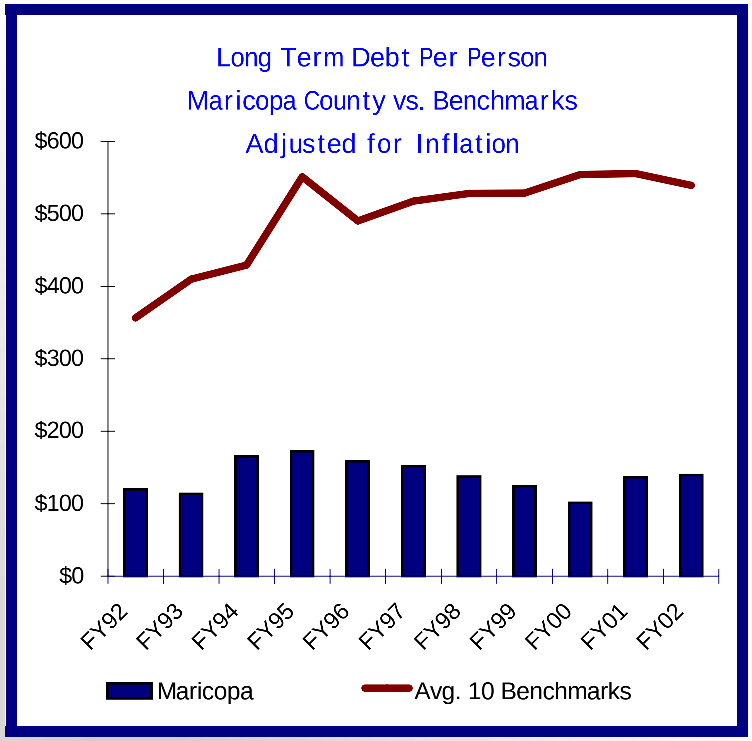
Combined rates include General Fund Obligation Bond Debt Service, and the Flood Control and Library Special Districts.

Maricopa County Debt is Very Low

Maricopa County has very low debt levels compared with the average of benchmark counties.

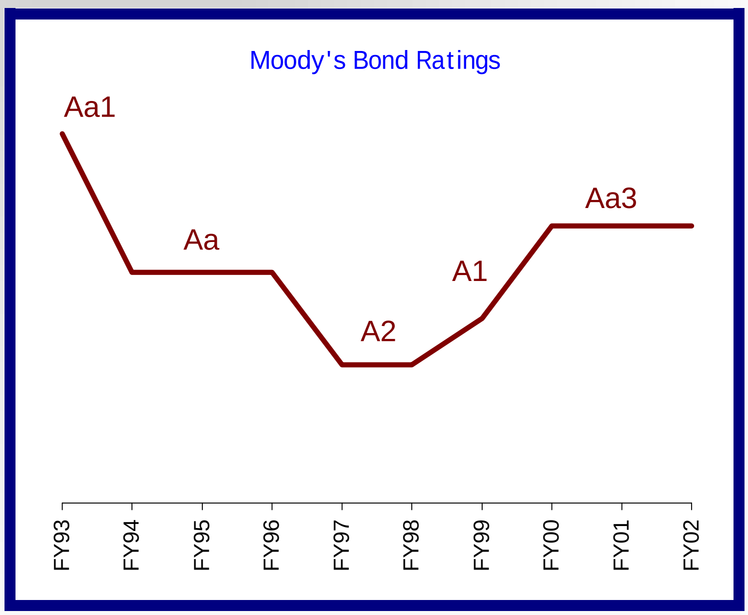
Maricopa's low debt level has resulted from a conservative, "pay as you go" approach to financing new capital assets/ projects.

FY04 will be the last year of the County's 1986 voter approved general obligation debt financing for capital projects. As of July 2005, Maricopa County will be considered free of general obligation debt.



Moody's considers ratings of Baa and higher as investment grade. Since 1994, Maricopa County has demonstrated an improving bond rating trend.

See page 15 for information about bond ratings.



Maricopa Integrated Health Systems

Maricopa Integrated Health Systems (MIHS) consists of the following entities:

- Maricopa Medical Center (hospital)
- Maricopa Health Plan (ambulatory managed care)
- Maricopa Long - Term Care Program (MLTCP / ALTCS)
- Health Select (managed employee care)
- Senior Select (Medicare plan)

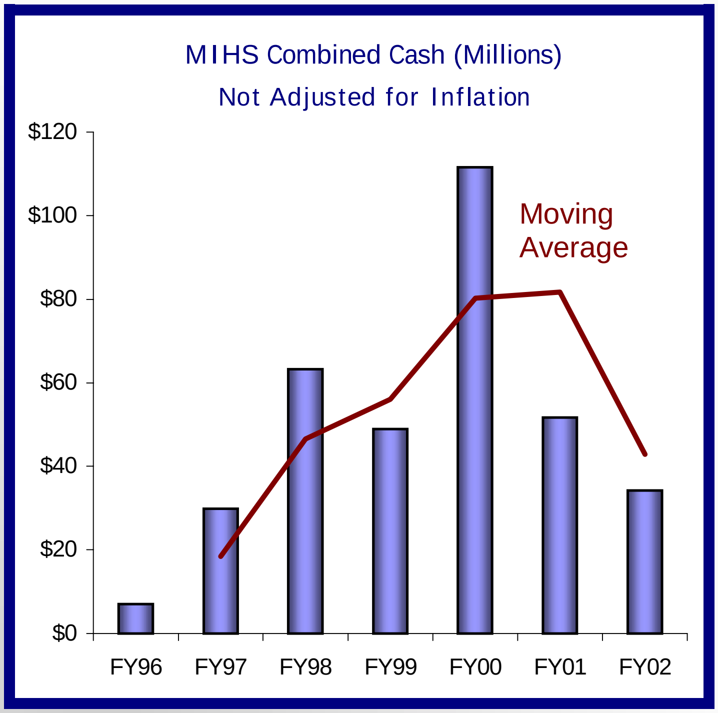
Medical Center deficits have been more than offset by MLTCP profits over past years. The following graphs show significant negative trends over recent years that may diminish the ability of the system to support itself.

Subsequent to FY02, Maricopa County has increased its efforts to spin off MIHS from Maricopa County by promoting the creation of a separate health system district. If these efforts are not successful, Maricopa County may elect to close portions of MIHS.

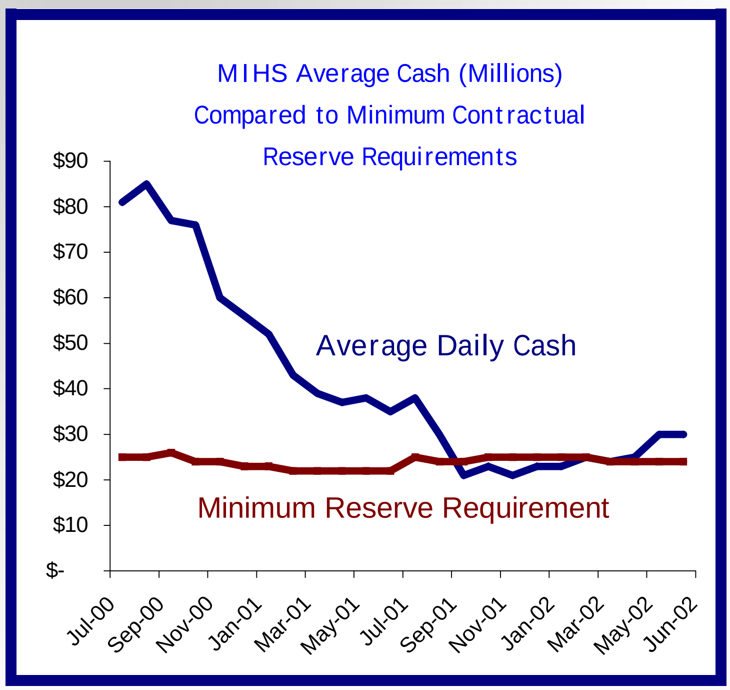
MIHS Cash Trend Causes Concern

Total Health System cash has declined significantly since FY00. The decline is attributed to declining profitability and expenditures for capital assets, as shown on the following pages.

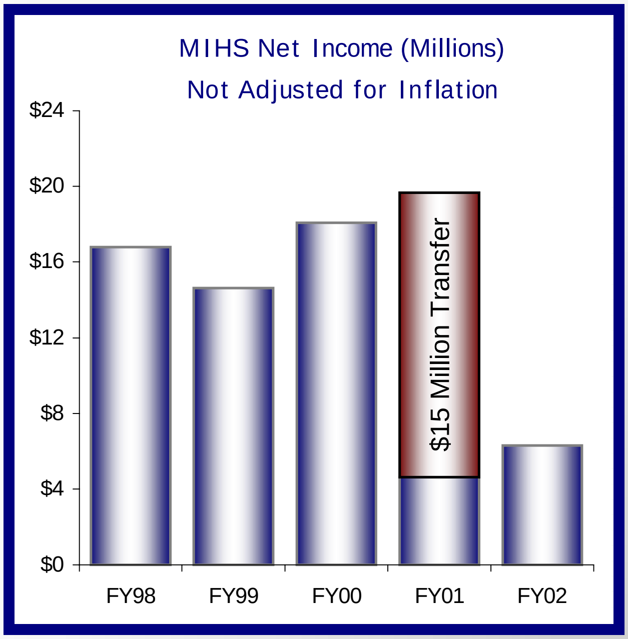
Subsequent to FY02, MIHS established a cash management plan to stabilize the declining trend.



Contractual Reserves consist of minimum balances specified in MLTCP and MHP contracts plus debt service reserve. The reserves should be viewed as minimum balance requirements for contractual compliance. They do not necessarily represent desirable business operating reserves, nor do they include provisions for Medical Center, Health Select, or Senior Select operations.



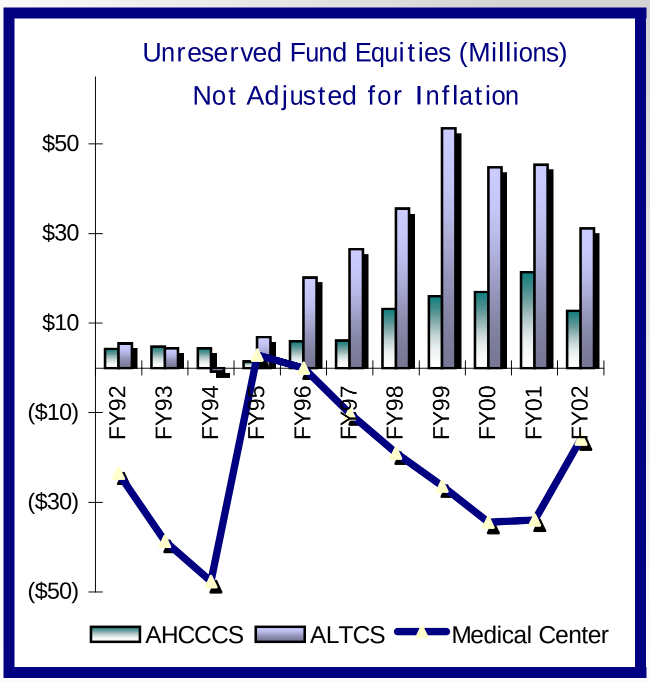
MIHS Net Income has Declined



Health system net income significantly declined in FY01 and FY02.

In FY01, $15 million of net income resulted from transferring Health Plan equity to the Medical Center via the General Fund. Combined MIHS Equity gains from net income were offset by the $15 million equity transfer out to the General Fund.

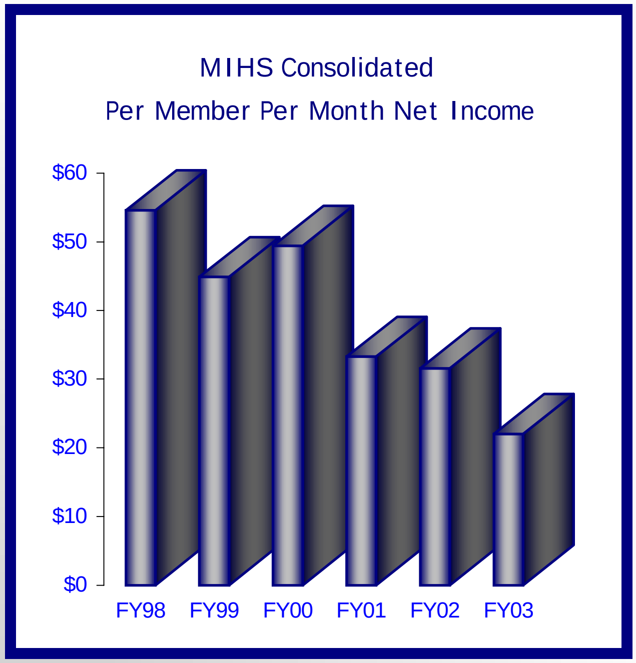
Several factors contributed to the net income decline, including the gradual loss of market share in the health system's most profitable health plan, the Maricopa Long Term Care Program. The chart at the bottom of page 12 shows this market share decline.



The health plans show healthy fund equities, whereas the medical center has had negative equity. Increases to the Medical Center fund equity were accomplished through fund transfers from the health plans and from the County General Fund.

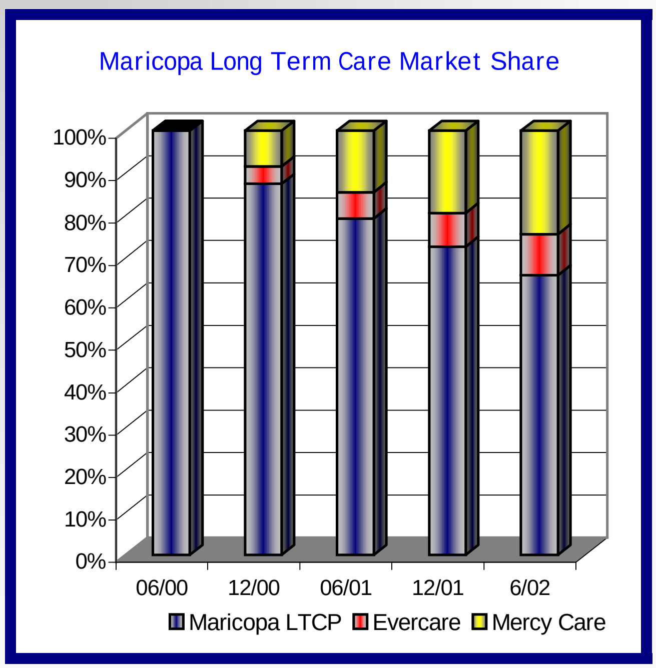
Health Plan Market Share has Declined

Health plans' profitability is often measured as a per member per month number. MIHS' per member per month profitability has been in decline for the last three years, as shown in the chart at right.



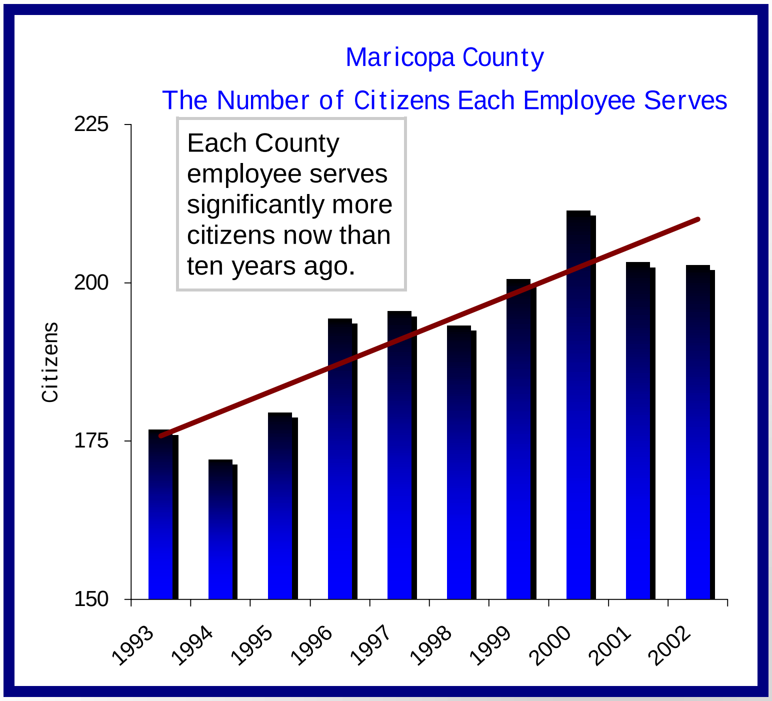
Data provided by MIHS Finance Department.

Maricopa Long Term Care Program's (MLTCP) market share has been steadily declining at the rate of 1% each month. The market share decline began in calendar year 2000 when the State of Arizona opened the long term care program to competition. Previously, MLTCP had been the sole contractor with the state for long term care in Maricopa County.



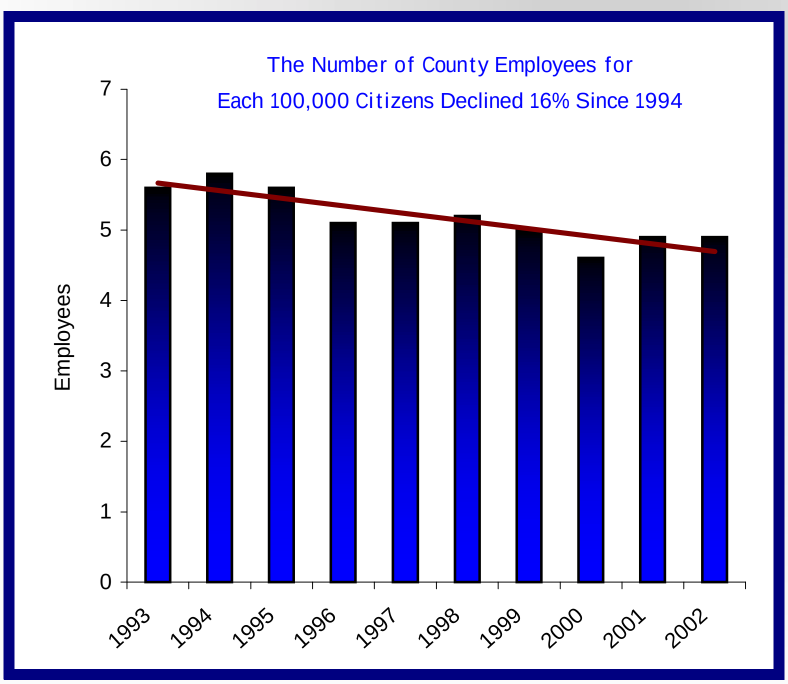
Historically, MLTCP has contributed the lion's share of Health System profits. Falling market share may jeopardize MIHS profitability.

Maricopa Employees are Serving More Citizens



Anticipating serious budgetary challenges (potential impacts of local economy and state budget crisis), Maricopa County developed its FY03 budget to keep base budgets the same or lower than FY02.

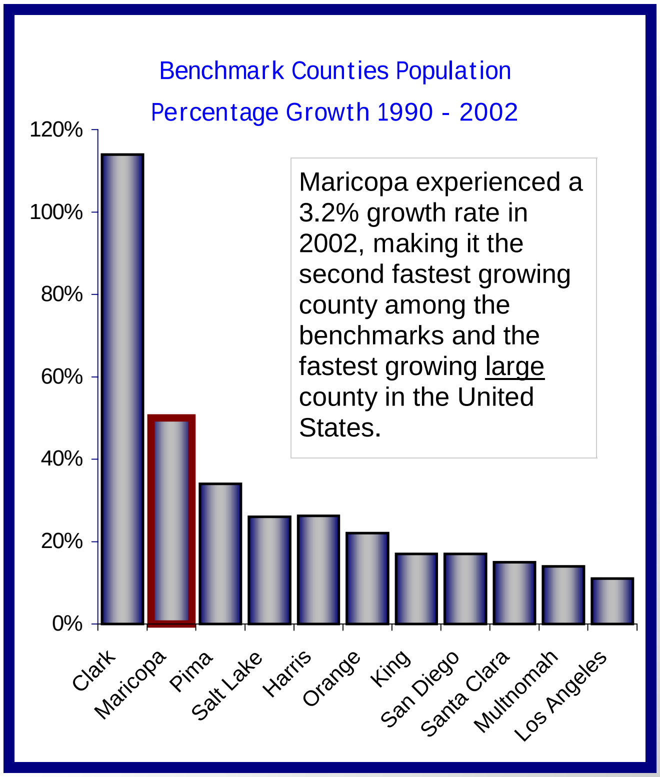
The FY03 budget significantly restricts new positions and salary increases while the current economic climate persists.

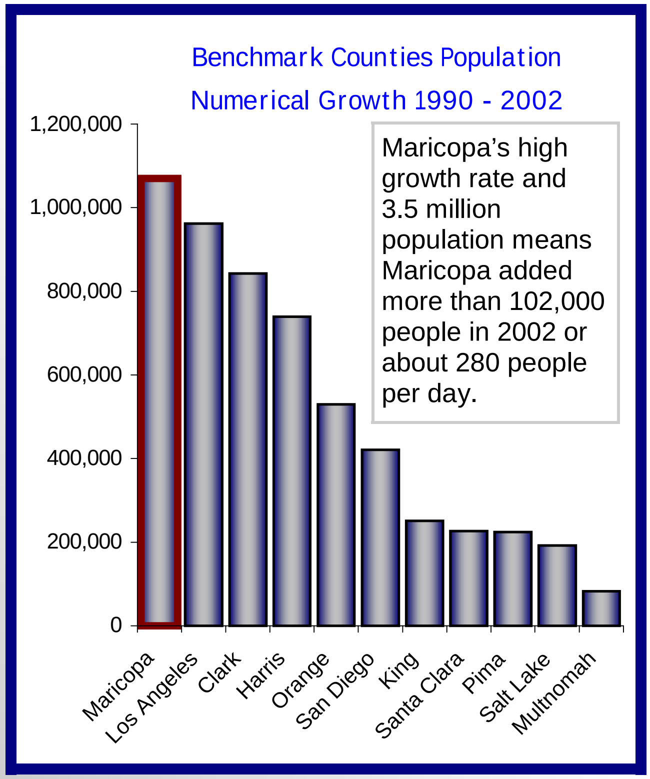


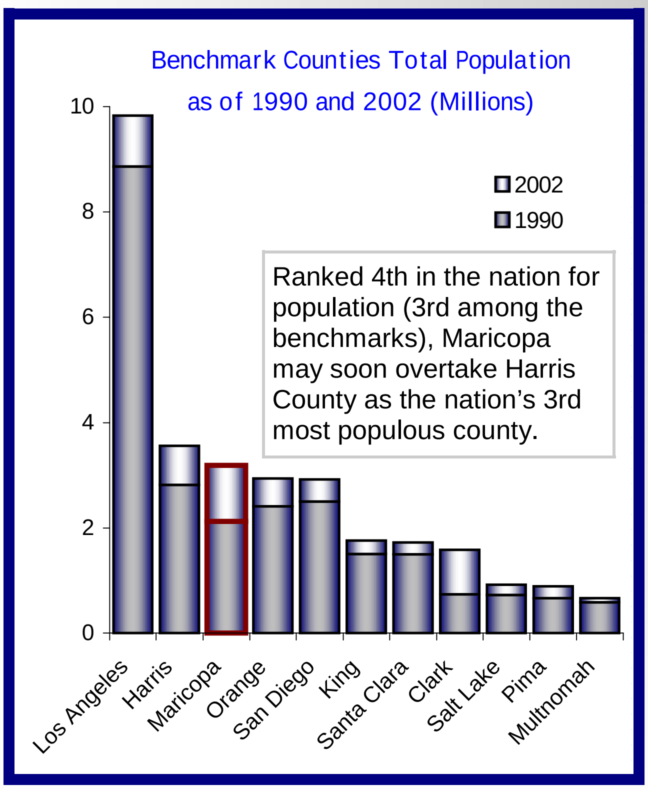
Maricopa County will face tremendous pressure to provide the same level of service to its citizens as population increases and service needs expand.

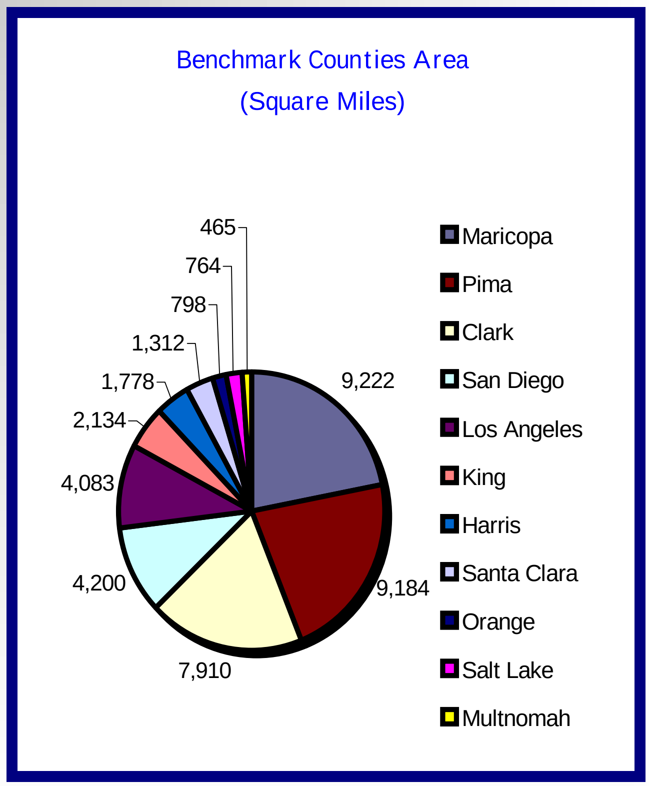
Subsequent event:
The FY04 budget anticipates as much as 10% budget reductions in departments providing non-mandated services.

Maricopa County Population is Growing Fast







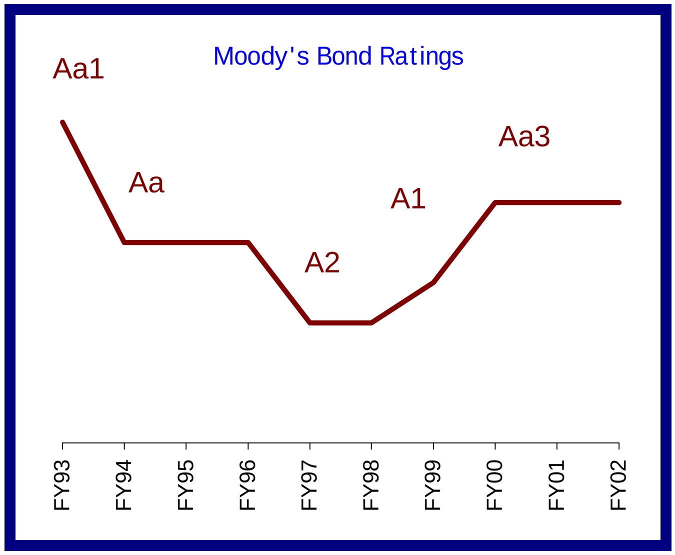


Bond Ratings are Strong

Financial Recovery is Reflected in the County's Bond Ratings:

Moody's — Aa-3
Fitch — AA

The County's financial position declined in the early 1990's. The County responded by restructuring its finances. Since June 1994, the Moody's County bond ratings have steadily improved. The graph illustrates Moody's bond ratings from FY93 through FY02:



What do the Moody's Ratings Mean?

According to Moody's, a rating helps investors determine the relative likelihood that they might lose money on a given fixed-income investment. Obligations that extend longer than one-year are rated ***Aaa*** through ***C.*** Moody's ***Aaa*** represents the highest quality, meaning that the obligation ranks highest in terms of investor safety. A ***C*** rating is the lowest level of credit quality. Investments rated ***Baa*** and above are considered "investment grade." Those rated ***Ba*** and below are considered "speculative grade". The numerical indicators further modify credit risk within each rating. A modifier of ***1*** indicates that the issue ranks in the higher end of its generic rating, while a modifier of ***3*** indicates that the issue ranks in the lower end of its generic rating[1].

The graph presented above shows that Maricopa County's Long-term bonds, rated **Aa-3** by Moody's, are considered high-grade bonds[1]. Maricopa County's trend since June 1994 has been one of improving ratings. In announcing its rating upgrade, Moody's referred to improvement in the County's financial condition, conservative fiscal strategies, elimination of non-service support for the County hospital, and the County's low debt position.[1]

What does the Fitch IBCA Rating Mean?

According to Fitch IBCA, credit ratings are an opinion on the ability of an entity to meet its financial commitments. These credit ratings are used by investors as indications of the likelihood of getting their money back in accordance with the terms on which they invested. "Investment-grade" ratings (international long-term 'AAA' 'BBB' categories) indicate a relatively low probability of default, while those in the "speculative" or "noninvestment grade" categories (international long-term 'BB' 'D') either signal a higher probability of default or that a default has already occurred. Ratings imply no specific prediction of default probability. However, for example, it is relevant to note that over the long term, defaults on 'AAA' rated U. S. corporate bonds have averaged less than 0.10% per annum, while the equivalent rate for 'BBB' rated bonds was 0.35%, and for 'B' rated bonds, 3.0%.[2]

1 Moody's Investor Service "Rating Actions, May 27, 2000," How to Use Ratings" and "Rating Definitions" [Online]. Available: http://www.Moodys.com.html.
2 Fitch IBCA "Rating Definitions" [Online]. Available: http://www.Fitchibca.com.html

Report Methodology

Definition

Financial Condition is defined as a local government's ability to finance services on a continuing basis. A county in good financial condition can sustain existing services to the public, withstand economic slumps, and meet the demands of changing service needs.

Objectives, Scope, and Methodology

The objective of this report is to evaluate the financial condition of Maricopa County using key indicators. Indicators were selected from authoritative sources on evaluating governmental entity financial condition and judged to be the most indicative of a county's overall financial health.

Ten benchmark counties' and Maricopa County's audited financial statements were used as primary sources of data for this report. The benchmark counties are:

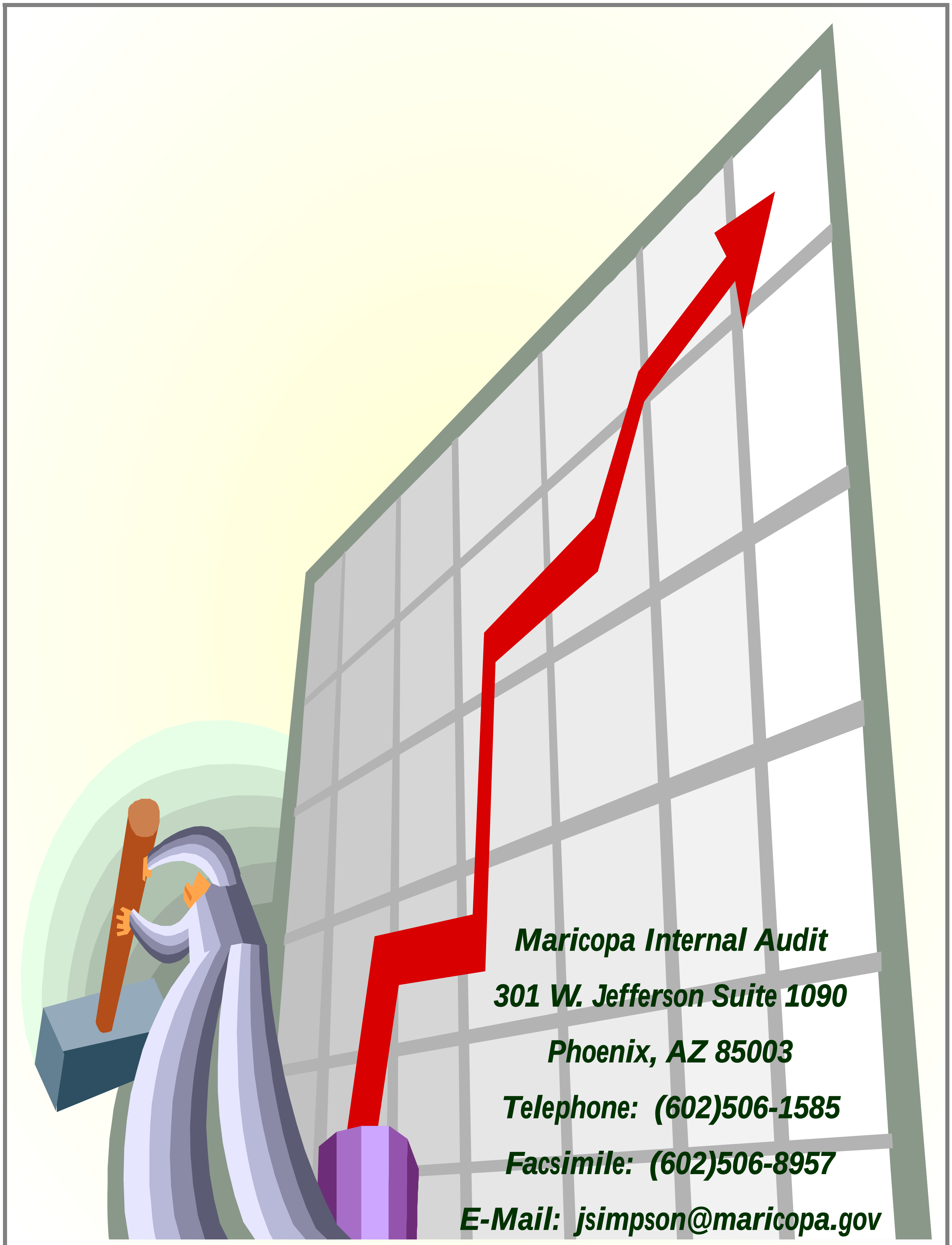
- Clark (Las Vegas, NV)
- Harris (Houston, TX)
- King (Seattle, WA)
- Los Angeles (Los Angeles, CA)
- Multnomah (Portland, OR)
- Orange (Santa Ana, CA)
- Pima (Tucson, AZ)
- Salt Lake (Salt Lake City, UT)
- San Diego (San Diego, CA)
- Santa Clara (San Jose, CA)

Other sources include the Governmental Accounting Standards Board (GASB), the International City/County Managers Association (ICMA), ASU Center for Business Research, Arizona Department of Economic Security Research Administration, Arizona Department of Revenue Econometrics Unit, Maricopa County's Strategic Plans (budgetary documents), and Auditor General Reports.

The focus of the analysis was on the General Fund, but does include other funds when the General Fund is affected by the other fund(s), or when an overall County trend is examined. When pertinent, each section and graph presented define the fund(s) included in the analysis.

Trend analysis is used in this report. Trend analysis involves examining financial indicators' historical data over several years. A trend is defined as the direction the data is moving over a three-to-five year period.

Fiscal years are identified as "FY02" (fiscal year ending June 30, 2002). Numbers are referred to as "actual," otherwise as "adjusted for inflation", "constant", or "real" (e.g., "2002 dollars"). An "actual" number is the amount originally published in the CAFR. An "adjusted for inflation" or "constant" number has been adjusted to the purchasing power of a 2002 dollar. The adjustment for inflation was made according to the "U.S. Consumer Price Index—All Items."



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