ARIZONA HEALTH CARE
COST CONTAINMENT SYSTEM

FINANCIAL STATEMENTS
AND SUPPLEMENTARY INFORMATION

Year Ended June 30, 2013

ARIZONA HEALTH CARE
COST CONTAINMENT SYSTEM

FINANCIAL STATEMENTS
AND SUPPLEMENTARY INFORMATION

Year Ended June 30, 2013

CONTENTS

MANAGEMENT'S DISCUSSION AND ANALYSIS

Management's Discussion and Analysis

For the Fiscal Year Ended June 30, 2013

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, 2013. The intent of this discussion and analysis is to look at AHCCCS' performance as a whole. We encourage readers to consider this information in conjunction with the basic financial statements and related footnotes that follow this section.

Financial Highlights

Government-Wide

- The assets of AHCCCS exceeded its liabilities at fiscal year ended June 30, 2013 by $34.1 million. AHCCCS' net position at June 30, 2013 is comprised of an unrestricted net asset of $9.0 million and net invested in capital assets of $25.1 million.

- AHCCCS' net position increased by $24.8 million during fiscal year 2013. The net financial position of governmental activities increased by $20.4 million, and the net position of the business-type activity increased by $4.4 million. The increase in governmental net position was primarily driven by an investment in an internally developed automated eligibility system in order to streamline the eligibility process, resulting in better, faster services to members and the organizations that serve them and allow for electronic data transfers between the state and the federally facilitated health care exchange. The business-type activity net position increase resulted from the second consecutive fiscal year of positive operations.

Fund Level

- As of the close of fiscal year 2013, AHCCCS' total governmental funds reported an ending fund balance of $2.1 million, a decrease of $2.8 million from fiscal year 2012. This decrease is attributable to expending a $4.0 million carry-forward balance from fiscal year 2012 of prepaid state matching funds received from political subdivisions for the temporary coverage expansions approved in the U.S. Department of Health and Human Services Section 1115 Waiver ("Waiver"). This amount was partially offset by an $821,000 increase in intergovernmental agreement funds and $300,000 of repayments to the Hospital Residency Loan Fund.

- Business-type activities during fiscal year 2013 resulted in operating income of $4.2 million compared to the operating income of $5.4 million in the prior fiscal year, representing the sixth year of continued profitability and second year of a positive net position balance since incurring a net deficit balance that began in fiscal year 2006. Operating results in fiscal year 2012 eliminated this deficit and brought the entity to a net position balance of $2.2 million at June 30, 2012. The net position balance at June 30, 2013 was $6.6 million. Additionally, $2.8 million in cash payments from operations and adjustments eliminated an outstanding reconciliation liability.

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

Overview of the Financial Statements

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

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

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

The Statement of Net Position (page 21) presents information on all of AHCCCS' assets and liabilities, with the difference between the two reported as "net position". Over time, increases or decreases in net position, along with other financial information, serve as indicators of AHCCCS' financial position and whether it is improving or deteriorating.

The Statement of Activities (page 22) presents information showing how AHCCCS' net position changed during the most recent fiscal year. All changes in net position are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods (e.g. incurred but not paid or reported fee-for-service and reinsurance claims, revenue from future Tobacco Master Settlement Agreement payments, prescription drug rebate receipts, business-type activities, and earned but unused vacation leave).

Both statements report activity for two categories:

- Governmental Activities - State appropriations along with federal, county and other local government intergovernmental revenues and member premium collections primarily support the activities in this category. The governmental activities of AHCCCS primarily consist of programs authorized by the Social Security Act Titles XIX (Medicaid) and XXI (Children's Health Insurance Program ("CHIP")) that are concentrated on the health needs of the citizens of Arizona through direct medical service payments and supplemental payments to qualifying hospital facilities throughout the State. The majority of AHCCCS' activities are reported in this category.

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

The government-wide financial statements can be found on pages 21 and 22.

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 23 through 25 of this report.

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

Annually, the Legislature adopts an appropriated budget for AHCCCS for the Traditional Medicaid services, Proposition 204 services, KidsCare, Children's Rehabilitative Services, Disproportionate Share Hospital ("DSH") payments, Rural Hospital payments, Voluntary match DSH, Graduate Medical Education ("GME"), and safety net care pool ("SNCP") supplemental hospital payments, Arizona Long-Term Care Services ("ALTCS") and AHCCCS administration programs. The annual appropriation is made separately for both the State share of the required matching funds and federal financial participation funds from the Social Security Act Titles XIX ("Medicaid") and XXI ("CHIP"). In addition to the appropriations and expenditure authority approved by the Legislature, AHCCCS also expends continuously appropriated funds for medical service payments from prescription drug rebate reimbursement receipts, for other third party liability recovery program activities, electronic health records infrastructure development, nursing facility supplemental payments, 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 26.

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 27 through 29 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 30 to 50.

Government-Wide Financial Analysis

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

AHCCCS Net Position
(in thousands of dollars)

	Governmental Activities		Business-Type Activities		Total	
	2013	2012	2013	2012	2013	2012
Current assets	$ 1,097,064	$ 874,484	$ 9,873	$ 8,865	$ 1,106,937	$ 883,349
Noncurrent assets	300	600	-	-	300	600
Capital assets	25,176	3,039	1	1	25,177	3,040
Total assets	1,122,540	878,123	9,874	8,866	1,132,414	886,989
Current liabilities	1,094,968	870,970	3,313	5,830	1,098,281	876,800
Long-term liabilities	-	-	-	879	-	879
Total liabilities	1,094,968	870,970	3,313	6,709	1,098,281	877,679
Net position:						
Invested in capital assets, net of depreciation	25,176	3,039	1	1	25,177	3,040
Unrestricted	2,396	4,114	6,560	2,156	8,956	6,270
Total net position	$ 27,572	$ 7,153	$ 6,561	$ 2,157	$ 34,133	$ 9,310

For AHCCCS, assets exceeded liabilities by $34.1 million at June 30, 2013 as compared to assets exceeding liabilities by $9.3 million at June 30, 2012.

During fiscal year 2013, the total Government-wide net position increased by $24.8 million to $34.1 million. The increase is primarily due to the investment in capital assets for an internally developed automated eligibility system. The investment was required to be compliant with the Patient Protection and Affordable Care Act ("ACA") and to qualify for 75 percent enhanced federal financial participation (FFP) for certain eligibility determination administrative functions that previously were eligible for the 50 percent FFP rate. The automated eligibility system redesign is for multiple human service programs and the amount funded by Medicaid through June 30, 2013 is $20.4 million and is reported as software under development in footnote 2. In addition to the investment in capital assets, the business-type activity contributed $4.4 million from current year operating income combined with interest and other income for the $24.8 million total increase.

The $2.4 million unrestricted net asset balance for governmental operations primarily consists of $1.3 million of funds limited to future spending for certain information technology activities. An additional component is a $900,000 balance in the Hospital Loan Residency Fund consisting of $300,000 in receivables that are due and available in future periods and a $600,000 cash balance. During fiscal year 2013, the governmental unrestricted net position decreased by $1.7 million due to the use in the current year of prior year prepaid state matching funds voluntarily provided by political subdivisions for temporary coverage expansions under the Section 1115 Waiver. The net position balance is also comprised of $25.2 million invested in capital assets. The $22.1 million increase in capital assets is primarily comprised of $20.4 of costs of a new eligibility system that is being developed to implement the ACA. Additionally, the business-type activity unrestricted net position of $6.6 million increased by $4.4 million as a result of current year operating and non-operating income.

AHCCCS Changes in Net Position
(in thousands of dollars)

	Governmental Activities		Business-Type Activities		Total	
	2013	2012	2013	2012	2013	2012
Revenues						
Program Revenues						
Charges for services	$ 5,416	$ 3,359	$ 26,872	$ 31,078	$ 32,288	$ 34,437
Other operating grants and contributions	747,660	598,867	-	-	747,660	598,867
Federal operating grants	5,977,384	5,987,458	-	-	5,977,384	5,987,458
General revenues						
State appropriations	2,016,660	2,052,782	-	-	2,016,660	2,052,782
Tobacco tax	131,441	130,058	-	-	131,441	130,058
Unrestricted investment earnings	45	82	59	63	104	145
Total revenues	8,878,606	8,772,606	26,931	31,141	8,905,537	8,803,747
Expenses						
Health Care	8,809,659	8,742,501	22,527	25,533	8,832,186	8,768,034
Excess before transfers	68,947	30,105	4,404	5,608	73,351	35,713
Transfers, net	(48,528)	(74,161)	-	(462)	(48,528)	(74,623)
Increase (decrease) in Net Position (deficit)	20,419	(44,056)	4,404	5,146	24,823	(38,910)
Net Position (deficit) – beginning of year	7,153	51,209	2,157	(2,989)	9,310	48,220
Net Position (deficit) – end of year	$ 27,572	$ 7,153	$ 6,561	$ 2,157	$ 34,133	$ 9,310

At June 30, 2013, both the governmental and business-type activities reported a positive unrestricted net position amount of $9.0 million which is a $2.7 million or 42.8 percent increase from the prior fiscal years' $6.3 million unrestricted net position.

Governmental activities in fiscal year 2013 increased the net position by $20.4 million. The increase is primarily due to the investment in capital assets for the development of a new automated eligibility system. The investment is necessary to implement the ACA beginning October 2013 when Arizona residents can register for insurance coverage and allow for electronic data transfers between the state and the federally facilitated health care exchange. Business-type activities increased the net position by $4.4 million primarily from $4.2 million in operating income.

Patient Protection and Affordable Care Act (ACA) of 2010

As part of the ACA, multiple opportunities were afforded to states with respect to the design of their Medicaid programs. Legislation was passed in the 2013 state legislative session that will restore the childless adults who are eligible for AHCCCS under the voter mandated Proposition 204 and expand coverage for adults from 101-133 percent of the federal poverty level ("FPL") beginning January 1, 2014. In order to participate in the various federal financial funding participation rates available under the ACA, a significant investment was required to modernize Medicaid eligibility determination information technology systems. AHCCCS and the Department of Economic Security leveraged an existing eligibility system to significantly upgrade and enhance the system to meet the new compliance requirements. Under the ACA, an eligibility determination made by the new Modified Adjusted Gross Income ("MAGI") methodology is eligible to receive the more generous federal funding rates including 100 percent for the adults between 101-133 percent of the FPL for program costs and qualifies for a 25 percent increase from 50 to 75 percent for administrative costs associated with eligibility determination functions for most staff activities and the system costs. Additionally, a time-limited specific exemption to the cost allocation requirements set forth in OMB Circular A-87 requiring that all costs be specifically allocated to the benefiting federal program was granted. This exemption allows an investment in the health program's eligibility determination systems to be leveraged at the highest 90 percent federal financial participation rate to apply to other federally-funded human service programs. Accordingly, AHCCCS and DES are jointly participating in the process to replace their respective existing systems under these favorable terms. The Medicaid share of the eligibility system investment though June 30, 2013 is $20.4 million and represents 81 percent of the $25.2 million invested in capital assets balance.

Governmental Activities

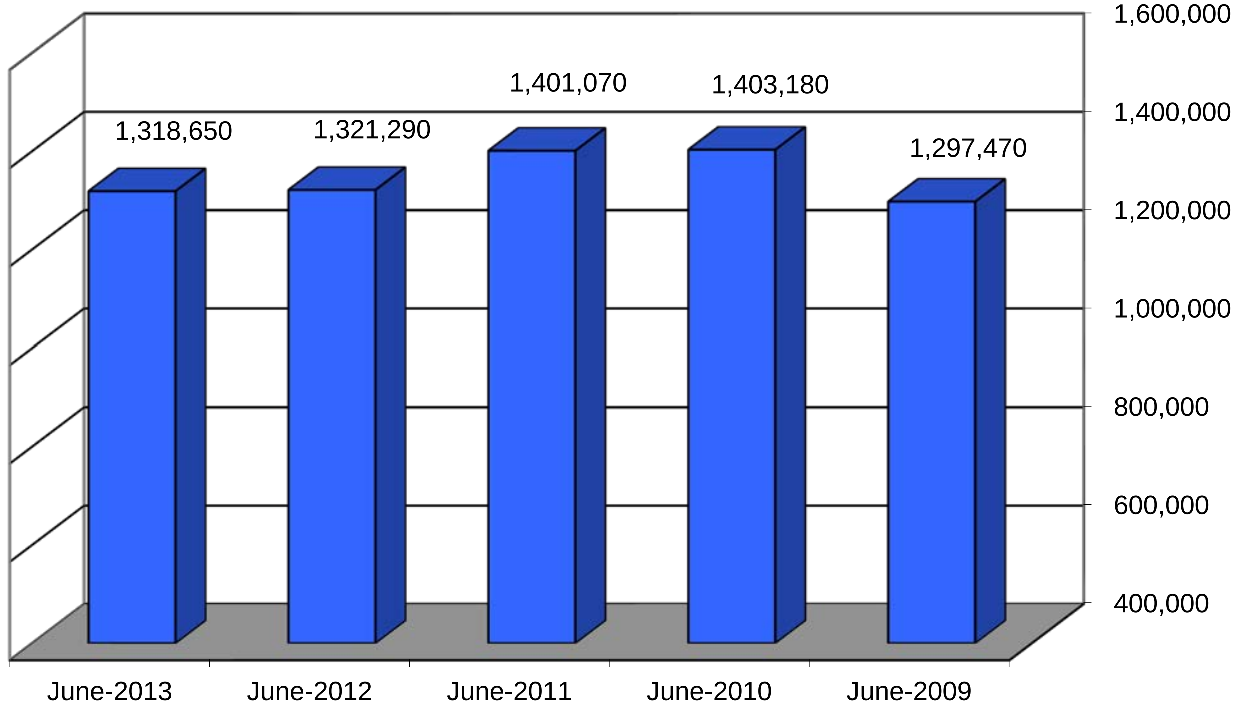
Fiscal year 2013 governmental activities increased the net position by $20.4 million primarily from the investment in capital assets.

Enrollment in AHCCCS programs had a minimal decrease in fiscal year 2013 as the result of a continued decrease in the Childless Adult population due to the enrollment freeze that was partially offset by the increase in the KidsCare II temporary coverage expansion program. Total enrollment for all of AHCCCS' programs at June 1, 2013 is 1,318,650, a decrease of only 2,640 members over June 1, 2012 or 0.2 percent decline as compared to the previous year's 79,780 or 5.7 percent decrease in members. The Childless Adult program freeze, effective July 8, 2011, resulted in a decrease of 40,753 members with the program declining to a total enrollment of 75,650 which is 33.7 percent of the June 2011 level of 224,492. Beginning on January 1, 2014, AHCCCS will re-open the childless adult population as part of the ACA restoration plan. Additionally, the continuation of the KidsCare enrollment freeze, which began January 1, 2010, resulting in an ending enrollment of 7,185 members, which is 38.9 percent of the June 2011 level of 18,469. However, this decrease was completely offset by the KidsCare II temporary coverage expansion. On April 6, 2013, the Centers for Medicare and Medicaid Services ("CMS") approved a new program under the Waiver. A component of the waiver was the temporary KidsCare II expansion where five months of the projected state match funds were provided in advance by the political subdivision partners according to their respective agreements. The KidsCare II program had an ending enrollment of 36,026 members at June 1, 2013. The KidsCare II program ending enrollment increased members by 34,119 from the June 1, 2012 enrollment of 1,907 members. This temporary KidsCare II program ends on December 31, 2013 when eligible members between 101-133 percent of the FPL will be covered in the ACA mandatory children's expansion program or advised that medical coverage is available through the Federally Facilitated Exchange.

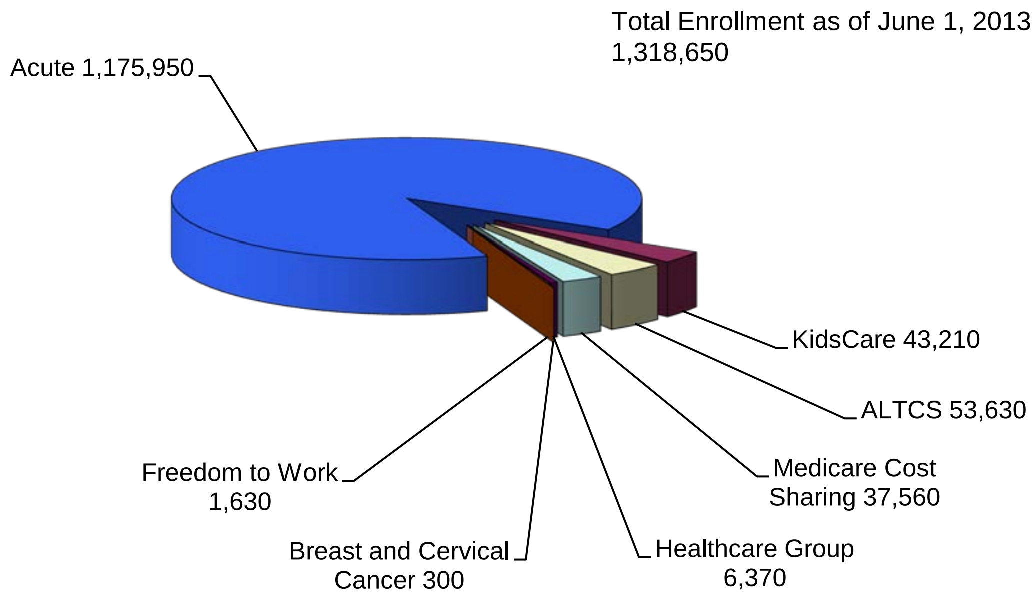
Overall, the financial impact of the Childless Adult population freeze to the healthcare industry statewide was somewhat mitigated by CMS' approval of two waivers related to payments for uncompensated care. CMS granted AHCCCS the authority to make supplemental payments to Indian Health Services ("IHS") and tribal 638 facilities to address the fiscal burden of uncompensated care for services provided by such facilities. Additionally, CMS approved the SNCP waiver, providing hospitals with additional funding to cover their costs for providing uncompensated care primarily due to the Childless Adult enrollment freeze. A condition of the SNCP waiver approval was that a portion of the funding provided by participating political subdivision partners for SNCP distributions be used to provide temporary coverage expansion for select populations, as the KidsCare II program has done. On April 16, 2013, CMS approved another modification to the Waiver that expanded the SNCP and related coverage expansion programs.

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

AHCCCS Membership Growth



AHCCCS Enrollment by Program



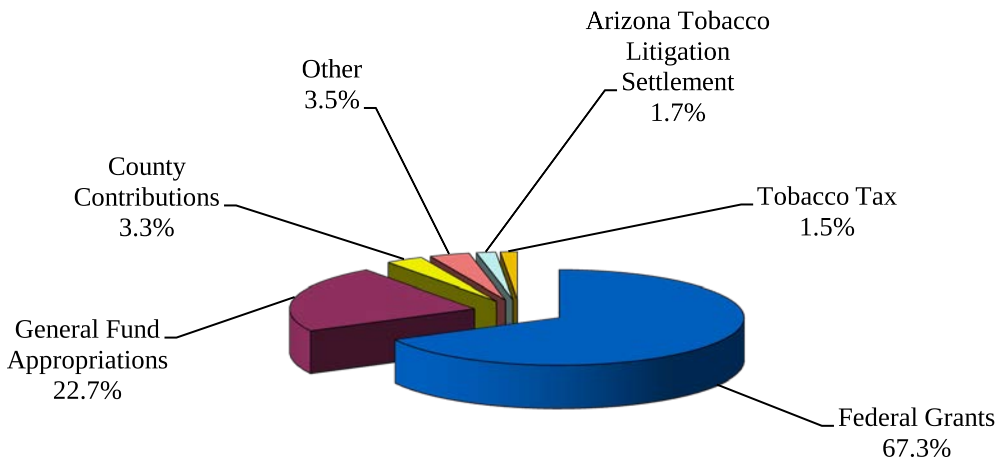
The cost of health care programs, including Title XIX Medicaid and Title XXI CHIP, totaled $8,809.7 million in fiscal year 2013, a $67.2 million increase from the $8,742.5 million reported in fiscal year 2012. As shown in the statement of activities, the amount of expenditures funded from federal grants through CMS was $5,977.4 million (67.9 percent) in fiscal 2013 as compared to $5,987.5 million (68.5 percent) in fiscal 2012. Program funding in the form of federal financial participation is primarily determined through the Federal Medical Assistance Percentage ("FMAP") rate used to provide the amount of federal matching funds for qualifying State medical assistance expenditures. The FMAP is based on the relationship between Arizona's per capita personal income and the national average per capita personal income over three calendar years. The FMAP is recalculated each federal fiscal year and decreased by 1.62 percent to 65.68 percent from the prior year's rate of 67.30 percent during most of the state fiscal year 2013. Overall, program expenditures increased by 0.8 percent over the prior fiscal year. However, expenditures funded by state appropriations decreased in fiscal year 2013 primarily due to the Childless Adults enrollment freeze. The increase in program expenditures was from supplemental hospital payments funded by voluntary contributions from political subdivision netting to an overall 0.8 percent increase. These supplemental hospital payments funded by political subdivision voluntary contributions resulted in payments of $889.8 million being distributed to Arizona hospitals, which is a $207.5 million or 30.4 percent increase over the $682.3 distributed in the prior fiscal year. The increase was primarily driven by the CMS approved SNCP program waiver that mitigates the impact of the childless adults enrollment freeze and other medical service and rate cuts. The SNCP distributions are schedule to end for dates of service after December 31, 2013 when the AHCCCS program both restores and expands the childless adult population under the ACA.

State, county and miscellaneous funding sources combined to provide $2,901.2 million in State funding sources and appropriations in fiscal year 2013, a $116.1 million increase over the $2,785.1 million reported in fiscal year 2012 primarily related to the decrease in FMAP and increase in voluntary political subdivision funding for supplemental hospital payments. 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 $1,297.2 million, and an additional $719.5 million was passed through from other State agencies in order to provide the State's share for Title XIX Medicaid eligible medical assistance expenditures. Arizona counties contributed $288.9 million as determined by statutory funding formulas, session law and other intergovernmental agreements. Tax collections on tobacco products provided $131.4 million in State match funding. The tobacco tax year-over-year collections increased in fiscal year 2013, for the first time after six consecutive years of decreases, by $1.4 million to $131.4 million or a 1.1 percent increase compared to the $8.4 million or 6.0 percent decrease in fiscal year 2012. An additional $149.1 million in State revenue funding was provided by Arizona's share of tobacco litigation settlement funds. This included a $48.1 million one-time payment as the State signed a multi-year settlement, resolving the diligent enforcement disputes for 2003 through 2012. In previous years, participating manufacturers paid a portion of their master settlement agreement ("MSA") payment into the dispute payment account ("DPA") representing the non-participating manufacturer ("NPM") adjustment portion of their payment. Essentially, those manufacturers claimed that the NPM adjustment should be applied to the payments until the states prove they diligently enforced their escrow statutes. Because the independent auditor decided that the issue must be arbitrated before the NPM adjustment can be applied, the manufacturers began depositing that portion of their annual payment into the DPA as allowed by the MSA. As a result of the settlement, those monies in the DPA were released and disbursed. Pursuant to the settlement, Arizona finally received monies that were part of previous MSA annual payments. This resulted in a higher than usual MSA annual payment received in fiscal year 2013. Overall, these MSA 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 MSA with major tobacco companies, are recorded. Payments are based on cigarette and other tobacco product sales from the preceding year. AHCCCS has accrued $50.0 million for the period January 1, 2013 through June 30, 2013 based on Arizona's Joint Legislative Budget Committee 2014 estimated payment. In addition to the annual and one-time settlement payments described above, AHCCCS continues to receive the Strategic Contribution Fund payment through April 15, 2017. The amounts of the payments are dependent upon several adjustments, the magnitude of which will not be fully known until an independent auditor provides its calculations in February or March of each year. Other factors 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. Finally, Tribal gaming receipts distributed to

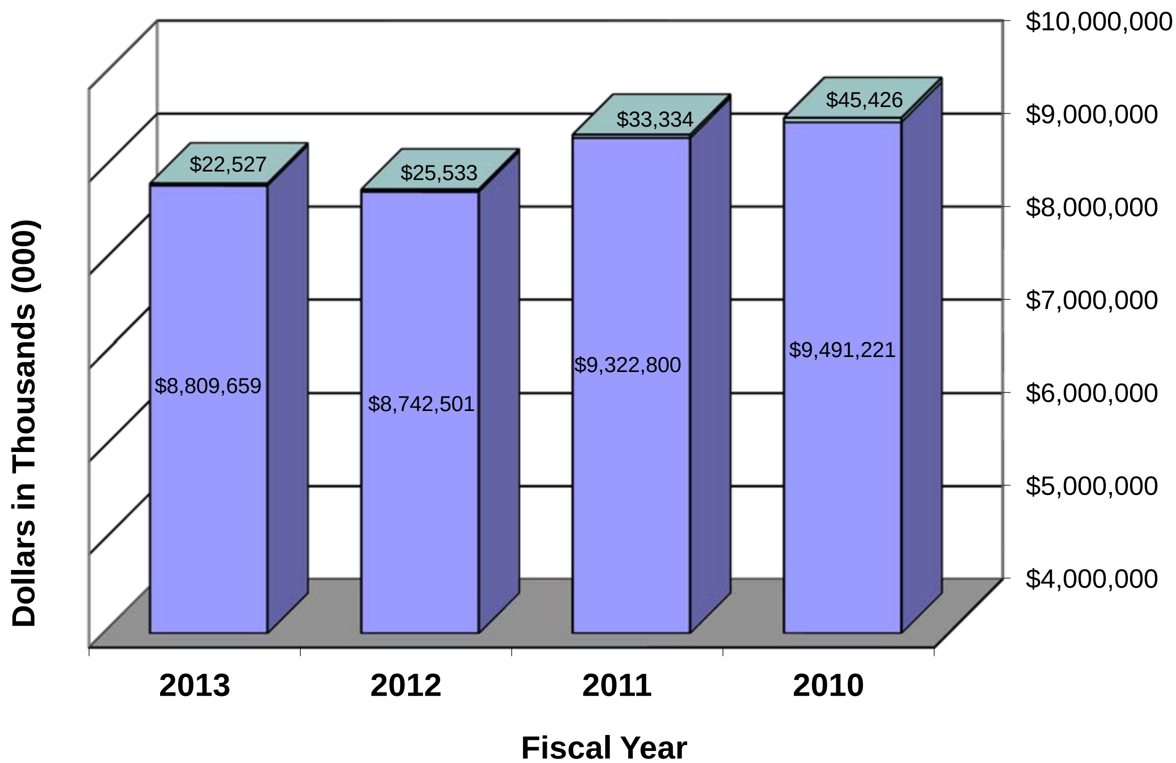
AHCCCS as determined by statutory formula provided $21.5 million in additional funding. The April 2012 CMS approved Waiver amendment allows AHCCCS the authority to obtain federal match on a qualifying portion of the gaming receipts for a two year period ending federal fiscal year 2013. Hospital emergency departments and level 1 trauma facilities received a total benefit of $33.8 million that included $12.3 million in federal funds from the waiver and tribal gaming receipts.

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

Revenues by Source - Governmental Activities



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 2 to 50 employees and employees of political subdivisions. HCG contracts with two health plans from the existing network of AHCCCS Managed Care Organization ("MCO") health plans to provide managed care medical services. HCG's administrative responsibilities include enrollment/renewal, fulfillment, premium billing, customer service, collections, fund disbursement and data analysis. HCG also is responsible for regulatory oversight and providing reinsurance to the health plans.

Performance

HCG reported operating income in fiscal year 2013 of $4.2 million and an increase in net position of $4.4 million. This continues a six-year trend of operating profitability before General Fund subsidies that began in fiscal year 2008 when HCG began successfully managing both program and administrative costs through a series of cuts, changes, realignments, and premium adjustments to match revenues with expenses. Premium rates were adjusted to fund projected medical and administrative costs and to provide payments to health plans that were owed reconciliation amounts for prior fiscal years.

In addition to being profitable for the last six fiscal years, HCG is self-sustaining and, since fiscal year 2010, has received no General Fund subsidies. Overall, fiscal year 2013 results increased HCG's $2.2 million net position balance at June 30, 2012 to a net position of $6.6 million at June 30, 2013.

Reconciliation Liability

In the first two quarters of fiscal year 2009 and in years prior, HCG reconciled the medical costs experienced by the plans above a contractual target medical loss ratio (stop loss target) that was based on the capitation paid annually to each plan. This stop loss payment was made for the difference in medical losses above the target medical loss ratio. If medical costs exceeded capitation, HCG paid the plans from available reconciliation reserves. In fiscal year 2013, HCG eliminated all reconciliation liabilities from all prior years. This reconciliation balance for the last seven years is shown below:

June 30, 2007	-	$ 22.5 million
June 30, 2008	-	$ 19.2 million
June 30, 2009	-	$ 13.4 million
June 30, 2010	-	$ 12.4 million
June 30, 2011	-	$ 6.8 million
June 30, 2012	-	$ 2.8 million
June 30, 2013		$ 0

The reconciliation liability carried over from prior fiscal years has been reduced by $22.5 million since June 30, 2007. The liability was eliminated using a combination of cash generated from operations, General Fund subsidies, reinsurance and forgiveness of debt. Reduction to the reconciliation balance in fiscal year 2013 was produced from cash from operations and adjustments related to claim runout and reinsurance coverage.

The following table summarizes reconciliation liability activity for fiscal year 2013:

Healthcare Group Reconciliation Liability as of June 30, 2013
Fiscal Year 2013 Activity
(in thousands of dollars)

	Reconciliation Period		
	FY 07	**FY 08**	**Total**
Balance June 30, 2012	$ 52	$ 2,745	$ 2,797
Payments made	(52)	(858)	(910)
Adjustments	-	(1,887)	(1,887)
Balance June 30, 2013	$ -	$ -	$ -

Effective January 1, 2009, HCG's contracted health plans agreed, in contract, that no future reconciliation costs will be recognized by HCG, except for adjustments to the existing reconciliation for services rendered through December 31, 2008. HCG contractors are now being compensated for attaining Nationally Recognized Utilization Management Standards, as mandated by Laws 2008, Chapter 288. The performance standards are developed by Milliman Inc., customized to each health plans' unique member population and further stratified by the level of medical management such as well managed, moderately managed, and loosely managed. The compensation amount will be no more than 2% of total premium collected. After the end of the fourth quarter, if the contractors perform well, each will receive a payment. If a health plan performs poorly, it will forfeit the reserved amount and HCG will retain the amount and apply it to any existing liabilities. As of June 30, 2013, HCG has in reserves $228,626 for potential payout with a scheduled disbursement in December 2013. This reserve amount is included in the Statement of Net Position – Proprietary Fund current accrued programmatic costs amount.

Enrollment

Since lifting the July 2008 legislatively mandated enrollment freeze, enrollment has declined in each fiscal year since 2008. The table below shows the year to year changes for June 2012 and 2013.

Year to Year Enrollment Change				
Group Size	**2012 vs. 2011**	**% Change**	**2013 vs. 2012**	**% Change**
1	**(345)**	**(19%)**	**(243)**	**(16%)**
2 +	**(183)**	**(16%)**	**(102)**	**(11%)**
Total	**(528)**	**(18%)**	**(345)**	**(14%)**

By the end of fiscal year 2013, HCG's group enrollment had decreased approximately 14%. Average total revenue per member per month in fiscal year 2013 was $332. Along with enrollment, revenue has declined every fiscal year since 2008.

Summary

Due to continued effective administrative and programmatic management a $23.7 million net deficit at June 30, 2007 was turned into a $6.6 million positive net position at June 30, 2013. The Arizona State Legislature passed legislation to repeal HCG effective January 1, 2014. This legislation was necessary, because HCG would not be able to compete with other health coverage options that will be available in 2014 under ACA health care reform. With the passage of Laws 2013, First Special Session, Chapter 10, HCG will stop providing coverage to all enrolled members effective December 31, 2013. The HCG fund will continue through December 31, 2014. Upon termination of the HCG Fund, any remaining fund balance will revert to the State general fund unless the Legislature determines otherwise.

Financial Analysis of AHCCCS' Governmental Funds

Governmental Funds

At the end of fiscal year 2013, AHCCCS' governmental funds reported combined ending fund balances totaling $2.1 million, a decrease of $2.8 million from the prior year. The decrease is primarily due to the utilization of the fiscal year 2012 $4.1 million carry-forward balance of prepaid state matching funds received from participating political subdivisions specifically for the temporary coverage expansion of the Title XXI CHIP (KidsCare II) program. This decrease was partially offset by a combined $1.3 million increase from indirect allocation transfers, hospital residency loan repayments, and nursing facility assessments to cover the costs of administering the program. Any utilization of these balances must either be for qualifying information technology related activities, by legislative directive or program administration.

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

The Other Governmental Funds consist of nine individual funds comprising 100 percent of the total fund balance of $2.1 million available for qualifying activities. The Other Governmental Funds' fiscal year 2013 fund balances consist of assigned fund balances in the amount of $1.5 million and committed funds of $600,000. Revenue from taxes on cigarettes and other related tobacco products increased 1.0 percent from fiscal year 2012 and generated $91.6 million for the current year compared to $90.7 million in fiscal year 2012. Since the passage of ballot proposition 203 in November 2006, tobacco tax collections have declined by $56.5 million or 38.2 percent since the $148.1 million high point of collection in fiscal year 2006. Total tobacco tax collections account for 53.5 percent of the total Other Governmental Funds revenues in fiscal year 2013 compared to 83.2 percent of the total Other Governmental Funds revenues back in fiscal year 2006.

General Fund Budgetary Highlights

Differences totaling $522.4 million occurred between the original and the final amended administrative and programmatic expenditure budgets. During the 2013 legislative session, the legislature appropriated all voluntary payments from political subdivisions for DSH, GME, SNCP hospital payments, and for program coverage expansion including KidsCare II. Prior to the Legislature appropriating these voluntary payments, they were treated as non-appropriated expenditures and were not included as part of the General Fund. The legislation allows these voluntary amounts to be increased for any political subdivision funds including the federal matching monies in excess of the original appropriation. This resulted in a net $522.4 million supplemental appropriation increase in fiscal year 2013. The increase was directly to the applicable program special line items. Other differences relate to special line item adjustments that utilized surpluses from one line item to offset shortfalls in another line item. These appropriation transfers are approved by the Governor's Office of Strategic Planning and Budgeting and are in accordance with legislative authority. The major special line item supplemental increases are briefly summarized as follows:

- $376.3 million increase for payments to specified hospitals funded by voluntary Intergovernmental agreements with political subdivisions including the City of Phoenix hospital assessment tax for the purpose of providing the state matching funds
- $76.6 million increase for the voluntary GME special line item based on increased political subdivision contributions including federal matching monies in excess of the original appropriation
- $48.8 million increase for program coverage expansion including the expanded KidsCare II funded by voluntary intergovernmental agreements with political subdivisions including the City of Phoenix hospital assessment tax for the purpose of providing the state matching funds
- $20.8 million increase for the voluntary disproportionate share hospital special line item based on increased political subdivision contributions including federal matching monies in excess of the original appropriation
- $28.4 million appropriation special line item transfer increase for administration costs primarily related to the development of the automated eligibility system necessary to comply with new federal requirements of the ACA funded by surpluses in the program special line items

At June 30, 2013, actual cash basis appropriated program expenditures were $289.4 million less than budgetary estimates primarily resulting from surplus federal expenditure authority.

Capital Asset Administration

AHCCCS' investment in capital assets for its governmental and business-type activities as of June 30, 2013 amounts to $25.177 million, net of accumulated depreciation and amortization. This investment in capital assets includes furniture, vehicles, equipment and internally generated software for projects started after June 30, 2009. Land, buildings and improvements are under the management of the State and are accounted for on the State's comprehensive annual financial report. Total net capital assets increased $22.137 million or 728 percent over the prior fiscal year balance. Investment in internally generated software (completed and under development) increased $20.540 million consisting of upgrades and enhancements to Medicaid eligibility systems related to the ACA of $20.379 million and $161,000 for the continuing development of the next mandated versions of the electronic Transaction and Code Set standards under the Health Insurance Portability and Accountability Act. The remaining capital asset additions of $1.597 million are for the replacement of vehicles, furniture and equipment and upgraded servers and related IT equipment items.

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

	Governmental Activities		Business-Type Activities		Total	
	2013	2012	2013	2012	2013	2012
Vehicles	$ 822	$ 327	$ -	$ -	$ 822	$ 327
Furniture and equipment	2,120	1,018	1	1	2,121	1,019
Software	1,800	-	-	-	1,800	-
Software under development	20,434	1,694	-	-	20,434	1,694
Total net position	$ 25,176	$ 3,039	$ 1	$ 1	$ 25,177	$ 3,040

Additional information on AHCCCS' capital assets can be found in Note 2 to the accompanying financial statements on pages 39 and 40.

Contingent Liabilities

In January 2001, AHCCCS obtained a Waiver from CMS to receive federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204. The Waiver requires that over the term of the original agreement (April 1, 2001 through September 30, 2011) and the new agreement (October 1, 2011 through September 30, 2016), that the population covered by the Waiver be budget neutral for CMS. Budget neutral means that CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. The budget neutrality calculation is dependent on a number of variables including the number of members, the eligibility category of members and the general economy and its impact on unemployment, medical inflation and policy decisions made by the Legislature that may impact program costs. In accordance with the Waiver, AHCCCS has two years subsequent to September 30, 2011 to report expenditures related to the budget neutrality period ended September 30, 2011. Through June 30, 2013, AHCCCS remains under the cumulative reporting limit threshold. Accordingly, management is projecting that as of June 30, 2013, AHCCCS does not have any liability to CMS related to the budget neutrality agreement and the accompanying financial statements have not been adjusted for the impact of any liability AHCCCS may have related to the Waiver budget neutrality agreement. On October 21, 2011, CMS approved a new Waiver through September 30, 2016. The Waiver continues to include a budget neutrality provision through September 30, 2016. Accordingly, AHCCCS management is projecting that as of June 30, 2013, AHCCCS does not have any liability to CMS related to the budget neutrality agreement and the accompanying financial statements have not been adjusted for the impact of any liability AHCCCS may have related to the Waiver budget neutrality agreement.

In December 2006, the Department of Health and Human Services, Office of Inspector General, Office of Audit Services ("OIG") commenced an audit of the Direct Service Claiming ("DSC") program. The OIG requested that AHCCCS provide the OIG with all DSC claims data for the period from January 2004 through June 2006. The data represented over 9.5 million claim lines and $124.0 million of federal funds paid to the Local Education Authorities ("LEAs") statewide under the DSC program.

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

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

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

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

CMS completed a review of the OIG findings and AHCCCS' response and concurs with OIG on all but one of the claims in question. OIG recalculated the extrapolation and revised the estimate to $19,924 million. CMS has requested the funds be returned. AHCCCS disagrees with the sampling methodology and extrapolation and plans to appeal the decision to the Departmental Appeals Board once CMS issues a disallowance. If and when all administrative appeals are exhausted, AHCCCS will request a refund from the LEAs or will deduct the amount from future payments in accordance with the intergovernmental agreement. The recoupment liability of $19,924 million is included in the due to the federal government with a corresponding receivable in the due from the State and local governments in the accompanying financial statements. As the recoupment is a reduction of prior school-based services expense, AHCCCS has properly recorded the $19,924 million as a reduction in school-based services expense for the year ended June 30, 2013.

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

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

In March 2011, the OIG commenced an audit of the MAC program for the period January 1, 2004, through September 30, 2008 reviewing a total of 19 quarters. The OIG provided AHCCCS with a draft audit report and related findings in August 2012 stating that AHCCCS, through its TPA, did not always retain required documentation to support the random moment time study ("RMTS") methodology used to allocate school-based administrative costs to the Medicaid program and the RMTS methodology was not fully consistent with federal requirements. The report states that the RMTS supporting documentation for 2 of the 19 quarters was not retained and that the RMTS methodology for the remaining 17 quarters was determined to be inconsistent with federal requirements. The OIG determined that the unallowable federal reimbursement was $5.422 million and $6.295 million, respectively, for a total of $11.717 million.

Certain elements of the calculations performed by the contractor and the OIG are similar causing duplication of approximately $2.076 million for a total net unallowable cost of $9.641 million. AHCCCS anticipates receiving a disallowance and intends to file an appeal with the CMS Departmental Appeals Board ("DAB"). AHCCCS internal legal counsel has indicated that it is reasonably possible that some additional amount will be disallowed and recouped by CMS. AHCCCS will request a refund from the LEAs or will deduct the amount from future payments in accordance with the intergovernmental agreement. The recoupment liability of $9.641 million is included in the due to the federal government with a corresponding receivable in the due from the State and local governments in the accompanying financial statements. As the recoupment is a reduction of prior school-based services expense, AHCCCS has properly recorded the $9.641 million as a reduction in school-based services expense for the year ended June 30, 2013.

AHCCCS previously reported a $20.665 million liability related to the OIG audit of the buy-in of Medicare Part B premiums. As of June 30, 2013, AHCCCS has returned the $20.665 million and no further liability exists as of June 30, 2013. AHCCCS has received a waiver that allows FFP for the cost of Part B premiums for this eligibility category prospectively effective October 22, 2011.

Economic Factors and Next Year's Budgets and Rates

AHCCCS enrollment for fiscal year 2013 is best described as erratic with seven of the twelve months having increasing membership. However, the overall result was a decrease of 1,930 for all AHCCCS programs except for the business-type Healthcare Group program. For the fiscal year 2013, June 2012 over June 2013 period, the Title XIX full service enrollment declined by 43,170 members primarily due to the continued enrollment freeze on the Childless Adult / AHCCCS Care population. Enrollment for the first quarter of fiscal year 2014 continues to follow the same erratic pattern resulting in an overall increase of 6,710 full service program members for the year. Arizona continues its recovery from the Great Recession based on a 2.5 percent increase over the prior year in a leading index (the Federal Reserve Bank of Philadelphia's "coincident index") used by the Joint legislative Budget Committee. Although this increase ranks Arizona with the twenty-sixth highest growth rate nationally, the indicator is still 10.0 percent below its August 2007 peak. While housing continues to improve as pending foreclosures decreased and the median price of a single family home increased 26.7 percent from June 2012, the unemployment rate has remained at the same 8.3 percent level of August 2012. Accordingly, AHCCCS is projecting that most populations not subject to enrollment freezes will continue to see modest growth similar to the fiscal year 2013 results.

The total statewide Medicaid fiscal year 2014 appropriation is $7,078.0 million and includes a $416.6 million projection for the cost of restoring the Proposition 204 population and expansion of the adult and children populations up to 133 percent of the FPL under the Affordable Care Act.

For contract year 2014, the Acute Care capitation rates are expected to increase by 0.49 percent which is reflective of the competitive bid process associated with the Contract Year 2014 Acute request for proposal. The contract year 2014 Arizona Long Term Care System ("ALTCS" Elderly and Physically Disabled ("EPD")) capitation rates are estimated to increase by 3.44 percent. The largest factors impacting the ALTCS EPD rates are projected fee for service provider rate increases for certain providers based either on access to care needs, Medicare or Arizona Department of Health Services ("ADHS") fee schedule rates, legislative mandates, or cost of living adjustments. As part of the fiscal year 2015 budget submission, AHCCCS is requesting a 3% capitation rate increase for all programs for contract year 2015.

Legislation was passed as part of the 2013 Legislative Session to both restore the Proposition 204 adult program and provide expansion coverage for children and adults up to 133 percent of the FPL. The legislation was necessary to implement expansion for children under age 19 as required by the ACA and cover the optional adult population eligible for the 100 percent FMAP rate that will be available until January 2017. AHCCCS used certain assumptions in projecting future enrollment regarding presentation rates and the woodwork impact or adjusting for the effect of members who are currently eligible for Medicaid, but for whatever reason have not previously enrolled. Other major ACA mandates impacting enrollment and costs include member enrollment and renewal simplifications, the requirement that certain primary care physicians and services be reimbursed at no less than 100% of the Medicare payment rates; and how costs associated with a tax on the health insurance industry beginning in calendar year 2014 will affect future rates. Language in the 2013 legislation appropriated sufficient monies to implement the changes and AHCCCS projects the impact to increase expenditures by $416.5 million for the last six months of fiscal year 2014.

A lawsuit was filed in the Arizona Superior Court for Maricopa County by a group of plaintiffs, consisting mostly of state legislators, seeking a declaration that the hospital assessment established under ARS 36-2901.08 is allegedly a tax passed in a manner inconsistent with the requirements for a tax established by the state constitution. The lawsuit was filed in September 2013. In response, the defendants, the governor and the director of AHCCCS filed a motion to dismiss based on lack of standing. A response to that motion is pending, and the court has not ruled on the motion .AHCCCS intends to vigorously defend the lawsuit.

If the assessment is declared invalid, the program will have insufficient funds to cover childless adult with income up to 133% of FPL, but under the holding in *Fogliano v. State*, AHCCCS will adjust eligibility standards to match available remaining funds.

AHCCCS continues to aid in the development of a robust healthcare information technology ("HIT") by offering financial assistance to providers and other entities in adopting and using health HIT as provided under the American Recovery and Reinvestment Act of 2009. In fiscal year 2013, $63.8 million in federal funds were disbursed to Arizona hospitals and providers as incentives. Projections for fiscal year 2013 include $38.6 million declining to $31.6 million in fiscal year 2015 in non-appropriated federal pass-through expenditure authority for Arizona providers that may be eligible for Medicaid incentive payment funding.

AHCCCS' budget request for fiscal year 2015, submitted to the Governor in September 2013 included a rebase of the fiscal year 2014 budget projecting that fiscal year 2014 appropriations are expected to be sufficient to cover projected agency expenditures with a small estimated surplus. However, factors such as CMS decisions, legal decisions, case load changes compared to projections may influence any final fiscal year surplus or a need and amount of a supplemental appropriation. Additionally, at the federal level, uncertainty over the passage and length of extension of the federal budget and raising the debt limit may affect the state and federal economies. Management will closely monitor all these factors in relation to the adequacy of the fiscal year 2014 appropriation and fiscal year 2015 budget.

Request for Information

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

INDEPENDENT AUDITORS' REPORT

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)

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities, the business-type activities and the aggregate remaining fund information of AHCCCS as of and for the year ended June 30, 2013, and the related notes to the financial statements, which collectively comprise AHCCCS' financial statements as listed in the table of contents on pages 21 through 29.

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, 2013, 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.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

Opinion

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, as of June 30, 2013, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that management's discussion and analysis on pages 1 – 18 and budgetary comparison information on page 26 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

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

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated November 19, 2013 on our consideration of AHCCCS' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering AHCCCS' internal control over financial reporting and compliance.

Mayer Hoffman McCann P.C.

Phoenix, Arizona
November 19, 2013

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET POSITION

June 30, 2013
(amounts expressed in thousands)

A S S E T S

	Governmental Activities	Business-type Activities	Total
CURRENT ASSETS			
Cash	$ 119,298	$ 9,873	$ 129,171
Restricted cash	87,263	-	87,263
Due from state and local governments	152,212	-	152,212
Due from the federal government	556,668	-	556,668
Tobacco settlement receivable	50,000	-	50,000
Receivables and other	131,623	-	131,623
TOTAL CURRENT ASSETS	1,097,064	9,873	1,106,937
NONCURRENT ASSETS			
Hospital residency program loans	300	-	300
Furniture, vehicles and equipment, net of accumulated depreciation	25,176	1	25,177
TOTAL NONCURRENT ASSETS	25,476	1	25,477
TOTAL ASSETS	1,122,540	9,874	1,132,414

L I A B I L I T I E S

	Governmental Activities	Business-type Activities	Total
CURRENT LIABILITIES			
Accounts payable	30,429	10	30,439
Other accrued liabilities	2,896	19	2,915
Deferred revenue	30,740	2,999	33,739
Due to federal, state and county governments	168,183	-	168,183
Accrued programmatic costs	859,102	229	859,331
Compensated absences	3,618	56	3,674
TOTAL LIABILITIES	1,094,968	3,313	1,098,281

COMMITMENTS AND CONTINGENCIES

N E T P O S I T I O N

	Governmental Activities	Business-type Activities	Total
INVESTED IN CAPITAL ASSETS	25,176	1	25,177
UNRESTRICTED	2,396	6,560	8,956
TOTAL NET POSITION	$ 27,572	$ 6,561	$ 34,133

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF ACTIVITIES

Year Ended June 30, 2013
(amounts expressed in thousands)

		Program Revenues			Net (Expense) Revenue and Changes in Net Position		
	Program Expenses	**Charges for Services**	**Federal Operating Grants**	**Other Operating Grants and Contributions**	**Governmental Activities**	**Business-type Activities**	**Total**
PROGRAMS							
Government activities:							
Health care programs	$ 8,809,659	$ 5,416	$ 5,977,384	$ 747,661	$ (2,079,199)	$ -	$ (2,079,199)
Business-type activities:							
Healthcare Group	22,527	26,872	-	-	-	4,345	4,345
TOTAL PROGRAMS	$ 8,832,186	$ 32,287	$ 5,977,384	$ 747,661	(2,079,199)	4,345	(2,074,854)
General revenues:							
State appropriations					2,016,660	-	2,016,660
Tobacco tax					131,441	-	131,441
Unrestricted investment earnings					45	59	104
					2,148,146	59	2,148,205
Transfers:							
Transfers out					(48,528)	-	(48,528)
Total general revenues and transfers					2,099,618	59	2,099,677
CHANGE IN NET POSITION					20,419	4,404	24,823
NET POSITION, BEGINNING OF YEAR					7,153	2,157	9,310
NET POSITION, END OF YEAR					$ 27,572	$ 6,561	$ 34,133

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BALANCE SHEET - GOVERNMENTAL FUNDS

June 30, 2013
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
ASSETS			
Cash	$ 93,362	$ 25,936	$ 119,298
Restricted cash	86,343	920	87,263
Due from state and local governments	169,283	15,632	184,915
Due from the federal government	467,408	22,979	490,387
Due from other funds	11,708	-	11,708
Receivables and other	35,003	-	35,003
TOTAL ASSETS	$ 863,107	$ 65,467	$ 928,574
LIABILITIES			
Accounts payable	$ 30,104	$ 325	$ 30,429
Other accrued liabilities	2,495	401	2,896
Deferred revenue	30,070	670	30,740
Due to federal, state and county governments	168,052	131	168,183
Due to other funds	-	11,708	11,708
Accrued programmatic costs	632,386	50,136	682,522
TOTAL LIABILITIES	863,107	63,371	926,478
COMMITMENTS AND CONTINGENCIES			
FUND BALANCES			
Committed	-	600	600
Assigned	-	1,496	1,496
TOTAL FUND BALANCES	-	2,096	2,096
TOTAL LIABILITIES AND FUND BALANCES	$ 863,107	$ 65,467	

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

Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds.	25,176
Liabilities for accrued paid time off are not due and payable from current financial resources and, therefore are not reported in the funds.	(3,618)
Receivables, offsetting the above accrued paid time off liability, are not available to pay for current period expenditures, therefore are not reported in the funds.	3,618
Accrued liabilities for programmatic costs are not due and payable from current financial resources and, therefore are not reported in the funds.	(176,579)
Receivables, offsetting the above accrued programmatic liability, are not available to pay for current period expenditures, therefore are not reported in the funds.	176,579
Long-term receivables for the Hospital Residency Loan program are not due and receivable in the current fiscal year and, therefore are not reported in the funds.	300
	$ 27,572

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, 2013
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
REVENUES			
State government:			
Appropriations	$ 1,309,588	$ -	$ 1,309,588
ISA pass through funds	719,484	-	719,484
Federal government:			
Acute care	3,336,781	13,239	3,350,020
Long-term care	732,504	24,384	756,888
ISA/IGA pass through funds	1,912,910	65	1,912,975
County and other local government:			
Acute care	50,902	-	50,902
Long-term care	237,990	-	237,990
IGA pass through funds	264,438	-	264,438
Tobacco litigation settlement revenue	149,125	-	149,125
Tobacco tax revenue	39,854	91,587	131,441
Gaming revenue	-	21,500	21,500
Nursing facility tax assessment	-	12,881	12,881
HAPA intergovernmental agreement revenue	-	7,122	7,122
Premium revenue	5,416	-	5,416
Other	3,413	334	3,747
TOTAL REVENUES	8,762,405	171,112	8,933,517
PROGRAMMATIC EXPENDITURES			
Medical Services:			
Traditional services	3,861,119	37,916	3,899,035
Proposition 204 services	1,423,098	18,978	1,442,076
KidsCare services	66,988	-	66,988
Long-term care services	2,054,105	37,139	2,091,244
Childrens rehabilitative services	114,788	-	114,788
School-based services	45,504	-	45,504
Transplant services non-Medicaid	-	171	171
Hospital Payments:			
Disproportionate share	120,434	-	120,434
Rural and critical access hospital	13,858	-	13,858
Graduate medical education	196,609	-	196,609
Trauma center services	-	33,805	33,805
Safety net care pool	525,101	-	525,101
Other:			
Medicare Part D clawback	80,600	-	80,600
Health information technology	62,984	-	62,984
TOTAL PROGRAMMATIC EXPENDITURES	8,565,188	128,009	8,693,197
ADMINISTRATIVE EXPENDITURES	188,823	8,525	197,348
ADMINISTRATIVE EXPENDITURES PASSED THROUGH	(2,527)	65	(2,462)
TOTAL EXPENDITURES	8,751,484	136,599	8,888,083
EXCESS OF REVENUES OVER EXPENDITURES	10,921	34,513	45,434
OTHER FINANCING SOURCES (USES)			
Transfers out:			
To State General Fund	(10,600)	-	(10,600)
To Arizona Department of Economic Security	(3,221)	-	(3,221)
To Arizona Department of Health Services	-	(33,571)	(33,571)
To Arizona Attorney General	(1,136)	-	(1,136)
Repayments under the hospital residency loan program	-	300	300
TOTAL OTHER FINANCING SOURCES (USES)	(14,957)	(33,271)	(48,228)
NET CHANGE IN FUND BALANCES	(4,036)	1,242	(2,794)
FUND BALANCES, BEGINNING OF YEAR	4,036	854	4,890
FUND BALANCES, END OF YEAR	$ -	$ 2,096	$ 2,096

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

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

Year Ended June 30, 2013
(amounts expressed in thousands)

Amounts reported for governmental activities in the statement of activities (page 22) are different because:

Change in fund balances - total governmental funds (page 24)	$	(2,794)
Repayment of loaned funds under the Hospital Residency Loan Program provides current financial resources of governmental funds. This amount represents the loan repayments received in the current fiscal year and is recorded as a current financial resource in the governmental funds.		(300)
Governmental funds report capital outlays as expenditures. However, in the statement of activities, the cost of those assets is allocated over their estimated useful lives and reported as depreciation expense. This is the amount by which capital outlays exceeded depreciation in the prior period.		23,513
Change in net position of governmental activities (page 22)	$	20,419

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BUDGETARY COMPARISON SCHEDULE - GENERAL FUND

Year Ended June 30, 2013
(Unaudited)
(amounts expressed in thousands)

	Original Appropriation (Budget)	Final Appropriation (Budget)	Actual	Variance with Final Budget
REVENUES				
State appropriations	$ -	$ -	$ 1,274,951	$ -
State ISA pass through funds	-	-	815,240	-
Federal government	-	-	4,531,492	-
Federal ISA/IGA pass through funds	-	-	1,254,016	-
County government	-	-	288,876	-
County IGA pass through funds	-	-	243,485	-
Tobacco tax revenue	-	-	39,832	-
Tobacco litigation settlement	-	-	149,125	-
Other	-	-	6,642	-
Total revenues	-	-	8,603,659	-
OTHER FINANCING SOURCES				
Operating transfers in	-	-	10,297	-
TOTAL REVENUES AND OTHER FINANCING SOURCES	-	-	8,613,956	-
PROGRAMMATIC EXPENDITURES				
Traditional services	3,382,591	3,362,660	3,185,117	177,543
Proposition 204 services	1,107,024	1,099,199	1,093,830	5,369
KidsCare services	21,622	21,622	18,575	3,047
Childrens rehabilitative services	128,599	127,942	114,788	13,154
Disproportionate share	13,487	13,487	4,202	9,285
Rural and critical access hospitals	13,858	13,858	13,008	850
Graduate medical education	90,977	167,562	167,562	-
DSH Voluntary	28,457	49,273	49,273	-
Voluntary Political Subdivision - Hospital	-	376,268	376,268	-
Voluntary Political Subdivision - Coverage Expansion	-	48,752	48,753	(1)
Long-term care services	1,177,910	1,177,910	1,136,911	40,999
TOTAL PROGRAMMATIC EXPENDITURES	5,964,525	6,458,533	6,208,287	250,246
ADMINISTRATIVE EXPENDITURES	178,152	206,567	167,368	39,199
TOTAL APPROPRIATED EXPENDITURES	6,142,677	6,665,100	6,375,655	289,445
PRIOR YEAR APPROPRIATED EXPENDITURES	-	-	29,643	-
NON-APPROPRIATED EXPENDITURES	-	-	2,208,451	-
REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES	-	-	207	-
FUND BALANCES, BEGINNING OF YEAR	-	-	158,367	-
FUND BALANCES, END OF YEAR	$ -	$ -	$ 158,574	$ -

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET POSITION - PROPRIETARY FUND

June 30, 2013
(amounts expressed in thousands)

ASSETS	
CURRENT ASSETS	
Cash	$ 9,873
CAPITAL ASSETS	
Furniture, vehicles and equipment, net of accumulated depreciation	1
TOTAL ASSETS	9,874
LIABILITIES	
CURRENT LIABILITIES	
Accounts payable	10
Other accrued liabilities	19
Deferred revenue - premiums	2,999
Accrued programmatic costs	229
Compensated absences due within one year	56
TOTAL LIABILITIES	3,313
COMMITMENTS AND CONTINGENCIES	
NET POSITION	
NET INVESTED IN CAPITAL ASSETS	1
UNRESTRICTED	6,560
TOTAL NET POSITION	$ 6,561

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET POSITION - PROPRIETARY FUND

Year Ended June 30, 2013
(amounts expressed in thousands)

OPERATING REVENUES	
Premium revenue	$ 26,872
OPERATING EXPENSES	
Payments to health plans and providers	21,566
Salaries and employee benefits	866
Professional and outside services	106
Other	174
TOTAL OPERATING EXPENSES	22,712
OPERATING INCOME	4,160
NONOPERATING REVENUES	
Other income	185
Investment income	59
TOTAL NONOPERATING REVENUE	244
CHANGE IN NET POSITION	4,404
NET POSITION, BEGINNING OF YEAR	2,157
NET POSITION, END OF YEAR	$ 6,561

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF CASH FLOWS - PROPRIETARY FUND

Year Ended June 30, 2013
(amounts expressed in thousands)

CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from customers	$	26,339
Payments to health plans		(24,414)
Payments to employees		(861)
Payments to suppliers		(300)
Net cash provided by operating activities		764
CASH FLOWS FROM INVESTING ACTIVITIES		
Settlement income		185
Investment income		59
Net cash provided by investing activities		244
NET CHANGE IN CASH		1,008
CASH, BEGINNING OF YEAR		8,865
CASH, END OF YEAR	$	9,873
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Operating income	$	4,160
Adjustment to reconcile operating income to net cash provided by operating activities:		
Changes in operating net assets and liabilities:		
Decrease in accounts payable and other accrued liabilities		(19)
Decrease in deferred revenue - premiums		(533)
Decrease in accrued programmatic costs		(2,850)
Increase in accrued compensated absences		6
NET CASH PROVIDED BY OPERATING ACTIVITIES	$	764

See Notes to Financial Statements

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

A. Reporting entity

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

The Arizona Legislature ("Legislature") established AHCCCS in November 1981 to administer health care for the State's indigent population. AHCCCS is a State agency managed by an independent cabinet level administration created by the Legislature and is funded by a combination of federal, State, county and local funds. The federal portion is funded through the Centers for Medicare and Medicaid Services ("CMS") of the U.S. Department of Health and Human Services under a Section 1115 Waiver ("Waiver") approved by CMS, which exempts the AHCCCS program from certain requirements of conventional Medicaid programs. Approval of the Waiver, by CMS, extends through September 30, 2016. The childless adult population, currently a waiver category, was scheduled to end on December 31, 2013. However, during the 2013 First Special Session of the Arizona Legislature, the definition of an eligible person was expanded effective January 1, 2014 to include a person whose household's modified adjusted gross income is more than 100 percent but equal to or less than 133 percent of the federal poverty level. This definition includes the childless adult population. AHCCCS receives quarterly federal grants from CMS (as matching funds) to cover a portion of the health care costs of the residents of the State eligible for the Title XIX Medicaid program and Title XXI Children's Health Insurance Program ("CHIP"). State appropriations and county funding levels are based on annual budgets as dictated by the Legislature and as specified by Arizona Statutory funding formula and Session Law.

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

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

B. Basis of presentation

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

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

(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 2013, AHCCCS did not have any major funds; accordingly, all governmental funds other than the General Fund are aggregated and reported as other governmental funds.

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

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

Proprietary funds distinguish operating revenues and expenses from non-operating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. The principal operating revenues of the HCG are premiums charged to small, uninsured businesses with 2 to 50 employees and employees of political subdivisions for medical coverage. Operating expenses for the HCG 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 proceeding the month of coverage. At June 30, 2013, the proprietary fund deferred revenue of $2,999 consists of premium payments received for fiscal year 2014 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 revenues to be available if they are collected within 31 days of the end of the current fiscal year. The governmental funds deferred revenue consists of revenue received in advance for services not yet provided. Expenditures generally are recorded when a liability is incurred, as under accrual accounting. Accrued programmatic costs include received but unpaid claims and estimates for incurred but not reported ("IBNR") claims paid in the 31-day period following the end of the fiscal year. Actual results for accrued programmatic costs may differ from such estimates. These differences are recorded in the period in which they are identified. However, expenditures related to compensated absences and claims and judgments are recorded only when payment is due.

(1) Summary of significant accounting policies (continued)

In fiscal year 2013, 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.

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 $216,434 at June 30, 2013, including restricted funds of $87,263.

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 $86,343 for the Interagency Service Agreement ("ISA") Fund. The ISA Fund is used to properly account for, control, and report receipts and disbursements associated with ISAs which are not required to be reported in other funds. Fund receipts consist of monies received from other entities and are utilized to match federal funding under the Medicaid and CHIP programs under the terms stated in the ISAs. Cash in the Other Governmental Funds is legally restricted in the amount of $920 for the Hawaii Arizona PMMIS Alliance ("HAPA") Fund, as described in Note 4 and is offset by accrued expenditures of $250 and deferred revenue of $670 at June 30, 2013.

(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, 2013, no bank overdraft existed.

E. Net position / fund balance

AHCCCS adopted GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position* in fiscal year 2013. The requirements of this Statement will improve financial reporting by standardizing the presentation of deferred outflows of resources and deferred inflows of resources and their effects on a government's net position. The fiscal year 2013 partial implementation includes the terminology change from "net assets" to "net position" in financial statement presentations.

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

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

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

Nonspendable fund balance

Nonspendable fund balance – this includes amounts that cannot be spent because they are either not spendable in form (such as inventory) or legally or contractually required to be maintained intact (such as endowments). At June 30, 2013, AHCCCS had no nonspendable fund balance.

Spendable fund balance

Restricted fund balance – this includes amounts that can be spent only for specific purposes stipulated by legal requirements imposed by other governments, external resource providers, or creditors. AHCCCS imposed restrictions do not create a restricted fund balance unless the legal document that initially authorized the revenue (associated with that portion of fund balance) also included language that specified the limited use for which the authorized revenues were to be expended. At June 30, 2013, AHCCCS had no restricted fund balance.

(1) Summary of significant accounting policies (continued)

Committed fund balance – this includes amounts that can only be used for specific purposes pursuant to constraints imposed by formal action of the Legislature. Those committed amounts cannot be used for any other purpose unless the Legislature removes or changes the specified use by taking the same type of action (for example, statute, session law, etc.) that it employed to previously commit those amounts. If the Legislative action that limits the use of the funds was separate from the action that initially created the revenues that form the basis for the fund balance, then the resultant fund balance is considered to be committed, not restricted. AHCCCS considers a resolution, a statute, or a session law action to constitute a formal action of the Legislature for the purposes of establishing committed fund balance. At June 30, 2013, AHCCCS' committed fund balance totaled $600.

Assigned fund balance – this includes amounts constrained by the Legislature for specific purposes. Assigned fund balances include all remaining amounts (except negative amounts) that are reported in the governmental funds, other than the general fund, that are not classified as nonspendable and are neither restricted nor committed and amounts in the general fund that are intended to be used for a specific purpose. By reporting particular amounts that are not restricted or committed in a special revenue fund, AHCCCS has assigned those amounts to the purpose of the respective funds. At June 30, 2013, AHCCCS' assigned fund balance totaled $1,496.

Unassigned fund balance – this includes the remaining spendable amounts which are not included in one of the other classifications. At June 30, 2013, AHCCCS had no unassigned fund balance.

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

F. Capitation payments

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

Capitation is paid prospectively as well as for prior period coverage ("PPC"). The PPC period generally is from the effective date of eligibility to the day a member is enrolled with a contracted health plan. The risk under PPC is shared by both the contracted health plans and AHCCCS for the contract year. AHCCCS reconciles the actual PPC medical costs to the PPC net capitation paid during the contract year. The reconciliation limits the contractors' profits and losses to 2% of net capitation. Receivables and other are net of approximately $23,088 at June 30, 2013 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. Effective May 1, 2011 the Medical Expense Deduction ("MED") program was frozen and no new applications were accepted for this category pursuant to the MED Phase-Out plan approved by CMS. The MED program ended September 30, 2011, therefore, the contract year ended September 30, 2011 was the final year in which the MED population was included in the PPC reconciliation.

(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

Similar risk sharing is in place for medical costs incurred by contracted health plans for the Title XIX Waiver Group ("TWG") (MED and non-MED) members. AHCCCS reconciles the contractors' medical costs net of reinsurance to the total net capitation payments and delivery supplemental payments paid for the contract year. The reconciliation limits the contractors' profits or losses to 3% for the MED and 2% for the non-MED population. Receivables and other include approximately $43,396 at June 30, 2013 that represents estimated settlement payments due from contracted health plans for the TWG MED and non-MED reconciliations. Actual results may differ from this estimate and such differences will be recorded in the period in which they are identified. The MED program ended September 30, 2011, therefore, the contract year ended September 30, 2011 was the final MED reconciliation.

Effective with contract year ending September 30, 2012, AHCCCS will recoup/reimburse a percentage of the contractors' profit or loss for certain prospective risk groups using a tiered approach. Populations subject to this tiered reconciliation are limited to Temporary Assistance to Needy Families ("TANF"), Sixth Omnibus Budget Reconciliation Act ("SOBRA"), SSI with Medicare, SSI without Medicare, and SOBRA Family Planning. Expenses incurred and revenues received for covered services with dates of service during PPC are excluded from this reconciliation, as are non-capped newborn expenses. The reconciliation will limit the contractors' profits and losses to the percent of prospective net capitation according to the following schedule:

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

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

Profits in excess of the percentages set forth above will be recouped by AHCCCS. Losses in excess of the percentages set forth above will be paid to the contractor. Accrued programmatic costs are net of approximately $7,906 at June 30, 2013 that represents estimated settlement payments due from contracted health plans for the tiered reconciliation.

(1) Summary of significant accounting policies (continued)

G. Reinsurance payments

AHCCCS provides a stop-loss reinsurance program for its contracted health plans for partial reimbursement, after a deductible is met, of reinsurable covered medical services incurred for members. The program includes a deductible, which varies based on the program and in some cases, the health plans' enrollment. Regular reinsurance in the Acute and Children Rehabilitative Services ("CRS") programs covers partial reimbursement of covered inpatient facility medical services. This coverage applies to prospective enrollment periods. Regular reinsurance in the Arizona Long-Term Care Services ("ALTCS") Program applies to prospective enrollment periods and is only available for members who have had an inpatient stay during the contract year. Once an inpatient stay has occurred, all reinsurance covered services for the entire contract year may be applied to meet the deductible. Regular reinsurance covered services only include medically necessary acute care services, including outpatient and inpatient hospitalizations. AHCCCS reimburses the health plans based on a coinsurance amount for reinsurable covered services incurred above the deductible. This reinsurance provides partial reimbursement of reinsurance eligible covered services and will reimburse 75% of eligible costs above the deductible level up to $650 of covered expenses and 100% thereafter.

The reinsurance program also provides reimbursement for covered organ transplantation and catastrophic disorders such as certain high cost behavioral health and blood related disorders. For transplants, payment is limited to 85% of the AHCCCS contract amount for the transplant services rendered or 85% of the health plans' paid amount, whichever is lower. There is no deductible for catastrophic reinsurance cases, and AHCCCS reimburses the health plans at a percentage of the health plans' paid amount, less the coinsurance amount, unless the costs are paid under a subcapitated arrangement. For members receiving certain biotech drugs, only the drug costs will be covered under the Catastrophic Reinsurance Program. AHCCCS pays 85% of the health plans' paid amount for catastrophic reinsurance for certain blood related disorders up to $650 of covered expenses and 100% thereafter. AHCCCS pays 75% of the health plans' paid amount for catastrophic reinsurance for certain high cost behavioral health up to $650 of covered expenses and 100% thereafter.

H. Fee-for-service payments

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

The ESP provides for emergency medical care to persons who are not eligible for full AHCCCS coverage due to their lack of United States citizenship or lawful alien status. Outpatient medical services for the ESP, members enrolled in a health plan for less than 30 days and American Indian program enrolled members that receive services at a non-Indian Health Services ("IHS")\638 facility are reimbursed using the AHCCCS Outpatient Hospital Fee Schedule. Inpatient medical services for these populations are reimbursed based on the category of service provided and an inpatient per-diem reimbursement rate system or at the outlier reimbursement rate. Professional and non-hospital services for these populations are reimbursed at the AHCCCS fee for service rates.

(1) Summary of significant accounting policies (continued)

Inpatient and outpatient medical services provided at an IHS facility are reimbursed at rates determined by the U.S. Department of Health and Human Services, Indian Health Services. Tribal-owned facilities contracted with IHS are reimbursed at rates determined by the U.S. Department of Health and Human Services, Indian Health Services or at the AHCCCS fee for service rates. Off-reservation services provided by non-IHS/638 providers are reimbursed based on the AHCCCS fee-for-service rates, AHCCCS inpatient per-diem reimbursement rate system or at the outlier reimbursement rate and the AHCCCS Outpatient Hospital Fee Schedule.

I. Incurred but not reported programmatic expenditures

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

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

J. Hospital and nursing facility payments

CMS and the Legislature authorized AHCCCS to make Disproportionate Share, Safety Net Care Pool, Graduate Medical Education, Rural Hospital, Critical Access Hospital, Trauma Center and Nursing Facility supplemental payments in fiscal year 2013. Disproportionate share payments to Arizona hospitals that provided care to a disproportionate share (as defined) of the State's indigent population totaled $120,434. Safety Net Care Pool payments to fund unreimbursed costs incurred by hospitals in caring for the uninsured totaled $525,101. Graduate Medical Education payments to reimburse hospitals with GME programs for the additional costs of treating AHCCCS members utilizing graduate medical students totaled $196,609. Critical Access Hospital payments to provide increased reimbursement to small rural hospitals that are federally designated as critical access hospitals totaled $1,700. Rural Hospital payments to increase inpatient reimbursement rates for qualifying rural hospitals totaled $12,158. Trauma center services to reimburse hospitals in Arizona for unrecovered trauma center readiness costs and unrecovered emergency services costs totaled $33,805. Nursing Facility supplemental payments utilize a quality assessment on health care items and services provided by nursing facilities to qualify for federal matching funds for supplemental payments for covered Medicaid expenditures, not to exceed the Medicare upper payment limit. The payments are included with long-term care medical services and totaled $37,139.

K. Taxes

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

L. 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, 2013. Actual results may differ from these estimates.

(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

M. 100% Federal poverty level expansion and CMS Waiver

On November 7, 2000, the Arizona voters approved ballot Proposition 204. One of its primary components directed AHCCCS to increase the minimum qualifying income eligibility level up to 100% of the Federal Poverty Level. Proposition 204 also designated AHCCCS as the administrator of the tobacco litigation settlement funds awarded to the State for compensation of costs incurred in providing its citizens with health care and other services necessitated by the use of tobacco products.

In January 2001, AHCCCS obtained a Waiver from CMS to receive federal funding for certain non-categorically linked populations including those made eligible by the passage of Proposition 204. The Waiver requires that over the term of the agreement the populations covered by the Waiver be budget neutral for CMS. The Waiver period for budget neutrality began April 1, 2001 and extended through federal fiscal year 2011, at which time any federal funds received by the State that exceed the negotiated budget neutrality limit were to be returned to CMS. AHCCCS was granted a new Waiver from CMS in October 2011. The Waiver period for budget neutrality began October 1, 2011 and extends through federal fiscal year 2016. Management believes that as of June 30, 2013, AHCCCS does not have any liability to CMS related to either budget neutrality agreement and, accordingly, no liability is recorded in the accompanying financial statements. See Note 9.

AHCCCS has classified the Arizona Tobacco Litigation Settlement Fund, created by ballot Proposition 204, as part of its General Fund. These funds are restricted for use as specified in the litigation settlement and/or legislation. Annual settlement payments, based on cigarette sales from the preceding calendar year are made in April. In addition, supplemental payments may be received as tobacco companies enter into the tobacco master settlement agreement. AHCCCS received annual and strategic contribution fund payments of $149,125 in fiscal year 2013 for the period from January 1, 2012 to December 31, 2012. Revenue and a related receivable of $50,000 were accrued for the period of January 1, 2013 through June 30, 2013 and are included in Tobacco Settlement Receivable and Other Operating Grants and Contributions in the accompanying Statement of Net Position and Statement of Activities.

N. Hospital residency loan program

The hospital residency loan program was created to loan monies for the establishment of start-up and ongoing costs for residency programs in accredited hospitals. The hospital loans are interest-free and are due and will become available in future periods when certain criteria are met triggering repayment or beginning in fiscal year 2013 with five annual installments after the execution date whichever is earlier. Payment of the loans may be made in advance of the due date and, as such, AHCCCS received advance payments of $300 in fiscal year 2013.

Annual maturities of the loan receivable as of June 30, 2013 are as follows:

Years Ending June 30,	
2014	$ -
2015	-
2016	-
2017	120
2018	180
Total	$ 300

(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

O. Prescription Drug Rebate Program

The Patient Protection and Affordable Care Act included a provision to extend drug rebates to managed care programs and to increase the rebate amount drug manufacturers are required to pay under the Medicaid drug rebate program. AHCCCS received CMS approval on January 26, 2011 to participate in the drug rebate program, both managed care and fee-for-service, for drugs dispensed on or after March 23, 2010. AHCCCS received rebate reimbursements and delinquent account interest in the amount of $173,263 in 2013. Of this amount, $106,847 was returned to the Federal government in fiscal 2013 and $12,996 will be returned subsequent to June 30, 2013. The remaining $53,420 is available to offset a portion of General Fund current and future fiscal year expenditures. Additionally, AHCCCS has accrued the unpaid invoice balance of $103,370 as of June 30, 2013 which is included in receivables and other in the accompanying statement of net position. Of this accrued receivable, $71,026 will be returned to the Federal government and is netted against the due from the Federal government in the accompanying financial statements and $32,344 is available to offset future fiscal year expenditures, which is netted against the due from state and local governments in the accompanying financial statements.

(2) Capital assets

Capital assets, which consist of furniture, vehicles and equipment and internally generated computer software, are reported in the governmental and business-type activity columns in the government-wide statement of net position. Tangible capital assets are defined as assets with an initial, individual cost of more than $5 and an estimated useful life in excess of one year. Such assets are recorded at historical cost and are depreciated over their estimated useful lives ranging from three to five years. Intangible capital assets consist of internally generated computer software with an initial cost of at least $1,000 and will be amortized over an estimated useful life of five years. Expenditures for incomplete projects are reported as Software Under Development. The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend assets' lives are not capitalized. Net asset balances and current fiscal year activity are as follows:

Balance, June 30, 2012	$ 3,040
Additions	22,746
Retirements	-
Depreciation	(609)
Balance, June 30, 2013	$ 25,177

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, 2013, management does not believe impairment indicators are present, and there were no idle capital assets.

(dollar amounts expressed in thousands)

(2) Capital assets (continued)

At June 30, 2013, capital assets included approximately $22,434 of software under development. Approximately $20,740 was capitalized in fiscal year 2013. Internally generated software includes AHCCCS' continuing development of the next mandated version of the electronic Transaction and Code Set standards under the Health Insurance Portability and Accountability Act of 2010 as well as upgrades and enhancements to Medicaid eligibility systems related to the Patient Protection and Affordable Care Act of 2010 ("ACA"). Total project costs are estimated to be approximately $75.8 million. Medicaid eligibility system development eligible for the 90 percent Federal financial participation rate will be ongoing through December 2015.

AHCCCS accounts for internally generated computer software in accordance with GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. In accordance with Statement No. 51, outlays associated with activities in the preliminary project stage should be expensed as incurred. Outlays related to activities in the application development stage are capitalized. Capitalization of such outlays will cease no later than the point at which the computer software is substantially complete and operational.

(3) Compensated absences

It is the State's policy to permit employees to accumulate earned but unused vacation, compensatory and sick pay benefits. Employees may accumulate up to 240 or 320 hours of vacation depending upon their position classification. Vacation hours in excess of the maximum amount that are unused at the calendar year end are forfeited. There is no liability recorded on AHCCCS' financial statements for sick leave as any amounts eligible for payment when employees separate from State service are the responsibility of the Arizona Department of Administration. The amount recorded in the government-wide financial statements consists of employees' vested accrued vacation and accrued compensatory time benefits. All compensated absences are due within one year. Balances and current fiscal year activity are as follows:

Balance, June 30, 2012	$	3,343
Additions		5,034
Reductions		(4,703)
Balance, June 30, 2013	$	3,674

(4) Other governmental funds

At June 30, 2013, the other governmental net position of $2,096 included activity within the following funds:

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

- Tobacco Products Tax Fund, Emergency Health Services Account ("TPTF-EHSA") - The Arizona Department of Revenue allocates the tobacco tax revenue to the TPTF-EHSA which is used solely for the reimbursement of uncompensated care, primary care services and trauma centers readiness costs. Monies remaining unexpended and unencumbered in the account on June 30th of each year revert to the Proposition 204 Protection Account, a general fund. Revenue sources for the TPTF-EHSA include tobacco tax proceeds and investment income.

(dollar amounts expressed in thousands)

(4) Other governmental funds (continued)

- Trauma and Emergency Services Fund ("TES") - This fund is comprised of gaming revenues to be used to reimburse hospitals in Arizona for unrecovered trauma center readiness costs and unrecovered emergency services costs.

- Nursing Facility Assessment Fund ("NFA") - This fund consists of monies received from the nursing facility assessment, federal monies received as a result of expenditures made attributable to monies deposited in the fund, interest, legislative appropriations, grants, gifts, contributions and devices. The monies in this fund shall be used to qualify for federal matching funds for supplemental payments for nursing facility services and administrative cost to administer the fund.

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

- Miscellaneous Funds - These funds account for various grants and other money received for specific purposes including the Hawaii Arizona PMMIS Alliance ("HAPA") and the Hospital Loan Residency Fund. HAPA represents AHCCCS' project with Hawaii whereby AHCCCS provides data processing services for Hawaii's Medicaid program. The Hospital Loan Residency Fund was created and consists of legislative appropriations and loan repayment monies for the establishment of a hospital loan program to fund start-up and ongoing costs for residency programs in accredited hospitals. The hospital loans are interest-free and are due and will become available in future periods when certain criteria are met triggering repayment or beginning in fiscal year 2013 with five annual installments after the execution date whichever is earlier.

Other governmental funds earned, expended and transferred during the fiscal year ended June 30, 2013 were as follows:

	TTHCF – MNA	TPTF – EHSA	TES Fund	NFA Fund	TPL Fund	Misc. Funds	Total
Net position, June 30, 2012	$ -	$ -	$ 6	$ -	$ -	$ 848	$ 854
Receipts	72,609	18,978	21,501	37,265	743	19,986	171,082
Interest earned	2	-	15	3	-	11	31
Expenditures	(39,040)	(18,978)	(21,522)	(37,139)	(743)	(19,178)	(136,600)
Transfers in (out):							
Arizona Dept. of Health Services	(33,571)	-	-	-	-	-	(33,571)
Hospital Loan Residency Fund	-	-	-	-	-	300	300
Net position, June 30, 2013	$ -	$ -	$ -	$ 129	$ -	$ 1,967	$ 2,096

(5) Proprietary fund - operations

Healthcare Group (HCG) was established in 1988 by the State to administer health care services primarily to small, uninsured businesses with 1 to 25 employees and employees of political subdivisions. That range was later changed to 2 to 50 employees. HCG contracts with two health plans from the existing network of AHCCCS health plans (HMOs) to provide managed care medical services.

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

(5) Proprietary fund – operations (continued)

The HMO contracted health plans are prepaid on a "per member, per month" (PMPM) basis. Capitation payments are made prospectively. In the first two quarters of fiscal year 2009 and in years prior, HCG reconciled the medical costs experienced by the plans above a contractual target medical loss ratio (stop loss target) that was based on the capitation paid annually to each plan. This stop loss payment was made for the difference in medical losses above the target medical loss ratio. If medical costs exceeded capitation, HCG paid the plans this reconciliation from available reconciliation reserves. Due to very high losses in fiscal year 2007 (Note 6), HCG negotiated payment terms with the contracted health plans to repay the remaining liabilities owed from fiscal years 2007 and 2008 over the next several fiscal years. At June 30, 2013, HCG eliminated all remaining reconciliation liabilities pertaining to these fiscal years. In total, since fiscal year 2007, HCG eliminated the entire debt, amounting to $22,509.

Effective January 1, 2009, HCG's health plans agreed, in contract, that no future reconciliation costs will be recognized by HCG. In addition to capitation payments, HCG contractors are now compensated for attaining Nationally Recognized Utilization Management Standards, as mandated by Laws 2008, Chapter 288. The performance standards are developed by Milliman Inc., customized to each health plan's unique member population and further stratified by the level of medical management such as well managed, moderately managed, and loosely managed. The compensation amount will be no more than 2% of total premiums collected. After the end of the fiscal year, if the contractors meet performance standards, each will receive a payment. If a health plan performs poorly, it will forfeit the reserved amount, and HCG will retain the amount and apply it to any existing liabilities. By compensating the health plans based on a set amount of reserves already collected from member premiums, HCG eliminates the potential for any unanticipated losses (or gains) from variation in HMO utilization. As of June 30, 2013 HCG has in reserves $229 for potential payout with a scheduled disbursement in December 2013. This reserve amount is included in accrued programmatic costs at June 30, 2013. See further discussion in Note 6.

(6) Proprietary fund – financial condition

In fiscal year 2013, HCG reported operating income of $4,160 and an increase in net position of $4,404; resulting in a net position balance of $6,561. This continues a six-year trend of operating profitability before General Fund subsidies that began in fiscal year 2008 when HCG began successfully managing both program and administrative costs through a series of cuts, changes, realignments, and premium adjustments to match revenues with expenses.

Prior to fiscal year 2008, HCG was unable to cover its costs due to net medical losses (medical costs exceeded premiums received). At June 30, 2007 HCG carried a reconciliation liability of $22,509. At June 30, 2013 HCG has eliminated this debt entirely using a combination of cash generated from operations, General Fund subsidies (fiscal years 2008 and 2009), reinsurance and forgiveness of debt. Since prior to 2010, HCG has not received General Fund subsidies to offset prior year losses. Additionally, in fiscal years 2010 through 2012 HCG made a cash transfers to the General Fund totaling $1,280.

(dollar amounts expressed in thousands)

(6) Proprietary fund – financial condition (continued)

The following table summarizes HCG's reconciliation liability activity for fiscal year 2013:

Healthcare Group Reconciliation Liability as of June 30, 2013
Fiscal Year 2013 Activity

	Reconciliation Period		
	FY 07	FY 08	Total
Balance June 30, 2012	$ 52	$ 2,745	$ 2,797
Payments made	(52)	(858)	(910)
Adjustments	-	(1,887)	(1,887)
Balance June 30, 2013	$ -	$ -	$ -

There was no reconciliation liability for fiscal year 2009.

Due to continued effective administrative and programmatic management a $23,717 net deficit at June 30, 2007 was turned into a $6,561 positive net position at June 30, 2013. The Arizona State Legislature passed legislation to repeal HCG effective January 1, 2014. This legislation was necessary, because HCG would not be able to compete with other health coverage options that will be available in 2014 under health care reform. With the passage of Laws 2013, First Special Session, Chapter 10, HCG will stop providing coverage to all enrolled members effective December 31, 2013. The HCG fund will continue through December 31, 2014. Upon termination of the HCG Fund, any remaining fund balance will revert to the State general fund unless the Legislature determines otherwise.

(7) Retirement plan

AHCCCS employees are covered by a defined benefit retirement plan administered by the Arizona State Retirement System Board. Benefits are established by State statute and provide retirement and long-term disability benefits to AHCCCS employees. The retirement plan is funded by payroll deductions from eligible employees' gross wages and matching amounts contributed by AHCCCS. These amounts satisfy the statutory requirement that employees and AHCCCS contributions must cover the actuarially determined current service costs of the retirement plan, plus amortization over a 30-year period of the unfunded past service liability. Payroll deductions as a percentage of employee wages were 10.9 percent for retirement and 0.24 percent for long-term disability for fiscal year 2013. The matching amount contributed to the retirement plan by AHCCCS was $4,564 in fiscal year 2013 and is included in administrative expenditures in the accompanying government-wide and governmental fund financial statements.

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

(dollar amounts expressed in thousands)

(8) Budgetary basis of accounting

The financial statements of AHCCCS are prepared in conformity with U.S. generally accepted accounting principles ("GAAP"). AHCCCS, like other State agencies, prepares its annual operating budget on a basis that differs from the GAAP basis. Encumbrances as of June 30th can be liquidated during a four week administrative period known as the 13th month. The budget basis expenditures reported in the financial statements include both the fiscal year paid and the 13th month activity. The State does not have a legally adopted budget for revenues. Prior fiscal year expenditures of $29,643 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, 2013.

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, 2013:

	General Fund Actual
Budgetary Basis Fund Balance, June 30, 2013	$ 158,574
Budgetary Basis of Accounting	
Increases to fund balance:	
Cash	2,192
Due from State and local governments	169,283
Due from the federal government	467,408
Due from Other Fund	11,708
Receivables and other	35,003
Total increases	685,594
Decrease to fund balance:	
Deferred revenue	(30,070)
Due to State and county governments	(168,052)
Accrued programmatic costs	(632,386)
Payables and other	(13,660)
Total decreases	(844,168)
Total GAAP basis fund balance	$ -

Non-appropriated expenditures of $2,208,451 in the General Fund consist primarily of federal and state matching pass-through payments to other agencies.

(9) Contingencies

Litigation and investigations – AHCCCS has been named as a defendant in a variety of litigation, all of which are being defended by in-house and external legal counsel. One case is an effort by Plaintiffs to obtain coverage by AHCCCS for individuals age 21 years or older who, due to their disabilities, require incontinence briefs. It is reasonably possible that the Plaintiffs will prevail and the programmatic cost of providing the briefs to all disabled adult members would be large, however, the cost cannot be reasonably estimated and no liability has been recorded as of June 30, 2013. It is the opinion of AHCCCS upon consultation with legal counsel, that none of these claims are likely to have a material adverse effect on AHCCCS' financial statements. In addition, AHCCCS believes that the funding of any material adverse judgment, sanction or repayment obligation in excess of its appropriation would require a special appropriation by the State or would qualify for coverage by the Arizona Department of Administration, Risk Management Division which is tasked with the management and mitigation of liability, property and workers' compensation claims.

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

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

Budget neutrality agreement – In January 2001, AHCCCS obtained a Section 1115 Waiver from CMS that provides federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204. The Waiver requires that over the term of the original agreement (April 1, 2001 through September 30, 2011) and the new agreement (October 1, 2011 through September 30, 2016), that the populations covered by the Waiver be budget neutral for CMS. Budget neutral means that CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. The budget neutrality calculation is dependent on a number of variables including the number of members, the eligibility category of members and the general economy and its impact on unemployment, medical inflation and policy decisions that may impact program costs made by the Legislature. In accordance with the Waiver, AHCCCS has two years subsequent to September 30, 2011 to report expenditures related to the budget neutrality period ended September 30, 2011. Through June 30, 2013, AHCCCS remains under the cumulative reporting limit threshold for both waiver periods. Accordingly, the accompanying financial statements have not been adjusted for the impact of any liability AHCCCS may have related to the Waiver budget neutrality agreement.

School based claims audit – In December 2006, the Department of Health and Human Services, Office of Inspector General, Office of Audit Services ("OIG") commenced an audit of the Direct Service Claiming ("DSC") program. The OIG requested that AHCCCS provide the OIG with all DSC claims data for the period from January 2004 through June 2006. The data represented over 9.5 million claim lines and $124,000 of federal funds paid to the Local Education Authorities ("LEAs") statewide under the DSC program.

(9) Contingencies (continued)

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

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

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

Out of the $32 in federal dollars paid to the LEAs for the selected claims, the OIG identified a potential overpayment of $6.8 which represents an error rate of approximately 21%. The OIG has extrapolated the error rate and has issued a recommendation that CMS recoup $21,288 of program costs previously passed through to the LEAs under the DSC program. AHCCCS conducted a review and validation of the data set supporting the OIG findings and responded to CMS regarding the final OIG audit report and extrapolated finding amount on September 21, 2010. AHCCCS disagrees with the audit report and disputes approximately $4 or 59 percent of the identified overpayment amount of $6.8. AHCCCS has returned $2.7 of federal funds based on the non-disputed claims. Additionally, AHCCCS disagrees with the method used by the OIG to extrapolate the sample findings and engaged the services of statistical experts. The results of the experts’ review identified that the OIG’s sample size was too small to meet both standard statistical confidence levels and standard desired levels of precision and that the sample size was anywhere from 16 to over 90 times too small to make conclusive extrapolation.

CMS completed a review of the OIG findings and AHCCCS’ response and concurs with the OIG on all but one of the claims in question. The OIG recalculated the extrapolation and revised the estimate to $19,924. CMS has requested the funds be returned. AHCCCS disagrees with the sampling methodology and extrapolation and plans to appeal the decision to the Departmental Appeals Board once CMS issues a disallowance. If and when all administrative appeals are exhausted, AHCCCS will request a refund from the LEAs or will deduct the amount from future payments in accordance with the intergovernmental agreement. The recoupment liability of $19,924 is included in the due to the federal government with a corresponding receivable in the due from the State and local governments in the accompanying financial statements. As the recoupment is a reduction of prior school-based services expense, AHCCCS has properly recorded the $19,924 as a reduction in school-based services expense for the year ended June 30, 2013.

(9) Contingencies (continued)

School based administration claiming – The School Based Medicaid Administrative Claiming program ("MAC"), administered through a third party administrator ("TPA"), allows federal funding to pass through to the LEAs for certain administrative activities. In March 2006, the contractor began a review of the claim calculation for the period from January 2004 through September 2007 as a result of findings from an OIG audit in another state that questioned methods used in the claim calculation methodology. The recommendations of the TPA were initially adopted prospectively and resulted in a more conservative calculation of the MAC amounts. Subsequently, an assessment of the impact of the claim calculation changes concluded that there is an inability to accurately recalculate the MAC amounts retroactively. The maximum impact of the retroactive claim calculations is approximately $7,000, and CMS indicates that the OIG will review the MAC claims in question to reasonably calculate the overpayments.

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

CMS has instructed AHCCCS to refund the $9,300 in overpayments. The refund will be requested from the LEAs or deducted from future payments in accordance with the intergovernmental agreement. The amount due from the LEAs may be reduced by any recovery from the TPA as identified above unless an appropriation from the Legislature is obtained by the LEAs. At June 30, 2013, AHCCCS has recorded a liability of $9,300 which is included in the due to the Federal government with a corresponding receivable in the due from state and local governments in the accompanying financial statements.

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

Certain elements of the calculations performed by the contractor and the OIG are similar causing duplication of approximately $2,076 for a total net unallowable cost of $9,641. AHCCCS anticipates receiving a disallowance and intends to file an appeal with the CMS Departmental Appeals Board ("DAB"). AHCCCS internal legal counsel has indicated that it is reasonably possible that some additional amount will be disallowed and recouped by CMS. AHCCCS will request a refund from the LEAs or will deduct the amount from future payments in accordance with the intergovernmental agreement. The recoupment liability of $9,641 is included in the due to the federal government with a corresponding receivable in the due from the State and local governments in the accompanying financial statements. As the recoupment is a reduction of prior school-based services expense, AHCCCS has properly recorded the $9,641 as a reduction in school-based services expense for the year ended June 30, 2013.

Medicare Part B premium buy-in – AHCCCS previously reported a $20,665 liability related to the OIG audit of the Medicare Part B premium buy-in for certain eligibility categories. AHCCCS returned the $20,665 in fiscal year 2013, therefore, no liability exists as of June 30, 2013 and AHCCCS has received a waiver that allows federal financial participation for the cost of Part B premiums for these eligibility categories prospectively effective October 22, 2011.

(dollar amounts expressed in thousands)

(10) Interfund receivables, payables and transfers

Interfund activity is defined as transactions between funds administered by AHCCCS. The interfund balances as of June 30, 2013 consist of transfers from the Other Funds to the General Fund in the amount of $11,708.

In the government-wide statement of activities, the interfund activity has been eliminated. The total net transfers out of $48,528 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.

The following is a summary of transactions with these State agencies for the administrative services described above for the year ended June 30, 2013.

	Expenditures
Arizona Department of Economic Security	$ 72,588
Arizona Department of Administration	15,187
Arizona Department of Health Services	893
Arizona Board of Nursing	210
Arizona Office of Administrative Hearings	531
	$ 89,409

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.

(dollar amounts expressed in thousands)

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

The amounts passed through to ADES and ADHS are classified as Traditional, Proposition 204, KidsCare and Long-term care services expenditures in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds. The following is a summary of transactions with these State agencies for the services described above for the year ended June 30, 2013.

	Expenditures
Arizona Department of Economic Security	$ 961,750
Arizona Department of Health Services	1,217,255
	$ 2,179,005

Revenues include $288,892 from Arizona counties during fiscal year 2013. To the extent expenditures for long-term care services are less than county and State contributions, AHCCCS is required to remit such amounts equally to the State and the counties. At June 30, 2013, county and State contributions did not exceed related expenditures.

(12) Other pass through funds

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

Arizona county and local governments contributed $232,689 to qualify for matching Federal funds for the Graduate Medical Education, Safety Net Care Pool, Disproportionate Share Hospital and KidsCare II program payments and for the provision of qualifying services to hospitalized inmates. These amounts are included within county pass through funds in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds.

Arizona counties contributed $3,221 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, 2013, AHCCCS recorded the following pass through revenue in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds:

	Funds Passed Through
Arizona School Districts	
Administrative Services Federal Funds	$ 4,271
Program Services Federal Funds	16,546
Arizona Department of Economic Security	
County Contribution for Administrative Costs	3,221
Arizona Department of Health Services	
Cost reimbursement from Civil Monetary Penalties	155
	$ 24,193

(13) New pronouncements

The Governmental Accounting Standards Board ("GASB") issued several pronouncements prior to June 30, 2012 with effective dates within or after the fiscal year ended June 30, 2013. Management believes the impact of these statements does not affect current or future financial presentations by AHCCCS. AHCCCS adopted the following new pronouncement in the fiscal year ended June 30, 2013.

In June 2011, the GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position* which is effective for reporting periods beginning after December 13, 2011. The requirements of this Statement will improve financial reporting by standardizing the presentation of deferred outflows of resources and deferred inflows of resources and their effects on a government's net position. It alleviates uncertainty about reporting those financial statement elements by providing guidance where none previously existed. AHCCCS adopted Statement No. 63 in fiscal year 2013. The adoption of this statement did not have a significant impact on AHCCCS' financial statements.

In March 2012, the GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities,* which is effective for reporting periods beginning after December 15, 2012. The Statement No. 65 establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities. Statement No. 65 also provides other financial reporting guidance related to the impact of the financial statement elements deferred outflows of resources and deferred inflow of resources such as changes in the determination of the major fund calculations and limiting the use of the term *deferred* in financial statement presentations. AHCCCS is currently evaluating the impact of adopting Statement No. 65, but currently believes there will be no significant impact on its financial statements.

(14) Subsequent event

A lawsuit was filed in the Arizona Superior Court for Maricopa County by a group of plaintiffs, consisting mostly of state legislators, seeking a declaration that the hospital assessment established under ARS 36-2901.08 is allegedly a tax passed in a manner inconsistent with the requirements for a tax established by the state constitution. The lawsuit was filed in September 2013. In response, the defendants, the governor and the director of AHCCCS filed a motion to dismiss based on lack of standing. A response to that motion is pending, and the court has not ruled on the motion. AHCCCS intends to continue to vigorously defend the lawsuit.

If the assessment is declared invalid, the program will have insufficient funds to cover childless adult with income up to 133% of FPL, but under the holding in *Fogliano v. State*, AHCCCS will adjust eligibility standards to match available remaining funds.

SUPPLEMENTARY INFORMATION

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2013
(amounts expressed in thousands)

Federal Grantor/Pass Through Agency/Program	Federal CFDA Number	Expenditures	
U.S. Department of Health and Human Services			
Centers for Medicare and Medicaid Services			
Medicaid Program (Title XIX)			
Federal funds expended to vendors	93.778	$ 5,925,404	
Federal funds expended to subrecipients	93.778	2,703	
		5,928,107	*
Children's Health Insurance Program (Title XXI)	93.767	49,064	*
Medicaid Infrastructure Grant	93.768	213	
TOTAL EXPENDITURES OF FEDERAL AWARDS		$ 5,977,384	

*major programs

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2013
(dollar amounts expressed in thousands)

(1) Basis of presentation

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of ***Arizona Health Care Cost Containment System*** under programs of the federal government for the year ended June 30, 2013. 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*. Because the Schedule presents only a selected portion of the operations of AHCCCS, it is not intended and does not present the financial position, changes in net position or cash flows of AHCCCS.

(2) Summary of significant accounting policies

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

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

The program titles and CFDA numbers were obtained from the 2013 *Catalog of Federal Domestic Assistance*.

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

To the Director of the

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

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the governmental activities, the business-type activities, and the aggregate remaining financial information of ***Arizona Health Care Cost Containment System*** **(AHCCCS, an agency of the state of Arizona)**, as of and for the year ended June 30, 2013 and the related notes to the financial statements which collectively comprise ***Arizona Health Care Cost Containment System's*** basic financial statements, and have issued our report thereon dated November 19, 2013.

Internal Control Over Financial Reporting

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

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

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit, we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

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

Purpose of this Report

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

Mayer Hoffman McCann P.C.

Phoenix, Arizona
November 19, 2013

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 ON COMPLIANCE FOR EACH MAJOR FEDERAL PROGRAM AND REPORT ON INTERNAL CONTROL OVER COMPLIANCE

To the Director of the

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

Report on Compliance for Each Major Federal Program

We have audited ***Arizona Health Care Cost Containment System's*** compliance with the types of compliance requirements described in the *U.S. Office of Management and Budget* (OMB) *Circular A-133 Compliance Supplement* that could have a direct and material effect on each of ***Arizona Health Care Cost Containment System's*** major federal programs for the year ended June 30, 2013.

Management's Responsibility

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

Auditors' Responsibility

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

Our audit of ***Arizona Health Care Cost Containment System's*** major federal programs was conducted as part of the State of Arizona's Single Audit for the year ended June 30, 2013. The State of Arizona's major federal programs were determined by the Office of the Auditor General by applying the risk-based approach for determining major federal programs in accordance with OMB Circular A-133. Our Report on Compliance for Each Major Federal Program relates only to the portion of the programs that were administered by ***Arizona Health Care Cost Containment System*** and does not purport to, and does not, report on compliance over other portions, if any, of the major federal programs or any other major federal programs of the State of Arizona.

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

Opinion on Each Major Federal Program

In our opinion, ***Arizona Health Care Cost Containment System*** complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended June 30, 2013.

Report on Internal Control over Compliance

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

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

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of OMB Circular A-133 for each of ***Arizona Health Care Cost Containment System's*** major federal programs. Accordingly, this report is not suitable for any other purpose.

Mayer Hoffman McCann P.C.

Phoenix, Arizona
November 19, 2013