

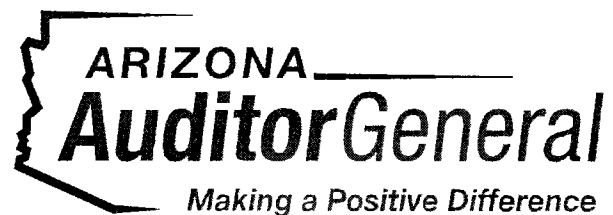
Department of Economic Security
Division of Developmental Disabilities ALTCS Contract

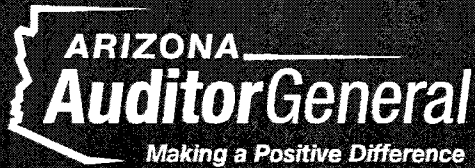
Annual Financial Report

Year Ended June 30, 2016

A Report to the Arizona Legislature

Debra K. Davenport
Auditor General





The Auditor General is appointed by the Joint Legislative Audit Committee, a bipartisan committee composed of five senators and five representatives. Her mission is to provide independent and impartial information and specific recommendations to improve the operations of state and local government entities. To this end, she provides financial audits and accounting services to the State and political subdivisions, investigates possible misuse of public monies, and conducts performance audits and special reviews of school districts, state agencies, and the programs they administer.

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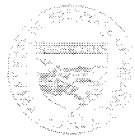
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ANNUAL FINANCIAL REPORT



DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

MELANIE M. CHESNEY
DEPUTY AUDITOR GENERAL

Independent auditors' report

Members of the Arizona State Legislature

Timothy Jeffries, Director
Department of Economic Security

Report on the financial statements

We have audited the accompanying financial statements of the State of Arizona, Department of Economic Security, Division of Developmental Disabilities, Arizona Long Term Care System Contract (ALTCS Contract), as of and for the year ended June 30, 2016, and the related notes to the financial statements, which collectively comprise the Division's ALTCS Contract's financial statements as listed in the table of contents.

Management's responsibility for the financial statements

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

Auditors' responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with 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 from material misstatement.

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

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the Division's ALTCS Contract as of June 30, 2016, and the respective changes in financial position thereof for the year then ended in accordance with U.S. generally accepted accounting principles.

Emphasis of matter

As discussed in Note 1, the Division's ALTCS Contract's financial statements are intended to present the financial position and the changes in financial position of only that portion of the governmental activities and major fund of the State of Arizona that is attributable to the transactions of the Division's ALTCS Contract. They do not purport to, and do not, present fairly the financial position of the State of Arizona as of June 30, 2016, and the changes in its financial position for the year then ended in conformity with U.S. generally accepted accounting principles. Our opinion is not modified with respect to this matter.

Other matters

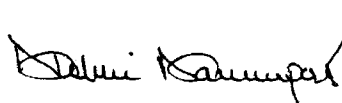
Supplementary information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Division's ALTCS Contract's financial statements. The supplementary schedules listed in the table of contents are presented for purposes of additional analysis and are not required parts of the financial statements.

The supplementary schedules are management's responsibility and were derived from and relate directly to the underlying accounting and other records used to prepare the financial statements. Such information 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 supplementary schedules are fairly stated, in all material respects, in relation to the financial statements as a whole.

Other reporting required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated November 22, 2016, on our consideration of the Division's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Division's internal control over financial reporting and compliance.



Debbie Davenport
Auditor General

November 22, 2016

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Balance sheet—special revenue fund
June 30, 2016

Assets

Cash and investments held by the State Treasurer	\$ 54,324,039
Due from other state funds	103,038,676
Due from providers	<u>2,162,197</u>
 Total assets	 <u>\$ 159,524,912</u>

Liabilities and fund balance

Liabilities:

Accrued administrative and payroll costs	\$ 10,781,389
Accrued medical and healthcare claims	81,781,277
Due to other state funds	<u>42,909,821</u>
 Total liabilities	 <u>135,472,487</u>

Fund balance:

Restricted for health and welfare	<u>24,052,425</u>
 Total liabilities and fund balance	 <u>\$ 159,524,912</u>

See accompanying notes to financial statements.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Statement of revenues, expenditures, and changes in fund balance—
special revenue fund
June 30, 2016

Revenues:	
Capitation	\$ 1,197,343,106
Investment earnings	3,599,233
Miscellaneous	<u>385,489</u>
Total revenues	<u>1,201,327,828</u>
Expenditures:	
Health and welfare:	
Aid to individuals	1,027,133,958
Allocated administrative expenditures	54,906,350
Case management	55,588,258
Professional and outside services	8,365,236
Premium tax	<u>29,281,601</u>
Total expenditures	<u>1,175,275,403</u>
Excess of revenues over expenditures	26,052,425
Other financing uses:	
Transfers to other state funds	<u>(36,814,703)</u>
Net change in fund balance	(10,762,278)
Fund balance, July 1, 2015	<u>34,814,703</u>
Fund balance, June 30, 2016	<u>\$ 24,052,425</u>

See accompanying notes to financial statements.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Notes to financial statements
June 30, 2016

Note 1 - Summary of significant accounting policies

The accounting policies of the Department of Economic Security (Department), Division of Developmental Disabilities (Division), Arizona Long Term Care System Contract (ALTCS Contract), conform to U.S. generally accepted accounting principles applicable to governmental units adopted by the Governmental Accounting Standards Board.

A. Reporting entity

For financial reporting purposes, the ALTCS Contract includes only that portion of the State's general fund that is attributable to the ALTCS Contract's transactions. The Division is responsible for administering the ALTCS Contract. Control by the Division was determined on the basis of accountability. Fiscal responsibility for the Division remains with the Department and, ultimately, with the State. The Division is a contractor with the Arizona Health Care Cost Containment System (AHCCCS) to provide medical and healthcare services to eligible enrollees of the AHCCCS Arizona Long Term Care System (ALTCS) program for the developmentally disabled. This program provides in-patient and out-patient medical and nursing services in addition to managed institutional and home- and community-based, long-term care services to eligible enrollees of the AHCCCS ALTCS program. The Division receives monthly premiums from AHCCCS for all eligible enrollees under the AHCCCS ALTCS program for the developmentally disabled.

B. Fund accounting

The Division's accounts are maintained in accordance with the principles of fund accounting to ensure that limitations and restrictions on the Division's available resources are observed. The principles of fund accounting require that resources be classified for accounting and reporting purposes into funds in accordance with the activities or objectives specified for those resources. Each fund is considered a separate accounting entity, and its operations are accounted for in a separate set of self-balancing accounts that comprise its assets, liabilities, fund balance, revenues, and expenditures.

The ALTCS Contract's financial transactions are reported as a special revenue fund since the proceeds are from specific revenue sources that are legally restricted to expenditures for specified purposes.

Although the ALTCS Contract is considered a special revenue fund when reported on individually, it becomes a part of the State's general fund at the combined state-wide level.

C. Basis of accounting

The ALTCS Contract financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Under this method, revenues are recognized when they become both measurable and available. Revenues are considered to be available when they are collected within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the Division considers capitation revenues to be available if they are collected within 90 days of the end of the current fiscal year and considers all other revenues to be available if they are collected within 30 days of the end of the current fiscal year. All ALTCS Contract revenue sources are susceptible to accrual. Expenditures are recognized when the related fund liability is incurred.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Notes to financial statements
June 30, 2016

D. Fund balance classifications

Fund balance is reported separately within classifications based on a hierarchy of the constraints placed on the use of those resources. The classifications are based on the relative strength of the constraints that control how the specific amounts can be spent. The classifications are nonspendable, restricted, and unrestricted, which includes committed, assigned, and unassigned fund balance classifications.

Restricted fund balances are those that have externally imposed restrictions on their usage by creditors, such as through debt covenants, grantors, contributors, or laws and regulations. Deficits in fund balance, if any, are reported as unassigned.

E. Capitation

The ALTCS Contract receives fixed capitation payments from AHCCCS based on certain rates for each AHCCCS member enrolled in the Division's ALTCS Contract program. The ALTCS Contract is required to provide all covered healthcare services to its members, regardless of the cost of care. If there are monies remaining, the ALTCS Contract retains the monies as profit; if the costs are higher than the amount of capitation payments from AHCCCS, the ALTCS Contract absorbs the loss.

F. Investment earnings

Investment earnings is composed of interest earned on the ALTCS Contract's portion of monies deposited with the State Treasurer.

G. Incurred but not reported (IBNR) methodology

The liability and expenditures reported for accrued medical and healthcare claims include IBNR medical claims, which are estimated using lag data provided by the Division's information systems, with adjustments as necessary for events that are outside the lag patterns. Amounts are based on historical expenditure patterns.

Note 2 - Cash and investments held by the State Treasurer

Arizona Revised Statutes (A.R.S.) requires state agencies' monies to be deposited with the State Treasurer and further requires those deposits to be invested in various pooled funds. Cash and investments held by the State Treasurer represent the ALTCS Contract's portion of those monies. The State Treasurer invests idle contract monies in an internal investment pool (Pool 3) and distributes interest to the ALTCS Contract. Interest earned from these invested monies is allocated monthly based on the average daily balance. Participant shares in the pool are purchased and sold based on the Net Position Value of the shares. As a result, the ALTCS Contract's portion of the pool is not identified with specific investments. The ALTCS Contract's portion of these deposits and investments is reported at fair value, measured on a monthly basis, which approximates the ALTCS Contract's value of participant pool shares.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Notes to financial statements
June 30, 2016

The State Treasurer's internal investment pool 3 is not required to be registered and is not registered with the Securities and Exchange Commission under the 1940 Investment Advisors Act. The activities and performance of the pool is reviewed monthly by the State Board of Investments in accordance with A.R.S. §35-311.

At June 30, 2016, the ALTCS Contract's deposits with the State Treasurer were as follows:

	Amount
State Treasurer's investment pool 3	\$15,007,523
Cash	<u>39,316,516</u>
Total	<u>\$54,324,039</u>

Credit Risk—Credit risk is the risk that an issuer or counterparty to an investment will not fulfill its obligations. The Department of Economic Security does not have a formal investment policy with respect to credit risk. The State Treasurer's investment pool 3 is unrated.

Interest Rate Risk—Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The Department of Economic Security does not have a formal interest rate risk policy. As of June 30, 2016, the State Treasurer's weighted average to maturity of its investments is 2.55 years.

Note 3 - Due from other state funds

Amounts due from other state funds at June 30, 2016, include:

- \$1,173,588 of interest earned, and
- \$101,865,088 of capitation and reinsurance.

Note 4 - Due from providers

The amount due from providers at June 30, 2016, is \$2,162,197 as a result of post-payment reviews of long-term care home and community-based service providers.

Note 5 - Accrued medical and healthcare claims

Accrued medical and healthcare claims totaling \$81,781,277 include IBNR medical claims.

Note 6 - Due to other state funds

Amounts due to other state funds at June 30, 2016, include:

- \$6,095,118 of premium tax payable to the Arizona Department of Insurance and
- \$36,814,703 of transfers payable to the state general fund.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Notes to financial statements
June 30, 2016

Note 7 - Acute care reinsurance

During the year ended June 30, 2016, the Division received reimbursements totaling \$5,160,182 from AHCCCS for acute care reinsurance expenditures for claims for enrollees incurred in prior fiscal years. These reimbursements are recorded as a reduction of aid to individuals expenditures.

The Division subcontracts with various health plans to provide acute care services to ALTCS enrollees. These health plans must submit clean reinsurance claims to the Division within 15 months from the date of service.

The Division disbursed a total of \$7,061,560 to the health plans during the year ended June 30, 2016, and had IBNR claims of \$275,000 for total acute care reinsurance expenditures of \$7,336,560.

Note 8 - Aid to individuals expenditures

Aid to individuals expenditures consists of expenditures summarized by type of service setting or service provided, as applicable:

Institutional care:	
Skilled nursing	\$ 3,438,357
Institutional care	11,821,379
Intermediate (mentally retarded)	13,384,614
Institutional care IBNR	<u>1,724,517</u>
Total institutional care	<u>30,368,867</u>
Home- and community-based services (HCBS):	
State-operated group home	6,525,383
Vendor-operated group home	260,921,795
Adult developmental home	55,920,851
Home-based services	442,456,443
HCBS IBNR	<u>77,761,112</u>
Total HCBS	<u>843,585,584</u>
Acute care:	
Acute care	148,982,479
Acute care IBNR	2,020,650
Reinsurance	7,061,560
Reinsurance IBNR	275,000
Reinsurance reimbursement	<u>(5,160,182)</u>
Total acute care	<u>153,179,507</u>
Total aid to individuals expenditures	<u>\$1,027,133,958</u>

During the year ended June 30, 2016, the ALTCS Contract recorded allocated charges of \$23,823,467 as expenditures for direct care services, including administrative costs the Division provided to clients. The expenditures were charged to the ALTCS Contract as aid to individuals expenditures based on a federally approved cost allocation plan.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Notes to financial statements
June 30, 2016

Note 9 - Allocated administrative expenditures

During the year ended June 30, 2016, the ALTCS Contract recorded allocated administrative charges of \$54,906,350 as expenditures for its share of the administrative and fiscal services the Department provided.

Note 10 - Premium tax

Arizona Revised Statutes §§36-2905 and 36-2944.01 require AHCCCS to pay a 2 percent premium tax on all capitation and other reimbursements paid to the ALTCS Contract. These premium taxes are reported as expenditures and are paid to the Arizona Department of Insurance.

Note 11 - Transfers

Transfers to other state funds during the year ended June 30, 2016, consisted of \$34,814,703 to the State General Fund as a result of Laws 2015, First Regular Session, Chapter 8, Section 32, and \$2 million to the State-Funded Long-Term Care Fund.

Note 12 - Commitments and contingencies

The State has the ultimate fiscal responsibility for the ALTCS Contract. Accordingly, any claims requiring additional resources require the Legislature's approval. Although there is a possibility that claims could be asserted that would require additional resources for the ALTCS Contract, in the division management's opinion, the possibility is low that valid claims will be asserted and claim amounts cannot reasonably be estimated.

Note 13 - Risk management

The Division is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; medical malpractice; and natural disasters. The Department is a participant in the State's self-insurance program, and in the division management's opinion, any unfavorable outcomes from these risks would be covered by that self-insurance program. Accordingly, the Department has no risk of loss beyond adjustments to future years' premium payments to the State's self-insurance program. All estimated losses for the State's unsettled claims and actions are determined on an actuarial basis and are included in the *State of Arizona Comprehensive Annual Financial Report*.

Note 14 - Related-party transactions

During the year ended June 30, 2016, the ALTCS Contract reimbursed the Division for \$23,823,467 of health and rehabilitative services provided to enrollees, including administrative costs. The ALTCS Contract also reimbursed the Division as well as other department divisions for \$54,906,350 of administrative and fiscal services and the Arizona Department of Insurance for \$29,281,601 of premium taxes due.

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Supplementary schedules

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Lag report for institutional care payments
Year Ended June 30, 2016

Quarter of payment	Quarter in which service was provided						Total
	Current	1 st Prior	2 nd Prior	3 rd Prior	4 th Prior	5 th Prior	
Current	\$ 6,322,274	\$ 1,546,857	\$ 37,904	\$ 29,277	\$ 19,692	\$ 2,029	\$ 7,907,035
1 st Prior		6,191,584	1,548,361	1,766,857	71,951	21,662	7,790,943
2 nd Prior			3,321,398	6,166,397	1,409,776	20,275	5,210,000
3 rd Prior					5,423,840	1,392,024	7,601,906
4 th Prior						5,757,969	6,820,762
5 th Prior							7,197,901
6 th Prior							5,823,737
Total	6,322,274	7,738,441	4,907,663	7,962,531	6,925,259	7,193,959	48,352,284
Expenses reported	8,586,389	7,312,867	7,757,027	6,712,584	6,878,427	6,767,856	51,546,177
Adjustment (1)	(622,397)	471,284	(2,829,297)	1,266,969	46,832	426,103	(1,469,376)
Remaining liability	\$ 1,641,718	\$ 45,710	\$ 20,067	\$ 17,022	\$ -	\$ -	\$ 1,724,517

(1) Adjustment amounts each quarter fluctuate because of unpredictable variables that affect the business cycle.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Lag report for home- and community-based services payments
Year Ended June 30, 2016

Quarter in which service was provided

Quarter of payment	Current	1 st Prior	2 nd Prior	3 rd Prior	4 th Prior	5 th Prior	6 th Prior	Total
Current	\$ 140,049,175	\$ 71,102,025	\$ 969,280	\$ 337,394	\$ 54,218	\$ 1,042,646	\$ 313,540	\$ 213,868,278
1 st Prior		134,421,735	70,260,457	1,063,539	346,159	189,597	(1,856)	206,279,631
2 nd Prior			137,908,224	67,341,738	1,213,037	503,211	88,824	207,055,034
3 rd Prior				136,663,760	39,516,490	15,829,557	3,522,758	195,532,565
4 th Prior					136,590,096	68,298,348	1,082,266	205,970,710
5 th Prior						123,614,517	66,302,292	189,916,809
6 th Prior							128,926,617	128,926,617
Total	140,049,175	205,523,760	209,137,961	205,406,431	177,720,000	209,477,876	200,234,441	1,347,549,644
Expenses reported	216,076,777	207,215,255	213,139,553	207,153,999	192,117,881	196,301,570	196,703,639	1,428,708,674
Adjustment (1)	(9,856,579)	3,365,823	879,360	(332,440)	(14,161,190)	13,176,306	3,530,802	(3,397,918)
Remaining liability	\$ 66,171,023	\$ 5,057,318	\$ 4,880,952	\$ 1,415,128	\$ 236,691	\$ -	\$ -	\$ 77,761,112

(1) Adjustment amounts each quarter fluctuate because of unpredictable variables that affect the business cycle.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Related-party transactions
Year Ended June 30, 2016

Related party and relationship	Service provided	Description of transactions or payment terms agreement	Amount
Department of Economic Security, Division of Developmental Disabilities, Intermediate Care Facility/Mentally Retarded, State Facilities	Health and rehabilitative services and administrative costs	Allocated by Title XIX case management time reporting, member days count, and modified total direct costs	\$13,384,614
Department of Economic Security, Division of Developmental Disabilities, State-Operated Group Homes, Home-Based Services, State Facilities	Health and rehabilitative services and administrative costs	Allocated by Title XIX case management time reporting, member days count, and modified total direct costs	10,438,853
Department of Economic Security, Division of Developmental Disabilities and all other divisions	Administrative and fiscal services	Allocated departmental overhead costs	54,906,350
Department of Insurance	Compliance with Arizona Revised Statutes §§36-2905 and 36-2944.01	Premium tax payments	29,281,601

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