

**ARIZONA HEALTH CARE  
COST CONTAINMENT SYSTEM**

**FINANCIAL STATEMENTS  
AND ADDITIONAL INFORMATION**

Year Ended June 30, 2005

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## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

## MANAGEMENT'S DISCUSSION AND ANALYSIS

For the Fiscal Year Ended June 30, 2005

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, 2005. 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:**

**Net Assets** - The assets of AHCCCS exceeded its liabilities at fiscal year ended June 30, 2005 by \$9.5 million (presented as "net assets"). Approximately \$4.3 million of the total net assets at June 30, 2005 is unrestricted and represents the amount available to meet AHCCCS' ongoing general obligations to members and creditors. The remaining net assets at June 30, 2005 are comprised of the amount invested in capital assets of \$5.2 million.

**Changes in Net Assets** - AHCCCS' total net assets decreased for the third consecutive year. The fiscal year 2005 decrease is \$1.7 million (a 14.9 percent decrease in total net assets) compared to the \$15.3 million (57.8 percent) decrease in total net assets that occurred in fiscal year 2004. One key factor in this change was a project to improve the accuracy of insurance information that is provided to our health plans and program contractors to cost avoid their claim payments through the identification of other sources of insurance for the covered member. This project utilized approximately \$550,000 of the prior year's available unrestricted balance. Also contributing to AHCCCS' overall decrease in net assets, the proprietary fund incurred a net operating loss of \$985,000 due primarily to the cost of infrastructure expansion (primarily personnel) to support future enrollment growth.

#### **Fund Level:**

**Governmental Funds - Fund Balances** - As of the close of fiscal year 2005, AHCCCS' total governmental funds reported an ending fund balance of \$3.2 million, a decrease of \$1.2 million (a 27.9 percent decrease) in comparison with the prior fiscal year.

**Proprietary Fund - Fund Balance** - The proprietary fund reported net assets of \$2.1 million at June 30, 2005. In fiscal year 2005, the proprietary fund incurred a net operating loss of \$4.8 million. This loss was partially offset by a net \$3.7 million transfer in from the General Fund to subsidize the proprietary fund operations. As a result, net assets decreased by approximately \$985,000.

### 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**

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

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

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

Both statements report two categories:

- **Governmental Activities** - State appropriations along with federal and county intergovernmental revenues primarily support the activities in this category. The governmental activities of AHCCCS are specific to programs authorized by the Social Security Act Titles XIX Medicaid and XXI State Children's Health Insurance Program (SCHIP) that are concentrated on the health needs of the citizens of Arizona. The majority of AHCCCS' activities are reported in this category.
- **Business-Type Activities** - This category is comprised of the Healthcare Group operations. Members/customers of Healthcare Group are charged a premium for the health care coverage provided. The State also subsidizes a portion of this program with an appropriation from the General Fund.

The government-wide financial statements can be found on pages 13 and 14.

### **Fund Financial Statements**

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

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

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the State's near-term financial decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities. The basic governmental funds financial statements and related reconciliations can be found on pages 15 through 17 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.

The Legislature adopts an appropriated budget for AHCCCS for the acute care, (includes separate line item appropriations for the Acute Care Base, Proposition 204 and KidsCare populations), long-term care and AHCCCS administration programs. The annual appropriation is made separately for both the State matching funds and federal financial participation funds from the Social Security Act Titles XIX (Medicaid) and XXI (State Children's Health Insurance Program). A budgetary comparison statement has been provided for the General Fund to demonstrate compliance with the budget on page 18.

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

AHCCCS maintains one proprietary fund that is classified as an enterprise fund. AHCCCS uses this fund to account for the program that provides health insurance coverage for qualifying business organizations including some State political subdivisions. The basic proprietary fund financial statements can be found on pages 19 through 21 of this report.

### Notes to the Financial Statements

The notes to the financial statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 22 to 35.

### Government-Wide Financial Analysis

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

	Governmental Activities		Business-type Activities		Total	
	2005	2004	2005	2004	2005	2004
Current assets	\$ 415,858	\$ 317,330	\$ 13,076	\$ 8,026	\$ 428,934	\$ 325,356
Capital assets	5,009	5,955	193	220	5,202	6,175
Total assets	<u>420,867</u>	<u>323,285</u>	<u>13,269</u>	<u>8,246</u>	<u>434,136</u>	<u>331,531</u>
Current liabilities	413,460	313,818	11,205	5,197	424,665	319,015
Noncurrent liabilities	-	1,389	-	-	-	1,389
Total liabilities	<u>413,460</u>	<u>315,207</u>	<u>11,205</u>	<u>5,197</u>	<u>424,665</u>	<u>320,404</u>
Net assets:						
Invested in capital assets, net of depreciation	5,009	4,256	193	220	5,202	4,476
Unrestricted	2,398	3,822	1,871	2,829	4,269	6,651
Total net assets	<u>\$ 7,407</u>	<u>\$ 8,078</u>	<u>\$ 2,064</u>	<u>\$ 3,049</u>	<u>\$ 9,471</u>	<u>\$ 11,127</u>

In the case of AHCCCS, assets exceeded liabilities by \$9.5 million and \$11.1 million at June 30, 2005 and 2004, respectively.

AHCCCS' unrestricted net assets consist of cash available at the close of the fiscal year and its investment in capital assets. That portion of the net assets at June 30, 2005 representing cash (45.1 percent) is available to pay administrative expenses in the next fiscal year. These balances generally are limited to funding certain information technology expenses, third party liability recovery and cost avoidance program activities and for Healthcare Group administration expenses. These uses conform to the legislative intent of the specific funds. AHCCCS uses its capital assets to provide services to citizens and consequently, these assets are not available for future spending.

AHCCCS Changes in Net Assets  
(in thousands of dollars)

	Governmental Activities		Business-type Activities		Total	
	2005	2004	2005	2004	2005	2004
<b>Revenues</b>						
Program Revenues						
Charges for services	\$ 8,743	\$ 5,418	\$ 33,616	\$ 30,602	\$ 42,359	\$ 36,020
Other Operating Grants and Contributions	414,534	377,681	-	-	414,534	377,681
Federal Operating Grants	4,189,659	3,671,335	-	-	4,189,659	3,671,335
General revenues						
State appropriations	1,291,753	970,649	-	-	1,291,753	970,649
Tobacco tax	202,019	194,171	-	-	202,019	194,171
Unrestricted investment earnings	<u>934</u>	<u>759</u>	<u>159</u>	<u>146</u>	<u>1,093</u>	<u>905</u>
Total revenues	<u>6,107,642</u>	<u>5,220,013</u>	<u>33,775</u>	<u>30,748</u>	<u>6,141,417</u>	<u>5,250,761</u>
<b>Expenses</b>						
Health Care	<u>6,072,917</u>	<u>5,204,025</u>	<u>38,460</u>	<u>33,437</u>	<u>6,111,377</u>	<u>5,237,462</u>
Excess (deficiency) before transfers	34,725	15,988	(4,685)	(2,689)	30,040	13,299
Transfers	<u>(35,396)</u>	<u>(31,539)</u>	<u>3,700</u>	<u>2,989</u>	<u>(31,696)</u>	<u>(28,550)</u>
<b>Increase (decrease) in net assets</b>	(671)	(15,551)	(985)	300	(1,656)	(15,251)
<b>Net assets – beginning of year</b>	<u>8,078</u>	<u>23,629</u>	<u>3,049</u>	<u>2,749</u>	<u>11,127</u>	<u>26,378</u>
<b>Net assets – end of year</b>	<u>\$ 7,407</u>	<u>\$ 8,078</u>	<u>\$ 2,064</u>	<u>\$ 3,049</u>	<u>\$ 9,471</u>	<u>\$ 11,127</u>

At June 30, 2005 and 2004, AHCCCS reported positive balances in net assets for the Agency as a whole, as well as for its separate governmental and business-type activities. Overall, net assets decreased by \$1.656 million, or 15 percent.

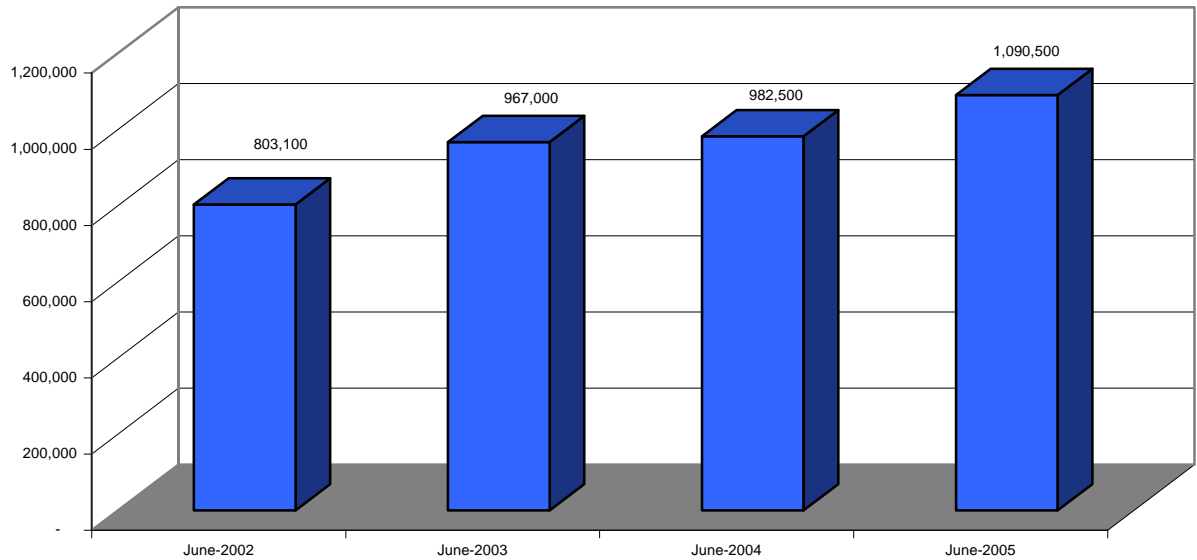
Governmental activities decreased AHCCCS' net assets by \$0.67 million during fiscal year 2005. The decrease is primarily the result of the coordination of benefits projected to enhance AHCCCS' third party liability database. The database file is used by AHCCCS, AHCCCS' health plans and program contractors to enhance the cost avoidance process. Business-type activities decreased by \$0.98 million. The decrease resulted primarily from infrastructure expansion, including personnel and system upgrades, to service the anticipated capacity increase to support future enrollment growth.

### Governmental Activities

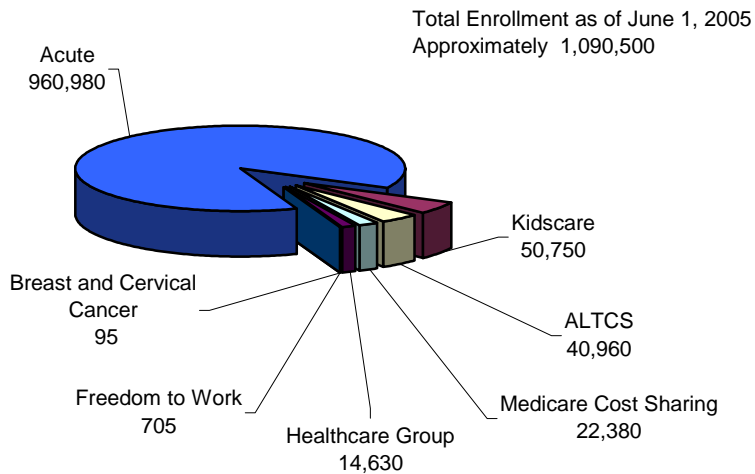
Governmental activities decreased AHCCCS' net assets by \$0.67 million during fiscal year 2005. The overall program enrollment growth of 11.0 percent (108,000 members) was the main contributing factor to the growth in program expenditures during the fiscal year 2005. The overall population reached a high of 1,090,850 as of May 1, 2005. Since March 1, 2001, just prior to the implementation of Proposition 204, the AHCCCS population has increased by 504,000 members to 1,090,500 as of June 1, 2005, including Healthcare Group, which equates to a 85.9 percent growth rate. Of this amount, 143,700 (28.5 percent of the total 8.0 percent growth rate) are members who were made eligible by Proposition 204 since the April 1, 2001 effective date.

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

### AHCCCS Membership Growth



### AHCCCS Enrollment by Program



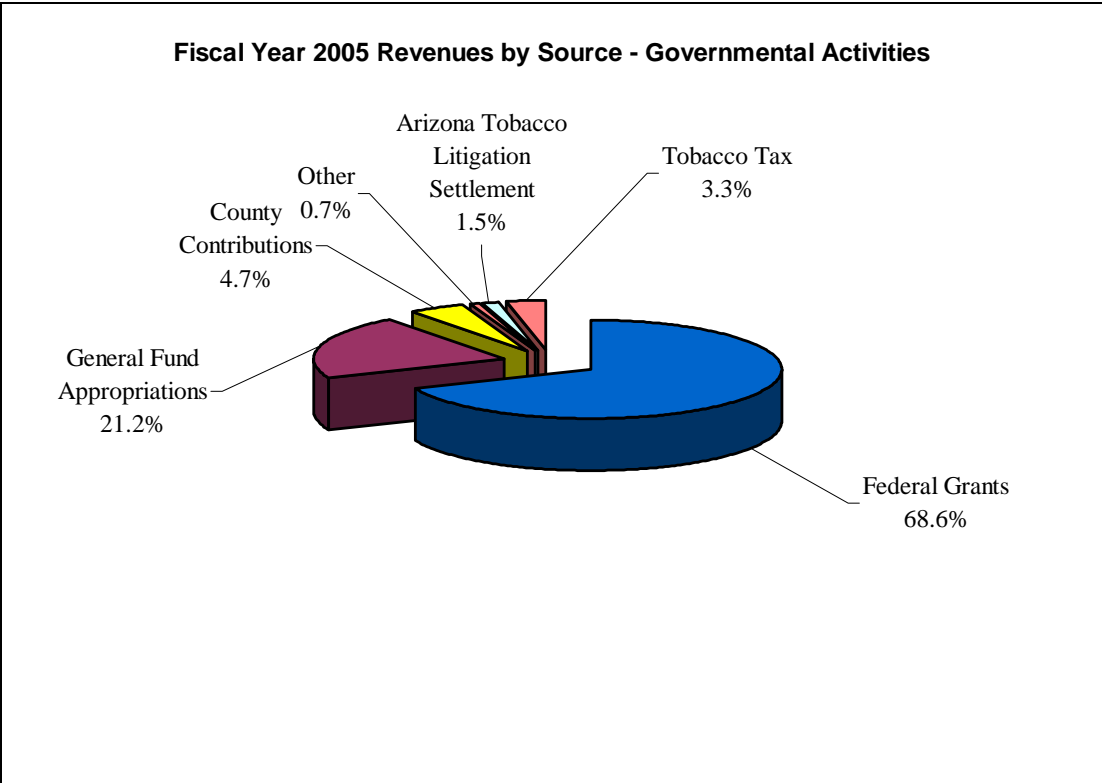
The cost of health care programs, including Title XIX Medicaid and Title XXI SCHIP, totaled \$6,072.9 million in fiscal 2005, an \$868.9 million increase over the \$5,204.0 million reported in fiscal year 2004. As shown in the statement of activities, the amount of expenditures funded from federal grants through the Centers for Medicare and Medicaid Services (CMS) was \$4,189.7 million (68.6 percent) in fiscal 2005 and \$3,671.3 million (70.5 percent) in fiscal 2004. Funding in the form of federal financial participation is primarily determined through the Federal Medical Assistance Percentages (FMAP) used to provide the amount of federal matching for State medical assistance expenditures. The FMAP or federal share of program costs is based on the relationship between Arizona's per capita personal income and the national average per capita personal income over three calendar years. The FMAP is recalculated each



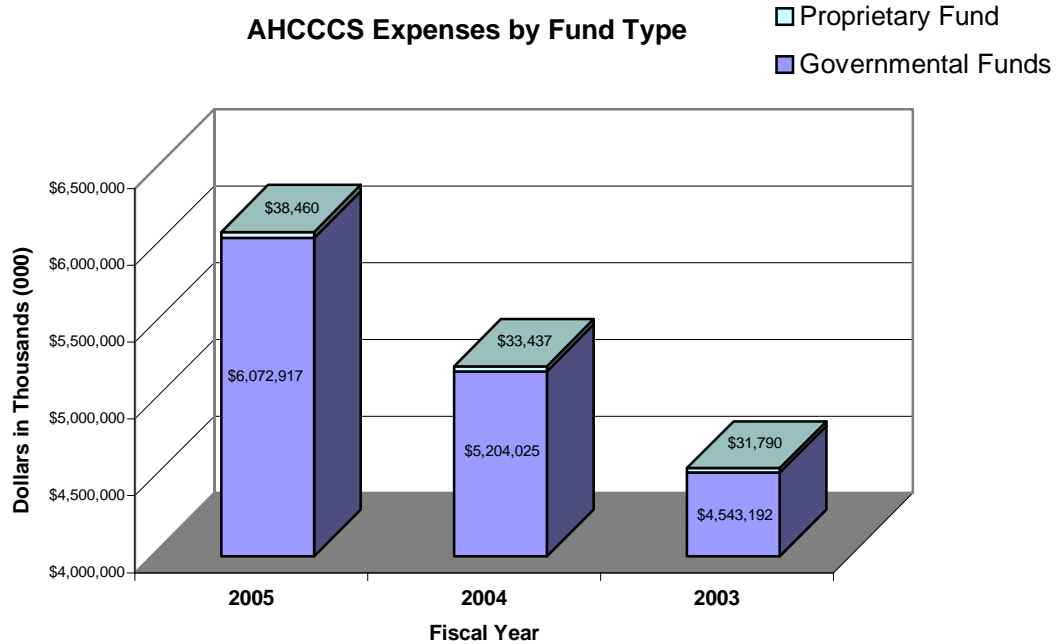
year and increased by .19 percent to 67.45 percent from the prior year's rate of 67.26 percent. The 2.95 percent temporary increase in the FMAP provided by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27) Subsection 401(a) expired at the beginning of FY 2005. This temporary increase had provided an additional \$153.5 million in grant revenue for fiscal year 2004 that was required to be replaced by State sources for the fiscal year ended June 30, 2005.

State, county and miscellaneous funding sources combined to provide \$1,918.0 million in State funding sources and appropriations in fiscal year 2005, a \$369.3 million increase over the \$1,548.7 million reported in fiscal year 2004. The following are the components of the state match funding sources. State General Fund revenues raised primarily in the form of sales and income taxes directed to AHCCCS amounted to \$901.6 million and an additional \$390.2 million was passed through from other State agencies in order to provide the State's share for Title XIX Medicaid and Title XXI SCHIP eligible medical assistance expenditures. Arizona counties contributed \$289.6 million as determined by Statutory funding formula and Session Law. Tax collections on tobacco products provided \$202.0 million in state match funding. An additional \$93.8 million in State revenue funding was provided by the annual payments awarded to AHCCCS as administrator of the Tobacco Litigation Settlement Funds awarded to Arizona. These revenues are recorded in accordance with the Governmental Accounting Standards Board (GASB) Technical Bulletin No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues* which clarified payments made to AHCCCS pursuant to the Master Settlement Agreement (MSA) with major tobacco companies. Payments are based on cigarette sales from the preceding year. AHCCCS has accrued \$44.8 million for the period through June 30, 2005, based on revised national payment estimates adjusted for historical payment trends. Tribal gaming receipts distributed to AHCCCS as determined by Statutory formula and other sources provided an additional \$40.7 million.

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



### AHCCCS Expenses by Fund Type



### Business-type Activities

The sole business-type activity for AHCCCS is the Healthcare Group (HCG). The HCG administers a prepaid medical coverage program for small businesses with 1 to 50 employees and employees of political subdivisions. HCG is intended to be self-funded by charging a premium to participating employers that covers both the costs of providing medical services and administrative costs of operating the program. However, the program has incurred operating losses for the past several years and has required a subsidy from the State to cover those operating losses. In fiscal year 2005, HCG was supported by a \$3.7 million subsidy from the General Fund. In fiscal 2004, this subsidy was \$2.989 million. The use of subsidy dollars is reflected as an Interfund Transfer in the Government-Wide Statement of Activities. Current legislation only provides the appropriated subsidy funding for Healthcare Group through fiscal year 2005. Also, HCG continues to adjust rates accordingly in an attempt to fully fund reinsurance payments to the participating health plans from premium collections. These rates are intended to eliminate the reliance on future appropriations.

HCG's projected final reinsurance expenses for the 2005 plan year are \$3.94 million. This is an increase of \$3.16 million from the \$0.78 million in reinsurance expense in fiscal year 2004. This increase is due to both an increase in reinsurance claims and to the growth in membership. Beginning in fiscal 2006, health plan medical costs will be reconciled on actual claims data rather than on accrued audited financial statements. This change combined with a new emphasis on the medical management aspect of the program is expected to reduce reinsurance costs and the need for future subsidies. Additionally, a percentage of premiums (ranging from 5 to 10 percent) are allocated to build a stabilization reserve. The percentage is actuarially determined and may vary by product and health plan. Claims data is monitored and reserve requirements adjusted as necessary. The stabilization reserves will be available to offset any negative impact to the health care organizations as new products are introduced, as well as reconciling any adverse claims experience on existing products.

As previously noted, the business-type activity decreased AHCCCS' net assets by \$0.98 million, after the \$3.7 million subsidy described above. The decrease resulted from appropriated administrative expenses of \$3.23 million that were in excess of premium revenue of \$2.06 million designated to fund the administrative appropriation, net of interest income. The administrative business infrastructure, primarily personnel, was expanded (approximately 13 people) to generate and support projected enrollment growth and was based on a fiscal year end projection of 20,000 members. These resources were directed toward new product development and the expansion of provider networks statewide. Enrollment growth

of 64 percent to 24,000 members by June 2006 is necessary to sustain the fiscal year 2006 administrative budget of \$3.6 million. Should this enrollment growth not be achieved, HCG would be required to scale back administrative expenditures to the level supported by actual enrollment. Implementation of HCG's marketing plan is reversing the declining enrollment trend from prior years. Enrollment increased to 14,600, a 30.4 percent increase from the previous fiscal year's enrollment of 11,200. This is a significant improvement from the 1.8 percent decline in enrollment in the previous year.

### **Financial Analysis of AHCCCS' Governmental Funds**

#### **Governmental Funds**

At the end of fiscal year 2005, AHCCCS' governmental funds reported combined ending fund balances totaling \$3.151 million, a decrease of \$1.218 million from the prior year balance.

The General Fund is the chief operating fund of the AHCCCS Acute Care, Proposition 204 and Long-Term Care programs. These programs primarily utilize a State general fund appropriation and revenue sources from the annual tobacco litigation settlement proceeds as well as taxes on tobacco products and Arizona counties.

The Other Governmental Funds consist of six individual funds that have a combined total fund balance of \$3.151 million available to meet future year obligations. The Other Governmental Fund's fiscal year-end available cash balance is \$3.151 million and represents all of the total governmental fund's unrestricted fund balance and consists of balances in the Hawaii Arizona PMMIS Alliance Fund and the Third Party Liability Fund and are available for certain administrative expenditures for information technology activities and third party liability recovery and cost avoidance program activities. The Tobacco Tax and Health Care Fund – Medically Needy Account's ending cash balance of \$2,451 was used to offset the accrual for IBNR programmatic claims and, accordingly, reports zero ending fund balances. Revenue from taxes on cigarettes and other related tobacco products generated \$141.2 million for the current year and accounts for 84.4 percent of the total Other Governmental Funds revenues.

#### **General Fund Budgetary Highlights**

Differences occurred between the original and the final amended administrative and programmatic expenditure budgets (\$207.34 million). The key factor that contributed to this difference was a combined increase of \$198.75 million for both Acute Base and Proposition 204 capitation costs. The overall program enrollment growth of 11.0% was the main contributing factor to the supplemental appropriation. All other differences relate to special line item adjustments that utilized surpluses from a line item to offset shortfalls in another line item. These appropriation transfers are approved by the Governor's Office of Strategic Planning and Budgeting and are in accordance with legislative authority. The major special line item revisions can be briefly summarized as follows:

- \$130.35 million increase to Acute Capitation
- \$ 68.40 million increase to Proposition 204 Capitation
- \$ 8.45 million increase to Base and Proposition 204 Medicare
- \$ 9.67 million increase to SCHIP and SCHIP Parents services
- \$ 15.22 million decrease to Base and Proposition 204 fee-for-service payments

At June 30, 2005, actual cash basis expenditures were \$108.88 million less than budgetary estimates, thus providing carry-forward balances that are available to be used for administrative adjustments as authorized by State statute.

#### **Capital Asset Administration**

AHCCCS' investment in capital assets for its governmental and business-type activities as of June 30, 2005 amounts to \$5.202 million, net of accumulated depreciation. This investment in capital assets includes furniture, vehicles and equipment. Land, buildings and improvements are under the management of the State and are accounted for on the State's comprehensive annual financial report. Purchases include the normal planned retirement and replacement of automated systems and related

equipment and vehicles. The total decrease in AHCCCS' investment in capital assets for the current fiscal year was 15.76 percent or \$973,000. The decrease primarily resulted from the increase in accumulated depreciation from the telecommunication equipment lease purchased in June 2004.

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

	Governmental Activities		Business-type Activities		Total	
	2005	2004	2005	2004	2005	2004
	Vehicles	\$ 355	\$ 557	\$ -	\$ -	\$ 355
Furniture and equipment	4,654	5,398	193	220	4,847	5,618
Total net assets	<u>\$ 5,009</u>	<u>\$ 5,955</u>	<u>\$ 193</u>	<u>\$ 220</u>	<u>\$ 5,202</u>	<u>\$ 6,175</u>

Additional information on AHCCCS' capital assets and lease obligation can be found in Notes 2 and 3 to the accompanying financial statements on page 27.

**Long-Term Contingent Liability**

In January 2001, AHCCCS obtained a Section 1115 Waiver ("Waiver") from CMS to receive federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204 by the citizens of Arizona. The Waiver requires that over the term of the agreement, April 1, 2001 through September 30, 2006, the population covered by the Waiver be budget neutral for CMS. Budget neutral means that CMS will not pay more for medical services with the Waiver than it would without the waiver. The Waiver Special Terms and Conditions (STC) include a monitoring arrangement that requires AHCCCS to report the financial results on a quarterly basis. It also established a diminishing annual threshold of the amount that AHCCCS is able to exceed the Budget Neutrality limit on an interim basis before being required to submit a corrective action plan. The STC reporting limit thresholds are monitored on a Federal Fiscal Year basis. The limit threshold for the three limit periods ended September 30, 2004, which is the last full reporting period, is 1.0 percent. As of June 30, 2005, reported date of service expenditures associated with the three periods ended September 30, 2004 are below the limit by \$97.8 million, or 1.39 percent. The fourth Budget Neutrality period does not end until September 30, 2005. Through June 30, 2005, AHCCCS remains under the cumulative reporting limit threshold.

During the current fiscal year, enrollment growth increased by 11.0 percent. In fiscal year 2004, enrollment growth was 1.6 percent. Total enrollment at June 1, 2005 was 1,090,500 as compared to 982,500 at June 1, 2004, an increase of 108,000 members. Projections prepared as part of the AHCCCS fiscal year 2007 budget request indicate that the Waiver will be budget neutral through September 30, 2006. However, it is important to note that the calculation of budget neutrality is comprised of many components and is very volatile. These include: estimating the number of new members due to Proposition 204, the economy and its impact on unemployment, medical inflation and policy decisions made by the Arizona Legislature that impact program costs.

**Economic Factors and Next Years Budgets and Rates**

AHCCCS continues to experience growth in its various membership populations. Enrollment grew at a rate of 11% during fiscal year 2005. The majority of the growth occurred in the first four months of the fiscal year. Since November 2004 the overall growth rate has slowed to 1 percent. AHCCCS expects enrollment to continue to grow at a projected 4.7 percent annual rate, which is at a lower rate than experienced during the first few months of fiscal year 2005. Unemployment rates, a key indicator of AHCCCS enrollment, have somewhat stabilized. However, the forecast reflects the continued trend of declining employer-based coverage. This factor combined with continued Arizona population growth, is likely to ensure positive AHCCCS enrollment growth through Fiscal Year 2006. A significant component of expected growth is due to outreach activities for the Medicare Part D Prescription Drug coverage as passed by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003.

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA) established the Medicare Part D prescription drug coverage, which will provide prescription drug coverage to certain Medicaid recipients who are Medicare eligible. Beginning January 2006, states must reimburse the federal government according to a prescribed formula, for savings due to prescription drug coverage under this act. The percentage of savings paid back will begin at 90%; then decrease over a ten-year period and will stabilize at 75% in 2015. The estimated General Fund amount for fiscal year 2006 is \$29.7 million.

AHCCCS capitation rates are required to be actuarially sound as required by the Federal Balanced Budget Act of 1997. Utilization and inflationary trends for health care costs are incorporated in the rate development process. The primary drivers for rate inflation continue to be increases in utilization and costs for pharmacy (24 percent of rate increase), physician costs (28 percent), and inpatient costs (18 percent). The contract year 2006 capitation rate increase ranges resulted in a weighted average increase of 8.0 percent.

The AHCCCS program that provides medical coverage for parents of KidsCare and SOBRA eligible children whose adjusted net countable income is between 100% and 200% of the Federal poverty level is scheduled for repeal as of June 30, 2006. In addition to providing health care to an estimated 14,500 Arizonans, a significant benefit of this program allows AHCCCS to use SCHIP (Title XXI) federal allotments for the Childless Adult populations within Proposition 204. Using SCHIP allotments provides a state match savings due to the enhanced SCHIP FMAP and SCHIP payments are not subject to budget neutrality. If the program is not extended, AHCCCS is estimating that Arizona may not utilize approximately \$35 million of the federal fiscal year 2007 SCHIP allotment, and Arizona may not be eligible for future redistributions of unused SCHIP dollars.

The possibility exists that AHCCCS will require a supplemental appropriation in fiscal year 2006. The budget request for fiscal year 2007 submitted to the Governor in September 2005, which includes a rebase of the fiscal year 2006 budget, indicated a potential fiscal year 2006 shortfall of \$134 million. This shortfall will be partially mitigated by applying \$73.5 million of unused fiscal year 2005 appropriation authority to claims received in fiscal year 2006 with dates of service prior to July 1, 2005. Other factors that may mitigate the need for a supplemental appropriation include favorable enrollment trends and favorable tobacco revenue collections. Management is closely monitoring these trends to determine if a supplemental appropriation will be necessary.

#### **Request for Information**

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

**INDEPENDENT AUDITORS' REPORT**

## INDEPENDENT AUDITORS' REPORT

To the Director of the

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

We have audited the accompanying financial statements of the governmental activities, the business-type activities and the aggregate remaining fund information of AHCCCS at and for the year ended June 30, 2005, as shown on pages 13 through 21. These financial statements are the responsibility of AHCCCS' management. Our responsibility is to express opinions on these financial statements based on our audit.

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

As discussed in Note 1, the financial statements of AHCCCS are intended to present the financial position, the changes in financial position and cash flows, where applicable, of only that portion of the governmental activities, the business-type activities and the aggregate remaining fund information of the state of Arizona that are attributable to the transactions of AHCCCS. They do not purport to, and do not, present fairly the financial position of the state of Arizona at June 30, 2005, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with U.S. generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities and the aggregate remaining fund information of AHCCCS at June 30, 2005, and the respective changes in financial position and cash flows, where applicable, thereof and the respective budgetary comparison for the general fund for the year then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 16, 2005 on our consideration of AHCCCS' internal control over financial reporting and on our tests of its compliance with certain provision of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The accompanying management's discussion and analysis on pages 1 through 10 and the budgetary comparison information on page 18 are not a required part of the basic financial statements but are supplementary information required by U.S. generally accepted auditing standards and the Governmental Accounting Standards Board (GASB). We have applied certain limited procedures, which consisted

principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

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

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

Phoenix, Arizona  
November 16, 2005

*Mayer Hoffman McCann P.C.*



## **BASIC FINANCIAL STATEMENTS**

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## STATEMENT OF NET ASSETS

June 30, 2005  
(amounts expressed in thousands)

<b><u>ASSETS</u></b>	<b><u>Governmental Activities</u></b>	<b><u>Business-type Activities</u></b>	<b><u>Total</u></b>
<b>CURRENT ASSETS</b>			
Cash	\$ 52,068	\$ 9,654	\$ 61,722
Restricted cash	9,093	-	9,093
Due from state and county governments	41,361	-	41,361
Due from the federal government	245,593	-	245,593
Tobacco settlement receivable	44,805	-	44,805
Internal balances	(3,414)	3,414	-
Receivables and other	<u>26,352</u>	<u>8</u>	<u>26,360</u>
TOTAL CURRENT ASSETS	415,858	13,076	428,934
<b>CAPITAL ASSETS</b>			
Furniture, vehicles and equipment, net of accumulated depreciation	<u>5,009</u>	<u>193</u>	<u>5,202</u>
TOTAL ASSETS	<u>420,867</u>	<u>13,269</u>	<u>434,136</u>
 <b><u>LIABILITIES</u></b>			
<b>CURRENT LIABILITIES</b>			
Accounts payable	4,136	371	4,507
Other accrued liabilities	3,437	93	3,530
Bank overdraft	1,078	-	1,078
Deferred revenue	19,059	6,721	25,780
Due to federal, state and county governments	33,978	-	33,978
Accrued programmatic costs	348,921	3,939	352,860
Current portion of compensated absences	<u>2,851</u>	<u>81</u>	<u>2,932</u>
TOTAL CURRENT LIABILITIES	<u>413,460</u>	<u>11,205</u>	<u>424,665</u>
 <b>COMMITMENTS AND CONTINGENCIES</b>			
 <b><u>NET ASSETS</u></b>			
INVESTED IN CAPITAL ASSETS	5,009	193	5,202
UNRESTRICTED	<u>2,398</u>	<u>1,871</u>	<u>4,269</u>
TOTAL NET ASSETS	<u>\$ 7,407</u>	<u>\$ 2,064</u>	<u>\$ 9,471</u>

See Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## STATEMENT OF ACTIVITIES

Year Ended June 30, 2005  
(amounts expressed in thousands)

	Program Revenues				Net (Expense) Revenue and Changes in Net Assets		Total
	Program Expenses	Charges for Services	Federal Operating Grants	Other Operating Grants and Contributions	Governmental Activities	Business-type Activities	
PROGRAMS							
Government activities:							
Health care programs	\$ 6,072,917	\$ 8,743	\$ 4,189,659	\$ 414,534	\$ (1,459,981)	\$ -	\$ (1,459,981)
Business-type activities:							
Healthcare Group	<u>38,460</u>	<u>33,616</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(4,844)</u>	<u>(4,844)</u>
TOTAL PROGRAMS	<u>\$ 6,111,377</u>	<u>\$ 42,359</u>	<u>\$ 4,189,659</u>	<u>\$ 414,534</u>	<u>(1,459,981)</u>	<u>(4,844)</u>	<u>(1,464,825)</u>
General revenues:							
State appropriations					1,291,753	-	1,291,753
Tobacco tax					202,019	-	202,019
Unrestricted investment earnings					<u>934</u>	<u>159</u>	<u>1,093</u>
					1,494,706	159	1,494,865
Transfers:							
Transfers in					849	-	849
Transfers out					(32,545)	-	(32,545)
Interfund transfers					<u>(3,700)</u>	<u>3,700</u>	<u>-</u>
Total general revenues and transfers					<u>1,459,310</u>	<u>3,859</u>	<u>1,463,169</u>
CHANGE IN NET ASSETS					(671)	(985)	(1,656)
NET ASSETS, BEGINNING OF YEAR					<u>8,078</u>	<u>3,049</u>	<u>11,127</u>
NET ASSETS, END OF YEAR					<u>\$ 7,407</u>	<u>\$ 2,064</u>	<u>\$ 9,471</u>

See Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## BALANCE SHEET - GOVERNMENTAL FUNDS

June 30, 2005  
(amounts expressed in thousands)

	<u>General Fund</u>	<u>Other Governmental Funds</u>	<u>Total Governmental Funds</u>
<b><u>ASSETS</u></b>			
Cash	\$ 40,956	\$ 11,112	\$ 52,068
Restricted cash	8,438	655	9,093
Due from state and county governments	13,080	14,781	27,861
Due from the federal government	89,915	-	89,915
Due from other funds	11,875	-	11,875
Receivables and other	332	-	332
TOTAL ASSETS	\$ 164,596	\$ 26,548	\$ 191,144
<b><u>LIABILITIES</u></b>			
Accounts payable	\$ 3,915	\$ 221	\$ 4,136
Other accrued liabilities	2,878	559	3,437
Bank overdraft	1,078	-	1,078
Deferred revenue	18,451	608	19,059
Due to federal, state and county governments	26,997	201	27,198
Due to other funds	3,414	11,875	15,289
Accrued programmatic costs	107,863	9,933	117,796
TOTAL LIABILITIES	164,596	23,397	187,993
COMMITMENTS AND CONTINGENCIES			
<b><u>FUND BALANCES</u></b>			
Unreserved	-	3,151	3,151
TOTAL FUND BALANCES	-	3,151	3,151
TOTAL LIABILITIES AND FUND BALANCES	\$ 164,596	\$ 26,548	
<p>Amounts reported for governmental activities in the statement of net assets are different because:</p> <p>Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds. <span style="float: right;">\$ 5,009</span></p> <p>Governmental funds report capital outlays as expenditures. However, in the statement of activities the cost of these assets is allocated over their estimated useful lives and reported as depreciation expense. This is the amount by which capital outlays (\$2,743) exceeded depreciation (\$1,990) in the current fiscal year. <span style="float: right;">(753)</span></p> <p>Long-term liabilities for accrued paid time off are not due and payable in the current fiscal year and, therefore, are not reported in the funds. <span style="float: right;">(2,851)</span></p> <p>Long-term receivables, offsetting the above accrued paid time off liability, which are not receivable in the current fiscal year and, therefore, are not reported in the funds. <span style="float: right;">2,851</span></p> <p>Accrued liabilities for programmatic costs are not due and payable from current financial resources and, therefore are not reported in the funds. <span style="float: right;">231,125</span></p> <p>Long-term receivables, offsetting the above accrued programmatic liability, which is not due and receivable in the current fiscal year and, therefore, are not reported in the funds. <span style="float: right; border-bottom: 1px solid black;">(231,125)</span></p>			
NET ASSETS OF GOVERNMENTAL ACTIVITIES			\$ 7,407

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, 2005  
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
<b>REVENUES</b>			
State government:			
Appropriations	\$ 851,083	\$ -	\$ 851,083
Pass through funds	390,197	-	390,197
Federal government:			
Acute care	2,453,284	413	2,453,697
Long-term care	596,763	-	596,763
Pass through funds	984,631	-	984,631
County government:			
Acute care	73,482	-	73,482
Long-term care	210,555	-	210,555
Pass through funds	5,567	-	5,567
Tobacco litigation settlement revenue	93,933	-	93,933
Tobacco tax revenue	60,859	141,160	202,019
Gaming revenue	-	16,688	16,688
Intergovernmental agreement revenue	-	7,075	7,075
Premium revenue	8,743	-	8,743
Other	6,378	1,848	8,226
<b>TOTAL REVENUES</b>	<b>5,735,475</b>	<b>167,184</b>	<b>5,902,659</b>
<b>PROGRAMMATIC EXPENDITURES</b>			
Capitation:			
Acute care	2,492,966	95,394	2,588,360
Long-term care	1,331,755	-	1,331,755
Children's Rehabilitative Services	49,965	-	49,965
Mental health services	716,340	-	716,340
Fee-for-service:			
Acute care	496,873	8,884	505,757
Long-term care	98,443	-	98,443
Trauma center services	-	16,768	16,768
Disproportionate share	142,355	-	142,355
Graduate medical education	21,148	-	21,148
Reinsurance	96,702	9,768	106,470
Medicare premiums:			
Acute care	70,713	5,940	76,653
Long-term care	22,578	-	22,578
Payments to counties	4,826	-	4,826
<b>TOTAL PROGRAMMATIC EXPENDITURES</b>	<b>5,544,664</b>	<b>136,754</b>	<b>5,681,418</b>
ADMINISTRATIVE EXPENDITURES	163,688	9,751	173,439
ADMINISTRATIVE EXPENDITURES PASSED THROUGH	13,624	-	13,624
<b>TOTAL EXPENDITURES</b>	<b>5,721,976</b>	<b>146,505</b>	<b>5,868,481</b>
EXCESS OF REVENUES OVER EXPENDITURES	13,499	20,679	34,178
<b>OTHER FINANCING SOURCES (USES)</b>			
Transfers out:			
To State General Fund	(3,714)	-	(3,714)
To Medically Needy Account	(5,769)	-	(5,769)
To Third Party Collection Fund	(1,165)	-	(1,165)
To Arizona Department of Health Services	-	(28,553)	(28,553)
To Arizona Department of Health Services Health Crisis Fund	(230)	(279)	(509)
To Healthcare Group	(3,700)	-	(3,700)
Transfers in:			
From AHCCCS General Fund	-	6,935	6,935
From Department of Juvenile Correction	160	-	160
From Attorney General	200	-	200
From Arizona Department of Health Services Dental Consultant	38	-	38
From Arizona Department of Health Services	491	-	491
From Department of Correction	190	-	190
<b>TOTAL OTHER FINANCING USES</b>	<b>(13,499)</b>	<b>(21,897)</b>	<b>(35,396)</b>
NET CHANGE IN FUND BALANCES	-	(1,217)	(1,218)
FUND BALANCES, BEGINNING OF YEAR	-	4,369	4,369
FUND BALANCES, END OF YEAR	\$ -	\$ 3,152	\$ 3,151

See Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

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

Year Ended June 30, 2005  
(amounts expressed in thousands)

Amounts reported for governmental activities in the statement of activities (page 14) are different because:

Net change in fund balance - total governmental funds (page 16)	\$	(1,218)
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Governmental funds report capital outlays as expenditures. However, in the statement of activities the cost of those assets is allocated over their estimated useful lives and reported as depreciation expense. Due to its pass through nature, AHCCCS accrues revenue sufficient to eliminate its deficit fund balance and, therefore, this is the amount by which capital outlays exceeded depreciation in the prior period.

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Change in net assets of governmental activities (page 14)	\$	<u>(671)</u>
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# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## BUDGETARY COMPARISON SCHEDULE - GENERAL FUND

Year Ended June 30, 2005  
(Unaudited)  
(amounts expressed in thousands)

	Original Appropriation (Budget)	Final Appropriation (Budget)	Actual	Variance with Final Budget
<b>REVENUES</b>				
State appropriations	\$ -	\$ -	\$ 879,000	\$ -
State pass-through funds	-	-	425,973	-
Federal government	-	-	3,130,561	-
Federal pass-through funds	-	-	911,239	-
County government	-	-	286,212	-
County pass-through funds	-	-	-	-
Tobacco tax revenue	-	-	60,603	-
Tobacco litigation settlement	-	-	93,933	-
Other	-	-	7,418	-
Total revenues	-	-	5,794,939	-
<b>OTHER FINANCING SOURCES</b>				
Operating transfers in	-	-	13,065	-
TOTAL REVENUES AND OTHER FINANCING SOURCES	-	-	5,808,004	-
<b>PROGRAMMATIC EXPENDITURES</b>				
Acute capitation	1,477,951	1,608,302	1,599,480	8,822
Acute fee-for-service	389,422	384,046	379,809	4,237
Proposition 204 capitation	862,873	931,268	911,856	19,412
Proposition 204 fee-for-service	148,924	139,083	131,426	7,657
Proposition 204 Medicare premiums	9,322	12,772	12,501	271
Medicare premiums	53,267	58,262	58,101	161
Graduate medical education	21,148	21,148	21,148	-
Disproportionate share	141,797	142,355	116,207	26,148
Breast and cervical cancer	425	790	646	144
Critical access hospitals	1,700	1,700	1,700	-
Freedom to work	3,928	3,943	3,802	141
County hold harmless	4,826	4,826	4,826	-
Long-term care	893,316	893,316	852,178	41,138
CHIP - Services	69,292	75,804	75,139	665
CHIP - Parents	30,027	33,183	33,098	85
TOTAL PROGRAMMATIC EXPENDITURES	4,108,218	4,310,798	4,201,917	108,881
ADMINISTRATIVE EXPENDITURES	164,649	169,412	157,169	12,243
OPERATING TRANSFERS OUT	-	-	46,805	(46,805)
TOTAL APPROPRIATED EXPENDITURES	4,272,867	4,480,210	4,405,891	74,319
PRIOR YEAR APPROPRIATED EXPENDITURES	-	-	49,481	-
NON-APPROPRIATED EXPENDITURES	-	-	1,357,101	-
REVENUES AND OTHER FINANCING SOURCES OVER (UNDER) EXPENDITURES	-	-	(4,469)	-
FUND BALANCES, BEGINNING OF YEAR	-	-	48,223	-
FUND BALANCES, END OF YEAR	\$ -	\$ -	\$ 43,754	\$ -

See Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## STATEMENT OF NET ASSETS - PROPRIETARY FUND

June 30, 2005  
(amounts expressed in thousands)

### **ASSETS**

#### CURRENT ASSETS

Cash	\$	9,654
Receivables and other		<u>3,422</u>
TOTAL CURRENT ASSETS		13,076

#### CAPITAL ASSETS

Furniture, vehicles and equipment, net of accumulated depreciation		<u>193</u>
TOTAL ASSETS	\$	<u>13,269</u>

### **LIABILITIES**

#### CURRENT LIABILITIES

Accounts payable	\$	371
Other accrued liabilities		93
Deferred revenue - premiums		5,511
Deferred revenue - premium stabilization reserve		1,210
Accrued programmatic costs		3,939
Compensated absences due within one year		<u>81</u>

TOTAL CURRENT LIABILITIES	\$	<u>11,205</u>
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#### COMMITMENTS AND CONTINGENCIES

### **NET ASSETS**

INVESTED IN CAPITAL ASSETS	\$	193
UNRESTRICTED		<u>1,871</u>
TOTAL NET ASSETS	\$	<u>2,064</u>

See Notes to Financial Statements



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

Year Ended June 30, 2005  
(amounts expressed in thousands)

OPERATING REVENUES	
Premium revenue	<u>\$ 33,616</u>
OPERATING EXPENSES	
Premiums paid to health plans	30,961
Reinsurance	3,403
Other programmatic	163
Salaries and employee benefits	1,697
Professional and outside services	1,549
Other	640
Depreciation	<u>47</u>
TOTAL OPERATING EXPENSES	<u>38,460</u>
OPERATING LOSS	(4,844)
NONOPERATING REVENUE (primarily investment income)	<u>159</u>
LOSS BEFORE TRANSFERS	(4,685)
TRANSFERS IN	
From General Fund	<u>3,700</u>
CHANGE IN NET ASSETS	(985)
NET ASSETS, BEGINNING OF YEAR	<u>3,049</u>
NET ASSETS, END OF YEAR	<u>\$ 2,064</u>

See Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## STATEMENT OF CASH FLOWS - PROPRIETARY FUND

Year Ended June 30, 2005  
(amounts expressed in thousands)

CASH FLOWS FROM OPERATING ACTIVITIES	
Receipts from customers	\$ 36,089
Payments to health plans	(31,366)
Payments to employees	(1,682)
Payments to suppliers	<u>(1,830)</u>
Net cash provided by operating activities	<u>1,211</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
Operating subsidies from other funds	<u>586</u>
CASH FLOW FROM CAPITAL AND RELATED FINANCING ACTIVITIES	
Payments for capital assets	<u>(20)</u>
CASH FLOWS FROM INVESTING ACTIVITIES	
Interest	<u>159</u>
NET CHANGE IN CASH	1,936
CASH, BEGINNING OF YEAR	<u>7,718</u>
CASH, END OF YEAR	<u>\$ 9,654</u>
RECONCILIATION OF OPERATING LOSS TO NET CASH USED IN OPERATING ACTIVITIES	
Operating loss	\$ (4,844)
Adjustment to reconcile operating loss to net cash used in operating activities:	
Depreciation	47
Changes in operating net assets and liabilities:	
Increase in accounts payable and other accrued liabilities	359
Increase in deferred revenue - premiums	1,264
Increase in deferred revenue - premium stabilization reserve	1,210
Increase in accrued programmatic costs	3,160
Increase in accrued compensated absences	<u>15</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>\$ 1,211</u>

See Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2005  
(dollar amounts expressed in thousands)

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

#### A. Reporting entity

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

The Arizona Legislature 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 Arizona Legislature ("Legislature"), and it is funded by a combination of federal, State and county funds. The federal portion is funded through the Centers for Medicare and Medicaid Services (CMS) of the U.S. Department of Health and Human Services under a Section 1115 waiver approved by CMS, which exempts the AHCCCS program from certain requirements of conventional Medicaid programs. This waiver has been renewed by CMS through September 30, 2006. AHCCCS receives quarterly federal grants from CMS (as matching funds) to cover a portion of the health care costs of the residents of the State eligible for the State's Title XIX Medicaid and Title XXI, State Children's Health Insurance Program (SCHIP Program). State appropriations and county funds are based on annual budgets as dictated by the Legislature and specified by Arizona Statutory funding formula and Session Law.

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

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

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

#### B. Basis of presentation

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

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

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

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2005  
(dollar amounts expressed in thousands)

### (1) Summary of significant accounting policies (continued)

Fund financial statements provide information about the Agency's funds. Separate financial statements are provided for the governmental and proprietary funds. The General Fund is the Agency's primary operating fund and it accounts for all financial resources except those required to be accounted for in another fund. AHCCCS has one business-type activity, Healthcare Group. In fiscal year 2005, AHCCCS did not have any major funds; accordingly, all remaining governmental funds are aggregated and reported as other governmental funds.

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

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

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

Proprietary fund revenues are recognized when they are earned and expenses are recognized when they are incurred. Member premiums are due by the first day of the month preceding the month of coverage. At June 30, 2005, the proprietary fund deferred revenue of \$5,511 which consists of premium payments received for fiscal year 2006 as required by contract and a premium stabilization reserve.

The governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, AHCCCS considers revenue to be available if they are collected within 31 days of the end of the current fiscal year. The governmental funds deferred revenue consists of county contributions for July 2005 deposited in advance. Expenditures generally are recorded when a liability is incurred, as under accrual accounting. Accrued programmatic costs include estimates for incurred but not reported (IBNR) claims for a 31-day period following the end of the fiscal year. Actual results for accrued programmatic costs may differ from such estimates. These differences are recorded in the period in which they are identified. However, expenditures related to capital leases, compensated absences and claims and judgments are recorded only when payment is due.

In fiscal year 2005, AHCCCS reports the following significant funds:

- a. The general fund is AHCCCS' 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.

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2005  
(dollar amounts expressed in thousands)

### (1) Summary of significant accounting policies (continued)

- c. The Healthcare Group fund, reported as a business-type activity, accounts for the activities of a prepaid medical coverage program primarily to small, uninsured businesses with 1 to 50 employees and employees of political subdivisions.

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

#### **D. Cash and investments**

Substantially all of the cash and investments maintained by AHCCCS are held by the State of Arizona Office of the Treasurer ("Treasurer") with other State monies. Investment income is allocated to AHCCCS on a pro rata basis. Amounts held by the Treasurer are recorded at fair value and totaled \$70,789 at June 30, 2005 including restricted funds of \$9,093.

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

Cash in the General Fund has been internally restricted by AHCCCS in the amount of \$8,438 for the Inter-Agency Service Agreement (ISA) Fund. The ISA Fund is used to properly account for, control, and report receipts and disbursements associated with ISA's, which are not required to be reported in other funds. Fund receipts consist of monies received from other entities and are utilized to match federal funding under the Medicaid and SCHIP programs under the terms stated in the ISA. Cash in the Other Governmental Funds is legally restricted in the amount of \$655 for the Hawaii Arizona PMMIS Alliance (HAPA) Fund, as described in Note 5 and is offset by an equal amount of deferred revenue at June 30, 2005.

In accordance with the Federal Cash Management Improvement Act guidelines, AHCCCS may only request federal funds under specified funding techniques. These techniques require that AHCCCS draw down or request funds for any check issued in accordance with its historical average check clearance pattern. The timing difference that occurs, due to drawing down funds after the issuance of checks, may result in bank overdrafts to AHCCCS at various times during the year. At June 30, 2005, a bank overdraft of \$1,078 existed which represented the excess of checks issued over federal funds deposited.

#### **E. Capitation payments**

AHCCCS' contracted health plans receive fixed capitation payments, generally in advance, based on certain rates for each AHCCCS member enrolled with the plan. The plans are required to provide all covered health care services to their members, regardless of the cost of care. If there are funds remaining, the plan retains the funds as profit; if the costs are higher than the amount of capitation payments from AHCCCS, the plan absorbs the loss, except for those cases eligible for reinsurance payments.

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2005  
(dollar amounts expressed in thousands)

### (1) Summary of significant accounting policies (continued)

Capitation is paid prospectively as well as for prior period coverage (PPC). The PPC period is from the first day of the month of application to the time of enrollment with a contracted health plan. The risk under PPC is shared by both the contracted health plans and AHCCCS for the contract year ended September 30, 2005. AHCCCS reconciles the actual PPC medical costs to the PPC capitation paid during the year. The reconciliation limits the contractor's profits and losses to 2%. Except for Title XIX waiver members, effective October 1, 2002, the PPC rates were adjusted and the reconciliation of PPC costs was not performed for the contract year ended September 30, 2003. The PPC reconciliation was reinstated for the contract year ended September 30, 2004 and after. Accrued programmatic costs include approximately \$10,000 at June 30, 2005 that represent estimated settlement payments due to contracted health plans for the PPC reconciliation.

Similar risk sharing is in place for medical costs incurred by contracted health plans for the Title XIX Waiver Group (TWG) members. AHCCCS reconciles the contractor's PPC and prospective medical costs to PPC capitation, prospective capitation, hospitalized supplemental payments, delivery supplemental payments and HIV/AIDS supplemental payments paid to the contractor during the year. The reconciliation limits the contractor's profits or losses to 2%. At June 30, 2005, AHCCCS recorded as a receivable approximately \$26,019 which represents estimated settlement payments due from contracted health plans for the TWG reconciliation. Actual results may differ from this estimate and such differences will be recorded in the period in which they are identified.

#### **F. Reinsurance payments**

AHCCCS provides a stop-loss reinsurance program for its contracted health plans for partial reimbursement, after a deductible is met, of reinsurable covered medical services incurred for members with an acute medical condition. The program includes a deductible, which varies based on the health plan's enrollment and the eligibility category of the members. For acute care members, health plans at the higher deductible levels may elect a lower deductible level at the beginning of a contract year. AHCCCS reimburses the health plans based on a coinsurance amount for reinsurable covered services incurred above the deductible.

The reinsurance program includes reinsurance reimbursement for covered organ transplantation. The reinsurance program also includes a special catastrophic reinsurance program which covers conditions such as certain brain injuries and certain blood related disorders. There is no deductible for catastrophic reinsurance cases and AHCCCS reimburses the health plans at a percentage of the health plans' paid amount, less the coinsurance amount, unless the costs are paid under a subcapitated arrangement. AHCCCS pays 85% of the health plans' paid amount up to \$650 and 100% thereafter for catastrophic reinsurance. Regular reinsurance provides partial reimbursement of reinsurance eligible covered services and will reimburse 75% of eligible costs above a certain deductible level. The deductible is the responsibility of the program contractor. 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.

#### **G. Fee-for-service payments**

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

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2005  
(dollar amounts expressed in thousands)

### (1) Summary of significant accounting policies (continued)

The ESP provides for emergency medical care to persons who are not eligible for full AHCCCS coverage due to their lack of United States citizenship or lawful alien status. Outpatient medical services for the ESP and for members enrolled in a health plan for less than 30 days are reimbursed at capped fee-for-service rates based on the category of service provided. Inpatient medical services for these populations are reimbursed based on the category of service provided and an inpatient per-diem reimbursement rate system.

Medical services provided at an IHS facility or by a tribal-owned facility licensed by IHS are reimbursed at rates determined by the Office of Management and Budget (OMB). Off-reservation services are reimbursed based on the AHCCCS fee-for-service rates.

#### **H. Incurred but not reported programmatic expenditures**

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

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

#### **I. Disproportionate share hospital payments**

CMS and the Legislature authorized AHCCCS to make disproportionate share payments to Arizona hospitals that provided care to a disproportionate share (as defined) of the State's indigent population. Expenditures for disproportionate share totaled \$116,207 for the year ended June 30, 2005.

#### **J. Taxes**

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

#### **K. Management's use of estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at June 30, 2005, and the reported amounts of revenues and expenditures during the fiscal year then ended. Actual results may differ from these estimates.

#### **L. 100% federal poverty level expansion and CMS waiver**

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

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2005  
(dollar amounts expressed in thousands)

### (1) Summary of significant accounting policies (continued)

AHCCCS obtained a waiver from CMS to receive federal funding for the newly eligible populations and to fund additional legislation passed during the 2001 State legislative session to implement Proposition 204. The CMS waiver requires that the newly covered population not previously categorically eligible for Medicaid be budget neutral for CMS. The waiver period for budget neutrality began April 1, 2001 and extends through federal fiscal year 2006, at which time any federal funds received by the State that exceed the negotiated budget neutrality limit must be returned to CMS. Because any future settlement amount is currently not determinable, no liability for any excess federal funds has been recorded in the accompanying financial statements. See Note 9.

AHCCCS has classified the Arizona Tobacco Litigation Settlement Fund, created by ballot Proposition 204, as part of its General Fund. These funds are restricted for use as specified in 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 \$92,905 in April 2005. Revenue and a related receivable of \$44,805 was accrued for the period of January 1 through June 30, 2005 and is included in tobacco tax revenue and tobacco settlement receivable in the accompanying statement of net assets and statement of activities.

### (2) Capital assets

Capital assets, which consist of furniture, vehicles and equipment, are reported in the governmental and business-type activity columns in the government-wide statement of net assets. Capital assets are defined as assets with an initial, individual cost of more than \$5 and an estimated useful life in excess of one year. Such assets are recorded at historical cost and are depreciated over their useful lives ranging from three to five years. The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend assets lives are not capitalized. Net asset balances and current fiscal year activity are as follows:

Balance, June 30, 2004	\$	6,175
Additions		1,065
Retirements		(122)
Depreciation		(1,916)
Balance, June 30, 2005	\$	<u>5,202</u>

### (3) Capital leases

On June 30, 2004, AHCCCS entered into a capital lease agreement with Baystone Financial Group. Under the lease agreement, AHCCCS acquired \$3,293 of telecommunications equipment. Of this total, \$1,594 was paid in the form of a cash down payment and the remaining \$1,699 was financed. The lease agreement qualified as a capital lease for accounting purposes and, therefore, a liability in the amount of \$1,699 was recorded in the government-wide financial statements, which represents the present value of the future minimum lease payments as of the lease inception date. The original lease agreement extended through June 2009. However, in anticipation of the Arizona Department of Administration's project to consolidate telecommunication services for the State of Arizona, AHCCCS paid the outstanding amount of approximately \$1,412 due under the lease agreement in June 2005. Assets totaling approximately \$1,996 will be transferred to the Arizona Department of Administration as part of the telecommunication consolidation project in fiscal 2006.



# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2005  
(dollar amounts expressed in thousands)

### (4) Compensated absences

It is the State's policy to permit employees to accumulate earned but unused vacation, compensatory and sick pay benefits. 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, 2004	\$	2,832
Additions		5,067
Reductions		(4,967)
Balance, June 30, 2005	\$	<u>2,932</u>

### (5) Other governmental funds

At June 30, 2005, the other governmental fund balance of \$3,151 was comprised of the following funds:

- Tobacco Tax and Health Care Fund, Medically Needy Account (TTHCF-MNA) - The Arizona Department of Revenue allocates funding to the TTHCF-MNA which provides funding for services provided through the Title XIX Medicaid and other legislatively authorized health related services or programs. Revenue sources for the TTHCF-MNA include Tobacco Tax proceeds and investment income.
- Tobacco Products Tax Fund Emergency Health Services Account (TPTF-EHSA) – The Arizona Department of Revenue allocates the tobacco tax revenue to the TPTF-EHSA which is used solely for the reimbursement of uncompensated care, primary care services and trauma centers readiness costs. Revenue sources for the TPTF-EHSA include tobacco tax proceeds and investment income.
- Third Party Liability Fund – This fund is comprised of monies recovered from first and third party payers under various AHCCCS recovery programs prior to the disbursement to the appropriate programs. These programs include casualty, special treatment trusts, estate and health insurance recoveries.
- Trauma and Emergency Services Fund – This fund is comprised of gaming revenues to be used to reimburse hospitals in Arizona for unrecovered trauma center readiness costs and unrecovered emergency services costs.
- Miscellaneous Funds – These funds account for various grants and other money received for specific purposes, and includes the Hawaii Arizona PMMIS Alliance (HAPA). HAPA represents AHCCCS' project with Hawaii whereby AHCCCS processes the claim for Hawaii's Medicaid program.

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2005  
(dollar amounts expressed in thousands)

**(5) Other governmental funds (continued)**

Other governmental funds earned, expended and transferred during the fiscal year ended June 30, 2005 were as follows:

	TTHCF - MNA	TPTF - EHSA	Third Party Liability Fund	Trauma and Emergency Services Fund	Miscel- laneous Funds	Total
Fund balances, June 30, 2004	\$ 1,831	\$ -	\$ 1,277	\$ -	\$ 1,261	\$ 4,369
Receipts	112,178	28,982	1,252	16,688	7,857	166,957
Interest earned	54	29	23	80	41	227
Expenditures	(91,013)	(29,011)	(1,917)	(16,768)	(7,796)	(146,505)
Transfers in (out):						
General Fund	5,770	-	1,165	-	-	6,935
Arizona Dept of Health Services	(28,553)	-	-	-	-	(28,553)
ADHS Health Crisis Fund	(279)	-	-	-	-	(279)
Other Funds	12	-	-	-	(12)	-
Fund balances, June 30, 2005	\$ -	\$ -	\$ 1,800	\$ -	\$ 1,351	\$ 3,151

**(6) Proprietary fund**

The Healthcare Group was established in 1988 by the State to administer prepaid medical coverage primarily to small, uninsured businesses with 1 to 50 employees and employees of political subdivisions. Healthcare Group Administration (HCGA) contracted with two health plans from the existing network of AHCCCS health plans to enroll members and provide healthcare services. Subsequent to fiscal year-end, the network was expanded to three health plans. HCGA conducts premium billing, collections, fund disbursement and data analysis. HCGA is responsible for the regulatory oversight of the health plans.

For fiscal year 2005, \$4.0 million was appropriated from the General Fund to subsidize Healthcare Group administrative and reinsurance costs. This allocation is included in transfers in the accompanying statement of revenues, expenses and changes in fund net assets – proprietary fund. HCGA revised its premium rates effective February 1, 2003 to fully fund reinsurance payments to the participating health plans from premium collections. These new rates are intended to eliminate the reliance on future appropriations. Current legislation only provides the appropriated subsidy funding for Healthcare Group through fiscal year 2005.

In connection with the new rates and offering of new products, HCGA has established a premium stabilization reserve funded by member premiums. The premium stabilization reserve will be available to offset any negative impact on the health plans related to the new products, and to fund any adverse claims experience on existing products. The balance in the premium stabilization reserve was approximately \$1,210 at June 30, 2005 and is included in deferred revenue in the accompanying statement of net assets – proprietary fund.

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2005  
(dollar amounts expressed in thousands)

### (7) Retirement plan

AHCCCS employees are covered by a defined benefit retirement plan administered by the Arizona State Retirement System Board. Benefits are established by State statute and provide retirement and long-term disability benefits to AHCCCS employees. The retirement plan is funded by payroll deductions from eligible employees' gross wages and matching amounts contributed by AHCCCS. These amounts satisfy the statutory requirement that employees and AHCCCS contributions must cover the actuarially determined current service costs of the retirement plan, plus amortization over a 30-year period of the unfunded past service liability. Payroll deductions as a percentage of employee wages were 5.2% for retirement and .5% for long-term disability for 2005. The matching amount contributed to the retirement plan by AHCCCS was \$2,620 in 2005 and is included in administrative expenditures in the accompanying government-wide and governmental fund financial statements.

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

### (8) Budgetary basis of accounting

The financial statements of AHCCCS are prepared in conformity with U.S. generally accepted accounting principles (GAAP). AHCCCS, like all other State agencies, prepares its annual budget on a basis that differs from the GAAP basis. The State's accounting system and Arizona Revised Statutes and policies provide for an additional accounting period (13<sup>th</sup> month) to make payments for goods or services received or incurred by the end of the fiscal year and subsequently invoiced during the 13<sup>th</sup> month. The financial statements report total budget basis expenditures to include both the fiscal year and the 13<sup>th</sup> month activity. The State does not have a legally adopted budget for revenues. Prior fiscal year expenditures of \$49,481 million 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 program 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 monies. Unexpended prior year available monies revert on December 31, 2005.

The following is a reconciliation of the GAAP basis statement of revenues, expenditures and changes in fund balances – governmental funds to the budgetary comparison schedules for the year ended June 30, 2005:

	<u>General Fund Actual</u>
Budgetary Basis Fund Balance, June 30, 2005	\$ <u>43,754</u>
Budgetary Basis of Accounting	
Increases to fund balance:	
Due from State and county governments	13,080
Due from the federal government	89,916
Due from other Fund	11,875
Receivables and other	<u>332</u>
Total increases	<u>115,203</u>

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2005  
(dollar amounts expressed in thousands)

### (8) Budgetary basis of accounting (continued)

Decreases to fund balance:

Deferred revenue	(18,451)
Due to State and county governments	(26,997)
Due to other funds	(3,414)
Accrued programmatic costs	(107,864)
Payables and other	<u>(2,231)</u>
Total decreases	<u>(158,957)</u>
Total GAAP basis fund balance	<u>\$ -</u>

Non-appropriated expenditures of \$1,357,100 in the general fund consist of federal pass-through payments to other agencies.

### (9) Contingencies

**Grant adjustment** - Amounts received from CMS are subject to audit and adjustments. At June 30, 2005, AHCCCS had claimed reimbursement from CMS on its Form CMS-64 of approximately \$101.4 million representing additional reimbursement AHCCCS believes it is due for health care services provided to Native Americans off the reservation. CMS has disallowed this claim through the September 2004 quarter and AHCCCS anticipates disallowances for the December 2004, March 2005 and June 2005 claims. AHCCCS appealed this decision and the U.S. Department of Health and Human Services, Departmental Appeals Board upheld the disallowance. As a result, AHCCCS has not drawn down these funds from CMS nor are they included in the accompanying financial statements. AHCCCS believes reimbursement of these funds is supported in law and continues to pursue recovery of these funds through legal efforts. See litigation and investigations below.

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

Additionally, AHCCCS has filed a lawsuit seeking recovery from the federal government for services provided to Native Americans off the reservation. The U. S. District Court for the District of Arizona entered a judgment in favor of the State in March 2005 that was appealed by CMS to the Ninth Circuit Court of Appeals in July 2005. In similar cases, North Dakota and South Dakota have had district court favorable judgments overturned on appeal to the 8th Circuit Court of Appeals. At June 30, 2005 no amounts have been recorded on the accompanying financial statements for the potential outcome of this litigation.

**Compliance with laws and regulations** - AHCCCS is subject to numerous laws, regulations and oversight by the federal government. These laws and regulations include, but are not necessarily limited to, matters such as government health care program participation requirements, reimbursement for member services and Medicaid fraud and abuse. Violations of these laws and regulations could result in expulsion from government health care programs, together with the imposition of significant financial sanctions. Management believes that AHCCCS is in compliance with fraud and abuse laws and regulations, as well as other applicable government laws and regulations. Compliance with such laws and regulations can be subject to future review and interpretation as well as regulatory actions unknown at this time.

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2005  
(dollar amounts expressed in thousands)

**(9) Contingencies (continued)**

**Budget neutrality agreement** – In January 2001, AHCCCS obtained a Section 1115 Waiver (“Waiver”) from CMS to receive federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204. The Waiver requires that over the term of the agreement (April 1, 2001 through September 30, 2006), the population covered by the Waiver be budget neutral for CMS. Under budget neutrality, CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions (STC) include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. It also established a diminishing annual threshold of the amount by which AHCCCS is able to exceed the budget neutrality limit on an interim basis before being required to submit a corrective action plan. The STC reporting limit thresholds are monitored on a Federal Fiscal Year basis. The limit threshold for the three limit periods ended September 30, 2004, which is the last full reporting period, is 1.0 percent. As of June 30, 2005, reported date of service expenditures associated with the three periods ended September 30, 2004 are below the limit by \$97.8 million, or 1.39 percent. The fourth Budget Neutrality period does not end until September 30, 2005. Through June 30, 2005, AHCCCS remain under the cumulative reporting limit threshold. The budget neutrality calculation is dependent on a number of variables including the number of new Proposition 204 members, the general economy and its impact on unemployment, medical inflation and policy decisions that may impact program costs made by the Legislature. Given the uncertainty surrounding these factors, AHCCCS is not presently able to determine if the budget neutrality limit will be exceeded or if it is exceeded that CMS will require repayment of the excess. Management believes that as of June 30, 2005, AHCCCS does not have any liability related to CMS for the budget neutrality agreement. Accordingly, the accompanying basic financial statements have not been adjusted for the impact of any liability AHCCCS may have related to the budget neutrality agreement for Proposition 204.

**(10) Interfund receivables, payables and transfers**

Interfund activity is defined as transactions between funds administered by AHCCCS. The composition of interfund balances as of June 30, 2005 is as follows:

<u>Receivable fund</u>	<u>Payable fund</u>	<u>Amount</u>		
Healthcare Group	General Fund	\$ 3,414		
<b>Transfers in</b>				
	<u>General</u>	<u>Other</u>	<u>Healthcare Group</u>	<u>Total</u>
Transfers out:				
General Fund	\$ -	\$ 6,935	\$ 3,700	\$10,635

In the government-wide statement of activities, the interfund activity has been eliminated. The total net transfers out of \$31,696 reported on the statement of activities represents transfer activities to other State agencies.

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

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

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2005  
(dollar amounts expressed in thousands)

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

**Administrative services** - The Arizona Department of Economic Security (ADES) charges AHCCCS to determine eligibility for certain Title XIX members. The Arizona Department of Administration charges AHCCCS for data center services and telephone line charges. The Arizona Department of Health Services (ADHS) charges AHCCCS for licensure and screening services and administrative costs associated with the SCHIP Vaccine for Children program. The Arizona Office of Administrative Hearings charges AHCCCS for administrative hearing services. The Arizona Board of Nursing charges AHCCCS for the cost of administering the nurse aid training program for nurse assistants. These expenditures are included in administrative expenditures in the accompanying statement of revenues, expenditures and changes in fund balances - governmental fund. The following is a summary of transactions with these State agencies for the services described above for the year ended June 30, 2005.

	<u>Expenditures</u>
Arizona Department of Economic Security	\$ 68,624
Arizona Department of Administration	10,655
Arizona Department of Health Services	1,188
Arizona Board of Nursing	339
Arizona Office of Administrative Hearings	316
	<u>\$ 81,122</u>

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

The amount passed through to ADES is classified as long-term care capitation programmatic expenditures and the amount passed through to ADHS is classified as capitation-mental health services and Children's Rehabilitative Services expenditures in the accompanying statement of revenues, expenditures and changes in fund balances - governmental funds. The following is a summary of transactions with these State agencies for the services described above for the year ended June 30, 2005.

	<u>Expenditures</u>
Arizona Department of Economic Security	\$ 617,802
Arizona Department of Health Services	796,363
	<u>\$ 1,414,165</u>

Revenues include \$284,038 from Arizona counties during fiscal year 2005. 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, 2005, AHCCCS has accrued \$11,387, payable 50% to the State and 50% to the counties, relating to the amount that county and State contributions exceeded related expenditures. This amount is included in the due to federal, State and county governments in the accompanying balance sheet - governmental funds.

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2005  
(dollar amounts expressed in thousands)

**(12) Other pass through funds**

Arizona school districts are eligible for federal matching funds for the administrative functions related to Early and Periodic Screening, Diagnosis and Treatment (EPSDT) outreach services at the school level. Arizona school districts are also eligible for federal matching funds on a fee-for-service basis for the provision of certain AHCCCS program services provided to eligible students. These amounts are included within federal pass through funds in the accompanying statement of revenues, expenditures and changes in fund balances - governmental funds.

Arizona counties contributed \$5.3 million as determined by statutory calculation for administrative costs incurred by ADES for eligibility determination and other implementation costs of Proposition 204.

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

At June 30, 2005, AHCCCS recorded the following pass through revenue in the accompanying statement of revenues, expenditures and changes in fund balance - governmental funds:

	<b>Funds Passed Through</b>
Arizona School Districts	
Administrative Services Federal Funds	\$ 12,887
Program Services Federal Funds	58,109
Arizona Department of Economic Security	
County Contribution for Administrative Costs	5,567
Arizona Department of Health Services	
Cost reimbursement from Civil Monetary Penalties	221
	<b>\$ 76,784</b>

**(13) New pronouncements**

The Governmental Accounting Standards (GASB) has issued several pronouncements prior to June 30, 2005 that have effective dates that may impact future financial presentations.

In November 2003, the GASB issued Statement Number 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. This Statement establishes accounting and financial reporting standards for impairment of capital assets. A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. This Statement also clarifies and establishes accounting requirements for insurance recoveries. The provisions of this Statement are effective for fiscal periods beginning after December 15, 2004.

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2005  
(dollar amounts expressed in thousands)

**(13) New pronouncements (continued)**

In December 2004, the GASB issued Statement No. 46, *Net Assets Restricted by Enabling Legislation*. This Statement clarifies that a legally enforceable enabling legislation restriction is one that a party external to government – such as citizens, public interest groups, or the judiciary – can compel a government to honor. The Statement states that the legal enforceability of an enabling legislation restriction should be reevaluated if any of the resources raised by the enabling legislation are used for a purpose not specific by the enabling legislation or if a government has other cause for reconsideration. Although the determination that a particular restriction is not legally enforceable may cause a government to review the enforceability of other restrictions, it should not necessarily lead a government to the same conclusion for all enabling legislation restrictions. This Statement also specifies the accounting and financial reporting requirements if new enabling legislation replaces existing enabling legislation or if legal enforceability is reevaluated. Finally, this Statement requires governments to disclose the portion of total net assets that is restricted by enabling legislation. The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2005.

Management has not currently determined what impact, if any, these statements may have on the financial statements of AHCCCS.



**ADDITIONAL INFORMATION**

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2005  
(amounts expressed in thousands)

<u>Federal Grantor / Pass-Through Agency / Program</u>	<u>Federal CFDA Number</u>	<u>Federal Expenditures</u>
<b>U.S. Department of Health and Human Services</b>		
Centers for Medicare and Medicaid Services		
Medicaid Program (Title XIX)	93.779	
Federal funds expended to vendors		\$ 4,097,856
Federal funds expended to subrecipients		8,055
Payment Accuracy Measurement Project		<u>374</u>
		4,106,285
 Children's Health Insurance Program (Title XXI)	 93.767	 83,335
 Health Resources and Services Administration		
State Planning Grant - Health Care Access for the Uninsured	93.256	<u>39</u>
 <b>TOTAL EXPENDITURES OF FEDERAL AWARDS</b>		 <b>\$ 4,189,659</b>



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

To the Director of the

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

We have audited the financial statements of the **Arizona Health Care Cost Containment System (AHCCCS, an agency of the state of Arizona)** at June 30, 2005 and for the year then ended, and have issued our report thereon dated November 16, 2005. We conducted our audit in accordance with U.S. generally accepted auditing standards and the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States.

**Internal Control Over Financial Reporting**

In planning and performing our audit, we considered the **Arizona Health Care Cost Containment System's** internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operations that we consider to be material weaknesses.

**Compliance and Other Matters**

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

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

Phoenix, Arizona  
November 16, 2005

*Mayer Hoffman McCann P.C.*