

**ARIZONA HEALTH CARE
COST CONTAINMENT SYSTEM**

**FINANCIAL STATEMENTS
AND SUPPLEMENTARY INFORMATION**

Year Ended June 30, 2015

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Management's Discussion and Analysis

For the Fiscal Year Ended June 30, 2015

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, 2015. 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

AHCCCS implemented Governmental Accounting Standards Board ("GASB") Statement No. 68, *Accounting and Financial Reporting for Pensions*, as amended by GASB Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date* ("GASB 68") in fiscal year 2015. With the new reporting change, AHCCCS is allocated its proportionate share of the Arizona State Retirement System's ("ASRS") net pension asset, deferred outflows of resources, deferred inflows of resources, and pension expense. A restatement to record the effects of the new reporting guidance decreased beginning net position by \$72.5 million and resulted in a current year net position decrease of \$72.9 million to record the pension liability. Current year results will be presented in the remaining discussion excluding the negative impact to net position of this liability as the GASB 68 statement is an accounting liability rather than a legal liability and distorts regular operating results. AHCCCS, as an agency of the State cannot raise revenue and would require an appropriation from the Arizona State Legislature in order to pay this pension liability. Additionally, decisions regarding the allocations are made by the administrators of the pension plan and not by AHCCCS management.

Government-Wide

- Excluding the impact of GASB 68 as discussed above, the assets and deferred outflow of resources of AHCCCS exceeded its liabilities and deferred inflow of resources at fiscal year ended June 30, 2015 by \$108.5 million. AHCCCS' net position at June 30, 2015 is comprised of an unrestricted net position of \$14.9 million and net invested in capital assets of \$93.6 million.
- Excluding the impact of GASB 68 as discussed above, AHCCCS' net position increased by \$30.5 million during fiscal year 2015. The net financial position of governmental activities increased by \$37.8 million, and the net position of the business-type activity decreased by \$7.3 million. The increase in governmental net position marks the third consecutive year of an increase and was primarily driven by the continued investment in an internally developed automated eligibility system. This investment is intended to streamline the eligibility process, resulting in better, faster services to members and the organizations that serve them. The system also allows for electronic data transfers between the state and the federally facilitated marketplace. The business-type activity net position decrease was the result of repealing the operating fund and transferring the remaining balance to the State's General Fund.

Fund Level

- As of the close of fiscal year 2015, AHCCCS' total governmental funds reported an ending fund balance of \$14.9 million, an increase of \$11.7 million from fiscal year 2014. This increase is primarily attributable to a \$9.5 million increase in the ending fund balance in the Hospital Assessment Fund and a \$2.1 million ending fund balance in the Prescription Drug Rebate Fund.
- Business-type activities ceased operations on December 31, 2013. In accordance with legislation that repeals the Business-type entity's operating fund from and after December 31, 2014, the remaining fund balance of \$7.253 million in the Health Care Group ("HCG") Fund reverted to the State General Fund during fiscal year 2015.

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

Overview of the Financial Statements

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

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

The Government-Wide Financial Statements are designed to provide readers with a broad overview of AHCCCS' finances that are comparable to a private-sector business. The Statement of Net Position and the Statement of Activities are two financial statements that report information about AHCCCS, as a whole, and its activities. The presentation in these statements is intended to help answer the question: is AHCCCS, as a whole, better off or worse off financially as a result of this year's activities? These financial statements are prepared using the flow of economic resources measurement focus and the full accrual basis of accounting. They take into account all revenues and expenses connected with the fiscal year even if cash involved has not been received or paid out. However, management believes it is best to exclude the distorting impact of the GASB 68 implementation when answering the *is AHCCCS, as a whole, better off or worse off financially as a result of this year's activities* question. Accordingly, these MD&A discussions take this approach when analyzing the current fiscal year's operation results.

The Statement of Net Position (page 17) presents information on all of AHCCCS' assets and deferred outflow of resources and liabilities and deferred inflow of resources, with the difference between the two reported as "net position". Over time, increases or decreases in net position, along with other financial information, serve as indicators of AHCCCS' financial position and whether it is improving or deteriorating.

The Statement of Activities (page 18) presents information showing how AHCCCS' net position changed during the most recent fiscal year. All changes in net position are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods (e.g. incurred but not paid or reported fee-for-service and reinsurance claims, revenue from future Tobacco Master Settlement Agreement payments, prescription drug rebate receipts, earned but unused vacation leave, and unfunded pension benefit obligation).

Both statements report activity for two categories:

- **Governmental Activities** - State appropriations along with federal, county and other local government intergovernmental revenues and member premium collections that primarily support the activities in this category. The governmental activities of AHCCCS primarily consist of programs authorized by the Social Security Act Titles XIX ("Medicaid") and XXI (Children's Health Insurance Program ("CHIP")) that are concentrated on the health needs of the citizens of Arizona through direct medical service payments and supplemental payments to qualifying hospital facilities throughout the State. The majority of activities are reported in this category.
- **Business-Type Activities** - This is the final reporting year for HCG as operations ceased on December 31, 2013 and the final cash reserves were transferred to the State's General Fund per legislation repealing the operating fund effective December 31, 2014.

The government-wide financial statements can be found on pages 17 and 18.

Fund Financial Statements (Reporting AHCCCS' Major Funds)

A fund is a legislatively authorized fiscal and accounting entity with a self-balancing set of accounts that AHCCCS uses to keep track of specific sources of funding and spending for specific activities or

objectives. AHCCCS, like other State agencies, uses fund accounting to ensure and demonstrate compliance with legislative appropriation funding requirements. All of the funds of AHCCCS can be divided into two categories: governmental funds and the proprietary fund.

Governmental funds - Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, the governmental funds financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financial position and requirements. This approach is known as using the flow of current financial resources measurement focus and the modified accrual basis of accounting. These financial statements provide a short-term view of AHCCCS' finances that assists management in determining whether there will be adequate financial resources available to meet current needs. When an asset is recorded in governmental fund financial statements but the revenue is not available, AHCCCS reports a deferred inflow of resources until such time as the revenue becomes available. Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the State's near-term financial decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities. The basic governmental funds financial statements and related reconciliation can be found on pages 19 through 21 of this report.

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

Annually, the Legislature adopts an appropriated budget for AHCCCS for the Traditional Medicaid services; Proposition 204 services; Patient Protection and Affordable Care Act ("ACA") Adult Expansion; KidsCare; Children's Rehabilitative Services; Disproportionate Share Hospital ("DSH") payments; Rural Hospital payments; and supplemental hospital payments for DSH, Graduate Medical Education ("GME"), and Safety Net Care Pool ("SNCP"); Arizona Long-Term Care Services ("ALTCS"); nursing facility supplemental payments and AHCCCS administration programs. The annual appropriation is made separately for both the State share of the required matching funds and federal financial participation funds from Medicaid and CHIP. In addition to the appropriations and expenditure authority approved by the Legislature, AHCCCS also expends continuously appropriated funds for medical service payments from prescription drug rebate reimbursement receipts, for other third party liability recovery program activities, electronic health records infrastructure development, and certain payments to hospitals for unfunded emergency department readiness costs and level 1 trauma center costs. The expenditures for unfunded emergency department readiness costs and level 1 trauma center costs are financed by revenues specifically collected for those purposes and are by statute continuously appropriated. At June 30, 2015, the trauma and emergency services fund had a zero fund balance. A budgetary comparison statement has been provided for the General Fund to demonstrate compliance with the budget on page 47.

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 22 through 24 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 25 to 46.

Government-Wide Financial Analysis

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

AHCCCS Net Position (in thousands of dollars)						
	Governmental Activities		Business-Type Activities		Total	
	2015	2014 – As Restated*	2015	2014	2015	2014 – As Restated*
Current assets	\$ 895,880	\$ 1,153,990	\$ -	\$ 7,257	\$ 895,880	\$ 1,161,247
Noncurrent assets	-	-	-	-	-	-
Capital assets	93,616	67,499	-	-	93,616	67,499
Total assets	989,496	1,221,489	-	7,257	989,496	1,228,746
Deferred outflow of resources	8,914	4,539*	-	-	8,914	4,539*
Current liabilities	881,015	1,150,772	-	4	881,015	1,150,776
Long-term liabilities	69,633	77,041*	-	-	69,633	77,041*
Total liabilities	950,648	1,150,772	-	4	950,648	1,150,776
Deferred inflow of resources	12,177	-	-	-	12,177	-
Net position:						
Invested in capital assets, net of depreciation	93,616	67,499	-	-	93,616	67,499
Unrestricted	(58,031)	(69,284)*	-	7,253	(58,031)	(62,031)*
Total net position	\$ 35,585	\$ (1,785)*	\$ -	\$ 7,253	\$ 35,585	\$ 5,468*

*Note: AHCCCS implemented GASB 68 in fiscal year 2015; therefore, pension liability and the related elements were not a required presentation in fiscal year 2014. The implementation of GASB 68 resulted in a restatement of AHCCCS's beginning net position from fiscal year 2014, which is reflected in the comparative table shown above.

For AHCCCS, assets and deferred outflow of resources exceeded liabilities and deferred inflow of resources by \$35.6 million at June 30, 2015 as compared to assets and deferred outflow of resources less than liabilities and deferred inflow of resources by \$1.8 million at June 30, 2014. Excluding the impact of GASB 68, assets and deferred outflow of resources exceeded liabilities and deferred inflow of resources by \$108.5 million at June 30, 2015 and \$78.0 million at June 30, 2014.

Excluding the impact of GASB 68, during fiscal year 2015, the total Government-wide net position increased by \$30.5 million. This third consecutive year of an increase is primarily due to the investment in capital assets for an internally developed automated eligibility system. The \$93.6 million invested in capital assets increased by \$26.1 million (net of accumulated depreciation) and is primarily comprised of the \$30.1 million of continued costs to develop and implement the new ACA compliant eligibility system. The automated eligibility system qualifies AHCCCS for 75 percent enhanced federal financial participation ("FFP") for certain eligibility determination administrative functions that previously were eligible for the 50 percent FFP rate. The project consists of three major phases. The first phase, initial implementation of the new system was completed during fiscal year 2014. The second phase is the transition from processing eligibility determinations in the existing legacy system to the new ACA compliant system which was nearly completed in fiscal year 2015. The third and final phase is the transition for long-term care eligibility determinations from the AHCCCS legacy system into the ACA compliant system that is scheduled for completion during fiscal 2016. Current year activity is reported as software under development in footnote 2.

The governmental operations unrestricted component of net position is comprised of a deficit balance of \$72.9 million for the impact of GASB 68 offset by a \$14.9 million balance primarily consisting of \$9.9 million for future spending on qualified medical services primarily for childless adult members with income from 1-100 percent of the federal poverty level ("FPL"), \$2.1 million for medical services from members covered in the Traditional Medicaid services program and \$1.4 million of funds limited to future spending for certain information technology activities. Other components include a \$900,000 cash balance in the Hospital Loan Residency Fund and \$450,700 of nursing facility assessment cash on hand. During fiscal year 2015, excluding the impact of GASB 68, the governmental unrestricted net position increased by \$11.6 million primarily due to a \$9.5 million increase in the Hospital Assessment Fund and a \$2.1 million increase in the state share of Prescription Drug Rebate receipts. Additionally, the business-type activity's unrestricted net position was reduced to zero as a result of the repeal of the operating fund and subsequent close-out residual equity transfer of \$7.3 million to the State's General Fund.

AHCCCS Changes in Net Position
(in thousands of dollars)

	Governmental Activities		Business-Type Activities		Total	
	2015	2014 – As Restated*	2015	2014	2015	2014 – As Restated*
Revenues						
Program Revenues						
Charges for services	\$ 568	\$ 5,028	\$ -	\$ 11,747	\$ 568	\$ 16,775
Other operating grants and contributions	804,754	716,301	-	-	804,754	716,301
Federal operating grants	7,867,949	6,557,721	-	-	7,867,949	6,557,721
General revenues						
State appropriations	1,991,673	2,007,751	-	-	1,991,673	2,007,751
Tobacco tax	134,369	129,041	-	-	134,369	129,041
Unrestricted investment earnings	90	74	-	59	90	133
Total revenues	<u>10,799,403</u>	<u>9,415,916</u>	<u>-</u>	<u>11,806</u>	<u>10,799,403</u>	<u>9,427,722</u>
Expenses						
Health Care	<u>10,706,667</u>	<u>9,314,354</u>	<u>-</u>	<u>11,114</u>	<u>10,706,667</u>	<u>9,325,468</u>
Excess before transfers	92,736	101,562	-	692	92,736	102,254
Transfers, net	<u>(55,366)</u>	<u>(58,417)</u>	<u>(7,253)</u>	<u>-</u>	<u>(62,619)</u>	<u>(58,417)</u>
Change in Net Position	37,370	43,145	(7,253)	692	30,117	43,837
Net Position – end of year	<u>\$ 35,585</u>	<u>\$ (1,785)*</u>	<u>\$ -</u>	<u>\$ 7,253</u>	<u>\$ 35,585</u>	<u>\$ 5,468*</u>

*Note: AHCCCS implemented GASB 68 in fiscal year 2015; therefore, pension expense and the related elements were not a required presentation in fiscal year 2014. The implementation of GASB 68 resulted in a restatement of AHCCCS's beginning net position from fiscal year 2014, which is reflected in the comparative table shown above.

At June 30, 2015, the governmental activity reported a deficit unrestricted net position of \$58.0 million. Excluding the impact of GASB 68 of \$72.9 million the governmental activity reported a positive unrestricted net position which totaled a combined \$14.9 million, which is a \$4.4 million increase (42.0 percent) from the prior fiscal year's \$10.5 million unrestricted net position. The total Governmental activities in fiscal year 2015 increased the net position by \$37.8 million, excluding the impact of GASB 68. The increase is primarily due to the investment in capital assets for the continued development, operations and maintenance costs working towards completion of phase two of the new automated eligibility system.

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

Beginning on January 1, 2014, the AHCCCS program implemented the ACA in accordance with Federal laws and regulations as approved by the Arizona Legislature. The ACA implementation included: the restoration of the childless adults (expansion state adults) who were previously eligible for AHCCCS under the voter mandated Proposition 204, expansion of coverage for adults from 100-133 percent of the

FPL (representing the populations determined to be non-mandatory by the Supreme Court of the United States), and the mandatory Child expansion for children ages 6-19 from 100-133 percent of the FPL. AHCCCS fully phased-in the Modified Adjusted Growth Income (MAGI) standard as well as the other ACA-related eligibility changes during the fiscal year resulting in an increased number of individuals enrolled in the program. These three distinct populations all have enhanced federal financial participation matching rates minimizing the cost of the matching State share. For fiscal year 2015, the expansion state adults were matched at an average rate of 85.65 percent, the expanded coverage for adults receives a 100 percent rate, and the child expansion are matched at an average rate of 77.71 percent. The state share for the restoration and expansion was provided from a CMS approved provider assessment collected from certain hospitals. In fiscal 2015, the assessment provided \$270.4 million of revenue. In order to qualify for the various enhanced federal financial funding participation rates available under the ACA, AHCCCS required a modernized Medicaid eligibility determination information technology system. AHCCCS and the Department of Economic Security (“DES”) continued to leverage and upgrade an existing eligibility system to meet the new compliance requirements. In addition to the enhanced program match rates provided by the ACA, an eligibility determination made by the new Modified Adjusted Gross Income (“MAGI”) methodology also qualifies for a 25 percent increase in the federal match from 50 to 75 percent for administrative costs associated with eligibility determination functions for most staff activities and the system costs. System development also qualified for a time-limited specific exemption to the cost allocation requirements set forth in OMB Circular A-87 requiring that all costs be specifically allocated to the benefiting program that CMS approved. The exemption also allows an investment in the health program’s eligibility determination systems to be leveraged at the highest (90 percent) federal financial participation rate to apply to other federally-funded human service programs in addition to Medicaid if the shared function is required by Medicaid. In July 2015, CMS announced a one-time extension of that timeline for an additional 3 years, through December 31, 2018. Accordingly, AHCCCS and DES continue to jointly participate in the process to develop the replacement to their respective existing systems under these favorable terms. The Medicaid investment in the eligibility system for the first phase placed into service in 2014, and continued development for the second phase through June 30, 2015 is \$89.5 million and represents 95.6 percent of the \$93.6 million invested in capital assets balance. Total costs are estimated to total approximately \$159.4 million.

AHCCCS enrollment for fiscal year 2015 was lower than projected, but still experienced significant growth over the prior year as the program continues to absorb the full impacts of the Proposition 204 restoration and the ACA adult and child expansion. Overall, enrollment increased by 171,160 members from 1,557,477 to 1,386,317 and by 370,417 members from December 1, 2013 (the period from implementation of the restoration and expansion through June 2015).

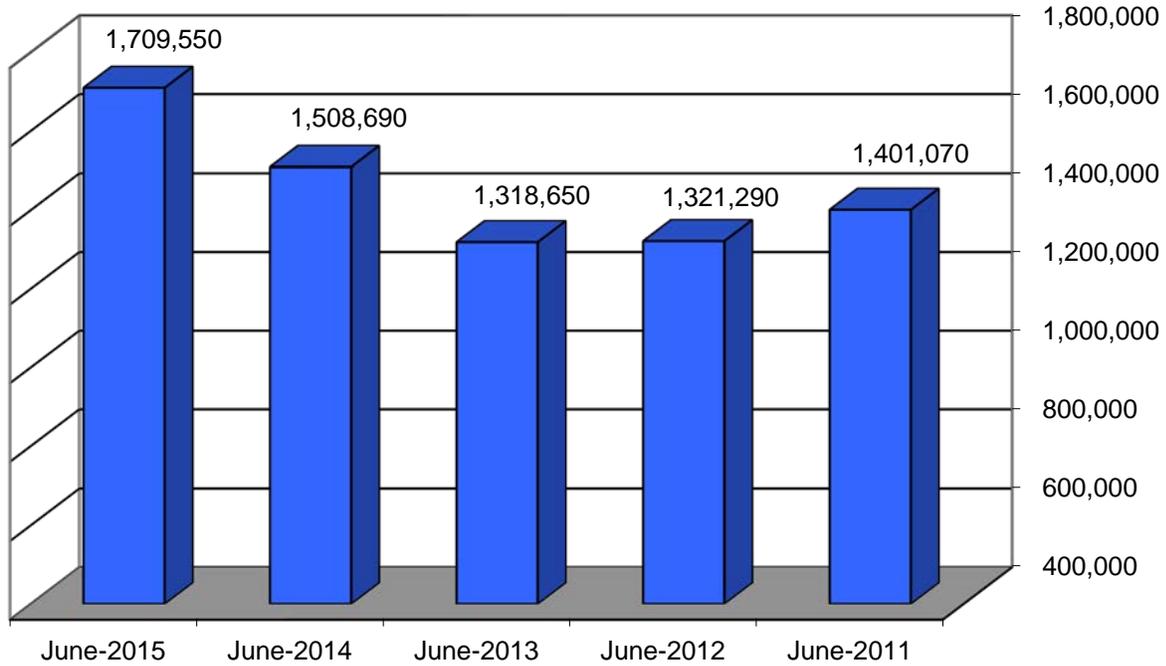
Governmental Activities

Fiscal year 2015 governmental activities increased the net position by \$30.5 million primarily from the investment in capital assets, excluding the impact of GASB 68.

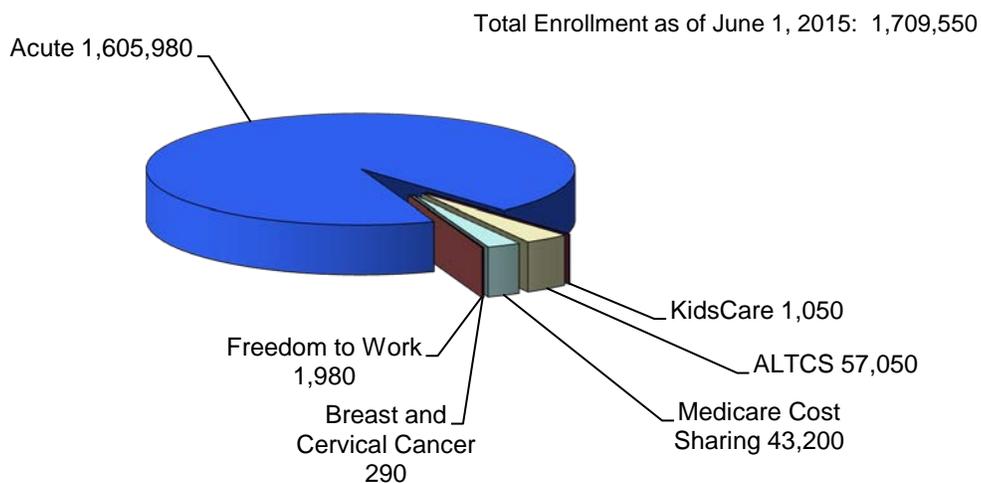
Enrollment in AHCCCS programs increased in fiscal year 2015 with total enrollment for all of AHCCCS' programs at June 1, 2015 of 1,709,550, an increase of 200,860 members (13.3 percent) from June 1, 2014. This compares to the previous year's 190,040 or 14.4 percent increase in members.

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

AHCCCS Membership Growth



AHCCCS Enrollment by Program

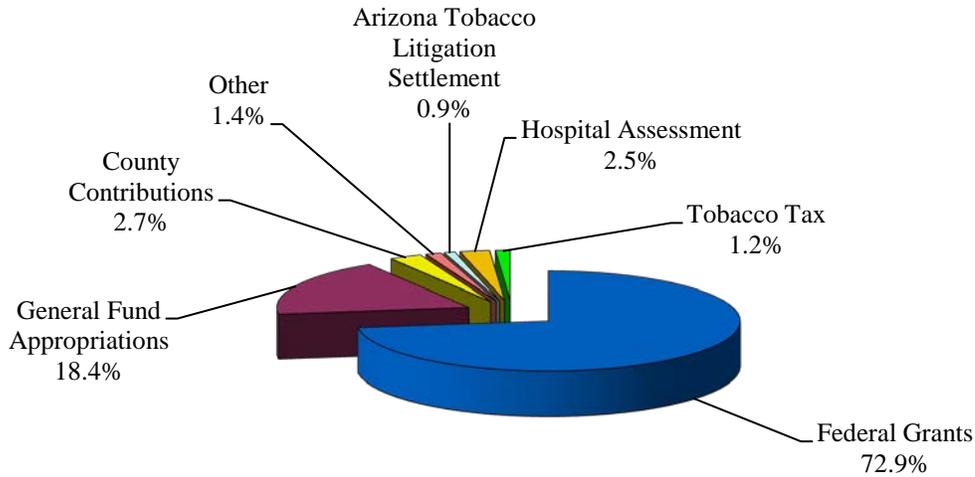


The cost of health care programs, including Medicaid and CHIP, totaled \$10,706.7 million in fiscal year 2015, a \$1,392.3 million increase from the \$9,314.4 million reported in fiscal year 2014. The increase in current fiscal year program expenditures continues to be primarily attributable to the enrollment increase. As shown in the statement of activities, the amount of expenditures funded from federal grants through CMS was \$7,867.9 million (73.5 percent) in fiscal 2015 as compared to \$6,557.7 million (70.4 percent) in fiscal 2014. Program funding in the form of federal financial participation is primarily determined through the Federal Medical Assistance Percentage ("FMAP") rate used to provide the amount of federal matching funds for qualifying State medical assistance expenditures. The FMAP is based on the relationship between Arizona's per capita personal income and the national average per capita personal income over three calendar years. The FMAP is recalculated each federal fiscal year and increased by 1.23 percent to 68.46 percent from the prior year's rate of 67.23 percent during three of the four quarters of state fiscal year 2015. In addition to the FMAP, the ACA introduced multiple new rates for the various new eligibility categories covered under the expansion. In Arizona, three additional rates applied to ACA expansion and Proposition 204 restoration covered populations. These three new rates were all in excess of the "regular" 68.46 FMAP with the rates for both the expansion state (childless adults - 0% to 100% FPL) and the newly eligible adults (adults - 100% to 133% FPL) changing on October 1st and January 1st of the fiscal year. Overall, program expenditures increased by 14.9 percent over the prior fiscal year. However, expenditures funded solely by state General Fund appropriations also decreased again in fiscal year 2015 primarily due to the higher ACA federal financial participation rates and from utilization of the hospital assessment as the state match source dedicated to fund the Proposition 204 populations. The hospital assessment produced revenue of approximately \$270.4 million in fiscal year 2015. Additionally, the supplemental hospital payment programs that are funded by political subdivision voluntary contributions provided payments of \$411.5 million that were distributed to Arizona hospitals. This is a \$478.4 million or 53.8 percent decrease from the \$889.8 million high point amount that was distributed in fiscal year 2013. The decrease is due to changes in the CMS approved SNCP program waiver and legislation intended to transition a hospital from reliance on supplemental payments such as the SNCP payment.

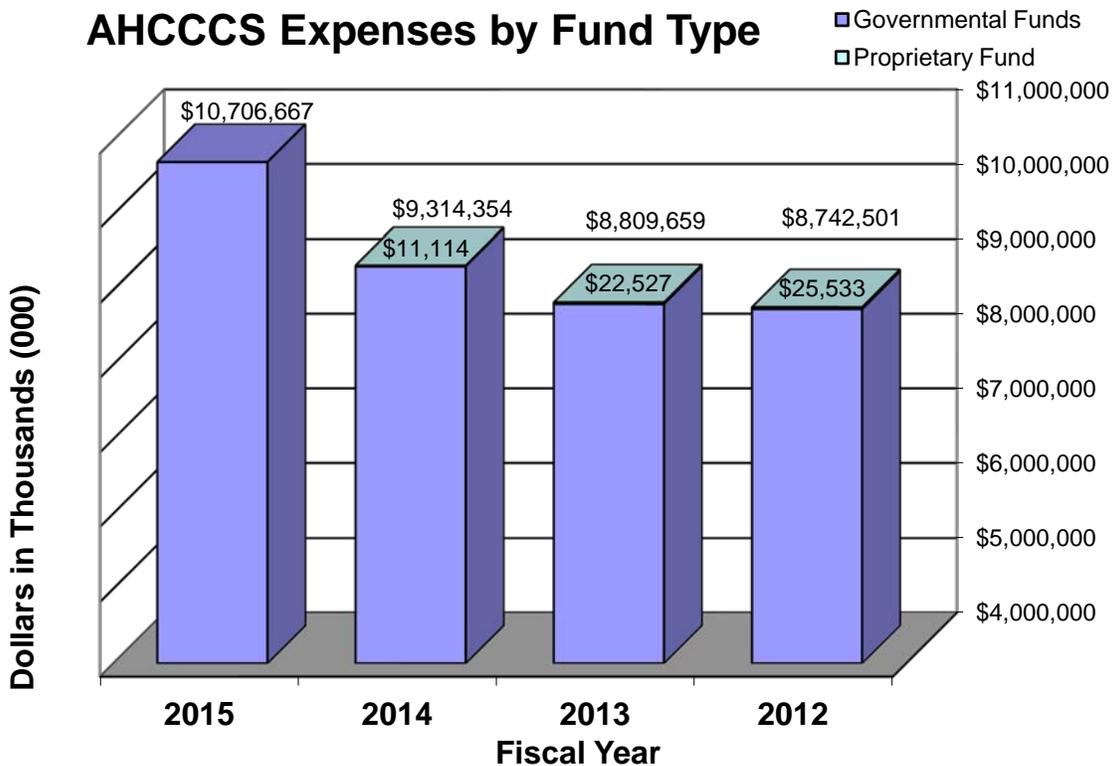
State, county and miscellaneous funding sources combined to provide \$2,931.5 million in State funding sources and appropriations in fiscal year 2015, a \$73.3 million increase over the \$2,858.2 million reported in fiscal year 2014 primarily related to a full 12 months of expenses for the ACA expansion and Proposition 204 restoration populations. The following are the components of the State match funding sources utilized in fiscal year 2015. State General Fund revenues raised primarily in the form of income and sales taxes directed to AHCCCS amounted to \$1,188.8 million, and an additional \$802.8 million was passed through from other State agencies in order to provide the State's share for Medicaid eligible medical assistance expenditures. Arizona counties contributed \$293.7 million as determined by statutory funding formulas, session law and other intergovernmental agreements. Tax collections on tobacco products provided \$134.4 million in State match funding. The tobacco tax year-over-year collections recorded a minimal \$5.3 million increase over the prior year's amount. An additional \$99.9 million in State revenue funding was provided by Arizona's share of tobacco litigation settlement funds. The master settlement agreement (MSA) revenues are recorded in accordance with the GASB Technical Bulletin No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues*, which clarifies how payments made to AHCCCS pursuant to the MSA with major tobacco companies, are recorded. Payments are based on cigarette and other tobacco product sales from the preceding year. AHCCCS has accrued \$50.0 million for the period January 1, 2015 through June 30, 2015 based on Arizona's Joint Legislative Budget Committee 2016 estimated payment. In addition to the annual settlement payments described above, AHCCCS continues to receive the Strategic Contribution Fund payment through April 15, 2017. The amounts of the payments are dependent upon several adjustments, the magnitude of which will not be fully known until an independent auditor provides its calculations in February or March of each year. Other factors that could also affect the MSA payment amount AHCCCS ultimately receives include default or bankruptcy by one or more tobacco companies and other unforeseen withheld payment amounts. Finally, Tribal gaming receipts determined by statutory formula distributed to AHCCCS provided \$22.3 million in additional funding.

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

Revenues by Source - Governmental Activities



AHCCCS Expenses by Fund Type



Business-Type Activities

The sole proprietary fund business-type activity for AHCCCS is the Healthcare Group that ended business operations on December 31, 2013. In accordance with the legislation, the remaining fund balance of \$7.253 million in the HCG Fund reverted to the State General Fund during fiscal year 2015.

Financial Analysis of AHCCCS' Governmental Funds

Governmental Funds

Excluding the impact of GASB 68, at the end of fiscal year 2015, AHCCCS' governmental funds reported combined ending fund balances totaling \$14.9 million, an increase of \$11.6 million from the prior year. This increase is attributable to \$9.5 million in the Hospital Assessment Fund and \$2.1 million in the Prescription Drug Rebate Fund carryforward balances representing unspent funds. The Hospital Assessment Fund and Prescription Drug Rebate Fund balances are available only for certain expenditures in fiscal year 2016. Any utilization of these balances must either be for medical services for qualifying populations by legislative directive.

The General Fund is the chief operating fund of the AHCCCS Traditional Medicaid services, Proposition 204 services, KidsCare, Children's Rehabilitative Services, DSH, Rural Hospital and ALTCS services programs. These programs primarily utilize a State general fund appropriation and revenue sources from the annual tobacco litigation settlement proceeds, taxes on tobacco products, contributions from Arizona counties, certified public expenditure methodologies, prescription drug rebate collections and political subdivision non-federal share matching agreements to provide the required state matching funds for federal Medicaid and CHIP revenue. AHCCCS also has authority to make supplemental distributions to hospitals for the GME, DSH and SNCP programs funded by voluntary contributions of the required state match from political subdivisions.

Excluding the impact of GASB 68, the Other Governmental Funds consist of eleven individual funds comprising the \$12.7 million of the total \$14.9 million fund balance available for qualifying activities. The Other Governmental Funds' fiscal year 2015 fund balances consist of assigned fund balances in the amount of \$13.9 million and committed funds of \$900,000. Revenue from taxes on cigarettes and other related tobacco products increased 7.33 percent from fiscal year 2014 and generated \$93.6 million for the current year compared to \$87.2 million in fiscal year 2014. Since the passage of ballot proposition 203 in November 2006, tobacco tax collections have declined by \$54.5 million or 36.8 percent since the \$148.1 million high point of collection in fiscal year 2006. Fiscal year 2015 was the first year with a full four quarters of collections for the Proposition 204 hospital assessment that generated \$270.4 million in available state matching revenue for program services. The hospital assessment revenue has replaced General Fund funding for the Proposition 204 eligible member categories. However, this funding has been challenged from a lawsuit filed by a group of plaintiffs, consisting mostly of state legislators, seeking a declaration that the hospital assessment established under ARS §36-2901.08 is allegedly a tax passed in a manner inconsistent with the requirements for a tax established by the state constitution. The lawsuit was filed in September 2013 and continues to work its way through the courts. AHCCCS received a favorable ruling in Arizona Superior Court on August 26, 2015 but expects the plaintiffs to appeal. AHCCCS intends to continue to vigorously defend the lawsuit on lack of standing. If the hospital assessment is declared invalid, the program will have insufficient funds to cover childless adults with income up to 133% of FPL, but under the holding in *Fogliano v. State*, AHCCCS has the option to adjust eligibility standards to match available remaining funds.

General Fund Budgetary Highlights

Differences totaling \$274.8 million occurred between the original and the final amended administrative and programmatic expenditure budgets. During the 2015 legislative session, the Arizona legislature appropriated all voluntary payments from political subdivisions for DSH, GME, SNCP and hospital payments. The fiscal year 2015 legislation again allows these voluntary amounts to be increased for any political subdivision funds including the federal matching monies in excess of the original appropriation. Additionally, fiscal 2015 legislation provided a net \$203.0 million supplemental appropriation increase in

fiscal year 2015 partially offset by a \$48.5 million General Fund ex-appropriation to the Traditional Medicaid services program. Other differences relate to special line item adjustments that utilized surpluses from one line item to offset shortfalls in another line item. These appropriation transfers are approved by the Governor's Office of Strategic Planning and Budgeting and are in accordance with legislative authority. The major special line item supplemental increases are briefly summarized as follows:

- \$344.7 million increase to the Proposition 204 services program comprised of a \$179.7 million supplement of federal expenditure authority and \$165 million special line item move of federal expenditure authority necessary to fund expenditures due to enrollment in excess of the budgetary projections.
- \$254.7 million decrease to the Traditional services program comprised of the \$48.5 million General Fund ex-appropriation and \$206.2 million expenditure transfers to other special line items
- \$109.3 million increase for SNCP payments to assist Phoenix Children's Hospital (PCH), for high levels of uncompensated care related to medical assistance provided to Medicaid eligible or to individuals who have no source of third party coverage with state matching funds voluntary provided by Intergovernmental agreements with eligible political subdivisions
- \$11.0 million increase for the voluntary disproportionate share hospital special line item based on increased political subdivision contributions including federal matching monies in excess of the original appropriation
- \$49.3 million appropriation special line item transfer increases primarily related to administrative costs to continue the development of the automated eligibility system necessary to comply with ACA federal requirements and increased federal matching rate for qualifying eligibility related costs that was not included in the original fiscal year 2015 administration appropriation funded by surpluses in the program special line items

At June 30, 2015, actual cash basis appropriated program expenditures were \$329.9 million less than budgetary estimates primarily resulting from surplus federal expenditure authority.

Capital Asset Administration

AHCCCS' investment in capital assets for its governmental activities as of June 30, 2016 is \$93.616 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 \$26.117 million or 38.7 percent over the prior fiscal year balance. Investment in internally generated software (completed and under development) increased \$30.089 million as a result of continued development and enhancements to Medicaid eligibility systems related to the ACA of \$29.925 million and \$162,413 for the continuing development of the next mandated versions of the electronic Transaction and Code Set standards under the Health Insurance Portability and Accountability Act. The remaining capital asset changes are for disposals in excess of additions including depreciation of vehicles, furniture and equipment and upgraded servers and related IT equipment items.

	Governmental Activities	
	2015	2014
Vehicles, Furniture & equipment	\$ 2,313	\$ 2,821
Software	27,047	30,511
Software under development	64,256	34,167
Total net position	\$ 93,616	\$ 67,499

Additional information on AHCCCS' capital assets can be found in Note 2 to the accompanying financial statements on pages 34 and 35.

Contingent Liabilities

In January 2001, AHCCCS obtained a Waiver from CMS to receive federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204. The Waiver requires that over the term of the original agreement (April 1, 2001 through September 30, 2011) and the new agreement (October 1, 2011 through September 30, 2016), that the population covered by the Waiver be budget neutral for CMS. Effective with the January 1, 2014 implementation of the eligibility expansion under the ACA to include the new adult group, members with income between 100% and 133% of the FPL, the budget neutrality measurement is performed separately for the new adult population. Budget neutral means that CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. The budget neutrality calculation is dependent on a number of variables including the number of members, the eligibility category of members and the general economy and its impact on unemployment, medical inflation and policy decisions made by the Legislature that may impact program costs. The cumulative federal share favorable variance for the waiver period ended September 30, 2014 was \$10,571.2 million. Through June 30, 2015, AHCCCS remains under the cumulative reporting limit threshold for the current waiver. Accordingly, management is projecting that as of June 30, 2015, 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.

AHCCCS continues to have several outstanding audit findings related to audits conducted by The Inspector General, Office of Audit Services ("OIG") covering the Direct Service Claiming ("DSC") and School Based Medicaid Administrative Claiming ("MAC") programs. AHCCCS disagrees with the findings in part, has returned the federal funds for non-disputed claims and plans to appeal the decision to the Department of Health and Human Services, Departmental Appeals Board ("DAB") once CMS issues a disallowance. If and when all administrative appeals are exhausted, AHCCCS will request a refund from the LEAs or will deduct the amount from future payments in accordance with the intergovernmental agreement. The recoupment liability of \$19.924 million for the DSC audit and \$18.941 million for the MAC audit is included in the due to the federal government with a corresponding receivable in the due from the State and local governments in the accompanying financial statements.

Economic Factors and Next Year's Budgets and Rates

AHCCCS enrollment for fiscal year 2015 was lower than projected, but still experienced significant growth over the prior year as the program continues to absorb the full impacts of the Proposition 204 restoration and adult expansion. For the period June 2014 to August 2015, AHCCCS forecasted growth of 258,000 members across all programs, an increase of 20.0%. Actual growth for that period was 189,000 members, an increase of 14.6%, representing a negative variance of 26.7%. The growth rates for fiscal year 2016 reflect the assumption that overall growth will continue in early fiscal year 2016 followed by a leveling off to normal population growth for most populations throughout all of fiscal year 2017. The Arizona economic recovery has shown signs of improvement, however it still lags behind when compared to national coincident index that gauges economic activity combining employment, average hours worked in manufacturing, unemployment rate, and inflation-adjusted wages. The coincident index increased by 3.3 percent compared to July 2014 but still falls short of the 3.5 percent increase for the U.S. index. The housing market has also shown signs of improvement as single family construction are increasing. Arizona's twelve month building permit totals are 14.5 percent more than August 2014. The unemployment rate continues to improve and has decreased to 6.3 percent when compared to the 6.9 percent level of August 2014. Accordingly, AHCCCS is projecting population growth will continue in early fiscal year 2016 followed by a leveling off to normal rates during fiscal year 2017.

The total Medicaid fiscal year 2016 appropriation for AHCCCS is \$8,491.0 million compared to the final \$8,429.0 million appropriation for fiscal year 2015. This moderate increase reflects the assumption that overall growth will continue in early fiscal year 2016 followed by a leveling off to normal population growth for most populations normalizing the impact of restoring the expansion state childless adult and

expansion of the newly eligible adult and children populations up to 133 percent of the FPL under the ACA. For contract year 2016, Acute Care capitation rates are projected to increase by 2.45 percent as compared to the 2.93 percent increase for contract year 2015. The 2016 increase is primarily based on utilization increases driven by pharmacy and emergency department expenses that account for 1.98 percent of the increase. Other drivers are the integration of physical and behavioral health services for adult members who are eligible for both Medicaid and Medicare (0.47 percent), high acuity pediatric adjustment factor (0.12 percent) and ambulance service rate increase approved by the Legislature (0.13 percent). The contract year 2016 Arizona Long Term Care System ("ALTCS" Elderly and Physically Disabled ("EPD")) capitation rates are estimated to increase by 1.89 percent as compared to the 1.16 percent increase for contract year 2015. The primary factors impacting the ALTCS EPD rates are provider rate increases, medical trend and mix changes for home and community based service providers. AHCCCS is estimating a 1.5 percent capitation rate increase for all programs for contract year 2017 as part of the fiscal year 2017 budget submission. However, it is important to note that federal law requires rates to be actuarially sound and the AHCCCS actuaries develop rates based on expected cost and utilization trends. In addition, AHCCCS must conduct an access to care analysis of its rates to assure that sufficient providers are willing to serve AHCCCS members. Therefore, depending on the results of this analysis and of the actuaries' determination of the expected costs of the managed care organizations, the actual capitation rates could be higher.

Although AHCCCS has implemented ACA expansion of enrollment beginning January 1, 2014, other major ACA mandates continue to impact the program and one of the more significant for fiscal year 2016 is the health insurance fee. AHCCCS paid \$67.9 million in fiscal year 2015 and the current year 2015 expenditures include an accrual for \$50.3 million for the first six months of calendar 2015. The fiscal year 2016 projection is \$102.0 million. In fiscal year 2017, the fee is projected to increase to \$108.0 million due to caseload increases which will increase revenue for Medicaid health plans and thus increase the amount required in reimbursement. This cost impacts the Acute, CRS, EPD, Division of Developmental Disabilities, and Division of Behavioral Health Services programs.

A lawsuit was filed by a group of plaintiffs, consisting mostly of state legislators, seeking a declaration that the hospital assessment established under ARS §36-2901.08 is allegedly a tax passed in a manner inconsistent with the requirements for a tax established by the state constitution. The lawsuit was filed in September 2013 and continues to work its way through the courts. AHCCCS received a favorable ruling in the Arizona Superior Court on August 26, 2015 but expects the plaintiff to appeal. AHCCCS intends to continue to vigorously defend the lawsuit on lack of standing. If the hospital assessment is declared invalid, AHCCCS will have insufficient funds to cover childless adults with income up to 133% of FPL, but under the holding in *Fogliano v. State*, AHCCCS may adjust eligibility standards to match available remaining funds.

AHCCCS continues to aid in the development of a robust healthcare information technology ("HIT") by offering financial assistance to providers and other entities in adopting and using health HIT. In fiscal year 2015, \$48.8 million in federal funds were disbursed to Arizona hospitals and providers as incentives. Projections for fiscal year 2016 include \$57.4 million in non-appropriated federal pass-through expenditure authority for Arizona providers and hospitals that may be eligible for Medicaid incentive payment funding.

Arizona's current Section 1115 Waiver is scheduled to expire on September 30, 2016. The Waiver allows Arizona to run its managed care model and exempts Arizona from certain provisions of the Social Security Act. It also includes expenditure authority for costs not otherwise matched by the federal government. Waiver programs are required to be budget neutral for the federal government – not cost more federal dollars than without a waiver.

AHCCCS will request CMS authority to continue current efficient and innovative programs, and will seek additional authority to implement new programs and processes such as the AHCCCS CARE program designed to introduce choice, accountability, responsibility and engagement to modernize Arizona's changing Medicaid program. Certain eligible members will need to contribute financially to more actively manage their own health needs by building a balance between requirements and incentives.

AHCCCS' budget request for fiscal year 2017, submitted to the Governor in September 2015 included a rebase of the fiscal year 2016 budget. The current forecast is for a \$735.0 million shortfall primarily comprised of \$671.7 million in Federal Expenditure Authority, \$34.4 million in Hospital Assessment Expenditure Authority and \$28.9 million in prescription Drug Rebate Fund state match funding authority. AHCCCS continues to experience the impacts of the many program changes resulting from the ACA. However, factors such as CMS decisions, legal decisions, case load changes compared to projections and the eligibility system shifts in population categories may influence any final fiscal year shortfall and potential need and amount of a supplemental appropriation. Management will closely monitor all these factors in relation to the adequacy of the fiscal year 2016 appropriation and fiscal year 2017 budget.

Request for Information

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

INDEPENDENT AUDITORS' REPORT



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INDEPENDENT AUDITORS' REPORT

To the Director of the

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

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the general fund, and the aggregate remaining fund information of AHCCCS as of and for the year ended June 30, 2015, and the related notes to the financial statements, which collectively comprise the AHCCCS' basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the general fund, and the aggregate remaining fund information of AHCCCS, as of June 30, 2015, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of a Matter

As discussed in Note 1, the financial Statements of AHCCCS are intended to present the financial position, the changes in financial position and cash flows, where applicable, of only that portion of the governmental activities, the business-type activities, the general fund and the aggregate remaining fund information of the State of Arizona that is attributable to the transactions of AHCCCS. They do not purport to, and do not, present fairly the financial position of the State of Arizona at June 30, 2015, the changes in the financial position, or, where applicable, the cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 13 to the financial statements, for the year ended June 30, 2015, AHCCCS adopted new accounting guidance, Governmental Accounting Standards Board Statement No. 68, *Accounting and Financial Reporting for Pensions*, as amended by GASB Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date*. Our opinions are not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 1-14, budgetary comparison information on page 47, and schedule of the agency's proportionate share of the net pension liability – cost sharing plan and schedule of the agency's pension contributions on pages 48-49 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise AHCCCS' basic financial statements. The accompanying Schedule of Expenditures of Federal Awards, and related notes, as required by the *Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations*, is presented for purposes of additional analysis and is not a required part of the basic financial statements.

The Schedule of Expenditures of Federal Awards is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the Schedule of Expenditures of Federal Awards is fairly stated, in all material aspects, in relation to the basic financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated December 11, 2015 on our consideration of AHCCCS' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering AHCCCS' internal control over financial reporting and compliance.



Phoenix, Arizona
December 11, 2015

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET POSITION

June 30, 2015
(amounts expressed in thousands)

ASSETS

	Governmental Activities	Business-type Activities	Total
CURRENT ASSETS			
Cash	\$ 152,486	\$ -	\$ 152,486
Designated cash	38,778	-	38,778
Restricted cash	1,473	-	1,473
Due from state and local governments	70,436	-	70,436
Due from the federal government	399,059	-	399,059
Tobacco settlement receivable	50,000	-	50,000
Receivables and other	183,648	-	183,648
TOTAL CURRENT ASSETS	895,880	-	895,880
NONCURRENT ASSETS			
Furniture, vehicles, equipment and software, net of accumulated depreciation	93,616	-	93,616
TOTAL NONCURRENT ASSETS	93,616	-	93,616
TOTAL ASSETS	989,496	-	989,496

DEFERRED OUTFLOW OF RESOURCES

Pension	8,914	-	8,914
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LIABILITIES

CURRENT LIABILITIES			
Accounts payable	9,825	-	9,825
Other accrued liabilities	1,917	-	1,917
Unearned revenue	24,536	-	24,536
Due to federal, state and county governments	162,553	-	162,553
Accrued programmatic claims	678,694	-	678,694
Compensated absences	3,490	-	3,490
TOTAL CURRENT LIABILITIES	881,015	-	881,015
NON-CURRENT LIABILITIES			
Net Pension Liability	69,633	-	69,633
TOTAL LIABILITIES	950,648	-	950,648

DEFERRED INFLOW OF RESOURCES

Pension	12,177	-	12,177
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COMMITMENTS AND CONTINGENCIES

NET POSITION

INVESTED IN CAPITAL ASSETS	93,616	-	93,616
UNRESTRICTED	(58,031)	-	(58,031)
TOTAL NET POSITION	\$ 35,585	\$ -	\$ 35,585

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF ACTIVITIES

Year Ended June 30, 2015
(amounts expressed in thousands)

PROGRAMS	Program Revenues				Net (Expense) Revenue and Changes in Net Position		
	Program Expenses	Charges for Services	Federal Operating Grants	Other Operating Grants and Contributions	Governmental Activities	Business-type Activities	Total
Government activities:							
Health care programs	\$ 10,706,667	\$ 568	\$ 7,867,949	\$ 804,754	\$ (2,033,396)	\$ -	\$ (2,033,396)
Business-type activities:							
Healthcare Group	-	-	-	-	-	-	-
TOTAL PROGRAMS	\$ 10,706,667	\$ 568	\$ 7,867,949	\$ 804,754	\$ (2,033,396)	\$ -	\$ (2,033,396)
General revenues:							
State appropriations					1,991,673	-	1,991,673
Tobacco tax					134,369	-	134,369
Unrestricted investment earnings					90	-	90
					2,126,132	-	2,126,132
Transfers:							
Transfers out					(55,366)	(7,253)	(62,619)
Total general revenues and transfers					2,070,766	(7,253)	2,063,513
CHANGE IN NET POSITION					37,370	(7,253)	30,117
NET POSITION, BEGINNING OF YEAR, as previously stated					70,717	7,253	77,970
Prior Period Adjustment					(72,502)	-	(72,502)
NET POSITION, BEGINNING OF YEAR, as restated					(1,785)	7,253	5,468
NET POSITION, END OF YEAR					\$ 35,585	\$ -	\$ 35,585

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BALANCE SHEET - GOVERNMENTAL FUNDS

June 30, 2015
(amounts expressed in thousands)

	<u>General Fund</u>	<u>Other Governmental Funds</u>	<u>Total Governmental Funds</u>
<u>ASSETS</u>			
Cash	\$ 119,446	\$ 33,040	\$ 152,486
Designated cash	38,778	-	38,778
Restricted cash	-	1,473	1,473
Due from state and local governments	50,193	20,243	70,436
Due from the federal government	382,949	16,110	399,059
Due from other funds	20,132	-	20,132
Tobacco settlement receivable	50,000	-	50,000
Receivables and other	<u>183,612</u>	<u>36</u>	<u>183,648</u>
TOTAL ASSETS	<u>\$ 845,110</u>	<u>\$ 70,902</u>	<u>\$ 916,012</u>
<u>LIABILITIES</u>			
Accounts payable	\$ 9,732	\$ 93	\$ 9,825
Other accrued liabilities	1,762	155	1,917
Unearned revenue	23,235	1,301	24,536
Due to federal, state and county governments	162,401	152	162,553
Due to other funds	-	20,132	20,132
Accrued programmatic claims	<u>392,774</u>	<u>36,341</u>	<u>429,115</u>
TOTAL LIABILITIES	<u>589,904</u>	<u>58,174</u>	<u>648,078</u>
<u>DEFERRED INFLOWS OF RESOURCES</u>			
Unavailable revenue	<u>253,069</u>	<u>-</u>	<u>253,069</u>
COMMITMENTS AND CONTINGENCIES			
<u>FUND BALANCES</u>			
Committed	-	900	900
Assigned	<u>2,137</u>	<u>11,828</u>	<u>13,965</u>
TOTAL FUND BALANCES	<u>2,137</u>	<u>12,728</u>	<u>14,865</u>
TOTAL LIABILITIES, DEFERRED INFLOWS OF RESOURCES, AND FUND BALANCES	<u>\$ 845,110</u>	<u>\$ 70,902</u>	

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

Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds.	93,616
Some liabilities, including net pension liabilities, are not due and payable in the current period and, therefore, are not reported in the funds.	(69,633)
Deferred outflows and inflows of resources related to pensions are applicable to future reporting periods and, therefore, are not reported in the funds.	(3,263)
A portion of liabilities for accrued paid time off of this amount is not due and payable from current financial resources and, therefore is not reported in the funds.	(3,490)
Receivables, offsetting the above accrued paid time off liability, will not be collected in 31 days, therefore are not reported in the funds.	3,490
A portion of accrued programmatic claims is not due and payable from current financial resources and, therefore is not reported in the funds.	(249,579)
A portion of receivables will not be collected in 31 days, therefore is not reported in the funds.	<u>249,579</u>
	<u>\$ 35,585</u>

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

Year Ended June 30, 2015
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
REVENUES			
State government:			
Appropriations	\$ 1,206,558	\$ -	\$ 1,206,558
ISA pass through funds	802,844	-	802,844
Federal government:			
Acute care	4,960,454	921	4,961,375
Long-term care	786,793	45,321	832,114
ISA/IGA pass through funds	2,163,182	108	2,163,290
County and other local government:			
Acute care	50,200	-	50,200
Long-term care	239,730	-	239,730
IGA pass through funds	87,593	-	87,593
Tobacco litigation settlement revenue	99,975	-	99,975
Tobacco tax revenue	40,742	93,627	134,369
Gaming revenue	-	22,301	22,301
Nursing facility tax assessment	-	20,882	20,882
Hospital assessment	-	270,442	270,442
HAPA intergovernmental agreement revenue	-	7,070	7,070
Premium revenue	568	-	568
Other	6,301	350	6,651
TOTAL REVENUES	10,444,940	461,022	10,905,962
PROGRAMMATIC EXPENDITURES			
Medical Services:			
Traditional services	4,136,994	37,892	4,174,886
Proposition 204 services	2,677,355	279,179	2,956,534
Newly eligible adults	273,939	-	273,939
KidsCare services	8,151	-	8,151
Long-term care services	2,318,966	66,000	2,384,966
Childrens rehabilitative services	227,353	-	227,353
School-based services	43,171	-	43,171
Transplant services non-Medicaid	-	2	2
Hospital Payments:			
Disproportionate share	118,393	-	118,393
Rural and critical access hospital	22,115	-	22,115
Graduate medical education	162,993	-	162,993
Trauma center services	-	22,340	22,340
Safety net care pool	85,608	-	85,608
Other:			
Medicare Part D clawback	82,238	-	82,238
Health information technology	48,835	-	48,835
TOTAL PROGRAMMATIC EXPENDITURES	10,206,111	405,413	10,611,524
ADMINISTRATIVE EXPENDITURES	210,734	9,385	220,119
ADMINISTRATIVE EXPENDITURES PASSED THROUGH	7,198	108	7,306
TOTAL EXPENDITURES	10,424,043	414,906	10,838,949
EXCESS OF REVENUES OVER EXPENDITURES	<u>20,897</u>	<u>46,116</u>	<u>67,013</u>
OTHER FINANCING SOURCES (USES)			
Transfers to other State agencies:			
To State General Fund	(15,298)	-	(15,298)
To Arizona Department of Economic Security	(3,384)	-	(3,384)
To Arizona Department of Health Services	-	(35,467)	(35,467)
To Arizona Department of Revenue	(436)	-	(436)
To Arizona Attorney General	(781)	-	(781)
Transfers between funds:			
To AHCCCS General Fund	-	(1,139)	(1,139)
From AHCCCS Other Fund	1,139	-	1,139
TOTAL OTHER FINANCING SOURCES (USES)	(18,760)	(36,606)	(55,366)
NET CHANGE IN FUND BALANCES	2,137	9,510	11,647
FUND BALANCES, BEGINNING OF YEAR	-	3,218	3,218
FUND BALANCES, END OF YEAR	\$ 2,137	\$ 12,728	\$ 14,865

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

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

Year Ended June 30, 2015
(amounts expressed in thousands)

Amounts reported for governmental activities in the statement of activities (page 18) are different because:

Change in fund balances - total governmental funds (page 20)	\$ 11,647
AHCCCS pension contributions are reported as expenditures in the governmental funds when made. However, they are reported as deferred outflows of resources in the Statement of net Position because the reported net position liability is measured a year before AHCCCS' report date. Pension expense, which is the change in the net pension liability adjusted for changes in deferred outflows and inflows of resources related to pensions, is reported in the Statement of Activities.	(394)
Governmental funds report capital outlays as expenditures. However, in the statement of activities, the cost of those assets is allocated over their estimated useful lives and reported as depreciation expense. This is the amount by which capital outlays exceeded depreciation in the prior period.	<u>26,117</u>
Change in net position of governmental activities (page 18)	<u>\$ 37,370</u>

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET POSITION - PROPRIETARY FUND

June 30, 2015
(amounts expressed in thousands)

ASSETS

CURRENT ASSETS

Cash \$ -

TOTAL CURRENT ASSETS -

CAPITAL ASSETS

Furniture, vehicles and equipment, net of accumulated depreciation -

TOTAL ASSETS -

LIABILITIES

CURRENT LIABILITIES

Accounts payable -

Other accrued liabilities -

TOTAL LIABILITIES -

COMMITMENTS AND CONTINGENCIES

NET POSITION

NET INVESTED IN CAPITAL ASSETS -

UNRESTRICTED -

TOTAL NET POSITION \$ -

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

Year Ended June 30, 2015
(amounts expressed in thousands)

OPERATING REVENUES		
Premium revenue	\$	-
OPERATING EXPENSES		
Payments to health plans and providers		-
Salaries and employee benefits		-
Professional and outside services		-
Other		-
Depreciation		-
TOTAL OPERATING EXPENSES		-
OPERATING INCOME		-
NONOPERATING REVENUES		
Other income		-
Investment income		-
Nonoperating expense		-
TOTAL NONOPERATING REVENUE		-
OTHER FINANCING SOURCES (USES)		
Transfers to other State agencies:		
To State General Fund		(7,253)
CHANGE IN NET POSITION		(7,253)
NET POSITION, BEGINNING OF YEAR		7,253
NET POSITION, END OF YEAR	\$	-

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF CASH FLOWS - PROPRIETARY FUND

Year Ended June 30, 2015
(amounts expressed in thousands)

CASH FLOWS FROM OPERATING ACTIVITIES

Receipts from customers	\$	-
Settlement income		-
Payments to health plans		-
Payments to employees		-
Payments to suppliers		(4)
Net cash used in operating activities		<u>(4)</u>

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

Residual Equity Transfer to State General Fund		<u>(7,253)</u>
------------------------------------------------	--	----------------

NET CHANGE IN CASH (7,257)

CASH, BEGINNING OF YEAR 7,257

CASH, END OF YEAR \$ -

RECONCILIATION OF OPERATING INCOME TO NET CASH USED IN OPERATING ACTIVITIES

Operating income	\$	-
Adjustment to reconcile operating income to net cash provided by operating activities:		
Depreciation		-
Settlement income		-
Changes in operating net assets and liabilities:		
Decrease in accounts payable and other accrued liabilities		(4)
Decrease in deferred revenue - premiums		-
Decrease in accrued programmatic costs		-
Decrease in accrued compensated absences		-
NET CASH USED IN OPERATING ACTIVITIES	\$	<u>(4)</u>

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

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

Arizona Health Care Cost Containment System's accounting policies conform to generally accepted accounting principles applicable to governmental units adopted by the Government Accounting Standards Board (GASB).

For the year ended June 30, 2015, **Arizona Health Care Cost Containment System** implemented the provisions of GASB Statement No. 68, Accounting and Financial Reporting for Pensions, as amended by GASB Statement No. 71, Pension Transition for Contributions Made Subsequent to the Measurement Date, GASB Statement Nos. 68 and 71 establish standards for measuring and recognizing net pension (assets and) liabilities, deferred outflows of resources, deferred inflows of resources, and expenses/expenditures related to pension benefits provided through defined benefit pension plans. In addition, Statement No. 68 requires disclosure of information related to pension benefits. The implementation of GASB Statement Nos. 68 and 71 resulted in a beginning net position restatement in Note 13 as well as additional footnote disclosure in Note 6.

A. Reporting entity

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

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

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

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

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

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

B. Basis of presentation

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

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

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

Fund financial statements provide information about the Agency's funds. Separate financial statements are provided for the governmental and proprietary funds. The General Fund is the Agency's primary operating fund, and it accounts for all financial resources except those required to be accounted for in another fund. AHCCCS had one business-type activity, Healthcare Group, which ceased operations effective December 31, 2013. In fiscal year 2015, AHCCCS did not have any major funds; accordingly, all governmental funds other than the General Fund are aggregated and reported as other governmental funds.

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

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

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

Proprietary fund revenues are recognized when they are earned, and expenses are recognized when they are incurred. Proprietary fund operations ceased December 31, 2013 and the residual fund balance was transferred to the state general fund in fiscal year 2015.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

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

In fiscal year 2015, AHCCCS reports the following significant funds:

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

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

D. Cash and investments

Substantially all of the cash and investments maintained by AHCCCS are held by the State of Arizona Office of the Treasurer ("Treasurer") with other State monies in an internal cash and investment pool. Investment income is allocated to AHCCCS on a pro rata basis. Amounts held by the Treasurer are recorded at fair value and totaled \$192,737 at June 30, 2015, including designated and restricted funds of \$40,251.

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.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

Cash in the General Fund has been internally designated by AHCCCS in the amount of \$25,410 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 \$1,473 for the Hawaii Arizona PMMIS Alliance (“HAPA”) Fund, as described in Note 4 and is offset by accrued expenditures of \$173 and unearned revenue of \$1,300 at June 30, 2015.

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, 2015, no bank overdraft existed.

E. Deferred Outflows and Inflows of Resources

The statement of net position and balance sheet include separate sections for deferred outflows of resources and deferred inflows of resources. Deferred outflows of resources represent a consumption of net position that applies to future periods that will be recognized as an expense or expenditure in future periods. Deferred inflows of resources represent an acquisition of net position or fund balance that applies to future periods and will be recognized as revenue in future periods.

F. Pensions

For purposes of measuring the net pension (asset and) liability, deferred outflows of resources and deferred inflows of resources related to pensions, and pension expense, information about the ASRS pension plan’s fiduciary net position and additions to/deductions from the ASRS plan’s fiduciary net position have been determined on the same basis as they are reported by the ASRS plan. For this purpose, ASRS benefit payments (including refunds of employee contributions) are recognized when due and payable in accordance with the benefit terms.

G. Net position / fund balance

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

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

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

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

Nonspendable fund balance

Nonspendable fund balance – this includes amounts that cannot be spent because they are either not spendable in form (such as inventory) or legally or contractually required to be maintained intact (such as endowments). At June 30, 2015, AHCCCS had no nonspendable fund balance.

Spendable fund balance

Restricted fund balance – this includes amounts that can be spent only for specific purposes stipulated by legal requirements imposed by other governments, external resource providers, or creditors. AHCCCS imposed restrictions do not create a restricted fund balance unless the legal document that initially authorized the revenue (associated with that portion of the fund balance) also included language that specified the limited use for which the authorized revenues were to be expended. At June 30, 2015, 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, 2015, AHCCCS' committed fund balance totaled \$900 and related to the hospital residency loan fund.

Assigned fund balance – this includes amounts constrained by the Legislature for specific purposes. Assigned fund balances include all remaining amounts (except negative amounts) that are reported in the governmental funds, other than the general fund, that are not classified as nonspendable and are neither restricted nor committed and amounts in the general fund that are intended to be used for a specific purpose. By reporting particular amounts that are not restricted or committed in a special revenue fund, AHCCCS has assigned those amounts to the purpose of the respective funds. At June 30, 2015, AHCCCS' assigned fund balance totaled \$13,965.

Unassigned fund balance – this includes the remaining spendable amounts which are not included in one of the other classifications. At June 30, 2015, AHCCCS had no unassigned fund balance.

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

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

H. Capitation payments

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

Capitation is paid prospectively as well as for prior period coverage ("PPC"). The PPC period generally is from the effective date of eligibility to the day a member is enrolled with a contracted health plan. The risk under PPC is shared by both the contracted health plans and AHCCCS for the contract year. AHCCCS reconciles the actual PPC medical costs to the PPC net capitation paid during the contract year. The reconciliation limits the contractors' profits and losses to 2% of net capitation. Accrued programmatic claims are net of approximately \$73,391 at June 30, 2015 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.

Similar risk sharing is in place for medical costs incurred by contracted health plans for the Title XIX Waiver Group ("TWG") members. AHCCCS reconciles the contractors' medical costs net of reinsurance to the total net capitation payments and delivery supplemental payments paid for the contract year. The reconciliation limits the contractors' profits or losses to 2%. Accrued programmatic claims are net of approximately \$464 at June 30, 2015 that represents estimated settlement payments due from contracted health plans for the TWG reconciliation. Actual results may differ from this estimate and such differences will be recorded in the period in which they are identified.

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

Profits in excess of the percentages set forth in the contract will be recouped by AHCCCS. Losses in excess of the percentages set forth in the contract will be paid to the contractor. Accrued programmatic claims are net of approximately \$67,539 at June 30, 2015 that represents estimated settlement payments due from contracted health plans for the tiered reconciliation.

Effective with contract year ending September 30, 2014, AHCCCS will recoup/reimburse a percentage of the contractors' profit or loss for the new adult population with income up to 100% FPL. The reconciliation limits the contractors' profits and losses to 1% of net capitation. Accrued programmatic claims are net of approximately \$2,573 at June 30, 2015 that represents estimated settlement payments due from the contracted health plans.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

Effective with contract year ending September 30, 2013, AHCCCS will recoup/reimburse a percentage of the contractors' profit or loss for the Children's Rehabilitative Services ("CRS") population. The reconciliation limits the contractors' profits and losses to a percent of net capitation as specified in the contract. Accrued programmatic costs include approximately \$6,323 at June 30, 2015 that represents estimated settlement payments due to the contracted health plan.

I. 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 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.

J. Fee-for-service payments

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

The ESP provides for emergency medical care to persons who are not eligible for full AHCCCS coverage due to their lack of United States citizenship or lawful alien status. Outpatient medical services for the ESP, prior quarter coverage, 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.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(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.

K. Incurred but not reported programmatic expenditures

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

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

L. Hospital Assessment Fund

The hospital assessment fund, established pursuant to ARS §36-2901.09 on January 1, 2014, consists of monies collected from an assessment on hospitals for the purpose of funding a portion of the non-federal share of costs for the Proposition 204 eligible population. AHCCCS recorded assessment revenues in the amount of \$270,442 and expenditures in the amount of \$260,917 during fiscal year 2015 ending with a net fund balance of \$9,886 at June 30, 2015.

M. Hospital and nursing facility payments

CMS and the Legislature authorized AHCCCS to make Disproportionate Share, Safety Net Care Pool, Graduate Medical Education, Rural Hospital, Critical Access Hospital, Trauma Center and Nursing Facility supplemental payments in fiscal year 2015. Disproportionate share payments to Arizona hospitals that provided care to a disproportionate share (as defined) of the State's indigent population totaled \$118,393. Safety Net Care Pool payments to fund unreimbursed costs incurred by CMS approved hospitals, under the SNCP program waiver, in caring for the uninsured totaled \$85,608. Graduate Medical Education payments to reimburse hospitals with GME programs for the additional costs of treating AHCCCS members utilizing graduate medical students totaled \$162,993. Critical Access Hospital payments to provide increased reimbursement to small rural hospitals that are federally designated as critical access hospitals totaled \$9,957. Rural Hospital payments to increase inpatient reimbursement rates for qualifying rural hospitals totaled \$12,158. Trauma center services to reimburse hospitals in Arizona for unrecovered trauma center readiness costs and unrecovered emergency services costs totaled \$22,340. Nursing Facility supplemental payments utilize a quality assessment on health care items and services provided by nursing facilities to qualify for federal matching funds for supplemental payments for covered Medicaid expenditures, not to exceed the Medicare upper payment limit. The payments are included with long-term care medical services and totaled \$77,918.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

N. Taxes

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

O. Management's use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities, and the reported amounts of revenues and expenditures at June 30, 2015. Actual results may differ from these estimates.

P. 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. Effective with the January 1, 2014 implementation of the eligibility expansion under the ACA to include the new adult group, members with income between 100% and 133% of the FPL, the budget neutrality measurement is performed separately for the newly eligible adult population. Management believes that as of June 30, 2015, AHCCCS does not have any liability to CMS related to either budget neutrality agreement and, accordingly, no liability is recorded in the accompanying financial statements. See Note 8.

AHCCCS has classified the Arizona Tobacco Litigation Settlement Fund, created by ballot Proposition 204, as part of its General Fund. These funds are restricted for use as specified in the litigation settlement and/or legislation. Annual settlement payments, based on cigarette sales from the preceding calendar year are made in April. In addition, supplemental payments may be received as tobacco companies enter into the tobacco master settlement agreement. AHCCCS received annual and strategic contribution fund payments of \$99,975 in fiscal year 2015 for the period from January 1, 2013 to December 31, 2013. Revenue and a related receivable of \$50,000 were accrued for the period of January 1, 2015 through June 30, 2015 and are included in Tobacco Settlement Receivable and Other Operating Grants and Contributions in the accompanying Statement of Net Position and Statement of Activities.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

Q. Prescription Drug Rebate Program

The ACA included a provision to extend drug rebates to managed care programs and to increase the rebate amount drug manufacturers are required to pay under the Medicaid drug rebate program. AHCCCS received CMS approval on January 26, 2011 to participate in the drug rebate program, both managed care and fee-for-service, for drugs dispensed on or after March 23, 2010. AHCCCS received rebate reimbursements and delinquent account interest in the amount of \$376,651 in 2015. Of this amount, \$238,230 was returned to the Federal government in fiscal 2015 and \$42,626 will be returned subsequent to June 30, 2015. The remaining \$95,795 is available to offset a portion of General Fund current and future fiscal year expenditures. Additionally, AHCCCS has accrued the unpaid invoice balance of \$183,569 as of June 30, 2015 which is included in receivables and other in the accompanying statement of net position. Of this accrued receivable, \$141,966 will be returned to the Federal government and is netted against the due from the Federal government in the accompanying financial statements and \$41,603 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 column in the government-wide statement of net position. Tangible capital assets are defined as assets with an initial, individual cost of more than \$5 and an estimated useful life in excess of one year. Such assets are recorded at historical cost and are depreciated over their estimated useful lives ranging from three to five years. Intangible capital assets consist of internally generated computer software with an initial cost greater than \$1,000. Software is amortized over an estimated useful life of five to ten years. Expenditures for incomplete projects are reported as Software Under Development. The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend assets' lives are not capitalized.

Net asset balances and current fiscal year activity are as follows:

	<u>Balance</u> <u>June 30, 2014</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance</u> <u>June 30, 2015</u>
Governmental Activities:				
Capital assets, not being depreciated:				
Software under development	\$ 34,167	\$ 30,089	\$ -	\$ 64,256
Capital assets, being depreciated:				
Vehicles, Furniture & Equipment	8,814	525	(415)	8,924
Software	<u>32,643</u>	<u>-</u>	<u>-</u>	<u>32,643</u>
Total capital assets, being depreciated	<u>41,457</u>	<u>525</u>	<u>(415)</u>	<u>41,567</u>
Less accumulated depreciation for:				
Vehicles, Furniture & Equipment	(5,993)	(1,033)	415	(6,611)
Software	<u>(2,132)</u>	<u>(3,464)</u>	<u>-</u>	<u>(5,596)</u>
Total accumulated depreciation	<u>(8,125)</u>	<u>(4,497)</u>	<u>415</u>	<u>(12,207)</u>
Total capital assets being depreciated, net	<u>33,332</u>	<u>(3,972)</u>	<u>-</u>	<u>29,360</u>
Governmental activities capital assets, net	<u>\$ 67,499</u>	<u>\$ 26,117</u>	<u>\$ -</u>	<u>\$ 93,616</u>

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(2) Capital assets (continued)

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, 2015, management does not believe impairment indicators are present, and there were no idle capital assets.

At June 30, 2015, capital assets included \$64,256 of software under development. Approximately \$30,089 was capitalized in fiscal year 2015. Internally generated software includes AHCCCS' continuing development of the next mandated version of the electronic Transaction and Code Set standards under the Health Insurance Portability and Accountability Act of 2010 as well as upgrades and enhancements to Medicaid eligibility systems related to the ACA. Eligibility system development project costs are estimated to be approximately \$159.4 million through September 2017 and are eligible for the 90 percent Federal financial participation rate.

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, 2014	\$	3,633
Additions		5,041
Reductions		(5,184)
Balance, June 30, 2015	\$	<u>3,490</u>

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(4) Other governmental funds

At June 30, 2015, the other governmental fund balance of \$12,728 included activity within the following funds:

- Tobacco Tax and Health Care Fund, Medically Needy Account (“MNA”) - The Arizona Department of Revenue allocates funding to the MNA which provides funding for services provided through the Title XIX Medicaid and other legislatively authorized health related services or programs. Revenue sources for the MNA include tobacco tax proceeds and investment income.
- Tobacco Products Tax Fund, Emergency Health Services Account (“EHSA”) - The Arizona Department of Revenue allocates the tobacco tax revenue to the EHSA which is used solely for the reimbursement of uncompensated care, primary care services and trauma centers readiness costs. Monies remaining unexpended and unencumbered in the account on June 30th of each year revert to the Proposition 204 Protection Account, a general fund. Revenue sources for the EHSA include tobacco tax proceeds and investment income.
- Trauma and Emergency Services Fund - This fund is comprised of gaming revenues to be used to reimburse hospitals in Arizona for unrecovered trauma center readiness costs and unrecovered emergency services costs.
- Nursing Facility Assessment Fund - This fund consists of monies received from the nursing facility assessment, federal monies received as a result of expenditures made attributable to monies deposited in the fund, interest, legislative appropriations, grants, gifts, contributions and devices. The monies in this fund shall be used to qualify for federal matching funds for supplemental payments for nursing facility services and administrative cost to administer the fund.
- Hospital Assessment Fund - This fund consists of monies collected from an assessment on hospitals for the purposes of funding a portion of the non-federal share of the Medicaid expansion and the entire Proposition 204 population on and after January 1, 2014.
- Third Party Liability and Recovery Audit Fund - This fund is comprised of monies recovered from first and third party payers under various AHCCCS recovery programs prior to disbursement to the appropriate parties, contractors and programs. These programs primarily include casualty, special treatment trusts, estate, health insurance recoveries, and recovery audit collections.
- Miscellaneous Funds - These funds account for various grants and other money received for specific purposes including the Hawaii Arizona PMMIS Alliance (“HAPA”) and the Hospital Loan Residency Fund. HAPA represents AHCCCS’ project with Hawaii whereby AHCCCS provides data processing services for Hawaii’s Medicaid program. The Hospital Loan Residency Fund was created and consists of legislative appropriations and loan repayment monies for the establishment of a hospital loan program to fund start-up and ongoing costs for residency programs in accredited hospitals. The hospital loans were paid in full as of June 30, 2014.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(4) Other governmental funds (continued)

Other governmental funds earned, expended and transferred during the fiscal year ended June 30, 2015 were as follows:

	Fund Balance June 30, 2014	Receipts	Interest Earned	Expenditures	Transfers In/(out)	Fund Balance June 30, 2015
Tobacco Tax and Health Care Fund, Medically Needy Account	\$ -	\$ 74,227	\$ 2	\$ (38,762)	\$ (35,467)	\$ -
Tobacco Products Tax Fund, Emergency Health Services Account	-	19,401	-	(18,262)	(1,139)	-
Trauma and Emergency Services Fund	-	22,302	38	(22,340)	-	-
Nursing Facility Assessment Fund	275	66,201	7	(66,032)	-	451
Hospital Assessment Fund	361	270,442	-	(260,917)	-	9,886
Third Party Liability and Recovery Audit Fund	-	602	-	(602)	-	-
Miscellaneous Funds	2,582	7,794	7	(7,992)	-	2,391
	\$ 3,218	\$ 460,969	\$ 54	\$ (414,907)	\$ (36,606)	\$ 12,728

(5) Proprietary fund

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

(6) Retirement plan

AHCCCS contributes to the ASRS plan described below. The plan is a component unit of the State of Arizona.

At June 30, 2015, AHCCCS reported the following aggregate amounts related to pensions for all plans to which it contributes:

Statement of Net Position and Statement of Activities	Governmental Activities	Business-Type Activities	Total
Net pension assets	\$ -	\$ -	\$ -
Net pension liabilities	69,633	-	69,633
Deferred outflows of resources	8,914	-	8,914
Deferred inflows of resources	12,177	-	12,177
Pension expense	4,942	-	4,492

AHCCCS's accrued payroll and employee benefits includes no amounts of outstanding pension contribution amounts payable to all pension plans for the year ended June 30, 2015. Also, AHCCCS reported \$4,942 of pension contributions as expenditures in the governmental funds related to all pension plans to which it contributes.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(6) Retirement plan (continued)

Plan description – AHCCCS employees participate in the ASRS. The ASRS administers a cost-sharing multiple-employer defined benefit pension plan, a cost-sharing multiple-employer defined benefit health insurance premium benefit (“OPEB”) plan, and a cost-sharing multiple-employer defined benefit long-term disability (“OPEB”) plan. The Arizona State Retirement System Board governs the ASRS according to the provisions of A.R.S. Title 38, Chapter 5, Articles 2 and 2.1. The ASRS issues a publicly available financial report that includes its financial statements and required supplementary information. The report is available on its Web site at www.azasrs.gov.

Benefits provided – The ASRS provides retirement, health insurance premium supplement, long-term disability, and survivor benefits. State statute establishes benefit terms. Retirement benefits are calculated on the basis of age, average monthly compensation, and service credit as follows:

ASRS	Retirement	
	Initial membership date:	
	Before July 1, 2011	On or after July 1, 2011
Years of service and age required to receive benefit	Sum of years and age equals 80 10 years age 62 5 years age 50* any years age 65	30 years age 55 25 years age 60 10 years age 62 5 years age 50* any years age 65
Final average salary is based on	Highest 36 consecutive months of last 120 months	Highest 60 consecutive months of last 120 months
Benefit percent per year of service	2.1% to 2.3%	2.1% to 2.3%

*With actuarially reduced benefits.

Retirement benefits for members who joined the ASRS prior to September 13, 2013, are subject to automatic cost-of-living adjustments based on excess investment earning. Members with a membership date on or after September 13, 2013, are not eligible for cost-of-living adjustments. Survivor benefits are payable upon a member’s death. For retired members, the survivor benefit is determined by the retirement benefit option chosen. For all other members, the beneficiary is entitled to the member’s account balance that includes the member’s contributions and employer’s contributions, plus interest earned.

Contributions – In accordance with state statutes, annual actuarial valuations determine active member and employer contribution requirements. The combined active member and employer contribution rates are expected to finance the costs of benefits employees earn during the year, with an additional amount to finance any unfunded accrued liability. For the year ended June 30, 2015, active ASRS members were required by statute to contribute at the actuarially determined rate of 11.6 percent (11.48 percent for retirement and 0.12 percent for long-term disability) of the members’ annual covered payroll, and AHCCCS was required by statute to contribute at the actuarially determined rate of 11.6 percent (10.89 percent for retirement, 0.59 percent for health insurance premium benefit, and 0.12 percent for long-term disability) of the active members’ annual covered payroll. In addition, AHCCCS was required by statute to contribute at the actuarially determined rate of 9.57 percent (9.31 percent for retirement, 0.20 percent for health insurance premium benefit, and 0.06 percent for long-term disability) of annual covered payroll of retired members who worked for AHCCCS in positions that would typically be filled by an employee who contributes to the ASRS.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(6) Retirement plan (continued)

During fiscal year 2015, AHCCCS paid for ASRS pension contributions as follows: 94.41 percent from the General Fund and 5.59 percent from other funds.

Pension liability – At June 30, 2015, AHCCCS reported a liability of \$69,633 for its proportionate share of the ASRS' net pension liability. The net pension liability was measured as of June 30, 2014. The total pension liability used to calculate the net pension liability was determined using update procedures to roll forward the total pension liability from an actuarial valuation as of June 30, 2013, to the measurement date of June 30, 2014. AHCCCS's proportion of the net pension liability was based on AHCCCS's actual contributions to the plan relative to the total of all participating employers' contributions for the year ended June 30, 2014. AHCCCS's proportion measured as of June 30, 2014, was 0.470599 percent, which was an (increase/decrease) of 0.007174 percent from its proportion measured as of June 30, 2013.

Pension expense and deferred outflows/inflows of resources – For the year ended June 30, 2015, AHCCCS recognized pension expense for ASRS of \$4,942. At June 30, 2015, AHCCCS reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

<u>ASRS</u>	<u>Deferred Outflows of Resources</u>	<u>Deferred Inflows of Resources</u>
Differences between expected and actual experience	\$ 3,539	\$ -
Net difference between projected and actual earnings on pension plan investments	-	12,177
Changes in proportion and differences between AHCCCS contributions and proportionate share of contributions	827	-
AHCCCS contributions subsequent to the measurement date	4,548	-
Total	<u>\$ 8,914</u>	<u>\$ 12,177</u>

The \$4,548 reported as deferred outflows of resources related to ASRS pensions resulting from AHCCCS contributions subsequent to the measurement date will be recognized as a reduction of the net pension liability in the year ending June 30, 2016. Other amounts reported as deferred outflows of resources and deferred inflows of resources related to ASRS pension will be recognized as a decrease in pension expense as follows:

<u>Year ending June 30</u>	
2016	\$ 1,146
2017	1,146
2018	2,475
2019	3,044

Actuarial Assumptions – The significant actuarial assumptions used to measure the total pension liability are as follows:

ASRS	
Actuarial valuation date	June 30, 2013
Actuarial roll forward date	June 30, 2014
Actuarial cost method	Entry age normal
Investment rate of return	8%
Projected salary increases	3 - 6.75%
Inflation	3%
Permanent benefit increase	Included
Mortality rates	1994 GAM Scale BB

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(6) Retirement plan (continued)

Actuarial assumptions used in the June 30, 2013, valuation were based on the results of an actuarial experience study for the 5-year period ended June 30, 2012.

The long-term expected rate of return on ASRS pension plan investments was determined to be 8.79 percent using a building-block method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. The target allocation and best estimates of arithmetic real rates of return for each major asset class are summarized in the following table:

ASRS		
Asset Class	<u>Target Allocation</u>	<u>Long-term Expected Real Rate of Return</u>
Equity	63%	7.03%
Fixed income	25%	3.20%
Commodities	4%	4.50%
Real estate	8%	4.75%
Total	<u>100%</u>	

Discount Rate – The discount rate used to measure the ASRS total pension liability was 8 percent, which is less than the long-term expected rate of return of 8.79 percent. The projection of cash flows used to determine the discount rate assumed that contributions from participating employers will be made based on the actuarially determined rates based on the ASRS Board’s funding policy, which establishes the contractually required rate under Arizona statute. Based on those assumptions, the pension plan’s fiduciary net position was projected to be available to make all projected future benefit payments of current plan members. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability.

Sensitivity of AHCCCS’s proportionate share of the ASRS net pension liability to changes in the discount rate – The following table presents AHCCCS’s proportionate share of the net pension liability calculated using the discount rate of 8 percent, as well as what AHCCCS’s proportionate share of the net pension liability would be if it were calculated using a discount rate that is 1 percentage point lower (7 percent) or 1 percentage point higher (9 percent) than the current rate:

	<u>1% Decrease</u>	<u>Current Discount Rate</u>	<u>1% Increase</u>
	(7.00%)	(8.00%)	(9.00%)
AHCCCS’s proportionate share of the net pension liability	\$ 88,012	\$ 69,633	\$ 59,661

Pension plan fiduciary net position – Detailed information about the pension plan’s fiduciary net position is available in the separately issued ASRS financial report.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(7) Budgetary basis of accounting

The financial statements of AHCCCS are prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP"). AHCCCS, like other State agencies, prepares its annual operating budget on a basis that differs from the GAAP basis. Encumbrances as of June 30th can be liquidated during a four week administrative period known as the 13th month. The budget basis expenditures reported in the financial statements include both the fiscal year paid and the 13th month activity. The State does not have a legally adopted budget for revenues. Prior fiscal year expenditures of \$331,891 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, 2015.

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, 2015:

	<u>General Fund Actual</u>
Budgetary Basis Fund Balance, June 30, 2015	\$ <u>157,352</u>
Budgetary Basis of Accounting	
Increases to fund balance:	
Cash	766
Due from state and local governments	86,518
Due from the federal government	419,274
Due from other fund	20,132
Tobacco settlement receivable	50,000
Receivables and other	<u>183,612</u>
Total increases	<u>\$ 760,302</u>
Decrease to fund balance:	
Unearned revenue	(23,235)
Due to state and county governments	(162,401)
Accrued programmatic costs	(392,773)
Payables and other	(11,389)
Unavailable revenue	<u>(325,719)</u>
Total decreases	<u>(915,517)</u>
Total GAAP basis fund balance	<u>\$ 2,137</u>

Non-appropriated expenditures of \$2,712,929 in the General Fund consist primarily of federal and state matching pass-through payments to other agencies.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(8) Contingencies

Litigation and investigations – AHCCCS has been named as a defendant in a variety of litigation, all of which are being defended by in-house and external legal counsel. One case is a lawsuit filed in the Arizona Superior Court for Maricopa County by a group of plaintiffs, consisting mostly of state legislators, seeking a declaration that the hospital assessment established under ARS 36-2901.08 is allegedly a tax passed in a manner inconsistent with the requirements for a tax established by the state constitution. The lawsuit was filed in September 2013 and continues to work its way through the courts. AHCCCS received a favorable ruling in Arizona Superior Court on August 26, 2015 but expects the plaintiffs to appeal. AHCCCS intends to continue to vigorously defend the lawsuit on lack of standing. If the hospital assessment is declared invalid, the program will have insufficient funds to cover childless adults with income up to 133% of FPL, but under the holding in *Fogliano v. State*, AHCCCS has the option to adjust eligibility standards to match available remaining funds.

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

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

Budget neutrality agreement – In January 2001, AHCCCS obtained a Section 1115 Waiver from CMS that provides federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204. The Waiver requires that over the term of the original agreement (April 1, 2001 through September 30, 2011) and the new agreement (October 1, 2011 through September 30, 2016), that the populations covered by the Waiver be budget neutral for CMS. Effective with the January 1, 2014 implementation of the eligibility expansion under the ACA to include the new adult group, members with income between 100% and 133% of the FPL, the budget neutrality measurement is performed separately for the new adult population. Budget neutral means that CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. The budget neutrality calculation is dependent on a number of variables including the number of members, the eligibility category of members and the general economy and its impact on unemployment, medical inflation and policy decisions made by the Legislature that may impact program costs. Through June 30, 2015, AHCCCS remains under the cumulative reporting limit threshold for the current waiver. Accordingly, management is projecting that as of June 30, 2015, 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.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(8) Contingencies (continued)

School based claims audit – AHCCCS continues to have several outstanding audit findings related to audits conducted by the Department of Health and Human Services, Office of Inspector General, Office of Audit Services (“OIG”) related to the Direct Service Claiming (“DSC”) and Medicaid Administrative Claiming (“MAC”) programs. AHCCCS disagrees with the findings in part, has returned the federal funds for non-disputed claims and plans to appeal the decision to the Department of Health and Human Services, Departmental Appeals Board (“DAB”) once CMS issues a disallowance. If and when all administrative appeals are exhausted, AHCCCS will request a refund from the LEAs or will deduct the amount from future payments in accordance with the intergovernmental agreement. The recoupment liability of \$19,924 for the DSC audit and \$18,941 for the MAC audit is included in the due to the federal government with a corresponding receivable in the due from the State and local governments in the accompanying financial statements.

(9) Interfund receivables, payables and transfers

Interfund activity is defined as transactions between funds administered by AHCCCS. The interfund balances as of June 30, 2015 consist of transfers from the Other Funds to the General Fund in the amount of \$20,132.

In the government-wide statement of activities, the interfund activity has been eliminated. The total net transfers out of \$55,366 reported on the statement of activities represents transfer activities to other State agencies.

(10) Transactions with other State agencies and counties

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

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

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

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

The following is a summary of transactions with these State agencies for the administrative services described above for the year ended June 30, 2015:

	<u>Expenditures</u>
Arizona Department of Economic Security	\$ 112,480
Arizona Department of Administration	19,146
Arizona Department of Health Services	855
Arizona Board of Nursing	210
Arizona Office of Administrative Hearings	474
Attorney General's Office	781
	<u>\$ 133,946</u>

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

The amounts passed through to ADES and ADHS are classified as Traditional, Proposition 204, Newly eligible adults, KidsCare and Long-term care services expenditures in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds. The following is a summary of transactions with these State agencies for the services described above for the year ended June 30, 2015:

	<u>Expenditures</u>
Arizona Department of Economic Security	\$ 1,151,009
Arizona Department of Health Services	1,755,414
	<u>\$ 2,906,423</u>

Revenues include \$289,930 from Arizona counties during fiscal year 2015. 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, 2015, county and State contributions exceeded related expenditures in the amount of \$13,368. This amount is included in the due to federal, state and county governments in the accompanying Balance Sheet – Governmental Funds.

(11) Other pass through funds

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

Arizona county and local governments contributed \$123,607 to qualify for matching Federal funds for the Graduate Medical Education, Safety Net Care Pool and Disproportionate Share Hospital program payments and for the provision of qualifying services to hospitalized inmates. These amounts are included within county IGA pass through funds in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(11) Other pass through funds (continued)

Arizona counties contributed \$3,384 as determined by statutory calculation for administrative costs incurred by ADES for eligibility determinations and other operating costs associated with Proposition 204.

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

At June 30, 2015, AHCCCS recorded the following pass through revenue in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds:

	<u>Funds Passed Through</u>
Arizona School Districts	
Administrative Services Federal Funds	\$ 7,026
Program Services Federal Funds	29,988
Arizona Department of Economic Security	
County Contribution for Administrative Costs	3,384
Arizona Department of Health Services	
Cost reimbursement from Civil Monetary Penalties	343
	<u>\$ 40,741</u>

(12) New pronouncement

The Governmental Accounting Standards Board ("GASB") issued several pronouncements prior to June 30, 2015 with effective dates within or after the fiscal year ended June 30, 2015. AHCCCS adopted the following new pronouncement in the fiscal year ended June 30, 2015:

In June 2012, the GASB issued Statement No. 68, *Accounting and Financial Reporting for Pensions*, as amended by GASB Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date*, which is effective for reporting periods beginning after June 15, 2014. The primary objective of this Statement is to improve accounting and financial reporting by state and local governments for pensions. It also improves information provided by state and local governmental employers about financial support for pensions that is provided by other entities. This Statement establishes standards for measuring and recognizing liabilities, deferred outflows of resources, and deferred inflows of resources, and expenditures. AHCCCS adopted Statement No. 68 in fiscal year 2015. See Note 13.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(13) Change in accounting principle

Net position as of July 1, 2014, has been restated as follows for the implementation of GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*, as amended by GASB Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date*.

	Governmental Activities	Business-Type Activities	Total
Net Position June 30, 2014, as previously reported	\$ 70,717	\$ 7,253	\$ 77,970
Prior period adjustment—implementation of GASB 68:			
Net pension liability (measurement date as of June 30, 2013)	(77,041)	-	(77,041)
Deferred outflows – AHCCCS contributions made during fiscal year 2014	4,539	-	4,539
Total prior period adjustment	(72,502)	-	(72,502)
Net Position July 1, 2014, as restated	\$ (1,785)	\$ 7,253	\$ 5,468

(14) Subsequent events

AHCCCS' budget request for fiscal year 2017, submitted to the Governor in September 2015 included a rebase of the fiscal year 2016 budget. The current forecast is for a \$735.0 million shortfall primarily comprised of \$671.7 million in Federal Expenditure Authority, \$34.4 million in Hospital Assessment Expenditure Authority and \$28.9 million in prescription Drug Rebate Fund state match funding authority. AHCCCS continues to experience the impacts of the many program changes resulting from the ACA. However, factors such as CMS decisions, legal decisions, case load changes compared to projections and the eligibility system shifts in population categories may influence any final fiscal year shortfall and potential need and amount of a supplemental appropriation. Management will closely monitor all these factors in relation to the adequacy of the fiscal year 2016 appropriation and fiscal year 2017 budget.

REQUIRED SUPPLEMENTARY INFORMATION

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BUDGETARY COMPARISON SCHEDULE - GENERAL FUND

Year Ended June 30, 2015
(Unaudited)
(amounts expressed in thousands)

	<u>Original Appropriation (Budget)</u>	<u>Final Appropriation (Budget)</u>	<u>Actual</u>	<u>Variance with Final Budget</u>
REVENUES				
State appropriations	\$ -	\$ -	\$ 1,229,117	\$ -
State ISA pass through funds	-	-	902,494	-
Federal government	-	-	6,154,947	-
Federal ISA/IGA pass through funds	-	-	1,954,223	-
County and other local government	-	-	300,762	-
County IGA pass through funds	-	-	130,317	-
Tobacco tax revenue	-	-	40,495	-
Tobacco litigation settlement	-	-	99,975	-
Other	-	-	884	-
Total revenues	<u>-</u>	<u>-</u>	<u>10,813,214</u>	<u>-</u>
OTHER FINANCING SOURCES				
Operating transfers in	<u>-</u>	<u>-</u>	<u>8,021</u>	<u>-</u>
TOTAL REVENUES AND OTHER FINANCING SOURCES	<u>-</u>	<u>-</u>	<u>10,821,235</u>	<u>-</u>
PROGRAMMATIC EXPENDITURES				
Traditional services	3,862,008	3,607,270	3,421,700	185,570
Proposition 204 services	1,725,888	2,070,593	2,035,152	35,441
Newly eligible adults	227,370	212,370	205,851	6,519
KidsCare services	6,223	7,513	7,074	439
Childrens rehabilitative services	197,070	222,042	219,113	2,929
Disproportionate share	13,487	13,487	4,202	9,285
Rural and critical access hospitals	22,650	22,650	22,115	535
Voluntary Political Subdivision Programs	253,792	374,066	361,837	12,229
Long-term care services	<u>1,290,651</u>	<u>1,294,651</u>	<u>1,236,413</u>	<u>58,238</u>
TOTAL PROGRAMMATIC EXPENDITURES	7,599,139	7,824,642	7,513,457	311,185
ADMINISTRATIVE EXPENDITURES	<u>177,891</u>	<u>227,135</u>	<u>208,467</u>	<u>18,668</u>
TOTAL APPROPRIATED EXPENDITURES	<u>7,777,030</u>	<u>8,051,777</u>	<u>7,721,924</u>	<u>329,853</u>
PRIOR YEAR APPROPRIATED EXPENDITURES	-	-	331,891	-
NON-APPROPRIATED EXPENDITURES	<u>-</u>	<u>-</u>	<u>2,712,929</u>	<u>-</u>
REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES	-	-	54,491	-
FUND BALANCES, BEGINNING OF YEAR	<u>-</u>	<u>-</u>	<u>102,861</u>	<u>-</u>
FUND BALANCES, END OF YEAR	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 157,352</u>	<u>\$ -</u>

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF AGENCY'S PROPORTIONATE SHARE OF THE NET PENSION LIABILITY - COST SHARING PLAN

Year Ended June 30, 2015
(Unaudited)
(amounts expressed in thousands)

	Reporting Fiscal Year	
	(Measurement Date)	
	2015	2014 through
	(2014)	2006
Agency's proportion of the net pension liability	0.470599%	Information
Agency's proportionate share of the net pension liability	\$ 69,633	not available
Agency's covered-employee payroll	\$ 43,181	
Agency's proportionate share of the net pension liability as a percentage of its covered-employee payroll	161.26%	
Plan fiduciary net position as a percentage of the total pension liability	69.49%	

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF THE AGENCY'S PENSION CONTRIBUTIONS

Year Ended June 30, 2015
(Unaudited)
(amounts expressed in thousands)

	<u>Reporting Fiscal Year</u>						2009 through 2006
	2015	2014	2013	2012	2011	2010	
Statutorily required contribution	\$ 4,548	4,779	4,466	4,238	3,600	4,140	Information not available
Agency's contributions in relation to the statutorily required contribution	<u>\$ 4,548</u>	<u>4,779</u>	<u>4,466</u>	<u>4,238</u>	<u>3,600</u>	<u>4,140</u>	
Agency's contribution deficiency (excess)	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	
Agency's covered-employee payroll	42,770	\$ 43,181	40,970	40,364	37,494	45,999	
Agency's contributions as a percentage of its covered- employee payroll	10.63%	11.07%	10.90%	10.50%	9.60%	9.00%	

See Notes to Financial Statements

SUPPLEMENTARY INFORMATION

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2015
(amounts expressed in thousands)

Federal Grantor/Pass Through Agency/Program	Federal CFDA Number	Expenditures
U.S. Department of Health and Human Services		
Centers for Medicare and Medicaid Services		
Medical Assistance Program (Title XIX)		
Federal funds expended to vendors	93.778	\$ 7,778,976
Federal funds expended to subrecipients	93.778	<u>4,812</u>
		7,783,788 *
Children's Health Insurance Program (Title XXI)	93.767	83,842 *
Testing Experience and Functional Tools Grant	93.627	<u>319</u>
TOTAL EXPENDITURES OF FEDERAL AWARDS		<u>\$ 7,867,949</u>

*major programs

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2015
(dollar amounts expressed in thousands)

(1) **Basis of presentation**

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of **Arizona Health Care Cost Containment System** under programs of the federal government for the year ended June 30, 2015. The information in this Schedule is presented in accordance with the requirements of the *Office of Management and Budget (OMB) Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations*. Because the Schedule presents only a selected portion of the operations of AHCCCS, it is not intended and does not present the financial position, changes in net position or cash flows of AHCCCS.

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

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

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

The program titles and CFDA numbers were obtained from the 2015 *Catalog of Federal Domestic Assistance*.



Mayer Hoffman McCann P.C.

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

To the Director of the

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

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the governmental activities, the business-type activities, the general fund, and the aggregate remaining fund information of **Arizona Health Care Cost Containment System (AHCCCS, an agency of the state of Arizona)**, as of and for the year ended June 30, 2015 and the related notes to the financial statements which collectively comprise **Arizona Health Care Cost Containment System's** basic financial statements, and have issued our report thereon dated December 11, 2015.

Internal Control Over Financial Reporting

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

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying schedule of findings and questioned costs as item 2015-001, we did identify a deficiency in internal control that we consider to be a material weakness.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiency described in the accompanying schedule of findings and questioned costs as item 2015-001 to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether **Arizona Health Care Cost Containment System's** financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed an instance of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and that are described in the accompanying schedule of findings and questioned costs as item number 2015-001.

Arizona Health Care Cost Containment System's Response to Findings

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

Purpose of this Report

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

A handwritten signature in black ink that reads "Mayer Hoffman McCann P.C." The signature is written in a cursive, flowing style.

Phoenix, Arizona
December 11, 2015



Mayer Hoffman McCann P.C.

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

To the Director of the

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

Report on Compliance for Each Major Federal Program

We have audited ***Arizona Health Care Cost Containment System's*** compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of ***Arizona Health Care Cost Containment System's*** major federal programs for the year ended June 30, 2015. ***Arizona Health Care Cost Containment System's*** major federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

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

Auditors' Responsibility

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

Our audit of ***Arizona Health Care Cost Containment System's*** major federal programs was conducted as part of the State of Arizona's Single Audit for the year ended June 30, 2015. The State of Arizona's major federal programs were determined by the Office of the Auditor General by applying the risk-based approach for determining major federal programs in accordance with OMB Circular A-133. Our Report on Compliance for Each Major Federal Program relates only to the portion of the programs that were administered by ***Arizona Health Care Cost Containment System*** and does not purport to, and does not, report on compliance over other portions, if any, of the major federal programs or any other major federal programs of the State of Arizona.

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

Basis for Qualified Opinion on CFDA # 93.778 Medical Assistance Program (Title XIX) and CFDA # 93.767 Children's Health Insurance Program (Title XXI)

As described in the accompanying schedule of findings and questioned costs, **Arizona Health Care Cost Containment System** did not comply with requirements regarding CFDA # 93.778 Medical Assistance Program (Title XIX) and CFDA # 93.767 Children's Health Insurance Program (Title XXI) as described in finding numbers 2015-002 for Allowable Costs. Compliance with such requirements is necessary, in our opinion, for **Arizona Health Care Cost Containment System** to comply with the requirements applicable to that program.

Qualified Opinion on CFDA # 93.778 Medical Assistance Program (Title XIX) and CFDA # 93.767 Children's Health Insurance Program (Title XXI)

In our opinion, except for the noncompliance described in the Basis for Qualified Opinion paragraph, **Arizona Health Care Cost Containment System** complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on CFDA # 93.778 Medical Assistance Program (Title XIX) and CFDA # 93.767 Children's Health Insurance Program (Title XXI) for the year ended June 30, 2015.

Other Matters

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

Report on Internal Control over Compliance

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

Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that have not been identified. However, as discussed below, we identified a certain deficiency in internal control over compliance that we consider to be a material weakness.

A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance. We consider the deficiency in internal control over compliance described in the accompanying schedule of findings and questioned costs as item 2015-002 to be a material weakness.

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

Purpose of this report

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

A handwritten signature in black ink that reads "Mayer Hoffman McCann P.C." The signature is written in a cursive, flowing style.

Phoenix, Arizona
December 11, 2015

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Year Ended June 30, 2015

Section I – Summary of Auditors' Results

Financial Statements

Type of Auditors' Report Issued:

Unmodified

Internal control over financial reporting:

Material weaknesses identified?

Yes

No

Significant deficiencies identified?

Yes

None reported

Noncompliance material to financial statements noted?

Yes

No

Federal Awards

Internal control over major programs:

Material weaknesses identified?

Yes

No

Significant deficiencies identified?

Yes

None reported

Type of Auditors' Report issued:

Qualified

Any audit findings disclosed that are required to be reported in accordance with Section 510(a) of OMB Circular A-133?

Yes

No

Identification of major programs:

CFDA Number

Name of Federal Program or Cluster

93.778

Medical Assistance Program (Title XIX)

93.767

Children's Health Insurance Program (Title XXI)

Dollar threshold used to distinguish between type A and type B programs:

\$23,603,849

Auditee qualified as low-risk auditee?

Yes

No

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Year Ended June 30, 2015

Section II – Financial Statement Findings

Item: 2015-001

- Criteria:** A strong and efficient system of internal controls over purchasing and disbursements is critically important to governmental organizations. Internal controls over the purchasing, procurement, contracting and accounts payable processes should be established and maintained to include limitations on purchasing authority, proper segregation of duties, and appropriate reviews of invoices and warrants.
- Condition and Context:** During fiscal year 2015, an AHCCCS internal investigation identified an employee embezzlement. The embezzlement involved AHCCCS' Contracts and Purchasing Administrator, who used their position to initiate and approve vendor invoices related to a multi-service contract. The Contracts and Purchasing Administrator was then able to use his long tenure and standing within AHCCCS to obtain possession of the paper warrants prior to their mailing to the vendor. In many instances, the vendor invoices were fraudulent. However, in some instances, the vendor invoices were legitimate and the invoices were subsequently adjusted off by the vendor for an unknown reason. AHCCCS believes the fraud occurred over a ten year period (2006-2015) and the total amount misappropriated was \$5,757,728. The funds were misappropriated from AHCCCS' administrative budget, which approximates \$200 million annually.
- Effect:** For the period from fiscal year 2006 through fiscal year 2015, AHCCCS estimates that their Contracts and Purchasing Administrator misappropriated \$5,757,728 of fraudulent vendor payments under a multi-service contract. The funds were misappropriated from AHCCCS' administrative budget, which approximates \$200 million annually.
- Cause:** Using his authority, tenure and standing within AHCCCS, the Contracts and Purchasing Administrator was able to circumvent existing controls to misappropriate funds. The Contracts and Purchasing Administrator had the authority to initiate and approve the vendor invoices under his delegated procurement authority and position. Additionally, he was able to use his long tenure and standing within AHCCCS to obtain possession of the paper warrants prior to their mailing to the vendor.
- Recommendation:** We recommend that AHCCCS review their existing internal control environment surrounding purchasing and disbursements to limit delegated procurement authority and to ensure proper segregation of duties. We also recommend that AHCCCS enforce its existing policies to ensure that the distribution of paper warrants, as well as the review and approval of any paper warrants prior to their distribution, must be segregated from individuals who initiate a purchase requisition and or the payment request. Finally, we recommend that AHCCCS periodically audit vendor accounts and reconcile vendor receipt detail to AHCCCS payment detail.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Year Ended June 30, 2015

Section III – Federal Awards Findings

Item: 2015-002

CFDA Numbers:	93.778 and 93.767
Program:	Medical Assistance Program and Children's Health Insurance Program
Agency:	U.S. Department of Health and Human Services
Agency Award Years:	July 1, 2014 through June 30, 2015
Questioned Costs:	\$2,941,326 (\$2,816,400 from the Medical Assistance Program (Title XIX) – 93.778 and \$124,926 from the Children's Health Insurance Program (Title XXI) – 93.767)
Criteria:	A strong and efficient system of internal controls over purchasing and disbursements is critically important to governmental organizations. Internal controls over the purchasing, procurement, contracting and accounts payable processes should be established and maintained to include limitations on purchasing authority, proper segregation of duties, and appropriate reviews of invoices and warrants.
Condition and Context:	During fiscal year 2015, an AHCCCS internal investigation identified an employee embezzlement. The embezzlement involved AHCCCS' Contracts and Purchasing Administrator, who used his position to initiate and approve vendor invoices related to a multi-service contract. The Contracts and Purchasing Administrator was then able to use his long tenure and standing within AHCCCS to obtain possession of the paper warrants prior to their mailing to the vendor. In many instances, the vendor invoices were fraudulent. However, in some instances, the vendor invoices were legitimate and the invoices were subsequently adjusted off by the vendor for an unknown reason. AHCCCS believes the fraud occurred over a ten year period (2006-2015) and the total cumulative amount misappropriated is estimated at \$5,757,728. The funds were misappropriated from AHCCCS' administrative budget, which approximates \$200 million annually.
Effect:	For the period from fiscal year 2006 through fiscal year 2015, AHCCCS estimates that their Contracts and Purchasing Administrator misappropriated \$5,757,728 of fraudulent vendor payments under a multi-service contract. The funds were misappropriated from AHCCCS' administrative budget, which approximates \$200 million annually. As these funds were administrative disbursements, there is a federal share with \$2,816,400 allocated to Title XIX (93.778) and \$124,926 allocated to Title XXI (93.767).
Cause:	Using his authority, tenure and standing within AHCCCS, the Contracts and Purchasing Administrator was able to circumvent existing controls to misappropriate funds. The Contracts and Purchasing Administrator had the authority to initiate and approve the vendor invoices under his delegated procurement authority and position. Additionally, he was able to use his long tenure and standing within AHCCCS to obtain possession of the paper warrants prior to their mailing to the vendor.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Year Ended June 30, 2015

Recommendation:

We recommend that AHCCCS review their existing internal control environment surrounding purchasing and disbursements to limit delegated procurement authority and to ensure proper segregation of duties. We also recommend that AHCCCS enforce its existing policies to ensure that the distribution of paper warrants, as well as the review and approval of any paper warrants prior to their distribution, must be segregated from individuals who initiate a purchase requisition and or the payment request. Finally, we recommend that AHCCCS periodically audit vendor accounts and reconcile vendor receipt detail to AHCCCS payment detail.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Year Ended June 30, 2015

Section IV – Status of Prior Years Findings

Item: 2014-001

CFDA Numbers: 93.778

Program: Medical Assistance Program

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

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

Questioned Costs: N/A

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

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

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

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

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

Current Status: We performed similar testing in the current year and noted no such exceptions.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Year Ended June 30, 2015

Section V – Corrective Action Plan

Item: 2015-001 and 2015-002

Subject: Allowable Costs

Name of Contact

Person: Jeffery Tegen, Assistant Director

Phone Number: (602) 417-4705

Date of Completion: December 31, 2015

**Corrective Action
Plan:**

AHCCCS will ensure assets are properly safeguarded and controlled and internal control policies and procedures are reviewed, strengthened and followed so that no single individual has control over the purchasing process to initiate a transaction, approve that transaction and have access to the paper warrant. AHCCCS has contracted with an Independent CPA to review, assess and provide recommendations for purchasing and accounts payable internal control policies and procedures. The Agency has worked with the Arizona State Procurement Office to reduce the previously unlimited delegated procurement authority to a revised limited delegated procurement authority of \$10,000. In addition, AHCCCS has established a policy that all payment transactions must utilize the central warrant mailing service provided by the Arizona Department of Administration – General Accounting Office in conjunction with the July 1, 2015 implementation of the new Statewide Accounting System. Finally, AHCCCS will aggressively prosecute the accused former employee and exhaust all available remedies to recover all embezzled assets in the timeliest manner possible.