ARIZONA HEALTH CARE
COST CONTAINMENT SYSTEM

FINANCIAL STATEMENTS
AND ADDITIONAL INFORMATION

Year Ended June 30, 2008

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CONTENTS

MANAGEMENT’S DISCUSSION AND ANALYSIS

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For the Fiscal Year Ended June 30, 2008

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, 2008. The intent of this discussion and analysis is to look at AHCCCS' performance as a whole. We encourage readers to consider this information in conjunction with the basic financial statements and related footnotes that follow this section.

Financial Highlights

Government-Wide

- The liabilities of AHCCCS exceeded its assets (presented as "net deficit") at fiscal year ended June 30, 2008 by $10.5 million. AHCCCS' net deficit at June 30, 2008 is comprised of an unrestricted net deficit of $12.7 million and the amount invested in capital assets of $2.2 million.

- The total AHCCCS net assets deficit decreased by $5.5 million during fiscal year 2008. Net assets of governmental activities decreased by $2.4 million, while the net assets deficit of the business-type activity decreased by $7.9 million.

Fund Level

- As of the close of fiscal year 2008, AHCCCS' total governmental funds reported an ending fund balance of $1.8 million, a decrease of $3.1 million. Approximately 57.7 percent of the decrease is attributable to the appropriated program expenses that included the carry forward balance of the Temporary Medical Coverage (TMC) program that the legislature temporarily suspended for fiscal year 2009. The appropriated program expenses for fiscal year 2008 utilized the $1.6 million beginning fund balance as a current fiscal year source of funds.

- Business-type activities during fiscal year 2008 resulted in a positive operating gain of $217,000 compared to the operating loss of $20.7 million in the prior year, which constitutes a major turn-around. Overall operating results, including a General Fund subsidy, decreased the net deficit to $15.8 million as compared to the $23.7 million net deficit at June 30, 2007. In addition to posting an operating income, HCG received a $7.25 million General Fund subsidy to reduce its reconciliation liability incurred in fiscal year 2006 and 2007. This allowed HCG to decrease its net deficit position to $15.8 million at June 30, 2008; an improvement of over $7.9 million from the year prior.

More detailed information regarding the government-wide financial statements and fund level financial statements can be found beginning on page 2.

Overview of the Financial Statements

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

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

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

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

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

Both statements report two categories:

- Governmental Activities - State appropriations along with federal, county intergovernmental revenues and member premium collections primarily support the activities in this category. The governmental activities of AHCCCS consist primarily of programs authorized by the Social Security Act Titles XIX (Medicaid) and XXI (State Children's Health Insurance Program (SCHIP)) that are concentrated on the health needs of the citizens of Arizona. The majority of AHCCCS' activities are reported in this category.

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

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

Fund Financial Statements (Reporting AHCCCS' Major Funds)

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

Governmental funds - Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, the governmental funds financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financial position and requirements. This approach is known as using the flow of current financial resources measurement focus and the modified accrual basis of accounting. These financial statements provide a short-term view of AHCCCS' finances that assists management in determining whether there will be adequate financial resources available to meet current needs.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the State's near-term financial decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities. The basic governmental funds financial statements and related reconciliations can be found on pages 21 through 23 of this report.

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

Annually, the Legislature adopts an appropriated budget for AHCCCS for the acute care (includes separate line item appropriations for the Acute Care Base, Proposition 204, KidsCare, KidsCare Parents, Breast & Cervical Cancer, Freedom-to-Work and TMC populations and supplemental payments to hospitals), Long-term Care and AHCCCS Administration programs. The annual appropriation is made separately for both the State funds and federal financial participation funds from the Social Security Act Titles XIX (Medicaid) and XXI (State Children's Health Insurance Program). In addition to the appropriation expenditure authority approved by the Legislature, AHCCCS also expends funds for other third party liability recovery and cost avoidance program activities and certain payments to hospitals for unfunded emergency department readiness costs and level 1 trauma center costs. The expenditures for unfunded emergency department readiness costs and level 1 trauma center costs are financed by revenues specifically collected for those purposes and are by statute continuously appropriated. A budgetary comparison statement has been provided for the General Fund to demonstrate compliance with the budget on page 24.

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

AHCCCS maintains one proprietary fund that is classified as an enterprise fund. AHCCCS uses this fund to account for the program that provides health insurance coverage for qualifying business organizations including some State political subdivisions. The basic proprietary fund financial statements can be found on pages 25 through 27 of this report.

Notes to the Financial Statements

The notes to the financial statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 28 to 44.

Government-Wide Financial Analysis

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

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

	Governmental Activities		Business-Type Activities		Total	
	2008	2007	2008	2007	2008	2007
Current assets	$ 768,280	$ 654,949	$ 14,190	$ 12,568	$ 782,470	$ 667,517
Noncurrent assets	900	-	-	-	900	-
Capital assets	2,160	2,587	103	129	2,263	2,716
Total assets	771,340	657,536	14,293	12,697	785,633	670,233
Current liabilities	766,013	649,856	15,213	18,383	781,226	668,239
Long-term liabilities	-	-	14,877	18,031	14,877	18,031
Total liabilities	766,013	649,856	30,090	36,414	796,103	686,270
Net assets (deficit):						
Invested in capital assets, net of depreciation	2,160	2,587	103	129	2,263	2,716
Restricted net assets	-	-	-	12	-	12
Unrestricted (deficit)	3,167	5,093	(15,900)	(23,858)	(12,733)	(18,765)
Total net assets (deficit)	$ 5,327	$ 7,680	$ (15,797)	$ (23,717)	$ (10,470)	$ (16,037)

For AHCCCS, liabilities exceeded assets by $10.5 million at June 30, 2008 as compared to liabilities exceeding assets by $16.0 million at June 30, 2007.

The largest portion of the AHCCCS total net deficit (150.9%) is due to a $15.8 million net deficit for HCG, the sole AHCCCS business-type activity. During fiscal year 2008, HCG net deficit decreased by $7.9 million. This decrease in the net deficit is primarily due to a $7.25 million General Fund subsidy to fund prior fiscal years 2006 and 2007 reconciliation liability and operating losses along with an increase in premium revenue to align member premiums with medical loss experience.

A $3.2 million unrestricted net asset balance for governmental operations partially offsets the business-type activity unrestricted net deficit. The governmental unrestricted balance primarily consists of funds in the amount of $1.7 million limited to future spending for certain information technology expenses and a $900,000 hospital residency program loans receivable due and available in future periods upon collection of the loans. During the year, governmental unrestricted net assets decreased by $1.9 million. This decrease is related to appropriated expenses utilizing a carry forward fund balance from the TMC program that the legislature temporarily suspended for fiscal year 2009. The appropriated program expenses for fiscal year 2008 utilized the $1.6 million beginning fund balance as a current fiscal year source of funds. Additionally, $447,000 of qualifying information technology programming expense was funded from available balances authorized by state statute. The net deficit in unrestricted net assets is also offset by net assets of $2.3 million invested in capital assets. AHCCCS uses these capital assets to provide services to its members.

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

	Governmental Activities		Business-Type Activities		Total	
	2008	2007	2008	2007	2008	2007
Revenues						
Program Revenues						
Charges for services	$ 13,666	$ 12,197	$ 77,042	$ 70,007	$ 90,708	$ 82,204
Other operating grants and contributions	486,708	420,602	-	35	486,708	420,637
Federal operating grants	5,209,662	4,727,031	10	171	5,209,672	4,727,202
General revenues						
State appropriations	1,946,433	1,761,301	-	-	1,946,433	1,761,301
Tobacco tax	168,786	193,421	-	-	168,786	193,421
Unrestricted investment earnings	1,639	2,196	443	446	2,082	2,642
Total revenues	7,826,894	7,116,748	77,495	70,659	7,904,389	7,187,407
Expenses						
Health Care	7,788,853	7,065,549	76,825	90,708	7,865,678	7,156,257
Excess (deficiency) before transfers	38,041	51,199	670	(20,049)	38,711	31,150
Transfers, net	(40,394)	(49,274)	7,250	-	(33,144)	(49,274)
Increase (decrease) in net assets	(2,353)	1,925	7,920	(20,049)	5,567	(18,124)
Net assets (deficit) – beginning of year	7,680	5,755	(23,717)	(3,668)	(16,037)	2,087
Net assets (deficit) – end of year	$ 5,327	$ 7,680	$ (15,797)	$ (23,717)	$ (10,470)	$ (16,037)

At June 30, 2008, the governmental activities ended in a positive net asset position. The combined business-type activity and government-wide activities closed the fiscal year with a deficit net assets balance. Although the business-type activity reported a $7.9 million decrease in net assets deficit, this is the third consecutive fiscal year that the business-type activity has reported a deficit net asset balance. The deficit in the business-type activity still contributes to a government-wide net deficit for the Agency as a whole. Overall, the net assets deficit was decreased by $5.6 million, or 34.7 percent from the net assets deficit at June 30, 2007.

Governmental activities decreased AHCCCS' net assets by $2.353 million during fiscal year 2008. This decrease is related to appropriated expenses utilizing a carry forward fund balance from the TMC program that the legislature temporarily suspended for fiscal year 2009. The appropriated program expenses for fiscal year 2008 utilized the $1.6 million beginning fund balance as a current fiscal year source of funds. Additionally, $447,000 of qualifying information technology programming expenses were funded from available balances as allowed by state statute. Business-type activities increased net assets by $7.920 million. The increase is primarily attributable to a $7.25 million General Fund subsidy provided in order to fund its reconciliation liability incurred in fiscal years 2006 and 2007 and operating losses. Fiscal year 2008 resulted in an operating gain of $217,000 compared to the operating loss of $20 million in the prior year. Overall operating results covered expenses in the fiscal year. Including the General Fund subsidy, HCG decreased its net deficit position to $15.8 million at June 30, 2008; an improvement of over $7.9 million from the year prior.

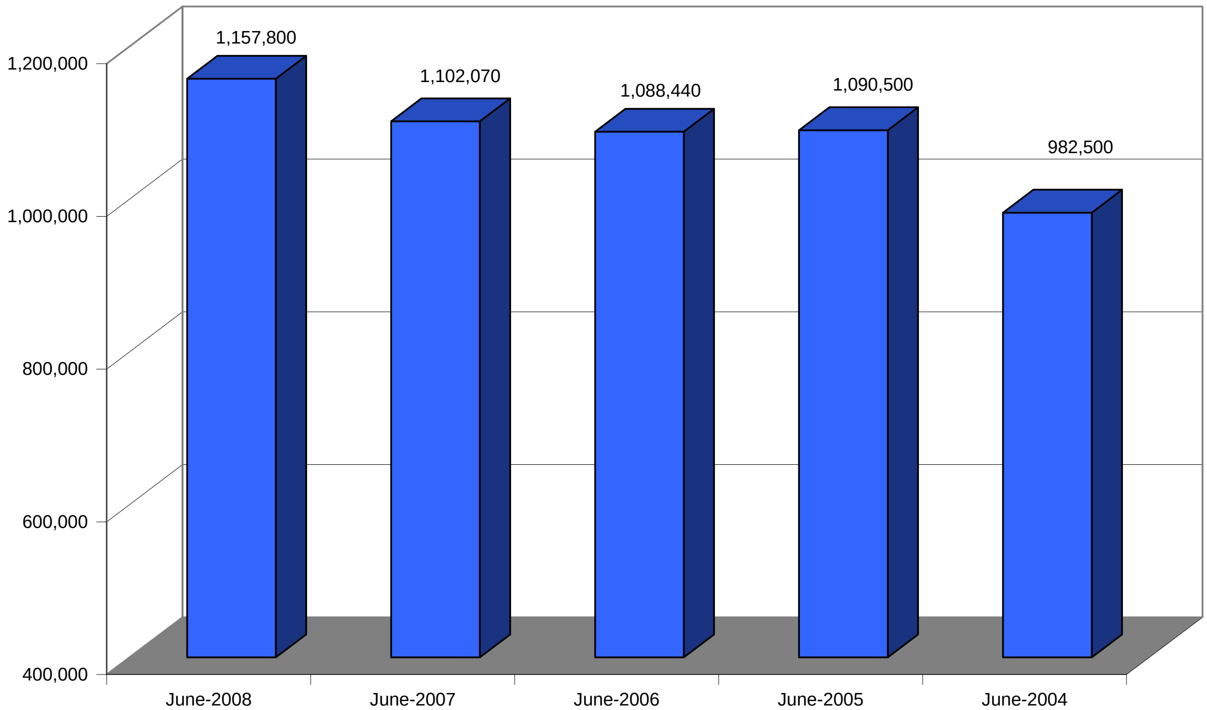
Governmental Activities

Fiscal year 2008 governmental activities decreased net assets by $2.353 million. The decrease is primarily related to appropriated expenses utilizing a carry forward fund balance from the Temporary Medical Coverage program that the legislature temporarily suspended for fiscal year 2009. The appropriated program expenses for fiscal year 2008 utilized the $1.6 million beginning fund balance as a current fiscal year source of funds. Additionally, $447,000 of qualifying information technology programming expenses was funded from available balances authorized by state statute.

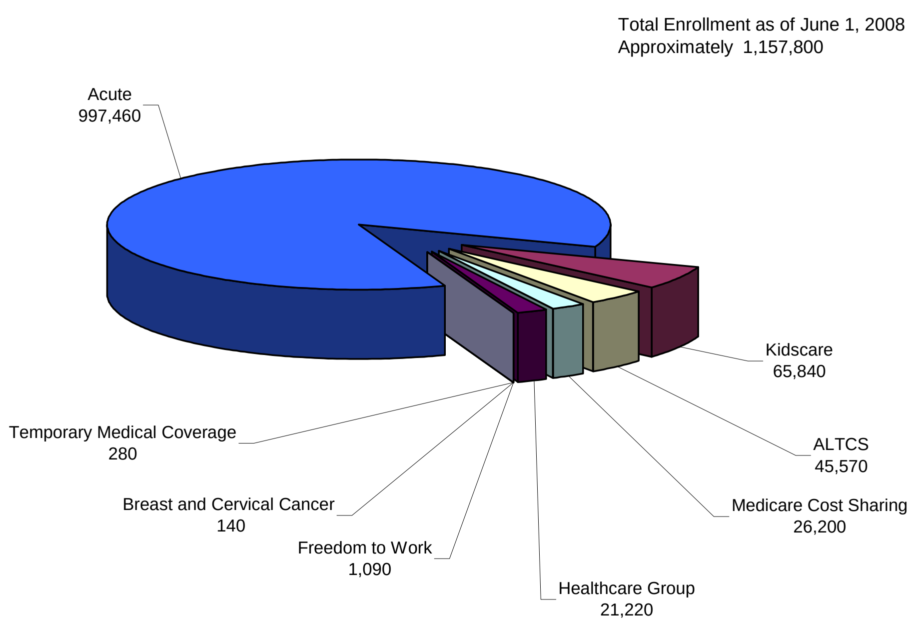
The overall AHCCCS program continued to see growth in program medical expenditures during fiscal year 2008. Enrollment has increased in six out of the past seven fiscal years. The single year of decline was fiscal year 2006. The increase in program expenditures in fiscal year 2008 is attributable to provider reimbursement inflation and increased enrollment. AHCCCS' overall governmental activity population was 1,157,800 as of June 1, 2008. Since March 1, 2001, just prior to the implementation of Proposition 204, the overall AHCCCS population has increased by 571,302 including Healthcare Group, which equates to a 97.4 percent growth rate. Of this amount, 151,300 (26.5 percent of the total 97.4 percent growth rate) are members who were made eligible by the Proposition 204 program expansion since the April 1, 2001 effective date.

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

AHCCCS Membership Growth



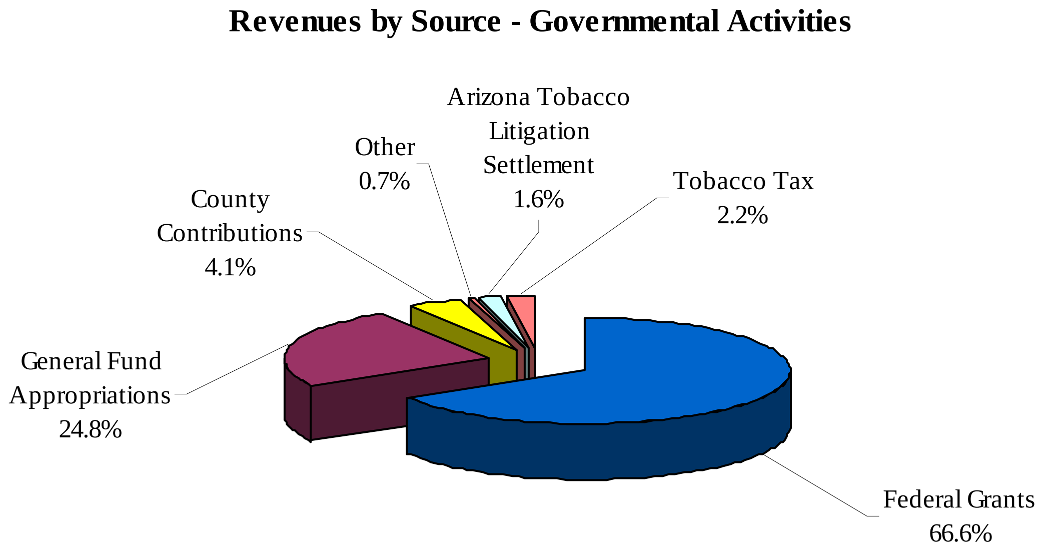
AHCCCS Enrollment by Program

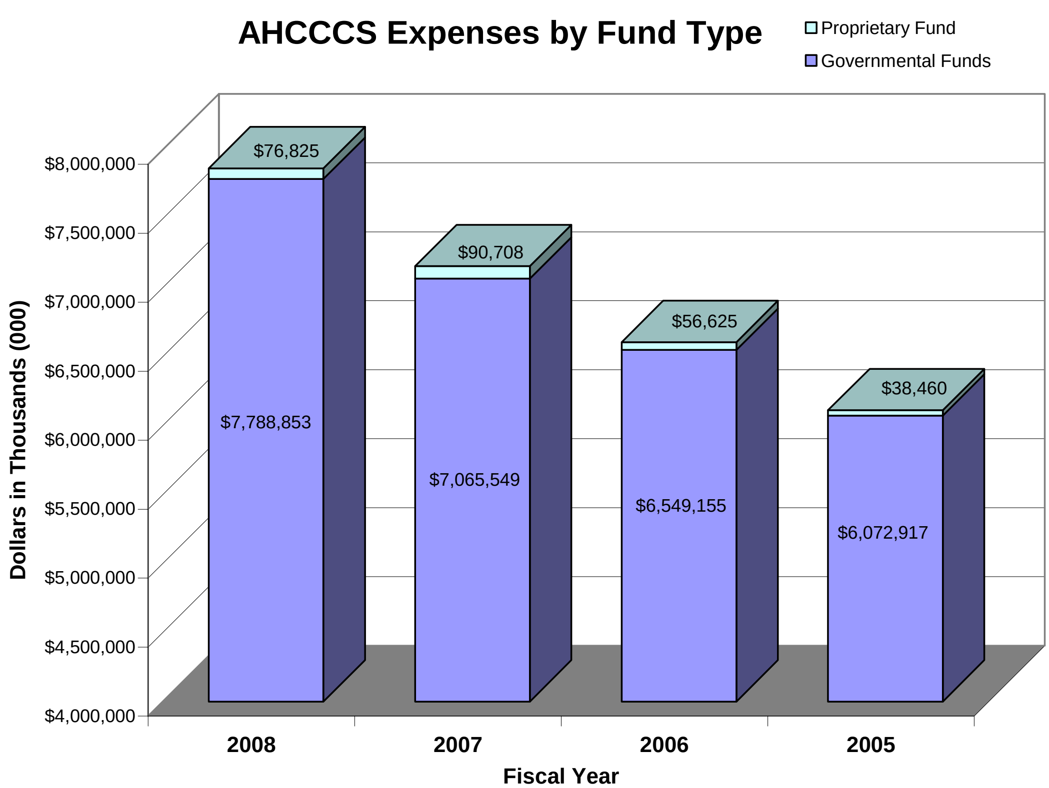


The cost of health care programs, including Title XIX Medicaid and Title XXI SCHIP, totaled $7,788.9 million in fiscal year 2008, a $723.4 million increase over the $7,065.5 million reported in fiscal year 2007. As shown in the statement of activities, the amount of expenditures funded from federal grants through the Centers for Medicare and Medicaid Services (CMS) was $5,209.7 million (66.9 percent) in fiscal 2008 as compared to $4,727.2 million (66.9 percent) in fiscal 2007. Program funding in the form of federal financial participation is primarily determined through the Federal Medical Assistance Percentages (FMAP) used to provide the amount of federal matching for State medical assistance expenditures. The FMAP is based on the relationship between Arizona's per capita personal income and the national average per capita personal income over three calendar years. The FMAP is recalculated each year and decreased by 0.27 percent to 66.20 percent from the prior year's rate of 66.47 percent. This decrease resulted in a cost shift of approximately $21 million to State sources for fiscal year 2008. The overall increase in program expenditures can primarily be attributed to an average 6.0 percent capitation rate inflation growth across all capitated programs. Yearly capitation rate increases have averaged 7.2 percent over the last 5 years, with the lowest increase of 4.2 percent in fiscal year 2003 and the highest of 13.9 percent in fiscal year 2004. Other increases in governmental expenditures include $32.4 million for expansion of the Graduate Medical Education program and $12.2 million for expenditures related to Medicare Clawback payments made to CMS.

State, county and miscellaneous funding sources combined to provide $2,617.2 million in State funding sources and appropriations in fiscal year 2008, a $227.5 million increase over the $2,389.7 million reported in fiscal year 2007. The following are the components of the State match funding sources. State General Fund revenues raised primarily in the form of income and sales taxes directed to AHCCCS amounted to $1,316.5 million and an additional $629.9 million was passed through from other State agencies in order to provide the State's share for Title XIX Medicaid and Title XXI SCHIP eligible medical assistance expenditures. Arizona counties contributed $319.3 million as determined by Statutory funding formulas and Session Law. Tax collections on tobacco products provided $168.8 million in State match funding, however, collections significantly decreased by $24.6 million or 12.7 percent. An additional $126.6 million in State revenue funding was provided by the annual payments to AHCCCS as administrator of the Tobacco Litigation Settlement Funds awarded to Arizona. These revenues are recorded in accordance with the Governmental Accounting Standards Board (GASB) Technical Bulletin No. 2004-1, Tobacco Settlement Recognition and Financial Reporting Entity Issues, which clarifies how payments made to AHCCCS pursuant to the Master Settlement Agreement (MSA) with major tobacco companies are recorded. Payments are based on cigarette sales from the preceding year. AHCCCS has accrued $57.0 million for the period from January 1, 2008 through June 30, 2008 based on Arizona's Joint Legislative Budget Committee 2009 estimated payment. In addition to the annual payment described above, AHCCCS received the first Strategic Contribution Fund (SCF) payment. Under the MSA, starting on April 15, 2008 and on April 15 of each year through 2017, the tobacco companies that joined the MSA are required to make a "strategic contribution payment" to the States in addition to the MSA Annual Payment. The amount of the payment is dependent upon several adjustments, the magnitude of which will not be fully known until an Independent Auditor provides its calculations in February or March of each year. Other factors could also affect the SCF Payment amount that AHCCCS ultimately receives, including default or bankruptcy by one or more tobacco companies and unforeseen withholding of SCF Payment amounts. Tribal gaming receipts distributed to AHCCCS as determined by statutory formula and other sources provided an additional $56.1 million. Payments of $23.4 million were made to hospital emergency departments and level 1 trauma facilities from tribal gaming receipts.

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





Business-Type Activities

The sole proprietary fund business-type activity for AHCCCS is the Healthcare Group (HCG). HCG was established in 1988 by the State to administer health care services primarily to small, uninsured businesses with 1 to 25 employees and employees of political subdivisions. That range was later increased to 1 to 50 employees. HCG contracts with three health plans from the existing network of AHCCCS health plans, Health Maintenance Organizations (HMOs), to provide managed care medical services. In fiscal year 2006, HCG started offering a Preferred Provider Organization (PPO) option through a third party administrator in order to provide health care coverage statewide. In fiscal year 2009 this geographical coverage will exclude Maricopa and Pima Counties. HCG's administrative responsibilities include enrollment/renewal, fulfillment, premium billing, customer service, collections, fund disbursement and data analysis. Also, HCG is responsible for providing reinsurance for certain HMO losses and regulatory oversight of the HMO's and the third party administrator.

The business-type activities generated a net gain of $7.9 million based on operating income of $217,000 following a $23.7 million loss in the year prior. Significant factors contributing to this turnaround are discussed below.

Changes in Fiscal Year 2008

Premium Rate and Benefit Changes: While historically, rate increases have been implemented to cover projected medical and administrative costs, the increase during fiscal year 2006 and fiscal year 2007 were insufficient to meet the pace of rising cost of medical care and high utilization of the HCG membership, which resulted in net losses in both fiscal year 2006 and fiscal year 2007. Effective September 2007, HCG increased premiums by approximately 18% overall in an effort to bring premiums into balance with its medical utilization. HCG adjusted its premium rates, as depicted in the following table for September 2007, to fund the projected medical and administrative costs associated with operations. The table below shows the weighted average premium increase in September 2007 for the different group sizes.

HMO - September 2007			
Groups of 1	**Groups of 1**	**Groups of 2-50**	**Groups of 2-50**
New	Renew	New	Renew
12.9%	31.7%	8.4%	16.9%

PPOS - September 2007			
Groups of 1	**Groups of 1**	**Groups of 2-50**	**Groups of 2-50**
New	Renew	New	Renew
24.0%	24.6%	24.0%	22.7%

To establish efficiency through consistency, HCG implemented the annual premium increase to all employer groups on the same date. The September 2007 premium increase that became effective for all employer groups varied based on group size, health plan, and community location (rural vs. urban). HCG also maintains its ability to adjust rates mid year if need, with a 60-day notice to employer groups.

Eliminated Zero Deductible Plans: The zero dollar deductible plans were eliminated and approximately 4,490 members either self-terminated their coverage or were transitioned into a minimum $500 deductible plan as of January 1, 2007, thereby requiring a higher cost sharing.

Focus on Wellness Care: To ensure HCG members continued to stay healthy and receive quality, wellness-focused care, HCG implemented changes to the benefit plans eliminating the requirement to meet their deductible for wellness care. Members pay only a co-payment for preventive/wellness visits, primary care physician visits, urgent care, and basic lab and x-ray services.

Groups of 'One' Guaranteed Issue: HCG has been the only healthcare coverage option in the state of Arizona that is guaranteed issue for groups of one, resulting in a higher medical risk profile compared to other small business health care coverage available within the State. At June 30, 2008, groups of one totaled 5,596 groups. To address their increased cost of care, employer groups with only 'one' employee were further community rated as a separate group – adjusting their premiums to cover a higher cost of care.

Higher Medical Costs: Hospital participation in the HCG program is not mandatory. Although HCG does not provide routine coverage at out-of-network facilities, costs for services at non-participating hospitals rose faster than projected mostly related to care received as a result of an emergency room visit at a non-contracted facility. The coinsurance applied to out-of-network facilities was increased by 20.0 percent to cover this added cost. The PPO product was also transitioned to a Preferred Point of Service (PPOS) tiered network, with the higher cost hospitals placed at a separate tier associated with a higher coinsurance.

Hospital Default Rate: Effective September 19, 2007, Laws 2007, Chapter 263 (HB 2789) placed a default rate for payment of one hundred fourteen percent (114%) of the AHCCCS reimbursement rate if a contract does not exist between a Healthcare Group contractor and a hospital provider. The impact of this was a cost savings of approximately $3.2 million in calendar year 2006 and an estimated cost savings of $2.5 to $3.0 million in calendar years 2007 and 2008.

Higher Utilization of Services: "Bare Period" requirements result in higher medical utilization for new members who have been without continuous coverage; and in turn utilize services upon enrollment at a higher rate than members who had continuous coverage. Although a twelve-month pre-existing policy remains in effect, a benefit dollar maximum of $100,000 was placed on members during their first 12-months of enrollment.

Administrative Costs: In fiscal year 2008 HCG reduced its administrative expense by nearly 36% compared to the year prior, from $8.1 million to $5.2 million, respectively. This was accomplished largely by moving more communications to an electronic format, utilizing a fulfillment vendor for mailings, and eliminating administrative functions being performed at HCG, in duplicate, within the HMO's operations. Also, significant reductions in the usage of consultants and contracted/temporary labor, and elimination of some FTE positions helped reduce personnel costs by over 50%. Health plan contracts were also amended to decrease the relative amount of their administrative payments, thus reducing reconciliation costs.

Change in fiscal year 2009- PPOS availability: Effective October 2008, Laws 2008, Chapter 288 (HB 2275) restricts the PPOS program to counties with a population of less than 500,000; thus eliminating the PPOS option in Maricopa and Pima Counties. Data has demonstrated that activity in these two counties accounted for substantially higher medical costs on average per person than that of other counties. To the extent that the PPOS costs were more than premiums collected, funds had to be reallocated in order to pay these medical claims. It is projected in fiscal year 2009 the PPOS program in the remaining rural counties will operate on a break even basis with medical costs equaling the medical premiums received, resulting in a medical loss ratio reduction of approximately 35.0 percent in fiscal year 2009 compared to fiscal year 2008.

Enrollment

In fiscal year 2008 HCG was required to adhere to a temporary enrollment freeze. Chapter 263 placed a temporary enrollment limit and an enrollment freeze on HCG effective September 19, 2007, not allowing the enrollment of any additional employer groups. The freeze ended on July 31, 2008, allowing HCG to resume enrollment of new groups as of August 1, 2008. Although the freeze was lifted July 31, 2008, Chapter 288 placed additional limitations on enrollment by prohibiting enrollment of any new business groups with only 'one' employee.

The group enrollment table below demonstrates the decrease in enrollment experienced in fiscal year 2008.

Group Size as of June	2007	2008	Pct of Total (2008)	Change	Percent Change	% of Total Change
1	6,888	5,596	**72%**	-1,292	-19%	**79%**
2	1,327	1,207	**15%**	-120	-9%	**7%**
3-10	1,130	921	**12%**	-209	-18%	**13%**
11+	69	47	**1%**	-22	-32%	**1%**
Total	**9,414**	**7,771**	**100%**	**-1,643**	-17%	**100%**

By the end of fiscal year 2008 HCG's group enrollment declined approximately 17% from the year prior, yet due to the rate increase in September 2007, premium revenues declined by only 13.6%. Average total revenue per member per month in August 2007 was $244, while the same amount in September 2007 was $273. This per member per month revenue increase was essential to keep HCG from experiencing a net loss for the year. In fiscal year 2009 average per member per month revenue is projected to be over $310.

HCG Subsidy and Reconciliation Liability

HCG reconciles the medical costs experienced by the Plans above a contractual target medical loss ratio (stop loss target) that is based on the capitation paid annually to each plan. This stop loss payment is made for the difference in medical losses above the target medical loss ratio. If medical costs exceed capitation, HCG pays the plans from the reconciliation reserves available. At June 30, 2008 the reconciliation liability is $19.2 million. The following table summarizes reconciliation liability activity for fiscal year 2008:

Healthcare Group Reconciliation Liability as of June 30, 2008
Fiscal Year 2008 Activity
(in thousands of dollars)

	Reconciliation Period			
	FY 06	FY 07	FY 08	Total
Balance June 30, 2007	$ 5,051	$ 17,458	$ -	$ 22,509
Payments made	(5,156)	(2,354)	-	(7,510)
Accruals and adjustments	105	(227)	4,324	4,202
Balance June 30, 2008	$ -	$ 14,877	$ 4,324	$ 19,201

The reconciliation liability will be paid by allocating 2% of medical premium revenues for a reconciliation reserve, from residual earnings, and from future State subsidies. Reconciliation payment terms differ by each plan, such as, accruing 1% per month or repayment within 60 days of final reconciliation.

Even though deficit reduction measures resulted in a net gain for fiscal year 2008, a fiscal year 2008 General Fund subsidy of $7.25 million was required to pay down a portion of the prior fiscal years reconciliation liabilities. Additionally, a $5.0 million General Fund subsidy was approved by the Legislature for fiscal year 2009. However, there can be no assurance that future subsidies will be provided to continue to fund prior year losses.

In conclusion, in fiscal year 2008 HCG experienced a significant financial and operational turnaround compared with the prior two fiscal years results. HCG has been successful in managing both program and administrative costs through a series of cuts, changes and realignments, and ultimately has more effectively matched revenues with expenses via premium adjustments. For fiscal year 2009 management believes that HCG will continue to operate without incurring additional losses. Further, it is projected that HCG will not incur any additional reconciliation liability in fiscal year 2009.

Going Concern Matters

As previously discussed, through a series of deficit reduction actions HCG was able to generate a net gain in fiscal year 2008 and reduce its net deficit position by $7.9 million from the year prior. Even though HCG's performance in fiscal year 2008 was positive compared with the previous two years and management currently projects that the positive trend will continue, $15.8 million remained as a net deficit at year end due to the outstanding reconciliation liability owed to the HMO's for the previous two fiscal years. It is not anticipated in the foreseeable future that operations will generate sufficient cash flow to significantly pay down the remaining prior deficit.

If a General Fund subsidy is not provided in fiscal year 2010 or if the fiscal year 2009 General Fund subsidy is reduced due to the state's General Fund deficit or the current favorable medical loss trend does not continue, each health plan contractor will have to make its own decision as to whether their organization is willing to carry the medical loss liability from the HCG line of business until or if premiums are adequate to recover their prior year losses. Should the health plans elect to call the prior year reconciliation liabilities before HCG has sufficient funds to provide such payments and new terms are not negotiated, or the Legislature does not provide HCG with additional subsidies, it raises substantial doubt about HCG's ability to remain as a going concern. However, until the aforementioned events present themselves, HCG plans to continue operations. Accordingly, the accompanying financial statements have been prepared assuming that HCG will continue as a going concern.

Financial Analysis of AHCCCS' Governmental Funds

Governmental Funds

At the end of fiscal year 2008, AHCCCS' governmental funds reported combined ending fund balances totaling $1.840 million, a decrease of $3.083 million from the prior year balance.

The General Fund is the chief operating fund of the AHCCCS Acute Care, KidsCare, KidsCare Parents, Breast & Cervical Cancer, Freedom-to-Work, TMC and Long-Term Care 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 and certified public expenditure methodologies to provide the required state matching funds for federal Title XIX and Title XXI revenue.

The Other Governmental Funds consist of eight individual funds that have a combined total fund balance of $1.840 million available to meet future year obligations. The Other Governmental Fund's fiscal year 2008 fund balance, 100 percent of the governmental fund's unrestricted fund balance, is primarily comprised of the balance in the Hawaii Arizona PMMIS Alliance Fund. Monies in this fund are only available for certain expenditures. A total of $1.7 million is available for administrative expenditures for information technology activities. Revenue from taxes on cigarettes and other related tobacco products declined 13 percent over fiscal year 2007 and generated $118 million for the current year compared to $135 million in fiscal year 2007. Total tobacco tax collections account for 73.1 percent of the total Other Governmental Funds revenues compared to 77.1 percent of the total Other Governmental Funds revenues in fiscal year 2007.

General Fund Budgetary Highlights

Differences totaling $56.6 million occurred between the original and the final amended administrative and programmatic expenditure budgets. A net $56.6 million supplemental appropriation was provided for the AHCCCS program in fiscal year 2008 that included a $7.2 million reduction to administrative line items. All other differences relate to special line item adjustments that utilized surpluses from a 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 revisions and supplemental increases can be briefly summarized as follows:

- $29.5 million increase to Acute Base Special Line Items
- $55.0 million increase to Acute Proposition 204 Special Line Items
- $7.3 million decrease to Acute Hospital and other Special Line Items
- $16.5 million decrease to SCHIP and SCHIP Parents services
- $4.2 million decrease to Administration

At June 30, 2008, actual cash basis appropriated expenditures were $177.1 million less than budgetary estimates, thus providing carry-forward balances that are available to be used for administrative adjustments as authorized by State statute.

Capital Asset Administration

AHCCCS' investment in capital assets for its governmental and business-type activities as of June 30, 2008 amount to $2.263 million, net of accumulated depreciation. This investment in capital assets includes furniture, vehicles and equipment. Land, buildings and improvements are under the management of the State and are accounted for on the State's comprehensive annual financial report. Purchases include the normal planned retirement and replacement of automated systems equipment. The total decrease in AHCCCS' investment in capital assets for the current fiscal year was 16.7 percent or $453,000 and is primarily attributable a reduction of the motor pool fleet from 112 to 67 vehicles along with normal depreciation and retirement of information technology equipment.

AHCCCS Capital Assets
(net of depreciation, in thousands of dollars)

	Governmental Activities		Business-Type Activities		Total	
	2008	2007	2008	2007	2008	2007
Vehicles	$ 725	$ 945	$ 23	$ 31	$ 748	$ 976
Furniture and equipment	1,435	1,642	80	98	1,515	1,740
Total net assets	$ 2,160	$ 2,587	$ 103	$ 129	$ 2,263	$ 2,716

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

Long-Term Contingent Liability

In January 2001, AHCCCS obtained a Section 1115 Waiver ("Waiver") from CMS to receive federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204. The original Waiver period (April 1, 2001 through September 30, 2006) has been extended to September 30, 2011 and requires that the population covered by the Waiver be budget neutral for CMS over the term of the agreement. Budget neutral means that CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions (STC) include a monitoring arrangement that requires AHCCCS to report the demonstration year's financial results on a quarterly basis. It also established a diminishing annual threshold of the amount that AHCCCS is able to exceed the calculated cumulative Budget Neutrality limit on an interim basis before being required to submit a corrective action plan. The STC reporting limit thresholds are monitored on a Federal Fiscal Year basis. The STC limit threshold for the first seven limit periods (April 1, 2001 through September 30, 2008) is .75 percent. The threshold declines by 0.25 percent for limit periods eight and nine and is zero percent for the limit period ended September 30, 2011. As of June 30, 2008, reported date of service expenditures associated with the six periods ended September 30, 2007 are below the limit by $164.5 million, or 0.94 percent. Through June 30, 2008, AHCCCS remains under the cumulative reporting limit threshold. 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. Given the uncertainty surrounding these factors, AHCCCS is not presently able to determine if the budget neutrality limit will be exceeded or if it is exceeded that CMS will require repayment of the excess. Management believes that as of June 30, 2008, AHCCCS does not have any liability to CMS related to the budget neutrality agreement. Accordingly, the accompanying basic financial statements have not been adjusted for the impact of any liability AHCCCS may have related to the Waiver budget neutrality agreement.

Economic Factors and Next Year's Budgets and Rates

The AHCCCS program experienced considerable enrollment growth in fiscal year 2008 following a period of modest growth in the prior fiscal year. Fiscal year 2006 remains as the only year of declining enrollment out of the previous six fiscal years. Enrollment for all government-wide programs grew at a rate of 5.1 percent during fiscal year 2008. The overall change was primarily due to growth in the Title XIX Waiver Group (TWG) childless adults (17 percent), Title XIX families and children (9 percent) and long term care (5 percent) program populations. That growth was partially offset by a 28 percent decrease in the Title XXI KidsCare Parent population. AHCCCS expects enrollment to grow in all of the major populations through fiscal year 2009 except for the childless adults group due to a legislative change in the frequency of eligibility re-determinations from a 12 month to a 6 month period. Arizona continues to experience a statewide economic downturn that began in the previous fiscal year resulting in higher unemployment primarily in the construction industry due to the housing market decline. Forecasters with the W.P. Carey School of Business at Arizona State University believe that it is unlikely that Arizona's economy will improve much for at least another year. The growth rates built into the population forecasts reflect this assumption that populations will continue to be impacted by the slowdown in the economy, with some reduction in growth occurring as the economy begins to recover in 2010.

AHCCCS awarded new managed care contracts to provide Medicaid services across the state for the acute care program for contract year ending September 2009. The awards were made on a competitive bid basis and a total of 58 bids from 12 health plans were received and reviewed. A total of 20 awards were made across 7 geographic service areas. Long-Term Care contracts were renewed as awards are on a separate cycle and were made in a prior fiscal year. AHCCCS sets capitation rates within actuarially sound risk bands as required by the Federal Balanced Budget Act of 1997. The contract year 2009 resulted in an Acute Care weighted average rate increase of 8.7 percent and a Long-Term Care weighted average increase of 2.5 percent, resulting in an overall weighted average rate increase of 7.3 percent. The contract year 2009 overall weighted average increase compares unfavorably to the contract year 2008 6.7 percent (6.9 percent for Acute Care, 3.7 percent for Long-Term Care) capitation rate increase. The fiscal year 2010 budget includes estimated increases in contract year 2010 for Acute Care of 6.0% (7.0% for TWG) and Long-Term Care of 6.0%.

AHCCCS' budget request for fiscal year 2010 submitted to the Governor in September 2008 includes a rebase of the fiscal year 2009 budget. The revised projection indicates a potential fiscal year 2009 Acute Care shortfall of $183.3 million. This shortfall can be partially mitigated by applying $44.9 million of unused fiscal year 2008 appropriation authority to claims paid in fiscal year 2009 with dates of service prior to July 1, 2008. Other factors that may influence the need for or amount of a supplemental appropriation include enrollment trends greater than projected and tobacco revenue collections lower than projected. Management is closely monitoring these trends and the adequacy of fiscal year appropriations.

Request for Information

This financial report is designed to provide a general overview of AHCCCS' finances for the State's citizens and taxpayers, and AHCCCS' 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

INDEPENDENT AUDITORS' REPORT

To the Director of the

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

We have audited the accompanying financial statements of the governmental activities, the business-type activities and the aggregate remaining fund information of AHCCCS at and for the year ended June 30, 2008, as shown on pages 19 through 27. These financial statements are the responsibility of AHCCCS' management. Our responsibility is to express opinions on these financial statements based on our audit.

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

As discussed in Note 1, the financial statements of AHCCCS are intended to present the financial position, the changes in financial position and cash flows, where applicable, of only that portion of the governmental activities, the business-type activities and the aggregate remaining fund information of the state of Arizona that are attributable to the transactions of AHCCCS. They do not purport to, and do not, present fairly the financial position of the state of Arizona at June 30, 2008, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with U.S. generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities and the aggregate remaining fund information of AHCCCS at June 30, 2008, and the respective changes in financial position and cash flows, where applicable, thereof and the respective budgetary comparison for the general fund for the year then ended in conformity with U.S. generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that Healthcare Group, AHCCCS' business-type activity will continue as a going concern. As discussed in Note 6 to the financial statements, Healthcare Group's significant operating losses in the past years and significant net deficit raise substantial doubt about its ability to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification of asset carrying amounts or the amount and classification of liabilities that might result should Healthcare Group be unable to continue as a going concern.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 8, 2008 on our consideration of AHCCCS' internal control over financial reporting and on our tests of its compliance with certain provision of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The accompanying management's discussion and analysis on pages 1 through 16 and the budgetary comparison information on page 24 are not a required part of the basic financial statements but are supplementary information required by U.S. generally accepted auditing standards and the Governmental Accounting Standards Board (GASB). We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise AHCCCS' basic financial statements. The accompanying Schedule of Expenditures of Federal Awards is presented for purposes of additional analysis as required by the U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. This schedule has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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

Mayer Hoffman McCann P.C.

Phoenix, Arizona
December 8, 2008

BASIC FINANCIAL STATEMENTS

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET ASSETS (DEFICIT)

June 30, 2008
(amounts expressed in thousands)

ASSETS	Governmental Activities	Business-type Activities	Total
CURRENT ASSETS			
Cash	$ 83,752	$ 14,169	$ 97,921
Restricted cash	13,124	-	13,124
Due from state and county governments	120,824	-	120,824
Due from the federal government	493,417	-	493,417
Tobacco settlement receivable	57,002	-	57,002
Receivables and other	161	21	182
TOTAL CURRENT ASSETS	768,280	14,190	782,470
NONCURRENT ASSETS			
Hospital residency program loans	900	-	900
Furniture, vehicles and equipment, net of accumulated depreciation	2,160	103	2,263
TOTAL NONCURRENT ASSETS	3,060	103	3,163
TOTAL ASSETS	771,340	14,293	785,633
LIABILITIES			
CURRENT LIABILITIES			
Accounts payable	3,488	329	3,817
Other accrued liabilities	3,866	113	3,979
Bank overdraft	655	-	655
Deferred revenue	22,686	8,047	30,733
Due to federal, state and county governments	37,713	-	37,713
Accrued programmatic costs	693,985	6,594	700,579
Compensated absences	3,620	130	3,750
TOTAL CURRENT LIABILITIES	766,013	15,213	781,226
ACCRUED PROGRAMMATIC COSTS, less current portion	-	14,877	14,877
TOTAL LIABILITIES	766,013	30,090	796,103
COMMITMENTS AND CONTINGENCIES			
NET ASSETS (DEFICIT)			
INVESTED IN CAPITAL ASSETS	2,160	103	2,263
UNRESTRICTED (DEFICIT)	3,167	(15,900)	(12,733)
TOTAL NET ASSETS (DEFICIT)	$ 5,327	$ (15,797)	$ (10,470)

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF ACTIVITIES

Year Ended June 30, 2008
(amounts expressed in thousands)

	Program Expenses	Program Revenues: Charges for Services	Program Revenues: Federal Operating Grants	Program Revenues: Other Operating Grants and Contributions	Net (Expense) Revenue and Changes in Net Assets: Governmental Activities	Net (Expense) Revenue and Changes in Net Assets: Business-type Activities	Total
PROGRAMS							
Government activities:							
Health care programs	$ 7,788,853	$ 13,666	$ 5,209,662	$ 486,708	$ (2,078,817)	$ -	$ (2,078,817)
Business-type activities:							
Healthcare Group	76,825	77,042	10	-	-	227	227
TOTAL PROGRAMS	$ 7,865,678	$ 90,708	$ 5,209,672	$ 486,708	(2,078,817)	227	(2,078,590)
General revenues:							
State appropriations					1,946,433	-	1,946,433
Tobacco tax					168,786	-	168,786
Unrestricted investment earnings					1,639	443	2,082
					2,116,858	443	2,117,301
Transfers:							
Transfers in					-	7,250	7,250
Transfers out					(40,394)	-	(40,394)
Total general revenues and transfers					2,076,464	7,693	2,084,157
CHANGE IN NET ASSETS (DEFICIT)					(2,353)	7,920	5,567
NET ASSETS, BEGINNING OF YEAR					7,680	(23,717)	(16,037)
NET ASSETS (DEFICIT), END OF YEAR					$ 5,327	$ (15,797)	$ (10,470)

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BALANCE SHEET - GOVERNMENTAL FUNDS

June 30, 2008
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
ASSETS			
Cash	$ 72,083	$ 11,669	$ 83,752
Restricted cash	11,936	1,188	13,124
Due from state and county governments	76,897	13,565	90,462
Due from the federal government	248,880	-	248,880
Due from other funds	10,409	-	10,409
Receivables and other	142	19	161
TOTAL ASSETS	$ 420,347	$ 26,441	$ 446,788
LIABILITIES			
Accounts payable	$ 3,425	$ 63	$ 3,488
Other accrued liabilities	3,688	178	3,866
Bank overdraft	655	-	655
Deferred revenue	21,877	809	22,686
Due to federal, state and county governments	37,398	315	37,713
Due to other funds	-	10,409	10,409
Accrued programmatic costs	353,304	12,827	366,131
TOTAL LIABILITIES	420,347	24,601	444,948
COMMITMENTS AND CONTINGENCIES			
FUND BALANCES			
Unreserved	-	1,840	1,840
TOTAL FUND BALANCES	-	1,840	1,840
TOTAL LIABILITIES AND FUND BALANCES	$ 420,347	$ 26,441	

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

Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds.	2,160
Governmental funds report capital outlays as expenditures. However, in the statement of activities the cost of these assets is allocated over their estimated useful lives and reported as depreciation expense. This is the amount by which depreciation $1,526 exceeded capital outlays ($1,099) in the current fiscal year.	427
Long-term receivable for the hospital residency loan program is not due and receivable in the current fiscal year and, therefore is not reported in the funds	900
Long-term liabilities for accrued paid time off are not due and payable in the current fiscal year and, therefore, are not reported in the funds.	(3,620)
Long-term receivables, offsetting the above accrued paid time off liability, which are not receivable in the current fiscal year and, therefore, are not reported in the funds.	3,620
Long-term accrued liabilities for programmatic costs are not due and payable from current financial resources and, therefore are not reported in the funds.	(327,854)
Long-term receivables, offsetting the above accrued programmatic liability, which is not due and receivable in the current fiscal year and, therefore, are not reported in the funds.	327,854
NET ASSETS OF GOVERNMENTAL ACTIVITIES	$ 5,327

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCES - GOVERNMENTAL FUNDS

Year Ended June 30, 2008
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
REVENUES			
State government:			
Appropriations	$ 1,327,063	$ -	$ 1,327,063
Pass through funds	629,894	-	629,894
Federal government:			
Acute care	3,219,908	10,200	3,230,108
Long-term care	744,219	-	744,219
Pass through funds	1,237,733	122	1,237,855
County government:			
Acute care	59,879	-	59,879
Long-term care	255,826	-	255,826
Pass through funds	3,610	-	3,610
Tobacco litigation settlement revenue	115,587	-	115,587
Tobacco tax revenue	51,174	117,612	168,786
Gaming revenue	-	23,434	23,434
Intergovernmental agreement revenue	-	8,564	8,564
Premium revenue	13,666	-	13,666
Other	9,421	1,027	10,448
TOTAL REVENUES	7,667,980	160,959	7,828,939
PROGRAMMATIC EXPENDITURES			
Capitation:			
Acute care	3,219,428	79,269	3,298,697
Long-term care	1,752,644	-	1,752,644
Children's rehabilitative services	74,292	-	74,292
Mental health services	941,923	-	941,923
Fee-for-service:			
Acute care	718,905	-	718,905
Long-term care	108,425	-	108,425
Trauma center services	-	23,573	23,573
Disproportionate share	102,540	-	102,540
Graduate medical education	66,844	-	66,844
Reinsurance	262,234	-	262,234
Medicare:			
Acute care premiums	111,334	9,626	120,960
Long-term care premiums	31,660	-	31,660
Part D clawback payments	57,942	-	57,942
Part D drug co-pay	3,733	-	3,733
Payments to counties	4,826	-	4,826
TOTAL PROGRAMMATIC EXPENDITURES	7,456,730	112,468	7,569,198
ADMINISTRATIVE EXPENDITURES	196,035	20,297	216,332
ADMINISTRATIVE EXPENDITURES PASSED THROUGH	5,076	122	5,198
TOTAL EXPENDITURES	7,657,841	132,887	7,790,728
EXCESS OF REVENUES OVER EXPENDITURES	10,139	28,072	38,211
OTHER FINANCING SOURCES (USES)			
Transfers out:			
To State General Fund	(1,566)	-	(1,566)
To AHCCCS General Fund	-	(100)	(100)
To Healthcare Group	(7,250)	-	(7,250)
To Arizona Government Information Technology Agency	(312)	-	(312)
To Arizona Department of Emergency and Military Affairs	(56)	-	(56)
To Arizona Department of Economic Security	(2,683)	-	(2,683)
To Arizona Department of Health Services	-	(28,443)	(28,443)
To Arizona Department of Health Services Health Crisis Fund	-	(84)	(84)
Transfers in:			
From AHCCCS Other Funds	100	-	100
Hospital residency loan program	-	(900)	(900)
TOTAL OTHER FINANCING SOURCES (USES)	(11,767)	(29,527)	(41,294)
NET CHANGE IN FUND BALANCES	(1,628)	(1,455)	(3,083)
FUND BALANCES, BEGINNING OF YEAR	1,628	3,295	4,923
FUND BALANCES, END OF YEAR	$ -	$ 1,840	$ 1,840

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

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

Year Ended June 30, 2008
(amounts expressed in thousands)

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

Net change in fund balance - total governmental funds (page 22)	$	(3,083)
The Hospital Residency Loan Program receivable consumes current financial resources of governmental funds while the repayment of the loan provides current financial resources of governmental funds This amount is the use of current financial resources in the current year.		900
Governmental funds report capital outlays as expenditures. However, in the statement of activities the cost of those assets is allocated over their estimated useful lives and reported as depreciation expense. Due to its pass through nature, AHCCCS accrues revenue sufficient to eliminate its deficit fund balance and, therefore, this is the amount by which depreciation exceeded capital outlays in the prior period.		(170)
Change in net assets of governmental activities (page 20)	$	(2,353)

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BUDGETARY COMPARISON SCHEDULE - GENERAL FUND

Year Ended June 30, 2008
(Unaudited)
(amounts expressed in thousands)

	Original Appropriation (Budget)	Final Appropriation (Budget)	Actual	Variance with Final Budget
REVENUES				
State appropriations	$ -	$ -	$ 1,296,570	$ -
State pass-through funds	-	-	689,142	-
Federal government	-	-	3,867,745	-
Federal pass-through funds	-	-	1,214,404	-
County government	-	-	324,038	-
County pass-through funds	-	-	3,581	-
Tobacco tax revenue	-	-	50,783	-
Tobacco litigation settlement	-	-	115,587	-
Other	-	-	14,055	-
Total revenues	-	-	7,575,905	-
OTHER FINANCING SOURCES				
Operating transfers in	-	-	8,384	-
TOTAL REVENUES AND OTHER FINANCING SOURCES	-	-	7,584,289	-
PROGRAMMATIC EXPENDITURES				
Acute capitation	1,830,964	1,921,543	1,915,353	6,190
Reinsurance	108,133	109,550	95,962	13,588
Acute fee-for-service	497,367	434,866	432,294	2,572
Proposition 204 capitation	968,755	1,098,248	1,087,291	10,957
Proposition 204 reinsurance	109,441	42,441	38,454	3,987
Proposition 204 fee-for-service	175,537	168,067	163,980	4,087
Proposition 204 Medicare premiums	18,907	19,377	19,277	100
Medicare premiums	91,929	91,978	91,754	224
SOBRA Pregnant Woman	5,337	-	-	-
Graduate medical education	44,157	42,657	-	42,657
Disproportionate share	30,350	30,350	4,202	26,148
Hospital loan residency program	1,000	-	-	-
Rural hospital reimbursement	12,158	12,158	12,158	-
Breast and cervical cancer	2,131	1,051	984	67
Critical access hospitals	1,700	1,700	1,699	1
Freedom to work	8,044	6,174	6,155	19
Part D copay subsidy	1,030	2,640	2,602	38
Part D clawback payments	27,022	26,735	26,735	-
SSDI temporary medical coverage	10,326	11,552	9,922	1,630
County hold harmless	4,826	4,826	-	4,826
Long-term care	1,099,330	1,099,330	1,041,976	57,354
ALTCS clawback	20,429	20,429	19,225	1,204
LTC Part D copay subsidy	470	949	870	79
LTC board of nursing	210	210	210	-
CHIP - Services	125,685	119,112	119,074	38
CHIP - Parents	50,296	40,401	39,069	1,332
TOTAL PROGRAMMATIC EXPENDITURES	5,245,534	5,306,344	5,129,246	177,098
ADMINISTRATIVE EXPENDITURES	201,564	198,119	187,733	10,386
OPERATING TRANSFERS OUT	8,000	7,250	7,250	-
TOTAL APPROPRIATED EXPENDITURES	5,455,098	5,511,713	5,324,229	187,484
PRIOR YEAR APPROPRIATED EXPENDITURES	-	-	230,662	-
NON-APPROPRIATED EXPENDITURES	-	-	2,006,336	-
REVENUES AND OTHER FINANCING SOURCES OVER (UNDER) EXPENDITURES	-	-	23,062	-
FUND BALANCES, BEGINNING OF YEAR	-	-	57,311	-
FUND BALANCES, END OF YEAR	$ -	$ -	$ 80,373	$ -

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET ASSETS (DEFICIT) - PROPRIETARY FUND

June 30, 2008
(amounts expressed in thousands)

ASSETS		
CURRENT ASSETS		
Cash	$	14,169
Receivables and other		21
TOTAL CURRENT ASSETS		14,190
CAPITAL ASSETS		
Furniture, vehicles and equipment, net of accumulated depreciation		103
TOTAL ASSETS	$	14,293
LIABILITIES		
CURRENT LIABILITIES		
Accounts payable	$	329
Other accrued liabilities		113
Deferred revenue - premiums		8,047
Accrued programmatic costs		6,594
Compensated absences due within one year		130
TOTAL CURRENT LIABILITIES		15,213
ACCRUED PROGRAMMATIC COST, less current portion above		14,877
TOTAL LIABILITIES	$	30,090
COMMITMENTS AND CONTINGENCIES		
NET ASSETS (DEFICIT)		
INVESTED IN CAPITAL ASSETS	$	103
UNRESTRICTED (DEFICIT)		(15,900)
TOTAL NET ASSETS (DEFICIT)	$	(15,797)

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

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

Year Ended June 30, 2008
(amounts expressed in thousands)

OPERATING REVENUES	
Premium revenue	$ 77,042
OPERATING EXPENSES	
Premiums paid to health plans	55,468
Reinsurance	5,138
Other programmatic	11,033
Salaries and employee benefits	2,908
Professional and outside services	1,258
Other	953
Depreciation	67
TOTAL OPERATING EXPENSES	76,825
OPERATING INCOME	217
NONOPERATING REVENUE	
Investment income	443
Grant revenue	10
TOTAL NONOPERATING REVENUE	453
INCOME BEFORE TRANSFERS	670
TRANSFERS IN	
From General Fund	7,250
CHANGE IN NET ASSETS	7,920
NET ASSETS (DEFICIT), BEGINNING OF YEAR	(23,717)
NET ASSETS (DEFICIT), END OF YEAR	$ (15,797)

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF CASH FLOWS - PROPRIETARY FUND

Year Ended June 30, 2008
(amounts expressed in thousands)

CASH FLOWS FROM OPERATING ACTIVITIES	
Receipts from customers	$ 75,034
Payments to health plans	(64,067)
Payments to providers	(11,357)
Payments to employees	(2,888)
Payments to suppliers	(2,759)
Net cash used in operating activities	(6,037)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
Operating subsidies from other funds	7,250
Grant revenue	10
Net cash provided by non-capital financing activities	7,260
CASH FLOWS FROM INVESTING ACTIVITIES	
Payments to purchase property and equipment	(41)
Investment income	444
Net cash provided by investing activities	403
NET CHANGE IN CASH	1,626
CASH, BEGINNING OF YEAR	12,543
CASH, END OF YEAR	$ 14,169
RECONCILIATION OF OPERATING INCOME TO NET CASH USED IN OPERATING ACTIVITIES	
Operating income	$ 217
Adjustment to reconcile operating income to net cash provided by operating activities:	
Depreciation	67
Changes in operating net assets and liabilities:	
Decrease in prepaid rent	3
Decrease in accounts payable and other accrued liabilities	(554)
Decrease in deferred revenue - premiums	(2,006)
Decrease in accrued programmatic costs	(3,785)
Increase in accrued compensated absences	21
NET CASH USED IN OPERATING ACTIVITIES	$ (6,037)

See Notes to Financial Statements

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

A. Reporting entity

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

The Arizona Legislature (“Legislature”) established AHCCCS in November 1981 to administer health care for the State’s indigent population. AHCCCS is a State agency managed by an independent cabinet level administration created by the Legislature and is funded by a combination of federal, State and county 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, 2011. 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 State’s Title XIX Medicaid program and Title XXI State Children’s Health Insurance Program (“SCHIP”). State appropriations and county funding levels are based on annual budgets as dictated by the Legislature and specified by Arizona Statutory funding formula and Session Law.

AHCCCS provides acute and long-term health care coverage to eligible residents of Arizona. Eligible residents include those who qualify under Section 1931(b) of the Social Security Act, individuals who are aged, blind or disabled, children who meet certain age requirements from families receiving food stamps, children and pregnant women whose household income meets eligibility requirements, certain single adults, childless couples, parents of SCHIP and Medicaid children under the Health Insurance Flexibility and Accountability Demonstration initiative, uninsured women needing active treatment for breast and/or cervical cancer, individuals with disabilities who want to work and who meet certain SSI eligibility criteria and disabled individuals who receive Social Security Disability Income (“SSDI”) payments, are not eligible for Medicare, and are no longer eligible for other AHCCCS programs.

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

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

B. Basis of presentation

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

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

(1) Summary of significant accounting policies (continued)

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

Fund financial statements provide information about the Agency's funds. Separate financial statements are provided for the governmental and proprietary funds. The General Fund is the Agency's primary operating fund, and it accounts for all financial resources except those required to be accounted for in another fund. AHCCCS has one business-type activity, Healthcare Group. In fiscal year 2008, AHCCCS did not have any major funds; accordingly, all governmental funds other than the General Fund are aggregated and reported as other governmental funds.

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

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

Proprietary funds distinguish between operating revenues and expenses from non-operating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. The principal operating revenues of the Healthcare Group are premiums charged to small, uninsured businesses with 1 to 50 employees and employees of political subdivisions for medical coverage. Operating expenses for the Healthcare Group include the costs of medical services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

Proprietary fund revenues are recognized when they are earned, and expenses are recognized when they are incurred. Member premiums are due by the first day of the month preceding the month of coverage. At June 30, 2008, the proprietary fund deferred revenue of $8,047 consists of premium payments received for fiscal year 2009 as required by contract.

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

(1) Summary of significant accounting policies (continued)

In fiscal year 2008, 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 1 to 50 employees and employees of political subdivisions.

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

D. Cash and investments

Substantially all of the cash and investments maintained by AHCCCS are held by the State of Arizona Office of the Treasurer ("Treasurer") with other State monies. Investment income is allocated to AHCCCS on a pro rata basis. Amounts held by the Treasurer are recorded at fair value and totaled $111,045 at June 30, 2008, including restricted funds of $13,124.

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

Cash in the General Fund has been internally restricted by AHCCCS in the amount of $11,936 for the Inter-Agency 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 SCHIP programs under the terms stated in the ISAs. Cash in the Other Governmental Funds is legally restricted in the amount of $1,188 for the Hawaii Arizona PMMIS Alliance (HAPA) Fund, as described in Note 4 and is offset by an equal amount of accrued expenditures and deferred revenue at June 30, 2008.

(1) Summary of significant accounting policies (continued)

In accordance with the Federal Cash Management Improvement Act guidelines, AHCCCS may only request federal funds under specified funding techniques. These techniques require that AHCCCS draw down or request funds for any check issued 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, 2008, a bank overdraft of $655 existed which represented the excess of checks issued over federal funds deposited.

E. Capitation payments

Contracted health plans 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 from AHCCCS, the plan absorbs the loss, except for those cases eligible for reinsurance payments or risk sharing reconciliations.

Capitation is paid prospectively as well as for prior period coverage (PPC). The PPC period generally is from the first day of the month of application to the time of enrollment 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 capitation paid during the contract year. The reconciliation limits the contractor's profits and losses to 2%. Accrued programmatic costs include approximately $91,710 at June 30, 2008 that represents estimated settlement payments due to 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 contractor's medical costs to the total capitation payments, hospitalized supplemental payments, delivery supplemental payments and HIV/AIDS supplemental payments paid for the contract year. The reconciliation limits the contractor's profits or losses to 2%. Accrued programmatic costs include approximately $26,436 at June 30, 2008 that represents estimated settlement payments due to contracted health plans for the TWG reconciliation. Actual results may differ from this estimate, and such differences will be recorded in the period in which they are identified.

F. 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 with an acute medical condition. The program includes a deductible, which varies based on the health plan's enrollment and the eligibility category of the members. AHCCCS will adjust the deductible levels based upon enrollment levels and, in some cases; the contracted health plan with a higher deductible level may elect a lower deductible level. 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.

(1) Summary of significant accounting policies (continued)

The reinsurance program also provides reimbursement for covered organ transplantation and catastrophic disorders such as certain high cost behavioral health and blood related disorders. For transplants, payment is limited to 85% of the AHCCCS contract amount for the transplant services rendered or 85% of the health plans' paid amount, whichever is lower. There is no deductible for catastrophic reinsurance cases, and AHCCCS reimburses the health plans at a percentage of the health plans' paid amount, less the coinsurance amount, unless the costs are paid under a subcapitated arrangement. 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.

G. Fee-for-service payments

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

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 and for members enrolled in a health plan for less than 30 days 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.

Medical services provided at an IHS facility or by a tribal-owned facility licensed by IHS are reimbursed at rates determined by the Department of Health and Human Services, Indian Health Services. Off-reservation services are reimbursed based on the AHCCCS fee-for-service rates and the AHCCCS Outpatient Hospital Fee Schedule.

H. Incurred but not reported programmatic expenditures

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

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

(1) Summary of significant accounting policies (continued)

I. Disproportionate share hospital payments

CMS and the Legislature authorized AHCCCS to make disproportionate share payments to Arizona hospitals that provided care to a disproportionate share (as defined) of the State's indigent population. Expenditures for disproportionate share totaled $102,540 for the year ended June 30, 2008. See Note 13.

J. Taxes

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

K. Management's use of estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities, and the reported amounts of revenues and expenditures at June 30, 2008. Actual results may differ from these estimates.

L. 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 extends through federal fiscal year 2011, at which time any federal funds received by the State that exceed the negotiated budget neutrality limit must be returned to CMS. Management believes that as of June 30, 2008, AHCCCS does not have any liability to CMS related to the budget neutrality agreement and, accordingly, no liability is recorded in the accompanying financial statements. See Note 9.

AHCCCS has classified the Arizona Tobacco Litigation Settlement Fund, created by ballot Proposition 204, as part of its General Fund. These funds are restricted for use as specified in the litigation settlement and/or legislation. Annual settlement payments, based on cigarette sales from the preceding calendar year are made in April. In addition, supplemental payments may be received as tobacco companies enter into the tobacco master settlement agreement. AHCCCS received an annual payment of $91,343 and a strategic contribution fund payment of $24,244 in April 2008 for the period from January 1, 2007 to December 31, 2007. Revenue and a related receivable of $57,002 was accrued for the period of January 1, 2008 through June 30, 2008 and is included in Tobacco Settlement Receivable and Other Operating Grants and Contributions in the accompanying Statement of Net Assets and Statement of Activities.

(dollar amounts expressed in thousands)

(2) Capital assets

Capital assets, which consist of furniture, vehicles and equipment, are reported in the governmental and business-type activity columns in the government-wide statement of net assets. 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. The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend assets lives are not capitalized. Net asset balances and current fiscal year activity are as follows:

Balance, June 30, 2007	$	2,716
Additions		1,140
Retirements		(20)
Depreciation		(1,573)
Balance, June 30, 2008	$	2,263

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, 2008, management does not believe impairment indicators are present, and there were no idle capital assets.

(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, 2007	$	3,502
Additions		6,103
Reductions		(5,855)
Balance, June 30, 2008	$	3,750

(dollar amounts expressed in thousands)

(4) Other governmental funds

At June 30, 2008, the other governmental fund balance of $2,740 was comprised of the following funds:

- Tobacco Tax and Health Care Fund, Medically Needy Account (TTHCF-MNA) - The Arizona Department of Revenue allocates funding to the TTHCF-MNA which provides funding for services provided through the Title XIX Medicaid and other legislatively authorized health related services or programs. Revenue sources for the TTHCF-MNA include tobacco tax proceeds and investment income.

- Tobacco Products Tax Fund, Emergency Health Services Account (TPTF-EHSA) - The Arizona Department of Revenue allocates the tobacco tax revenue to the TPTF-EHSA which is used solely for the reimbursement of uncompensated care, primary care services and trauma centers readiness costs. Revenue sources for the TPTF-EHSA include tobacco tax proceeds and investment income.

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

- 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.

- 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 is established consisting of legislative appropriations and loan repayment monies for the establishment of a hospital loan program to fund start-up and ongoing costs for residency programs in accredited hospitals. The hospital loans are interest-free and are due and will become available in future periods when certain criteria are met triggering repayment or beginning in fiscal year 2013 with five annual installments after the execution date whichever is earlier.

Other governmental funds earned, expended and transferred during the fiscal year ended June 30, 2008 were as follows:

	TTHCF - MNA	TPTF - EHSA	Third Party Liability Fund	Trauma and Emergency Services Fund	Miscel-laneous Funds	Total
Fund balances, June 30, 2007	$ -	$ -	$ -	$ -	$ 3,295	$ 3,295
Receipts	93,228	24,384	970	23,434	18,731	160,747
Interest earned	1	8	22	140	41	212
Expenditures	(64,702)	(24,392)	(992)	(23,574)	(20,127)	(133,787)
Transfers in (out):						
AHCCCS General Fund	-	-	-	-	(100)	(100)
Arizona Dept of Health Services	(28,443)	-	-	-	-	(28,443)
ADHS Health Crisis Fund	(84)	-	-	-	-	(84)
Fund balances, June 30, 2008	$ -	$ -	$ -	$ -	$ 1,840	$ 1,840

(5) Proprietary fund - operations

Healthcare Group was established in 1988 by the State to administer health care services primarily to small, uninsured businesses with 1 to 25 employees and employees of political subdivisions. That range was later increased to 1 to 50 employees. HCG contracted with three health plans from the existing network of AHCCCS health plans (HMOs) to provide managed care medical services. In fiscal year 2006, HCG started offering a PPO option through a third party administrator in order to provide health care coverage statewide. In fiscal year 2009 this geographical coverage will exclude Maricopa and Pima Counties. HCG's administrative responsibilities include enrollment/renewal, fulfillment, premium billing, collections, fund disbursement and data analysis. Also, HCG is responsible for certain oversight functions of the HMO's and the third party administrator.

The HMO contracted health plans are prepaid on a "per member, per month" (PMPM) basis. Capitation payments are made prospectively. Pursuant to contractual agreement, HCG reconciles the health plans' actual medical expenses reported to the capitation payments made by HCG during the contract year to determine if any additional payments are required. Such additional payments are subject to the contracted health plan's medical loss ratio as well as the availability of funds in HCG to fund such payments. Accrued programmatic costs include approximately $19.2 million of estimated settlement payments due to contracted health plans based on the reconciliations prepared as of June 30, 2008. Due to HCG's financial condition (see Note 6) and the inadequacies of reserves, HCG is currently negotiating payment terms with the 3 contracted health plans to repay the remaining liabilities owed over the next two to three fiscal years.

In fiscal year 2008, there was a $7.250 million General Fund appropriation to subsidize HCG's operations. In fiscal year 2008, HCG raised premium rates and reduced program and administrative costs. The changes resulted in a net operating increase of $217 and a reduction in the net deficit by $7.920 million. Future financial operations of HCG will be dependent on setting actuarially sound premium rates for the various plan options and stable enrollment. See further discussion in Note 6.

(6) Proprietary fund – decrease in net deficit and turnaround from prior fiscal year

As of June 30, 2008, HCG had a net deficit of $15,797 as a result of significant losses in prior fiscal years. In fiscal year 2008 HCG revenues were sufficient to cover all expenses incurred in that year. HCG received a $7.25 million General Fund subsidy in order to reduce its liabilities owed to its contracted HMO's for reconciliations incurred in fiscal year 2006 and fiscal year 2007. HCG decreased its net deficit position to $15.8 million at June 30, 2008.

In fiscal year 2007, Management projected a net loss of $2 - $8 million for fiscal year 2008. This was a conservative estimate as HCG recognized a net gain of $0.7 million before a $7.25 million General Fund subsidy. In fiscal year 2006 and fiscal year 2007 HCG was unable to cover its costs due to the PPOS operating at net medical losses (medical costs were more than premiums received). The elimination of the availability of the PPOS program in Maricopa and Pima Counties in fiscal year 2009 is projected to bring the remaining PPOS program to a break even point, thus allowing HCG to begin to accumulate reserves for the purpose of eliminating its reconciliation liabilities.

Many other actions were taken to address HCG's losses in fiscal year 2006 and fiscal year 2007 and to address the deficit. The significant actions and events are as follows:

- Eliminated Zero Deductible Plans: The zero dollar deductible plans were eliminated and 4,939 members either terminated their coverage or were transitioned into a minimum of $500 deductible plan as of January 1, 2007, thereby requiring a higher cost sharing.

(6) Proprietary fund – decrease in net deficit and turnaround from prior fiscal year (continued)

- Focus on Wellness Care: To ensure HCG members continued to stay healthy and receive quality, wellness-focused care, HCG implemented changes to the benefit plans eliminating the requirement to meet their deductible for wellness care. Members pay only a co-payment for preventive/wellness visits, PCP visits, urgent care, and basic lab and x-ray services.
- Groups of 'One' Guaranteed Issue: HCG has been the only healthcare coverage option in the state of Arizona that is guaranteed issue for groups of one, resulting in a higher medical risk profile compared to other small business health care coverage available within the State. At June 30, 2008, groups of one totaled 5,596 groups. To address their increased cost of care, employer groups with only 'one' employee were further community rated as a separate group, adjusting their premiums to cover a higher cost of care.
- Higher Medical Costs: Hospital participation in the HCG program is not mandatory. Although HCG does not provide routine coverage at out-of-network facilities, costs for services at non-participating hospitals rose faster than projected mostly related to care received as a result of an emergency room visit at a non-contracted facility. The coinsurance applied to out-of-network facilities was increased by 20 percent to cover this added cost. The PPO product was also transitioned to a PPOS tiered network, with the higher cost hospitals placed at a separate tier associated with a higher coinsurance.
- Hospital Default Rate: Effective September 19, 2007, Laws 2007, Chapter 263 (HB 2789) placed a default rate for payment of one hundred fourteen (114) percent of the AHCCCS reimbursement rate if a contract does not exist between a Healthcare Group contractor and a hospital provider. The impact of this was a cost savings of approximately $3.2 million in calendar year 2006 and estimated cost savings of $2.5 and $3.0 million in calendar years 2007 and 2008.
- Higher Utilization of Services: "Bare Period" requirements result in higher medical utilization for new members who have been without continuous coverage; and in turn utilize services upon enrollment at a higher rate than members who had continuous coverage. Although a twelve-month pre-existing conditions policy remains in effect, a benefit dollar maximum of $100,000 was placed on members during their first 12-months of enrollment.
- Administrative Costs: In fiscal year 2008 HCG reduced its administrative expense to $5.2 million from the $8.1 million expended in fiscal year 2007. This was accomplished largely by moving more communications to an electronic format, utilizing a fulfillment vendor for mailings, and eliminating administrative functions being performed at HCG that were redundant with the HMO's operations. Additional reductions occurred in the usage of consultants and contracted/temporary labor and elimination of some FTE positions helped reduce personnel type costs by over 50 percent. Health plan contracts were also amended to decrease the relative amount of their administrative payments, thus reducing reconciliation costs.
- Change in Fiscal Year 2009 - PPOS availability: Effective October 2008, Laws 2008, Chapter 288 (HB 2275) restricts the PPOS program to counties with a population of less than 500,000 thus eliminating the PPOS option in Maricopa and Pima Counties. To the extent that the PPOS costs were more than premiums collected, funds had to be reallocated in order to pay these medical claims. It is projected in fiscal year 2009 that the PPOS program in the remaining rural counties will operate on a break even basis with medical costs equaling the medical premiums received, resulting in a medical loss ratio reduction of approximately 35 percent in fiscal year 2009 compared to fiscal year 2008.

(6) Proprietary fund – decrease in net deficit and turnaround from prior fiscal year (continued)

For fiscal year 2009 management is projecting that HCG will continue to operate without incurring additional losses. Further, it is projected that HCG will not incur any additional reconciliation liability in fiscal year 2009. The following table summarizes reconciliation liability activity for fiscal year 2008.

Healthcare Group Reconciliation Liability as of June 30, 2008
Fiscal Year 2008 Activity
(in thousands of dollars)

	Reconciliation Period			
	FY 06	FY 07	FY 08	Total
Balance June 30, 2007	$ 5,051	$ 17,458	$ -	$ 22,509
Payments made	5,156	2,354	-	7,510
Accruals and adjustments	105	(227)	4,324	4,202
Balance June 30, 2008	$ -	$ 14,877	$ 4,324	$ 19,201

The reconciliation liability will be paid by allocating 2% of medical premium revenues for a reconciliation reserve, from residual earnings, and from any State subsidies provided by the Legislature. Reconciliation payment terms differ by each plan, such as, accruing 1% per month or repayment within 60 days of final reconciliation.

There can be no assurance that these operating improvements will occur or will provide sufficient cash to fund operating expenses. Additionally, if there is an adverse change in enrollment and the premium increases are not sufficient to fund the reserves for past losses and future medical claims experience costs, then HCG will be required to further scale back administrative expenditures to the level supported by actual enrollment and/or require a subsidy from the State General Fund to cover these operating costs. There can be no assurances that the Legislature will approve such a subsidy from the State General Fund.

Even though deficit reduction measures resulted in a net gain for fiscal year 2008, a fiscal year 2008 General Fund subsidy of $7.25 million was required to pay down a portion of the prior fiscal year reconciliation liabilities and a net deficit of $15.8 million still exists as of June 30, 2008. A $5.0 million General Fund subsidy was passed by the Legislature for fiscal year 2009. However, there is no assurance that future subsidies will be provided to continue to pay down prior year losses. It is not anticipated in the foreseeable future that operations will generate sufficient cash flow to significantly pay down the remaining prior deficit. If a General Fund subsidy is not provided in fiscal year 2010 or if the fiscal year 2009 General Fund subsidy is reduced due to the state's General Fund deficit or the current favorable medical loss trend does not continue, each health plan contractor will have to make its own decision as to whether their organization is willing to carry the medical loss liability from the HCG line of business until or if premiums are adequate to recover their prior year losses. Should the health plan elect to call the prior year reconciliation liabilities before HCG has sufficient funds to provide such payments and new terms are not negotiated, or the Legislature does not provide HCG with additional subsidies, it raises substantial doubt in HCG's ability to continue as a going concern.

Accordingly, the accompanying financial statements have been prepared assuming that HCG will continue as a going concern. The matters discussed above raise substantial doubt about HCG's ability to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification of asset carrying amounts or the amount and classification of liabilities that might result should HCG be unable to continue as a going concern.

(7) Retirement plan

AHCCCS employees are covered by a defined benefit retirement plan administered by the Arizona State Retirement System Board. Benefits are established by State statute and provide retirement and long-term disability benefits to AHCCCS employees. The retirement plan is funded by payroll deductions from eligible employees' gross wages and matching amounts contributed by AHCCCS. These amounts satisfy the statutory requirement that employees and AHCCCS contributions must cover the actuarially determined current service costs of the retirement plan, plus amortization over a 30-year period of the unfunded past service liability. Payroll deductions as a percentage of employee wages were 9.1 percent for retirement and 0.5 percent for long-term disability for 2008. The matching amount contributed to the retirement plan by AHCCCS was $5,438 in 2008 and is included in administrative expenditures in the accompanying government-wide and governmental fund financial statements.

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

(8) Budgetary basis of accounting

The financial statements of AHCCCS are prepared in conformity with U.S. generally accepted accounting principles (GAAP). AHCCCS, like all other State agencies, prepares its annual budget on a basis that differs from the GAAP basis. The State's accounting system and Arizona Revised Statutes and policies provide for an additional accounting period (13^{th} month) to make payments for goods or services received or incurred by the end of the fiscal year and subsequently paid during the 13^{th} month. The budget basis expenditures reported in the financial statements include both the fiscal year paid and the 13^{th} month activity. The State does not have a legally adopted budget for revenues. Prior fiscal year expenditures of $230,662 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, 2008.

(dollar amounts expressed in thousands)

(8) Budgetary basis of accounting (continued)

The following is a reconciliation of the GAAP Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds to the budgetary comparison schedules for the year ended June 30, 2008:

	General Fund Actual
Budgetary Basis Fund Balance, June 30, 2008	$ 80,373
Budgetary Basis of Accounting	
Increases to fund balance:	
Due from State and county governments	76,898
Due from the federal government	248,880
Due from other Fund	10,409
Receivables and other	142
Total increases	336,329
Decrease to fund balance:	
Deferred revenue	(21,878)
Due to State and county governments	(37,398)
Accrued programmatic costs	(353,304)
Payables and other	(4,122)
Total decreases	(416,702)
Total GAAP basis fund balance	$ -

Non-appropriated expenditures of $2,006,336 in the general fund consist of federal and state matching pass-through payments to other agencies.

(9) Contingencies

Litigation and investigations - AHCCCS has been named as a defendant in a variety of litigation, all of which are being defended by in-house and contracted legal counsel. It is the opinion of AHCCCS, upon consultation with legal counsel, that none of these claims is likely to have a material adverse effect on its 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.

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

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

(9) Contingencies (continued)

Budget neutrality agreement - AHCCCS' Waiver from CMS 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 agreement (April 1, 2001 through September 30, 2011), that the population covered by the Waiver be budget neutral for CMS. AHCCCS negotiated an extension of the Waiver with CMS that extends the budget neutrality for an additional period of five years. In addition, the Waiver was amended to include the Arizona Long Term Care program expenditures making them subject to budget neutrality beginning October 1, 2006. Under budget neutrality, CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions (STC) include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. It also established a diminishing annual threshold of the amount by which AHCCCS is able to exceed the budget neutrality limit on an interim basis before being required to submit a corrective action plan. The STC reporting limit thresholds are monitored on a Federal Fiscal Year basis. The STC limit threshold for the first six limit periods (April 1, 2001 through September 30, 2007) is 1.0 percent. The threshold declines by 0.25 percent for limit periods seven through nine and is zero percent for the limit period ended September 30, 2011. As of June 30, 2008, reported date of service expenditures associated with the six limit periods ended September 30, 2007 are below the limit by $375.8 million, or 2.13 percent. Through June 30, 2008, AHCCCS remains under the cumulative reporting limit threshold. The budget neutrality calculation is dependent on a number of variables including the number of members, the eligibility category of members and the general economy and its impact on unemployment, medical inflation and policy decisions that may impact program costs made by the Legislature. Given the uncertainty surrounding these factors, AHCCCS is not presently able to determine if the budget neutrality limit will be exceeded or if it is exceeded that CMS will require repayment of the excess. Management believes that as of June 30, 2008, AHCCCS does not have any liability to CMS related to the budget neutrality agreement. Accordingly, the accompanying basic financial statements have not been adjusted for the impact of any liability AHCCCS may have related to the Waiver budget neutrality agreement.

(10) Interfund receivables, payables and transfers

Interfund activity is defined as transactions between funds administered by AHCCCS. The interfund balances as of June 30, 2008 consist of transfers from the Other Funds to the General Fund in the amount of $10,409.

In the government-wide statement of activities, the interfund activity has been eliminated. The total net transfers out of $40,394 reported on the statement of activities represents transfer activities to other State agencies.

(11) Transactions with other State agencies and counties

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

(dollar amounts expressed in thousands)

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

Administrative services - The Arizona Department of Economic Security (ADES) charges AHCCCS to determine eligibility for certain Title XIX members. The Arizona Department of Administration charges AHCCCS for data center services, communication lines, risk management and training. The Arizona Department of Health Services (ADHS) charges AHCCCS for licensure and screening services and administrative costs associated with the SCHIP Vaccine for Children program. 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. The Arizona Department of Insurance charges for audit services. These expenditures are included in administrative 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 administrative services described above for the year ended June 30, 2008.

	Expenditures
Arizona Department of Economic Security	$ 92,770
Arizona Department of Administration	14,215
Arizona Department of Health Services	2,056
Arizona Board of Nursing	209
Arizona Office of Administrative Hearings	362
Arizona Department of Insurance	200
	$ 109,812

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 amount passed through to ADES is classified as long-term care capitation and the amount passed through to ADHS is classified as capitation-mental health services and Children's Rehabilitative 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, 2008.

	Expenditures
Arizona Department of Economic Security	$ 873,496
Arizona Department of Health Services	1,020,579
	$ 1,894,075

Revenues include $315,705 from Arizona counties during fiscal year 2008. 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. Laws 2008, Chapter 288, Section 11 requires AHCCCS, in fiscal year 2009, to transfer approximately $17,831 of the county share of refunds for fiscal year 2007 and fiscal year 2008 to the budget neutrality compliance fund. At June 30, 2008, AHCCCS has accrued $20,528 relating to the remaining amount that county and State contributions exceeded related expenditures. This amount is included in the due to federal, State and county governments in the accompanying Balance Sheet - Governmental Funds.

(dollar amounts expressed in thousands)

(12) Other pass through funds

Arizona school districts are eligible for federal matching funds for the administrative functions related to Early and Periodic Screening, Diagnosis and Treatment (EPSDT) outreach services at the school level. Arizona school districts are also 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 counties contributed $2,683 as determined by statutory calculation for administrative costs incurred by ADES for eligibility determinations and other operating costs of 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, 2008, AHCCCS recorded the following pass through revenue in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balance - Governmental Funds:

	Funds Passed Through
Arizona School Districts	
Administrative Services Federal Funds	$ 2,955
Program Services Federal Funds	19,400
Arizona Department of Economic Security	
County Contribution for Administrative Costs	2,683
Arizona Department of Health Services	
Cost reimbursement from Civil Monetary Penalties	274
	$ 25,312

(13) Disproportionate share hospital payment methodology

Disproportionate share hospital (DSH) payments reported on the Statement of Revenues, Expenditures and Changes in Fund Balances – Governmental Funds and the Budgetary Comparison Schedule – General Fund decreased in fiscal year 2008 from the amounts reported in fiscal year 2007 primarily due to a funding methodology revision included in the October 1, 2006 Waiver renewal. The revision changed the way the State match for the Federal DSH monies is made from an appropriation to AHCCCS to a certified public expenditure (CPE) process by the public hospitals. It did not change the amount of net funding provided to the participating hospitals or the net impact to the State.

The financial statement impact decreases the DSH payments reported in the Statement of Revenues, Expenditures and Changes in Fund Balances – Governmental Funds in fiscal year 2008 by $39 million, which is the amount of the State match portion of the CPE. It also reduces the DSH payments reported in the Budgetary Comparison Schedule – General Fund by $111.2 million, the total amount certified by the public hospitals less a $4.2 million amount retained by one of the public hospitals.

(14) New pronouncements

The Governmental Accounting Standards Board (GASB) issued several pronouncements prior to June 30, 2008 with effective dates within or after the fiscal year ending June 30, 2008. Management believes the impact of these statements does not affect current or future financial presentations by AHCCCS. In addition, AHCCCS adopted no new pronouncements in the fiscal year ending June 30, 2008.

(15) Subsequent events

Enrollment trends continue to rise in fiscal year 2009. The September 2008 enrollment of 1,131,493 is 61,764 members or 5.8% higher than the September 2007 enrollment. Enrollment has increased in seven consecutive months. Based on the upward trend for acute care caseload, AHCCCS' management is projecting that a supplemental appropriation in fiscal year 2009 will be required. In addition, according to the October 2008 Monthly Fiscal Highlights Report published by the Joint Legislative Budget Committee, the State of Arizona continues to experience shortfalls in its General Fund revenue collections that could be between $700,000 and $1,100,000. It is expected that the Legislature will reduce the state fiscal year 2009 budget in order to maintain a balanced budget. The impact such a revision will have on the AHCCCS fiscal year 2009 appropriation is not known at this time. The accompanying basic financial statements have not been adjusted for any changes that might result from the outcome of these uncertainties.

ADDITIONAL INFORMATION

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2008
(amounts expressed in thousands)

Federal Grantor / Pass-Through Agency / Program	Federal CFDA Number	Federal Expenditures
U.S. Department of Health and Human Services		
Centers for Medicare and Medicaid Services		
Medicaid Program (Title XIX)	93.778	
Federal funds expended to vendors		$ 5,079,364
Federal funds expended to subrecipients		1,754
		5,081,118
Children's Health Insurance Program (Title XXI)	93.767	121,367
Maternal and Child Health Federal Consolidated Programs	97.110	60
Medicaid Infrastructure Grant	93.768	570
Medicaid Transformation Grants	93.793	6,486
Social Services Research and Demonstration	93.647	61
Health Resources and Services Administration		
State Planning Grant - Health Care Access for the Uninsured	93.256	10
TOTAL EXPENDITURES OF FEDERAL AWARDS		$ 5,209,672

See Notes to Financial Statements

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

To the Director of the

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

We have audited the financial statements of the ***Arizona Health Care Cost Containment System*** **(AHCCCS, an agency of the state of Arizona)** at June 30, 2008 and for the year then ended, and have issued our report thereon dated December 8, 2008. 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.

Internal Control Over Financial Reporting

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

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the ***Arizona Health Care Cost Containment System's*** ability to initiate, authorize, record, process or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the ***Arizona Health Care Cost Containment System's*** financial statements that is more than inconsequential will not be prevented or detected by the ***Arizona Health Care Cost Containment System's*** internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the ***Arizona Health Care Cost Containment System's*** internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

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

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

Phoenix, Arizona
December 8, 2008

Mayer Hoffman McCann P.C.