# ARIZONA HEALTH CARE
# COST CONTAINMENT SYSTEM

## FINANCIAL STATEMENTS
## AND ADDITIONAL INFORMATION

Year Ended June 30, 2012

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CONTENTS

# MANAGEMENT'S DISCUSSION AND ANALYSIS

## Management's Discussion and Analysis

For the Fiscal Year Ended June 30, 2012

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, 2012. 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, 2012 by $9.3 million. AHCCCS' net assets at June 30, 2012 are comprised of an unrestricted net asset of $6.3 million and $3.0 million invested in capital assets.

- AHCCCS net assets decreased by $38.9 million during fiscal year 2012. Net assets of governmental activities decreased by $44.0 million, while the net deficit of the business-type activity decreased by $5.1 million. The business-type activity net deficit decrease resulted in a positive net asset balance of $2.2 million for the first time since fiscal year 2005.

- The increased Federal Medical Assistance Percent rate from the American Recovery and Reinvestment Act ("ARRA") of 2009 ended on June 30, 2011. The Centers for Medicare and Medicaid Services ("CMS") continued the separate grant award and accounting for ARRA funds for one additional quarter through the quarter ended September 30, 2011 for qualifying payments. This final ARRA period increased Federal Medical Assistance Payments ("FMAP") by $7.992 million during fiscal year 2012 reducing the amount of state funds normally required to match federal funds. However, the applicable ARRA FMAP rate will still apply for any future qualifying adjustment.

#### Fund Level

- As of the close of fiscal year 2012, AHCCCS' total governmental funds reported an ending fund balance of $4.9 million, a decrease of $26.5 million. The decrease is attributable to using the carry-forward Medicaid prescription drug rebate receipts from fiscal year 2011 for current fiscal year payments and an increase in the Hospital Residency Loan Fund. At June 30, 2011, the Prescription Drug Rebate Fund had a committed fund balance of $31.0 million from receipts in excess of the fiscal year 2011 legislative appropriation and a $100,000 repayment received in fiscal year 2012 on the hospital residency loan program receivable. The fiscal year 2011 Prescription Drug Rebate fund balance was fully expended in fiscal year 2012. Additionally for fiscal year 2012, there is no such committed fund balance as the prescription drug rebate receipts received in fiscal year 2012 represent the billing periods of March 2011 through June 2012 which were recognized as available in accordance with the governmental funds revenue recognition criteria that include receipts collected within 31 days of the end of the current fiscal year.

- Business-type activities during fiscal year 2012 resulted in operating income of $5.4 million compared to the operating income of $4.9 million in the prior fiscal year, representing the fifth year of continued profitability since incurring a net deficit balance that began in fiscal year 2006. The net deficit balance at June 30, 2011 was $3.0 million. Operating results in fiscal year 2012 eliminated this deficit and brought the entity to a net asset balance of $2.2 million at June 30, 2012. Additionally cash payments and adjustments reduced the reconciliation liability by $4.0 million.

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 Assets 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.

The Statement of Net Assets (page 19) presents information on all of AHCCCS' assets and liabilities, with the difference between the two reported as "net assets". Over time, increases or decreases in net assets, 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 assets (deficit) changed during the most recent fiscal year. All changes in net assets 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 reported fee-for-service and reinsurance claims, revenue from future Tobacco Master Settlement Agreement payments, prescription drug rebate receipts, business-type activity managed care health plans' target medical loss ratio reconciliations, 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 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 AHCCCS' activities are reported in this category.

- Business-Type Activities - This category is comprised of the Healthcare Group ("HCG") operations. Members/customers of HCG are charged a premium that is used to fund the health care coverage provided and associated administrative functions.

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.

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 reconciliations 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, KidsCare, Children's Rehabilitative Services, Disproportionate Share Hospital payments, Rural Hospital payments, ALTCS services and AHCCCS administration programs. The annual appropriation is made separately for both the State funds and federal financial participation funds from the Social Security Act Titles XIX (Medicaid) and XXI (Children's Health Insurance Program). 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, supplemental payments to hospitals, 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. A budgetary comparison statement has been provided for the General Fund to demonstrate compliance with the budget on page 24.

**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 25 through 27 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 28 to 49.

## Government-Wide Financial Analysis

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

AHCCCS Net Assets (Deficit)
(in thousands of dollars)

| | Governmental Activities | | Business-Type Activities | | Total | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 | 2012 | 2011 |
| Current assets | $ 874,484 | $ 776,477 | $ 8,865 | $ 8,941 | $ 883,349 | $ 785,418 |
| Noncurrent assets | 600 | 700 | - | - | 600 | 700 |
| Capital assets | 3,039 | 1,663 | 1 | 3 | 3,040 | 1,666 |
| Total assets | 878,123 | 778,840 | 8,866 | 8,944 | 886,989 | 787,784 |
| Current liabilities | 870,970 | 727,631 | 5,830 | 7,282 | 876,800 | 734,913 |
| Long-term liabilities | - | - | 879 | 4,651 | 879 | 4,651 |
| Total liabilities | 870,970 | 727,631 | 6,709 | 11,933 | 877,679 | 739,564 |
| Net assets (deficit): | | | | | | |
| Invested in capital assets, net of depreciation | 3,039 | 1,663 | 1 | 3 | 3,040 | 1,666 |
| Unrestricted (deficit) | 4,114 | 49,546 | 2,156 | (2,992) | 6,270 | 46,554 |
| Total net assets (deficit) | $ 7,153 | $ 51,209 | $ 2,157 | $ (2,989) | $ 9,310 | $ 48,220 |

For AHCCCS, assets exceeded liabilities by $9.3 million at June 30, 2012 as compared to assets exceeding liabilities by $48.2 million at June 30, 2011.

Total Government-wide unrestricted net assets decreased by $40.3 million to $6.3 million. The decrease is primarily due to the utilization of the fiscal year 2011 $49.2 million Prescription Drug Rebate Fund's carry-forward balance. This decrease was partially offset by a $4.1 million carry-forward balance of prepaid state matching funds specifically for the temporary expansion of the Title XXI CHIP ("KidsCare II") program and the $5.4 million current year operating income combined with interest and other income that decreased the business-type activity net deficit by $5.1 million resulting in a $2.2 million unrestricted net asset balance.

The $4.1 million unrestricted net asset balance for governmental operations primarily consists of a carry-forward balance of state match funded by political subdivisions for the temporary expansion of the KidsCare program. On April 6, 2012, CMS approved two new programs under the Section 1115 Demonstration Waiver. A component of the Waiver was the temporary KidsCare II expansion where five months of the projected state match funds were provided in advance by the political subdivision partners according to their respective agreements. An additional component is $600,000 in hospital residency program loans receivable that are due and available in future periods upon collection of the loans. During the year, governmental unrestricted net assets decreased by $44.1 million as use of the carry-forward balance attributable to prescription drug rebate receipts was approved by legislative appropriation to pay for health care programs. The net assets balance is also comprised of $3.0 million of net assets invested in capital assets. AHCCCS uses these capital assets to provide services to its members. Additionally, the business-type activity accounts for $2.2 million of unrestricted net assets as a result of $5.4 million of operating income after six consecutive years of reporting a net deficit balance. The operating income is the continued result of successfully managing both program and administrative costs where premium rates are set to fund projected medical and administrative costs and to provide payments to health plans that are owed reconciliation amounts for prior fiscal years.

AHCCCS Changes in Net Assets (Deficit)
(in thousands of dollars)

| | Governmental Activities | | Business-Type Activities | | Total | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 | 2012 | 2011 |
| **Revenues** | | | | | | |
| Program Revenues | | | | | | |
| Charges for services | $ 3,359 | $ 5,595 | $ 31,078 | $ 38,428 | $ 34,437 | $ 44,023 |
| Other operating grants and contributions | 598,867 | 406,025 | - | - | 598,867 | 406,025 |
| Federal operating grants | 5,987,458 | 6,865,613 | - | - | 5,987,458 | 6,865,613 |
| General revenues | | | | | | |
| State appropriations | 2,052,782 | 1,995,616 | - | - | 2,052,782 | 1,995,616 |
| Tobacco tax | 130,058 | 138,432 | - | - | 130,058 | 138,432 |
| Forgiveness of debt | - | - | - | 1,330 | - | 1,330 |
| Unrestricted investment earnings | 82 | 60 | 63 | 50 | 145 | 110 |
| Total revenues | 8,772,606 | 9,411,341 | 31,141 | 39,808 | 8,803,747 | 9,451,149 |
| **Expenses** | | | | | | |
| Health Care | 8,742,501 | 9,322,800 | 25,533 | 33,334 | 8,768,034 | 9,356,134 |
| Excess before transfers | 30,105 | 88,541 | 5,608 | 6,474 | 35,713 | 95,015 |
| Transfers, net | (74,161) | (39,552) | (462) | (453) | (74,623) | (40,005) |
| **Increase (decrease) in net Assets (deficit)** | (44,056) | 48,989 | 5,146 | 6,021 | (38,910) | 55,010 |
| **Net assets (deficit) – beginning of year** | 51,209 | 2,220 | (2,989) | (9,010) | 48,220 | (6,790) |
| **Net assets (deficit) – end of year** | $ 7,153 | $ 51,209 | $ 2,157 | $ (2,989) | $ 9,310 | $ 48,220 |

At June 30, 2012, both the governmental and business-type activities reported a positive unrestricted net asset position. However, there was a $40.3 million or 86.5 percent decrease from the prior fiscal year $46.6 million unrestricted net assets balance.

Governmental activities in fiscal year 2012 decreased net assets by $44.1 million. The decrease is primarily due to the utilization of the fiscal year 2011 $49.2 million Prescription Drug Rebate Fund's carry-forward balance. This decrease was partially offset by a $4.1 million carry-forward balance of prepaid state matching funds specifically for the temporary expansion of the Title XXI CHIP ("KidsCare II") program. Business-type activities increased net assets by $5.1 million from annual operating results that generated $5.4 million in operating income. The positive operating income allowed HCG to eliminate its June 30, 2011 $3.0 million net deficit.

## American Recovery & Reinvestment Act of 2009

ARRA provided states fiscal relief during the recent recession by increasing the FMAP rate during an eleven quarter recession period (October 1, 2008 through June 30, 2011) from approximately 66 percent to between 71 and 76 percent. AHCCCS received over $2.153 billion of increased FMAP relief since ARRA's inception. This amount includes $7.992 million received during fiscal year 2012. Although ARRA did not decrease overall expenditures, it reduced the state's share and increased the federal share of each dollar spent. This partly explains why federal operating grants decreased by $878.155 million while the AHCCCS share decreased by a smaller amount.

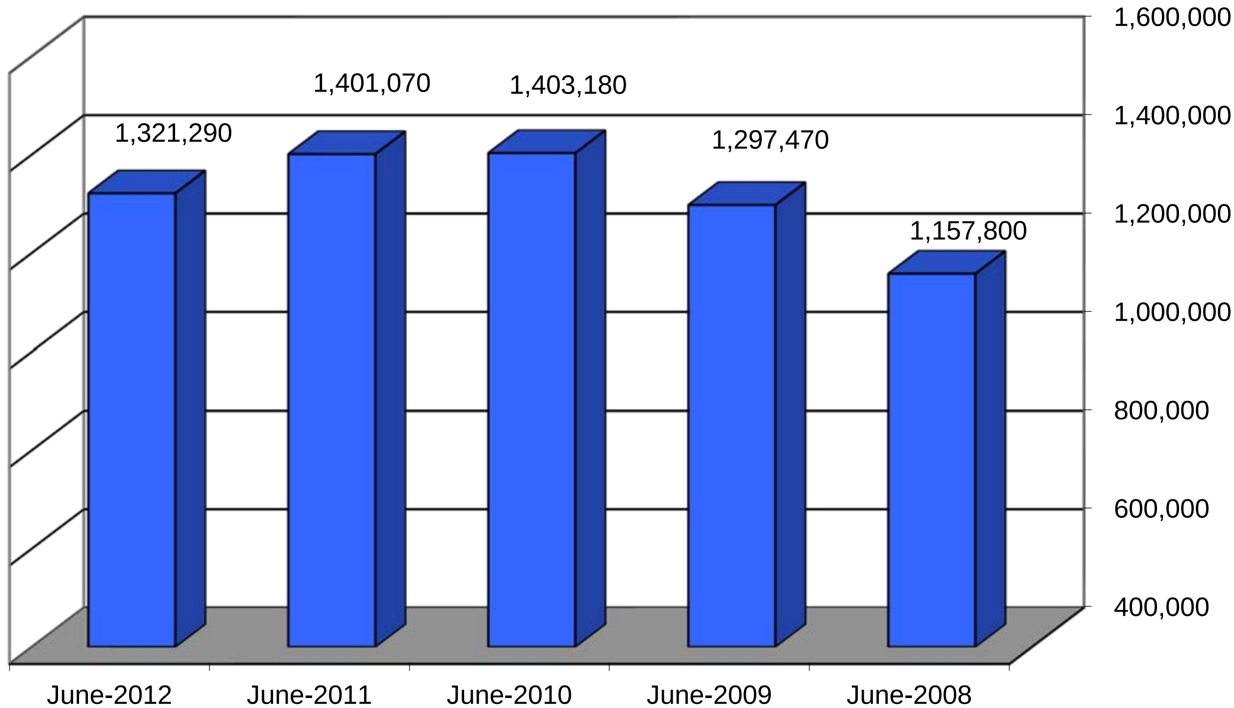
## Governmental Activities

Fiscal year 2012 governmental activities decreased net assets by $44.06 million. This decrease is primarily attributable to the use of the Medicaid prescription drug rebate program $49.2 million carry-forward balance for current year expenditures.

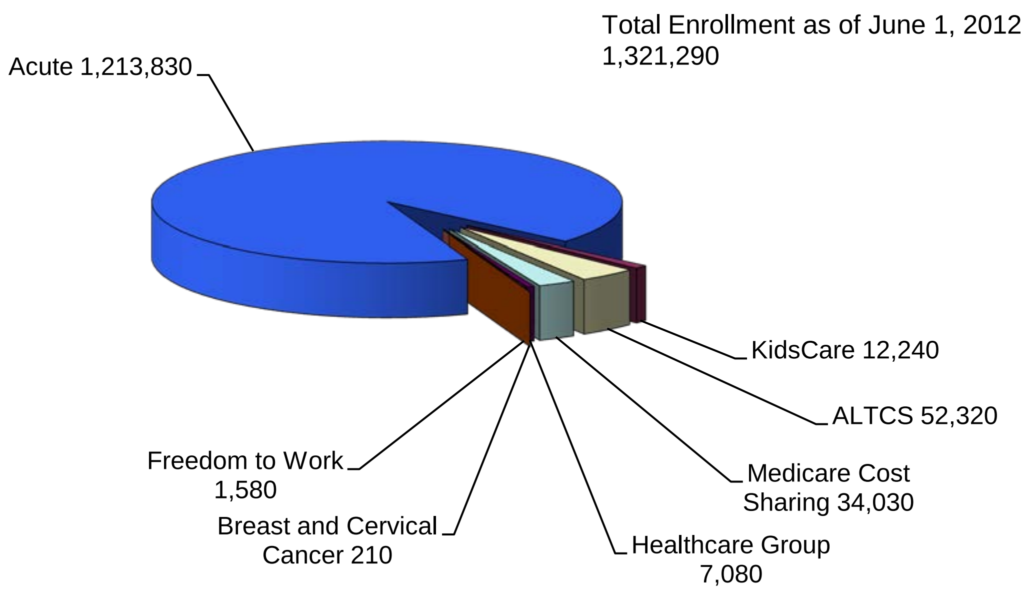
Enrollment in AHCCCS programs decreased in fiscal year 2012 primarily as a result of enrollment freezes to the Childless Adult and KidsCare populations. Enrollment at June 1, 2012 is 1,321,290, a decrease of 79,780 members over June 1, 2011 or 5.7 percent as compared to the previous year's minimal decrease in members of 2,110 or 0.2 percent during fiscal year 2011. The Childless Adult freeze, effective July 8, 2011, resulted in a decrease of 108,089 members or 48.2 percent from the June 2011 level of 224,492. The continuation of the KidsCare freeze, which began January 1, 2010, resulted in a decrease of 8,138 or 44.1 percent from the June 2011 level of 18,469. The Childless Adults freeze was just one component of an overall Medicaid reform plan that reduced the fiscal year 2012 Medicaid appropriations by over $1.6 billion. The overall financial impact to expenditures was somewhat mitigated by CMS' approval of two waivers related to payments for uncompensated care. On April 6, 2012, CMS granted AHCCCS authority to make supplemental payments to Indian Health Services ("IHS") and tribal 638 facilities to address the fiscal burden of uncompensated care for services provided by such facilities. On the same date, CMS approved the Safety Net Care Pool ("SNCP"), which is a program to provide hospitals with funding to cover their costs for providing uncompensated care primarily due to the Childless Adult freeze. A condition of the SNCP waiver approval was that a portion of the funding provided by participating political subdivision partners be used to open enrollment in the KidsCare program by over 21,000 children through the period ending December 31, 2013.

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

## AHCCCS Change in Membership



## AHCCCS Enrollment by Program

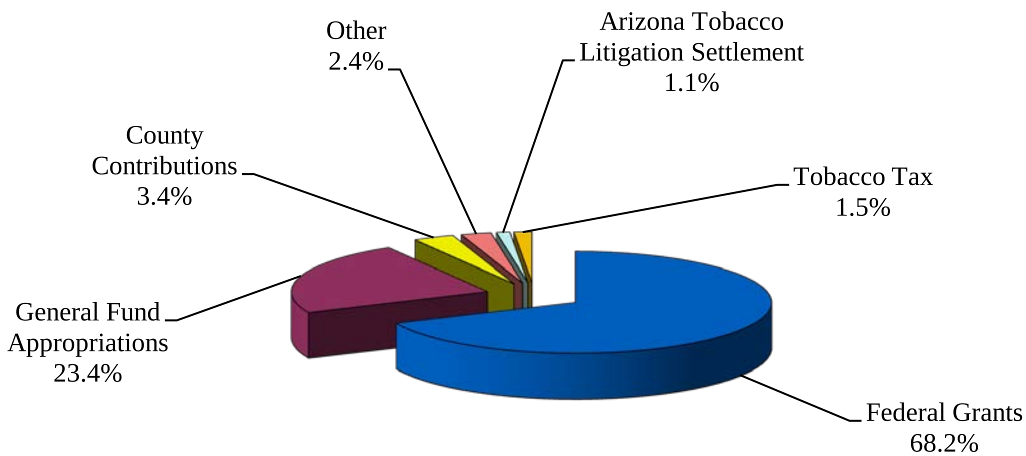


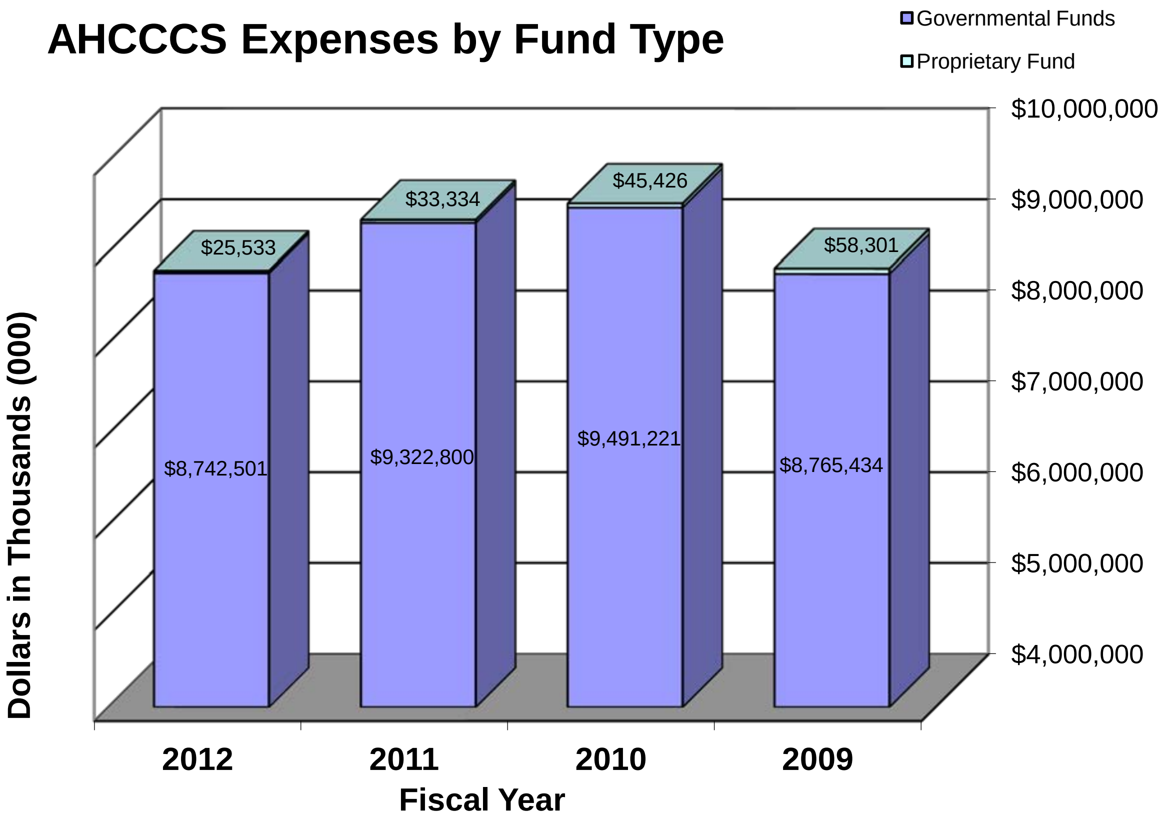

The cost of health care programs, including Title XIX Medicaid and Title XXI CHIP, totaled $8,742.5 million in fiscal year 2012, a $580.3 million decrease from the $9,322.8 million reported in fiscal year 2011. As shown in the statement of activities, the amount of expenditures funded from federal grants through the Centers for Medicare and Medicaid Services ("CMS") was $5,987.5 million (68.5 percent) in fiscal 2012 as compared to $6,865.6 million (73.6 percent) in fiscal 2011. Program funding in the form of federal financial participation is primarily determined through the FMAP rate used to provide the amount of federal matching funds for 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 year and increased by 1.45 percent to 67.30 percent from the prior year's rate of 65.85 percent. The decrease in program expenditures in fiscal year 2012 is attributable to program changes in the form of enrollment freezes, provider rate reductions, and medical service limits where the implementation spanned both the current and prior fiscal year.

State, county and miscellaneous funding sources combined to provide $2,785.1 million in State funding sources and appropriations in fiscal year 2012, a $239.4 million increase over the $2,545.7 million reported in fiscal year 2011 primarily related to the expiration of the federal funding from the ARRA FMAP increase over the prior fiscal year. The following are the components of the State match funding sources. State General Fund revenues raised primarily in the form of income and sales taxes directed to AHCCCS amounted to $1,311.7 million, and an additional $741.1 million was passed through from other State agencies in order to provide the State's share for Title XIX Medicaid and Title XXI CHIP eligible medical assistance expenditures. Arizona counties contributed $293.0 million as determined by Statutory funding formulas and Session Law as adjusted by the political subdivision maintenance of contribution ARRA requirement and other intergovernmental agreements. Tax collections on tobacco products provided $130.1 million in State match funding. The tobacco tax year-over-year decrease experienced in the prior four fiscal years continued with an $8.4 million or 6.0 percent decrease compared to the $629,000 or 0.5 percent decrease in fiscal year 2011. An additional $97.0 million in State revenue funding was provided by Arizona's share of Tobacco Litigation Settlement Funds. These 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 Master Settlement Agreement ("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, 2012 through June 30, 2012 based on Arizona's Joint Legislative Budget Committee 2012 estimated payment. In addition to the annual payment described above, AHCCCS continues to receive the Strategic Contribution Fund ("SCF") 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 could also affect the Master Settlement Agreement ("MSA") Payment amount that AHCCCS ultimately receives, including default or bankruptcy by one or more tobacco companies and other unforeseen withheld payment amounts. Tribal gaming receipts distributed to AHCCCS as determined by statutory formula and other sources provided an additional $21.2 million. In April 2012, CMS approved a Waiver amendment where AHCCCS received the authority to obtain federal match in the amount of $14.3 million on a qualifying portion of the gaming receipts. Hospital emergency departments and level 1 trauma facilities received a total benefit of $35.5 million from the waiver and tribal gaming receipts.

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**






**Business-Type Activities**

The sole proprietary fund business-type activity for AHCCCS is the Healthcare Group ("HCG"). HCG was established in 1988 by the State to administer health care services primarily to small, uninsured businesses with 2 to 50 employees and employees of political subdivisions. HCG contracts with two health plans from the existing network of AHCCCS Managed Care Organization ("MCOs") health plans to provide managed care medical services. HCG's administrative responsibilities include enrollment/renewal, fulfillment, premium billing, customer service, collections, fund disbursement and data analysis. HCG also is responsible for regulatory oversight and providing reinsurance to the health plans.

**Performance**

HCG reported operating income in fiscal year 2012 of $5.4 million and an increase in net assets of $5.1 million. This continues a five-year trend of operating profitability which began in fiscal year 2008 when HCG began successfully managing both program and administrative costs through a series of cuts, changes, realignments, and premium adjustments to match revenues with expenses. Premium rates were adjusted to fund projected medical and administrative costs and to provide payments to health plans that are owed reconciliation amounts for prior fiscal years.

In addition to being profitable for the last five fiscal years, HCG is self-sustaining and, since fiscal year 2010, has received no General Fund subsidies. Additionally, in fiscal year 2012, HCG made a $462,000 cash transfer to the General Fund. Overall, fiscal year 2012 operations resulted in moving HCG's $3.0 million net deficit balance at June 30, 2011 to a net asset position of $2.2 million at June 30, 2012; the highest net asset position since fiscal year 2004.

**Reconciliation Liability**

In the first two quarters of fiscal year 2009 and in years prior, HCG reconciled the medical costs experienced by the Plans above a contractual target medical loss ratio (stop loss target) that was based on the capitation paid annually to each plan. This stop loss payment was made for the difference in medical losses above the target medical loss ratio. If medical costs exceeded capitation, HCG paid the plans from available reconciliation reserves. At June 30, 2012, HCG continues to carry a reconciliation liability balance from fiscal years 2007 and 2008. This reconciliation balance for the last six years is shown below:

| | | |
|---|---|---|
| June 30, 2007 | - | $ 22.5 million |
| June 30, 2008 | - | $ 19.2 million |
| June 30, 2009 | - | $ 13.4 million |
| June 30, 2010 | - | $ 12.4 million |
| June 30, 2011 | - | $ 6.8 million |
| June 30, 2012 | - | $ 2.8 million |

The reconciliation liability carried over from prior fiscal years has been reduced by $19.7 million since June 30, 2007. The liability was reduced by $4.0 million in fiscal year 2012 from a beginning balance at June 30, 2011 of $6.8 million to an ending balance of $2.8 million at June 30, 2012. The overall reconciliation balance has been reduced using a combination of cash generated from operations, General Fund subsidies, reinsurance and forgiveness of debt. The reduction to the reconciliation balance in fiscal year 2012 was produced from cash from operations and adjustments related to claim runout and reinsurance coverage.

The following table summarizes reconciliation liability activity for fiscal year 2012:

**Healthcare Group Reconciliation Liability as of June 30, 2012**
**Fiscal Year 2012 Activity**
(in thousands of dollars)

| | Reconciliation | | |
|---|---|---|---|
| | **FY 07** | **FY 08** | **Total** |
| Balance June 30, 2011 | $ 3,321 | $ 3,453 | $ 6,774 |
| Payments made | (1,082) | (662) | (1,744) |
| Adjustments | (2,187) | (46) | (2,233) |
| Balance June 30, 2012 | $ 52 | $ 2,745 | $ 2,797 |

The remaining reconciliation liability will be paid by allocating 2% or more of medical premium revenues for a reconciliation reserve from residual earnings. Additionally, payments may be generated from residual earnings.

Effective January 1, 2009, HCG's contracted health plans agreed, in contract, that no future reconciliation costs will be recognized by HCG, except for adjustments to the existing reconciliation for services rendered through December 31, 2008. HCG contractors are now being compensated for attaining Nationally Recognized Utilization Management Standards, as mandated by Laws 2008, Chapter 288. The performance standards are developed by Milliman Inc., customized to each health plans' unique member population and further stratified by the level of medical management such as well managed, moderately managed, and loosely managed. The compensation amount will be no more than 2% of total premium collected. After the end of the fourth quarter, if the contractors perform well, each will receive a payment. If a health plan performs poorly, it will forfeit the reserved amount and HCG will retain the amount and apply it to any existing liabilities. As of June 30, 2012, HCG has in reserves $281,904 for potential payout with a scheduled disbursement in December 2012. This reserve amount is included in the Statement of Net Assets current accrued programmatic costs.

## Enrollment

Since lifting the July 2008 legislatively mandated enrollment freeze, enrollment has declined in each fiscal year since 2008; however, fiscal year 2012 had the lowest year over year enrollment decline since 2008. The table below shows the year to year changes for June 2011 and 2012.

| Year to Year Enrollment Change | | | | |
|---|---|---|---|---|
| **Group Size** | **2011 vs. 2010** | **% Change** | **2012 vs. 2011** | **% Change** |
| **1** | **(637)** | **(26%)** | **(345)** | **(19%)** |
| **2 +** | **(311)** | **(22%)** | **(183)** | **(16%)** |
| **Total** | **(948)** | **(24%)** | **(528)** | **(18%)** |

By the end of fiscal year 2012, HCG's group enrollment had decreased approximately 18%. Average total revenue per member per month in fiscal year 2012 was $345 compared to $353 in fiscal year 2011. Along with enrollment, revenue has declined in every fiscal year since 2008; however, fiscal year 2012 had the lowest year over year revenue decline since 2008.

## Summary

HCG has achieved operating income each fiscal year since 2008 and management currently projects that the positive trend will continue. Due to continued effective administrative and programmatic management a $3.0 million net deficit at June 30, 2011 was turned into a $2.2 million net asset position at June 30, 2012. Despite continued expected enrollment decline, HCG anticipates continued profitability and the ability to eliminate the outstanding reconciliation liability from cash flow from operations by December 31, 2013.

According to current Federal health reform legislation, effective January 1, 2014 health insurance exchanges will be instituted when it is expected that HCG will cease operations. To date, no State legislation has been enacted affecting the operations of HCG. As such HCG plans to continue operations and to continue to pay down the outstanding liability.

## Financial Analysis of AHCCCS' Governmental Funds

## Governmental Funds

At the end of fiscal year 2012, AHCCCS' governmental funds reported combined ending fund balances totaling $4.9 million, a decrease of $26.5 million from the prior year. The decrease is primarily due to the utilization of the fiscal year 2011 $31.0 million Prescription Drug Rebate Fund's carry-forward balance. This decrease was partially offset by a $4.1 million carry-forward balance of prepaid state matching funds received from participating political subdivisions specifically for the temporary expansion of the Title XXI CHIP (KidsCare II) program.

The General Fund is the chief operating fund of the AHCCCS Traditional Medicaid services, Proposition 204 services, KidsCare, Children's Rehabilitative Services, Disproportionate Share Hospital payments, Rural Hospital payments 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 Title XIX and Title XXI revenue.

The Other Governmental Funds consist of eight individual funds that have a combined total fund balance of $854,000 available to meet future year obligations. The Other Governmental Fund's fiscal year 2012 fund balances consist of assigned fund balances in the amount of $554,000 and committed funds of $300,000. Revenue from taxes on cigarettes and other related tobacco products declined 5.9 percent from fiscal year 2011 and generated $90.7 million for the current year compared to $96.4 million in fiscal year 2011. Since the passage of ballot proposition 203 in November 2006, tobacco tax collections have declined by $57.5 million or 38.8 percent since $148.1 was collected in fiscal year 2006. Total tobacco tax collections account for 67.0 percent of the total Other Governmental Funds revenues in fiscal year 2012 compared to 83.2 percent of the total Other Governmental Funds revenues back in fiscal year 2006.

## General Fund Budgetary Highlights

Differences totaling $536.6 million occurred between the original and the final amended administrative and programmatic expenditure budgets. The AHCCCS program received a net $536.6 million supplemental appropriation increase in fiscal year 2012. The increase was directly to the program special line items. The supplemental appropriation increase was based on projected shortfalls that resulted from delayed approval and certain modifications by CMS to the Governor's proposed Medicaid Reform plan. Medicaid Reform included a combination of an enrollment freeze and benefit modifications necessary for AHCCCS to operate the program within available State resources. Additionally, the supplemental eliminated the 2012 fiscal year Capitation Deferral. The supplemental appropriation utilized fiscal year 2011 carry-forward prescription drug rebate receipts to provide a portion of the state matching funds. 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 and revisions are briefly summarized as follows:

- $292.1 million increase to the Traditional program Special Line Item comprised of a $358.3 supplemental increase and $66.2 million Special Line Item appropriation transfers out
- $576.3 million increase to the Proposition 204 program Special Line Item comprised of a $173.6 million supplemental increase and $402.8 million in Special Line Item appropriation transfers in
- $344.3 million Capitation Deferral Special Line Item transfers out
- $11.4 million increase to the Children's Rehabilitative Services Special Line Item comprised of Special Line Item appropriation transfers in
- $3.2 million supplemental increase in state match to the Arizona Long Term Care program from the Prescription Drug Rebate Fund
- $4.1 million decrease to the KidsCare Special Line Item comprised of a $1.6 million supplemental increase and a $5.7 million Special Line Item appropriation transfers out

At June 30, 2012, actual cash basis appropriated program expenditures were $315.1 million less than budgetary estimates primarily consisting of surplus federal expenditure authority.

## Capital Asset Administration

AHCCCS' investment in capital assets for its governmental and business-type activities as of June 30, 2012 amounts to $3.040 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 $1.374 million or 82.5 percent over the prior fiscal year balance. The primary increase relates to an increase in internally generated software in the amount of $920,000 for the continuing development of the next mandated versions of the electronic Transaction and Code Set ("TCS") standards under the Health Insurance Portability and Accountability Act. The balance of $454,000 is for the replacement 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 | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 | 2012 | 2011 |
| Vehicles | $ 327 | $ 287 | $ - | $ - | $ 327 | $ 287 |
| Furniture and equipment | 1,018 | 602 | 1 | 3 | 1,019 | 605 |
| Software under development | 1,694 | 774 | - | - | 1,694 | 774 |
| Total net assets | $ 3,039 | $ 1,663 | $ 1 | $ 3 | $ 3,040 | $ 1,666 |

Additional information on AHCCCS' capital assets can be found in Note 2 to the accompanying financial statements on pages 37 and 38.

**Contingent Liabilities**

In January 2001, AHCCCS obtained a Section 1115 Waiver ("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. 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 ("STC") 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. In accordance with the Waiver, AHCCCS has 2 years subsequent to September 30, 2011 to report expenditures related to the budget neutrality period ended September 30, 2011. Through June 30, 2012, AHCCCS remains under the cumulative reporting limit threshold. Accordingly, Management is projecting that as of June 30, 2012, 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. On October 21, 2011 CMS approved a new Waiver through September 30, 2016. The Waiver continues to include a budget neutrality provision through September 30, 2016. Accordingly, Management is projecting that as of June 30, 2012, 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. On April 6, 2012, CMS approved a modification to the Waiver that includes several revisions including the safety net care pool and related KidsCare II programs.

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. The OIG requested that AHCCCS provide the OIG with all DSC claims data for the period from January 2004 through June 2006. The data represented over 9.5 million claim lines and $124.0 million of federal funds paid to the Local Education Authorities ("LEAs") statewide under the DSC program.

From the data AHCCCS provided, the OIG sampled 100 students "members months" (where one student member month is all claims for one student for one month) and commenced their review. There were approximately 175 contracted LEAs during the timeframe of the audit. The 100 student months of records that were sampled represented 44 of the 175 LEAs statewide. The audit represented a total of 2,000 claims under review.

The OIG conducted on-site audits at fifteen LEAs which represented 49 of the 100 student (member) months. The OIG performed desk reviews on the remainder of the LEAs. The total federal dollars paid to the LEAs for these claims totaled approximately $32,000.

In March 2010, the OIG provided AHCCCS with the audit report and related findings which focused primarily on: services not provided or service units over billed; documentation requirements not met; speech therapy provider requirements not met; unallowable transportation services; prescribing or referring provider requirements not met; and student eligibility not met. The highest frequency of errors occurred in services not provided or service units over billed, documentation requirements not met, and speech therapy provider requirements not met.

Out of the $32,000 in federal dollars paid to the LEAs for the selected claims, the OIG identified an overpayment of approximately $6,800 which represents an error rate of approximately 21%. The OIG has extrapolated the error rate and the audit report recommends that CMS recoup approximately $21.288 million of program costs previously passed through to the LEAs under the DSC program. AHCCCS conducted a review and validation of the data set supporting the OIG findings and responded to CMS regarding the final OIG audit report and extrapolated finding amount on September 21, 2010. AHCCCS disagrees with the audit report and disputes $3,987 or 59 percent of the identified overpayment amount of $6,764. AHCCCS has returned $2,700 of Federal Funds based on the non-disputed claims. Additionally, AHCCCS disagrees with the method used by the OIG to extrapolate the sample findings and engaged the services of statistical experts. The results of the expert's review identified that the OIG's sample size was too small to meet both standard statistical confidence levels and standard desired levels of precision and that the sample size was anywhere from 16 to over 90 times too small to make conclusive extrapolations.

CMS completed a review of the OIG findings and AHCCCS' response and concurs with OIG on all but one of the claims in question. OIG recalculated the extrapolation and revised the estimate to $21.210 million. CMS has requested the return of the funds. The refund will be requested from the LEAs or deducted from future payments in accordance with the intergovernmental agreement. The recoupment liability of $21.210 million is included in the due to the federal government line item with a corresponding receivable in the due from the state and local governments line item in the accompanying financial statements as of June 30, 2012.

The School Based Medicaid Administrative Claiming ("MAC"), administered through a third party administrator (TPA), allows federal funding to pass through to the LEAs for certain administrative activities. In March 2006, the contractor began a review of the claim calculation for the period from January 2004 through September 2007 as a result of findings from an OIG audit in another state that questioned methods used in the claim calculation methodology. The recommendations of the TPA were initially adopted prospectively and resulted in a more conservative calculation of the MAC amounts. Subsequently, an assessment of the impact of the claim calculation changes concluded that there is an inability to accurately recalculate the MAC amounts retroactively. The maximum impact of the retroactive claim calculations is approximately $7 million and CMS indicates that the OIG will review the MAC claims in question to reasonably calculate the overpayments.

In August 2008, the TPA identified that the prospective implementation failed to include all of the recommendations having a direct impact on the claims paid from December 2005 through December 2007 resulting in an additional $2.3 million overpayment. AHCCCS has requested that the TPA either return the approximate $2.3 million maximum overpayment or recalculate what the payments should have been and return the resulting overpayment. CMS has instructed AHCCCS to refund the $9.3 million in overpayments. The refund will be requested from the LEAs or deducted from future payments in accordance with the intergovernmental agreement. The amount due from the LEAs may be reduced by any recovery from the TPA as identified above unless an appropriation from the Legislature is obtained by the LEAs. The recoupment liability of $9.3 million is included in the due to the federal government with a corresponding receivable in the due from the state and local governments of $9.3 million in the accompanying financial statements.

In March 2011, the OIG commenced an audit of the MAC program for the period January 1, 2004, through September 30, 2008 reviewing a total of 19 quarters. The OIG provided AHCCCS with a draft audit report and related findings in August 2012 stating that AHCCCS, through its TPA, did not always retain required documentation to support the random moment time study ("RMTS") methodology used to allocate school-based administrative costs to the Medicaid program and the RMTS methodology was not fully consistent with Federal requirements. The report states that the RMTS supporting documentation for

2 of the 19 quarters was not retained and that the RMTS methodology for the remaining 17 quarters was determined to be inconsistent with Federal requirements. The OIG determined that the unallowable Federal reimbursement was $5.422 million and $6.295 million, respectively, for a total of $11.717 million. Certain elements of the calculations performed by the contractor and the OIG are similar causing duplication of approximately $2.076 million for a total net contingent liability of $18.941 million.

In February 2010, the U.S. Department of Health and Human Services, Office of Inspector General, Office of Audit Services ("OIG") commenced an audit of the buy-in of Medicare Part B premiums. The OIG audit period covered Part B premiums paid by the State and claimed for Federal reimbursement for the quarters ended December 31, 2007, through September 30, 2009. In January 2012 the OIG issued a draft recommendation that AHCCCS refund $13.052 million for unallowable Part B premiums claimed. Based on the OIG findings, CMS has also reviewed the Medicare Part B eligibility categories and Federal claiming for the all four quarters in fiscal year 2011 and determined that AHCCCS has not complied with Federal requirements and formally issued grant award disallowance letters for certain claimed amounts for the five quarters ended September 2011. In addition, AHCCCS anticipates receiving a disallowance for the three quarters ended December 31, 2009, March 31, 2010 and June 30, 2010.

AHCCCS based Federal claiming on two separate State Medicaid Directors Letters where CMS has stated that, at the State's option, FFP is available for the cost of Part B premiums for the eligibility category in question. The questioned category is individuals eligible for both Medicaid and Medicare, but who were not cash recipients, deemed cash recipients, Qualified Medicare Beneficiaries, Specified Low-Income Medicare Beneficiaries, or Qualified Individuals 1 and are covered as a State option. Upon receipt of the disallowance, AHCCCS returned $13.280 million to CMS in fiscal year 2012. Accordingly, a liability of $20.655 million is included in the due to the federal government in the accompanying financial statements for the period from December 31, 2007 through June 30, 2010. AHCCCS filed an appeal to the CMS Departmental Appeals Board for the amounts formally disallowed and intends to file an appeal of future disallowances. Internal counsel has indicated that it is reasonably possible that some portion of the deferred amount may be disallowed and recouped by CMS. However, AHCCCS received a waiver that allows FFP for the cost of Part B premiums for this eligibility category prospectively effective October 22, 2011.

## Economic Factors and Next Year's Budgets and Rates

AHCCCS enrollment declined for most of fiscal year 2012 primarily due to the enrollment freeze on the Childless Adult ("AHCCCS Care") population. From June 2011, the Title XIX full service enrollment has decreased in 10 of 12 months of fiscal year 2012 with a net overall decrease during that period of over 88,460 members. During the same period, the frozen AHCCCS Care population has declined by over 108,089. Enrollment in fiscal year 2013 has varied with three months of growth spurred by the initial intake of the KidsCare II program followed by two months of declines resulting in an overall decline of 9,362 members for the year. Although the recovery from the Great Recession appears to be slower than past recoveries, there are positive signals regarding the Arizona economy. The unemployment rate has continued to decline slightly and retail sales continue to increase. Additionally, the housing market seems to be showing signs of improvement. However, the recent news on the U.S. economy has been less positive and may dampen the Arizona recovery. Accordingly, AHCCCS is projecting that most populations not subject to enrollment freezes will continue to see modest growth. Finally, the impact of the Patient Protection and Affordable Care Act (ACA) on population growth remains unclear and difficult to project.

The total statewide Medicaid fiscal year 2013 appropriation compared to fiscal year 2012 reflects an increase of over $415 million. The fiscal year 2012 appropriation included a reduction of over $1.6 billion by the Legislature to adjust the State's Medicaid program to declining State revenues. This reduction was planned to be attained through a series of program changes in the form of enrollment freezes, provider rate reductions, and medical service limits. CMS approved the majority of the reform plan, however, certain components were rejected and in some cases the savings were not as great as originally estimated.

For contract year 2013, the Acute Care capitation rates are expected to increase by 2.95 percent. The three largest factors impacting the acute rates are inflationary cost trends, an experience adjustment, and a rebase of the reinsurance offsets to better align the anticipated reinsurance revenue with actual experience. The contract year 2013 Arizona Long Term Care System (ALTCS Elderly and Physically Disabled) capitation rates are increasing by 2.42 percent. The three largest factors impacting these rates are utilization and inflationary trends due to a change in the mix of services, a rebase of the capitation rates from the prior contract year 2012 competitive bid and an increase in the anticipated mix of Home and Community Based Services placement with a corresponding decrease in Nursing Facility placement. As part of the FY 2014 budget submission, AHCCCS is requesting a 3% capitation rate increase for contract year 2014 for all programs.

AHCCCS continues to review the Medicaid provisions of the ACA and the subsequent June 28, 2012 Supreme Court ruling that Medicaid expansion for adult populations is a state option. This decision has presented the State with multiple and complex opportunities regarding the future of the Arizona Medicaid program. Major decisions will be necessary regarding the future and possible restoration of the Childless Adult program recognizing that it is ultimately up to Arizona policy-makers to determine the programs future considering available resources. These changes are both exceedingly complex and are occurring in an environment of considerable uncertainty regarding what federal requirements, flexibility and responsibilities may be afforded under the new federal healthcare plan for the State's Medicaid program.

While much uncertainty still exists over certain ACA provisions, AHCCCS has included funding for the following ACA related issues in the fiscal year 2014 budget submission: Costs for expansion of Medicaid for children aged 6-18 up to 138% FPL; costs for anticipated woodwork experience for members currently eligible, but for whatever reason have not enrolled; costs for reduced membership churn associated with streamlined redetermination requirements; costs associated with the anticipated requirement that Federal Emergency Services be provided to Childless Adult members; funding for a requirement that certain primary care physicians and services be reimbursed at no less than 100% of the Medicare payment rates; and costs associated with a fee on the health insurance industry.

AHCCCS' budget request for fiscal year 2014, submitted to the Governor in September 2012 included a rebase of the fiscal year 2013 budget that projects fiscal year 2013 appropriations are expected to be sufficient to cover projected agency expenditures with a small estimated surplus. However, factors such as CMS decisions, legal decisions, case load changes compared to projections may influence any final fiscal year surplus or the need for or amount of a supplemental appropriation. Additionally, at the federal level, uncertainty over the Budget Control Act ("BCA") may affect the state and federal economies. The BCA passed in August 2011 requires Congress to enact measures to reduce the federal budget deficit by $1.2 trillion over ten years. While Medicaid is specifically exempted from automatically triggered reductions, Congress may still enact targeted reductions, and the impact of other federal spending reductions on the economy is difficult to measure. Management will closely monitor all these factors in relation to the adequacy of the fiscal year 2013 appropriation and fiscal year 2014 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)**

We have audited the accompanying financial statements of the governmental activities, the business-type activities and the aggregate remaining fund information of AHCCCS as of and for the year ended June 30, 2012, as shown on pages 19 through 27 as listed in the table of contents. These financial statements are the responsibility of AHCCCS' management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with U.S. generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

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 and the aggregate remaining fund information of the state of Arizona that are 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, 2012, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with U.S. generally accepted accounting principles.

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 and the aggregate remaining fund information of AHCCCS at June 30, 2012, and the respective changes in financial position and cash flows, where applicable, for the year then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 6, 2012 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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

U.S. generally accepted accounting principles require that the management's discussion and analysis on pages 1 through 16 and budgetary comparison information on page 24 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 U.S. generally accepted auditing standards, 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.

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

This report is intended solely for the information and use of AHCCCS and the state of Arizona Auditor General and is not intended to be and should not be used by anyone other than these specified parties.

Mayer Hoffman McCann P.C.

Phoenix, Arizona
December 6, 2012

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## STATEMENT OF NET ASSETS

June 30, 2012
(amounts expressed in thousands)

**ASSETS**

| | Governmental Activities | Business-type Activities | Total |
|---|---|---|---|
| CURRENT ASSETS | | | |
| Cash | $ 139,046 | $ 8,865 | $ 147,911 |
| Restricted cash | 46,238 | - | 46,238 |
| Due from state and local governments | 96,459 | - | 96,459 |
| Due from the federal government | 379,589 | - | 379,589 |
| Tobacco settlement receivable | 50,000 | - | 50,000 |
| Receivables and other | 163,152 | - | 163,152 |
| TOTAL CURRENT ASSETS | 874,484 | 8,865 | 883,349 |
| Hospital residency program loans | 600 | - | 600 |
| Furniture, vehicles and equipment, net of accumulated depreciation | 3,039 | 1 | 3,040 |
| TOTAL NONCURRENT ASSETS | 3,639 | 1 | 3,640 |
| TOTAL ASSETS | 878,123 | 8,866 | 886,989 |

**LIABILITIES**

| | Governmental Activities | Business-type Activities | Total |
|---|---|---|---|
| CURRENT LIABILITIES | | | |
| Accounts payable | 3,860 | 29 | 3,889 |
| Other accrued liabilities | 2,640 | 19 | 2,659 |
| Deferred revenue | 21,398 | 3,532 | 24,930 |
| Due to federal, state and county governments | 91,646 | - | 91,646 |
| Accrued programmatic costs | 748,133 | 2,200 | 750,333 |
| Compensated absences | 3,293 | 50 | 3,343 |
| TOTAL CURRENT LIABILITIES | 870,970 | 5,830 | 876,800 |
| ACCRUED PROGRAMMATIC COSTS, less current portion | - | 879 | 879 |
| TOTAL LIABILITIES | 870,970 | 6,709 | 877,679 |
| COMMITMENTS AND CONTINGENCIES | | | |

**NET ASSETS**

| | Governmental Activities | Business-type Activities | Total |
|---|---|---|---|
| INVESTED IN CAPITAL ASSETS | 3,039 | 1 | 3,040 |
| UNRESTRICTED NET ASSETS | 4,114 | 2,156 | 6,270 |
| TOTAL NET ASSETS | $ 7,153 | $ 2,157 | $ 9,310 |

## ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

### STATEMENT OF ACTIVITIES

Year Ended June 30, 2012
(amounts expressed in thousands)

| | | Program Revenues | | | Net (Expense) Revenue and Changes in Net Assets | | |
|---|---|---|---|---|---|---|---|
| | **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 | $ 8,742,501 | $ 3,359 | $ 5,987,458 | $ 598,867 | $ (2,152,817) | $ - | $ (2,152,817) |
| Business-type activities: | | | | | | | |
| Healthcare Group | 25,533 | 31,078 | - | - | - | 5,545 | 5,545 |
| TOTAL PROGRAMS | $ 8,768,034 | $ 34,437 | $ 5,987,458 | $ 598,867 | (2,152,817) | 5,545 | (2,147,272) |
| General revenues: | | | | | | | |
| State appropriations | | | | | 2,052,782 | - | 2,052,782 |
| Tobacco tax | | | | | 130,058 | - | 130,058 |
| Unrestricted investment earnings | | | | | 82 | 63 | 145 |
| | | | | | 2,182,922 | 63 | 2,182,985 |
| Transfers: | | | | | | | |
| Transfers out | | | | | (74,161) | (462) | (74,623) |
| Total general revenues and transfers | | | | | 2,108,761 | (399) | 2,108,362 |
| CHANGE IN NET ASSETS (DEFICIT) | | | | | (44,056) | 5,146 | (38,910) |
| NET ASSETS (DEFICIT), BEGINNING OF YEAR | | | | | 51,209 | (2,989) | 48,220 |
| NET ASSETS, END OF YEAR | | | | | $ 7,153 | $ 2,157 | $ 9,310 |

See Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## BALANCE SHEET - GOVERNMENTAL FUNDS

June 30, 2012
(amounts expressed in thousands)

| | General Fund | Other Governmental Funds | Total Governmental Funds |
|---|---|---|---|
| **ASSETS** | | | |
| Cash | $ 116,846 | $ 22,200 | $ 139,046 |
| Restricted cash | 45,514 | 724 | 46,238 |
| Due from state and local governments | 105,359 | 11,379 | 116,738 |
| Due from the federal government | 256,483 | 14,313 | 270,796 |
| Due from other funds | 9,634 | - | 9,634 |
| Receivables and other | 29,383 | - | 29,383 |
| TOTAL ASSETS | $ 563,219 | $ 48,616 | $ 611,835 |
| **LIABILITIES** | | | |
| Accounts payable | $ 2,646 | $ 1,214 | $ 3,860 |
| Other accrued liabilities | 2,023 | 617 | 2,640 |
| Deferred revenue | 20,888 | 510 | 21,398 |
| Due to federal, state and county governments | 91,485 | 161 | 91,646 |
| Due to other funds | - | 9,634 | 9,634 |
| Accrued programmatic costs | 442,141 | 35,626 | 477,767 |
| TOTAL LIABILITIES | 559,183 | 47,762 | 606,945 |
| COMMITMENTS AND CONTINGENCIES | | | |
| **FUND BALANCES** | | | |
| Committed | - | 300 | 300 |
| Assigned | 4,036 | 554 | 4,590 |
| TOTAL FUND BALANCES | 4,036 | 854 | 4,890 |
| TOTAL LIABILITIES AND FUND BALANCES | $ 563,219 | $ 48,616 | |

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

| | |
|---|---|
| Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds. | 3,039 |
| Governmental funds report capital outlays as expenditures. However, in the statement of activities, the cost of these assets is allocated over their estimated useful lives and reported as depreciation expense. This is the amount by which capital outlays $1,739 exceeded depreciation ($363) in the current fiscal year. | (1,376) |
| Long-term liabilities for accrued paid time off are not due and payable in the current fiscal year and, therefore are not reported in the funds. | (3,293) |
| Long-term receivables, offsetting the above accrued paid time off liability, are not receivable in the current fiscal year and, therefore are not reported in the funds. | 3,293 |
| Long-term accrued liabilities for programmatic costs are not due and payable from current financial resources and, therefore are not reported in the funds. | (270,366) |
| Long-term receivables, offsetting the above accrued programmatic liability, are not due and receivable in the current fiscal year and, therefore are not reported in the funds. | 270,366 |
| Long-term receivables for the Hospital Residency Loan program are not due and receivable in the current fiscal year and, therefore are not reported in the funds. | 600 |
| | $ 7,153 |

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, 2012
(amounts expressed in thousands)

| | General Fund | Other Governmental Funds | Total Governmental Funds |
|---|---|---|---|
| REVENUES | | | |
| State government: | | | |
| Appropriations | $ 1,337,479 | $ - | $ 1,337,479 |
| Pass through funds | 741,096 | - | 741,096 |
| Federal government: | | | |
| Acute care | 3,357,349 | 15,224 | 3,372,573 |
| Long-term care | 737,793 | - | 737,793 |
| Pass through funds | 1,898,130 | 40 | 1,898,170 |
| County and other local government: | | | |
| Acute care | 35,733 | - | 35,733 |
| Long-term care | 257,296 | - | 257,296 |
| Pass through funds | 186,942 | - | 186,942 |
| Tobacco litigation settlement revenue | 101,067 | - | 101,067 |
| Tobacco tax revenue | 39,384 | 90,674 | 130,058 |
| Gaming revenue | - | 21,215 | 21,215 |
| Intergovernmental agreement revenue | - | 7,093 | 7,093 |
| Premium revenue | 3,359 | - | 3,359 |
| Other | (7,413) | 1,121 | (6,292) |
| TOTAL REVENUES | 8,688,215 | 135,367 | 8,823,582 |
| PROGRAMMATIC EXPENDITURES | | | |
| Medical Services: | | | |
| Traditional services | 3,699,162 | 35,806 | 3,734,968 |
| Proposition 204 services | 1,825,571 | 18,754 | 1,844,325 |
| KidsCare services | 31,901 | - | 31,901 |
| Long-term care services | 2,038,291 | - | 2,038,291 |
| Childrens rehabilitative services | 127,332 | - | 127,332 |
| School-based services | (2,268) | - | (2,268) |
| Transplant services non-Medicaid | - | 102 | 102 |
| Hospital Payments: | | | |
| Disproportionate share | 173,068 | - | 173,068 |
| Rural and critical access hospital | 13,858 | - | 13,858 |
| Graduate medical education | 210,773 | - | 210,773 |
| Trauma center services | - | 35,580 | 35,580 |
| Safety net care pool | 249,000 | - | 249,000 |
| Other: | | | |
| Medicare Part D clawback | 73,579 | - | 73,579 |
| Health information technology | 76,183 | - | 76,183 |
| TOTAL PROGRAMMATIC EXPENDITURES | 8,516,450 | 90,242 | 8,606,692 |
| ADMINISTRATIVE EXPENDITURES | 161,393 | 8,457 | 169,850 |
| ADMINISTRATIVE EXPENDITURES PASSED THROUGH | (610) | 40 | (570) |
| TOTAL EXPENDITURES | 8,677,233 | 98,739 | 8,775,972 |
| EXCESS OF REVENUES OVER EXPENDITURES | 10,982 | 36,628 | 47,610 |
| OTHER FINANCING SOURCES (USES) | | | |
| Transfers out: | | | |
| To State General Fund | (5) | (1,028) | (1,033) |
| To Arizona Department of Economic Security | (3,161) | - | (3,161) |
| To Arizona Department of Health Services | (33,900) | (35,167) | (69,067) |
| To Arizona Attorney General | (900) | - | (900) |
| Repayments under the hospital residency loan program | - | 100 | 100 |
| TOTAL OTHER FINANCING SOURCES (USES) | (37,966) | (36,095) | (74,061) |
| NET CHANGE IN FUND BALANCES | (26,984) | 533 | (26,451) |
| FUND BALANCES, BEGINNING OF YEAR | 31,020 | 321 | 31,341 |
| FUND BALANCES, END OF YEAR | $ 4,036 | $ 854 | $ 4,890 |

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, 2012
(amounts expressed in thousands)

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

| | | |
|---|---|---|
| Net change in fund balance - total governmental funds (page 22) | $ | (26,451) |
| Drug rebate revenues reported in the statement of activities in fiscal year 2011 were not currently available. These funds were made available in fiscal year 2012 and are reported only in the statement of revenues, expenditures and changes in fund balances - governmental funds for fiscal year 2012. | | (18,164) |
| 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. | | (100) |
| 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. Due to its pass through nature, AHCCCS accrues revenue sufficient to eliminate its deficit fund balance and, therefore, this is the amount by which capital outlays exceeded depreciation in the prior period. | | 659 |
| Change in net assets of governmental activities (page 20) | $ | (44,056) |

## ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

### BUDGETARY COMPARISON SCHEDULE - GENERAL FUND

Year Ended June 30, 2012
(Unaudited)
(amounts expressed in thousands)

| | Original Appropriation (Budget) | Final Appropriation (Budget) | Actual | Variance with Final Budget |
|---|---|---|---|---|
| REVENUES | | | | |
| State appropriations | $ - | $ - | $ 1,414,587 | $ - |
| State pass through funds | - | - | 880,371 | - |
| Federal government | - | - | 4,443,284 | - |
| Federal pass through funds | - | - | 1,233,348 | - |
| County government | - | - | 349,431 | - |
| County pass through funds | - | - | 45,625 | - |
| Tobacco tax revenue | - | - | 39,792 | - |
| Tobacco litigation settlement | - | - | 101,067 | - |
| Other | - | - | 3,296 | - |
| Total revenues | - | - | 8,510,801 | - |
| OTHER FINANCING SOURCES | | | | |
| Operating transfers in | - | - | 8,678 | - |
| TOTAL REVENUES AND OTHER FINANCING SOURCES | - | - | 8,519,479 | - |
| PROGRAMMATIC EXPENDITURES | | | | |
| Traditional services | 2,894,220 | 3,186,286 | 3,090,485 | 95,801 |
| Proposition 204 services | 995,271 | 1,571,608 | 1,443,290 | 128,318 |
| KidsCare services | 36,068 | 31,925 | 31,072 | 853 |
| Childrens rehabilitative services | 110,127 | 121,569 | 121,534 | 35 |
| Disproportionate share | 13,487 | 13,487 | 4,202 | 9,285 |
| Rural and critical access hospitals | 13,858 | 13,858 | 13,858 | - |
| Capitation deferral | 344,345 | 38 | 38 | - |
| Long-term care services | 1,244,829 | 1,248,039 | 1,167,191 | 80,848 |
| TOTAL PROGRAMMATIC EXPENDITURES | 5,652,205 | 6,186,810 | 5,871,670 | 315,140 |
| ADMINISTRATIVE EXPENDITURES | 175,164 | 177,203 | 154,718 | 22,485 |
| TOTAL APPROPRIATED EXPENDITURES | 5,827,369 | 6,364,013 | 6,026,388 | 337,625 |
| PRIOR YEAR APPROPRIATED EXPENDITURES | - | - | 29,233 | - |
| NON-APPROPRIATED EXPENDITURES | - | - | 2,418,808 | - |
| REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES | - | - | 45,050 | - |
| FUND BALANCES, BEGINNING OF YEAR | - | - | 113,317 | - |
| FUND BALANCES, END OF YEAR | $ - | $ - | $ 158,367 | $ - |

See Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## STATEMENT OF NET ASSETS - PROPRIETARY FUND

June 30, 2012
(amounts expressed in thousands)

| | | |
|---|---|---|
| **ASSETS** | | |
| CURRENT ASSETS | | |
| Cash | $ | 8,865 |
| CAPITAL ASSETS | | |
| Furniture, vehicles and equipment, net of accumulated depreciation | | 1 |
| TOTAL ASSETS | $ | 8,866 |
| **LIABILITIES** | | |
| CURRENT LIABILITIES | | |
| Accounts payable | $ | 29 |
| Other accrued liabilities | | 19 |
| Deferred revenue - premiums | | 3,532 |
| Accrued programmatic costs | | 2,200 |
| Compensated absences due within one year | | 50 |
| TOTAL CURRENT LIABILITIES | | 5,830 |
| ACCRUED PROGRAMMATIC COST, less current portion above | | 879 |
| TOTAL LIABILITIES | $ | 6,709 |
| COMMITMENTS AND CONTINGENCIES | | |
| **NET ASSETS** | | |
| INVESTED IN CAPITAL ASSETS | $ | 1 |
| UNRESTRICTED | | 2,156 |
| TOTAL NET ASSETS | $ | 2,157 |

See Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS (DEFICIT) - PROPRIETARY FUND

Year Ended June 30, 2012
(amounts expressed in thousands)

| | |
|---|---|
| OPERATING REVENUES | |
| Premium revenue | $ 31,078 |
| OPERATING EXPENSES | |
| Payments to health plans and providers | 24,381 |
| Salaries and employee benefits | 1,000 |
| Professional and outside services | 133 |
| Other | 202 |
| Depreciation | 2 |
| TOTAL OPERATING EXPENSES | 25,718 |
| OPERATING INCOME | 5,360 |
| NONOPERATING REVENUES | |
| Other income | 185 |
| Investment income | 63 |
| INCOME BEFORE TRANSFERS | 5,608 |
| TRANSFERS OUT | |
| To State General Fund | (462) |
| CHANGE IN NET ASSETS | 5,146 |
| NET ASSETS (DEFICIT), BEGINNING OF YEAR | (2,989) |
| NET ASSETS, END OF YEAR | $ 2,157 |

See Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## STATEMENT OF CASH FLOWS - PROPRIETARY FUND

Year Ended June 30, 2012
(amounts expressed in thousands)

| | |
|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES | |
| Receipts from customers | $ 30,227 |
| Payments to health plans | (28,654) |
| Payments to employees | (1,027) |
| Payments to suppliers | (408) |
| Net cash provided by operating activities | 138 |
| CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES | |
| Transfer to State General Fund | (462) |
| Net cash used by non-capital financing activities | (462) |
| CASH FLOWS FROM INVESTING ACTIVITIES | |
| Settlement income | 185 |
| Investment income | 63 |
| Net cash provided by investing activities | 248 |
| NET CHANGE IN CASH | (76) |
| CASH, BEGINNING OF YEAR | 8,941 |
| CASH, END OF YEAR | $ 8,865 |
| RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES | |
| Operating income | $ 5,360 |
| Adjustment to reconcile operating income to net cash provided by operating activities: | |
| Depreciation | 2 |
| Changes in operating net assets and liabilities: | |
| Decrease in accounts payable and other accrued liabilities | (73) |
| Decrease in deferred revenue - premiums | (851) |
| Decrease in accrued programmatic costs | (4,272) |
| Decrease in accrued compensated absences | (28) |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | $ 138 |

See Notes to Financial Statements

## (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 U.S. generally accepted accounting principles 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, extended through September 30, 2011. AHCCCS was granted a new waiver in October 2011 which is effective October 1, 2011 through September 30, 2016. The childless adult population, currently a waiver category is scheduled to end January 1, 2014. This change will require an amendment to the Waiver. 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 specified by Arizona Statutory funding formula and Session Law.

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 SSI eligibility criteria.

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 has the Healthcare Group line of business, which provides medical coverage primarily to small businesses. The activities of Healthcare Group are included in the proprietary fund. See Notes 5 and 6 for information on the Healthcare Group.

### 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.

The government-wide financial statements (i.e., the statement of net assets 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.

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

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 has one business-type activity, Healthcare Group. In fiscal year 2012, 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 between 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 Healthcare Group are premiums charged to small, uninsured businesses with 2 to 50 employees and employees of political subdivisions for medical coverage. Operating expenses for the Healthcare Group include the costs of medical services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are 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 preceding the month of coverage. At June 30, 2012, the proprietary fund deferred revenue of $3,532 consists of premium payments received for fiscal year 2013 as required by contract.

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 revenue to be available if they are collected within 31 days of the end of the current fiscal year. The governmental funds deferred 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 (IBNR) 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 and claims and judgments are recorded only when payment is due.

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

In fiscal year 2012, 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.

Private-sector standards of accounting and financial reporting issued prior to December 1, 1989, generally are followed in both the government-wide and proprietary fund financial statements to the extent that those standards do not conflict with or contradict guidance of the Governmental Accounting Standards Board ("GASB"). Governments also have the option of following subsequent private-sector guidance for their business-type activities and enterprise funds, subject to this same limitation. AHCCCS has elected to follow subsequent private-sector guidance.

### D. Financial presentation

In fiscal year 2012, the presentation of Legislative appropriations was modified to collapse separate special line item appropriations for capitation, reinsurance, fee-for-service, Medicare premiums, etc. into lump sum appropriations for the Traditional and Prop 204 services special line items. This presentation change is reflected in the programmatic expenditures presentation in the Statement of Revenues, Expenditures and Changes in Fund Balances – Governmental Funds as well as the Budgetary Comparison Schedule – General Fund for fiscal year 2012.

### E. 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. Investment income is allocated to AHCCCS on a pro rata basis. Amounts held by the Treasurer are recorded at fair value and totaled $194,149 at June 30, 2012, including restricted funds of $46,238.

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.

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

Cash in the General Fund has been internally restricted by AHCCCS in the amount of $45,514 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 $724 for the Hawaii Arizona PMMIS Alliance ("HAPA") Fund, as described in Note 4 and is offset by accrued expenditures of $214 and deferred revenue of $510 at June 30, 2012.

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, 2012, no bank overdraft existed.

### F. Net assets / fund balance

The difference between fund assets and liabilities is "Net Assets" on the government-wide and proprietary fund statements and "Fund Balance" on the governmental fund statements. Net assets are reported in three categories:

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

Effective July 1, 2010, AHCCCS adopted GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*. GASB Statement No. 54 provides more clearly defined fund balance categories to make the nature and extent of the constraints placed on a government's fund balance more transparent. GASB Statement No. 54 also clarifies the existing governmental fund type definitions to improve the comparability of governmental fund financial statements and help financial statement users to better understand the purpose for which governments have chosen to use particular funds for financial reporting. The classifications 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, restricted, committed, assigned and unassigned, 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, 2012, AHCCCS had no nonspendable fund balance.

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

**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 restricted fund balance unless the legal document that initially authorized the revenue (associated with that portion of fund balance) also included language that specified the limited use for which the authorized revenues were to be expended. At June 30, 2012, AHCCCS had no restricted fund balance.

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, 2012, AHCCCS' committed fund balance totaled $300.

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, 2012, AHCCCS' assigned fund balance totaled $4,590.

Unassigned fund balance – this includes the remaining spendable amounts which are not included in one of the other classifications. At June 30, 2012, 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 Legislature. AHCCCS fund balances classified as assigned include balances that are constrained for specific purposes, and are not committed.

### G. 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.

(dollar amounts expressed in thousands)

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

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 $4,182 at June 30, 2012 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. Effective May 1, 2011 the MED program was frozen and no new applications were accepted for this category pursuant to the MED Phase-Out plan approved by CMS. The MED program ended September 30, 2011, therefore, the contract year ended September 30, 2011 was the final year in which the MED population was included in the PPC reconciliation.

Similar risk sharing is in place for medical costs incurred by contracted health plans for the Title XIX Waiver Group ("TWG") (MED and non-MED) 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 3% for the MED and 2% for the non-MED population. Accrued programmatic costs are net of approximately $72,429 at June 30, 2012 that represents estimated settlement payments due from contracted health plans for the TWG MED and non-MED reconciliations. Actual results may differ from this estimate and such differences will be recorded in the period in which they are identified. This program ended September 30, 2011, therefore, the contract year ended September 30, 2011 was the final TWG reconciliation.

Effective with contract year ending September 30, 2012, AHCCCS will recoup/reimburse a percentage of the contractors' profit or loss for all prospective risk groups excluding State-only funded transplants, using a tiered approach. The reconciliation will limit the contractors' profits and losses to the percent of prospective net capitation according to the following schedule:

| Profit | Contractor Share | State Share | Max Contractor Profit | Cumulative Contractor Profit |
|---|---|---|---|---|
| <= 3% | 100% | 0% | 3% | 3% |
| > 3% and <= 5% | 75% | 25% | 1.5% | 4.5% |
| > 5% and <= 7% | 50% | 50% | 1% | 5.5% |
| > 7% and <= 9% | 25% | 75% | 0.5% | 6% |
| > 9% | 0% | 100% | 0% | 6% |

| Loss | Contractor Share | State Share | Max Contractor Loss | Cumulative Contractor Loss |
|---|---|---|---|---|
| <= 3% | 100% | 0% | 3% | 3% |
| > 3% and <= 6% | 50% | 50% | 1.5% | 4.5% |
| > 6% | 0% | 100% | 0% | 4.5% |

Profits in excess of the percentages set forth above will be recouped by AHCCCS. Losses in excess of the percentages set forth above will be paid to the contractor. Accrued programmatic costs are net of approximately $1,512 at June 30, 2012 that represents estimated settlement payments due from contracted health plans for the tiered reconciliation.

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

### H. 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.

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.

### I. 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 and Tribal ALTCS 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.

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

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.

### J. Incurred but not reported programmatic expenditures

In the accompanying financial statements, medical services expenditures include claims paid, claims in process and pending, 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.

The estimates for IBNR programmatic claims are developed using actuarial methods based upon 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, and adjustments are reflected in the period determined.

### K. Hospital payments

CMS and the Legislature authorized AHCCCS to make Disproportionate Share, Safety Net Care Pool, Graduate Medical Education ("GME"), Rural Hospital and Critical Access Hospital supplemental hospital payments in fiscal year 2012. Disproportionate share payments to Arizona hospitals that provided care to a disproportionate share (as defined) of the State's indigent population totaled $173,068. Safety Net Care Pool payments to fund unreimbursed costs incurred by hospitals in caring for the uninsured totaled $249,000. GME payments to reimburse hospitals with GME programs for the additional costs of treating AHCCCS members with graduate medical students totaled $210,773. 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.

### 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 U.S. generally accepted accounting principles 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, 2012. Actual results may differ from these estimates.

(dollar amounts expressed in thousands)

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

### 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.

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. Management believes that as of June 30, 2012, 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 9.

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 $101,067 in fiscal year 2012 for the period from January 1, 2011 to December 31, 2011. Revenue and a related receivable of $50,000 were accrued for the period of January 1, 2012 through June 30, 2012 and are included in Tobacco Settlement Receivable and Other Operating Grants and Contributions in the accompanying Statement of Net Assets 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 are interest-free and are due and will become available in future periods when certain criteria are met triggering repayment or beginning in fiscal year 2013 with five annual installments after the execution date whichever is earlier. Payment of the loans may be made in advance of the due date and, as such, AHCCCS received an advance payment of $100 in fiscal year 2012.

Annual maturities of the loan receivable as of June 30, 2012 are as follows:

| Years Ending June 30, | |
|---|---|
| 2013 | $ - |
| 2014 | 80 |
| 2015 | 80 |
| 2016 | 80 |
| 2017 | 180 |
| Thereafter | 180 |
| Total | $ 600 |

(dollar amounts expressed in thousands)

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

### P. Prescription Drug Rebate Program

The Patient Protection and Affordable Care Act 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 $290,854 as of June 30, 2012. Of this amount, $203,764 will be returned to the Federal government, and $87,090 is available to offset a portion of General Fund current and future fiscal year expenditures. The unpaid invoice balance of $84,988 as of June 30, 2012 is included in receivables in the accompanying statement of net assets. Of this amount, $59,820 will be returned to the Federal government and is netted against the due from the Federal government in the accompanying financial statements and $25,168 is available to offset future fiscal year expenditures, which is netted against the due from state and local governments in the accompanying financial statements.

## (2) Capital assets

Capital assets, which consist of furniture, vehicles and equipment and internally generated computer software, are reported in the governmental and business-type activity columns in the government-wide statement of net assets. 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 of at least $1,000 and will be amortized over an estimated useful life of five 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, 2011 | $ | 1,666 |
| Additions | | 1,739 |
| Retirements | | - |
| Depreciation | | (365) |
| Balance, June 30, 2012 | $ | 3,040 |

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, 2012, management does not believe impairment indicators are present, and there were no idle capital assets.

(dollar amounts expressed in thousands)

**(2) Capital assets (continued)**

At June 30, 2012, AHCCCS had incurred approximately $1,694 of costs related to internally generated computer software, which is included in capital assets. Approximately $920 was incurred in fiscal year 2012. Internally generated software represents AHCCCS' continuing development of the next mandated version of the electronic Transaction and Code Set ("TCS") standards under the Health Insurance Portability and Accountability Act of 2010. The total costs associated with the internally generated computer software are estimated to be approximately $1,983. The software is projected to be completed by December 31, 2012. 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, 2011 | $ 3,397 |
| Additions | 4,722 |
| Reductions | (4,776) |
| Balance, June 30, 2012 | $ 3,343 |

**(4) Other governmental funds**

At June 30, 2012, the other governmental fund balance of $854 included activity within the following funds:

- Tobacco Tax and Health Care Fund, Medically Needy Account ("TTHCF-MNA") - The Arizona Department of Revenue allocates funding to the TTHCF-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 TTHCF-MNA include tobacco tax proceeds and investment income.

- Tobacco Products Tax Fund, Emergency Health Services Account ("TPTF-EHSA") - The Arizona Department of Revenue allocates the tobacco tax revenue to the TPTF-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 TPTF-EHSA include tobacco tax proceeds and investment income.

- 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.

(dollar amounts expressed in thousands)

## (4) Other governmental funds (continued)

- Third Party Liability Fund - This fund is comprised of monies recovered from first and third party payers under various AHCCCS recovery programs prior to the disbursement to the appropriate parties, contractors and programs. These programs primarily include casualty, special treatment trusts, estate and health insurance recoveries.

- 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 are interest-free and are due and will become available in future periods when certain criteria are met triggering repayment or beginning in fiscal year 2013 with five annual installments after the execution date whichever is earlier.

Other governmental funds earned, expended and transferred during the fiscal year ended June 30, 2012 were as follows:

| | TTHCF - MNA | TPTF - EHSA | Trauma and Emergency Services Fund | Third Party Liability Fund | Miscel-laneous Funds | Total |
|---|---|---|---|---|---|---|
| Fund balances, June 30, 2011 | $ - | $ - | $ - | $ - | $ 321 | $ 321 |
| Receipts | 71,920 | 18,754 | 21,215 | 1,461 | 21,943 | 135,293 |
| Interest earned | - | - | 58 | 7 | 9 | 74 |
| Expenditures | (36,753) | (18,754) | (21,267) | (860) | (21,105) | (98,739) |
| Transfers in (out): | | | | | | |
| State General Fund | - | - | - | (608) | (420) | (1,028) |
| Arizona Dept of Health Services | (35,167) | - | - | - | - | (35,167) |
| Hospital Loan Residency Fund | - | - | - | - | 100 | 100 |
| Fund balances, June 30, 2012 | $ - | $ - | $ 6 | $ - | $ 848 | $ 854 |

## (5) Proprietary fund - operations

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. That range was later changed to 2 to 50 employees. HCG contracts with two health plans from the existing network of AHCCCS health plans ("MCOs") to provide managed care medical services.

HCG's administrative responsibilities include enrollment/renewal, fulfillment, premium billing, customer service, collections, fund disbursement and data analysis. HCG is also responsible for regulatory oversight and providing reinsurance to the health plans.

## (5) Proprietary fund – operations (continued)

The HMO contracted health plans are prepaid on a "per member, per month" ("PMPM") basis. Capitation payments are made prospectively. In the first two quarters of fiscal year 2009 and in years prior, HCG reconciled the medical costs experienced by the plans above a contractual target medical loss ratio (stop loss target) that was based on the capitation paid annually to each plan. This stop loss payment was made for the difference in medical losses above the target medical loss ratio. If medical costs exceeded capitation, HCG paid the plans this reconciliation from available reconciliation reserves. Due to very high losses in fiscal year 2007 (Note 6), HCG negotiated payment terms with the contracted health plans to repay the remaining liabilities owed from fiscal years 2007 and 2008 over the next several fiscal years. At June 30, 2012, HCG continued to carry a reconciliation liability balance totaling $2,797; which is included in accrued programmatic costs. Since fiscal year 2007 HCG has reduced this liability by $19,712.

Effective January 1, 2009, HCG's contracted health plans agreed, in contract, that no future reconciliation costs will be recognized by HCG, except for adjustments to the existing reconciliation for services rendered through December 31, 2008. In addition to capitation payments, HCG contractors are now compensated for attaining Nationally Recognized Utilization Management Standards, as mandated by Laws 2008, Chapter 288. The performance standards are developed by Milliman Inc., customized to each health plan's unique member population and further stratified by the level of medical management such as well managed, moderately managed, and loosely managed. The compensation amount will be no more than 2% of total premiums collected. After the end of the fiscal year, if the contractors meet performance standards, each will receive a payment. If a health plan performs poorly, it will forfeit the reserved amount, and HCG will retain the amount and apply it to any existing liabilities. By compensating the health plans based on a set amount of reserves already collected from member premiums, HCG eliminates the potential for any unanticipated losses (or gains) from variation in MCO utilization. As of June 30, 2012, HCG has in reserves $282 for potential payout with a scheduled disbursement in December 2012. This reserve amount is included in the $2,200 current accrued programmatic costs at June 30, 2012. See further discussion in Note 6.

## (6) Proprietary fund – financial condition

In fiscal year 2012, HCG reported operating income of $5,360 and an increase in net assets of $5,146. This continues a five-year trend of operating profitability before General Fund subsidies that began in fiscal year 2008 when HCG began successfully managing both program and administrative costs through a series of cuts, changes, realignments, and premium adjustments to match revenues with expenses. Overall, fiscal year 2012 results turned HCG's $2,989 net deficit balance at June 30, 2011 into a net asset position of $2,157 at June 30, 2012; the highest net asset position since fiscal year 2004.

Prior to fiscal year 2008, HCG was unable to cover its costs due to net medical losses (medical costs exceeded premiums received). Since ending fiscal year 2007 with a liability of $22,509, HCG has reduced this balance by $19,712 using a combination of cash generated from operations, and adjustments related to claim runout, reinsurance coverage, General Fund subsidies, reinsurance and forgiveness of debt. Since 2010, HCG has not received General Fund subsidies to offset prior year losses. Additionally, in fiscal years 2010 through 2012 HCG made cash transfers to the General Fund totaling $1,280.

(dollar amounts expressed in thousands)

## (6) Proprietary fund – financial condition (continued)

The following table summarizes HCG's reconciliation liability activity for fiscal year 2012:

**Healthcare Group Reconciliation Liability as of June 30, 2012**
**Fiscal Year 2012 Activity**

| | Reconciliation Period | | |
|---|---|---|---|
| | FY 07 | FY 08 | Total |
| Balance June 30, 2011 | $ 3,321 | $ 3,453 | $ 6,774 |
| Payments made | (1,082) | (662) | (1,744) |
| Adjustments | (2,187) | (46) | (2,233) |
| Balance June 30, 2012 | $ 52 | $ 2,745 | $ 2,797 |

There was no reconciliation liability for fiscal year 2009.

The remaining reconciliation liability will be paid by allocating 2% or more of medical premium revenues for a reconciliation reserve from residual earnings. Additionally, payments may be generated from residual earnings.

HCG has achieved operating income each fiscal year since 2008 and management currently projects that the positive trend will continue. Due to continued effective administrative and programmatic management, a $2,989 net deficit at June 30, 2011 was turned into a $2,157 net asset position at June 30, 2012. Despite continued expected enrollment decline, HCG anticipates continued profitability and the ability to eliminate the outstanding reconciliation liability from cash flow from operations by December 31, 2013.

According to current Federal health reform legislation, effective January 1, 2014 health insurance exchanges will be instituted and HCG will cease operations. To date, no State legislation has been enacted affecting the operations of HCG. As such, HCG plans to continue operations until it receives directions to cease operations.

## (7) 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 10.5 percent for retirement and 0.24 percent for long-term disability for fiscal year 2012. The matching amount contributed to the retirement plan by AHCCCS was $4,339 in fiscal year 2012 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").

(dollar amounts expressed in thousands)

## (8) Budgetary basis of accounting

The financial statements of AHCCCS are prepared in conformity with U.S. generally accepted accounting principles ("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 $29,233 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, 2012.

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, 2012:

| | General Fund Actual |
|---|---|
| Budgetary Basis Fund Balance, June 30, 2012 | $ 158,367 |
| Budgetary Basis of Accounting | |
| Increases to fund balance: | |
| Cash | 776 |
| Due from State and local governments | 105,359 |
| Due from the federal government | 256,483 |
| Due from Other Fund | 9,634 |
| Receivables and other | 29,383 |
| Total increases | 401,635 |
| Decrease to fund balance: | |
| Deferred revenue | (20,888) |
| Due to State and county governments | (91,485) |
| Accrued programmatic costs | (442,141) |
| Payables and other | (1,452) |
| Total decreases | (555,966) |
| Total GAAP basis fund balance | $ 4,036 |

Non-appropriated expenditures of $2,418,808 in the General Fund consist of federal and state matching pass-through payments to other agencies.

## (9) 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 alleges AHCCCS failed to adjust the hospital tier rates concurrent with changes made to the outlier thresholds from 1994 to 1998. It is reasonably possible that the hospitals will prevail; however, AHCCCS cannot reasonably estimate an amount, and no liability has been recorded as of June 30, 2012. Another 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, 2012. Another case challenges the denial of payment on the basis that the treatment was experimental and therefore not a covered service. 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 quality 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 population covered by the Waiver be budget neutral for CMS. 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. In accordance with the Waiver, AHCCCS has 2 years subsequent to September 30, 2011 to report expenditures related to the budget neutrality period ended September 30, 2011. Through June 30, 2012, AHCCCS remains under the cumulative reporting limit threshold for both waiver periods. Accordingly, 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. The OIG requested that AHCCCS provide the OIG with all DSC claims data for the period from January 2004 through June 2006. The data represented over 9.5 million claim lines and $124,000 of federal funds paid to the Local Education Authorities ("LEAs") statewide under the DSC program.

**(9) Contingencies (continued)**

From the data AHCCCS provided, the OIG sampled 100 students "members months" (where one student member month is all claims for one student for one month) and commenced their review. There were approximately 175 contracted LEAs during the timeframe of the audit. The 100 student months of records that were sampled represented 44 of the 175 LEAs statewide. The audit represented a total of 2,000 claims under review.

The OIG conducted on-site audits at fifteen LEAs which represented 49 of the 100 student (member) months. The OIG performed desk reviews on the remainder of the LEAs. The total federal dollars paid to the LEAs for these claims totaled approximately $32.

In March 2010, the OIG provided AHCCCS with the audit report and related findings which focused primarily on: services not provided or service units over billed; documentation requirements not met; speech therapy provider requirements not met; unallowable transportation services; prescribing or referring provider requirements not met; and student eligibility not met. From the preliminary findings, the highest frequency of errors occurred in services not provided or service units over billed, documentation requirements not met, and speech therapy provider requirements not met.

Out of the $32 in federal dollars paid to the LEAs for the selected claims, OIG identified a potential overpayment of $6.8 which represents an error rate of 21%. OIG has extrapolated the error rate and has issued a recommendation that CMS recoup $21,288 of program costs previously passed through to the LEAs under the DSC program. AHCCCS conducted a review and validation of the data set supporting the OIG findings and responded to CMS regarding the final OIG audit report and extrapolated finding amount on September 21, 2010. AHCCCS disagrees with the audit report and disputes $4 or 59 percent of the identified overpayment amount of $6.8. AHCCCS has returned $2.7 based on the claims that AHCCCS does not dispute.

CMS completed a review of the OIG findings and AHCCCS' response and concurs with OIG on all but one of the claims in question. OIG recalculated the extrapolation and revised the estimate to $21,210. CMS has requested the funds be returned. AHCCS 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 $21,210 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. As the recoupment is a reduction of prior school-based services expense, AHCCCS has properly recorded the $21,210 as a reduction in school-based services expense for the year ended June 30, 2012.

**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. In March 2006, the contractor began a review of the claim calculation for the period from January 2004 through September 2007 as a result of findings from an OIG audit in another state that questioned methods used in the claim calculation methodology. The recommendations of the TPA were initially adopted prospectively and resulted in a more conservative calculation of the MAC amounts. Subsequently, an assessment of the impact of the claim calculation changes concluded that there is an inability to accurately recalculate the MAC amounts retroactively. The maximum impact of the retroactive claim calculations is approximately $7,000, and CMS indicates that the OIG will review the MAC claims in question to reasonably calculate the overpayments.

## (9) Contingencies (continued)

In August 2008, the TPA identified that the prospective implementation failed to include all of the recommendations having a direct impact on the claims paid from December 2005 through December 2007. AHCCCS has requested that the TPA either return the approximate $2,300 maximum overpayment or recalculate what the payments should have been and return the resulting overpayment.

CMS has instructed AHCCCS to refund the $9,300 in overpayments. The refund will be requested from the LEAs or deducted from future payments in accordance with the intergovernmental agreement. The amount due from the LEAs may be reduced by any recovery from the TPA as identified above. At June 30, 2012, AHCCCS has recorded a liability of $9,300 which is included in the due to the Federal government with a corresponding receivable in the due from state and local governments in the accompanying financial statements. As the funds will be recouped from the LEAs, AHCCCS has properly recorded the amount as a reduction in administrative expenses passed through for the year ended June 30, 2012.

In March 2011 the OIG commenced an audit of the MAC program for the period January 1, 2004, through September 30, 2008, a total of 19 quarters. The OIG provided AHCCCS with the draft audit report and related findings in August 2012 stating that AHCCCS, through its TPA, did not always retain required documentation to support the random moment time study (“RMTS”) methodology used to allocate school-based administrative costs to the Medicaid program and the RMTS methodology was not fully consistent with Federal requirements. The report states that the RMTS supporting documentation for 2 of the 19 quarters was not retained and that the RMTS methodology for the remaining 17 quarters was determined to be inconsistent with Federal requirements. The OIG determined that the unallowable Federal reimbursement was $5,422 and $6,295, respectively, for a total of $11,717.

Certain elements of the calculations performed by the contractor and the OIG are similar causing duplication of approximately $2,076 for a total net unallowable cost of $9,641. AHCCCS anticipates receiving a disallowance and intends to file an appeal with the CMS Departmental Appeals Board (“DAB”). AHCCCS internal legal counsel has indicated that it is reasonably possible that some additional amount will be disallowed and recouped by CMS. However, AHCCCS cannot, at this early stage, reasonably estimate an additional unallowable cost and no repayment liability has been recorded as of June 30, 2012.

**Medicare Part B premium buy-in** – In February 2010, the U.S. Department of Health and Human Services, Office of Inspector General, Office of Audit Services (“OIG”) commenced an audit of the buy-in of Medicare Part B premiums. The OIG audit period covered Part B premiums paid by the State and claimed for Federal reimbursement for the quarters ended December 31, 2007, through September 30, 2009. In January 2012 the OIG issued a draft recommendation that AHCCCS refund $13,052 for unallowable Part B premiums claimed.

Based on the OIG findings, CMS reviewed the Medicare Part B eligibility categories and Federal claiming for the quarters ended September 30, 2010 through September 30, 2011, and determined that AHCCCS did not comply with Federal requirements and formally disallowed certain claimed amounts for these five quarters ended September 30, 2011 in the amount of $13,280. In addition, AHCCCS anticipates receiving a disallowance for the three quarters ended December 31, 2009 through June 30, 2010 in the amount of $7,603 as well as the recommended $13,052 from the OIG.

## (9) Contingencies (continued)

AHCCCS bases Federal claiming on two separate State Medicaid Directors Letters where CMS has stated that, at the State's option, Federal Financial Participation ("FFP") is available for the cost of Part B premiums for the eligibility category in question. The questioned category is individuals eligible for both Medicaid and Medicare, but who were not cash recipients, deemed cash recipients, Qualified Medicare Beneficiaries, Specified Low-Income Medicare Beneficiaries, or Qualified Individuals 1 and are covered as a State option. Upon receipt of the disallowances, AHCCCS returned $13,280 to CMS in fiscal year 2012. Accordingly, a liability of $20,655 is included in the due to the federal government in the accompanying financial statements for the period from December 31, 2007 through June 30, 2010. AHCCCS filed an appeal to the DAB for the amounts formally disallowed and intends to file an appeal of future disallowances. Internal counsel has indicated that it is reasonably possible that some portion of the deferred amount may be disallowed and recouped by CMS. AHCCCS received a waiver that allows FFP for the cost of Part B premiums for this eligibility category prospectively effective October 22, 2011.

## (10) Interfund receivables, payables and transfers

Interfund activity is defined as transactions between funds administered by AHCCCS. The interfund balances as of June 30, 2012 consist of transfers from the Other Funds to the General Fund in the amount of $9,634.

In the government-wide statement of activities, the interfund activity has been eliminated. The total net transfers out of $74,623 reported on the statement of activities represents transfer activities to other State agencies.

## (11) 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 Title XIX 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.

(dollar amounts expressed in thousands)

## (11) 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, 2012.

| | Expenditures |
|---|---|
| Arizona Department of Economic Security | $ 83,250 |
| Arizona Department of Administration | 13,865 |
| Arizona Department of Health Services | 1,961 |
| Arizona Board of Nursing | 242 |
| Arizona Office of Administrative Hearings | 345 |
| | $ 99,663 |

**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, 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, 2012.

| | Expenditures |
|---|---|
| Arizona Department of Economic Security | $ 997,398 |
| Arizona Department of Health Services | 1,285,695 |
| | $ 2,283,093 |

Revenues include $293,029 from Arizona counties during fiscal year 2012. 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, 2012, county and State contributions did not exceed related expenditures.

## (12) 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 $88,984 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 counties contributed $3,161 as determined by statutory calculation for administrative costs incurred by ADES for eligibility determinations and other operating costs associated with Proposition 204.

(dollar amounts expressed in thousands)

## (12) Other pass through funds (continued)

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, 2012, AHCCCS recorded the following pass through revenue in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balance - Governmental Funds:

| | Funds Passed Through |
|---|---|
| Arizona School Districts | |
| Administrative Services Federal Funds | $ 6,931 |
| Program Services Federal Funds | 18,304 |
| Arizona Department of Economic Security | |
| County Contribution for Administrative Costs | 3,161 |
| Arizona Department of Health Services | |
| Cost reimbursement from Civil Monetary Penalties | 120 |
| | $ 28,516 |

## (13) American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 (“ARRA”) provides fiscal relief to states to protect and maintain State Medicaid programs through June 30, 2011. This relief is granted in the ARRA, Title V, Sections 5001 and 5002 in the form of temporary increases in the federal matching assistance percentage (“FMAP”) rates, and increases to the Disproportionate Share Hospital (“DSH”) allotments. The increased Federal Medical Assistance Percent rate from ARRA ended on June 30, 2011. CMS continued the separate grant award and accounting for ARRA funds for one additional through the quarter ended September 30, 2011 for qualifying payments. This final ARRA period increased FMAP by $7,992 during fiscal year 2012 reducing the amount of state funds normally required to match federal funds. However, the applicable ARRA FMAP rate will still apply for any future qualifying adjustment.

State agencies benefited from the increased FMAP rates for claimed federal expenditures for fiscal year 2012 as follows:

| | |
|---|---|
| Arizona Health Care Cost Containment System | $ 2,058 |
| Arizona Department of Economic Security | 5,575 |
| Arizona School Districts | 359 |
| | $ 7,992 |

## (14) New pronouncements

The Governmental Accounting Standards Board ("GASB") issued several pronouncements prior to June 30, 2012 with effective dates within or after the fiscal year ended June 30, 2012. Management believes the impact of these statements does not affect current or future financial presentations by AHCCCS. AHCCCS adopted no new pronouncements in the fiscal year ended June 30, 2012.

## (15) Subsequent events

Passage of the Patient Protection and Affordable Care Act of 2010 ("ACA") and subsequent Supreme Court decision presented the State with multiple and complex opportunities regarding the future of the Arizona Medicaid program. While many of these important decisions are still under consideration, the fiscal year 2014 budget submission includes funding for several mandatory components of the ACA and assumes the restoration of enrollment into the Prop 204 Childless Adult program recognizing that it is ultimately up to Arizona policy-makers to determine available resources. This is a time of unprecedented change in the health care system. These changes are both exceedingly complex and are occurring in an environment of considerable uncertainty regarding federal requirements and flexibility. As a result, AHCCCS' estimates regarding the impact of these many changes continue to evolve as new information becomes available.

AHCCCS enrollment declined for most of fiscal year 2012 primarily due to the enrollment freeze on the Childless Adult (AHCCCS Care) population. Title XIX full service enrollment decreased in 10 of the 12 months in fiscal year 2012 with a net overall decrease of 88,460. During the same period, the frozen AHCCCS Care population declined by 108,089. Enrollment in fiscal year 2013 has varied with three months of growth spurred by the initial intake of the KidsCare II program followed by two months of declines resulting in an overall decline of 9,362 members through November 2012. The growth rates built into the population forecasts reflect the assumption that most populations not subject to enrollment freezes will continue to see modest growth. Budget projections indicate that the fiscal year 2013 appropriations are expected to be sufficient to cover projected Agency expenditures with a small estimated surplus.

# ADDITIONAL INFORMATION

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2012
(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 | | | |
| Medicaid Program (Title XIX) | | | |
| Federal funds expended to vendors | 93.778 | $ 5,950,697 | |
| American Recovery and Reinvestment Act | 93.778-R | 7,992 | |
| Federal funds expended to subrecipients | 93.778 | 5,519 | |
| | | 5,964,208 | * |
| Children's Health Insurance Program (Title XXI) | 93.767 | 22,989 | * |
| Medicaid Infrastructure Grant | 93.768 | 261 | |
| **TOTAL EXPENDITURES OF FEDERAL AWARDS** | | $ 5,987,458 | |

*major programs

See Independent Auditors' Report
See Notes to Schedule of Expenditures of Federal Awards

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2012
(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*** and is presented on the accrual basis of accounting. 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*. Therefore, some amounts presented in this Schedule may differ from amounts presented in, or used in, the preparation of the basic financial statements.

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

The program titles and CFDA numbers were obtained from the 2012 *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 the financial statements of the ***Arizona Health Care Cost Containment System*** **(AHCCCS, an agency of the state of Arizona)** as of and for the year ended June 30, 2012 and have issued our report thereon dated December 6, 2012. We conducted our audit in accordance with U.S. generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

**Internal Control Over Financial Reporting**

Management of the ***Arizona Health Care Cost Containment System*** is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the ***Arizona Health Care Cost Containment System's*** internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the ***Arizona Health Care Cost Containment System's*** internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the ***Arizona Health Care Cost Containment System's*** internal control over financial reporting.

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 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.

Our consideration of internal control over financial reporting 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 financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined previously.

## Compliance and Other Matters

As part of obtaining reasonable assurance about whether the ***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.*

This report is intended solely for the information and use of the management of ***Arizona Health Care Cost Containment System*** and the state of Arizona Auditor General and is not intended to be and should not be used by anyone other than these specified parties.

Mayer Hoffman McCann P.C.

Phoenix, Arizona
December 6, 2012