ARIZONA HEALTH CARE
COST CONTAINMENT SYSTEM

FINANCIAL STATEMENTS
AND ADDITIONAL INFORMATION

Year Ended June 30, 2009

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

FINANCIAL STATEMENTS AND ADDITIONAL INFORMATION

Year Ended June 30, 2009

CONTENTS

MANAGEMENT’S DISCUSSION AND ANALYSIS

Management's Discussion and Analysis

For the Fiscal Year Ended June 30, 2009

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, 2009. 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, 2009 by $7.0 million. AHCCCS' net deficit at June 30, 2009 is comprised of an unrestricted net deficit of $8.3 million and the amount invested in capital assets of $1.2 million.

- The total AHCCCS net deficit decreased by $3.4 million during fiscal year 2009. Net assets of governmental activities decreased by $1.6 million, while the net deficit of the business-type activity decreased by $5.0 million.

- The American Recovery and Reinvestment Act of 2009 increased Federal Medical Assistance Payments by $561.6 million during fiscal year 2009.

Fund Level

- As of the close of fiscal year 2009, AHCCCS' total governmental funds reported an ending fund balance of $685,000, a decrease of $1.2 million. The net decrease in the Intergovernmental Services Fund – (AHCCCS Operating Fund - Hawaii Arizona PMMIS Agreement (HAPA) Savings Fund) accounted for 96.4 percent of the change and is primarily attributable to a $1.1 million transfer to the State's General Fund authorized by the Legislature. Approximately $650,000 of IT expenditures was funded as part of AHCCCS' efforts to reduce General Fund expenditures due to budget reductions from the current year revenues.

- The American Recovery and Reinvestment Act of 2009 increased Federal Medical Assistance Percentage (FMAP) payments by $551.1 million during fiscal year 2009 for governmental funds.

- Business-type activities during fiscal year 2009 resulted in positive operating income of $3.2 million compared to the modest operating income of $217,000 in the prior fiscal year, which continues the positive turn-around trend that began in fiscal year 2008. Overall positive operating results and a General Fund subsidy from the State decreased the net deficit to $10.8 million at June 30, 2009 as compared to the $15.8 million net deficit balance at June 30, 2008. In addition to posting operating income, HCG received a $2.8 million General Fund subsidy to reduce its reconciliation liability incurred in fiscal years 2006 and 2007.

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 20) 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 21) 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 activity for 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 primarily consist of programs authorized by the Social Security Act Titles XIX (Medicaid) and XXI (Children's Health Insurance Program (CHIP)) that are concentrated on the health needs of the citizens of Arizona. The majority of AHCCCS' activities are reported in this category.

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

The government-wide financial statements can be found on pages 20 and 21.

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 22 through 24 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 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 (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, supplemental payments to county hospitals, electronic health records infrastructure development and certain payments to hospitals for unfunded emergency department readiness costs and level 1 trauma center costs. The expenditures for unfunded emergency department readiness costs and level 1 trauma center costs are financed by revenues specifically collected for those purposes and are by statute continuously appropriated. A budgetary comparison statement has been provided for the General Fund to demonstrate compliance with the budget on page 25.

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 26 through 28 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 29 to 46.

Government-Wide Financial Analysis

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

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

	Governmental Activities		Business-Type Activities		Total	
	2009	2008	2009	2008	2009	2008
Current assets	$ 936,326	$ 768,280	$ 11,933	$ 14,190	$ 948,259	$ 782,470
Noncurrent assets	900	900	-	-	900	900
Capital assets	1,195	2,160	45	103	1,240	2,263
Total assets	938,421	771,340	11,978	14,293	950,399	785,633
Current liabilities	934,676	766,013	8,782	15,213	943,458	781,226
Long-term liabilities	-	-	13,985	14,877	13,985	14,877
Total liabilities	934,676	766,013	22,767	30,090	957,443	796,103
Net assets (deficit):						
Invested in capital assets, net of depreciation	1,195	2,160	45	103	1,240	2,263
Unrestricted (deficit)	2,550	3,167	(10,834)	(15,900)	(8,284)	(12,733)
Total net assets (deficit)	$ 3,745	$ 5,327	$ (10,789)	$ (15,797)	$ (7,044)	$ (10,470)

For AHCCCS, liabilities exceeded assets by $7.0 million at June 30, 2009 as compared to liabilities exceeding assets by $10.5 million at June 30, 2008.

The largest portion of the AHCCCS total net deficit (153.2%) is due to a $10.8 million net deficit for HCG, the sole AHCCCS business-type activity. However, during fiscal year 2009, the HCG net deficit decreased by $5.0 million. This decrease in the net deficit is due to a combination of $3.2 million in operating income and a $2.8 million General Fund subsidy to fund prior fiscal years 2006 and 2007 reconciliation liability offset by a $1.0 million non-operating loss. The operating income is a result of actuarially sound rates where premium revenue aligned member premiums with medical loss experience.

A $2.5 million unrestricted net asset balance for governmental operations partially offsets the business-type activity unrestricted net deficit. The two significant components of the governmental unrestricted balance consists of funds of $611,000 that are limited to future spending for certain information technology expenses and $900,000 in 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 $617,000. This decrease is related to funding AHCCCS IT projects in the amount of $650,000 and a $1.1 million transfer to the State's General Fund authorized by the Legislature from the Intergovernmental Services Fund net of annual direct and indirect cost recovery revenue. These activities were part of AHCCCS' and the State's efforts to reduce General Fund expenditures due to budget reductions required by declining State revenues. The net deficit in unrestricted net assets is also offset by net assets of $1.2 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	
	2009	2008	2009	2008	2009	2008
Revenues						
Program Revenues						
Charges for services	$ 13,153	$ 13,666	$ 60,462	$ 77,042	$ 73,615	$ 90,708
Other operating grants and contributions	448,031	486,708	-	-	448,031	486,708
Federal operating grants	6,344,793	5,209,662	-	10	6,344,793	5,209,672
General revenues						
State appropriations	1,884,780	1,946,433	-	-	1,884,780	1,946,433
Tobacco tax	150,620	168,786	-	-	150,620	168,786
Unrestricted investment earnings	301	1,639	199	443	500	2,082
Total revenues	8,841,678	7,826,894	60,661	77,495	8,902,339	7,904,389
Expenses						
Health Care	8,765,434	7,788,853	58,301	76,825	8,823,735	7,865,678
Excess before transfers	76,244	38,041	2,360	670	78,604	38,711
Transfers, net	(77,826)	(40,394)	2,648	7,250	(75,178)	(33,144)
Increase (decrease) in net assets	(1,582)	(2,353)	5,008	7,920	3,426	5,567
Net assets (deficit) – beginning of year	5,327	7,680	(15,797)	(23,717)	(10,470)	(16,037)
Net assets (deficit) – end of year	$ 3,745	$ 5,327	$ (10,789)	$ (15,797)	$ (7,044)	$ (10,470)

At June 30, 2009, 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 net deficit balance. Although the business-type activity reported a $5.0 million decrease in its net deficit, this is the fourth consecutive fiscal year that the business-type activity has reported a net deficit balance. The deficit in the business-type activity still contributes to a government-wide net deficit for the Agency as a whole. However, the Agency's overall net deficit decreased by $3.4 million, or 32.7 percent from the net deficit at June 30, 2008.

Governmental activities increased AHCCCS' net deficit by $1.582 million during fiscal year 2009. This increase is related to activity in the intergovernmental services fund. The primary cause was a $1.148 million transfer to the State General Fund authorized by the Legislature to address declining state revenues to reduce a statewide fiscal year budget deficit. Additionally, AHCCCS utilized $650,000 to supplement expenditures for qualifying information technology programming to upgrade software used by the administration in the operation of automated systems. These decreases resulted in a net $1.1 million reduction to the fund after current year revenue deposits. Business-type activities decreased the net deficit by $5.008 million. The improvement is primarily attributable to annual operating results that generated $3.2 million in income, a $1.0 million non-operating loss and a $2.8 million General Fund subsidy provided in order to fund HCG's reconciliation liability that was incurred in fiscal years 2006 and 2007. The fiscal year 2009 operating income of $3.2 million compares favorably to the $217,000 income from operations in the prior year. Overall operating results including the General Fund subsidy allowed HCG to continue the positive trend of decreasing its net deficit position to $10.8 million at June 30, 2009 compared to $15.8 million from the year prior.

American Recovery & Reinvestment Act of 2009

On February 17, 2009, the American Recovery and Reinvestment Act (ARRA or the Act) of 2009 was signed into law to provide fiscal relief to States to protect and maintain State Medicaid programs. The Act provides, among other items, an increase to the FMAP rate during the Act's recession adjustment period defined as October 1, 2008 to December 31, 2010. The ARRA period covers 9 quarters (3 in state fiscal year 2009; 4 in state fiscal year 2010; and 2 in state fiscal year 2011) with Title 5001 of the ARRA legislation providing approximately $87 billion in grant money to help States, the District of Columbia and Territories meet their health care needs. AHCCCS estimates that it could receive between $1.7 billion to $1.9 billion in ARRA Medicaid money during the adjusted FMAP period for the Title XIX Medicaid program including pass through funds to other state agencies.

In order for AHCCCS to be eligible to receive the increased FMAP, it must comply with the following maintenance of effort requirements:

- States are ineligible for increased FMAP if eligibility standards, methodologies, or procedures are more restrictive than what was in effect July 1, 2008. There were provisions that allowed states to reverse changes made prior to the passage of ARRA and still be able to receive the increased FMAP. AHCCCS fell into this category and was required to reverse a change in the timing of redeterminations for a population segment in order to become eligible.
- States must comply with prompt payment requirements to providers and must submit a quarterly report that it is in compliance with this provision.
- States cannot deposit or credit any reserve or rainy day funds with revenue from increased FMAP and will be required to report on how the increased FMAP dollars are spent.
- States are ineligible for the increased FMAP if it requires political subdivisions to pay a greater percentage of the non-federal share for quarters during the recession adjustment period than the percentage that would have been required by the State under such plan on September 2008.

The ARRA provided for an increase to the FMAP rate for the recession adjustment period of October 1, 2008 to December 31, 2010 covering 9 quarters (3 in state fiscal year 2009; 4 in state fiscal year 2010; and 2 in state fiscal year 2011). The increased FMAP is calculated based on three components consisting of a maintenance of FMAP or a hold harmless provision that maintains the federal fiscal year 2008 rate of 66.20 percent, a general 6.2 percent increase provision and an increased unemployment adjustment provision. The increased unemployment adjustment variable component resulted in AHCCCS qualifying for the tier 2 rate for the December 2008 and March 2009 quarters and the higher tier 3 rate for the June 2009 quarter. AHCCCS is guaranteed to remain eligible for the tier 3 rate through June 30, 2010 and would need for the state unemployment rate to average less than 7.12 percent for three consecutive months prior to April 2010. Arizona's most recent seasonally adjusted rate for September 2009 was 9.1 percent. The following table shows the projected FMAP and increase rate amounts for the ARRA recession adjustment period.

Arizona Projected ARRA FMAP Increase Percentages

FFY	Current FMAP	Adj FMAP (Tier 2)	Adj FMAP (Tier 3)	Increase (Tier 2)	Increase (Tier 3)
2009	65.77%	75.01%	75.93%	9.24%	10.16%
2010	65.75%	75.01%	75.93%	9.26%	10.18%
2011 (1Q)		75.01%	75.93%	9.26%	10.18%

This FMAP increase resulted in a cost shift of approximately $561.6 million of additional Federal revenue funds and a corresponding reduction to State sources for fiscal year 2009.

Funding for disproportionate share hospital (DSH) payments is not included in the increased FMAP rate. However, the ARRA provides for a temporary 2.5% increase in the state DSH allotment for fiscal years 2009 and 2010. The DSH allotment increased $2,480 for federal fiscal year 2009 and is projected to increase by $5,040 in federal fiscal year 2010.

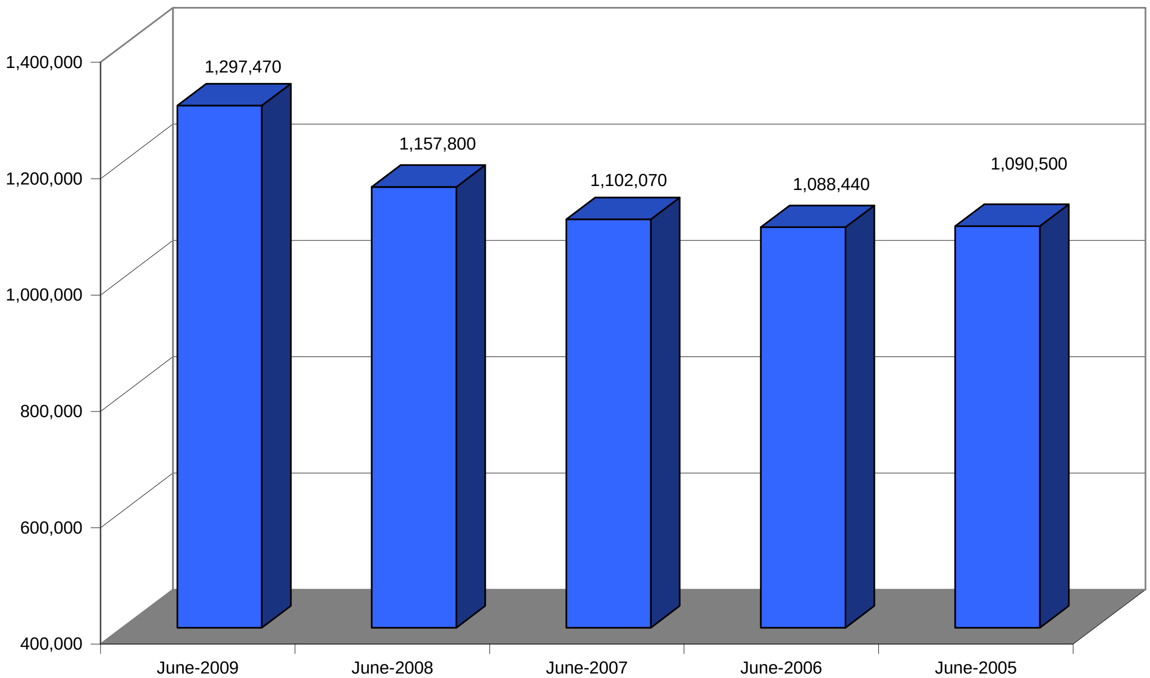
Governmental Activities

Fiscal year 2009 governmental activities increased the net deficit by $1.582 million. This increase is primarily related to funding AHCCCS information technology projects in the amount of $650,000 and a $1.1 million transfer to the State's General Fund authorized by the Legislature from the Intergovernmental Services Fund.

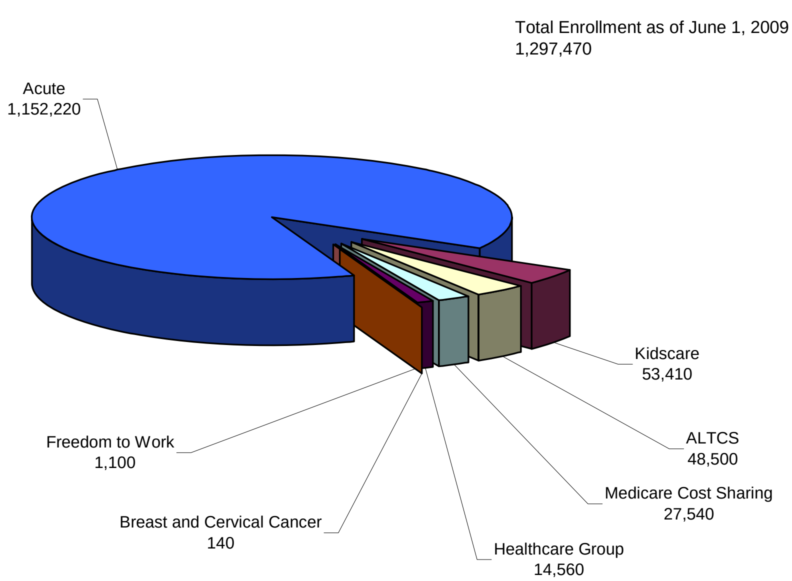
During state fiscal year 2009, the AHCCCS program experienced the most significant enrollment growth since the Proposition 204 expansion in calendar years 2001 to 2003. Since June 2008, AHCCCS enrollment has grown in 10 out of 12 months with the most significant growth coming in the last 5 months. Enrollment at June 1, 2009 is 1,297,470, an increase of 139,670 members over June 1, 2008 or 12.1 percent. The increase in program expenditures in fiscal year 2009 is primarily attributable to the increase in enrollment and provider rates. Although provider rates were increased at the beginning of the contract year 2009 cycle, hospital inpatient and outpatient rates were frozen by the Legislature at their September 2008 levels. Additionally, mid-year budget cuts were required due to the State's declining revenues. In February 2009, certain fee-for-service provider rates were cut by 5.0 percent, and in May 2009, capitation rates were reduced to reflect the impact of the fee-for-service reductions for the health plans that use AHCCCS rates for provider reimbursement.

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

AHCCCS Membership Growth



AHCCCS Enrollment by Program



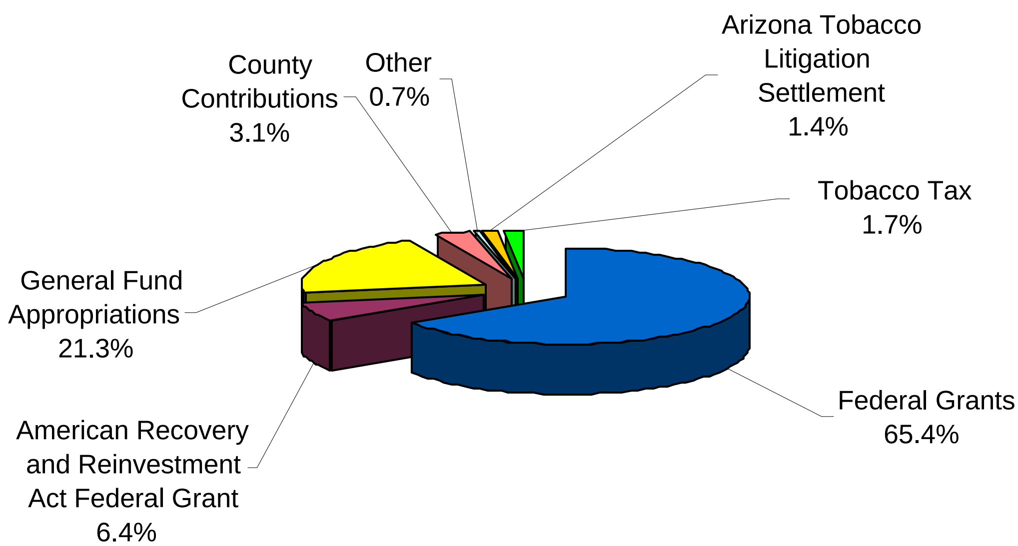
The cost of health care programs, including Title XIX Medicaid and Title XXI CHIP, totaled $8,765.4 million in fiscal year 2009, a $976.5 million increase over the $7.788.9 million reported in fiscal year 2008. As shown in the statement of activities, the amount of expenditures funded from federal grants through the Centers for Medicare and Medicaid Services (CMS) was $6,344.8 million (72.4 percent) in fiscal 2009 as compared to $5,209.7 million (66.9 percent) in fiscal 2008. Program funding in the form of federal financial participation is primarily determined through the FMAP rate 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 was scheduled to decrease by 0.43 percent to 65.77 percent from the prior year's rate of 66.20 percent. However, ARRA provided for an increase to the FMAP rate for the recession adjustment period of October 1, 2008 to December 31, 2010. This FMAP increase attributable to ARRA resulted in a cost shift of approximately $561.6 million of additional Federal revenue funds and a corresponding reduction to state match sources for fiscal year 2009.

The overall increase in program expenditures can primarily be attributed to the 12.1 percent increase to enrollment excluding the business-type activity program. An additional factor continues to be capitation rate inflation growth across all capitated programs. Yearly capitation rate increases have averaged 6.7 percent over the last 5 years, with the lowest increase of 5.7 percent in fiscal year 2007 and the highest of 8.7 percent in fiscal year 2009.

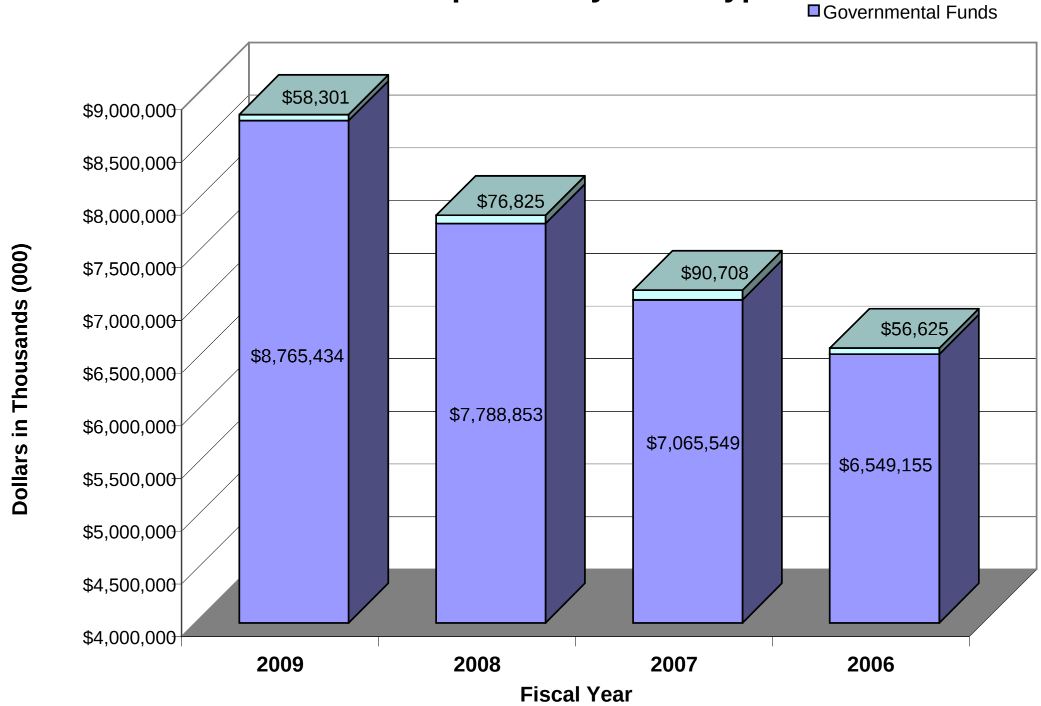
State, county and miscellaneous funding sources combined to provide $2,496.9 million in State funding sources and appropriations in fiscal year 2009, a $120.3 million decrease over the $2,617.2 million reported in fiscal year 2008 primarily related to the federal funding from the ARRA FMAP increase. The following are the components of the State match funding sources. State General Fund revenues raised primarily in the form of income and sales taxes directed to AHCCCS amounted to $1,311.8 million and an additional $572.9 million was passed through from other State agencies in order to provide the State's share for Title XIX Medicaid and Title XXI CHIP eligible medical assistance expenditures. Arizona counties contributed $272.5 million as determined by Statutory funding formulas and Session Law as adjusted by the political subdivision maintenance of contribution ARRA requirement and other intergovernmental agreements. Tax collections on tobacco products provided $150.6 million in State match funding and continued the year-over-year decrease of $18.2 million or 10.8 percent compared to the $24.6 million or 12.7 percent decrease in fiscal year 2008. An additional $127.7 million in State revenue funding was provided by 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 and other tobacco product sales from the preceding year. AHCCCS has accrued $59.1 million for the period from January 1, 2009 through June 30, 2009 based on Arizona's Joint Legislative Budget Committee 2010 estimated payment. In addition to the annual payment described above, AHCCCS continues to receive the Strategic Contribution Fund (SCF) payment through April 15 2017. The amounts of the payments are dependent upon several adjustments, the magnitude of which will not be fully known until an independent auditor provides its calculations in February or March of each year. Other factors could also affect the MSA Payment amount that AHCCCS ultimately receives, including default or bankruptcy by one or more tobacco companies and other unforeseen withheld payment amounts. Tribal gaming receipts distributed to AHCCCS as determined by statutory formula and other sources provided an additional $52.0 million. Hospital emergency departments and level 1 trauma facilities benefited from $20.9 million in tribal gaming receipts.

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

Revenues by Source - Governmental Activities



AHCCCS Expenses by Fund Type



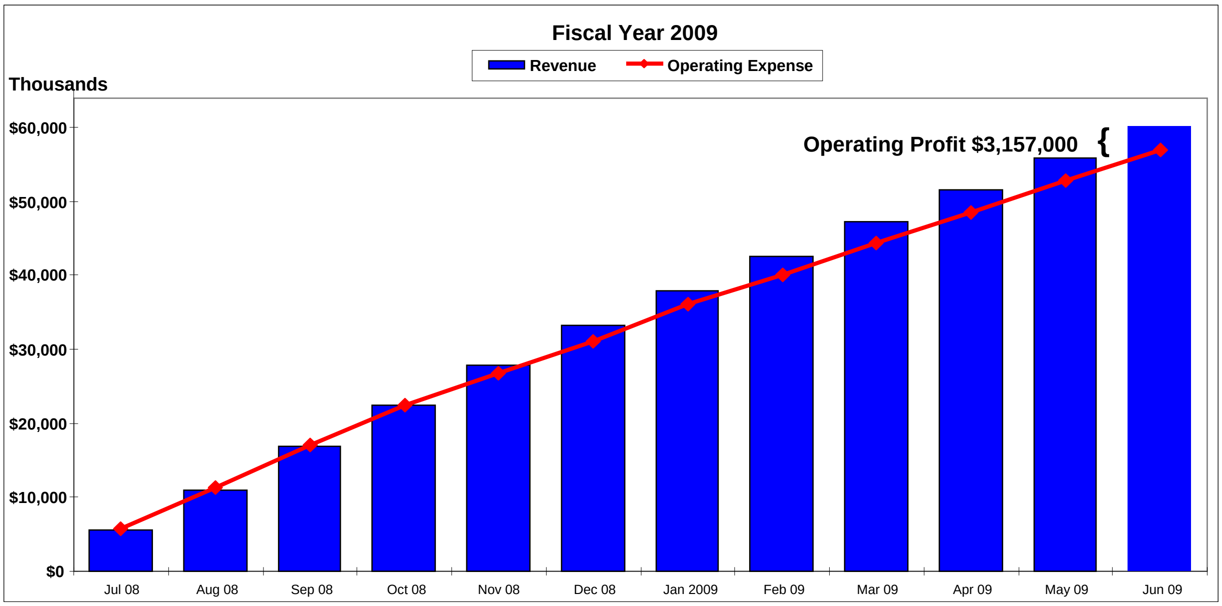
Business-Type Activities

The sole proprietary fund business-type activity for AHCCCS is the Healthcare Group (HCG). HCG was established in 1988 by the State to administer health care services primarily to small, uninsured businesses with 1 to 25 employees and employees of political subdivisions. That range was later changed to 2 to 50 employees. HCG contracts with 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. 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 HMOs and the third party administrator.

HCG generated a net decrease in net deficit of $5.0 million based primarily on operating income of $3.2 million and a $2.8 million subsidy from the State. Operating income of $3.2 million is a substantial improvement from the operating income of $217,000 in fiscal year 2008 and an even more remarkable improvement from the operating loss of $20.7 million from fiscal year 2007.

The chart below depicts monthly approximated cumulative profitability for fiscal year 2009.



Premium Changes

Effective September 2008, HCG increased premiums by approximately 13%. The premium rates were adjusted to fund projected medical and administrative costs and to provide consistent payments to health plans owed funds based upon reconciliations for prior fiscal years. The table below shows the average premium increase in September 2008 for the different group sizes.

Average Premium Increase September 2008			
HMO		PPOS	
Groups of 1	Groups of 2-50	Groups of 1	Groups of 2-50
14.07%	10.19%	24.91%	23.41%

Change in fiscal year 2009 - PPOS availability

Effective October 2008, Laws 2008, Chapter 288 restricted the Preferred Point of Service (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 PPOS costs were greater than premiums collected, funds had to be reallocated in order to pay these medical claims.

Enrollment

In fiscal year 2008, HCG was required to adhere to a temporary enrollment freeze. Laws 2007 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. 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 table below shows the composition of enrollment by group size as of June 30, 2009 in comparison with June 30, 2008.

Enrollment by Group Size						
	FY 2008		FY 2009		FY 2009 vs FY 2008	
Group Size	Enrollment	Mix	Enrollment	Mix	2009 vs 2008	% Change
1	5,596	72%	3,686	68%	(1,910)	(34%)
2 +	2,175	28%	1,699	32%	(476)	(22%)
Total	7,771	100%	5,385	100%	(2,386)	(31%)

By the end of fiscal year 2009, HCG's group enrollment had declined approximately 31% from the prior year, yet due to the rate increase in September 2008, premium revenues declined by only 21%. Average total revenue per member per month in August 2008 was $268; in September 2008 it was $317. This per member per month revenue increase was essential to keep HCG from experiencing a net loss for the year.

HCG Subsidy and Reconciliation Liability

In the first two quarters of fiscal year 2009 and in years prior, HCG reconciled the medical costs experienced by the Plans above a contractual target medical loss ratio (stop loss target) that 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 was $19.2 million. At June 30, 2009 the reconciliation liability was $13.4 million. The following table summarizes reconciliation liability activity for fiscal year 2009:

Healthcare Group Reconciliation Liability as of June 30, 2009
Fiscal Year 2009 Activity
(in thousands of dollars)

	Reconciliation Period			
	FY 07	FY 08	FY 09	Total
Balance June 30, 2008	$ 14,877	$ 4,324	$ -	$ 19,201
Payments made	(5,281)	-	(150)	(5,431)
Accruals and adjustments	(13)	(502)	150	(365)
Balance June 30, 2009	$ 9,583	$ 3,822	$ -	$ 13,405

The remaining reconciliation liability will be paid by allocating 2% of medical premium revenues for a reconciliation reserve, from residual earnings, and from future State subsidies. In fiscal year 2009, HCG received a net General Fund subsidy of $2.65 million to reduce its reconciliation liability incurred in fiscal year 2007; however, there can be no assurance that future General Fund subsidies will be provided to continue to fund prior year losses.

In fiscal year 2008 and 2009, HCG experienced a significant financial and operational turnaround compared with the prior two fiscal years. 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 2010, management believes that HCG will continue to operate without incurring additional losses.

Health Plan Utilization Management Standards

Effective January 1, 2009 all three HCG contractors agreed, in contract, that no future reconciliation costs will be recognized by HCG except for adjustments to the existing reconciliation for services rendered through December 31, 2008. HCG contractors will be compensated for attaining Nationally Recognized Utilization Management Standards, as mandated by Chapter 288. This amount will be no more than 6% of total premium collected. In January 2009, HCG began reserving for these anticipated payments. After the end of the fourth quarter, if the contractors perform well, each will receive a payment. If a health plan performs poorly, it will forfeit the reserved amount, and HCG will retain the amount and apply it to any existing liabilities. By compensating the health plans based on a set amount of reserves already collected from member premiums, HCG then eliminates the potential for any unanticipated losses (or gains) from variations in HMO utilization. As of June 30, 2009, the funded reserve amount for the Health Plan Utilization Management Standards is $582,000. Per contract, distributions from these reserves will be determined in December 2009.

Subsequent Event

Subsequent to June 30, 2009, HCG took over the provider payment function from HCG's PPOS TPA. As a result of provider payment reconciliations and payment history research, HCG determined that due to certain errors on the part of the third party administrator approximately $996,000 was owed to providers for services provided in fiscal years 2009 and prior. This amount is reflected on the Statement of Revenues, Expenses and Changes in Net Assets (Deficit) as an Other loss. HCG is currently working with AHCCCS legal counsel to resolve this ongoing issue and is seeking reimbursement for this loss.

Going Concern Matters

Even though HCG posted operating income of $3.16 million in fiscal year 2009 and management currently projects that the positive trend will continue, $10.8 million remained as a net deficit at June 30, 2009 due to the outstanding reconciliation liability owed to the HMO's for prior fiscal years. It is not anticipated in the near future that operations will generate sufficient cash flow to entirely pay off the remaining deficit.

Should HCG be required to accelerate payments for 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 and to continue to pay down the outstanding liability. 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 2009, AHCCCS' governmental funds reported combined ending fund balances totaling $685,000, a decrease of $1.155 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 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 $685,000 available to meet future year obligations. The Other Governmental Fund's fiscal year 2009 unrestricted balance is primarily comprised of the balance in the Intergovernmental Services - Hawaii Arizona PMMIS Alliance Fund. Monies in this fund are only available for certain expenditures. A total of $611,400 is available for administrative expenditures for information technology activities in future periods. Revenue from taxes on cigarettes and other related tobacco products declined 11.1 percent over fiscal year 2008 and generated $104.5 million for the current year compared to $117.6 million in fiscal year 2008. Total tobacco tax collections account for 73.4 percent of the total Other Governmental Funds revenues compared to 73.1 percent of the total Other Governmental Funds revenues in fiscal year 2008.

General Fund Budgetary Highlights

Differences totaling $234.2 million occurred between the original and the final amended administrative and programmatic expenditure budgets. A net $234.2 million supplemental appropriation was provided for the AHCCCS program in fiscal year 2009 that included a $240.8 program increase and a $6.6 million reduction to administrative line items. The primary causes of the supplemental increases were significant enrollment growth to the Proposition 204 eligibility categories. Additional budget adjustments related to the ARRA increased federal expenditure authority with a corresponding General Fund reduction in the amount of $323.1 million of ARRA increased FMAP funds actually received and expended. 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 supplemental increases and revisions are briefly summarized as follows:

- $319.5 million increase to Acute Proposition 204 Capitation comprised of a $204.2 supplemental and $115.3 in Special Line Item appropriation transfers
- $87.5 million decrease to the combined Acute Care Base and Proposition 204 Reinsurance Special Line Items
- $54.7 million increase to the Long Term Care program Special Line Items
- $33.3 million decrease to CHIP and CHIP Parents services Special Line Items
- $9.8 million net decrease to Acute Capitation and Fee-for-Service and Proposition 204 Fee-for-Service Special Line Items
- $5.8 million net decrease to Administration

At June 30, 2009, actual cash basis appropriated program expenditures were $206.8 million less than budgetary estimates, however, $45.8 million of the surplus relates to county funding that was legislatively directed to the State's General Fund and is not an available carry-forward balance that can 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, 2009 amount to $1.240 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. Normal automated systems equipment replacement purchases were held to a minimum in fiscal year 2009 due to State's budgetary position. The total decrease in AHCCCS' investment in capital assets for the current fiscal year was 45.2 percent or $1.023 million and is primarily attributable to the reduction in fiscal year 2009 of an additional 17 vehicles from the motor pool fleet with a net book value of $394,100 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	
	2009	2008	2009	2008	2009	2008
Vehicles	$ 505	$ 725	$ 15	$ 23	$ 520	$ 748
Furniture and equipment	690	1,435	30	80	720	1,515
Total capital assets, net	$ 1,195	$ 2,160	$ 45	$ 103	$ 1,240	$ 2,263

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

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 have 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, 2009) is .50 percent. The threshold declines by 0.25 percent for limit period nine and is zero percent for the limit period ended September 30, 2011. As of June 30, 2009, reported date of service expenditures associated with the six periods ended September 30, 2008 are below the limit by $126.0 million, or 0.56 percent. Through June 30, 2009, 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, 2009, 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.

In December 2006, the Department of Health and Human Services, Office of Inspector General, Office of Audit Services (OIG) commenced an audit of the Direct Service Claiming (DSC) program. The OIG requested that AHCCCS provide the OIG with all DSC claims data for the period from January 2004 through June 2006. The data represented over 9.5 million claim lines and $124 million dollars of federal funds paid to the Local Education Authorities (LEAs) statewide under the DSC program.

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

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

In September, 2009, the OIG provided AHCCCS with preliminary findings which focused primarily on: services not provided or service units over billed; documentation requirements not met; speech therapy provider requirements not met; unallowable transportation services; prescribing or referring provider requirements not met; and student eligibility not met. From the preliminary findings, the highest frequency of errors occurred in services not provided or service units over billed, documentation requirements not met, and speech therapy provider requirements not met.

Out of the $32,000 in federal dollars paid to the LEAs for the selected claims, OIG identified a potential overpayment of approximately $6,800 which represents an error rate of approximately 21%. OIG has extrapolated the error rate and has issued a draft report recommending that CMS recoup approximately $21 million of program costs previously passed through to the LEAs under the DSC program. AHCCCS is in the process of reviewing and validating the data set supporting the OIG findings and responded to OIG on October 8, 2009; AHCCCS has not yet received a response from OIG. AHCCCS disagrees with certain findings including 12 of the 51 errors relating to speech therapy provider requirements not met. AHCCCS also disagrees with the method with which OIG has extrapolated the sample findings. AHCCCS has reserved the opportunity to review the details of the methodology used to extrapolate and its right to contest any action taken by CMS based on the extrapolation.

Internal counsel has indicated that it is reasonably possible that some amount will be disallowed and recouped by CMS. However, at this preliminary stage, AHCCCS cannot reasonably estimate an amount and no repayment liability has been recorded.

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

In August 2008, the TPA identified that the prospective implementation failed to include all of the recommendations having a direct impact on the claims paid from December 2005 through December 2007. AHCCCS has requested that the TPA either return the approximate $2.3 million maximum overpayment or recalculate what the payments should have been and return the resulting overpayment.

In April 2009, AHCCCS requested guidance from CMS regarding the retroactive calculations of all claims in question and received a response in November 2009. CMS has declined AHCCCS' request to allow AHCCCS to make the changes to the MAC calculation on a prospective basis only and recommends that an attempt be made to resolve the errors in previous quarters. In addition, CMS has instructed AHCCCS to refund the $9.3 million in overpayments. AHCCCS intends to request that the LEAs refund the amounts, or the funds will be deducted from future payments in accordance with the intergovernmental agreement. The amount due from the LEAs may be reduced by any recovery from the TPA as discussed above.

The recoupment liability of $9.3 million is included in the due to the federal government with a corresponding receivable in the due from the state and local governments of $9.3 million in the accompanying financial statements.

Economic Factors and Next Year's Budgets and Rates

The AHCCCS program experienced the most significant enrollment growth since the Proposition 204 expansion in calendar years 2001 to 2003. Fiscal year 2006 remains as the only year of declining enrollment out of the previous seven fiscal years. Enrollment for all government-wide programs grew at a rate of 12.0 percent during fiscal year 2009. The overall change was primarily due to growth in the Title XIX Waiver Group (TWG) childless adults (25.3 percent) and the Title XIX families and children (24.2 percent) program populations. That growth was partially offset by a 18.9 percent decrease in the combined Title XXI KidsCare and KidsCare Parent populations. Although most recent economic forecasts believe that the national recession may be coming to an end, most agree that Arizona's recovery will lag behind the rest of the nation due to the real estate market issues and other challenges. Accordingly, AHCCCS is projecting that populations will continue to be impacted by the state's economic issues with some reduction in growth starting in April 2010. Additionally, the ARRA increased FMAP comes with a series of conditions that states must meet to remain eligible. These conditions include restrictions on changing eligibility standards, prompt payment requirements for certain providers, limitations on use of the additional funding, and political subdivision savings sharing requirement. The eligibility standard requirement directly impacted enrollment growth for the childless adults group as a legislative change to the frequency of eligibility re-determinations from a 12-month to a 6-month period had to be reversed in order to be ARRA eligibility.

Legislation was passed to freeze hospital rates at the current levels and allow for up to 5% rate reductions for other services. Also for contract year 2010, AHCCCS is reducing the risk contingency for health plans from 2% to 1%, reducing health plan administration by 5.88%, and requiring health plans not already at the lowest reinsurance deductible level to drop one level. The result of these actions and assumptions is an overall weighted rate decrease of 2.4% for Acute rates and a slight decrease of .4% for ALTCS rates versus the current contract year 2009 rates.

This marks the second year in a row that hospital rates will be frozen and the fiscal year 2009 budget reductions already implemented included fee-for-service rate reductions for certain providers and capitation reductions effective May 1, 2009. Due to the reductions and freezes in reimbursement rates to health plans, hospitals, and other providers made during the past year and in recognition that the program must increase capitation rates to reflect changes in medical utilization, absent changes in benefit levels, the fiscal year 2011 budget request includes rate increases of 5.0% across the board for both prior and prospective payments for contract year 2011.

AHCCCS' budget request for fiscal year 2011 submitted to the Governor in September 2009 includes a rebase of the fiscal year 2010 budget. The revised projection indicates a potential fiscal year 2010 total shortfall of $302.4 million. The factors that may influence the need for or amount of a supplemental appropriation include enrollment trends greater than appropriated 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 its members, providers and creditors. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Arizona Health Care Cost Containment System, Division of Business and Finance, Attention: Finance Administrator MD 5400, 701 East Jefferson, Phoenix, Arizona 85034.

INDEPENDENT AUDITORS' REPORT

MHM
Mayer Hoffman McCann P.C.
An Independent CPA Firm

3101 North Central Avenue, Suite 300
Phoenix, Arizona 85012
602-264-6835 ph
602-265-7631 fx
www.mhm-pc.com

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, 2009, as shown on pages 20 through 28. 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, 2009, 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, 2009, 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 17, 2009 on our consideration of AHCCCS' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The accompanying management's discussion and analysis on pages 1 through 17 and the budgetary comparison information on page 25 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 17, 2009

BASIC FINANCIAL STATEMENTS

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET ASSETS (DEFICIT)

June 30, 2009
(amounts expressed in thousands)

ASSETS	Governmental Activities	Business-type Activities	Total
CURRENT ASSETS			
Cash	$ 38,295	$ 11,676	$ 49,971
Restricted cash	75,170	-	75,170
Due from state and local governments	212,469	-	212,469
Due from the federal government	551,133	-	551,133
Tobacco settlement receivable	59,140	-	59,140
Receivables and other	119	257	376
TOTAL CURRENT ASSETS	936,326	11,933	948,259
NONCURRENT ASSETS			
Hospital residency program loans	900	-	900
Furniture, vehicles and equipment, net of accumulated depreciation	1,195	45	1,240
TOTAL NONCURRENT ASSETS	2,095	45	2,140
TOTAL ASSETS	938,421	11,978	950,399
LIABILITIES			
CURRENT LIABILITIES			
Accounts payable	6,077	1,085	7,162
Other accrued liabilities	4,072	114	4,186
Bank overdraft	3,268	-	3,268
Deferred revenue	17,000	6,036	23,036
Payable to providers	-	996	996
Due to federal, state and county governments	152,621	-	152,621
Accrued programmatic costs	747,923	429	748,352
Compensated absences	3,715	122	3,837
TOTAL CURRENT LIABILITIES	934,676	8,782	943,458
ACCRUED PROGRAMMATIC COSTS, less current portion	-	13,985	13,985
TOTAL LIABILITIES	934,676	22,767	957,443
COMMITMENTS AND CONTINGENCIES			
NET ASSETS (DEFICIT)			
INVESTED IN CAPITAL ASSETS	1,195	45	1,240
UNRESTRICTED NET ASSETS (DEFICIT)	2,550	(10,834)	(8,284)
TOTAL NET ASSETS (DEFICIT)	$ 3,745	$ (10,789)	$ (7,044)

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF ACTIVITIES

Year Ended June 30, 2009
(amounts expressed in thousands)

		Program Revenues			Net (Expense) Revenue and Changes in Net Assets		
	Program Expenses	**Charges for Services**	**Federal Operating Grants**	**Other Operating Grants and Contributions**	**Governmental Activities**	**Business-type Activities**	**Total**
PROGRAMS							
Government activities:							
Health care programs	$ 8,765,434	$ 13,153	$ 6,344,793	$ 448,031	$ (1,959,457)	$ -	$ (1,959,457)
Business-type activities:							
Healthcare Group	58,301	60,462	-	-	-	2,161	2,161
TOTAL PROGRAMS	$ 8,823,735	$ 73,615	$ 6,344,793	$ 448,031	(1,959,457)	2,161	(1,957,296)
General revenues:							
State appropriations					1,884,780	-	1,884,780
Tobacco tax					150,620	-	150,620
Unrestricted investment earnings					301	199	500
					2,035,701	199	2,035,900
Transfers:							
Transfers in					-	2,800	2,800
Transfers out					(77,826)	(152)	(77,978)
Total general revenues and transfers					1,957,875	2,847	1,960,722
CHANGE IN NET ASSETS (DEFICIT)					(1,582)	5,008	3,426
NET ASSETS (DEFICIT), BEGINNING OF YEAR					5,327	(15,797)	(10,470)
NET ASSETS (DEFICIT), END OF YEAR					$ 3,745	$ (10,789)	$ (7,044)

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BALANCE SHEET - GOVERNMENTAL FUNDS

June 30, 2009
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
ASSETS			
Cash	$ 21,280	$ 17,015	$ 38,295
Restricted cash	74,117	1,053	75,170
Due from state and local governments	134,851	11,606	146,457
Due from the federal government	290,791	-	290,791
Due from other funds	6,541	-	6,541
Receivables and other	108	11	119
TOTAL ASSETS	$ 527,688	$ 29,685	$ 557,373
LIABILITIES			
Accounts payable	$ 5,877	$ 200	$ 6,077
Other accrued liabilities	3,803	269	4,072
Bank overdraft	3,268	-	3,268
Deferred revenue	16,231	769	17,000
Due to federal, state and county governments	152,401	220	152,621
Due to other funds	-	6,541	6,541
Accrued programmatic costs	346,108	21,001	367,109
TOTAL LIABILITIES	527,688	29,000	556,688
COMMITMENTS AND CONTINGENCIES			
FUND BALANCES			
Unreserved	-	685	685
TOTAL FUND BALANCES	-	685	685
TOTAL LIABILITIES AND FUND BALANCES	$ 527,688	$ 29,685	

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.	1,195
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 $995 exceeded capital outlays ($30) in the current fiscal year.	965
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.	(3,715)
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.	3,715
Long-term accrued liabilities for programmatic costs are not due and payable from current financial resources and, therefore are not reported in the funds.	(380,814)
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.	380,814
Long-term receivables for the Hospital Residency Loan program are not due and receivable in the current period and therefore are not reported in the funds.	900
NET ASSETS OF GOVERNMENTAL ACTIVITIES	$ 3,745

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, 2009
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
REVENUES			
State government:			
Appropriations	$ 1,276,221	$ -	$ 1,276,221
Pass through funds	572,908	-	572,908
Federal government:			
Acute care	3,938,904	7,271	3,946,175
Long-term care	869,816	-	869,816
Pass through funds	1,512,913	84	1,512,997
County government:			
Acute care	41,879	-	41,879
Long-term care	207,142	-	207,142
Pass through funds	23,480	-	23,480
Tobacco litigation settlement revenue	125,571	-	125,571
Tobacco tax revenue	46,085	104,535	150,620
Gaming revenue	-	20,875	20,875
Intergovernmental agreement revenue	-	8,042	8,042
Premium revenue	13,153	-	13,153
Other	17,565	1,640	19,205
TOTAL REVENUES	8,645,637	142,447	8,788,084
PROGRAMMATIC EXPENDITURES			
Capitation:			
Acute care	3,742,458	60,704	3,803,162
Long-term care	1,860,992	-	1,860,992
Children's rehabilitative services	84,699	-	84,699
Mental health services	1,144,663	-	1,144,663
Fee-for-service:			
Acute care	773,738	110	773,848
Long-term care	125,449	-	125,449
Trauma center services	-	20,948	20,948
Disproportionate share	98,038	-	98,038
Graduate medical education	80,906	-	80,906
Reinsurance	286,867	2,149	289,016
Medicare:			
Acute care premiums	119,385	8,488	127,873
Long-term care premiums	33,736	-	33,736
Part D clawback payments	62,407	-	62,407
Part D drug co-pay	2,924	-	2,924
TOTAL PROGRAMMATIC EXPENDITURES	8,416,262	92,399	8,508,661
ADMINISTRATIVE EXPENDITURES	179,073	16,689	195,762
ADMINISTRATIVE EXPENDITURES PASSED THROUGH	6,905	85	6,990
TOTAL EXPENDITURES	8,602,240	109,173	8,711,413
EXCESS OF REVENUES OVER EXPENDITURES	43,397	33,274	76,671
OTHER FINANCING SOURCES (USES)			
Transfers out:			
To State General Fund	(37,737)	(1,343)	(39,080)
To Healthcare Group	(2,800)	-	(2,800)
To Arizona Government Information Technology Agency	(19)	-	(19)
To Arizona Department of Economic Security	(2,841)	-	(2,841)
To Arizona Department of Health Services	-	(32,393)	(32,393)
To Arizona Department of Health Services Health Crisis Fund	-	(693)	(693)
TOTAL OTHER FINANCING SOURCES (USES)	(43,397)	(34,429)	(77,826)
NET CHANGE IN FUND BALANCES	-	(1,155)	(1,155)
FUND BALANCES, BEGINNING OF YEAR	-	1,840	1,840
FUND BALANCES, END OF YEAR	$ -	$ 685	$ 685

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, 2009
(amounts expressed in thousands)

Amounts reported for governmental activities in the statement of activities (page 21) are different because:

Net change in fund balance - total governmental funds (page 23)	$	(1,155)
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.		(427)
Change in net assets of governmental activities (page 21)	$	(1,582)

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BUDGETARY COMPARISON SCHEDULE - GENERAL FUND

Year Ended June 30, 2009
(Unaudited)
(amounts expressed in thousands)

	Original Appropriation (Budget)	Final Appropriation (Budget)	Actual	Variance with Final Budget
REVENUES				
State appropriations	$ -	$ -	$ 1,237,921	$ -
State pass-through funds	-	-	701,404	-
Federal government	-	-	4,858,259	-
Federal pass-through funds	-	-	1,371,820	-
County government	-	-	309,244	-
County pass-through funds	-	-	13,473	-
Tobacco tax revenue	-	-	46,829	-
Tobacco litigation settlement	-	-	125,571	-
Other	-	-	13,843	-
Total revenues	-	-	8,678,364	-
OTHER FINANCING SOURCES				
Operating transfers in	-	-	24,709	-
TOTAL REVENUES AND OTHER FINANCING SOURCES	-	-	8,703,073	-
PROGRAMMATIC EXPENDITURES				
Acute capitation	2,051,643	2,106,472	2,091,573	14,899
Acute reinsurance	134,202	103,014	102,924	90
Acute fee-for-service	573,396	533,043	531,755	1,288
Proposition 204 capitation	1,186,371	1,507,262	1,503,510	3,752
Proposition 204 reinsurance	129,920	73,665	73,596	69
Proposition 204 fee-for-service	243,375	228,201	222,137	6,064
Proposition 204 Medicare premiums	20,629	22,900	22,735	165
Medicare premiums	96,275	96,223	96,170	53
Graduate medical education	44,906	46,598	-	46,598
Disproportionate share	30,350	30,350	4,202	26,148
Rural hospital reimbursement	12,158	12,158	-	12,158
Breast and cervical cancer	1,530	984	913	71
Critical access hospitals	1,700	1,736	1,700	36
Freedom to work	8,913	6,479	6,450	29
Part D copay subsidy	1,030	2,151	2,151	-
Medicare clawback payments	28,845	28,795	28,794	1
SSDI temporary medical coverage	3,247	3,247	3,138	109
County hold harmless	4,826	-	-	-
Long-term care	1,173,829	1,229,277	1,134,882	94,395
ALTCS clawback	20,741	20,741	20,707	34
LTC Part D copay subsidy	470	589	589	-
LTC board of nursing	210	210	210	-
CHIP - Services	145,268	116,178	115,408	770
CHIP - Parents	34,901	30,690	30,625	65
TOTAL PROGRAMMATIC EXPENDITURES	5,948,735	6,200,963	5,994,169	206,794
ADMINISTRATIVE EXPENDITURES	197,301	193,710	177,085	16,625
OPERATING TRANSFERS OUT	5,000	2,841	2,800	41
TOTAL APPROPRIATED EXPENDITURES	6,151,036	6,397,514	6,174,054	223,460
PRIOR YEAR APPROPRIATED EXPENDITURES	-	-	134,315	-
NON-APPROPRIATED EXPENDITURES	-	-	2,386,399	-
REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES	-	-	8,305	-
FUND BALANCES, BEGINNING OF YEAR	-	-	80,373	-
FUND BALANCES, END OF YEAR	$ -	$ -	$ 88,678	$ -

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET ASSETS (DEFICIT) - PROPRIETARY FUND

June 30, 2009
(amounts expressed in thousands)

ASSETS		
CURRENT ASSETS		
Cash	$	11,676
Receivables and other		257
TOTAL CURRENT ASSETS		11,933
CAPITAL ASSETS		
Furniture, vehicles and equipment, net of accumulated depreciation		45
TOTAL ASSETS	$	11,978
LIABILITIES		
CURRENT LIABILITIES		
Accounts payable	$	1,085
Other accrued liabilities		114
Deferred revenue - premiums		6,036
Payable to providers		996
Accrued programmatic costs		429
Compensated absences due within one year		122
TOTAL CURRENT LIABILITIES		8,782
ACCRUED PROGRAMMATIC COST, less current portion above		13,985
TOTAL LIABILITIES	$	22,767
COMMITMENTS AND CONTINGENCIES		
NET ASSETS (DEFICIT)		
INVESTED IN CAPITAL ASSETS	$	45
UNRESTRICTED (DEFICIT)		(10,834)
TOTAL NET ASSETS (DEFICIT)	$	(10,789)

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, 2009
(amounts expressed in thousands)

OPERATING REVENUES	
Premium revenue	$ 60,462
OPERATING EXPENSES	
Premiums paid to health plans	47,852
Reinsurance	967
Other programmatic	4,676
Salaries and employee benefits	2,425
Professional and outside services	764
Other	563
Depreciation	58
TOTAL OPERATING EXPENSES	57,305
OPERATING INCOME	3,157
NONOPERATING REVENUE (EXPENSE)	
Investment income	199
Other loss	(996)
INCOME BEFORE TRANSFERS	2,360
TRANSFERS IN	
From State General Fund	2,800
TRANSFERS OUT	
To State General Fund	(152)
CHANGE IN NET ASSETS	5,008
NET ASSETS (DEFICIT), BEGINNING OF YEAR	(15,797)
NET ASSETS (DEFICIT), END OF YEAR	$ (10,789)

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF CASH FLOWS - PROPRIETARY FUND

Year Ended June 30, 2009
(amounts expressed in thousands)

CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from customers	$	58,450
Payments to health plans		(54,342)
Payments to providers		(6,209)
Payments to employees		(2,432)
Payments to suppliers		(807)
Net cash used by operating activities		(5,340)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Operating subsidies from other funds		2,800
Transfer to State General Fund		(152)
Net cash provided by non-capital financing activities		2,648
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment income		199
NET CHANGE IN CASH		(2,493)
CASH, BEGINNING OF YEAR		14,169
CASH, END OF YEAR	$	11,676

RECONCILIATION OF OPERATING INCOME TO NET CASH USED IN OPERATING ACTIVITIES		
Operating income	$	3,157
Adjustment to reconcile operating income to net cash provided by operating activities:		
Depreciation		58
Changes in operating net assets and liabilities:		
Increase in receivable		(236)
Increase in accounts payable and other accrued liabilities		757
Decrease in deferred revenue - premiums		(2,011)
Decrease in accrued programmatic costs		(7,057)
Decrease in accrued compensated absences		(8)
NET CASH USED BY OPERATING ACTIVITIES	$	(5,340)

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 Title XIX Medicaid program and Title XXI Children's Health Insurance Program ("CHIP"). State appropriations and county funding levels are based on annual budgets as dictated by the Legislature and specified by Arizona Statutory funding formula and Session Law.

AHCCCS provides acute and long-term health care coverage to eligible residents of Arizona. Eligible residents include those who qualify under Section 1931(b) of the Social Security Act, individuals who are aged, blind or disabled, children who meet certain age requirements from families receiving food stamps, children and pregnant women whose household income meets eligibility requirements, certain single adults, childless couples, parents of CHIP and Medicaid children under the Health Insurance Flexibility and Accountability Demonstration initiative, uninsured women needing active treatment for breast and/or cervical cancer and individuals with disabilities who want to work and who meet certain SSI eligibility criteria.

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

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

B. Basis of presentation

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

The government-wide financial statements (i.e., the statement of net assets (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 2009, AHCCCS did not have any major funds; accordingly, all governmental funds other than the General Fund are aggregated and reported as other governmental funds.

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

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

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

Proprietary fund revenues are recognized when they are earned, and expenses are recognized when they are incurred. Member premiums are due by the first day of the month preceding the month of coverage. At June 30, 2009, the proprietary fund deferred revenue of $6,036 consists of premium payments received for fiscal year 2010 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 paid in the 31-day period following the end of the fiscal year. Actual results for accrued programmatic costs may differ from such estimates. These differences are recorded in the period in which they are identified. However, expenditures related to compensated absences and claims and judgments are recorded only when payment is due.

(1) Summary of significant accounting policies (continued)

In fiscal year 2009, AHCCCS reports the following significant funds:

a. The general fund is the primary operating fund for the Title XIX Medicaid program and the Title XXI State Children's Health Insurance Program.

b. Special revenue funds, reported as other governmental funds, account for various health and administrative programs.

c. The Healthcare Group fund, reported as a business-type activity, accounts for the activities of a medical coverage program primarily for small, uninsured businesses with 2 to 50 employees and employees of political subdivisions.

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

D. 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 $125,141 at June 30, 2009, including restricted funds of $75,170.

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 $74,117, $34,815 for the Interagency Service Agreement (ISA) Fund and $39,302 for the AHCCCS and Long Term Care Funds. The ISA Fund is used to properly account for, control, and report receipts and disbursements associated with ISAs which are not required to be reported in other funds. Fund receipts consist of monies received from other entities and are utilized to match federal funding under the Medicaid and CHIP programs under the terms stated in the ISAs. The cash restricted in the AHCCCS and Long Term Care Funds represents amounts payable to the counties to comply with section 5001(g)(2) of the American Recovery and Reinvestment Act of 2009. Cash in the Other Governmental Funds is legally restricted in the amount of $1,053 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, 2009.

(1) Summary of significant accounting policies (continued)

In accordance with the Federal Cash Management Improvement Act of 1990 guidelines, AHCCCS may only request federal funds under specified funding techniques. These techniques require that AHCCCS draw down or request funds such that the timing of the receipt of the funds is interest neutral to both the State and Federal governments. For disbursements made through electronic fund transfers, funds must be drawn such that they are received by the State on the same day as the disbursement. For disbursements made through issuance of a check, funds must be drawn such that they are received by the State in accordance with its historical average check clearance pattern. The timing difference that occurs, due to drawing down funds after the issuance of checks, may result in bank overdrafts to AHCCCS at various times during the year. At June 30, 2009, a bank overdraft of $3,268 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, 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 effective date of eligibility to the day a member is enrolled with a contracted health plan. The risk under PPC is shared by both the contracted health plans and AHCCCS for the contract year. AHCCCS reconciles the actual PPC medical costs to the PPC net capitation paid during the contract year. The reconciliation limits the contractor’s profits and losses to 2%. Accrued programmatic costs include approximately $3,379 at June 30, 2009 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 net capitation payments, reinsurance payments, a percentage of 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 $37,096 at June 30, 2009 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, AHCCCS inpatient per-diem reimbursement rate system 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 $98,038 for the year ended June 30, 2009.

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, 2009. 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, 2009, 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 annual and strategic contribution fund payments of $125,571 in fiscal year 2009 for the period from January 1, 2008 to December 31, 2008. Revenue and a related receivable of $59,140 were accrued for the period of January 1, 2009 through June 30, 2009 and are 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, 2008	$	2,263
Additions		30
Retirements		(5)
Depreciation		(1,048)
Balance, June 30, 2009	$	1,240

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, 2009, 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, 2008	$	3,750
Additions		5,594
Reductions		(5,507)
Balance, June 30, 2009	$	3,837

(4) Other governmental funds

At June 30, 2009, the other governmental fund balance of $685 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.

- 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.

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

- Miscellaneous Funds - These funds account for various grants and other money received for specific purposes including the Hawaii Arizona PMMIS Alliance (HAPA) and the Hospital Loan Residency Fund. HAPA represents AHCCCS' project with Hawaii whereby AHCCCS provides data processing services for Hawaii's Medicaid program. The Hospital Loan Residency Fund 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.

(dollar amounts expressed in thousands)

(4) Other governmental funds (continued)

Other governmental funds earned, expended and transferred during the fiscal year ended June 30, 2009 were as follows:

	TTHCF - MNA	TPTF - EHSA	Trauma and Emergency Services Fund	Third Party Liability Fund	Miscel-laneous Funds	Total
Fund balances, June 30, 2008	$ -	$ -	$ -	$ -	$ 1,840	$ 1,840
Receipts	82,589	21,945	20,875	1,941	14,992	142,342
Interest earned	3	-	73	5	24	105
Expenditures	(49,506)	(21,945)	(20,948)	(1,750)	(15,024)	(109,173)
Transfers in (out):						
State General Fund	-	-	-	(196)	(1,147)	(1,343)
Arizona Dept of Health Services	(32,393)	-	-	-	-	(32,393)
ADHS Health Crisis Fund	(693)	-	-	-	-	(693)
Fund balances, June 30, 2009	$ -	$ -	$ -	$ -	$ 685	$ 685

(5) Proprietary fund - operations

Healthcare Group (HCG) was established in 1988 by the State to administer health care services primarily to small, uninsured businesses with 1 to 25 employees and employees of political subdivisions. That range was later changed to 2 to 50 employees. HCG contracts with 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 Preferred Provider Organization (PPO) option through a third party administrator in order to provide health care coverage statewide. Effective October 2008, Laws 2008, Chapter 288 restricted the PPO program to counties with a population of less than 500,000; thus eliminating the PPO option in 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 HMOs 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, effective July 1, 2008 through December 31, 2008 and in prior years, HCG reconciled the health plans' actual medical expenses reported to the capitation payments made by HCG during the contract year to determine if any additional payments were 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. For the period July 1, 2008 through December 31, 2008 there was no reconciliation liability as of June 30, 2009. However, at June 30, 2009, accrued programmatic costs include approximately $13.4 million of estimated settlement payments due to contracted health plans based on prior period reconciliations. Due to HCG's financial condition (Note 6) and the inadequacies of revenues, HCG has negotiated payment terms with the three contracted health plans to repay the remaining liabilities owed over the next few fiscal years.

In fiscal year 2009, HCG reported operating income of $3,157 and recorded a net $2,648 General Fund subsidy to fund the continued repayment of prior year reconciliation liability. See further discussion in Note 6.

(5) Proprietary fund - operations

Effective January 1, 2009, and on a go forward basis, all three HCG contractors agreed, in contract, that no future reconciliation costs will be recognized by HCG except for adjustments to the existing reconciliation for services rendered through December 31, 2008. HCG contractors will be compensated for attaining Nationally Recognized Utilization Management Standards, as mandated by Chapter 288. This amount will be no more than 6% of total premiums collected. In January 2009, HCG began reserving for these anticipated payments. As of June 30, 2009, the amount HCG has allocated and reserved was $582. After the end of the fourth quarter in fiscal year 2009, if the contractors meet certain performance standards, each will receive a payment. If a health plan fails to meet performance standards, it will forfeit the reserved amount, and HCG will retain the amount and apply it to any existing liabilities. The performance standards are developed by Milliman, Inc., customized to each health plan's unique member population and further stratified by the level of medical management such as well managed, moderately managed, and loosely managed. By compensating the health plans based on a set amount of reserves already collected from member premiums, HCG then eliminates the potential for any unanticipated losses (or gains) from variation in HMO utilization.

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

As of June 30, 2009, HCG had a net deficit of $10,789 as a result of significant losses in prior fiscal years. In fiscal years 2008 and 2009, HCG revenues were sufficient to cover all expenses incurred in the respective years. In addition to HCG's fiscal year 2009 operating income of $3,157, HCG received a net $2,648 General Fund subsidy in order to reduce its liabilities owed to its contracted HMOs for reconciliations incurred in previous fiscal years. HCG management also made significant administrative and programmatic changes in order to eliminate future losses and reduce the net deficit. Some significant changes included the elimination of the PPO program in Maricopa and Pima Counties, employers with groups of one being placed in a separate group with adjusted premiums to cover higher cost of care, and a continued decrease in administrative costs. As a result, HCG was able to reduce their net deficit in fiscal year 2009 by $5,008.

For fiscal year 2010 management is projecting that HCG will continue to operate without incurring additional losses. The following table summarizes HCG's reconciliation liability activity for fiscal year 2009.

Healthcare Group Reconciliation Liability as of June 30, 2009
Fiscal Year 2009 Activity
(in thousands of dollars)

	Reconciliation Period			
	FY 07	FY 08	FY 09	Total
Balance June 30, 2008	$ 14,877	$ 4,324	$ -	$ 19,201
Payments made	(5,281)	-	(150)	(5,431)
Accruals and adjustments	(13)	(502)	150	(365)
Balance June 30, 2009	$ 9,583	$ 3,822	$ -	$ 13,405

The remaining 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.

There can be no assurance that operating improvements realized over the past two fiscal years will continue to 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.

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

Subsequent to June 30, 2009, HCG took over the provider payment function from HCG's preferred point of service third party administrator. As a result of provider payment reconciliations and payment history research, HCG determined that due to certain errors on the part of the third party administrator approximately $996 was owed to providers for services provided in fiscal years 2009 and prior. This amount is reflected on the Statement of Revenues, Expenses and Changes in Net Assets/(Deficit) as an Other Expense. HCG is currently working with AHCCCS legal counsel to resolve this ongoing issue and is seeking reimbursement for this loss.

Even though deficit reduction measures resulted in a net gain for fiscal year 2009, a net deficit of $10,789 still exists as of June 30, 2009. It is not anticipated in the near future that operations will generate sufficient cash flow to significantly pay down the deficit. Additionally, 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 in HCG's ability to continue as a going concern.

In conclusion, even though HCG posted operating income of $3,157 in fiscal year 2009 and management currently projects that the positive trend will continue, $10,789 remained as a net deficit at year end due to the outstanding reconciliation liability owed to the HMO's for prior fiscal years. It is not anticipated in the near future that operations will generate sufficient cash flow to entirely pay off the outstanding obligation.

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 8.95 percent for retirement and 0.50 percent for long-term disability for 2009. The matching amount contributed to the retirement plan by AHCCCS was $4,986 in 2009 and is included in administrative expenditures in the accompanying government-wide and governmental fund financial statements.

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

(dollar amounts expressed in thousands)

(8) Budgetary basis of accounting

The financial statements of AHCCCS are prepared in conformity with U.S. generally accepted accounting principles (GAAP). AHCCCS, like other State agencies, prepares its annual operating budget on a basis that differs from the GAAP basis. Encumbrances as of June 30th can be liquidated during a four week administrative period known as the 13th month. The budget basis expenditures reported in the financial statements include both the fiscal year paid and the 13th month activity. The State does not have a legally adopted budget for revenues. Prior fiscal year expenditures of $134,315 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, 2009.

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, 2009:

	General Fund Actual
Budgetary Basis Fund Balance, June 30, 2009	$ 88,678
Budgetary Basis of Accounting	
Increases to fund balance:	
Due from State and local governments	134,851
Due from the federal government	290,791
Due from other Fund	6,541
Receivables and other	108
Total increases	432,291
Decrease to fund balance:	
Deferred revenue	(16,231)
Due to State and county governments	(152,401)
Accrued programmatic costs	(346,108)
Payables and other	(6,229)
Total decreases	(520,969)
Total GAAP basis fund balance	$ -

Non-appropriated expenditures of $2,386,399 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.

Budget neutrality agreement - AHCCCS was granted a Waiver from CMS that provides federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204. The Waiver requires that over the term of the 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 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, 2009, reported date of service expenditures associated with the six limit periods ended September 30, 2008 are below the limit by $126.0 million, or .56 percent. Through June 30, 2009, 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, 2009, AHCCCS does not have any liability to CMS related to the budget neutrality agreement. Accordingly, the accompanying financial statements have not been adjusted for the impact of any liability AHCCCS may have related to the Waiver budget neutrality agreement.

School based claims audit - In December 2006, the Department of Health and Human Services, Office of Inspector General, Office of Audit Services (OIG) commenced an audit of the Direct Service Claiming (DSC) program. The OIG requested that AHCCCS provide the OIG with all DSC claims data for the period from January 2004 through June 2006. The data represented over 9.5 million claim lines and $124 million dollars of federal funds paid to the Local Education Authorities (LEAs) statewide under the DSC program.

(9) Contingencies (continued)

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

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

In September, 2009, the OIG provided AHCCCS with preliminary findings which focused primarily on: services not provided or service units over billed; documentation requirements not met; speech therapy provider requirements not met; unallowable transportation services; prescribing or referring provider requirements not met; and student eligibility not met. From the preliminary findings, the highest frequency of errors occurred in services not provided or service units over billed, documentation requirements not met, and speech therapy provider requirements not met.

Out of the $32 in federal dollars paid to the LEAs for the selected claims, OIG identified a potential overpayment of approximately $6.8 which represents an error rate of approximately 21%. OIG has extrapolated the error rate and has issued a draft report recommending that CMS recoup approximately $21 million of program costs previously passed through to the LEAs under the DSC program. AHCCCS is in the process of reviewing and validating the data set supporting the OIG findings and responded to OIG on October 8, 2009; AHCCCS has not received a response from OIG. AHCCCS disagrees with certain findings including 12 of the 51 errors relating to speech therapy provider requirements not met. AHCCCS also disagrees with the method with which OIG has extrapolated their sample findings. AHCCCS has reserved the opportunity to review the details of the methodology used to extrapolate and its right to contest any action taken by CMS based on the extrapolation.

Internal counsel has indicated that it is reasonably possible that some amount will be disallowed and recouped by CMS. However, at this preliminary stage, AHCCCS cannot reasonably estimate an amount, and no repayment liability has been recorded as of June 30, 2009.

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

In August 2008, the TPA identified that the prospective implementation failed to include all of the recommendations having a direct impact on the claims paid from December 2005 through December 2007. AHCCCS has requested that the TPA either return the approximate $2.3 million maximum overpayment or recalculate what the payments should have been and return the resulting overpayment.

(9) Contingencies (continued)

In April 2009, AHCCCS requested guidance from CMS regarding the retroactive calculations of all claims in question and received a response in November 2009. CMS has declined AHCCCS' request to allow AHCCCS to make the changes to the MAC calculation on a prospective basis only and recommends that an attempt be made to resolve the errors in previous quarters. In addition, CMS has instructed AHCCCS to refund the $9.3 million in overpayments. AHCCCS intends to request that the LEAs refund the amounts, or the funds will be deducted from future payments in accordance with the intergovernmental agreement. The amount due from the LEAs may be reduced by any recovery from the TPA as discussed above.

The recoupment liability of $9.3 million is included in the due to the federal government with a corresponding receivable in the due from the state and local governments of $9.3 million in the accompanying financial statements.

(10) Interfund receivables, payables and transfers

Interfund activity is defined as transactions between funds administered by AHCCCS. The interfund balances as of June 30, 2009 consist of transfers from the Other Funds to the General Fund in the amount of $6,541.

In the government-wide statement of activities, the interfund activity has been eliminated. The total net transfers out of $77,978 reported on the statement of activities represents transfer activities to other State agencies.

(11) Transactions with other State agencies and counties

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

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

(dollar amounts expressed in thousands)

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

The following is a summary of transactions with these State agencies for the administrative services described above for the year ended June 30, 2009.

	Expenditures
Arizona Department of Economic Security	$ 82,993
Arizona Department of Administration	14,763
Arizona Department of Health Services	1,946
Arizona Board of Nursing	210
Arizona Office of Administrative Hearings	357
	$ 100,269

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, 2009.

	Expenditures
Arizona Department of Economic Security	$ 896,952
Arizona Department of Health Services	1,231,095
	$ 2,128,047

Revenues include $249,021 from Arizona counties during fiscal year 2009. This amount has been adjusted to reflect the reduction in county contributions required by the political subdivision contribution limitations of the American Recovery and Reinvestment Act of 2009. See note 13. 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 2009, First Special Session, Chapter 4, Section 6, requires AHCCCS, in fiscal year 2009, to transfer $17,831 of the county share of refunds for fiscal year 2007 and fiscal year 2008 to the state general fund. At June 30, 2009, county and State contributions did not exceed related expenditures.

(12) Other pass through funds

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

(dollar amounts expressed in thousands)

(12) Other pass through funds (continued)

Arizona counties contributed $2,841 as determined by statutory calculation for administrative costs incurred by ADES for eligibility determinations and other operating costs associated with Proposition 204.

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

At June 30, 2009, 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	$ 5,146
Program Services Federal Funds	22,743
Arizona Department of Economic Security	
County Contribution for Administrative Costs	2,841
	$ 30,730

(13) American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 (ARRA) provides fiscal relief to States to protect and maintain State Medicaid programs. This relief is granted in the ARRA, Title V, Section 5001 and 5002 in the form of temporary increases in the federal matching assistance percentage (FMAP) rates, and increases to the Disproportionate Share Hospital (DSH) allotments. The FMAP rate increases vary based upon the maintenance of FMAP and unemployment rate provisions of the ARRA. The FMAP rate increased in fiscal year 2009 from 65.77% to 75.01% effective October 1, 2008 through March 31, 2009 and from 65.77% to 75.93% effective April 1, 2009 through June 30, 2009. The DSH allotment increased by $2,480 for federal fiscal year 2009 and is projected to increase by $5,040 for federal fiscal year 2010.

In order for states to be eligible to receive the increased FMAP, states must comply with the following maintenance of effort requirements:

- States are ineligible for increased FMAP if eligibility standards, methodologies, or procedures are more restrictive than what was in effect July 1, 2008. There are provisions that allow states to reverse changes made prior to the passage of ARRA and still be able to receive the increased FMAP. AHCCCS fell into this category and was required to reverse a change in the timing of redetermination for a population segment in order to become eligible.
- States must comply with prompt payment requirements to providers and must submit a quarterly report that it is in compliance with this provision.
- States cannot deposit or credit any reserve or rainy day funds with revenue from increased FMAP and will be required to report on how the increased FMAP dollars are spent.
- States are ineligible for the increased FMAP if it requires political subdivisions to pay a greater percentage of the non-federal share for quarters during the recession adjustment period than the percentage that would have been required by the State under such plan on September 2008.

(dollar amounts expressed in thousands)

(13) American Recovery and Reinvestment Act of 2009

Arizona counties contribute to the non-federal share of the Acute Base Capitation program and the Arizona Long-Term Care (LTC), Elderly and Physically Disabled (EPD) program; therefore, with the application of the political subdivision maintenance of effort provision, the required county contributions decreased in fiscal year 2009 by $10,350 for the Acute Base Capitation program and $50,849 for the LTC, EPD program.

State agencies and political subdivisions benefited from the increased FMAP rates for claimed federal expenditures for fiscal year 2009 as follows:

Arizona Health Care Cost Containment System	$	391,043
Arizona Department of Health Services		85,516
Arizona Department of Economic Security		58,958
Arizona Department of Corrections		162
Arizona School Districts		1,896
Arizona Counties		141
	$	537,716

(14) New pronouncements

The Governmental Accounting Standards Board (GASB) issued several pronouncements prior to June 30, 2009 with effective dates within or after the fiscal year ending June 30, 2009. 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, 2009.

(15) Subsequent events

The AHCCCS KidsCare Parents Program was eliminated effective October 1, 2009. The fiscal year 2010 budget includes a corresponding reduction in the amount of $27,933.

In FY 2009, the AHCCCS program experienced the most significant enrollment growth since the Proposition 204 expansion in calendar years 2001 to 2003. Since February 2007, AHCCCS enrollment has increased in 25 out of 30 months with the most significant growth from February through August 2009. The August 2009 enrollment of 1,220,124 (this number does not include Federal Emergency Services members, Healthcare Group enrollment, or certain Medicare Cost Sharing populations) represents an all time record high. The statewide economic recession is resulting in higher unemployment and more Arizonans are requiring assistance with their health care needs. Most recent economic forecasts believe that the national recession may be coming to an end; however, most agree that Arizona’s recovery will lag behind the rest of the nation due to the real estate market issues and other challenges. The growth rates built into the population forecasts reflect the assumption that populations will continue to be impacted by the state’s economic issues with some reduction in growth starting in April 2010.

ADDITIONAL INFORMATION

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2009
(amounts expressed in thousands)

Federal Grantor/Pass Through Agency	Federal CFDA Number	Expenditures	
U.S. Department of Health and Human Services			
Centers for Medicare and Medicaid Services			
Medicaid Program (Title XIX)			
Federal funds expended to vendors	93.778	$ 5,662,637	
American Recovery and Reinvestment Act	93.778-R	561,610	
Federal funds expended to subrecipients	93.778	3,417	
		6,227,664	*
Children's Health Insurance Program (Title XXI)	93.767	110,550	*
Medicaid Infrastructure Grant	93.768	329	
Medicaid Transformation Grants	93.793	6,250	
TOTAL EXPENDITURES OF FEDERAL AWARDS		$ 6,344,793	

*major programs

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

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2009

(dollar amounts expressed in thousands)

(1) Basis of presentation

The accompanying schedule of expenditures of federal awards includes the federal grant activity of ***Arizona Health Care Cost Containment System*** and is presented on the accrual basis of accounting. The information in this schedule is presented in accordance with the requirements of *U.S. Office of Management and Budget (OMB) Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in, the preparation of the basic financial statements.

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

The program titles and CFDA numbers were obtained from the 2009 *Catalog of Federal Domestic Assistance*.

MHM

Mayer Hoffman McCann P.C.

An Independent CPA Firm

3101 North Central Avenue, Suite 300
Phoenix, Arizona 85012
602-264-6835 ph
602-265-7631 fx
www.mhm-pc.com

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, 2009 and for the year then ended, and have issued our report thereon dated December 17, 2009. 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 entity'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 entity's financial statements that is more than inconsequential will not be prevented or detected by the entity'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 entity'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.

Mayer Hoffman McCann P.C.

Phoenix, Arizona
December 17, 2009