

**ARIZONA HEALTH CARE
COST CONTAINMENT SYSTEM**

**FINANCIAL STATEMENTS
AND SUPPLEMENTARY INFORMATION**

Year Ended June 30, 2014

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Management's Discussion and Analysis

For the Fiscal Year Ended June 30, 2014

Management of the Arizona Health Care Cost Containment System ("AHCCCS" or the "Agency") provides this Management's Discussion and Analysis for the benefit of the readers of the AHCCCS financial statements. This narrative overview and analysis of the financial activities of AHCCCS is for the fiscal year ended June 30, 2014. The intent of this discussion and analysis is to look at AHCCCS' performance as a whole. We encourage readers to consider this information in conjunction with the basic financial statements and related footnotes that follow this section.

Financial Highlights

Government-Wide

- The assets of AHCCCS exceeded its liabilities at fiscal year ended June 30, 2014 by \$77.9 million. AHCCCS' net position at June 30, 2014 is comprised of an unrestricted net position of \$10.5 million and net invested in capital assets of \$67.4 million.
- AHCCCS' net position increased by \$43.8 million during fiscal year 2014. The net financial position of governmental activities increased by \$43.1 million, and the net position of the business-type activity increased by \$692,000. The increase in governmental net position was primarily driven by the continued investment in an internally developed automated eligibility system in order to streamline the eligibility process, resulting in better, faster services to members and the organizations that serve them. The system also allows for electronic data transfers between the state and the federally facilitated marketplace. The business-type activity net position increase was based on six months of operations through December 31, 2013. Healthcare Group ("HCG") ceased operations on December 31, 2013 and transitioned its members to the federally facilitated marketplace for their health insurance coverage needs effective January 1, 2014.

Fund Level

- As of the close of fiscal year 2014, AHCCCS' total governmental funds reported an ending fund balance of \$3.2 million, an increase of \$1.1 million from fiscal year 2013. This increase is primarily attributable to \$300,000 of final repayments to the Hospital Residency Loan Fund, a \$318,500 increase in the Intergovernmental Services Agreement Fund (AHCCCS Operating Fund – Hawaii Arizona PMMIS Agreement (HAPA) Savings Fund), representing unspent funds, and a \$361,000 ending balance in the new Hospital Assessment Fund.
- Business-type activities ended operations as it ceased providing coverage to enrolled members effective December 31, 2013. Operations during fiscal year 2014 resulted in operating income of \$578,000 representing the seventh year of continued profitability. The remaining \$7.253 million ending net position (cash) will automatically transfer to the State's General Fund based on legislation that repeals the Business-type entity's operating fund from and after December 31, 2014.

More detailed information regarding the government-wide financial statements and fund level financial statements can be found below.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to AHCCCS' basic financial statements, which are comprised of three components: 1) government-wide financial statements, 2) fund financial statements and 3) notes to the financial statements.

Government-Wide Financial Statements (Reporting AHCCCS as a Whole)

The Government-Wide Financial Statements are designed to provide readers with a broad overview of AHCCCS' finances that are comparable to a private-sector business. The Statement of Net Position and the Statement of Activities are two financial statements that report information about AHCCCS, as a whole, and its activities. The presentation in these statements is intended to help answer the question: is AHCCCS, as a whole, better off or worse off financially as a result of this year's activities? These financial statements are prepared using the flow of economic resources measurement focus and the full accrual basis of accounting. They take into account all revenues and expenses connected with the fiscal year even if cash involved has not been received or paid out.

The Statement of Net Position (page 19) presents information on all of AHCCCS' assets and liabilities, with the difference between the two reported as "net position". Over time, increases or decreases in net position, along with other financial information, serve as indicators of AHCCCS' financial position and whether it is improving or deteriorating.

The Statement of Activities (page 20) presents information showing how AHCCCS' net position changed during the most recent fiscal year. All changes in net position are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods (e.g. incurred but not paid or reported fee-for-service and reinsurance claims, revenue from future Tobacco Master Settlement Agreement payments, prescription drug rebate receipts, business-type activities, and earned but unused vacation leave).

Both statements report activity for two categories:

- **Governmental Activities** - State appropriations along with federal, county and other local government intergovernmental revenues and member premium collections that primarily support the activities in this category. The governmental activities of AHCCCS primarily consist of programs authorized by the Social Security Act Titles XIX ("Medicaid") and XXI (Children's Health Insurance Program ("CHIP")) that are concentrated on the health needs of the citizens of Arizona through direct medical service payments and supplemental payments to qualifying hospital facilities throughout the State. The majority of activities are reported in this category.
- **Business-Type Activities** - This category was comprised of HCG operations. Members/customers of HCG were charged a premium that was used to fund the health care coverage provided and associated administrative functions. HCG ceased operations on December 31, 2013 and transitioned its members to the federally facilitated marketplace for their health insurance coverage needs effective January 1, 2014.

The government-wide financial statements can be found on pages 19 and 20.

Fund Financial Statements (Reporting AHCCCS' Major Funds)

A fund is a legislatively authorized fiscal and accounting entity with a self-balancing set of accounts that AHCCCS uses to keep track of specific sources of funding and spending for specific activities or objectives. AHCCCS, like other State agencies, uses fund accounting to ensure and demonstrate compliance with legislative appropriation funding requirements. All of the funds of AHCCCS can be divided into two categories: governmental funds and the proprietary fund.

Governmental funds - Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, the governmental funds financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financial position and requirements. This approach is known as using the flow of current financial

resources measurement focus and the modified accrual basis of accounting. These financial statements provide a short-term view of AHCCCS' finances that assists management in determining whether there will be adequate financial resources available to meet current needs. When an asset is recorded in governmental fund financial statements but the revenue is not available, AHCCCS reports a deferred inflow of resources until such time as the revenue becomes available. Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the State's near-term financial decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities. The basic governmental funds financial statements and related reconciliation can be found on pages 21 through 23 of this report.

AHCCCS reports two fund categories: General Fund and Other Governmental Funds. Information on these funds is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures and changes in fund balances.

Annually, the Legislature adopts an appropriated budget for AHCCCS for the Traditional Medicaid services; Proposition 204 services; Patient Protection and Affordable Care Act ("ACA") Adult Expansion; KidsCare; Children's Rehabilitative Services; Disproportionate Share Hospital ("DSH") payments; Rural Hospital payments; Voluntary Match KidsCare II and supplemental hospital payments for DSH, Graduate Medical Education ("GME"), and Safety Net Care Pool ("SNCP"); Arizona Long-Term Care Services ("ALTCS"); nursing facility supplemental payments and AHCCCS administration programs. The annual appropriation is made separately for both the State share of the required matching funds and federal financial participation funds from Medicaid and CHIP. In addition to the appropriations and expenditure authority approved by the Legislature, AHCCCS also expends continuously appropriated funds for medical service payments from prescription drug rebate reimbursement receipts, for other third party liability recovery program activities, electronic health records infrastructure development, and certain payments to hospitals for unfunded emergency department readiness costs and level 1 trauma center costs. The expenditures for unfunded emergency department readiness costs and level 1 trauma center costs are financed by revenues specifically collected for those purposes and are by statute continuously appropriated. At June 30, 2014, the trauma and emergency services fund had a zero fund balance. A budgetary comparison statement has been provided for the General Fund to demonstrate compliance with the budget on page 46.

Proprietary fund - This fund is used to account for activities that charge customers for the services provided. Proprietary funds are prepared using the flow of economic resources measurement focus and the full accrual basis of accounting; the same method used by private sector businesses. There is no reconciliation needed between the government-wide financial statements for business-type activities and the proprietary fund financial statements.

AHCCCS maintains one proprietary fund that is classified as an enterprise fund. AHCCCS uses this fund to account for the program that provides health insurance coverage for qualifying business organizations including some State political subdivisions. The basic proprietary fund financial statements can be found on pages 24 through 26 of this report.

Notes to the Financial Statements

The notes to the financial statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 27 to 45.

Government-Wide Financial Analysis

As noted earlier, the net position may serve over time as a useful indicator of a government agency's financial position.

AHCCCS Net Position
(in thousands of dollars)

	Governmental Activities		Business-Type Activities		Total	
	2014	2013	2014	2013	2014	2013
Current assets	\$ 1,153,990	\$ 1,097,064	\$ 7,257	\$ 9,873	\$ 1,161,247	\$ 1,106,937
Noncurrent assets	-	300	-	-	-	300
Capital assets	<u>67,499</u>	<u>25,176</u>	<u>-</u>	<u>1</u>	<u>67,499</u>	<u>25,177</u>
Total assets	<u>1,221,489</u>	<u>1,122,540</u>	<u>7,257</u>	<u>9,874</u>	<u>1,228,746</u>	<u>1,132,414</u>
Current liabilities	<u>1,150,772</u>	<u>1,094,968</u>	<u>4</u>	<u>3,313</u>	<u>1,150,776</u>	<u>1,098,281</u>
Total liabilities	<u>1,150,772</u>	<u>1,094,968</u>	<u>4</u>	<u>3,313</u>	<u>1,150,776</u>	<u>1,098,281</u>
Net position:						
Invested in capital assets, net of depreciation	67,499	25,176	-	1	67,499	25,177
Unrestricted	<u>3,218</u>	<u>2,396</u>	<u>7,253</u>	<u>6,560</u>	<u>10,471</u>	<u>8,956</u>
Total net position	<u>\$ 70,717</u>	<u>\$ 27,572</u>	<u>\$ 7,253</u>	<u>\$ 6,561</u>	<u>\$ 77,970</u>	<u>\$ 34,133</u>

For AHCCCS, assets exceeded liabilities by \$77.9 million at June 30, 2014 as compared to assets exceeding liabilities by \$34.1 million at June 30, 2013.

During fiscal year 2014, the total Government-wide net position increased by \$43.8 million to \$77.9 million. The increase is primarily due to the investment in capital assets for an internally developed automated eligibility system as it was in the prior fiscal year. The \$67.5 million invested in capital assets increased by \$42.3 million and is primarily comprised of the \$41.9 million of continued costs to develop and implement the new ACA compliant eligibility system. The automated eligibility system allows for certain eligibility determination administrative functions that previously were eligible for the 50 percent FFP rate to qualify for 75 percent enhanced federal financial participation ("FFP"). The first phase, initial implementation, of the new system became operational January 1, 2014 quarter and was approved by CMS for the enhanced 75 percent administrative match rate. For fiscal year 2014, eligibility expenditures totaling \$37.8 million were claimed at the 75 percent match rate resulting in a \$9.5 million state share savings in eligibility and related expenditures. In addition to the \$10.3 million of expenditures for the first phase of operations, system development work also continued during the year with the amount funded by Medicaid through June 30, 2014 totaling \$33.5 million and is reported as software under development in footnote 2.

The governmental operations unrestricted component of net position is comprised of a \$3.2 million net position balance primarily consisting of \$1.6 million of funds limited to future spending for certain information technology activities. Other components include a \$900,000 cash balance in the Hospital Loan Residency Fund and \$636,000 of hospital and nursing facility assessments cash on hand and accounts receivable. During fiscal year 2014, the governmental unrestricted net position increased by \$821,700 primarily due to a \$318,500 increase in the Intergovernmental Services Agreement Fund (AHCCCS Operating Fund – Hawaii Arizona PMMIS Agreement (HAPA) Savings Fund), representing unspent funds, and a \$361,000 ending balance (increase) in the new Hospital Assessment Fund. Additionally, the business-type activity unrestricted net position of \$7.2 million increased by \$692,000 as a result of operating and non-operating income from the final six months of business activities.

AHCCCS Changes in Net Position
(in thousands of dollars)

	Governmental Activities		Business-Type Activities		Total	
	2014	2013	2014	2013	2014	2013
Revenues						
Program Revenues						
Charges for services	\$ 5,028	\$ 5,416	\$ 11,747	\$ 26,872	\$ 16,775	\$ 32,288
Other operating grants and contributions	716,301	747,660	-	-	716,301	747,660
Federal operating grants	6,557,721	5,977,384	-	-	6,557,721	5,977,384
General revenues						
State appropriations	2,007,751	2,016,660	-	-	2,007,751	2,016,660
Tobacco tax	129,041	131,441	-	-	129,041	131,441
Unrestricted investment earnings	<u>74</u>	<u>45</u>	<u>59</u>	<u>59</u>	<u>133</u>	<u>104</u>
Total revenues	9,415,916	8,878,606	11,806	26,931	9,427,722	8,905,537
Expenses						
Health Care	<u>9,314,354</u>	<u>8,809,659</u>	<u>11,114</u>	<u>22,527</u>	<u>9,325,468</u>	<u>8,832,186</u>
Excess before transfers	101,562	68,947	692	4,404	102,254	73,351
Transfers, net	<u>(58,417)</u>	<u>(48,528)</u>	<u>-</u>	<u>-</u>	<u>(58,417)</u>	<u>(48,528)</u>
Increase in Net Position	43,145	20,419	692	4,404	43,837	24,823
Net Position – beginning of year	<u>27,572</u>	<u>7,153</u>	<u>6,561</u>	<u>2,157</u>	<u>34,133</u>	<u>9,310</u>
Net Position – end of year	<u>\$ 70,717</u>	<u>\$ 27,572</u>	<u>\$ 7,253</u>	<u>\$ 6,561</u>	<u>\$ 77,970</u>	<u>\$ 34,133</u>

At June 30, 2014, both the governmental and business-type activities reported a positive unrestricted net position which totaled a combined \$10.5 million, which is a \$1.5 million increase (16.9 percent) from the prior fiscal year's \$9.0 million unrestricted net position.

Governmental activities in fiscal year 2014 increased the net position by \$43.1 million. The increase is primarily due to the investment in capital assets for the implementation of the first phase and continued development of the new automated eligibility system. The investment was necessary to implement the ACA allowing Arizona residents to register for insurance coverage beginning January 1, 2014 and allowing for electronic data transfers between the state and the federally facilitated marketplace. Business-type activities increased the net position by \$692,000 from the final six months of operations.

Medicaid Restoration and Expansion - Patient Protection and Affordable Care Act (ACA) of 2010

Beginning on January 1, 2014, the AHCCCS program implemented the ACA in accordance with Federal laws and regulations as approved by the Arizona Legislature. The ACA implementation included: the restoration of the childless adults (expansion state adults) who were previously eligible for AHCCCS under the voter mandated Proposition 204, expansion of coverage for adults from 100-133 percent of the federal poverty level ("FPL") (representing the populations determined to be non-mandatory by the Supreme Court of the United States), and the mandatory Child expansion for children ages 6-19 from 100-133 percent of the FPL. These three distinct populations all have enhanced federal financial participation matching rates effective January 1, 2014. The expansion state adults are matched at an 83.62% percent rate, the expanded coverage for adults receives a 100 percent rate, and the child expansion are matched at the 77.06 percent expenditure match rate. The state legislation for the restoration and expansion included an assessment to certain hospitals to fund the state share of expenditures for the expansion state adults. The assessment provided \$75 million of revenue in the current fiscal year. Participation in the various federal financial funding participation rates available under the ACA required a modernized Medicaid eligibility determination information technology system. AHCCCS and the Department of Economic Security ("DES") continued to leverage and upgrade an existing eligibility system to meet the new compliance requirements. In addition to the enhanced program

match rates provided by the ACA, an eligibility determination made by the new Modified Adjusted Gross Income ("MAGI") methodology also qualifies for a 25 percent increase in the federal match from 50 to 75 percent for administrative costs associated with eligibility determination functions for most staff activities and the system costs. System development also qualified for a time-limited specific exemption to the cost allocation requirements set forth in OMB Circular A-87 requiring that all costs be specifically allocated to the benefiting program was granted. The exemption also allows an investment in the health program's eligibility determination systems to be leveraged at the highest (90 percent) federal financial participation rate to apply to other federally-funded human service programs in addition to Medicaid if the shared function is required by Medicaid. Accordingly, AHCCCS and DES are jointly participating in the process to replace their respective existing systems under these favorable terms. The Medicaid investment in the eligibility system for the first phase placed into service in 2014, and continued development for the second phase through June 30, 2014 is \$62.6 million and represents 92.7 percent of the \$67.5 million invested in capital assets balance.

AHCCCS experienced significant member growth in the final six months of fiscal year 2014 due to the January 1, 2014 implementation of the ACA expansion, including the restoration of the Proposition 204 population. Enrollment for April 2014 increased by 74,109 members and enrollment for May 2014 saw an additional 48,491 members enroll with AHCCCS. These increases represented the largest two consecutive months of growth in the history of the AHCCCS program. Overall enrollment increased by 211,827 members for the December 1, 2013 through June 1, 2014 period excluding the final month of HCG enrollment. The largest increase occurred in the restoration of the Proposition 204 adults, which are now known as expansion state adults. Although this level of growth was unprecedented, it was in line with forecasted growth.

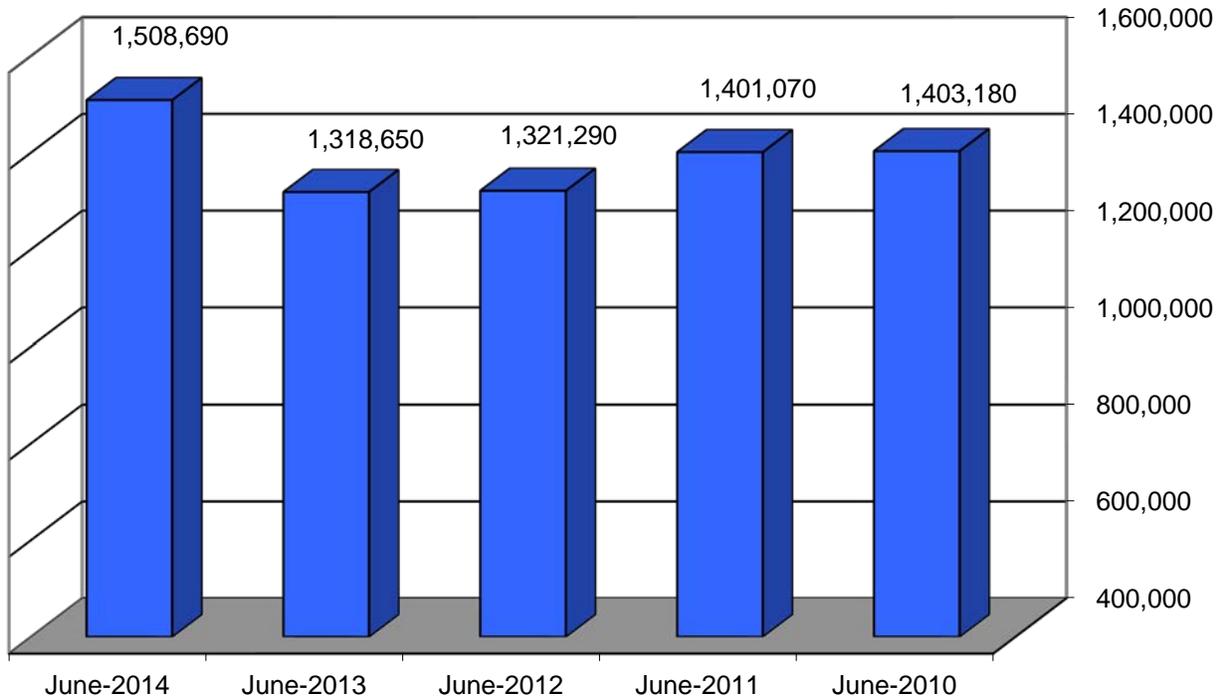
Governmental Activities

Fiscal year 2014 governmental activities increased the net position by \$43.1 million primarily from the investment in capital assets.

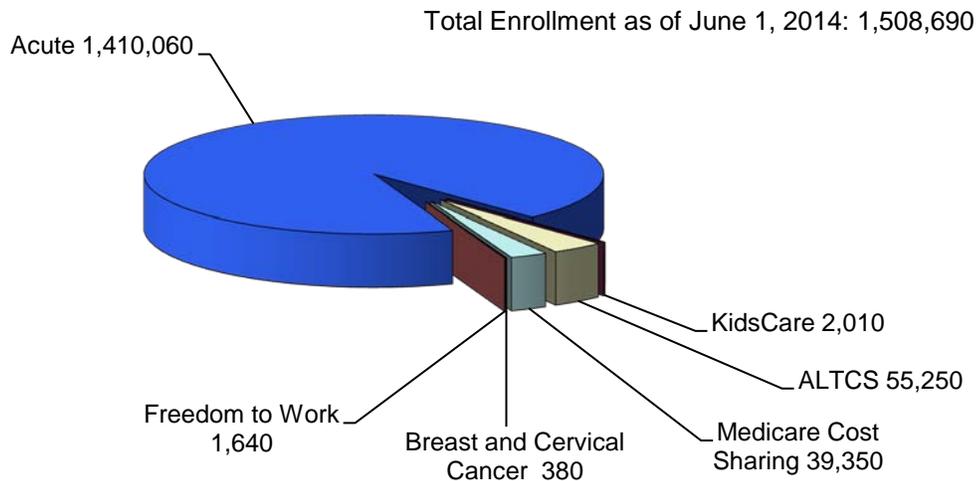
Enrollment in AHCCCS programs increased in fiscal year 2014 as the result of the ACA expansion and simultaneous ending of the Childless Adult program enrollment freeze beginning January 1, 2014. Total enrollment for all of AHCCCS' programs at June 1, 2014 is 1,508,690, an increase of 190,040 members over June 1, 2013 or 14.4 percent growth as compared to the previous year's 2,640 or 0.2 percent decrease in members. The Proposition 204 Childless Adult program freeze, effective July 8, 2011, continued through the first six months of the fiscal year resulting in a steady decline to a low of 67,770 members before the January 1, 2014 restoration re-opened enrollment ending the fiscal year at 215,740 members. Additionally, the continuation of the KidsCare enrollment freeze, which began January 1, 2010, resulted in an ending enrollment of 2,010 members, which is just 10.9 percent of the June 2011 level of 18,469. Also, effective February 1, 2014, the KidsCare II temporary coverage expansion program expired with an ending enrollment of 37,101. Originally, the program was set to expire December 31, 2013, but AHCCCS requested a one-month extension due to the numerous problems associated with accessing enrollment opportunities through the Federally Facilitated Marketplace. Notices were sent to approximately 23,000 families with income between 100-133% FPL who transitioned to Medicaid under the Child expansion effective January 1, 2014. Notices were also sent to approximately 14,000 families with income over 133% FPL directing them to apply for coverage under the Federally Facilitated Marketplace.

The following charts depict AHCCCS membership growth and enrollment by program for the reporting period:

AHCCCS Membership Growth



AHCCCS Enrollment by Program



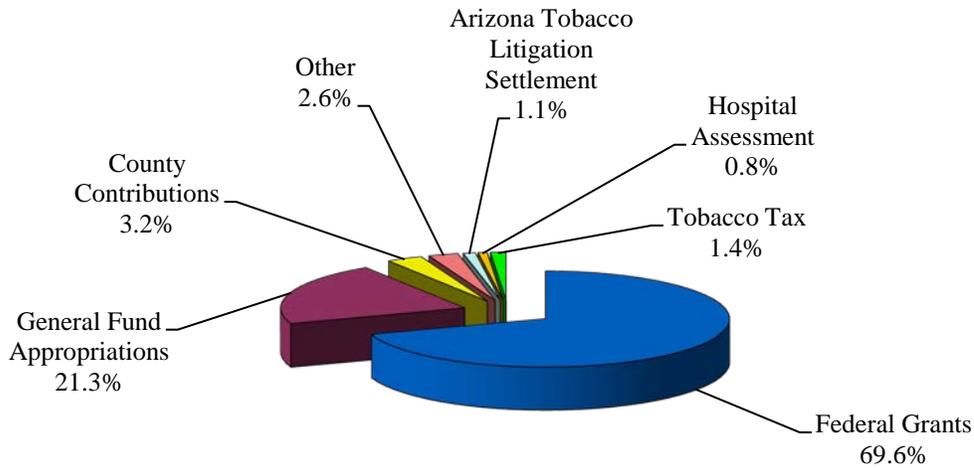
The cost of health care programs, including Medicaid and CHIP, totaled \$9,314.4 million in fiscal year 2014, a \$504.3 million increase from the \$8,809.7 million reported in fiscal year 2013. As shown in the statement of activities, the amount of expenditures funded from federal grants through CMS was \$6,557.7 million (70.4 percent) in fiscal 2014 as compared to \$5,977.4 million (67.9 percent) in fiscal 2013. Program funding in the form of federal financial participation is primarily determined through the Federal Medical Assistance Percentage ("FMAP") rate used to provide the amount of federal matching funds for qualifying State medical assistance expenditures. The FMAP is based on the relationship between Arizona's per capita personal income and the national average per capita personal income over three calendar years. The FMAP is recalculated each federal fiscal year and increased by 1.55 percent to 67.23 percent from the prior year's rate of 65.68 percent during three of the four quarters of state fiscal year 2014. In addition to the FMAP, the ACA introduced multiple new rates for the various new eligibility categories covered under the expansion. In Arizona, three additional rates applied to covered populations beginning on January 1, 2014. These three new rates were all in excess of the "regular" 67.23 FMAP with the rates for both the expansion state (childless adults - 0% to 100% FPL) and the newly eligible adults (adults - 100% to 133% FPL) changing on October 1st and January 1st of the fiscal year. Overall, program expenditures increased by 5.7 percent over the prior fiscal year. However, expenditures funded by state appropriations decreased in fiscal year 2014 primarily due to the higher ACA federal financial participation rates and the introduction of the hospital assessment as the state match source dedicated to fund the Proposition 204 populations. The hospital assessment totaled approximately \$75 million in fiscal year 2014. The increase in current fiscal year program expenditures is primarily attributable to the enrollment increase compared to the prior year where it was attributable to supplemental hospital payments to fund uncompensated care costs. However, supplemental hospital payments in fiscal year 2014 funded by political subdivision voluntary contributions resulted in payments of \$608.1 million distributed to Arizona hospitals. This is a \$281.7 million or 31.7 percent decrease from the \$889.8 distributed in the prior fiscal year. The decrease was due to changes in the CMS approved SNCP program waiver and legislation that ended the City of Phoenix's Access to Care hospital assessment program coinciding with the January 1, 2014 AHCCCS program changes that expanded enrollment thus reducing the impact of the childless adults enrollment freeze and other medical service and rate cuts that had a negative effect on hospital reimbursements.

State, county and miscellaneous funding sources combined to provide \$2,858.2 million in State funding sources and appropriations in fiscal year 2014, a \$43.1 million decrease over the \$2,901.2 million reported in fiscal year 2013 primarily related to the increase in FMAP and the three new additional enhanced FFP rates applied to the ACA restoration and expansion populations. The following are the components of the State match funding sources utilized in fiscal year 2014. State General Fund revenues raised primarily in the form of income and sales taxes directed to AHCCCS amounted to \$1,243.6 million, and an additional \$764.2 million was passed through from other State agencies in order to provide the State's share for Medicaid eligible medical assistance expenditures. Arizona counties contributed \$297.4 million as determined by statutory funding formulas, session law and other intergovernmental agreements. Tax collections on tobacco products provided \$129.0 million in State match funding. The tobacco tax year-over-year collections saw a minimal \$2.4 million decrease reversing the increase in fiscal year 2013 and returning to the previous trend that resulted in six consecutive years of decreases. An additional \$100.8 million in State revenue funding was provided by Arizona's share of tobacco litigation settlement funds. Although considerably lower than the \$149.1 million received in fiscal year 2013, it compares favorably due to the \$48.1 million one-time payment due to the multi-year settlement the State signed to resolve the diligent enforcement disputes for 2003 through 2012. Overall, these master settlement agreement (MSA) revenues are recorded in accordance with the Governmental Accounting Standards Board ("GASB") Technical Bulletin No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues*, which clarifies how payments made to AHCCCS pursuant to the MSA with major tobacco companies, are recorded. Payments are based on cigarette and other tobacco product sales from the preceding year. AHCCCS has accrued \$50.0 million for the period January 1, 2014 through June 30, 2014 based on Arizona's Joint Legislative Budget Committee 2015 estimated payment. In addition to the annual and one-time settlement payments described above, AHCCCS continues to receive the Strategic Contribution Fund payment through April 15, 2017. The amounts of the payments are dependent upon several adjustments, the magnitude of which will not be fully known until an independent auditor provides its calculations in February or March of each year. Other factors that

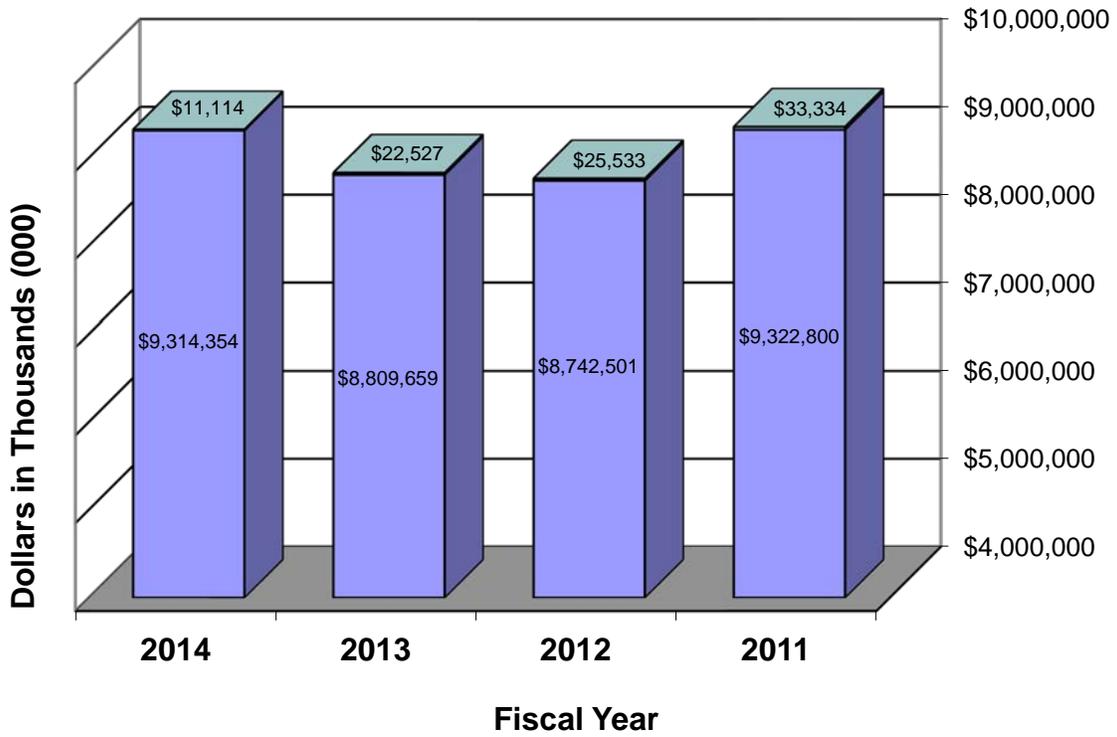
could also affect the MSA payment amount AHCCCS ultimately receives, include default or bankruptcy by one or more tobacco companies and other unforeseen withheld payment amounts. Finally, Tribal gaming receipts determined by statutory formula distributed to AHCCCS provided \$21.5 million in additional funding.

The following charts depict revenues by source of the governmental activities for the fiscal year and expenses by fund type for the reporting period:

Revenues by Source - Governmental Activities



AHCCCS Expenses by Fund Type



Business-Type Activities

The sole proprietary fund business-type activity for AHCCCS is the Healthcare Group (“HCG”). HCG ended business operations on December 31, 2013 as the Arizona State Legislature passed legislation to repeal HCG effective January 1, 2014. Members were advised to apply for health insurance coverage through the Federally Facilitated Marketplace for individual plans and plans for small businesses through the Small Business Health Options Program Marketplace.

Performance

HCG reported operating income in fiscal year 2014 of \$578,000 and an increase in net position of \$692,000. The final period of operating results concluded with the seventh consecutive year of profitability beginning back in fiscal year 2008. The ending unrestricted net position for HCG is \$7.253 million. In accordance with the legislation, any remaining fund balance in the HCG Fund will revert to the State General Fund effective January 1, 2015 unless the Legislature determines otherwise.

Financial Analysis of AHCCCS’ Governmental Funds

Governmental Funds

At the end of fiscal year 2014, AHCCCS’ governmental funds reported combined ending fund balances totaling \$3.2 million, an increase of \$1.1 million from the prior year. This increase is attributable to \$300,000 of final repayments to the Hospital Residency Loan Fund, a \$318,500 increase in the Intergovernmental Services Agreement Fund (AHCCCS Operating Fund – Hawaii Arizona PMMIS Agreement (HAPA) Savings Fund), representing unspent funds, and a \$361,000 increase in the new Hospital Assessment Fund. These increases represent 87 percent of the \$1.1 million positive change. The Hospital Assessment Fund and HAPA Savings Fund balances are available only for certain expenditures in fiscal year 2015. Any utilization of these balances must either be for qualifying information technology related activities, medical services for qualifying populations or by legislative directive or program administration.

The General Fund is the chief operating fund of the AHCCCS Traditional Medicaid services, KidsCare, Children’s Rehabilitative Services, DSH, Rural Hospital and ALTCS services programs. These programs primarily utilize a State general fund appropriation and revenue sources from the annual tobacco litigation settlement proceeds, taxes on tobacco products, contributions from Arizona counties, certified public expenditure methodologies, prescription drug rebate collections and political subdivision non-federal share matching agreements to provide the required state matching funds for federal Medicaid and CHIP revenue. Although the General Fund provided an appropriation to the Proposition 204 services program in fiscal year 2014, the Hospital Assessment Fund’s assessments and collection began effective January 1, 2014 and is intended to supplement the tobacco tax and tobacco settlement collections and replace the General Fund going forward as the state match for federal Medicaid revenue. AHCCCS also has authority to make supplemental distributions to hospitals for the GME, DSH and SNCP programs funded by voluntary contributions of the required state match from political subdivisions.

The Other Governmental Funds consist of ten individual funds comprising 100 percent of the total fund balance of \$3.2 million available for qualifying activities. The Other Governmental Funds’ fiscal year 2014 fund balances consist of assigned fund balances in the amount of \$2.3 million and committed funds of \$900,000. Revenue from taxes on cigarettes and other related tobacco products decreased 4.75 percent from fiscal year 2013 and generated \$87.2 million for the current year compared to \$91.6 million in fiscal year 2013. Since the passage of ballot proposition 203 in November 2006, tobacco tax collections have declined by \$60.9 million or 41.1 percent since the \$148.1 million high point of collection in fiscal year 2006.

General Fund Budgetary Highlights

Differences totaling \$723.6 million occurred between the original and the final amended administrative and programmatic expenditure budgets. During the 2014 legislative session, the Arizona legislature appropriated all voluntary payments from political subdivisions for DSH, GME, SNCP hospital payments, and for program coverage expansion including KidsCare II and Proposition 204 qualifying adults. The fiscal year 2014 legislation again allows these voluntary amounts to be increased for any political subdivision funds including the federal matching monies in excess of the original appropriation. Additionally, the controlling fiscal 2014 legislation allowed for appropriation increases necessary to fund the January 1, 2014 Medicaid restoration and ACA expansion including the state match funded by the hospital assessment. This resulted in a net \$723.6 million supplemental appropriation increase in fiscal year 2014 partially offset by a \$73.4 million General Fund ex-appropriation allocated to both the Traditional services and Proposition 204 services programs. Other differences relate to special line item adjustments that utilized surpluses from one line item to offset shortfalls in another line item. These appropriation transfers are approved by the Governor's Office of Strategic Planning and Budgeting and are in accordance with legislative authority. The major special line item supplemental increases are briefly summarized as follows:

- \$321.9 million increase for payments to specified hospitals funded by voluntary Intergovernmental agreements with political subdivisions including the City of Phoenix hospital assessment tax for the purpose of providing the state matching funds
- \$374.9 million increase to fund payments for the Medicaid restoration and ACA expansion populations comprised of \$309.0 million for the Proposition 204 services program and \$65.9 million for the adults between 100% - 133% FPL funded by a 100 percent FFP rate
- \$26.3 million increase for the voluntary GME special line item based on increased political subdivision contributions including federal matching monies in excess of the original appropriation
- \$21.4 million increase for program coverage expansion including the expanded KidsCare II funded by voluntary intergovernmental agreements with political subdivisions including the City of Phoenix hospital assessment tax for the purpose of providing the state matching funds
- \$14.9 million increase for the voluntary disproportionate share hospital special line item based on increased political subdivision contributions including federal matching monies in excess of the original appropriation
- \$70.3 million appropriation special line item transfer increases primarily related to administrative costs to continue the development of the automated eligibility system necessary to comply with new federal requirements of the ACA and increased eligibility related costs incurred due to the significant enrollment growth funded by surpluses in the program special line items

At June 30, 2014, actual cash basis appropriated program expenditures were \$500.7 million less than budgetary estimates primarily resulting from surplus federal expenditure authority.

Capital Asset Administration

AHCCCS' investment in capital assets for its governmental and business-type activities as of June 30, 2014 is \$67.499 million, net of accumulated depreciation and amortization. This investment in capital assets includes furniture, vehicles, equipment and internally generated software for projects started after June 30, 2009. Land, buildings and improvements are under the management of the State and are accounted for on the State's comprehensive annual financial report. Total net capital assets increased \$42.323 million or 168.1 percent over the prior fiscal year balance. Investment in internally generated software (completed and under development) increased \$44.377 million as a result of upgrades and enhancements to Medicaid eligibility systems related to the ACA of \$43.807 million and \$570,075 for the continuing development of the next mandated versions of the electronic Transaction and Code Set standards under the Health Insurance Portability and Accountability Act. The remaining capital asset changes are for disposals in excess of additions including depreciation of vehicles, furniture and equipment and upgraded servers and related IT equipment items.

AHCCCS Capital Assets (net of depreciation, in thousands of dollars)						
	Governmental Activities		Business-Type Activities		Total	
	2014	2013	2014	2013	2014	2013
	Vehicles	\$ 612	\$ 822	\$ -	\$ -	\$ 612
Furniture and equipment	2,209	2,120	-	1	2,209	2,121
Software	30,511	1,800	-	-	30,511	1,800
Software under development	34,167	20,434	-	-	34,167	20,434
Total net position	<u>\$ 67,499</u>	<u>\$ 25,176</u>	<u>\$ -</u>	<u>\$ 1</u>	<u>\$ 67,499</u>	<u>\$ 25,177</u>

Additional information on AHCCCS' capital assets can be found in Note 2 to the accompanying financial statements on pages 36 and 37.

Contingent Liabilities

In January 2001, AHCCCS obtained a Waiver from CMS to receive federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204. The Waiver requires that over the term of the original agreement (April 1, 2001 through September 30, 2011) and the new agreement (October 1, 2011 through September 30, 2016), that the population covered by the Waiver be budget neutral for CMS. Effective with the January 1, 2014 implementation of the eligibility expansion under the ACA to include the new adult group, members with income between 100% and 133% of the FPL, the budget neutrality measurement is performed separately for the new adult population. Budget neutral means that CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. The budget neutrality calculation is dependent on a number of variables including the number of members, the eligibility category of members and the general economy and its impact on unemployment, medical inflation and policy decisions made by the Legislature that may impact program costs. In accordance with the Waiver, AHCCCS ended expenditure reporting as of September 30, 2013 related to the budget neutrality period ended September 30, 2011. The cumulative federal share favorable variance for the waiver period ended September 30, 2013 was \$ 2,162.7 million. Through June 30, 2014, AHCCCS remains under the cumulative reporting limit threshold for the current waiver. Accordingly, management is projecting that as of June 30, 2014, AHCCCS does not have any liability to CMS related to the budget neutrality agreement and the accompanying financial statements have not been adjusted for the impact of any liability AHCCCS may have related to the Waiver budget neutrality agreement.

In December 2006, the Department of Health and Human Services, Office of Inspector General, Office of Audit Services (“OIG”) commenced an audit of the Direct Service Claiming (“DSC”) program. In March 2010, the OIG provided AHCCCS with the audit report and related findings including a recommendation that CMS recoup \$21.288 million of program costs previously passed through to the LEAs under the DSC program. CMS subsequently adjusted the amount to \$19.924 million. AHCCCS disagrees with the findings in part, has returned \$2,700 of federal funds for non-disputed claims and plans to appeal the decision to the Department of Health and Human Services, Departmental Appeals Board (“DAB”) once CMS issues a disallowance. If and when all administrative appeals are exhausted, AHCCCS will request a refund from the LEAs or will deduct the amount from future payments in accordance with the intergovernmental agreement. The recoupment liability of \$19.924 million is included in the due to the federal government with a corresponding receivable in the due from the State and local governments in the accompanying financial statements.

The School Based Medicaid Administrative Claiming program (“MAC”), administered through a third party administrator (“TPA”), allows federal funding to pass through to the LEAs for certain administrative activities. Beginning in March 2006 and concluding in August 2008, the contractor performed a review of the claim calculation for the period from January 2004 through December 2007 as a result of findings from an OIG audit in another state that questioned methods used in the claim calculation methodology. The contractor’s assessment of the maximum impact of the retroactive claim calculations is approximately \$9.3 million and CMS has instructed AHCCCS to refund the \$9.3 million in overpayments. Subsequent to the self-disclosure to CMS, the OIG conducted an audit of the MAC program for the period from January 1, 2004, through September 30, 2008. The OIG provided AHCCCS with the audit report and related findings in January 2013 including a determination of unallowable Federal reimbursement of \$11.717 million.

Certain elements of the calculations performed by the contractor and the OIG overlap causing duplication of approximately \$2.076 million for a total net unallowable cost of \$9.641 million. AHCCCS intends to file an appeal with the DAB if a disallowance is received. AHCCCS internal legal counsel has indicated that it is reasonably possible that some additional amount will be disallowed and recouped by CMS. AHCCCS will request a refund from the LEAs or will deduct the amount from future payments in accordance with the intergovernmental agreement. The recoupment liability of \$18.941 million is included in the due to the federal government with a corresponding receivable in the due from the State and local governments in the accompanying financial statements.

Economic Factors and Next Year’s Budgets and Rates

As projected, AHCCCS experienced a significant enrollment increase for fiscal year 2014 upon the January 1, 2014 Medicaid restoration and ACA expansion implementation. For the fiscal year 2014, June 2013 over June 2014 period, the Medicaid full service enrollment increased by 153,446 for all AHCCCS programs except for the business-type Healthcare Group program that ceased operation on December 31, 2013. Enrollment for the first quarter of fiscal year 2015 continues to increase averaging 37,660 members per month, however the month over month growth is decelerating as the September 2014 increase was 30.9 percent less than July 2014’s growth. The Arizona economic recovery continues however it lags behind when compared to national coincident index that gauges economic activity combining employment, average hours worked in manufacturing, unemployment rate, and inflation-adjusted wages. The coincident index increased by 2.5 percent compared to August 2013 but still falls short of the 3.0 percent increase for the U.S. index. The housing market continued to weaken for single family construction as Arizona’s twelve month building permit totals are 1.4 percent lower than September 2013. The unemployment rate continues to improve and has decreased to 6.9 percent when compared to the 8.0 percent level of September 2013. Accordingly, AHCCCS is projecting population growth will continue in early fiscal year 2015 followed by a leveling off to normal rates during fiscal year 2016.

The total Medicaid fiscal year 2015 appropriation for AHCCCS is \$8,087.9 million compared to the final \$7,459.8 appropriation for fiscal year 2014. This increase reflects the impact of restoring the expansion state childless adult and expansion of the newly eligible adult and children populations up to 133 percent of the FPL under the ACA.

For contract year 2015, Acute Care capitation rates are projected to increase by 2.93 percent which is significantly higher than the 0.49 percent increase for contract year 2014 which was reflective of the competitive bid process associated with the 2014 contract year. The 2015 increase is primarily based on unit cost and utilization increases, high cost drug treatment options such as for the Hepatitis C drug Sovaldi, and ambulance service rate increase approved by the Legislature. The contract year 2015 Arizona Long Term Care System ("ALTCS" Elderly and Physically Disabled ("EPD")) capitation rates are estimated to increase by 1.16 percent. The largest factors impacting the ALTCS EPD rates are provider rate increases to both nursing facilities and home and community based service providers. AHCCCS is requesting a 3% capitation rate increase for all programs for contract year 2016 as part of the fiscal year 2016 budget submission.

As previously discussed, AHCCCS implemented the most sweeping health care legislation in decades with the most impactful being the restoration and ACA expansion of enrollment beginning January 1, 2014. Other major ACA mandates impacting fiscal year 2015 costs include the requirement that certain primary care physicians and services be reimbursed at no less than 100% of the Medicare payment rates in effect for a two year period ending December 31, 2014. Due to complicating factors such as rule making delays and lack of CMS guidance for managed care payment and encounter delays, AHCCCS only recently made an initial \$24.3 million payment and has accrued an additional \$97.9 million for the six quarter period through June 30, 2014. The true cost is not readily determinable at this time. An additional significant cost factor is the health insurance fee with a first year annual national projection of \$8 billion increasing to \$14.3 billion by 2018 and indexed thereafter effective January 1, 2014. CMS approved AHCCCS' payment methodology in August 2014 and the current year 2014 expenditures include an accrual for \$16.8 million for the first six months of calendar 2014. The fiscal year 2015 projection is \$77.5 million and \$124.6 million for fiscal year 2016.

A lawsuit was filed by a group of plaintiffs, consisting mostly of state legislators, seeking a declaration that the hospital assessment established under ARS 36-2901.08 is allegedly a tax passed in a manner inconsistent with the requirements for a tax established by the state constitution. The lawsuit was filed in September 2013 and has worked its way through the courts and is scheduled to be heard by the Arizona State Supreme Court in November 2014. AHCCCS intends to continue to vigorously defend the lawsuit on lack of standing. If the assessment is declared invalid, AHCCCS will have insufficient funds to cover childless adults with income up to 133% of FPL, but under the holding in *Fogliano v. State*, AHCCCS may adjust eligibility standards to match available remaining funds.

AHCCCS continues to aid in the development of a robust healthcare information technology ("HIT") by offering financial assistance to providers and other entities in adopting and using health HIT. In fiscal year 2014, \$49.9 million in federal funds were disbursed to Arizona hospitals and providers as incentives. Projections for fiscal year 2015 include \$48.7 million in non-appropriated federal pass-through expenditure authority for Arizona providers that may be eligible for Medicaid incentive payment funding.

AHCCCS' budget request for fiscal year 2016, submitted to the Governor in October 2014 included a rebase of the fiscal year 2015 budget. The current forecast is for a \$552.0 million shortfall primarily comprised of \$489.7 million in Federal Expenditure Authority and \$68.0 million needed in Hospital Assessment funding authority that requires up to an additional \$39.1 million in assessment and collections. The Agency also is currently projecting a General Fund surplus of \$7.0 million. AHCCCS continues to experience the impacts of the many program changes resulting from the ACA). However, factors such as CMS decisions, legal decisions, case load changes compared to projections may influence any final fiscal year shortfall and potential need and amount of a supplemental appropriation. Additionally, at the federal level, as a result of the November elections and party majorities in Congress and the Senate, health care legislation and funding priorities may be impacted. Management will closely monitor all these factors in relation to the adequacy of the fiscal year 2015 appropriation and fiscal year 2016 budget.

Request for Information

This financial report is designed to provide a general overview of AHCCCS' finances for the State's citizens and taxpayers, and its members, providers and creditors. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Arizona Health Care Cost Containment System, Division of Business and Finance, Attention: Finance Administrator, MD 5400, 701 East Jefferson, Phoenix, Arizona 85034.

INDEPENDENT AUDITORS' REPORT



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INDEPENDENT AUDITORS' REPORT

To the Director of the

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM (AHCCCS, an agency of the state of Arizona)

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the general fund and the aggregate remaining fund information of AHCCCS as of and for the year ended June 30, 2014, and the related notes to the financial statements, which collectively comprise AHCCCS' basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the general fund and the aggregate remaining fund information of AHCCCS, as of June 30, 2014, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of a Matter

As discussed in Note 1, the financial statements of AHCCCS are intended to present the financial position, the changes in financial position and cash flows, where applicable, of only that portion of the governmental activities, the business-type activities, the general fund and the aggregate remaining fund information of the state of Arizona that is attributable to the transactions of AHCCCS. They do not purport to, and do not, present fairly the financial position of the State of Arizona at June 30, 2014, the changes in its financial position, or, where applicable, its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that management's discussion and analysis on pages 1 – 16 and budgetary comparison information on page 46 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise AHCCCS' basic financial statements. The accompanying Schedule of Expenditures of Federal Awards, and related notes, as *required by Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations* is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. The information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the Schedule of Expenditures of Federal Awards is fairly stated, in all material respects, in relation to the basic financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated November 24, 2014 on our consideration of AHCCCS' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering AHCCCS' internal control over financial reporting and compliance.

Phoenix, Arizona
November 24, 2014



ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET POSITION

June 30, 2014
(amounts expressed in thousands)

ASSETS

	Governmental Activities	Business-type Activities	Total
CURRENT ASSETS			
Cash	\$ 113,800	\$ 7,257	\$ 121,057
Designated cash	26,793	-	26,793
Restricted cash	863	-	863
Due from state and local governments	149,006	-	149,006
Due from the federal government	680,672	-	680,672
Tobacco settlement receivable	50,000	-	50,000
Receivables and other	132,856	-	132,856
TOTAL CURRENT ASSETS	1,153,990	7,257	1,161,247
NONCURRENT ASSETS			
Furniture, vehicles, equipment and software, net of accumulated depreciation	67,499	-	67,499
TOTAL NONCURRENT ASSETS	67,499	-	67,499
TOTAL ASSETS	1,221,489	7,257	1,228,746

LIABILITIES

CURRENT LIABILITIES			
Accounts payable	23,658	3	23,661
Other accrued liabilities	2,985	1	2,986
Unearned revenue	21,637	-	21,637
Due to federal, state and county governments	142,673	-	142,673
Accrued programmatic claims	956,186	-	956,186
Compensated absences	3,633	-	3,633
TOTAL LIABILITIES	1,150,772	4	1,150,776

COMMITMENTS AND CONTINGENCIES

NET POSITION

INVESTED IN CAPITAL ASSETS	67,499	-	67,499
UNRESTRICTED	3,218	7,253	10,471
TOTAL NET POSITION	\$ 70,717	\$ 7,253	\$ 77,970

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF ACTIVITIES

Year Ended June 30, 2014
(amounts expressed in thousands)

	Program Revenues				Net (Expense) Revenue and Changes in Net Position		
	Program Expenses	Charges for Services	Federal Operating Grants	Other Operating Grants and Contributions	Governmental Activities	Business-type Activities	Total
PROGRAMS							
Government activities:							
Health care programs	\$ 9,314,354	\$ 5,028	\$ 6,557,721	\$ 716,301	\$ (2,035,304)	\$ -	\$ (2,035,304)
Business-type activities:							
Healthcare Group	11,114	11,747	-	-	-	633	633
TOTAL PROGRAMS	<u>\$ 9,325,468</u>	<u>\$ 16,775</u>	<u>\$ 6,557,721</u>	<u>\$ 716,301</u>	<u>(2,035,304)</u>	<u>633</u>	<u>(2,034,671)</u>
General revenues:							
State appropriations					2,007,751	-	2,007,751
Tobacco tax					129,041	-	129,041
Unrestricted investment earnings					74	59	133
					<u>2,136,866</u>	<u>59</u>	<u>2,136,925</u>
Transfers:							
Transfers out					<u>(58,417)</u>	<u>-</u>	<u>(58,417)</u>
Total general revenues and transfers					<u>2,078,449</u>	<u>59</u>	<u>2,078,508</u>
CHANGE IN NET POSITION					43,145	692	43,837
NET POSITION, BEGINNING OF YEAR					<u>27,572</u>	<u>6,561</u>	<u>34,133</u>
NET POSITION, END OF YEAR					<u>\$ 70,717</u>	<u>\$ 7,253</u>	<u>\$ 77,970</u>

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BALANCE SHEET - GOVERNMENTAL FUNDS

June 30, 2014
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
<u>ASSETS</u>			
Cash	\$ 86,679	\$ 27,121	\$ 113,800
Designated cash	26,793	-	26,793
Restricted cash	-	863	863
Due from state and local governments	134,314	14,692	149,006
Due from the federal government	669,970	10,702	680,672
Due from other funds	11,523	-	11,523
Tobacco settlement receivable	50,000	-	50,000
Receivables and other	132,724	132	132,856
TOTAL ASSETS	\$ 1,112,003	\$ 53,510	\$ 1,165,512
<u>LIABILITIES</u>			
Accounts payable	\$ 23,113	\$ 545	\$ 23,658
Other accrued liabilities	2,715	270	2,985
Unearned revenue	21,256	381	21,637
Due to federal, state and county governments	142,540	133	142,673
Due to other funds	-	11,523	11,523
Accrued programmatic claims	622,697	37,440	660,137
TOTAL LIABILITIES	812,321	50,292	862,613
<u>DEFERRED INFLOWS OF RESOURCES</u>			
Unavailable revenue	299,682	-	299,682
COMMITMENTS AND CONTINGENCIES			
<u>FUND BALANCES</u>			
Committed	-	900	900
Assigned	-	2,318	2,318
TOTAL FUND BALANCES	-	3,218	3,218
TOTAL LIABILITIES, DEFERRED INFLOWS OF RESOURCES, AND FUND BALANCES	\$ 1,112,003	\$ 53,510	

Amounts reported for governmental activities in the statement of net position are different because:

Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds.	67,499
A portion of liabilities for accrued paid time off of this amount is not due and payable from current financial resources and, therefore is not reported in the funds.	(3,633)
Receivables, offsetting the above accrued paid time off liability, will not be collected in 31 days, therefore are not reported in the funds.	3,633
A portion of accrued programmatic claims is not due and payable from current financial resources and, therefore is not reported in the funds.	(296,049)
A portion of receivables will not be collected in 31 days, therefore is not reported in the funds.	296,049
	\$ 70,717

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM
STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCES -
GOVERNMENTAL FUNDS

Year Ended June 30, 2014
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
REVENUES			
State government:			
Appropriations	\$ 1,239,228	\$ -	\$ 1,239,228
ISA pass through funds	764,151	-	764,151
Federal government:			
Acute care	3,663,082	688	3,663,770
Long-term care	775,925	33,305	809,230
ISA/IGA pass through funds	1,967,060	78	1,967,138
County and other local government:			
Acute care	50,515	-	50,515
Long-term care	243,479	-	243,479
IGA pass through funds	181,214	-	181,214
Tobacco litigation settlement revenue	100,765	-	100,765
Tobacco tax revenue	41,808	87,233	129,041
Gaming revenue	-	21,455	21,455
Nursing facility tax assessment	-	16,253	16,253
Hospital assessment	-	75,325	75,325
HAPA intergovernmental agreement revenue	-	7,332	7,332
Premium revenue	5,028	-	5,028
Other	19,700	338	20,038
TOTAL REVENUES	9,051,955	242,007	9,293,962
PROGRAMMATIC EXPENDITURES			
Medical Services:			
Traditional services	3,884,930	31,967	3,916,897
Proposition 204 services	1,707,176	93,375	1,800,551
Newly eligible adults	49,806	-	49,806
KidsCare services	55,985	-	55,985
Long-term care services	2,167,121	49,406	2,216,527
Childrens rehabilitative services	175,924	-	175,924
School-based services	28,669	-	28,669
Transplant services non-Medicaid	-	41	41
Hospital Payments:			
Disproportionate share	119,728	-	119,728
Rural and critical access hospital	13,858	-	13,858
Graduate medical education	151,356	-	151,356
Trauma center services	-	21,475	21,475
Safety net care pool	301,661	-	301,661
Other:			
Medicare Part D clawback	82,053	-	82,053
Health information technology	38,619	-	38,619
TOTAL PROGRAMMATIC EXPENDITURES	8,776,886	196,264	8,973,150
ADMINISTRATIVE EXPENDITURES	243,806	9,212	253,018
ADMINISTRATIVE EXPENDITURES PASSED THROUGH	8,477	78	8,555
TOTAL EXPENDITURES	9,029,169	205,554	9,234,723
EXCESS OF REVENUES OVER EXPENDITURES	22,786	36,453	59,239
OTHER FINANCING SOURCES (USES)			
Transfers to other State agencies:			
To State General Fund	(18,897)	(59)	(18,956)
To Arizona Department of Economic Security	(3,304)	-	(3,304)
To Arizona Department of Health Services	-	(35,357)	(35,357)
To Arizona Attorney General	(800)	-	(800)
Transfers between funds:			
To AHCCCS General Fund	-	(215)	(215)
From AHCCCS Other Fund	215	-	215
Repayments under the hospital residency loan program	-	300	300
TOTAL OTHER FINANCING SOURCES (USES)	(22,786)	(35,331)	(58,117)
NET CHANGE IN FUND BALANCES	-	1,122	1,122
FUND BALANCES, BEGINNING OF YEAR	-	2,096	2,096
FUND BALANCES, END OF YEAR	\$ -	\$ 3,218	\$ 3,218

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

RECONCILIATION OF THE STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCES - GOVERNMENTAL FUNDS TO THE STATEMENT OF ACTIVITIES

Year Ended June 30, 2014
(amounts expressed in thousands)

Amounts reported for governmental activities in the statement of activities (page 20) are different because:

Change in fund balances - total governmental funds (page 22)	\$ 1,122
Repayment of loaned funds under the Hospital Residency Loan Program provides current financial resources of governmental funds. This amount represents the loan repayments received in the current fiscal year and is recorded as a current financial resource in the governmental funds.	(300)
Governmental funds report capital outlays as expenditures. However, in the statement of activities, the cost of those assets is allocated over their estimated useful lives and reported as depreciation expense. This is the amount by which capital outlays exceeded depreciation in the prior period.	<u>42,323</u>
Change in net position of governmental activities (page 20)	<u>\$ 43,145</u>

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET POSITION - PROPRIETARY FUND

June 30, 2014

(amounts expressed in thousands)

ASSETS

CURRENT ASSETS

Cash

\$ 7,257

TOTAL ASSETS

7,257

LIABILITIES

CURRENT LIABILITIES

Accounts payable

3

Other accrued liabilities

1

TOTAL LIABILITIES

4

COMMITMENTS AND CONTINGENCIES

NET POSITION

UNRESTRICTED

7,253

TOTAL NET POSITION

\$ 7,253

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET POSITION -
PROPRIETARY FUND

Year Ended June 30, 2014
(amounts expressed in thousands)

OPERATING REVENUES	
Premium revenue	<u>\$ 11,747</u>
OPERATING EXPENSES	
Payments to health plans and providers	10,395
Salaries and employee benefits	586
Professional and outside services	80
Other	107
Depreciation	<u>1</u>
TOTAL OPERATING EXPENSES	<u>11,169</u>
OPERATING INCOME	<u>578</u>
NONOPERATING REVENUES	
Other income	62
Investment income	59
Nonoperating expense	<u>(7)</u>
TOTAL NONOPERATING REVENUE	<u>114</u>
CHANGE IN NET POSITION	692
NET POSITION, BEGINNING OF YEAR	<u>6,561</u>
NET POSITION, END OF YEAR	<u>\$ 7,253</u>

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF CASH FLOWS - PROPRIETARY FUND

Year Ended June 30, 2014
(amounts expressed in thousands)

CASH FLOWS FROM OPERATING ACTIVITIES	
Receipts from customers	\$ 8,748
Settlement income	62
Payments to health plans	(10,624)
Payments to employees	(642)
Payments to suppliers	(212)
Net cash used in operating activities	<u>(2,668)</u>
CASH FLOWS FROM INVESTING ACTIVITIES	
Investment income	59
Purchases of property and equipment	<u>(7)</u>
Net cash provided by investing activities	<u>52</u>
NET CHANGE IN CASH	(2,616)
CASH, BEGINNING OF YEAR	<u>9,873</u>
CASH, END OF YEAR	<u>\$ 7,257</u>
RECONCILIATION OF OPERATING INCOME TO NET CASH USED IN OPERATING ACTIVITIES	
Operating income	\$ 578
Adjustment to reconcile operating income to net cash provided by operating activities:	
Depreciation	1
Settlement income	62
Changes in operating net assets and liabilities:	
Decrease in accounts payable and other accrued liabilities	(25)
Decrease in deferred revenue - premiums	(2,999)
Decrease in accrued programmatic costs	(229)
Decrease in accrued compensated absences	<u>(56)</u>
NET CASH USED IN OPERATING ACTIVITIES	<u>\$ (2,668)</u>

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(1) Description of reporting entity and summary of significant accounting policies

A. Reporting entity

The accounting policies of the **Arizona Health Care Cost Containment System** ("AHCCCS" or the "Agency") conform to the accounting principles generally accepted in the United States of America applicable to governmental units. The financial statements of AHCCCS, as a department of the State of Arizona ("State"), are not intended to represent the related financial statement information of the primary government.

The Arizona Legislature ("Legislature") established AHCCCS in November 1981 to administer health care for the State's indigent population. AHCCCS is a State agency managed by an independent cabinet level administration created by the Legislature and is funded by a combination of federal, State, county and local funds. The federal portion is funded through the Centers for Medicare and Medicaid Services ("CMS") of the U.S. Department of Health and Human Services under a Section 1115 Waiver ("Waiver") approved by CMS, which exempts the AHCCCS program from certain requirements of conventional Medicaid programs. Approval of the Waiver, by CMS, extends through September 30, 2016. AHCCCS provides acute and long-term health care coverage to eligible residents of Arizona. Eligible residents include those who qualify under Section 1931(b) of the Social Security Act, individuals who are aged, blind or disabled, children who meet certain age requirements from families receiving food stamps, children and pregnant women whose household income meets eligibility requirements, certain single adults, childless couples, uninsured women needing active treatment for breast and/or cervical cancer and individuals with disabilities who want to work and who meet certain Supplemental Security Income ("SSI") eligibility criteria. Beginning on January 1, 2014, AHCCCS implemented the Patient Protection and Affordable Care Act ("ACA") of 2010. The ACA implementation included (a) the restoration of the childless adults (expansion state adults) who were previously eligible for AHCCCS under the voter mandated Proposition 204, (b) expanded coverage for adults from 100% to 133% of the federal poverty limit ("FPL") and (c) the mandatory child expansion for children ages 6-19 from 100% to 133% of the FPL. These three distinct populations all have enhanced federal financial participation matching rates effective January 1, 2014.

AHCCCS receives quarterly federal grants from CMS (as matching funds) to cover a portion of the health care costs of the residents of the State eligible for the Title XIX Medicaid program and Title XXI Children's Health Insurance Program ("CHIP"). State appropriations and county funding levels are based on annual budgets as dictated by the Legislature and as specified by Arizona Statutory funding formula and Session Law.

Under AHCCCS, health care coverage is provided substantially through a competitive bidding process with private and county-sponsored health plans bidding for the enrollment of AHCCCS eligibles by geographical service area. In addition, AHCCCS purchases health care services directly from providers.

AHCCCS also had the Healthcare Group ("HCG") line of business, which provided medical coverage primarily to small businesses. This business-type activity ended operations and ceased providing coverage to enrolled members after December 31, 2013. The activities of HCG are included in the proprietary fund. See Note 5 for information on HCG.

B. Basis of presentation

The basic financial statements include both government-wide and fund financial statements. The government-wide financial statements report information on the entire Agency while the fund financial statements focus on major funds. Each presentation provides valuable information that can be analyzed and compared between years to enhance the usefulness of the information.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

The government-wide financial statements (i.e., the statement of net position and the statement of activities) report information on the entire Agency. The effect of all significant interfund activity has been removed from these financial statements.

The statement of activities demonstrates the degree to which the governmental and business-type activities direct expenses are offset by program revenues. Direct expenses are those that are clearly identifiable with a specific function. Program revenues include appropriations, contributions and grants that are restricted for the operational or capital requirements of a particular function or segment.

Fund financial statements provide information about the Agency's funds. Separate financial statements are provided for the governmental and proprietary funds. The General Fund is the Agency's primary operating fund, and it accounts for all financial resources except those required to be accounted for in another fund. AHCCCS had one business-type activity, Healthcare Group, which ceased operations effective December 31, 2013. In fiscal year 2014, AHCCCS did not have any major funds; accordingly, all governmental funds other than the General Fund are aggregated and reported as other governmental funds.

C. Measurement focus, basis of accounting and financial statement presentation

The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting, as are the proprietary fund financial statements. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of the related cash flows.

Proprietary funds distinguish operating revenues and expenses from non-operating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. The principal operating revenues of the HCG were premiums charged to small, uninsured businesses with 2 to 50 employees and employees of political subdivisions for medical coverage. Operating expenses for the HCG included the costs of medical services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition were reported as non-operating revenues and expenses.

Proprietary fund revenues are recognized when they are earned, and expenses are recognized when they are incurred. Member premiums are due by the first day of the month proceeding the month of coverage. Proprietary fund operations ceased December 31, 2013.

The governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, AHCCCS considers revenues to be available if they are collected within 31 days of the end of the current fiscal year. When an asset is recorded in governmental fund financial statements but the revenue is not available, AHCCCS reports a deferred inflow of resources until such time as the revenue becomes available. The governmental funds' unearned revenue consists of revenue received in advance for services not yet provided. Expenditures generally are recorded when a liability is incurred, as under accrual accounting. Accrued programmatic costs include received but unpaid claims and estimates for incurred but not reported claims paid in the 31-day period following the end of the fiscal year. Actual results for accrued programmatic costs may differ from such estimates. These differences are recorded in the period in which they are identified. However, expenditures related to compensated absences are recorded only when payment is due.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

In fiscal year 2014, AHCCCS reports the following significant funds:

- a. The general fund is the primary operating fund for the Title XIX Medicaid program and the Title XXI State Children's Health Insurance Program.
- b. Special revenue funds, reported as other governmental funds, account for various health and administrative programs.
- c. The Healthcare Group Fund, reported as a business-type activity, accounts for the activities of a medical coverage program primarily for small, uninsured businesses with 2 to 50 employees and employees of political subdivisions.

The general fund is the only major governmental fund of AHCCCS.

D. Cash and investments

Substantially all of the cash and investments maintained by AHCCCS are held by the State of Arizona Office of the Treasurer ("Treasurer") with other State monies in an internal cash and investment pool. Investment income is allocated to AHCCCS on a pro rata basis. Amounts held by the Treasurer are recorded at fair value and totaled \$148,713 at June 30, 2014, including restricted funds of \$27,656.

The State is statutorily limited (by ARS §35-312 and §35-313) to certain investment types. Additionally, State statutes require investments made to be in accordance with the "Prudent Person" rule. This rule imposes the responsibility of making investments with the judgment and care that persons of ordinary prudence would exercise in the management of their own affairs when considering both the probable safety of their capital and the probable income from that capital. The Treasurer issues a separately published Annual Financial Report that provides additional information relative to the Treasurer's total investment activities.

Cash in the General Fund has been internally designated by AHCCCS in the amount of \$26,793 for the Interagency Service Agreement ("ISA") Fund. The ISA Fund is used to properly account for, control, and report receipts and disbursements associated with ISAs which are not required to be reported in other funds. Fund receipts consist of monies received from other entities and are utilized to match federal funding under the Medicaid and CHIP programs under the terms stated in the ISAs. Cash in the Other Governmental Funds is legally restricted in the amount of \$863 for the Hawaii Arizona PMMIS Alliance ("HAPA") Fund, as described in Note 4 and is offset by accrued expenditures of \$482 and unearned revenue of \$381 at June 30, 2014.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

In accordance with the Federal Cash Management Improvement Act of 1990 guidelines, AHCCCS may only request federal funds under specified funding techniques. These techniques require that AHCCCS draw down or request funds such that the timing of the receipt of the funds is interest neutral to both the State and Federal governments. For disbursements made through electronic fund transfers, funds must be drawn such that they are received by the State on the same day as the disbursement. For disbursements made through issuance of a check, funds must be drawn such that they are received by the State in accordance with its historical average check clearance pattern. The timing difference that occurs, due to drawing down funds after the issuance of checks, may result in bank overdrafts to AHCCCS at various times during the year. At June 30, 2014, no bank overdraft existed.

E. Net position / fund balance

The difference between fund assets and liabilities is "Net Position" on the government-wide and proprietary fund statements. Net position is reported in three categories:

- Net position, invested in capital assets, consists of capital assets net of depreciation.
- Restricted net position is restricted due to legal restrictions from laws and regulations of other governments; or legally enforceable through enabling legislation of the State.
- Unrestricted net position consists of net position which does not meet the definition of the two preceding categories.

These categories are based primarily on the extent to which AHCCCS is bound to honor constraints on the specific purposes for which the amounts in those funds can be spent. In the governmental fund financial statements, fund balances are classified as nonspendable and spendable and are defined as follows:

Nonspendable fund balance

Nonspendable fund balance – this includes amounts that cannot be spent because they are either not spendable in form (such as inventory) or legally or contractually required to be maintained intact (such as endowments). At June 30, 2014, AHCCCS had no nonspendable fund balance.

Spendable fund balance

Restricted fund balance – this includes amounts that can be spent only for specific purposes stipulated by legal requirements imposed by other governments, external resource providers, or creditors. AHCCCS imposed restrictions do not create a restricted fund balance unless the legal document that initially authorized the revenue (associated with that portion of the fund balance) also included language that specified the limited use for which the authorized revenues were to be expended. At June 30, 2014, AHCCCS had no restricted fund balance.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

Committed fund balance – this includes amounts that can only be used for specific purposes pursuant to constraints imposed by formal action of the Legislature. Those committed amounts cannot be used for any other purpose unless the Legislature removes or changes the specified use by taking the same type of action (for example, statute, session law, etc.) that it employed to previously commit those amounts. If the Legislative action that limits the use of the funds was separate from the action that initially created the revenues that form the basis for the fund balance, then the resultant fund balance is considered to be committed, not restricted. AHCCCS considers a resolution, a statute, or a session law action to constitute a formal action of the Legislature for the purposes of establishing committed fund balance. At June 30, 2014, AHCCCS' committed fund balance totaled \$900 and related to the hospital residency loan fund.

Assigned fund balance – this includes amounts constrained by the Legislature for specific purposes. Assigned fund balances include all remaining amounts (except negative amounts) that are reported in the governmental funds, other than the general fund, that are not classified as nonspendable and are neither restricted nor committed and amounts in the general fund that are intended to be used for a specific purpose. By reporting particular amounts that are not restricted or committed in a special revenue fund, AHCCCS has assigned those amounts to the purpose of the respective funds. At June 30, 2014, AHCCCS' assigned fund balance totaled \$2,318.

Unassigned fund balance – this includes the remaining spendable amounts which are not included in one of the other classifications. At June 30, 2014, AHCCCS had no unassigned fund balance.

AHCCCS has neither adopted a minimum fund balance policy nor any agency specific policy for the order of spending fund balances; rather, AHCCCS follows the policies of the State and adheres to the purpose of legislative appropriations or Federal grant regulations. AHCCCS' fund balances classified as committed include balances that can only be used for specific purposes pursuant to constraints imposed by formal action of the Arizona Legislature. AHCCCS fund balances classified as assigned include balances that are constrained for specific purposes, and are not committed.

F. Capitation payments

Contracted health plans ("Contractors") receive fixed capitation payments, generally in advance, based on actuarially determined rates for each AHCCCS member enrolled with the plan. The plans are required to provide all covered health care services to their members, regardless of the cost of care. If there are funds remaining, the plan retains the funds as profit; if the costs are higher than the amount of capitation payments, the plan absorbs the loss, except for those cases eligible for reinsurance payments or risk sharing reconciliations, subject to a profit/loss risk corridor.

Capitation is paid prospectively as well as for prior period coverage ("PPC"). The PPC period generally is from the effective date of eligibility to the day a member is enrolled with a contracted health plan. The risk under PPC is shared by both the contracted health plans and AHCCCS for the contract year. AHCCCS reconciles the actual PPC medical costs to the PPC net capitation paid during the contract year. The reconciliation limits the contractors' profits and losses to 2% of net capitation. Accrued programmatic costs are net of approximately \$16,988 at June 30, 2014 that represents estimated settlement payments due from contracted health plans for the PPC reconciliation. Actual results may differ from this estimate and such differences will be recorded in the period in which they are identified.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

Similar risk sharing is in place for medical costs incurred by contracted health plans for the Title XIX Waiver Group ("TWG") members. AHCCCS reconciles the contractors' medical costs net of reinsurance to the total net capitation payments and delivery supplemental payments paid for the contract year. The reconciliation limits the contractors' profits or losses to 2%. Accrued programmatic costs include approximately \$7,143 at June 30, 2014 that represents estimated settlement payments due to contracted health plans for the TWG reconciliation. Actual results may differ from this estimate and such differences will be recorded in the period in which they are identified.

Effective with the contract year ending September 30, 2012, AHCCCS will recoup/reimburse a percentage of the contractors' profit or loss for certain prospective risk groups using a tiered approach. Populations subject to this tiered reconciliation for contract years ending September 30, 2012 and 2013 are limited to Temporary Assistance to Needy Families ("TANF"), Sixth Omnibus Budget Reconciliation Act ("SOBRA"), SSI with Medicare, SSI without Medicare, and SOBRA Family Planning. Beginning with the contract year ending September 30, 2014, the adult population with income up to 100% FPL was added to this reconciliation. Expenses incurred and revenues received for covered services with dates of service during PPC are excluded from this reconciliation, as are non-capped newborn expenses. The reconciliation will limit the contractors' profits and losses to a percent of prospective net capitation as specified in the contract.

Profits in excess of the percentages set forth in the contract will be recouped by AHCCCS. Losses in excess of the percentages set forth in the contract will be paid to the contractor. Accrued programmatic costs are net of approximately \$3,020 at June 30, 2014 that represents estimated settlement payments due from contracted health plans for the tiered reconciliation.

Effective with contract year ending September 30, 2014, AHCCCS will recoup/reimburse a percentage of the contractors' profit or loss for the new adult population with income up to 100% FPL. The reconciliation limits the contractors' profits and losses to 1% of net capitation. Accrued programmatic costs include approximately \$4,027 at June 30, 2014 that represents estimated settlement payments.

G. Reinsurance payments

AHCCCS provides a stop-loss reinsurance program for its contracted health plans for partial reimbursement, after a deductible is met, of reinsurable covered medical services incurred for members. The program includes a deductible, which varies based on the program and in some cases, the health plans' enrollment. Regular reinsurance in the Acute and Children Rehabilitative Services ("CRS") programs covers partial reimbursement of covered inpatient facility medical services. This coverage applies to prospective enrollment periods. Regular reinsurance in the Arizona Long-Term Care Services ("ALTCS") Program applies to prospective enrollment periods and is only available for members who have had an inpatient stay during the contract year. Once an inpatient stay has occurred, all reinsurance covered services for the entire contract year may be applied to meet the deductible. Regular reinsurance covered services only include medically necessary acute care services, including outpatient and inpatient hospitalizations. AHCCCS reimburses the health plans based on a coinsurance amount for reinsurable covered services incurred above the deductible. This reinsurance provides partial reimbursement of reinsurance eligible covered services and will reimburse 75% of eligible costs above the deductible level up to \$650 of covered expenses and 100% thereafter.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(1) **Summary of significant accounting policies (continued)**

The reinsurance program also provides reimbursement for covered organ transplantation and catastrophic disorders such as certain high cost behavioral health and blood related disorders. For transplants, payment is limited to 85% of the AHCCCS contract amount for the transplant services rendered or 85% of the health plans' paid amount, whichever is lower. There is no deductible for catastrophic reinsurance cases, and AHCCCS reimburses the health plans at a percentage of the health plans' paid amount, less the coinsurance amount, unless the costs are paid under a subcapitated arrangement. For members receiving certain biotech drugs, only the drug costs will be covered under the Catastrophic Reinsurance Program. AHCCCS pays 85% of the health plans' paid amount for catastrophic reinsurance for certain blood related disorders up to \$650 of covered expenses and 100% thereafter. AHCCCS pays 75% of the health plans' paid amount for catastrophic reinsurance for certain high cost behavioral health up to \$650 of covered expenses and 100% thereafter.

H. Fee-for-service payments

The AHCCCS program is responsible for the cost of providing medical services on a fee-for-service basis to three populations: persons enrolled in the Emergency Services Program ("ESP"), persons enrolled in a health plan for less than 30 days, and American Indian members enrolled with the American Indian Health Program or Arizona Long Term Care Tribal Case Management Program.

The ESP provides for emergency medical care to persons who are not eligible for full AHCCCS coverage due to their lack of United States citizenship or lawful alien status. Outpatient medical services for the ESP, members enrolled in a health plan for less than 30 days and American Indian program enrolled members that receive services at a non-Indian Health Services ("IHS")\638 facility are reimbursed using the AHCCCS Outpatient Hospital Fee Schedule. Inpatient medical services for these populations are reimbursed based on the category of service provided and an inpatient per-diem reimbursement rate system or at the outlier reimbursement rate. Professional and non-hospital services for these populations are reimbursed at the AHCCCS fee for service rates.

Inpatient and outpatient medical services provided at an IHS facility are reimbursed at rates determined by the U.S. Department of Health and Human Services, Indian Health Services. Tribal-owned facilities contracted with IHS are reimbursed at rates determined by the U.S. Department of Health and Human Services, Indian Health Services or at the AHCCCS fee-for-service rates. Off-reservation services provided by non-IHS/638 providers are reimbursed based on the AHCCCS fee-for-service rates, AHCCCS inpatient per-diem reimbursement rate system or at the outlier reimbursement rate and the AHCCCS Outpatient Hospital Fee Schedule.

I. Incurred but not reported programmatic expenditures

In the accompanying financial statements, medical services expenditures include paid claims, received but unpaid programmatic claims, and an estimate made by management for incurred but not reported ("IBNR") programmatic claims. These IBNR programmatic claims include charges by physicians, hospitals and other health care providers for services rendered to eligible members during the period for which claims have not yet been submitted as well as prior period capitation payments for members enrolled retrospectively.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

The estimates for IBNR programmatic claims are developed using historical data for payment patterns and other relevant factors. Such liabilities are necessarily based on assumptions and estimates, and while management believes the amount is adequate, the ultimate liability may be in excess of or less than the amount provided. The methods for making such estimates and for establishing the resulting liability are continually reviewed, by management, and adjustments are reflected in the period determined.

J. Hospital Assessment Fund

The hospital assessment fund, established pursuant to ARS section 36-2901.09 on January 1, 2014, consists of monies collected from an assessment on hospitals for the purpose of funding a portion of the non-federal share of costs for the Proposition 204 eligible population. AHCCCS recorded assessment revenues in the amount of \$75,325 and expenditures in the amount of \$74,964 during fiscal year 2014 ending with a net fund balance of \$361 at June 30, 2014.

K. Hospital and nursing facility payments

CMS and the Legislature authorized AHCCCS to make Disproportionate Share, Safety Net Care Pool, Graduate Medical Education, Rural Hospital, Critical Access Hospital, Trauma Center and Nursing Facility supplemental payments in fiscal year 2014. Disproportionate share payments to Arizona hospitals that provided care to a disproportionate share (as defined) of the State's indigent population totaled \$119,728. Safety Net Care Pool payments to fund unreimbursed costs incurred by hospitals in caring for the uninsured totaled \$301,661. Graduate Medical Education payments to reimburse hospitals with GME programs for the additional costs of treating AHCCCS members utilizing graduate medical students totaled \$151,356. Critical Access Hospital payments to provide increased reimbursement to small rural hospitals that are federally designated as critical access hospitals totaled \$1,700. Rural Hospital payments to increase inpatient reimbursement rates for qualifying rural hospitals totaled \$12,158. Trauma center services to reimburse hospitals in Arizona for unrecovered trauma center readiness costs and unrecovered emergency services costs totaled \$21,475. Nursing Facility supplemental payments utilize a quality assessment on health care items and services provided by nursing facilities to qualify for federal matching funds for supplemental payments for covered Medicaid expenditures, not to exceed the Medicare upper payment limit. The payments are included with long-term care medical services and totaled \$65,690.

L. Taxes

AHCCCS is an agency of the State of Arizona and is not subject to income taxes.

M. Management's use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities, and the reported amounts of revenues and expenditures at June 30, 2014. Actual results may differ from these estimates.

N. 100% Federal poverty level expansion and CMS Waiver

On November 7, 2000, the Arizona voters approved ballot Proposition 204. One of its primary components directed AHCCCS to increase the minimum qualifying income eligibility level up to 100% of the Federal Poverty Level. Proposition 204 also designated AHCCCS as the administrator of the tobacco litigation settlement funds awarded to the State for compensation of costs incurred in providing its citizens with health care and other services necessitated by the use of tobacco products.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

In January 2001, AHCCCS obtained a Waiver from CMS to receive federal funding for certain non-categorically linked populations including those made eligible by the passage of Proposition 204. The Waiver requires that over the term of the agreement the populations covered by the Waiver be budget neutral for CMS. The Waiver period for budget neutrality began April 1, 2001 and extended through federal fiscal year 2011, at which time any federal funds received by the State that exceed the negotiated budget neutrality limit were to be returned to CMS. AHCCCS was granted a new Waiver from CMS in October 2011. The Waiver period for budget neutrality began October 1, 2011 and extends through federal fiscal year 2016. Effective with the January 1, 2014 implementation of the eligibility expansion under the ACA to include the new adult group, members with income between 100% and 133% of the FPL, the budget neutrality measurement is performed separately for the newly eligible adult population. Management believes that as of June 30, 2014, AHCCCS does not have any liability to CMS related to either budget neutrality agreement and, accordingly, no liability is recorded in the accompanying financial statements. See Note 8.

AHCCCS has classified the Arizona Tobacco Litigation Settlement Fund, created by ballot Proposition 204, as part of its General Fund. These funds are restricted for use as specified in the litigation settlement and/or legislation. Annual settlement payments, based on cigarette sales from the preceding calendar year are made in April. In addition, supplemental payments may be received as tobacco companies enter into the tobacco master settlement agreement. AHCCCS received annual and strategic contribution fund payments of \$100,765 in fiscal year 2014 for the period from January 1, 2012 to December 31, 2012. Revenue and a related receivable of \$50,000 were accrued for the period of January 1, 2014 through June 30, 2014 and are included in Tobacco Settlement Receivable and Other Operating Grants and Contributions in the accompanying Statement of Net Position and Statement of Activities.

O. Hospital Residency Loan Program

The hospital residency loan program was created to loan monies for the establishment of start-up and ongoing costs for residency programs in accredited hospitals. The hospital loans were interest free and due when certain criteria were met. During fiscal year 2014, the remaining balance outstanding under the hospital residency loan program totaling \$300,000 was repaid in full to AHCCCS.

P. Prescription Drug Rebate Program

The ACA included a provision to extend drug rebates to managed care programs and to increase the rebate amount drug manufacturers are required to pay under the Medicaid drug rebate program. AHCCCS received CMS approval on January 26, 2011 to participate in the drug rebate program, both managed care and fee-for-service, for drugs dispensed on or after March 23, 2010. AHCCCS received rebate reimbursements and delinquent account interest in the amount of \$290,468 in 2014. Of this amount, \$164,265 was returned to the Federal government in fiscal 2014 and \$38,070 will be returned subsequent to June 30, 2014. The remaining \$88,133 is available to offset a portion of General Fund current and future fiscal year expenditures. Additionally, AHCCCS has accrued the unpaid invoice balance of \$132,682 as of June 30, 2014 which is included in receivables and other in the accompanying statement of net position. Of this accrued receivable, \$93,046 will be returned to the Federal government and is netted against the due from the Federal government in the accompanying financial statements and \$39,636 is available to offset future fiscal year expenditures, which is netted against the due from state and local governments in the accompanying financial statements.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(2) Capital assets

Capital assets, which consist of furniture, vehicles and equipment, and internally generated computer software, are reported in the governmental column in the government-wide statement of net position. Tangible capital assets are defined as assets with an initial, individual cost of more than \$5 and an estimated useful life in excess of one year. Such assets are recorded at historical cost and are depreciated over their estimated useful lives ranging from three to five years. Intangible capital assets consist of internally generated computer software with an initial cost greater than \$1,000. Software is amortized over an estimated useful life of five to ten years. Expenditures for incomplete projects are reported as Software Under Development. The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend assets' lives are not capitalized. Net asset balances and current fiscal year activity are as follows:

	Balance June 30, 2013	Increases	Decreases	Balance June 30, 2014
Governmental Activities:				
Capital assets, not being depreciated:				
Software under development	\$ 20,434	\$ 44,377	\$ (30,644)	\$ 34,167
Capital assets, being depreciated:				
Vehicles, Furniture & Equipment	8,850	607	(643)	8,814
Software	1,999	30,644	-	32,643
Total capital assets, being depreciated	10,849	31,251	(643)	41,457
Less accumulated depreciation for:				
Vehicles, Furniture & Equipment	(5,907)	(729)	643	(5,993)
Software	(200)	(1,932)	-	(2,132)
Total accumulated depreciation	(6,107)	(2,661)	643	(8,125)
Total capital assets being depreciated, net	4,742	28,590	-	33,332
Governmental activities capital assets, net	\$ 25,176	\$ 72,967	\$ (30,644)	\$ 67,499
Business type activities:				
Capital assets, being depreciated:				
Vehicles, Furniture & Equipment	\$ 169	\$ 7	\$ (176)	\$ -
Less accumulated depreciation for:				
Vehicles, Furniture & Equipment	(168)	(1)	169	-
Total capital assets being depreciated, net	1	6	(7)	-
Governmental activities capital assets, net	\$ 1	\$ 6	\$ (7)	\$ -

AHCCCS accounts for capital assets in accordance with the provisions of GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. GASB Statement No. 42 requires that capital assets be reviewed for impairment whenever events or changes in circumstances indicate a significant, unexpected decline in the service utility of a capital asset. If such assets are considered to be impaired and are still in use, the impairment can be recognized using the following methods: restoration cost approach, service unit approach, and a deflated depreciated replacement cost approach. If such assets are considered to be impaired and are no longer used, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. At June 30, 2014, management does not believe impairment indicators are present, and there were no idle capital assets.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(2) Capital assets (continued)

At June 30, 2014, capital assets included approximately \$34,167 of software under development. Approximately \$44,377 was capitalized in fiscal year 2014. Internally generated software includes AHCCCS' continuing development of the next mandated version of the electronic Transaction and Code Set standards under the Health Insurance Portability and Accountability Act of 2010 as well as upgrades and enhancements to Medicaid eligibility systems related to the ACA. Eligibility system development project costs are estimated to be approximately \$96.9 million and are eligible for the 90 percent Federal financial participation rate for cost incurred through December 2015.

AHCCCS accounts for internally generated computer software in accordance with GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. In accordance with Statement No. 51, outlays associated with activities in the preliminary project stage should be expensed as incurred. Outlays related to activities in the application development stage are capitalized. Capitalization of such outlays will cease no later than the point at which the computer software is substantially complete and operational.

(3) Compensated absences

It is the State's policy to permit employees to accumulate earned but unused vacation, compensatory and sick pay benefits. Employees may accumulate up to 240 or 320 hours of vacation depending upon their position classification. Vacation hours in excess of the maximum amount that are unused at the calendar year end are forfeited. There is no liability recorded on AHCCCS' financial statements for sick leave as any amounts eligible for payment when employees separate from State service are the responsibility of the Arizona Department of Administration. The amount recorded in the government-wide financial statements consists of employees' vested accrued vacation and accrued compensatory time benefits. All compensated absences are due within one year. Balances and current fiscal year activity are as follows:

Balance, June 30, 2013	\$	3,674
Additions		5,139
Reductions		(5,180)
Balance, June 30, 2014	\$	<u>3,633</u>

(4) Other governmental funds

At June 30, 2014, the other governmental fund balance of \$3,218 included activity within the following funds:

- Tobacco Tax and Health Care Fund, Medically Needy Account ("MNA") - The Arizona Department of Revenue allocates funding to the MNA which provides funding for services provided through the Title XIX Medicaid and other legislatively authorized health related services or programs. Revenue sources for the MNA include tobacco tax proceeds and investment income.
- Tobacco Products Tax Fund, Emergency Health Services Account ("EHSA") - The Arizona Department of Revenue allocates the tobacco tax revenue to the EHSA which is used solely for the reimbursement of uncompensated care, primary care services and trauma centers readiness costs. Monies remaining unexpended and unencumbered in the account on June 30th of each year revert to the Proposition 204 Protection Account, a general fund. Revenue sources for the EHSA include tobacco tax proceeds and investment income.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(4) Other governmental funds (continued)

- Trauma and Emergency Services Fund - This fund is comprised of gaming revenues to be used to reimburse hospitals in Arizona for unrecovered trauma center readiness costs and unrecovered emergency services costs.
- Nursing Facility Assessment Fund - This fund consists of monies received from the nursing facility assessment, federal monies received as a result of expenditures made attributable to monies deposited in the fund, interest, legislative appropriations, grants, gifts, contributions and devices. The monies in this fund shall be used to qualify for federal matching funds for supplemental payments for nursing facility services and administrative cost to administer the fund.
- Hospital Assessment Fund - This fund consists of monies collected from an assessment on hospitals for the purposes of funding a portion of the non-federal share of the Medicaid expansion and the entire Proposition 204 population on and after January 1, 2014.
- Third Party Liability and Recovery Audit Fund - This fund is comprised of monies recovered from first and third party payers under various AHCCCS recovery programs prior to disbursement to the appropriate parties, contractors and programs. These programs primarily include casualty, special treatment trusts, estate, health insurance recoveries, and recovery audit collections.
- Miscellaneous Funds - These funds account for various grants and other money received for specific purposes including the Hawaii Arizona PMMIS Alliance ("HAPA") and the Hospital Loan Residency Fund. HAPA represents AHCCCS' project with Hawaii whereby AHCCCS provides data processing services for Hawaii's Medicaid program. The Hospital Loan Residency Fund was created and consists of legislative appropriations and loan repayment monies for the establishment of a hospital loan program to fund start-up and ongoing costs for residency programs in accredited hospitals. The hospital loans were paid in full as of June 30, 2014.

Other governmental funds earned, expended and transferred during the fiscal year ended June 30, 2014 were as follows:

	Fund Balance June 30, 2013	Receipts	Interest Earned	Expenditures	Transfers In/(out)	Fund Balance June 30, 2014
Tobacco Tax and Health Care Fund Medically Needy Account	\$ -	\$ 68,606	\$ 2	\$ (33,251)	\$ (35,357)	\$ -
Tobacco Products Tax Fund Emergency Health Services Account	-	18,626	-	(18,411)	(215)	-
Trauma and Emergency Services Fund	-	21,455	20	(21,475)	-	-
Nursing Facility Assessment Fund	129	49,558	10	(49,422)	-	275
Hospital Assessment Fund	-	75,325	-	(74,964)	-	361
Third Party Liability and Recovery Audit Fund	-	686	-	(684)	(2)	-
Miscellaneous Funds	1,967	7,710	9	(7,347)	243	2,582
	\$ 2,096	\$ 241,966	\$ 41	\$ (205,554)	\$ (35,331)	\$ 3,218

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(5) Proprietary fund

Healthcare Group (HCG) was established in 1988 by the State to administer health care services primarily to small, uninsured businesses with 1 to 25 employees and employees of political subdivisions. Healthcare Group ended operations and ceased providing coverage to enrolled members effective December 31, 2013. Operations during fiscal year 2014 resulted in operating income of \$578 representing the seventh year of continued profitability in the final year of operations. The remaining \$7,253 ending net position (principally cash) will automatically transfer to the State's General Fund based on legislation that repeals the Business-type entity's operating fund from and after December 31, 2014.

(6) Retirement plan

AHCCCS employees are covered by a defined benefit retirement plan administered by the Arizona State Retirement System Board. Benefits are established by State statute and provide retirement and long-term disability benefits to AHCCCS employees. The retirement plan is funded by payroll deductions from eligible employees' gross wages and matching amounts contributed by AHCCCS. These amounts satisfy the statutory requirement that employees and AHCCCS contributions must cover the actuarially determined current service costs of the retirement plan, plus amortization over a 30-year period of the unfunded past service liability. Payroll deductions as a percentage of employee wages were 11.3 percent for retirement and 0.24 percent for long-term disability for fiscal year 2014. The matching amount contributed to the retirement plan by AHCCCS was \$4,881 in fiscal year 2014 and is included in administrative expenditures in the accompanying government-wide and governmental fund financial statements.

Retirement benefit payments are obligations of the retirement plan and not AHCCCS. Actuarial and financial data on the retirement plan are available from the retirement plan's separately issued Comprehensive Annual Financial Report ("CAFR").

(7) Budgetary basis of accounting

The financial statements of AHCCCS are prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP"). AHCCCS, like other State agencies, prepares its annual operating budget on a basis that differs from the GAAP basis. Encumbrances as of June 30th can be liquidated during a four week administrative period known as the 13th month. The budget basis expenditures reported in the financial statements include both the fiscal year paid and the 13th month activity. The State does not have a legally adopted budget for revenues. Prior fiscal year expenditures of \$161,085 paid in the current fiscal year in accordance with the administrative adjustment procedures as authorized by Arizona Revised Statutes are reported as a separate amount. AHCCCS' controlling statute for programmatic payments administrative adjustment procedures varies from the statutory requirement of other State agencies. AHCCCS is permitted to pay for approved system covered medical services presented after the close of the fiscal year in which they were incurred with either remaining prior year or current year available appropriations. Unexpended prior year available appropriations for programmatic payments revert on December 31, 2014.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(7) Budgetary basis of accounting (continued)

The following is a reconciliation of the GAAP Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds to the budgetary comparison schedules for the year ended June 30, 2014:

	<u>General Fund Actual</u>
Budgetary Basis Fund Balance, June 30, 2014	\$ <u>102,861</u>
Budgetary Basis of Accounting	
Increases to fund balance:	
Cash	1,824
Due from state and local governments	134,314
Due from the federal government	669,970
Due from other fund	11,523
Tobacco settlement receivable	50,000
Receivables and other	<u>132,724</u>
Total increases	1,000,355
Decrease to fund balance:	
Unearned revenue	(21,256)
Due to state and county governments	(142,540)
Accrued programmatic costs	(622,697)
Payables and other	(17,041)
Unavailable revenue	<u>(299,682)</u>
Total decreases	<u>(1,103,216)</u>
Total GAAP basis fund balance	<u>\$ -</u>

Non-appropriated expenditures of \$2,237,670 in the General Fund consist primarily of federal and state matching pass-through payments to other agencies.

(8) Contingencies

Litigation and investigations – AHCCCS has been named as a defendant in a variety of litigation, all of which are being defended by in-house and external legal counsel. One case is an effort by Plaintiffs to obtain coverage by AHCCCS for individuals age 21 years or older who, due to their disabilities, require incontinence briefs. It is reasonably possible that the Plaintiffs will prevail and the programmatic cost of providing the briefs to all disabled adult members would be large, however, the cost cannot be reasonably estimated and no liability has been recorded as of June 30, 2014. Another case is a lawsuit filed in the Arizona Superior Court for Maricopa County by a group of plaintiffs, consisting mostly of state legislators, seeking a declaration that the hospital assessment established under ARS 36-2901.08 is allegedly a tax passed in a manner inconsistent with the requirements for a tax established by the state constitution. The lawsuit was filed in September 2013 and has worked its way through the courts and is scheduled to be heard by the Arizona State Supreme court in November 2014. AHCCCS intends to continue to vigorously defend the lawsuit on lack of standing. If the assessment is declared invalid, the program will have insufficient funds to cover childless adults with income up to 133% of FPL, but under the holding in *Fogliano v. State*, AHCCCS has the option to adjust eligibility standards to match available remaining funds.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(8) Contingencies (continued)

It is the opinion of AHCCCS upon consultation with legal counsel, that none of these claims are likely to have a material adverse effect on AHCCCS' financial statements. In addition, AHCCCS believes that the funding of any material adverse judgment, sanction or repayment obligation in excess of its appropriation would require a special appropriation by the State or would qualify for coverage by the Arizona Department of Administration, Risk Management Division which is tasked with the management and mitigation of liability, property and workers' compensation claims.

Compliance with laws and regulations – AHCCCS is subject to numerous laws, regulations and oversight by the federal government. These laws and regulations include, but are not necessarily limited to, matters such as government health care program participation requirements, reimbursement for member services and Medicaid fraud and abuse. Violations of these laws and regulations could result in expulsion from government health care programs, together with the imposition of significant financial sanctions.

Management believes that AHCCCS is in compliance with fraud and abuse laws and regulations as well as other applicable government laws and regulations. Compliance with such laws and regulations can be subject to future review and interpretation as well as regulatory actions unknown at this time.

Budget neutrality agreement – In January 2001, AHCCCS obtained a Section 1115 Waiver from CMS that provides federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204. The Waiver requires that over the term of the original agreement (April 1, 2001 through September 30, 2011) and the new agreement (October 1, 2011 through September 30, 2016), that the populations covered by the Waiver be budget neutral for CMS. Effective with the January 1, 2014 implementation of the eligibility expansion under the ACA to include the new adult group, members with income between 100% and 133% of the FPL, the budget neutrality measurement is performed separately for the new adult population. Budget neutral means that CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. The budget neutrality calculation is dependent on a number of variables including the number of members, the eligibility category of members and the general economy and its impact on unemployment, medical inflation and policy decisions that may impact program costs made by the Legislature. Pursuant to the original Waiver, AHCCCS had two years subsequent to September 30, 2011 to report expenditures related to the budget neutrality period ended September 30, 2011, consequently, the budget neutrality period closed on September 30, 2013 in a budget neutral position. Through June 30, 2014, AHCCCS remains under the cumulative reporting limit threshold for the remaining waiver periods. Accordingly, management is projecting that as of June 30, 2014, AHCCCS does not have any liability to CMS related to the budget neutrality agreement and the accompanying financial statements have not been adjusted for the impact of any liability AHCCCS may have related to the Waiver budget neutrality agreement.

School based claims audit – In December 2006, the Department of Health and Human Services, Office of Inspector General, Office of Audit Services ("OIG") commenced an audit of the Direct Service Claiming ("DSC") program. In March 2010, the OIG provided AHCCCS with the audit report and related findings including a recommendation that CMS recoup \$21,288 of program costs previously passed through to the Local Education Authorities ("LEAs") under the DSC program. CMS subsequently adjusted the amount to \$19,927. AHCCCS disagrees with the findings in part, has returned \$2.7 of federal funds for non-disputed claims and plans to appeal the decision to the Department of Health and Human Services, Departmental Appeals Board ("DAB") once CMS issues a disallowance. If and when all administrative appeals are exhausted, AHCCCS will request a refund from the LEAs or will deduct the amount from future payments in accordance with the intergovernmental agreement. The recoupment liability of \$19,924 is included in the due to the federal government with a corresponding receivable in the due from the State and local governments in the accompanying financial statements.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(8) Contingencies (continued)

School based administration claiming – The School Based Medicaid Administrative Claiming program (“MAC”), administered through a third party administrator (“TPA”), allows federal funding to pass through to the LEAs for certain administrative activities. Beginning in March 2006 and concluding in August 2008, the contractor performed a review of the claim calculation for the period from January 2004 through December 2007 as a result of findings from an OIG audit in another state that questioned methods used in the claim calculation methodology. The contractor’s assessment of the maximum impact of the retroactive claim calculations is approximately \$9,300 and CMS has instructed AHCCCS to refund the \$9,300 in overpayments. Subsequent to the self-disclosure to CMS, the OIG conducted an audit of the MAC program for the period from January 1, 2004, through September 30, 2008. The OIG provided AHCCCS with the audit report and related findings in January 2013 including a determination of unallowable Federal reimbursement of \$11,717.

Certain elements of the calculations performed by the contractor and the OIG overlap causing duplication of approximately \$2,076 for a total net unallowable cost of \$9,641. AHCCCS intends to file an appeal with the DAB if a disallowance is received. AHCCCS internal legal counsel has indicated that it is reasonably possible that some additional amount will be disallowed and recouped by CMS. AHCCCS will request a refund from the LEAs or will deduct the amount from future payments in accordance with the intergovernmental agreement. The recoupment liability of \$18,941 is included in the due to the federal government with a corresponding receivable in the due from the State and local governments in the accompanying financial statements.

(9) Interfund receivables, payables and transfers

Interfund activity is defined as transactions between funds administered by AHCCCS. The interfund balances as of June 30, 2014 consist of transfers from the Other Funds to the General Fund in the amount of \$11,523.

In the government-wide statement of activities, the interfund activity has been eliminated. The total net transfers out of \$58,417 reported on the statement of activities represents transfer activities to other State agencies.

(10) Transactions with other State agencies and counties

Transactions with other State agencies and counties – AHCCCS contracts for administrative and programmatic services from other State agencies. Charges for administrative services are based on the performing agencies’ actual cost. Charges for programmatic services are generally based on actuarially determined capitation rates. The following is a summary of contracted services provided:

Administrative services – The Arizona Department of Economic Security (“ADES”) charges AHCCCS to determine eligibility for certain Medicaid members. The Arizona Department of Administration charges AHCCCS for data center services, communication lines, risk management and training. The Arizona Department of Health Services (“ADHS”) charges AHCCCS for licensure and screening services and administrative costs associated with the CHIP Vaccine for Children program and the Arizona State Immunization Information System. The Arizona Board of Nursing charges AHCCCS for the cost of administering the nurse aid training program for nurse assistants. The Arizona Office of Administrative Hearings charges AHCCCS for administrative hearing services. These expenditures are included in administrative expenditures in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(10) Transactions with other State agencies and counties (continued)

The following is a summary of transactions with these State agencies for the administrative services described above for the year ended June 30, 2014.

	<u>Expenditures</u>
Arizona Department of Economic Security	\$ 111,403
Arizona Department of Administration	17,052
Arizona Department of Health Services	777
Arizona Board of Nursing	210
Arizona Office of Administrative Hearings	581
Attorney General's Office	800
	<u>\$ 130,823</u>

Programmatic services – Certain health care related programmatic services are provided by other State agencies, which include ADES and ADHS. AHCCCS receives the State and federal funds for these services and transfers them to the appropriate agencies pursuant to the terms of intergovernmental agreements.

The amounts passed through to ADES and ADHS are classified as Traditional, Proposition 204, Newly eligible adults, KidsCare and Long-term care services expenditures in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds. The following is a summary of transactions with these State agencies for the services described above for the year ended June 30, 2014.

	<u>Expenditures</u>
Arizona Department of Economic Security	\$ 1,091,684
Arizona Department of Health Services	1,350,624
	<u>\$ 2,442,308</u>

Revenues include \$293,994 from Arizona counties during fiscal year 2014. To the extent expenditures for long-term care services are less than county and State contributions, AHCCCS is required to remit such amounts equally to the State and the counties. At June 30, 2014, county and State contributions exceeded related expenditures in the amount of \$2,435. This amount is included in the due to federal, state and county governments in the accompanying Balance Sheet – Governmental Funds.

(11) Other pass through funds

Arizona school districts are eligible for Federal matching funds for the administrative functions related to Early and Periodic Screening, Diagnosis and Treatment ("EPSDT") outreach services at the school level. Arizona school districts also are eligible for federal matching funds on a fee-for-service basis for the provision of certain AHCCCS program services provided to eligible students. These amounts are included within federal pass through funds in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds.

Arizona county and local governments contributed \$187,422 to qualify for matching Federal funds for the Graduate Medical Education, Safety Net Care Pool, Disproportionate Share Hospital and KidsCare II program payments and for the provision of qualifying services to hospitalized inmates. These amounts are included within county pass through funds in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(11) Other pass through funds (continued)

Arizona counties contributed \$3,304 as determined by statutory calculation for administrative costs incurred by ADES for eligibility determinations and other operating costs associated with Proposition 204.

ADHS, under an agreement between ADHS and the U.S. Department of Health and Human Services, receives reimbursement of state matching funds recovered through civil monetary penalties from certain nursing facilities.

At June 30, 2014, AHCCCS recorded the following pass through revenue in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds:

	<u>Funds Passed Through</u>
Arizona School Districts	
Administrative Services Federal Funds	\$ 6,262
Program Services Federal Funds	18,795
Arizona Department of Economic Security	
County Contribution for Administrative Costs	3,304
Arizona Department of Health Services	
Cost reimbursement from Civil Monetary Penalties	<u>212</u>
	<u>\$ 28,573</u>

(12) New pronouncements

The Governmental Accounting Standards Board ("GASB") issued several pronouncements prior to June 30, 2013 with effective dates within or after the fiscal year ended June 30, 2014. AHCCCS adopted the following new pronouncement in the fiscal year ended June 30, 2014.

In March 2012, the GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities*, which is effective for reporting periods beginning after December 15, 2012. Statement No. 65 establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities. Statement No. 65 also provides other financial reporting guidance related to the impact of the financial statement elements deferred outflows of resources and deferred inflow of resources such as changes in the determination of the major fund calculations and limiting the use of the term *deferred* in financial statement presentations. AHCCCS adopted Statement No. 65 in fiscal year 2014.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(13) Subsequent events

AHCCCS is currently forecasting a fiscal year 2015 total fund shortfall of \$552,000. The shortfall is primarily comprised of Federal Expenditure Authority (\$489,700) and Hospital Assessment Funding (\$68,000). AHCCCS intends to utilize up to \$342,100 of surplus fiscal year 2014 Expenditure Authority for administrative adjustments of expenditures with dates of service prior to July 1, 2014. These administrative adjustments will reduce the projected Expenditure Authority shortfall. The fiscal year 2015 Hospital Assessment funding is expected to generate receipts of \$233,100 reducing the shortfall to \$39,500 when compared to the FY 2015 appropriation of \$204,600. Options to mitigate the remaining shortfall include: an early Prior Period Coverage reconciliation; payment timing including a possible deferral of June 2015 capitation; increasing the assessment rates in the first or second calendar quarters of 2015; and/or obtaining a Federal Expenditure Authority and Hospital Assessment Fund appropriation increase from the Legislature.

The Agency also is currently projecting a General Fund surplus of \$7,000 and a CHIP fund shortfall of \$1,300. AHCCCS continues to experience the impacts of the many program changes resulting from the ACA. There are several issues that have the potential to affect the projected shortfall. They include:

- Continued volatility in caseload growth and prior period expenditures.
- Ongoing implementation of the ACA primary care physician rate increase.
- Implementation of the hospital presumptive eligibility program effective January 1, 2015.
- Implementation of the first ACA health insurer fee payment, which became effective January 1, 2014.

REQUIRED SUPPLEMENTARY INFORMATION

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BUDGETARY COMPARISON SCHEDULE - GENERAL FUND

Year Ended June 30, 2014
(Unaudited)
(amounts expressed in thousands)

	<u>Original Appropriation (Budget)</u>	<u>Final Appropriation (Budget)</u>	<u>Actual</u>	<u>Variance with Final Budget</u>
REVENUES				
State appropriations	\$ -	\$ -	\$ 1,222,446	\$ -
State ISA pass through funds	-	-	843,940	-
Federal government	-	-	5,079,698	-
Federal ISA/IGA pass through funds	-	-	1,320,948	-
County and other local government	-	-	298,897	-
County IGA pass through funds	-	-	195,274	-
Tobacco tax revenue	-	-	41,731	-
Tobacco litigation settlement	-	-	100,765	-
Other	-	-	6,776	-
Total revenues	<u>-</u>	<u>-</u>	<u>9,110,475</u>	<u>-</u>
OTHER FINANCING SOURCES				
Operating transfers in	-	-	8,365	-
TOTAL REVENUES AND OTHER FINANCING SOURCES	<u>-</u>	<u>-</u>	<u>9,118,840</u>	<u>-</u>
PROGRAMMATIC EXPENDITURES				
Traditional services	3,593,267	3,446,490	3,152,899	293,591
Proposition 204 services	1,029,648	1,331,828	1,273,084	58,744
Newly eligible adults	-	65,932	40,386	25,546
KidsCare services	38,907	60,304	55,568	4,736
Childrens rehabilitative services	111,736	159,150	156,368	2,782
Disproportionate share	13,487	13,487	4,202	9,285
Rural and critical access hospitals	13,858	13,858	13,008	850
Voluntary Political Subdivision Programs	354,642	717,762	684,639	33,123
Long-term care services	1,220,007	1,220,007	1,192,102	27,905
TOTAL PROGRAMMATIC EXPENDITURES	<u>6,375,552</u>	<u>7,028,818</u>	<u>6,572,256</u>	<u>456,562</u>
ADMINISTRATIVE EXPENDITURES	<u>177,389</u>	<u>247,696</u>	<u>203,542</u>	<u>44,154</u>
TOTAL APPROPRIATED EXPENDITURES	<u>6,552,941</u>	<u>7,276,514</u>	<u>6,775,798</u>	<u>500,716</u>
PRIOR YEAR APPROPRIATED EXPENDITURES	-	-	161,085	-
NON-APPROPRIATED EXPENDITURES	<u>-</u>	<u>-</u>	<u>2,237,670</u>	<u>-</u>
REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES	-	-	(55,713)	-
FUND BALANCES, BEGINNING OF YEAR	<u>-</u>	<u>-</u>	<u>158,574</u>	<u>-</u>
FUND BALANCES, END OF YEAR	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 102,861</u>	<u>\$ -</u>

SUPPLEMENTARY INFORMATION

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2014
(amounts expressed in thousands)

Federal Grantor/Pass Through Agency/Program	Federal CFDA Number	Expenditures
U.S. Department of Health and Human Services		
Centers for Medicare and Medicaid Services		
Medical Assistance Program		
Federal funds expended to vendors	93.778	\$ 6,494,034
Federal funds expended to subrecipients	93.778	<u>4,267</u>
		6,498,301 *
Children's Health Insurance Program	93.767	59,418 *
Testing Experience and Functional Tools Grant	93.627	<u>2</u>
TOTAL EXPENDITURES OF FEDERAL AWARDS		<u>\$ 6,557,721</u>

*major programs

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2014
(dollar amounts expressed in thousands)

(1) **Basis of presentation**

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of **Arizona Health Care Cost Containment System** under programs of the federal government for the year ended June 30, 2014. The information in this Schedule is presented in accordance with the requirements of *U.S. Office of Management and Budget (OMB) Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations*. Because the Schedule presents only a selected portion of the operations of AHCCCS, it is not intended and does not present the financial position, changes in net position or cash flows of AHCCCS.

(2) **Summary of significant accounting policies**

Expenditures reported on the Schedule of Expenditures of Federal Awards are reported on the accrual basis of accounting. Such expenditures are recognized following the cost principles contained in OMB Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments*, wherein certain types of expenditures are not allowable or are limited as to reimbursement.

(3) **Catalog of federal domestic assistance (CFDA) numbers**

The program titles and CFDA numbers were obtained from the 2014 *Catalog of Federal Domestic Assistance*.



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INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the Director of the

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM (AHCCCS, an agency of the state of Arizona)

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the governmental activities, the business-type activities, the general fund, and the aggregate remaining fund information of **Arizona Health Care Cost Containment System (AHCCCS, an agency of the state of Arizona)**, as of and for the year ended June 30, 2014 and the related notes to the financial statements which collectively comprise **Arizona Health Care Cost Containment System's** basic financial statements, and have issued our report thereon dated November 24, 2014.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered **Arizona Health Care Cost Containment System's** internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of **Arizona Health Care Cost Containment System's** internal control. Accordingly, we do not express an opinion on the effectiveness of the **Arizona Health Care Cost Containment System's** internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit, we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether **Arizona Health Care Cost Containment System's** financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Phoenix, Arizona
November 24, 2014

A handwritten signature in black ink that reads "Mayer Hoffman McCa P.C." The signature is written in a cursive style with a large, stylized 'M' and 'H'.



Mayer Hoffman McCann P.C.

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INDEPENDENT AUDITORS' REPORT ON COMPLIANCE FOR EACH MAJOR FEDERAL PROGRAM AND REPORT ON INTERNAL CONTROL OVER COMPLIANCE REQUIRED BY OMB CIRCULAR A-133

To the Director of the

Arizona Health Care Cost Containment System
(AHCCCS, an agency of the state of Arizona)

Report on Compliance for Each Major Federal Program

We have audited ***Arizona Health Care Cost Containment System's*** compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of ***Arizona Health Care Cost Containment System's*** major federal programs for the year ended June 30, 2014. ***Arizona Health Care Cost Containment System's*** major federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its federal programs.

Auditors' Responsibility

Our responsibility is to express an opinion on compliance for each of ***Arizona Health Care Cost Containment System's*** major federal programs based on our audit of the types of compliance requirements referred to above. Except as noted in the following paragraph, we conducted our audit of compliance in accordance with auditing standards generally accepted by the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on each major federal program occurred. An audit includes examining, on a test basis, evidence about ***Arizona Health Care Cost Containment System's*** compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

Our audit of ***Arizona Health Care Cost Containment System's*** major federal programs was conducted as part of the State of Arizona's Single Audit for the year ended June 30, 2014. The State of Arizona's major federal programs were determined by the Office of the Auditor General by applying the risk-based approach for determining major federal programs in accordance with OMB Circular A-133. Our Report on Compliance for Each Major Federal Program relates only to the portion of the programs that were administered by ***Arizona Health Care Cost Containment System*** and does not purport to, and does not, report on compliance over other portions, if any, of the major federal programs or any other major federal programs of the State of Arizona.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major federal program. However, our audit does not provide a legal determination of **Arizona Health Care Cost Containment System's** compliance.

Opinion on Each Major Federal Program

In our opinion, **Arizona Health Care Cost Containment System** complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended June 30, 2014.

Other Matters

The results of our auditing procedures disclosed an instance of noncompliance, which is required to be reported in accordance with *OMB Circular A-133* and which is described in the accompanying schedule of findings and questioned costs as item 2014-001. Our opinion on the major federal program is not modified with respect to this matter.

Arizona Health Care Cost Containment System's response to the noncompliance finding identified in our audit is described in the accompanying schedule of findings and questioned costs. **Arizona Health Care Cost Containment System's** response was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.

Report on Internal Control over Compliance

Management of **Arizona Health Care Cost Containment System** is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered **Arizona Health Care Cost Containment System's** internal control over compliance with the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program and to test and report on internal control over compliance in accordance with *OMB Circular A-133*, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of **Arizona Health Care Cost Containment System's** internal control over compliance.

A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of OMB Circular A-133. Accordingly, this report is not suitable for any other purpose.

Mayer Hoffman McCann P.C.

Phoenix, Arizona
November 24, 2014

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Year Ended June 30, 2014

Section I – Summary of Auditors' Results

Financial Statements

Type of Auditors' Report Issued: Unmodified

Internal control over financial reporting:

Material weaknesses identified? _____ Yes X No

Significant deficiencies identified? _____ Yes X None reported

Noncompliance material to financial statements noted? _____ Yes X No

Federal Awards

Internal control over major programs:

Material weaknesses identified? _____ Yes X No

Significant deficiencies identified? _____ Yes X None reported

Type of Auditors' Report issued: Unmodified

Any audit findings disclosed that are required to be reported in accordance with Section 510(a) of OMB Circular A-133? X Yes _____ No

Identification of major programs:

<u>CFDA Number</u>	<u>Name of Federal Program or Cluster</u>
93.778	Medical Assistance Program
93.767	Children's Health Insurance Program

Dollar threshold used to distinguish between type A and type B programs: \$19,673,160

Auditee qualified as low-risk auditee? X Yes _____ No

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Year Ended June 30, 2014

Section II – Financial Statement Findings

None

Section III – Federal Awards Findings

Item: 2014-001

CFDA Numbers: 93.778

Program: Medical Assistance Program

Agency: U.S. Department of Health and Human Services

Agency Award Years: July 1, 2013 through June 30, 2014

Questioned Costs: N/A

Criteria: According to the AHCCCS eligibility requirements, the SOBRA Child eligibility category allows enrollment/participation for participants from ages 6 to 18. The month after reaching the age of 19 and maintaining other eligibility criteria, participants should be moved out of the SOBRA child eligibility category and into a comparable AHCCCS program. Internal controls should be in place to provide reasonable assurance that participants are moved out of the SOBRA Child eligibility category the month after they turn 19 (aged out).

Condition: In connection with our testing, we noted certain participants were either not transferred from the SOBRA Child eligibility category to another eligibility group the month after they turned 19 or were transferred subsequent to the month after the participant turned 19 years of age.

Context: In order to test eligibility, we selected a sample of 40 participants to verify the participant met the applicable eligibility criteria. In connection with our testing, we noted one instance where a participant was enrolled in the SOBRA Child eligibility category and was not transferred from the SOBRA Child eligibility category the month after they turned 19. As a result of this exception, we expanded our testing to the entire population of the SOBRA Child eligibility category to ensure that participants were being properly transferred out of the SOBRA Child eligibility category the month after the participant turned 19 (aged out). Using eligibility data, we identified 1,948 individuals enrolled in the SOBRA Child eligibility category who were not transferred timely out of the SOBRA eligibility category in the month after the participant turned 19 in fiscal year 2014. For these 1,948 exceptions, we noted that the participants were incorrectly left in the SOBRA Child eligibility category and not transferred to another adult eligibility category for a total of 5,731 months.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Year Ended June 30, 2014

Section III – Federal Awards Findings (continued)

Effect: AHCCCS pays contracted health plans to provide services to the participants in the SOBRA Child eligibility category using a capitated per member, per month payment methodology. The SOBRA Child eligibility category per member per month payment is lower than the per member per month payment for the AHCCCS Care eligibility category (the eligibility category the SOBRA Child eligibility category participants would have been transferred to). As a result, given the 1,948 exceptions, the number of months participants were incorrectly left in the SOBRA Child eligibility category, and the per member per month capitation rate differentials between the SOBRA Child and AHCCCS Care eligibility categories, we determined that AHCCCS improperly paid (underpaid) capitation to contracted health plans by approximately \$1,225,704 as a result of the untimely transfer between eligibility categories.

Cause: AHCCCS' eligibility department had a large backlog and was not able to properly transfer participants between eligibility categories on a timely basis and in accordance with program requirements.

Recommendation: We recommend that AHCCCS establish policies and procedures to ensure that participants are transferred out of the SOBRA Child eligibility category the month following the participant's 19th birthday. This will include the implementation of an eligibility system enhancement to automatically transfer SOBRA Child eligible out of this eligibility program in the month following the participant's 19th birthday. We further recommend that AHCCCS review the size and compliment of their eligibility department to ensure the staffing is adequate to address eligibility changes in a timely manner.

Section IV – Status of Prior Years Findings

None

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Year Ended June 30, 2014

Section V – Corrective Action Plan

Item: 2014-001

Subject: Eligibility

Name of Contact Person: Penny Ellis, Deputy Assistant Director

Phone Number: (602) 417-4512

Date of Completion: October 2, 2014

Corrective Action Plan: To ensure individuals who turn age 19 are transitioned out of the SOBRA Child category timely, we implemented an automated process on October 2, 2014. The eligibility system, Health-e-Arizona Plus, identifies individuals turning 19 and automatically processes the change in categories effective the month after the individual's 19th birthday. This automated process will run each month. We will run monthly reports for three months to monitor this new process and make adjustments, if needed.

We are in the process of completing the retroactive changes. We have completed September and August age changes and will have all retroactive age changes completed by December 31, 2014.