ARIZONA HEALTH CARE
COST CONTAINMENT SYSTEM

FINANCIAL STATEMENTS
AND SUPPLEMENTARY INFORMATION

Year Ended June 30, 2016

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CONTENTS

MANAGEMENT’S DISCUSSION AND ANALYSIS

Management's Discussion and Analysis

For the Fiscal Year Ended June 30, 2016

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, 2016. 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 and deferred outflow of resources of AHCCCS exceeded its liabilities and deferred inflow of resources at fiscal year ended June 30, 2016 by $128.6 million. AHCCCS' net position at June 30, 2016 is comprised of a positive unrestricted net position of $16.7 million and net investment in capital assets of $111.9 million.

- AHCCCS' net position increased by $93.0 million during fiscal year 2016. The increase in governmental net position marks the fourth consecutive year of an increase and continues to be primarily driven by the continued investment in an internally developed automated eligibility system and increased collections of prescription drug rebate expenditure reimbursements. The capital asset investment streamlines the eligibility process, resulting in better, faster services to members and the organizations that serve them. The system also allows for electronic data transfers between the state and the federally facilitated marketplace and for most eligibility and enrollment staff functions to be claimed at the higher 75 percent enhanced administrative federal financial participation ("FFP") match rate. The Patient Protection and Affordable Care Act ("ACA") of 2010 expanded the nationally negotiated rebate agreements to Medicaid managed care organizations resulting in state match funding source in the form of an expenditure reimbursement or offset. The amount of invoiced drug rebates increased by $253.6 million over the prior year partially driven by increased utilization and program enrollment, contributing to the positive net position change.

Fund Level

As of the close of fiscal year 2016, AHCCCS' total governmental funds reported an ending fund balance of $90.5 million, an increase of $75.6 million from fiscal year 2015. This increase is primarily attributable to a $16.3 million increase in the ending fund balance in the Hospital Assessment Fund and a $59.3 million increase in the ending fund balance in the Prescription Drug Rebate Fund.

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

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

The governmental activities of AHCCCS primarily consist of programs authorized by the Social Security Act Titles XIX (“Medicaid”) and XXI (Children’s Health Insurance Program (“CHIP”)) that are concentrated on the health needs of the citizens of Arizona through direct medical service payments and supplemental payments to qualifying hospital facilities throughout the State. The majority of activities are reported in this category.

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

Fund Financial Statements (Reporting AHCCCS’ Major Funds)

A fund is a legislatively authorized fiscal and accounting entity with a self-balancing set of accounts that AHCCCS uses to keep track of specific sources of funding and spending for specific activities or objectives. AHCCCS, like other State agencies, uses fund accounting to ensure and demonstrate compliance with legislative appropriation funding requirements.

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

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

Annually, the Legislature adopts an appropriated budget for AHCCCS for the Traditional Medicaid services; Proposition 204 services; Patient Protection and Affordable Care Act ("ACA") Adult Expansion; KidsCare; Children's Rehabilitative Services; Disproportionate Share Hospital ("DSH") payments; Rural Hospital payments; and supplemental hospital payments for DSH, Graduate Medical Education ("GME"), and Safety Net Care Pool ("SNCP"); Arizona Long-Term Care Services ("ALTCS"); nursing facility supplemental payments and AHCCCS administration programs. The annual appropriation is made separately for both the State share of the required matching funds and federal financial participation funds from Medicaid and CHIP. In addition to the appropriations and expenditure authority approved by the Legislature, AHCCCS also expends continuously appropriated funds for medical service payments from prescription drug rebate reimbursement receipts, for other third party liability recovery program activities, electronic health records infrastructure development, and certain payments to hospitals for unfunded emergency department readiness costs and level 1 trauma center costs. The expenditures for unfunded emergency department readiness costs and level 1 trauma center costs are financed by revenues specifically collected for those purposes and are by statute continuously appropriated. At June 30, 2016, the trauma and emergency services fund had a zero fund balance. A budgetary comparison statement has been provided for the General Fund to demonstrate compliance with the budget on page 47.

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 22 to 46.

Government-Wide Financial Analysis

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

AHCCCS Net Position
(in thousands of dollars)

	Governmental Activities	
	2016	**2015**
Current assets	$ 1,233,416	$ 895,880
Noncurrent assets	-	-
Capital assets	111,946	93,616
Total assets	1,345,362	989,496
Deferred outflow of resources	7,005	8,914
Current liabilities	1,142,913	881,015
Long-term liabilities	73,088	69,633
Total liabilities	1,216,001	950,648
Deferred inflow of resources	7,759	12,177
Net position		
Net investment in capital assets	111,946	93,616
Unrestricted	16,661	(58,031)
Total net position	128,607	35,585

For AHCCCS, assets and deferred outflow of resources exceeded liabilities and deferred inflow of resources by $128.6 million at June 30, 2016 as compared to assets and deferred outflow of resources in excess of liabilities and deferred inflow of resources by $35.6 million at June 30, 2015.

The total Government-wide net position increased by $93.0 million. This increase is primarily due to increased collections of prescription drug rebate expenditure reimbursements along with the investment in capital assets for an internally developed automated eligibility system. The $112.0 million investment in capital assets increased by $18.3 million (net of accumulated depreciation) and is primarily comprised of the continued costs to develop and implement the new ACA compliant eligibility system. The automated eligibility system qualifies AHCCCS for 75 percent enhanced FFP for certain eligibility determination administrative functions that previously were eligible for the 50 percent FFP rate. The project consists of three major phases. The first phase, initial implementation of the new system, was completed during fiscal year 2014. The second phase was the transition from processing eligibility determinations in the existing legacy system to the new ACA compliant system and was completed in early fiscal year 2016. The third and final phase is the transition for long-term care eligibility determinations from the AHCCCS legacy system into the ACA compliant system, which is scheduled for completion during fiscal year 2017. Current year activity is reported as software and software under development in Note 2 to the accompanying financial statements.

The unrestricted component of net position is comprised of a positive balance of $16.7 million, primarily consisting of $61.4 million for medical services from members covered in the Traditional Medicaid services program, $26.1 million for future spending on qualified medical services primarily for childless adult members with income from 0-133 percent of the federal poverty level (“FPL”), and $1.2 million of funds limited to future spending for certain information technology activities. Other components include a $900,000 cash balance in the Hospital Loan Residency Fund and $614,700 of nursing facility assessment cash on hand. All of these balances are offset by the $73.8 million pension and other post-employment benefits liability at June 30, 2016. During fiscal year 2016, the governmental unrestricted net position increased primarily due to a $59.3 million increase in the state share of Prescription Drug Rebate receipts and a $16.3 million increase in the Hospital Assessment Fund. The prescription drug rebate expenditure reimbursements collections corresponds positively with enrollment and increased by $117.2 million (31.5 percent) over fiscal year 2015 resulting in the change to net position.

AHCCCS Changes in Net Position
(in thousands of dollars)

	Government Activities 2016	Government Activities 2015
Revenues		
Program revenues		
Charges for services	$ 357	$ 568
Other operating grants and contributions	782,700	804,754
Federal operating grants	8,685,760	7,867,949
General revenues		
State appropriations	2,030,866	1,991,673
Tobacco tax	132,666	134,369
Unrestricted investment Earnings	-	90
Total revenue	11,632,349	10,799,403
Expenses		
Health care	11,377,768	10,706,667
Excess before transfers	254,581	92,736
Transfers, net	(161,559)	(55,366)
Change in net position	93,022	37,370
Net position – end of year	128,607	35,585

At June 30, 2016, the governmental activity reported a unrestricted net position of $16.7 million, which is a $74.7 million increase (128.7 percent) from the prior fiscal year’s $58.0 million unrestricted net deficit position. The increase is primarily due to carryforward balances in the Prescription Drug Rebate and Hospital Assessment funds.

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

Beginning on January 1, 2014, the AHCCCS program implemented the ACA in accordance with Federal laws and regulations as approved by the Arizona Legislature. The ACA implementation allowed for the program to benefit from the enhanced federal financial participation matching rates for the three distinct eligible populations minimizing the cost of the matching State share. For fiscal year 2016, the restoration state adults at the 0% – 100% FPL were matched at an average rate of 89.08 percent, the expanded coverage for adults at the 100% – 133% FPL receives a 100 percent rate, and the child expansion are matched at an average rate of 94.48 percent. The state share for the restoration adult and expansion adult populations was provided from a CMS approved provider assessment collected from certain hospitals. In fiscal 2016, the assessment provided $250.2 million of revenue. The AHCCCS program also continued with the post implementation development and enhancement of a modernized Medicaid eligibility determination information technology system necessary to qualify for the enhanced federal match rates. In addition to the enhanced program match rates provided by the ACA, an eligibility determination made by the new Modified Adjusted Gross Income ("MAGI") methodology also qualifies both AHCCCS and the Department of Economic Security ("DES") for a 25 percent increase in the FFP federal match from 50 to 75 percent for administrative costs associated with eligibility determination functions for most staff activities and system operations costs. The investment in the health program's eligibility determination systems is also eligible to be leveraged at the highest (90 percent) federal financial participation and the regulation allowing the 90 percent rate to apply to other federally-funded human service programs in addition to Medicaid if the shared function is required by Medicaid has been extended through December 31, 2018. Accordingly, AHCCCS and DES continue to jointly participate in the process to develop the replacement to their respective existing systems under these favorable terms. The Medicaid investment in the eligibility system is broadly assigned three phases with the first two phases being completed and placed into service through fiscal year 2016. The third phase is in process and will be completed though June 30, 2017. The overall project value capitalized at June 30, 2016 totals $110.0 million, net of accumulated depreciation, and represents 98.2 percent of the $112.0 million invested in capital assets account balance. Total project investment costs through federal fiscal year 2018 are estimated at approximately $240.0 million based on the CMS approved updated budget.

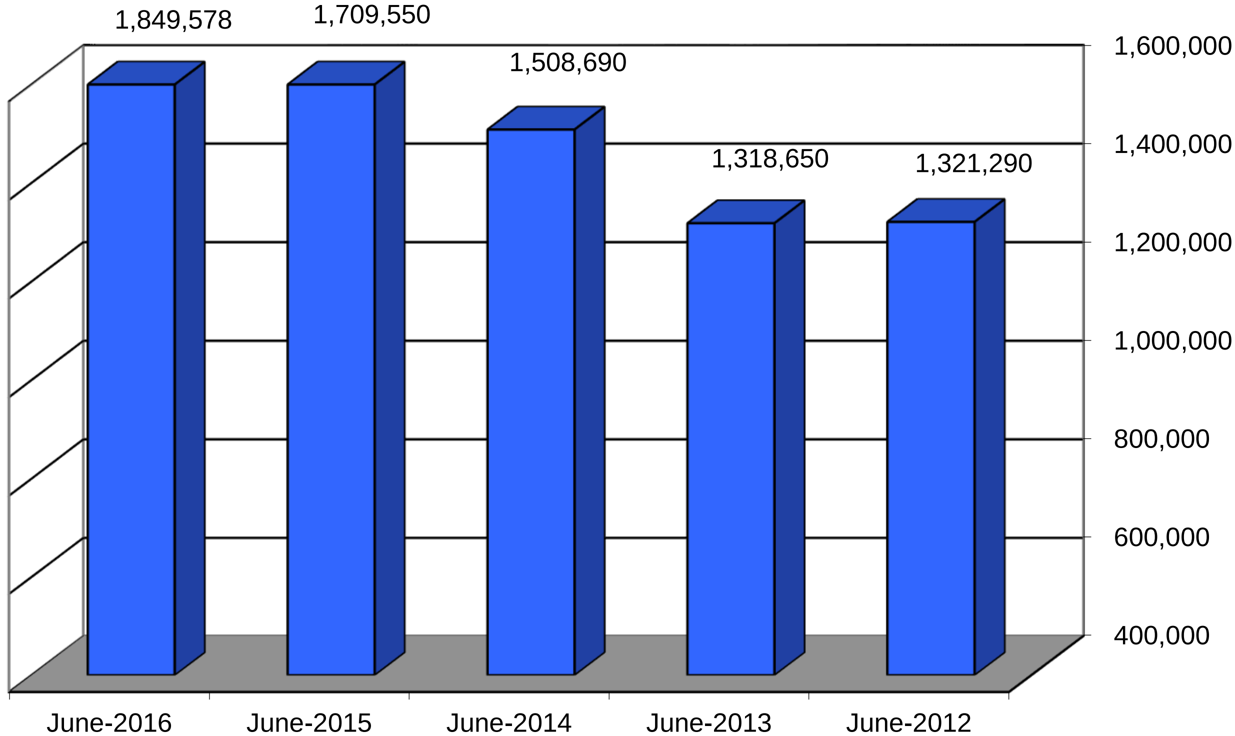
AHCCCS' actual enrollment for fiscal year 2016 was slightly higher than projected. Overall, the enrollment of full service members increased by 125,010 members from 1,557,193 to 1,682,203 for the current fiscal year and by 495,427 members from the December 1, 2013 (the period from implementation of the ACA restoration and expansion through June 2016).

Governmental Activities

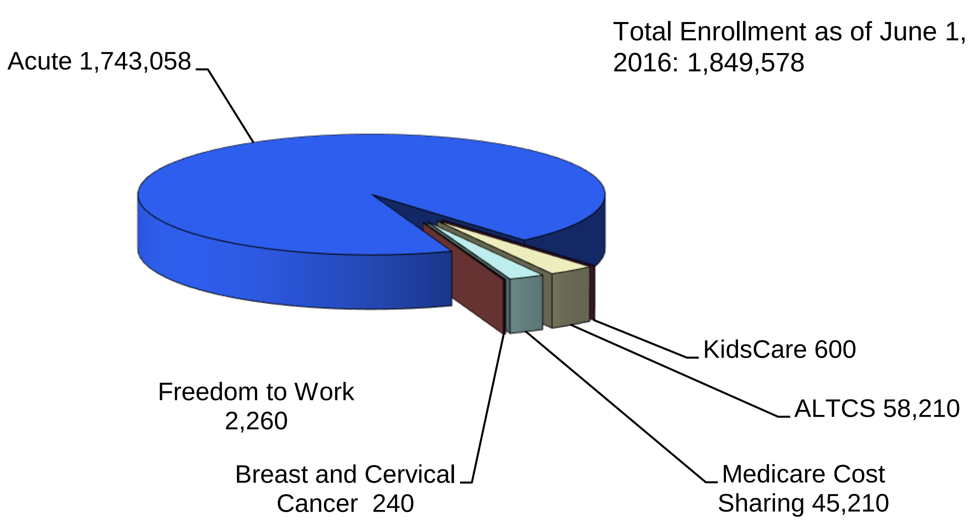
Enrollment in AHCCCS programs increased in fiscal year 2016 with total enrollment for all of AHCCCS' programs at June 1, 2016 of 1,849,578, an increase of 140,028 members (8.2 percent) from June 1, 2015. This compares to the previous year's 200,860 or 13.3 percent increase in members.

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

AHCCCS Membership Growth



AHCCCS Enrollment by Program

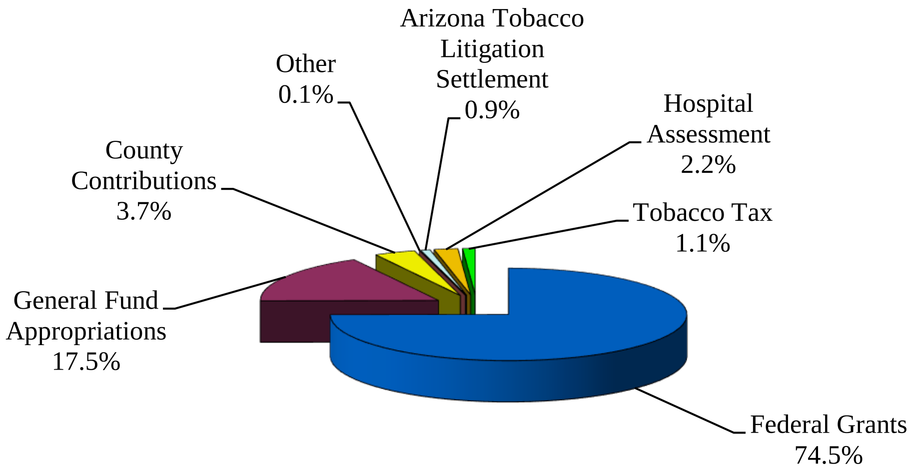


The cost of health care programs, including Medicaid and CHIP, totaled $11,377.8 million in fiscal year 2016, a $671.1 million increase from the $10,706.7 million reported in fiscal year 2015. The increase in current fiscal year program expenditures continues to be primarily attributable to the increase in enrollment. As shown in the statement of activities, the proportionate amount of expenditures funded from federal grants through CMS continues to increase year over year and was $8,685.8 million (76.3 percent of total) in fiscal 2016 as compared to $7,867.9 million (73.5 percent of total) in fiscal 2015. Current program funding in the form of federal financial participation is primarily determined through the Federal Medical Assistance Percentage ("FMAP") rate used to provide the amount of federal matching funds for qualifying State medical assistance expenditures. The FMAP is based on the relationship between Arizona's per capita personal income and the national average per capita personal income over three calendar years. The FMAP is recalculated each federal fiscal year and increased by 0.46 percent to 68.92 percent from the prior year's rate of 68.46 percent during three of the four quarters of state fiscal year 2015. In addition to the FMAP, the ACA introduced multiple new rates for the various new eligibility categories covered under the expansion. In Arizona, three additional rates applied to ACA expansion and Proposition 204 restoration covered populations. These three new rates were all in excess of the "regular" 68.92 FMAP with the rates for both the expansion state (childless adults - 0% to 100% FPL) and the newly eligible adults (adults – 100% to 133% FPL) changing on October 1st and January 1st of the fiscal year. Overall, program expenditures increased by 6.3 percent over the prior fiscal year. However, expenditures funded solely by state General Fund appropriations also decreased again in fiscal year 2016 by 0.8 percent primarily due to the higher ACA federal financial participation rates and from utilization of the hospital assessment as the state match source dedicated to fund the Proposition 204 populations. The hospital assessment produced revenue of approximately $250.2 million in fiscal year 2016. Additionally, the supplemental hospital payment programs that are funded by political subdivision voluntary contributions provided payments of $450.6 million that were distributed to various Arizona hospitals. This is a $439.2 million or 49.4 percent decrease from the $889.8 million high point amount that was distributed in fiscal year 2013. The decrease is due to changes in the CMS approved SNCP program waiver and legislation intended to transition the benefiting hospitals from reliance on supplemental payments such as the SNCP payment which will end on December 31, 2017 per the recently approved CMS Section 1115 Waiver.

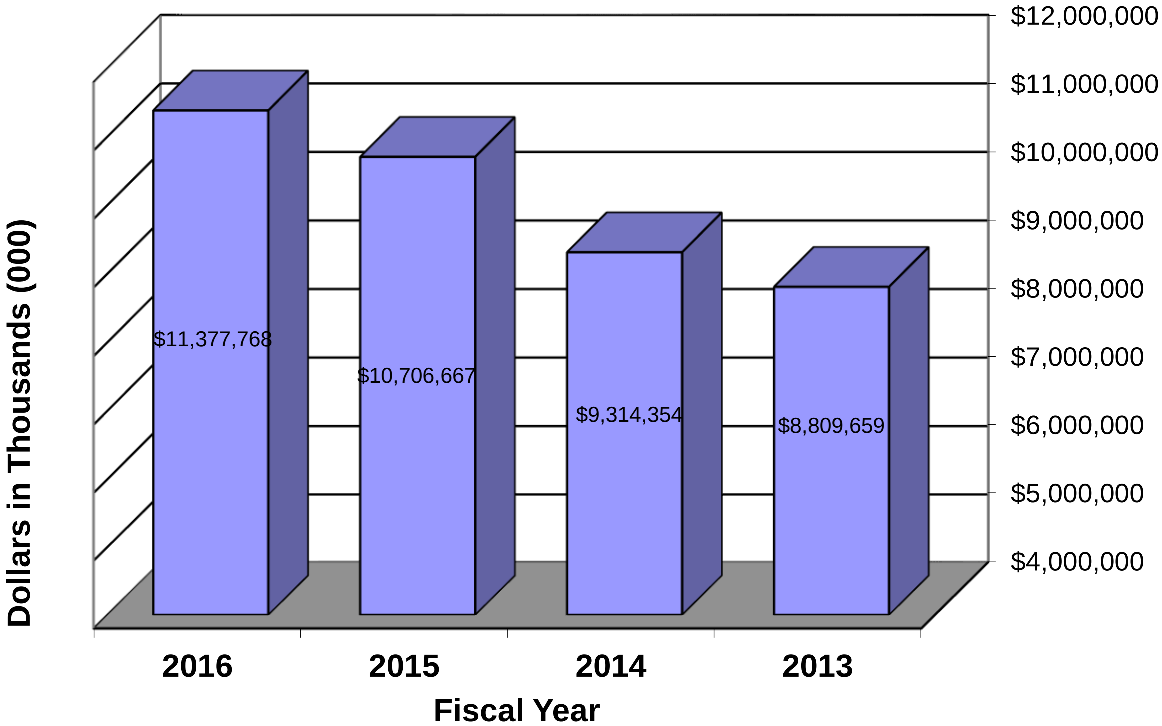
State, county and miscellaneous funding sources combined to provide $2,946.6 million in State funding sources and appropriations in fiscal year 2016, a slight $15.0 million increase over the $2,931.5 million reported in fiscal year 2015. The following are the components of the State match funding sources utilized in fiscal year 2016. State General Fund revenues raised primarily in the form of income and sales taxes directed to AHCCCS amounted to $1,195.5 million, and an additional $835.3 million was passed through from other State agencies in order to provide the State's share for Medicaid eligible medical assistance expenditures. Arizona counties contributed $433.0 million as determined by statutory funding formulas, session law and other intergovernmental agreements. Tax collections on tobacco products provided $132.6 million in State match funding. An additional $98.9 million in State revenue funding was provided by Arizona's share of tobacco litigation settlement funds. The master settlement agreement ("MSA") revenues are recorded in accordance with the 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, 2016 through June 30, 2016 based on Arizona's Joint Legislative Budget Committee 2017 estimated payment. In addition to the annual settlement payments described above, AHCCCS continues to receive the Strategic Contribution Fund payment through April 15, 2017. The amounts of the payments are dependent upon several adjustments, the magnitude of which will not be fully known until an independent auditor provides its calculations in February or March of each year. Other factors that could also affect the MSA payment amount AHCCCS ultimately receives include default or bankruptcy by one or more tobacco companies and other unforeseen withheld payment amounts. Finally, Tribal gaming receipts determined by statutory formula distributed to AHCCCS provided $22.4 million in additional funding.

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

Revenues by Source - Governmental Activities



AHCCCS Expenses by Fund Type



Financial Analysis of AHCCCS' Governmental Funds

Governmental Funds

AHCCCS' governmental funds reported combined ending fund balances totaling $90.5 million, an increase of $75.6 million from the prior year. This increase is attributable to $61.4 million in the Prescription Drug Rebate Fund and $26.2 million in the Hospital Assessment Fund carryforward balances representing unspent funds. The Prescription Drug Rebate Fund and Hospital Assessment Fund balances are available only for certain expenditures in fiscal year 2016. Any utilization of these balances must either be for medical services for qualifying populations or by legislative directive.

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

The Other Governmental Funds consist of eleven individual funds comprising the $29.1 million of the total $90.5 million fund balance available for qualifying activities. The Other Governmental Funds' fiscal year 2016 fund balances consist of assigned fund balances in the amount of $28.2 million and committed funds of $900,000. Revenue from taxes on cigarettes and other related tobacco products decreased 1.26 percent from fiscal year 2015 and generated $92.4 million for the current year compared to $93.6 million in fiscal year 2015. Since the passage of Proposition 203 in November 2006, tobacco tax collections have declined by $55.7 million or 37.6 percent since the $148.1 million high point of collection in fiscal year 2006. The collections for the Proposition 204 hospital assessment generated $250.2 million in fiscal year 2016 in available state matching revenue for program services that is down from the $270.4 million collected in fiscal year 2015. The reduction is due to revised expenditure projections augmented by another twelve months of actual expenditure data since the January 1, 2013 implementation of the assessment. The hospital assessment revenue has replaced General Fund funding for the Proposition 204 eligible member categories. However, this funding has been challenged from a lawsuit filed by a group of plaintiffs, consisting mostly of state legislators, seeking a declaration that the hospital assessment established under ARS §36-2901.08 is allegedly a tax passed in a manner inconsistent with the requirements for a tax established by the state constitution. The lawsuit was filed in September 2013 and continues to work its way through the courts. AHCCCS received a favorable ruling in the Arizona Court of Appeals in March 2017, which the plaintiffs intend to petition the Arizona Supreme Court for a review of the case. AHCCCS intends to continue to vigorously defend the lawsuit on lack of standing. If the hospital assessment is declared invalid, the program will have insufficient funds to cover childless adults with income up to 133% of FPL, but under the holding in *Fogliano v. State*, AHCCCS has the option to adjust eligibility standards to match available remaining funds. Additionally, based on the election of President Trump and continued Republican control of both the house and senate, there is considerable discussion regarding the repeal and replacement of the ACA that could trigger either the session law and or statutory requirement that AHCCCS stop collection of the assessment if the ACA is repealed or the FMAP for the expansion and restoration populations, as authorized by the ACA, falls to less than 80.0 percent. This would also most likely lead to insufficient funding and an adjustment to the eligibility standards necessary to match available funds.

General Fund Budgetary Highlights

Differences totaling $576.2 million occurred between the original and the final amended administrative and programmatic expenditure budgets. Legislation was passed during the 2016 session providing a $526.9 million supplemental appropriation increase. Additionally, the appropriated amounts for the voluntary payments from political subdivisions related to DSH, GME and SNCP supplemental hospital payments are eligible to be increased for any political subdivision funds including the federal matching monies in excess of the original appropriation. For fiscal year 2016, the voluntary line items for GME and DSH were increased by $49.3 million total fund. 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 General Accounting Office and 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:

- $227.5 million increase for the ACA Adult Expansion program covering newly eligible adults (adults – 100% to 133% FPL) as the expansion costs more than doubled the legislative projected enrollment growth and associated costs. Although this population category was funded at the 100.0 percent enhanced MAP rate during fiscal year 2016, the MAP rate will drop to 95.0 percent in effective October 1, 2017 eventually decreasing to 90.0 percent during fiscal year 2020 under the ACA.
- $123.5 million increase to the Proposition 204 services program necessary to fund expenditures due to enrollment in excess of the budgetary projections.
- $69.3 million increase to the Traditional services program.
- $23.4 million increase primarily related to administrative costs to continue the development of the automated eligibility system.

At June 30, 2016, actual cash basis appropriated program expenditures were $186.7 million less than budgetary estimates primarily resulting from surplus federal expenditure authority.

Capital Asset Administration

AHCCCS' investment in capital assets for its governmental activities as of June 30, 2016 is $111.946 million, net of accumulated depreciation and amortization. This investment in capital assets includes furniture, vehicles, equipment and internally generated software (intangible assets) for projects started after June 30, 2009. Land, buildings and improvements are under the management of the State and are separately accounted for on the State's comprehensive annual financial report. Total net capital assets increased $18.333 million or 19.6 percent over the prior fiscal year balance. The largest component of AHCCCS' investment in capital assets relates to internally developed software and software under development. Effective October 1 2016, $69.715 million of the software under developed was placed into service and moved into software. At June 30, 2016, software under development consists primarily of costs associated with phase three of AHCCCS' development of a new eligibility system. The remaining capital asset changes are for disposals in excess of additions including depreciation of vehicles, furniture and equipment and upgraded servers and related IT equipment items.

	Governmental Activities 2016	Governmental Activities 2015
Vehicles, furniture & equipment	$ 1,973	$ 2,313
Software	89,514	27,047
Software under development	20,459	64,256
Total net position	$ 111,946	$ 93,616

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

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, 2021), that the population covered by the Waiver be budget neutral for CMS. Effective with the January 1, 2014 implementation of the eligibility expansion under the ACA to include the new adult group, members with income between 100% and 133% of the FPL, the budget neutrality measurement is performed separately for the new adult population. Budget neutral means that CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. The budget neutrality calculation is dependent on a number of variables including the number of members, the eligibility category of members and the general economy and its impact on unemployment, medical inflation and policy decisions made by the Legislature that may impact program costs. The cumulative federal share favorable variance for the waiver period ended September 30, 2015 was $15,300.8 million. Through June 30, 2016, AHCCCS remains under the cumulative reporting limit threshold for the current waiver. Accordingly, management is projecting zero liability as of June 30, 2016 to CMS related to the budget neutrality agreement and the accompanying financial statements have not been adjusted for the impact of any liability AHCCCS may have related to the Waiver budget neutrality agreement.

AHCCCS continues to have several outstanding audit findings related to audits conducted by The Inspector General, Office of Audit Services (“OIG”) from fiscal year 2015 related to the Direct Service Claiming (“DSC”) and School Based Medicaid Administrative Claiming (“MAC”) programs. AHCCCS disagrees with the findings in part, however, has returned the federal funds for non-disputed claims and has received the final disallowance issued by CMS on October 20, 2016 relating to the MAC audit for $11.717 million. AHCCCS responded to the Secretary of the U.S Department of Health and Human Services (“DHHS”), pursuant to 42 U.S.C. § 1316(e)(1), on December 14, 2016, with a request for reconsideration of the MAC disallowed amount. AHCCCS plans to appeal to the DHHS, Departmental Appeals Board (“DAB”) should CMS deny the request for reconsideration. AHCCCS also intends to follow the same appeals protocol related to the DSC amount should CMS ever follow through with a final disallowance decision. However, the recoupment liability of $19.924 million for the DSC audit and $11.717 million for the MAC audit is included in the due to the federal government with a corresponding receivable in the due from the State and local governments in the accompanying financial statements per the applicable contract terms.

During the current fiscal year, the OIG issued a report in August 2016 for their review of Medicaid electronic health record (“EHR”) incentive payments to Hospitals finding a net overpayment in the amount of $14.831 million. AHCCCS does not agree with the OIG findings and is waiting for CMS’ determination on any final disallowed amount. The individual hospitals must return 100 percent of their respective disallowed amount per the EHR program’s terms and conditions, as agreed to in order to participate in the program and receive EHR incentive payments. However, the recoupment liability of $14.831 million for the finding is included in the due to the federal government with a corresponding receivable in the receivables and other in the accompanying financial statements.

Economic Factors and Next Year’s Budgets and Rates

AHCCCS enrollment for fiscal year 2016 was slightly higher than projected. For the period June 2015 to August 2016, AHCCCS forecasted growth of 120,000 members across all programs which is an increase of 7.9 percent. Actual growth for that period was 136,000 members, an increase of 9.0 percent, and a difference of only 16,000 individuals. Growth in the Proposition 204 Expansion State Adult (“ESA”) restoration and the Newly Eligible Adult (“NEA”) expansion programs was the main driver of this variance, adding 47,000 members, versus the forecast of 31,000 members. The growth rates for fiscal year 2017 reflect the similar assumption that overall growth will continue in early fiscal year 2017 followed by a leveling off to normal (pre January 1, 2014 ACA implementation) population growth for most populations throughout all of fiscal year 2018, but assuming slightly higher growth in adult restoration and expansion categories. The Arizona economic recovery continues to show signs of improvement and now compares favorably to the national coincident index that gauges economic activity combining employment, average hours worked in manufacturing, unemployment rate, and inflation-adjusted wages. The October 2016 coincident index for Arizona increased by 3.4 percent from August 2015, which compares favorably to the 3.0 percent increase for the U.S. index for the same period. Additionally, the housing market has also shown signs of improvement, as the October 2016 12-month total of single family construction permits are 15.3 percent more than a year ago. The unemployment rate continues to improve and has decreased to 5.8 percent when compared to the 6.3 percent level of August 2015. Accordingly, AHCCCS is projecting population growth will continue in early fiscal year 2017 followed by a leveling off to pre-restoration and expansion growth rates during fiscal year 2018.

The total fiscal year 2017 appropriation for AHCCCS is $11,380.2 million compared to the final $9,105.6 million appropriation for fiscal year 2016. This increase reflects the July 1, 2016 merger of all behavioral health and related services previously housed in the Arizona Department of Health Services. These behavioral health services appropriations include $100.6 million for non-Medicaid services. Additionally, the projected spending increase accounts for enrollment growth and utilization costs. The contract year 2017, Acute Care capitation rates are projected to increase by 3.12 percent as compared to the 2.45 percent increase for contract year 2016. The 2017 increase is primarily based on utilization increases driven by Hepatitis C pharmacy costs accounting for 1.19 of the 3.12 percent projected increase and adjustments to account for utilization of Federally Qualified Health Centers ("FQHC"s) and Rural Health Centers ("RHC"s) that operate under a cost reimbursement payment model account which account for 1.33 of the 3.12 percent increase. Other drivers are the high acuity pediatric adjustment factor (0.11 percent) and changes related to access-to-care requirements and legislative mandates that account for 0.26 percentage points of the increase The contract year 2017 Arizona Long Term Care System ("ALTCS" Elderly and Physically Disabled ("EPD")) capitation rates are estimated to increase by 3.84 percent. The primary factors impacting the ALTCS EPD rates are provider rate increases, medical trend and mix changes for home and community based service providers. Due to the passage of voter ballot initiative Proposition 206, AHCCCS positively adjusted both fee-for-service and capitation rates to reflect additional labor costs from the minimum wage increase. AHCCCS is also estimating a 3.0 percent capitation rate increase for all programs for contract year 2018 as part of the fiscal year 2018 budget submission. However, it is important to note that federal law requires rates to be actuarially sound and the AHCCCS actuaries develop rates based on expected cost and utilization trends. In addition, AHCCCS must conduct an access to care analysis of its rates to assure that sufficient providers are willing to serve AHCCCS members and factor the voter mandated minimum wage increase effective January 1, 2017. Therefore, depending on the results of this analysis and of AHCCCS' actuarial determination of the expected costs of the managed care organizations, the actual capitation rates could differ from projections.

Although AHCCCS has implemented ACA expansion of enrollment beginning January 1, 2014, the recent Presidential election result and political landscape raise significant uncertainty as to the status of the ACA Law, its related mandates and the potential impacts of any repeal and replace on the AHCCCS program. There are many complexities and integral relationships that impact any global level discussion of financial and member coverage. However, AHCCCS has published some impact analysis and will continue to provide stakeholder updates at https://www.azahcccs.gov/shared/news.html under AHCCCS News & Updates. Key impact projections at the time of this report date addressed what are some of the broadest of impacts to Arizona's Medicaid program. For example, the elimination of the non-categorical adults in the 0 to 133 percent of the FPL coupled with the elimination of the Managed Care prescription drug rebate collections used as a state match funding is estimated to increase General Fund cost by $328.0 million, remove up to $3,200.0 million in Federal funds from the Arizona economy and drop coverage for 425,338 members. AHCCCS will closely follow any developments related to any repeal and replace discussion and work closely with the Governor's Office and Arizona's Federally elected delegation to provided needed input and impact analysis.

A lawsuit was filed by a group of plaintiffs, consisting mostly of state legislators, seeking a declaration that the hospital assessment established under ARS §36-2901.08 is allegedly a tax passed in a manner inconsistent with the requirements for a tax established by the state constitution. The lawsuit was filed in September 2013 and continues to work its way through the courts. AHCCCS received a favorable ruling in the Arizona Court of Appeals on March 16, 2017, but expects the plaintiffs to petition the Arizona Supreme

Court for a review of the case. AHCCCS intends to continue to vigorously defend the lawsuit on lack of standing. If the hospital assessment is declared invalid, the program will have insufficient funds to cover childless adults with income up to 133% of FPL, but under the holding in *Fogliano v. State*, AHCCCS has the option to adjust eligibility standards to match available remaining funds.

AHCCCS continues to aid in the development of a robust healthcare information technology ("HIT") by offering financial assistance to providers and other entities in adopting and using health HIT. In fiscal year 2016, $23.0 million in federal funds were disbursed to Arizona hospitals and providers as incentives. Projections for fiscal year 2017 include $39.1 million in non-appropriated federal pass-through expenditure authority for Arizona providers and hospitals that may be eligible for Medicaid incentive payment funding.

CMS approved an extension of the Section 1115 Waiver through September 31, 2021. The approval included Arizona's request to modernize its Medicaid program and continue many of the existing authorities allowing AHCCCS to maintain its unique and successful managed care model, use home and community based services for members with long-term care needs and other innovations that make AHCCCS one of the most cost effective Medicaid programs in the nation. The Waiver allows Arizona to run its managed care model and exempts Arizona from certain provisions of the Social Security Act and includes expenditure authority for costs not otherwise matched by the federal government. Waiver programs are required to be budget neutral for the federal government − not cost more federal dollars than without a waiver.

AHCCCS' budget request for fiscal year 2018, submitted to the Governor in September 2016 included a rebase of the fiscal year 2017 budget. The current forecast is for a $12.9 million shortfall comprised of Hospital Assessment Expenditure Authority and represents the difference between the current assessment rate collections and the appropriated amount. AHCCCS continues to experience the impacts of the many program changes resulting from the ACA. However, factors such as Federal law changes, CMS decisions, legal decisions, case load changes compared to projections and the eligibility system shifts in population categories may influence any final fiscal year shortfall and potential need and amount of a supplemental appropriation. AHCCCS management will closely monitor all these factors in relation to the adequacy of the fiscal year 2017 appropriation and fiscal year 2018 budget request.

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

3101 N. Central Ave., Suite 300 ■ Phoenix, AZ 85012
Main: 602.264.6835 ■ Fax: 602.265.7631 ■ www.mhmcpa.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 general fund, and the aggregate remaining fund information of AHCCCS as of and for the year ended June 30, 2016, and the related notes to the financial statements, which collectively comprise AHCCCS' basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the general fund, and the aggregate remaining fund information of AHCCCS, as of June 30, 2016, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of a Matter

As discussed in Note 1, the financial statements of AHCCCS are intended to present the financial position, the changes in financial position and cash flows, where applicable, of only that portion of the governmental activities, the general fund and the aggregate remaining fund information of the State of Arizona that is attributable to the transactions of AHCCCS. They do not purport to, and do not, present fairly the financial position of the State of Arizona at June 30, 2016, the changes in the financial position, or, where applicable, the cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 12 to the financial statements, for the year ended June 30, 2016, AHCCCS adopted new accounting guidance, Governmental Accounting Standards Board Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets that are not within the Scope of GASB Statements No. 67 and 68.* Our opinions are not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 1-13, budgetary comparison information on page 47, and schedule of the agency's proportionate share of the net pension liability – cost sharing plan and schedule of the agency's pension contributions on pages 48-49 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise AHCCCS' basic financial statements. The accompanying Schedule of Expenditures of Federal Awards, and related notes, as required by Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Awards*, is presented for purposes of additional analysis and is not a required part of the basic financial statements.

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

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated March 21, 2017 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.

March 21, 2017

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET POSITION

June 30, 2016
(amounts expressed in thousands)

	Governmental Activities
ASSETS	
CURRENT ASSETS	
Cash	$ 215,855
Designated cash	65,455
Restricted cash	820
Due from state and local governments	63,861
Due from the federal government	605,304
Tobacco settlement receivable	50,000
Receivables and other	232,121
TOTAL CURRENT ASSETS	1,233,416
NONCURRENT ASSETS	
Furniture, vehicles, equipment and software, net of accumulated depreciation	111,946
TOTAL NONCURRENT ASSETS	111,946
TOTAL ASSETS	1,345,362
DEFFERRED OUTFLOW OF RESOURCES	
Pension	7,005
LIABILITIES	
CURRENT LIABILITIES	
Accounts payable	30,077
Other accrued liabilities	2,414
Unearned revenue	20,761
Due to federal, state and county governments	284,313
Accrued programmatic claims	801,578
Compensated absences	3,770
TOTAL CURRENT LIABILITIES	1,142,913
NON-CURRENT LIABILITIES	
Net Pension Liability	70,896
Net OPEB Liability	2,192
TOTAL LIABILITIES	1,216,001
DEFFERRED INFLOW OF RESOURCES	
Pension	7,759
COMMITMENTS AND CONTINGENCIES	
NET POSITION	
NET INVESTMENT IN CAPITAL ASSETS	111,946
UNRESTRICTED	16,661
TOTAL NET POSITION	$ 128,607

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF ACTIVITIES

Year Ended June 30, 2016
(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
PROGRAMS					
Government activities:					
Health care programs	$ 11,377,768	$ 357	$ 8,685,760	$ 782,700	$ (1,908,951)
TOTAL PROGRAMS	$ 11,377,768	$ 357	$ 8,685,760	$ 782,700	$ (1,908,951)
General revenues:					
State appropriations					2,030,866
Tobacco tax					132,666
Unrestricted investment earnings					-
					2,163,532
Transfers:					
Transfers out					(161,559)
Total general revenues and transfers					2,001,973
CHANGE IN NET POSITION					93,022
NET POSITION, BEGINNING OF YEAR					35,585
NET POSITION, END OF YEAR					$ 128,607

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BALANCE SHEET - GOVERNMENTAL FUNDS

June 30, 2016
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
ASSETS			
Cash	$ 175,342	$ 40,513	$ 215,855
Designated cash	65,455	-	65,455
Restricted cash	-	820	820
Due from state and local governments	44,271	19,590	63,861
Due from the federal government	589,291	16,013	605,304
Due from other funds	11,169	-	11,169
Tobacco settlement receivable	50,000	-	50,000
Receivables and other	231,773	348	232,121
TOTAL ASSETS	$ 1,167,301	$ 77,284	$ 1,244,585
LIABILITIES			
Accounts payable	$ 29,295	$ 782	$ 30,077
Other accrued liabilities	2,352	62	2,414
Unearned revenue	20,189	572	20,761
Due to federal, state and county governments	284,161	152	284,313
Due to other funds	-	11,169	11,169
Accrued programmatic claims	513,059	35,456	548,515
TOTAL LIABILITIES	849,056	48,193	897,249
DEFERRED INFLOWS OF RESOURCES			
Unavailable revenue	256,832	-	256,832
COMMITMENTS AND CONTINGENCIES			
FUND BALANCES			
Committed	-	900	900
Assigned	61,413	28,191	89,604
TOTAL FUND BALANCES	61,413	29,091	90,504
TOTAL LIABILITIES, DEFERRED INFLOWS OF RESOURCES, AND FUND BALANCES	$ 1,167,301	$ 77,284	

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.	111,946
Some liabilities, including net pension and other postemployment benefits liabilities, are not due and payable in the curent period and, therefore, are not reported in the funds.	(73,088)
Deferred outflows and inflows of of resources related to pensions are applicable to future reporting periods and, therefore, are not reported in the funds.	(755)
A portion of liabilities for accrued paid time off of this amount is not due and payable from current financial resources and, therefore is not reported in the funds.	(3,770)
Receivables, offsetting the above accrued paid time off liability, will not be collected in 31 days, therefore are not reported in the funds.	3,770
A portion of accrued programmatic claims is not due and payable from current financial resources and, therefore is not reported in the funds.	(253,062)
A portion of receivables will not be collected in 31 days, therefore is not reported in the funds.	253,062
	$ 128,607

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, 2016
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
REVENUES			
State government:			
Appropriations	$ 1,170,164	$ -	$ 1,170,164
ISA pass through funds	835,315	-	835,315
Federal government:			
Acute care	5,349,131	1,885	5,351,016
Long-term care	867,486	20,298	887,784
ISA/IGA pass through funds	2,447,661	-	2,447,661
County and other local government:			
Acute care	49,882	-	49,882
Long-term care	255,919	-	255,919
IGA pass through funds	127,171	-	127,171
Tobacco litigation settlement revenue	98,907	-	98,907
Tobacco tax revenue	40,222	92,444	132,666
Gaming revenue	-	22,445	22,445
Nursing facility tax assessment	-	49,394	49,394
Hospital assessment	-	250,214	250,214
HAPA intergovernmental agreement revenue	696	7,022	7,718
Premium revenue	357	-	357
Other	(78,979)	29	(78,950)
TOTAL REVENUES	11,163,932	443,731	11,607,663
PROGRAMMATIC EXPENDITURES			
Medical Services:			
Traditional services	4,178,886	24,694	4,203,580
Proposition 204 services	2,892,449	253,084	3,145,533
Newly eligible adults	485,966	-	485,966
KidsCare services	2,577	127	2,704
Long-term care services	2,385,574	72,464	2,458,038
Childrens rehabilitative services	252,187	-	252,187
School-based services	38,977	-	38,977
Transplant services non-Medicaid	-	-	-
Hospital Payments:			
Disproportionate share	20,261	-	20,261
Rural and critical access hospital	21,989	-	21,989
Graduate medical education	265,900	-	265,900
Trauma center services	-	22,448	22,448
Safety net care pool	120,019	-	120,019
Other:			
Medicare Part D clawback	88,088	-	88,088
Health information technology	8,176	-	8,176
TOTAL PROGRAMMATIC EXPENDITURES	10,761,049	372,817	11,133,866
ADMINISTRATIVE EXPENDITURES	214,606	9,849	224,455
ADMINISTRATIVE EXPENDITURES PASSED THROUGH	12,144	-	12,144
TOTAL EXPENDITURES	10,987,799	382,666	11,370,465
EXCESS OF REVENUES OVER EXPENDITURES	176,133	61,065	237,198
OTHER FINANCING SOURCES (USES)			
Transfers to other State agencies:			
To State General Fund	(108,488)	-	(108,488)
To Arizona Department of Economic Security	(3,493)	-	(3,493)
To Arizona Department of Health Services	(3,352)	(44,702)	(48,054)
To Arizona Department of Revenue	(726)	-	(726)
To Arizona Attorney General	(798)	-	(798)
Transfers between funds:			
To AHCCCS General Fund	-	-	-
From AHCCCS Other Fund	-	-	-
TOTAL OTHER FINANCING SOURCES (USES)	(116,857)	(44,702)	(161,559)
NET CHANGE IN FUND BALANCES	59,276	16,363	75,639
FUND BALANCES, BEGINNING OF YEAR	2,137	12,728	14,865
FUND BALANCES, END OF YEAR	$ 61,413	$ 29,091	$ 90,504

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

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

Year Ended June 30, 2016
(amounts expressed in thousands)

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

Change in fund balances - total governmental funds (page 20)	$	75,639
AHCCCS pension contributions are reported as expenditures in the governmental funds when made. However, they are reported as deferred outflows of resources in the Statement of Net Position because the reported net position liability is measured a year before AHCCCS' report date. Pension expense, which is the change in the net pension liability adjusted for changes in deferred outflows and inflows of resources related to pensions, is reported in the Statement of Activities.		1,246
Certain expenses reported in the Statement of Activities do not report the use of current financial resources and, therefore, are not reported as expenditures in the governmental funds.		(2,192)
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 current period.		18,329
Change in net position of governmental activities (page 18)	$	93,022

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

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

A. Reporting entity

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, 2021. AHCCCS provides acute and long-term health care coverage to eligible residents of Arizona. Eligible residents include those who qualify under Section 1931(b) of the Social Security Act, individuals who are aged, blind or disabled, children who meet certain age requirements from families receiving food stamps, children and pregnant women whose household income meets eligibility requirements, certain single adults, childless couples, uninsured women needing active treatment for breast and/or cervical cancer and individuals with disabilities who want to work and who meet certain Supplemental Security Income (“SSI”) eligibility criteria. Beginning on January 1, 2014, AHCCCS implemented the Patient Protection and Affordable Care Act (“ACA”) of 2010. The ACA implementation included (a) the restoration of the childless adults (expansion state adults) who were previously eligible for AHCCCS under the voter mandated Proposition 204, (b) expanded coverage for adults from 100% to 133% of the federal poverty limit (“FPL”) and (c) the mandatory child expansion for children ages 6-19 from 100% to 133% of the FPL. These three distinct populations all have enhanced federal financial participation matching rates effective January 1, 2014.

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

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.

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.

(1) Summary of significant accounting policies (continued)

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

The statement of activities demonstrates the degree to which the governmental 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. 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 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. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of the related cash flows.

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

In fiscal year 2016, 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.

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

(1) Summary of significant accounting policies (continued)

D. Cash and investments

Substantially all of the cash and investments maintained by AHCCCS are held by the State of Arizona Office of the Treasurer ("Treasurer") with other State monies in an internal cash and investment pool. Investment income is allocated to AHCCCS on a pro rata basis. Amounts held by the Treasurer are recorded at fair value and totaled $282,130 at June 30, 2016, including designated and restricted funds of $66,275.

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 designated by AHCCCS in the amount of $65,455 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 $820 for the Hawaii Arizona PMMIS Alliance ("HAPA") Fund, as described in Note 4 and is offset by accrued expenditures of $248 and unearned revenue of $572 at June 30, 2016.

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. The application of required funding techniques is automated within the Arizona Financial Information System and controls the timing of federal funding draw downs. Any interest penalty accrued through the automated process is paid by the State from interest earned on the cash investments.

E. Deferred outflows and inflows of resources

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

(1) Summary of significant accounting policies (continued)

F. Pensions

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

G. Net position / fund balance

The difference between fund assets and liabilities is "Net Position" on the government-wide 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 and spendable and are defined as follows:

Nonspendable fund balance

Nonspendable fund balance – this includes amounts that cannot be spent because they are either not spendable in form (such as inventory) or legally or contractually required to be maintained intact (such as endowments). At June 30, 2016, AHCCCS had no nonspendable fund balance.

Spendable fund balance

Restricted fund balance – this includes amounts that can be spent only for specific purposes stipulated by legal requirements imposed by other governments, external resource providers, or creditors. AHCCCS imposed restrictions do not create a restricted fund balance unless the legal document that initially authorized the revenue (associated with that portion of the fund balance) also included language that specified the limited use for which the authorized revenues were to be expended. At June 30, 2016, AHCCCS had no restricted fund balance.

Committed fund balance – this includes amounts that can only be used for specific purposes pursuant to constraints imposed by formal action of the Legislature. Those committed amounts cannot be used for any other purpose unless the Legislature removes or changes the specified use by taking the same type of action (for example, statute, session law, etc.) that it employed to previously commit those amounts. If the Legislative action that limits the use of the funds was separate from the action that initially created the revenues that form the basis for the fund balance, then the resultant fund balance is considered to be committed, not restricted. AHCCCS considers a resolution, a statute, or a session law action to constitute a formal action of the Legislature for the purposes of establishing committed fund balance. At June 30, 2016, AHCCCS' committed fund balance totaled $900 and related to the hospital residency loan fund.

(1) Summary of significant accounting policies (continued)

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, 2016, AHCCCS' assigned fund balance totaled $89,604.

Unassigned fund balance – this includes the remaining spendable amounts which are not included in one of the other classifications. At June 30, 2016, AHCCCS had no unassigned fund balance.

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

H. Capitation payments

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

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. There are several risk mitigation strategies where AHCCCS offers the contractors a risk corridor for both PPC and prospective expenses which protects the contractors from excessive losses, while at the same time allowing an upper limit on profits. The PPC risk corridor limits contractors' profits and losses to 2% on net capitation and the prospective risk corridor limits contractors' profits to 4.5% and losses to 3% of net capitation.

I. Reinsurance payments

AHCCCS provides a stop-loss reinsurance program for its contracted health plans for partial reimbursement, after a deductible is met, of reinsurable covered medical services incurred for members. AHCCCS is self-insured for the reinsurance program which is characterized by an initial deductible level and a subsequent coinsurance percentage. The coinsurance percentage is the rate at which AHCCCS will reimburse the Contractor for covered services incurred above the deductible level. The deductible is the responsibility of the Contractor. 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 catastrophic reinsurance cases, there is no deductible level.

(1) Summary of significant accounting policies (continued)

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. For certain blood related disorders; the catastrophic reinsurance program reimburses the health plans at 85% of the health plans' paid amount up to $650 of covered expenses and 100% thereafter. For members receiving certain biotech drugs, only the drug costs are covered and AHCCCS pays 75% of the health plans' paid amount up to $650 of covered expenses and 100% thereafter.

J. Fee-for-service payments

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

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

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

K. Incurred but not reported programmatic expenditures

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

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

(1) Summary of significant accounting policies (continued)

L. Hospital Assessment Fund

The hospital assessment fund, established pursuant to ARS §36-2901.09 on January 1, 2014, consists of monies collected from an assessment on hospitals for the purpose of funding a portion of the non-federal share of costs for the Proposition 204 eligible population. AHCCCS recorded assessment revenues in the amount of $250,214 and expenditures in the amount of $233,930 during fiscal year 2016 ending with a net fund balance of $26,170 at June 30, 2016.

M. Hospital and nursing facility payments

CMS and the Legislature authorized AHCCCS to make Disproportionate Share, Safety Net Care Pool, Graduate Medical Education, Rural Hospital, Critical Access Hospital, Trauma Center and Nursing Facility supplemental payments in fiscal year 2016. Disproportionate share payments to Arizona hospitals that provided care to a disproportionate share (as defined) of the State's indigent population totaled $20,261. Safety Net Care Pool payments to fund unreimbursed costs incurred by CMS approved hospitals, under the SNCP program waiver, in caring for the uninsured totaled $120,019. Graduate Medical Education payments to reimburse hospitals with GME programs for the additional costs of treating AHCCCS members utilizing graduate medical students totaled $265,900. Critical Access Hospital payments to provide increased reimbursement to small rural hospitals that are federally designated as critical access hospitals and Rural Hospital payments to increase inpatient reimbursement rates for qualifying rural hospitals totaled $21,989. Trauma center services to reimburse hospitals in Arizona for unrecovered trauma center readiness costs and unrecovered emergency services costs totaled $22,448. 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 $105,293.

N. Taxes

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

O. Management's use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities, and the reported amounts of revenues and expenditures at June 30, 2016. Actual results may differ from these estimates.

P. 100% Federal poverty level expansion and CMS Waiver

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

(1) Summary of significant accounting policies (continued)

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 2021. Effective with the January 1, 2014 implementation of the eligibility expansion under the ACA to include the new adult group, members with income between 100% and 133% of the FPL, the budget neutrality measurement is performed separately for the newly eligible adult population. Management believes that as of June 30, 2016, AHCCCS does not have any liability to CMS related to either budget neutrality agreement and, accordingly, no liability is recorded in the accompanying financial statements. See Note 8.

AHCCCS has classified the Arizona Tobacco Litigation Settlement Fund, created by ballot Proposition 204, as part of its General Fund. These funds are restricted for use as specified in the litigation settlement and/or legislation. Annual settlement payments, based on cigarette sales from the preceding calendar year are made in April. In addition, supplemental payments may be received as tobacco companies enter into the tobacco master settlement agreement. AHCCCS received annual and strategic contribution fund payments of $98,907 in fiscal year 2016 for the period from January 1, 2014 to December 31, 2015. Revenue and a related receivable of $50,000 were accrued for the period of January 1, 2016 through June 30, 2016 and are included in Tobacco Settlement Receivable and Other Operating Grants and Contributions in the accompanying Statement of Net Position and Statement of Activities.

Q. Prescription Drug Rebate Program

The ACA included a provision to extend drug rebates to managed care programs and to increase the rebate amount drug manufacturers are required to pay under the Medicaid drug rebate program. AHCCCS received CMS approval on January 26, 2011 to participate in the drug rebate program, both managed care and fee-for-service, for drugs dispensed on or after March 23, 2010. AHCCCS received rebate reimbursements and delinquent account interest in the amount of $485,470 in 2016. Of this amount, $321,577 was returned to the Federal government in fiscal 2016 and $53,849 will be returned subsequent to June 30, 2016. This amount is netted against the due from the Federal government in the accompanying financial statements. The remaining $110,044 is available to offset a portion of General Fund current and future fiscal year expenditures. Additionally, AHCCCS has accrued the unpaid invoice balance of $216,942 as of June 30, 2016 which is included in receivables and other in the accompanying Statement of Net Position. Of this accrued receivable, $167,768 will be returned to the Federal government and is netted against the due from the Federal government in the accompanying financial statements and $49,174 is available to offset future fiscal year expenditures, which is netted against the due from state and local governments in the accompanying financial statements.

(dollar amounts expressed in thousands)

(2) Capital assets

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

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

Governmental Activities:	Balance June 30, 2015	Increases	Decreases	Balance June 30, 2016
Capital assets, not being depreciated:				
Software under development	$ 64,256	$ 20,459	$ (64,256)	$ 20,459
Capital assets, being depreciated:				
Vehicles, Furniture & Equipment	8,924	522	(2,433)	7,013
Software	32,643	70,748	-	103,391
Total capital assets, being depreciated	41,567	71,270	(2,433)	110,404
Less accumulated depreciation for:				
Vehicles, Furniture & Equipment	(6,611)	(862)	2,433	(5,040)
Software	(5,596)	(8,281)	-	(13,877)
Total accumulated depreciation	(12,207)	(9,143)	2,433	(18,917)
Total capital assets being depreciated, net	29,360	62,127	-	91,487
Governmental activities capital assets, net	$ 93,616	$ 82,586	$ (64,256)	$ 111,946

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, 2016, 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, 2016, capital assets included $20,459 of software under development. At June 30, 2016, software under develop is primarily comprised of the continued costs to develop and implement the new ACA compliant eligibility system. The automated eligibility system qualifies AHCCCS for 75 percent enhanced FFP for certain eligibility determination administrative functions that previously were eligible for the 50 percent FFP rate. The project consists of three major phases. The first phase, initial implementation of the new system, was completed during fiscal year 2014. The second phase was the transition from processing eligibility determinations in the existing legacy system to the new ACA compliant system and was completed in early fiscal year 2016. The third and final phase is the transition for long-term care eligibility determinations from the AHCCCS legacy system into the ACA compliant system, which is scheduled for completion during fiscal year 2017. The total remaining costs to incur under the project are estimated at $240,000.

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, 2015	$ 3,490
Additions	5,470
Reductions	(5,190)
Balance, June 30, 2016	$ 3,770

(4) Other governmental funds

At June 30, 2016, the other governmental fund balance of $29,091 included activity within the following funds:

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

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

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

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

- Hospital Assessment Fund - This fund consists of monies collected from an assessment on hospitals for the purposes of funding a portion of the non-federal share of the Medicaid expansion and the entire Proposition 204 population on and after January 1, 2014.

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

- Miscellaneous Funds - These funds account for various grants and other money received for specific purposes including the Hawaii Arizona PMMIS Alliance ("HAPA") and the Hospital Loan Residency Fund. HAPA represents AHCCCS' project with Hawaii whereby AHCCCS provides data processing services for Hawaii's Medicaid program. The Hospital Loan Residency Fund was created and consists of legislative appropriations and loan repayment monies for the establishment of a hospital loan program to fund start-up and ongoing costs for residency programs in accredited hospitals. The hospital loans were repaid in full as of June 30, 2014.

(dollar amounts expressed in thousands)

(4) Other governmental funds (continued)

Other governmental funds earned, expended and transferred during the fiscal year ended June 30, 2016 were as follows:

	Fund Balance June 30, 2015	Receipts	Interest Earned	Expenditures	Transfers In/(out)	Fund Balance June 30, 2016
Tobacco Tax and Health Care Fund, Medically Needy Account	$ -	$ 73,290	$ 2	$ (28,590)	$ (44,702)	$ -
Tobacco Products Tax Fund, Emergency Health Services Account	-	19,154	-	(19,154)	-	-
Trauma and Emergency Services Fund	-	22,445	2	(22,447)	-	-
Nursing Facility Assessment Fund	451	69,692	15	(69,543)	-	615
Hospital Assessment Fund	9,886	250,214	-	(233,930)	-	26,170
Third Party Liability and Recovery Audit Fund	-	656	-	(656)	-	-
Miscellaneous Funds	2,391	8,251	10	(8,346)	-	2,306
	$ 12,728	$ 443,702	$ 29	$ (382,666)	$ (44,702)	$ 29,091

(5) Retirement plan

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

At June 30, 2016, AHCCCS reported the following aggregate amounts related to pensions for all plans to which it contributes:

Statement of Net Position and Statement of Activities	Governmental Activities
Net pension assets	$ -
Net pension liabilities	70,896
Deferred outflows of resources	7,005
Deferred inflows of resources	7,759
Pension expense	3,375

AHCCCS's accrued payroll and employee benefits includes no amounts of outstanding pension contribution amounts payable to all pension plans for the year ended June 30, 2016. Also, AHCCCS reported $4,604 of pension contributions as expenditures in the governmental funds related to all pension plans to which it contributes.

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

(dollar amounts expressed in thousands)

(5) Retirement plan (continued)

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

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

*With actuarially reduced benefits.

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

Contributions – In accordance with state statutes, annual actuarial valuations determine active member and employer contribution requirements. The combined active member and employer contribution rates are expected to finance the costs of benefits employees earn during the year, with an additional amount to finance any unfunded accrued liability. For the year ended June 30, 2016, active ASRS members were required by statute to contribute at the actuarially determined rate of 11.47 percent (11.35 percent for retirement and 0.12 percent for long-term disability) of the members' annual covered payroll, and AHCCCS was required by statute to contribute at the actuarially determined rate of 11.47 percent (10.85 percent for retirement, 0.50 percent for health insurance premium benefit, and 0.12 percent for long-term disability) of the active members' annual covered payroll. In addition, AHCCCS was required by statute to contribute at the actuarially determined rate of 9.36 percent (9.17 percent for retirement, 0.13 percent for health insurance premium benefit, and 0.06 percent for long-term disability) of annual covered payroll of retired members who worked for AHCCCS in positions that would typically be filled by an employee who contributes to the ASRS.

During fiscal year 2016, AHCCCS paid for ASRS pension contributions as follows: 98.67 percent from the General Fund and 1.33 percent from other funds.

(dollar amounts expressed in thousands)

(5) Retirement plan (continued)

Pension liability – At June 30, 2016, AHCCCS reported a liability of $70,896 for its proportionate share of the ASRS' net pension liability. The net pension liability was measured as of June 30, 2015. The total pension liability used to calculate the net pension liability was determined using updated procedures to roll forward the total pension liability from an actuarial valuation as of June 30, 2014, to the measurement date of June 30, 2015. AHCCCS's proportion of the net pension liability was based on AHCCCS's actual contributions to the plan relative to the total of all participating employers' contributions for the year ended June 30, 2015. AHCCCS's proportion measured as of June 30, 2015, was 0.455150 percent, which was an increase of 0.015449 percent from its proportion measured as of June 30, 2014.

Pension expense and deferred outflows/inflows of resources – For the year ended June 30, 2016, AHCCCS recognized pension expense for ASRS of $3,375. At June 30, 2016, AHCCCS reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

ASRS	Deferred Outflows of Resources	Deferred Inflows of Resources
Differences between expected and actual experience	$ 1,934	$ 3,715
Net difference between projected and actual earnings on pension plan investments	-	2,272
Changes in proportion and differences between AHCCCS contributions and proportionate share of contributions	467	1,772
AHCCCS contributions subsequent to the measurement date	4,604	-
Total	$ 7,005	$ 7,759

The $4,604 reported as deferred outflows of resources related to ASRS pensions resulting from AHCCCS contributions subsequent to the measurement date will be recognized as a reduction of the net pension liability in the year ending June 30, 2017. Other amounts reported as deferred outflows of resources and deferred inflows of resources related to ASRS pension will be recognized as a decrease in pension expense as follows:

Years Ending June 30	
2017	$ 1,951
2018	3,244
2019	1,803
2020	(1,640)

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

ASRS	
Actuarial valuation date	June 30, 2014
Actuarial roll forward date	June 30, 2015
Actuarial cost method	Entry age normal
Investment rate of return	8%
Projected salary increases	3 - 6.75%
Inflation	3%
Permanent benefit increase	Included
Mortality rates	1994 GAM Scale BB

(dollar amounts expressed in thousands)

(5) Retirement plan (continued)

Actuarial assumptions used in the June 30, 2014, valuation were based on the results of an actuarial experience study for the 5-year period ended June 30, 2012.

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

ASRS

Asset Class	Target Allocation	Long-term Expected Real Rate of Return
Equity	58%	6.79%
Fixed income	25%	3.70%
Commodities	2%	3.93%
Real estate	10%	4.25%
Multi-asset	5%	3.41%
Total	100%	

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

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

	1% Decrease	Current Discount Rate	1% Increase
	(7.00%)	(8.00%)	(9.00%)
AHCCCS's proportionate share of the net pension liability	$ 92,897	$ 70,896	$ 55,817

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

(dollar amounts expressed in thousands)

(6) Other postemployment benefits

Other post-employment benefits ("OPEB") provided as part of state employment include the ASRS sponsored cost-sharing plan for the Long-Term Disability Fund and the Health Benefit Supplement Fund, as well as the Arizona Department of Administration sponsored single employer defined benefit post-employment plan.

Cost-Sharing Plan –The ASRS provides health insurance premium supplemental benefits and disability benefits to retired members, disabled members, and eligible dependents through the Health Benefit Supplement Fund ("HBS) and the Long Term Disability Fund ("LTD"), which are cost-sharing, multiple-employer defined benefit postemployment plans. Title 38, Chapter 5 of the A.R.S. assigns the authority to establish and amend the benefit provisions of the HBS plan and the LTD plan to the Arizona State Legislature. The ASRS issues a publically available financial report that includes the financial information and disclosure requirements for the HBS plan and the LTD plan. That report may be obtained by visiting www.azasrs.gov.

Contributions - For the ASRS HBS and LTD plans, contributions are recognized as revenues when due, pursuant to statutory and contractual requirements. Benefits and refunds are recognized when due and payable and expenses are recorded when the corresponding liabilities are incurred, regardless of when contributions are received or payments are made.

Funding Policy - The contribution requirements of plan members and AHCCCS are established by Title 38, Chapter 5 of the A.R.S. These contribution requirements are established and may be amended by the Arizona State Legislature. For the year ended June 30, 2016, active ASRS members and AHCCCS were each required by statute to contribute at the actuarially determined rate of 0.12 percent of the members' annual covered payroll for LTD. AHCCCS also contributed 0.50 percent for the HBS. In addition, AHCCCS was required to contribute 0.13 percent for the health insurance premium benefit and 0.06 percent for long-term disability based on annual covered payroll for retired members who worked for AHCCCS in positions that an employee who contributes to ASRS would typically fill. AHCCCS' contributions for the current and two preceding years for OPEB, all of which were equal to the required contributions, were as follows:

Fiscal Year	Health Benefit Supplemental Fund	Long-term Disability Fund
2016	212	51
2015	246	50
2014	254	102

The cost-sharing plan contributions are currently meeting their contribution requirements, therefore there is no net OPEB liability to disclose for the HBS or LTD plans.

(dollar amounts expressed in thousands)

(6) Other postemployment benefits (OPEB) (continued)

Single-Employer Plan

The Arizona Department of Administration ("ADOA") administers a single-employer defined benefit post-employment plan (ADOA Plan) that provides medical and accidental benefits to retired State employees and their dependents. Title 38, Chapter 4 of the A.R.S. assigns the authority to establish and amend the benefit provisions of the ADOA Plan to the Arizona State Legislature. The ADOA pays the medical costs incurred by retired employees, net of related premiums, which are paid entirely by the retiree or on behalf of the retiree. These premium rates are based on a blend of active employee and retiree experience, resulting in a contribution basis that is lower than the expected claim costs for retirees, creating an implicit subsidization of retirees by the ADOA Plan. ADOA does not issue a separate, publically available financial report for the ADOA Plan, however, the State of Arizona Comprehensive Annual Financial Report presents state-wide prior year information, which can be obtained by visiting gao.az.gov. Prior to June 30, 2016, AHCCCS' proportionate share of the net OPEB liability was immaterial to its financial statements and therefore was not separately presented. A portion of the ADOA Plan's implicit rate subsidy, if not fully funded, represents an obligation of AHCCCS for its proportionate share of the net OPEB obligation.

Funding Policy - The ADOA's current funding policy is pay-as-you-go for OPEB benefits. There are no dedicated assets at this time to offset the actuarial accrued liability. To the extent that the calculated annual required contribution exceeds the annual pay-as-you-go cost of providing OPEB benefits, a net OPEB obligation is created. ADOA does not issue a separate, publicly available financial report, therefore, information regarding AHCCCS' proportionate share of contributions for the last three years is not available.

Annual OPEB Cost and Net OPEB Obligation - AHCCCS' proportionate share of annual OPEB costs, OPEB contributions made, and changes in the OPEB obligation of the ADOA Plan for the year ended June 30, 2016, are as follows:

Annual required contribution	$ 2,111
Interest on net OPEB obligation	13
Adjustment to annual required contribution	(22)
Annual OPEB cost (expense)	2,102
Proportionate share of contributions made	(356)
Increase in net OPEB obligation	1,746
Net OPEB obligation - beginning of year	446
Net OPEB obligation - end of year	$ 2,192

AHCCCS' proportionate share of annual OPEB costs and net OPEB obligation are presented below, based on the AHCCCS' proportionate share of 1.56 percent. Only the current year actuarial valuation of AHCCCS' proportionate share of the annual OPEB costs of the ADOA plan is available:

Fiscal Year	Annual OPEB Costs	Percentage of Annual OPEB Cost Contributed	Net OPEB Obligation
2016	$ 2,102	16.95%	$ 2,192

(dollar amounts expressed in thousands)

(6) Other postemployment benefits (OPEB) (continued)

Actuarial Validation Date	Actuarial Value of Plan Assets	Actuarial Accrued Plan Assets (AAL)	(Unfunded) AAL	Funded Ratio	Annual Covered Payroll	(Unfunded) AAL as a Percentage of Covered Payroll
6/30/2016	$ -	$ 17,394	$ (17,394)	0.0%	$ 51,716	(33.6)%

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and healthcare cost trends. Actuarially determined amounts are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. The required schedule of funding progress which presents multi-year trend information about whether the actuarial value of the plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits is not included as only one year of information is currently available.

Actuarial Methods and Assumptions - Projections of ADOA Plan benefits for financial reporting purposes include the types of benefits provided at the time of each valuation and the pattern of sharing of cost between the employer and the ADOA Plan member to that point. The actuarial methods and assumptions used include techniques that are designed to reduce short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations. The ADOA Plan's actuarial methods and significant assumptions for the most recent actuarial valuation are as follows:

Actuarial Validation Date	June 30, 2016
Actuarial Cost Method	Entry age normal, level dollar
Actuarial assumptions:	
Investment rate of return	n/a
Projected salary increases	None
Discount rate	3%
Cost-of-living adjustments	None
Healthcare cost trend rate	7.0% initial, 4.5% ultimate
Amortization rate	Level dollar, open
Remaining amortization period	30 years

(dollar amounts expressed in thousands)

(7) Budgetary basis of accounting

The financial statements of AHCCCS are prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP"). AHCCCS, like other State agencies, prepares its annual operating budget on a basis that differs from the GAAP basis. Encumbrances as of June 30th can be liquidated during a four week administrative period known as the 13th month. The budget basis expenditures reported in the financial statements include both the fiscal year paid and the 13th month activity. The State does not have a legally adopted budget for revenues. Prior fiscal year expenditures of $536 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, 2016.

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, 2016:

	General Fund Actual
Budgetary Basis Fund Balance, June 30, 2016	$ 344,017
Budgetary Basis of Accounting	
Increases to fund balance:	
Cash	3,901
Due from state and local governments	43,991
Due from the federal government	488,588
Due from other fund	11,169
Tobacco settlement receivable	50,000
Receivables and other	100,640
Total increases	$ 698,289
Decrease to fund balance:	
Unearned revenue	(23,272)
Due to state and county governments	(168,907)
Accrued programmatic costs	(513,060)
Payables and other	(19,382)
Unavailable revenue	(256,272)
Total decreases	(980,893)
Total GAAP basis fund balance	$ 61,413

Non-appropriated expenditures of $2,916,369 in the General Fund consist primarily of federal and state matching pass-through payments to other agencies.

(8) Contingencies

Litigation and investigations – AHCCCS has been named as a defendant in a variety of litigation, all of which are being defended by in-house and external legal counsel. One case is a lawsuit filed in the Arizona Superior Court for Maricopa County by a group of plaintiffs, consisting mostly of state legislators, seeking a declaration that the hospital assessment established under ARS 36-2901.08 is allegedly a tax passed in a manner inconsistent with the requirements for a tax established by the state constitution. The lawsuit was filed in September 2013 and continues to work its way through the courts. AHCCCS received a favorable ruling in the Arizona Court of Appeals on March 16, 2017, but expects the plaintiffs to petition the Arizona Supreme Court for a review of the case. AHCCCS intends to continue to vigorously defend the lawsuit on lack of standing. If the hospital assessment is declared invalid, the program will have insufficient funds to cover childless adults with income up to 133% of FPL, but under the holding in *Fogliano v. State*, AHCCCS has the option to adjust eligibility standards to match available remaining funds.

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

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

Budget neutrality agreement – In January 2001, AHCCCS obtained a Section 1115 Waiver from CMS that provides federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204. The Waiver requires that over the term of the original agreement (April 1, 2001 through September 30, 2011) and the new agreement (October 1, 2011 through September 30, 2021), that the populations covered by the Waiver be budget neutral for CMS. Effective with the January 1, 2014 implementation of the eligibility expansion under the ACA to include the new adult group, members with income between 100% and 133% of the FPL, the budget neutrality measurement is performed separately for the new adult population. Budget neutral means that CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. The budget neutrality calculation is dependent on a number of variables including the number of members, the eligibility category of members and the general economy and its impact on unemployment, medical inflation and policy decisions made by the Legislature that may impact program costs. Through June 30, 2016, AHCCCS remains under the cumulative reporting limit threshold for the current waiver. Accordingly, management is projecting that as of June 30, 2016, 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.

(8) Contingencies (continued)

School based claims audits – AHCCCS continues to have several outstanding audit findings related to audits conducted by The Inspector General, Office of Audit Services ("OIG") from fiscal year 2015 related to the Direct Service Claiming ("DSC") and School Based Medicaid Administrative Claiming ("MAC") programs. AHCCCS disagrees with the findings in part, however, has returned the federal funds for non-disputed claims and has received the final disallowance issued by CMS on October 20, 2016 relating to the MAC audit for $11.717 million. AHCCCS responded to the Secretary of the U.S Department of Health and Human Services ("DHHS"), pursuant to 42 U.S.C. § 1316(e)(1), on December 14, 2016, with a request for reconsideration of the MAC disallowed amount. AHCCCS plans to appeal to the DHHS, Departmental Appeals Board ("DAB") should CMS deny the request for reconsideration. AHCCCS also intends to follow the same appeals protocol related to the DSC amount should CMS ever follow through with a final disallowance decision. However, a recoupment liability of $19.924 million for the DSC audit and $11.717 million for the MAC audit is included in the due to the federal government with a corresponding receivable in the due from the State and local governments in the accompanying financial statements per the applicable contract terms.

Medicaid electronic health record incentive payments - During the current fiscal year, the OIG issued a report in August 2016 for their review of Medicaid electronic health record ("EHR") incentive payments to Hospitals finding a net overpayment in the amount of $14.831 million. AHCCCS does not agree with the OIG findings and is waiting for CMS' determination on any final disallowed amount. The individual hospitals must return 100 percent of their respective disallowed amount per the EHR program's terms and conditions, as agreed to in order to participate in the program and receive EHR incentive payments. However, the recoupment liability of $14.831 million for the finding is included in the due to the federal government with a corresponding receivable in the receivables and other in the accompanying financial statements.

(9) Interfund receivables, payables and transfers

Interfund activity is defined as transactions between funds administered by AHCCCS. The interfund balances as of June 30, 2016 consist of transfers from the Other Funds to the General Fund in the amount of $11,169.

In the government-wide statement of activities, the interfund activity has been eliminated. The total net transfers out of $161,559 reported on the statement of activities represents transfer activities to other State agencies.

(10) Transactions with other State agencies and counties

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

(dollar amounts expressed in thousands)

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

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

The following is a summary of transactions with these State agencies for the administrative services described above for the year ended June 30, 2016:

	Expenditures
Arizona Department of Economic Security	$ 89,873
Arizona Department of Administration	18,112
Arizona Department of Health Services	174
Arizona Board of Nursing	210
Arizona Office of Administrative Hearings	288
Attorney General’s Office	798
	$ 109,455

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

The amounts passed through to ADES and ADHS are classified as Traditional, Proposition 204, Newly eligible adults, KidsCare and Long-term care services expenditures in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds. The following is a summary of transactions with these State agencies for the services described above for the year ended June 30, 2016:

	Expenditures
Arizona Department of Economic Security	$ 1,258,473
Arizona Department of Health Services	1,972,646
	$ 3,231,119

Revenues include $305,801 from Arizona counties during fiscal year 2016. 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, 2016, county and State contributions did not exceed related expenditures.

(dollar amounts expressed in thousands)

(11) Other pass through funds

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

Arizona county and local governments contributed $107,002 to qualify for matching Federal funds for the Graduate Medical Education, Safety Net Care Pool and Disproportionate Share Hospital program payments and for the provision of qualifying services to hospitalized inmates. These amounts are included within county IGA pass through funds in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds.

Arizona counties contributed $3,483 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, 2016, 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	$ 14,159
Program Services Federal Funds	39,811
Arizona Department of Economic Security	
County Contribution for Administrative Costs	3,483
Arizona Department of Health Services	
Cost reimbursement from Civil Monetary Penalties	470
	$ 57,923

(12) New pronouncement

The Governmental Accounting Standards Board ("GASB") issued several pronouncements prior to June 30, 2016 with effective dates within or after the fiscal year ended June 30, 2016. AHCCCS adopted the following new pronouncement in the fiscal year ended June 30, 2016:

In June 2015, the GASB issued Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*, the provisions of which are effective for fiscal years beginning after June 15, 2015, except those provisions that address employers and governmental nonemployer contributing entities for pensions that are not within the scope of Statement 68, which are effective for fiscal years beginning after June 15, 2016. The objective of this Statement is to improve the usefulness of information about pensions included in the general purpose external financial reports of state and local governments for making decisions and assessing accountability. This Statement results from a comprehensive review of the effectiveness of existing standards of accounting and financial reporting for all postemployment benefits with regard to providing decision-useful information, supporting assessments of accountability and interperiod equity, and creating additional transparency**.** AHCCCS adopted Statement No. 73 in fiscal year 2016. See Note 6.

(13) Subsequent events

The total fiscal year 2017 appropriation for AHCCCS is $11,380.2 million compared to the final $9,105.6 million appropriation for fiscal year 2016. This increase reflects the July 1, 2016 merger of all behavioral health and related services previously housed in the Arizona Department of Health Services. These behavioral health services appropriations include $100.6 million for non-Medicaid services. Additionally, the projected spending increase accounts for enrollment growth and utilization costs. The contract year 2017, Acute Care capitation rates are projected to increase by 3.12 percent as compared to the 2.45 percent increase for contract year 2016. The 2017 increase is primarily based on utilization increases driven by Hepatitis C pharmacy costs accounting for 1.19 of the 3.12 percent projected increase and adjustments to account for utilization of Federally Qualified Health Centers ("FQHC"s) and Rural Health Centers ("RHC"s) that operate under a cost reimbursement payment model account which account for 1.33 of the 3.12 percent increase. Other drivers are the high acuity pediatric adjustment factor (0.11 percent) and changes related to access-to-care requirements and legislative mandates that account for 0.26 percentage points of the increase The contract year 2017 Arizona Long Term Care System ("ALTCS" Elderly and Physically Disabled ("EPD")) capitation rates are estimated to increase by 3.84 percent. The primary factors impacting the ALTCS EPD rates are provider rate increases, medical trend and mix changes for home and community based service providers. Due to the passage of voter ballot initiative Proposition 206, AHCCCS positively adjusted both fee-for-service and capitation rates to reflect additional labor costs from the minimum wage increase. AHCCCS is also estimating a 3.0 percent capitation rate increase for all programs for contract year 2018 as part of the fiscal year 2018 budget submission. However, it is important to note that federal law requires rates to be actuarially sound and the AHCCCS actuaries develop rates based on expected cost and utilization trends. In addition, AHCCCS must conduct an access to care analysis of its rates to assure that sufficient providers are willing to serve AHCCCS members and factor the voter mandated minimum wage increase effective January 1, 2017. Therefore, depending on the results of this analysis and of AHCCCS' actuarial determination of the expected costs of the managed care organizations, the actual capitation rates could differ from projections.

(13) Subsequent events (continued)

In September 2016, CMS approved an extension of the Section 1115 Waiver through September 31, 2021. The approval included Arizona's request to modernize its Medicaid program and continue many of the existing authorities allowing AHCCCS to maintain its unique and successful managed care model, use home and community based services for members with long-term care needs and other innovations that make AHCCCS one of the most cost effective Medicaid programs in the nation. The Waiver allows Arizona to run its managed care model and exempts Arizona from certain provisions of the Social Security Act and includes expenditure authority for costs not otherwise matched by the federal government. Waiver programs are required to be budget neutral for the federal government − not cost more federal dollars than without a waiver.

AHCCCS' budget request for fiscal year 2018, submitted to the Governor in September 2016 included a rebase of the fiscal year 2017 budget. The current forecast is for a $12.9 million shortfall comprised of Hospital Assessment Expenditure Authority and represents the difference between the current assessment rate collections and the appropriated amount. AHCCCS continues to experience the impacts of the many program changes resulting from the ACA. However, factors such as Federal law changes, CMS decisions, legal decisions, case load changes compared to projections and the eligibility system shifts in population categories may influence any final fiscal year shortfall and potential need and amount of a supplemental appropriation. AHCCCS management will closely monitor all these factors in relation to the adequacy of the fiscal year 2017 appropriation and fiscal year 2018 budget request.

REQUIRED SUPPLEMENTARY INFORMATION

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BUDGETARY COMPARISON SCHEDULE - GENERAL FUND

Year Ended June 30, 2016
(Unaudited)
(amounts expressed in thousands)

	Original Appropriation (Budget)	Final Appropriation (Budget)	Actual	Variance with Final Budget
REVENUES				
State appropriations	$ -	$ -	$ 1,213,572	$ -
State ISA pass through funds	-	-	851,369	-
Federal government	-	-	6,311,503	-
Federal ISA/IGA pass through funds	-	-	2,385,869	-
County and other local government	-	-	299,153	-
County IGA pass through funds	-	-	110,239	-
Tobacco tax revenue	-	-	40,348	-
Tobacco litigation settlement	-	-	98,907	-
Other	-	-	2,025	-
Total revenues	-	-	11,312,985	-
OTHER FINANCING SOURCES				
Operating transfers in	-	-	-	-
TOTAL REVENUES AND OTHER FINANCING SOURCES	-	-	11,312,985	-
PROGRAMMATIC EXPENDITURES				
Traditional services	3,698,369	3,767,663	3,533,798	233,865
Proposition 204 services	2,184,810	2,308,302	2,235,244	73,058
Newly eligible adults	197,184	424,684	403,212	21,472
KidsCare services	6,295	6,295	2,078	4,217
Childrens rehabilitative services	234,867	266,339	250,423	15,916
Disproportionate share	5,087	5,087	-	5,087
Rural and critical access hospitals	22,650	22,650	21,989	661
Voluntary Political Subdivision Programs	313,097	362,399	321,166	41,233
Long-term care services	1,311,671	1,323,671	1,241,843	81,828
TOTAL PROGRAMMATIC EXPENDITURES	7,974,030	8,487,090	8,009,753	477,337
ADMINISTRATIVE EXPENDITURES	177,751	240,903	199,662	41,241
TOTAL APPROPRIATED EXPENDITURES	8,151,781	8,727,993	8,209,415	518,578
PRIOR YEAR APPROPRIATED EXPENDITURES	-	-	536	-
NON-APPROPRIATED EXPENDITURES	-	-	2,916,369	-
REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES	-	-	186,665	-
FUND BALANCES, BEGINNING OF YEAR	-	-	157,352	-
FUND BALANCES, END OF YEAR	$ -	$ -	$ 344,017	$ -

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

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

(Unaudited)
(amounts expressed in thousands)

	Reporting Fiscal Year (Measurement Date)		
	2016 (2015)	**2015 (2014)**	**2014 through 2006**
Agency's proportion of the net pension liability	0.455146%	0.470599%	Information
Agency's proportionate share of the net pension liability	$ 70,896	$ 69,633	not available
Agency's covered-employee payroll	$ 42,770	$ 43,181	
Agency's proportionate share of the net pension liability as a percentage of its covered-employee payroll	165.76%	161.26%	
Plan fiduciary net position as a percentage of the total pension liability	68.35%	69.49%	

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF THE AGENCY'S PENSION CONTRIBUTIONS

(Unaudited)
(amounts expressed in thousands)

	Reporting Fiscal Year							
	2016	2015	2014	2013	2012	2011	2010	2009 through 2006
Statutorily required contribution	$ 4,604	4,548	4,779	4,466	4,238	3,600	4,140	Information not available
Agency's contributions in relation to the statutorily required contribution	$ 4,604	4,548	4,779	4,466	4,238	3,600	4,140	
Agency's contribution deficiency (excess)	$ -	$ -	$ -	$ -	$ -	$ -	$ -	
Agency's covered-employee payroll	42,430	42,770	43,181	40,970	40,364	37,494	45,999	
Agency's contributions as a percentage of its covered-employee payroll	10.85%	10.63%	11.07%	10.90%	10.50%	9.60%	9.00%	

UNIFORM GUIDANCE
SUPPLEMENTARY REPORTS

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2016
(amounts expressed in thousands)

Federal Grantor/Pass Through Grantor/Program or Cluster Title	Federal CFDA Number	Contract Number	Passed through to Subrecipients	Federal Expenditures
U.S. Department of Health and Human Services				
Centers for Medicare and Medicaid Services				
Medical Assistance Program (Title XIX)	93.778	11-W-00275/09	$ 4,090	$ 8,625,687
Children's Health Insurance Program (Title XXI)	93.767	21-W-00064/9	-	60,060
Testing Experience and Functional Tools Grant	93.627	1H1331305A	-	13
TOTAL EXPENDITURES OF FEDERAL AWARDS			$ 4,090	$ 8,685,760

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

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2016
(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, 2016. The information in this Schedule is presented in accordance with the requirements of Title 2 U.S. Code of Federal Regulations Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* ("Uniform Guidance"). 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 the Uniform Guidance, wherein certain types of expenditures are not allowable or are limited as to reimbursement. Arizona Health Care Cost Containment System has elected not to use the 10-percent de minimis indirect cost rate allowed under the Uniform Guidance.

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

The program titles and CFDA numbers were obtained from the 2016 *Catalog of Federal Domestic Assistance*.

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

To the Directors 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 general fund, and the aggregate remaining fund information of ***Arizona Health Care Cost Containment System (AHCCCS, an agency of the state of Arizona),*** as of and for the year ended June 30, 2016, 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 March 21, 2017.

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 ***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.

March 21, 2017

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INDEPENDENT AUDITORS' REPORT ON COMPLIANCE FOR EACH MAJOR FEDERAL PROGRAM AND REPORT ON INTERNAL CONTROL OVER COMPLIANCE REQUIRED BY THE UNIFORM GUIDANCE

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 Programs

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") Compliance Supplement that could have a direct and material effect on ***Arizona Health Care Cost Containment System's*** major federal programs for the year ended June 30, 2016. ***Arizona Health Care Cost Containment System's*** major federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with federal statutes, regulations, and the terms and conditions of its federal awards 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 in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the audit requirements of Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (the "Uniform Guidance"). Those standards and the Uniform Guidance 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 a 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, 2016. 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 the Uniform Guidance. 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's*** complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on its major federal programs for the year ended June 30, 2016.

Other Matters

The results of our auditing procedures disclosed instances of noncompliance, which are required to be reported in accordance with the Uniform Guidance and which are described in the accompanying schedule of findings and questioned costs as items 2016-001 and 2016-002. Our opinion on each major federal program is not modified with respect to these matters.

Report on Internal Control Over Compliance

Management of ***Arizona Health Care Cost Containment System's*** 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 the major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for the major federal program and to test and report on internal control over compliance in accordance with the Uniform Guidance, 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 and therefore, material weaknesses or significant deficiencies may exist that were not identified. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, we identified certain deficiencies in internal control over compliance, as described in the accompanying schedule of findings and questioned costs as items 2016-001 and 2016-002, which we consider to be significant deficiencies.

Arizona Health Care Cost Containment System's response to the findings identified in our audit are described in the accompanying schedule of findings and questioned costs and corrective action plan. ***Arizona Health Care Cost Containment System's*** responses were not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on them.

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 the Uniform Guidance. Accordingly, this report is not suitable for any other purpose.

Mayer Hoffman McCann P.C.

March 21, 2017

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Year Ended June 30, 2016

Section I – Summary of Auditors' Results

Financial Statements

Type of Auditors' Report Issued:		Unmodified
Internal control over financial reporting:		
• Material weakness(es) identified?	_____ Yes	X No
• Significant deficiency(ies) identified?	_____ Yes	X None reported
Noncompliance material to combined financial statements noted?	_____ Yes	X No

Federal Awards

Internal control over major programs:		
• Material weakness(es) identified?	_____ Yes	X No
• Significant deficiency(ies) identified that are not considered to be material weakness(es)?	X Yes	_____ None reported
Type of Auditors' Report issued on compliance for major programs:		Unmodified
Any audit findings disclosed that are required to be reported in accordance with 2 CFR 200.516(a)?	X Yes	_____ No

Identification of major programs:

CFDA Number	Name of Federal Program or Cluster
93.778	Medical Assistance Program (Title XIX)
93.767	Children's Health Insurance Program (Title XXI)

Dollar threshold used to distinguish between type A and type B programs:		$26,057,280
Auditee qualified as low-risk auditee?	_____ Yes	X No

Section II – Financial Statement Findings

None Noted

Section III – Federal Award Findings

Item	2016-001
CFDA Number:	93.767
Program:	Children's Health Insurance Program
Federal Agency:	U.S. Department of Health and Human Services
Agency Award Year:	July 1, 2015 through June 30, 2016
Award Number Impacted:	21-W-00064/9
Compliance Requirement:	Eligibility
Questioned Costs:	$40,037
Criteria:	According to the AHCCCS eligibility requirements, the Kidscare eligibility category allows enrollment/participation for participants through age 18. The month after reaching the age of 19 and maintaining other eligibility criteria, participants should be moved out of the Kidscare eligibility category and into a comparable AHCCCS program. Internal controls should be in place to provide reasonable assurance that participants are moved out of the Kidscare eligibility category the month after they turn 19 (aged out).
Condition and Context:	In order to test eligibility, we selected a sample of 40 participants to verify the participant met the applicable eligibility criteria In connection with our testing, we noted one instance where a participant was enrolled in the Kidscare eligibility category and was not transferred from the Kidscare eligibility category the month after they turned 19. As a result of this exception, we expanded our testing to the entire population of the Kidscare eligibility category to ensure that participants were being properly transferred out of the Kidscare eligibility category the month after the participant turned 19 (aged out). Using eligibility data, we identified 235 individuals enrolled in the Kidscare eligibility category who were not transferred timely out of the Kidscare eligibility category in the month after the participant turned 19 in fiscal year 2016.
Effect:	AHCCCS pays contracted health plans to provide services to the participants in the Kidscare eligibility category using a capitated per member, per month payment methodology. As a result, given the 235 exceptions and the number of months parti cipants were incorrectly left in the eligibility category we determined that AHCCCS improperly paid to contracted health plans approximately $40,037 as a result of the untimely transfer between eligibility categories.
Cause:	AHCCCS' eligibility department had a large backlog and was not able to properly transfer participants between eligibility categories on a timely basis and in accordance with program requirements.

Recommendation:	We recommend that AHCCCS establish policies and procedures to ensure that participants are transferred out of the Kidscare eligibility category the month following the participant's 19th birthday. This will include the implementation of an eligibility system enhancement to automatically transfer out of this eligibility program in the month following the participant's 19th birthday. We further recommend that AHCCCS review the size and compliment of their eligibility department to ensure the staffing is adequate to address eligibility changes in a timely manner.
Views of Responsible Officials and Planned Corrective Action:	Management of ***Arizona Health Care Cost Containment System*** concurs with the finding. See Corrective Action Plan.
Item:	2016-002
CFDA Number:	93.767
Program:	Children's Health Insurance Program
Federal Agency:	U.S. Department of Health and Human Services
Agency Award Year:	July 1, 2015 through June 30, 2016
Award Number Impacted:	21-W-00064/9
Compliance Requirement:	Eligibility
Questioned Costs:	N/A
Criteria:	According to the AHCCCS eligibility requirements, the Kidscare eligibility category allows enrollment/participation for participants through age 18. The month after reaching the age of 19 and maintaining other eligibility criteria, participants should be moved out of the Kidscare eligibility category and into a comparable AHCCCS program. Internal controls should be in place to provide reasonable assurance that participants are moved out of the Kidscare eligibility category the month after they turn 19 (aged out).
Condition and Context:	In order to test eligibility, we selected a sample of 40 participants to verify the participant met the applicable eligibility criteria In connection with our testing, we noted one instance where a participant was enrolled in the Kidscare eligibility category with an open eligibility determination that was not set to expire at the end of their eligibility period. The participant was noted as eligible for the month of June 2016 and capitation payments in the amount of $153.34 were made for the participant.
Effect:	AHCCCS pays contracted health plans to provide services to the participants in the Kidscare eligibility category using a capitated per member, per month payment methodology. As a result, given the exception AHCCCS improperly overpaid contracted health plans for one month of the capitated rate as a result of the open determination.

Cause:	AHCCCS' eligibility department had combined a participant file that previously had assigned two AHCCCS identifying numbers. As the files were combined the older of the two files had an open eligibility determination for the Kidscare eligibility category that was not closed and as such the member was still shown as eligible for the Kidscare population.
Recommendation:	We recommend that AHCCCS establish policies and procedures to ensure that all previous eligibility files that are required to be merged with a current file be closed at the time of the merger to avoid any open determinations. We further recommend that AHCCCS review the size and compliment of their eligibility department to ensure the staffing is adequate to address eligibility changes in a timely manner.
Views of Responsible Officials and Planned Corrective Action:	Management of ***Arizona Health Care Cost Containment System*** concurs with the finding. See Corrective Action Plan.

Corrective Action Plan and Summary Schedule of Prior Audit Findings

Year Ended June 30, 2016

Corrective Action Plan

Item:	2016-001
CFDA Number:	93.767
Program:	Children's Health Insurance Program
Criteria:	According to the AHCCCS eligibility requirements, the Kidscare eligibility category allows enrollment/participation for participants through age 18. The month after reaching the age of 19 and maintaining other eligibility criteria, participants should be moved out of the Kidscare eligibility category and into a comparable AHCCCS program. Internal controls should be in place to provide reasonable assurance that participants are moved out of the Kidscare eligibility category the month after they turn 19 (aged out).
Condition and Context:	In order to test eligibility, we selected a sample of 40 participants to verify the participant met the applicable eligibility criteria In connection with our testing, we noted one instance where a participant was enrolled in the Kidscare eligibility category and was not transferred from the Kidscare eligibility category the month after they turned 19. As a result of this exception, we expanded our testing to the entire population of the Kidscare eligibility category to ensure that participants were being properly transferred out of the Kidscare eligibility category the month after the participant turned 19 (aged out). Using eligibility data, we identified 235 individuals enrolled in the Kidscare eligibility category who were not transferred timely out of the Kidscare eligibility category in the month after the participant turned 19 in fiscal year 2016.
Name of Contact Person and Title:	Jeffery Tegen, Assistant Director
Phone Number:	(602) 417-4705
Anticipated Completion Date:	June 30, 2017
Views of Responsible Officials and Corrective Actions:	Management of ***Arizona Health Care Cost Containment System*** concurs with the finding. To ensure individuals who turn 19 are transitioned out of the KidsCare category timely, AHCCCS has implemented two system enhancements to support the automatic transfer out of the KidsCare program and redetermination of eligibility in the month following the youth's 19th birthday. The initial enhancement implementing an automated age-out job was implemented at the end of 2014. A further enhancement was identified for scenarios when the age-out month and the renewal month coincide. A system change was implemented at the end of March 2016 that changed the order of the automated jobs and runs the age-out job before the renewal job to

prevent a pending renewal from extending eligibility in the wrong category. To identify and correct records that were processed before this date or that failed to transition timely for any reason, an ad hoc report and manual reconciliation process was implemented in October 2016 to identify records with members in an age-limited category past the month they aged out. Once identified, the reported records are distributed to the appropriate staff at each agency to redetermine eligibility or make corrections to the date of birth as needed. Increasing the number of staff working the report will expedite the process and reduce backlogs.

Item:	2016-002
CFDA Number:	93.767
Program:	Children's Health Insurance Program
Criteria:	According to the AHCCCS eligibility requirements, the Kidscare eligibility category allows enrollment/participation for participants through age 18. The month after reaching the age of 19 and maintaining other eligibility criteria, participants should be moved out of the Kidscare eligibility category and into a comparable AHCCCS program. Internal controls should be in place to provide reasonable assurance that participants are moved out of the Kidscare eligibility category the month after they turn 19 (aged out).
Condition and Context:	In order to test eligibility, we selected a sample of 40 participants to verify the participant met the applicable eligibility criteria In connection with our testing, we noted one instance where a participant was enrolled in the Kidscare eligibility category with an open eligibility determination that was not set to expire at the end of their eligibility period. The participant was noted as eligible for the month of June 2016 and capitation payments in the amount of $153.34 were made for the participant.
Name of Contact Person and Title:	Jeffery Tegen, Assistant Director
Phone Number:	(602) 417-4705
Anticipated Completion Date:	June 30, 2017
Views of Responsible Officials and Corrective Actions:	Management of ***Arizona Health Care Cost Containment System*** concurs with the finding. If followed, AHCCCS' established policies and procedures for record corrections would have prevented this error. The staff member was counseled in October 2016 regarding the error and its potential impacts to the customer and the agency. This worker was given additional training on processing multiple ID and overlaid eligibility corrections in the PMMIS database in October 2016, and was on 100% QA review to monitor work quality for three months and intermittent review afterward with no further error occurrences. We also continue to work on system enhancements to reduce or eliminate root causes of multiple IDs and overlays that necessitate manual record corrections. We

have implemented several system edits and validations in 2016 that prevent system users (both customers and staff) from accidentally creating new unique ID numbers for someone already known to the system, as well as restricting the number and types of users that can change certain demographic data. DES and AHCCCS continue to address these potential issues in a dedicated workgroup to reduce and clean-up multiple unique person IDs.

Summary of Prior Year Findings

Items: 2015-001 and 2015-002

CFDA Numbers: 93.778 and 93.767

Program: Medical Assistance Program and Children's Health Insurance Program

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

Agency Award Year: July 1, 2014 through June 30, 2015

Questioned Costs: $2,941,326 ($2,816,400 from the Medical Assistance Program (Title XIX) – 93.778 and $124,926 from the Children's Health Insurance Program (Title XXI) – 93.767)

Condition: AHCCCS made the required adjustment to their Federal expenditure claim returning the federal share with the quarter ending September 30, 2016 CMS-64 related to the direct misappropriation of funds embezzlement. Additionally, AHCCCS provided supporting documentation to CMS of the implementation of strengthened internal controls allowing CMS to close their audit finding follow up. However, subsequent to the issuance of the fiscal year 2015 report and based on completion of an outside forensic audit, AHCCCS submitted a $7,725,277 proof of loss claim insurance claim. The additional $1,815,873 non-direct misappropriation of funds relates to facility service and property rent schemes violating the related party disclosure responsibilities of the contracting function. Upon receipt of any insurance proceeds related to the non-direct misappropriation of funds, AHCCCS will refund the appropriate federal share.

Current Status: The federal share of the misappropriated funds was refunded on both the CMS-64 and CMS-21 during 2016.