ARIZONA HEALTH CARE
COST CONTAINMENT SYSTEM

FINANCIAL STATEMENTS
AND ADDITIONAL INFORMATION

Year Ended June 30, 2006

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MANAGEMENT'S DISCUSSION AND ANALYSIS

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For the Fiscal Year Ended June 30, 2006

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, 2006. 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, 2006 by $2.1 million (presented as "net assets"). AHCCCS' net assets at June 30, 2006 are comprised of the amount invested in capital assets of $2.9 million and an unrestricted net deficit of $885,000. The unrestricted net deficit is the result of a $3.9 million net deficit in the business-type activity, offset by unrestricted net assets of $3.0 million in the governmental-type activities. The unrestricted net assets of the general government activities of $3.0 million at June 30, 2006 are available to meet AHCCCS' ongoing general obligations to members and creditors.

Changes in Net Assets - AHCCCS' total net assets decreased for the fourth consecutive year. The fiscal year 2006 decrease is $7.4 million (a 78 percent decrease in total net assets from June 30, 2005) compared to the $1.7 million (14.9 percent) decrease in total net assets that occurred in fiscal year 2005. This decrease is primarily the result of a significant operating loss in AHCCCS' business-type activity. The key factor in the operating loss is the $8.6 million stop loss/stop gain contractual reconciliation of the managed care plan's capitation revenue to net medical costs. The reconciliation accrual exceeds the amount available in the financial stabilization reserves. Additional business-type activity contributing factors were continued start-up costs and a claims experience loss of $1.7 million associated with the introduction of a new Preferred Provider Organization (PPO) type insurance coverage plan. The start-up costs include the administrative infrastructure and Third Party Administrator contract for claims processing and access to an established statewide provider network. The initial premium rates were not sufficient to cover the higher than expected services utilization of the initial PPO plan membership. The governmental activities experienced a loss of $1.6 million from the transfer of certain telephone equipment to the Arizona Department of Administration (ADOA) in connection with the ADOA's project to consolidate statewide telecommunications assets.

Fund Level:

Governmental Funds - Fund Balances - As of the close of fiscal year 2006, AHCCCS' total governmental funds reported an ending fund balance of $2.3 million, a decrease of $0.8 million (a 25.6 percent decrease) in comparison with the prior fiscal year.

Proprietary Fund - Fund Balance - The proprietary fund reported a net deficit of $3.7 million at June 30, 2006, a decrease of $5.7 million (a 278 percent decrease from net assets of $2.1 million at June 30, 2005) in comparison with the prior fiscal year. In fiscal year 2006, the proprietary fund incurred a net operating loss of $6.2 million. In fiscal year 2005, the proprietary fund incurred a net operating loss of $4.8 million, which was net of a $3.7 million transfer from the General Fund to subsidize the proprietary fund operations in fiscal year 2005. In fiscal year 2006, a subsidy was not requested, and the premium rates and stabilization reserve collections have not been sufficient to cover operating activities. This has resulted in further erosion of the net assets and a net deficit position at the close of fiscal year 2006.

Future financial operations will be dependent on setting actuarially sound premium rates for the various plan options and sufficient enrollment growth. Management has developed plans to address these issues. However, there can be no assurance that these operating improvements will occur or will provide sufficient cash to fund operating expenses. Accordingly, the accompanying financial statements have been prepared assuming that the business-type activity will continue as a going concern. The matters discussed above raise substantial doubt about the business-type activity's ability to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification of asset carrying amounts or the amount and classification of liabilities that might result should the business-type activity be unable to continue as a going concern.

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 are 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 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" or in instances where liabilities exceed assets "net deficit." 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, business-type activity managed care health plans' stop loss reconciliations, and earned but unused vacation leave).

Both statements report two categories:

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

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

The government-wide financial statements can be found on pages 16 and 17.

Fund Financial Statements

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

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

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the State's near-term financial decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities. The basic governmental funds financial statements and related reconciliations can be found on pages 18 through 19 of this report.

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

Annually, the Legislature adopts an appropriated budget for AHCCCS for the acute care, (includes separate line item appropriations for the Acute Care Base, Proposition 204 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). In addition to the appropriation expenditure authority approved by the Legislature, AHCCCS also expends funds for other third party liability recovery and cost avoidance program activities and certain payments to hospitals for unfunded emergency department readiness costs and level 1 trauma center costs. These expenditures are financed by revenues specifically collected for those purposes and are by statute continuously appropriated. A budgetary comparison statement has been provided for the General Fund to demonstrate compliance with the budget on page 21.

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 22 through 24 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 25 to 39.

Government-Wide Financial Analysis

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

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

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
Current assets	$ 470,157	$ 415,858	$ 14,353	$ 13,076	$ 484,510	$ 428,934
Capital assets	2,758	5,009	152	193	2,910	5,202
Total assets	472,915	420,867	14,505	13,269	487,420	434,136
Current liabilities	467,160	413,460	16,048	11,205	483,208	424,665
Long-term liabilities	-	-	2,125	-	2,125	-
Total liabilities	467,160	413,460	18,173	11,205	485,333	424,665
Net assets (deficit):						
Invested in capital assets, net of depreciation	2,758	5,009	152	193	2,910	5,202
Restricted net assets	-	-	62	-	62	-
Unrestricted (deficit)	2,997	2,398	(3,882)	1,871	(885)	4,269
Total net assets (deficit)	$ 5,755	$ 7,407	$ (3,668)	$ 2,064	$ 2,087	$ 9,471

In the case of AHCCCS, assets exceeded liabilities by $2.1 million and $9.5 million at June 30, 2006 and 2005, respectively.

AHCCCS' total net assets balance at the close of the fiscal year is comprised entirely of its investment in capital assets (e.g. vehicles and equipment) for the agency as a whole. The $3.0 million net asset balance for governmental operations is offset by the $3.9 million unrestricted deficit in net assets of the business-type activities resulting in a net deficit in unrestricted net assets of $885,000. The net deficit in unrestricted net assets is offset by net assets of $2.9 million invested in capital assets.

For the governmental activity alone, net assets consist of cash available at the close of the fiscal year and its investment in capital assets. The unrestricted portion of the net assets at June 30, 2006 representing cash (40.7 percent) is available to pay administrative expenses in the next fiscal year. These balances are generally limited to future spending for certain information technology expenses and third party liability recovery and cost avoidance program activities. These uses conform to the legislative intent of the specific funds. AHCCCS uses its capital assets to provide services to its members and as such, these assts are not available for future spending.

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

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
Revenues						
Program Revenues						
Charges for services	$ 10,072	$ 8,743	$ 50,392	$ 33,616	$ 60,464	$ 42,359
Other operating grants and contributions	405,154	414,534	108	-	405,262	414,534
Federal operating grants	4,425,397	4,189,659	80	-	4,425,477	4,189,659
General revenues						
State appropriations	1,527,406	1,291,753	-	-	1,527,406	1,291,753
Tobacco tax	212,221	202,019	-	-	212,221	202,019
Unrestricted investment earnings	1,178	934	313	159	1,491	1,093
Total revenues	6,581,428	6,107,642	50,893	33,775	6,632,321	6,141,417
Expenses						
Health Care	6,549,155	6,072,917	56,625	38,460	6,605,780	6,111,377
Excess (deficiency) before transfers	32,273	34,725	(5,732)	(4,685)	26,541	30,040
Transfers	(33,925)	(35,396)	-	3,700	(33,925)	(31,696)
Increase (decrease) in net assets	(1,652)	(671)	(5,732)	(985)	(7,384)	(1,656)
Net assets – beginning of year	7,407	8,078	2,064	3,049	9,471	11,127
Net assets (deficit) – end of year	$ 5,755	$ 7,407	$ (3,668)	$ 2,064	$ 2,087	$ 9,471

At June 30, 2006, the governmental activities and the government-wide total ended with a positive net asset position. The business-type activity closed the fiscal year with a deficit net assets balance. In previous fiscal years, AHCCCS reported positive balances in all three categories of net assets for the Agency as a whole, as well as for its separate governmental and business-type activities. Overall, net assets decreased by $7.384 million, or 78.0 percent from net assets at June 30, 2005.

Governmental activities decreased AHCCCS' net assets by $1.652 million during fiscal year 2006. The decrease is primarily the result of a loss from the transfer of certain telephone equipment to the Arizona Department of Administration's project to consolidate statewide telecommunications assets. Business-type activities decreased net assets by $5.732 million. The decrease resulted primarily from claims loss and contractual stop/loss reconciliation costs in excess of premium collections. Additionally, administrative infrastructure expansion costs to increase PPO program enrollment and service the increase were not fully funded by the portion of premiums allocated to cover the administrative functions.

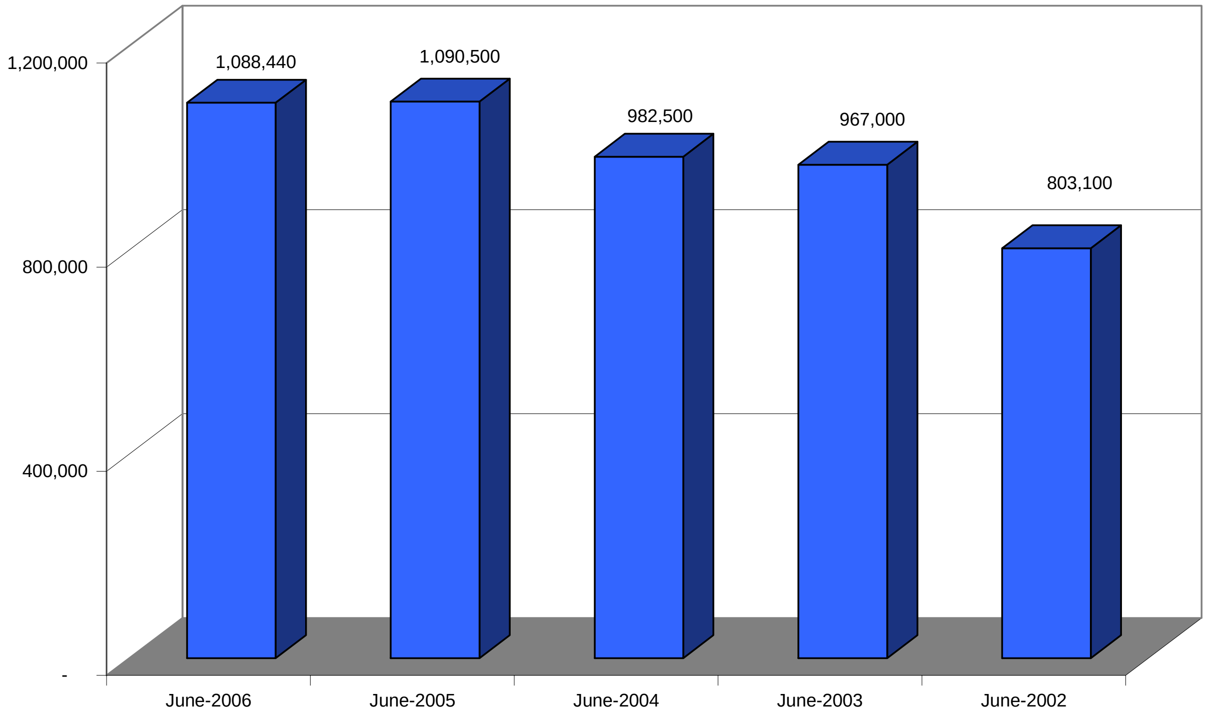
Governmental Activities

Governmental activities decreased AHCCCS' net assets by $1.652 million during fiscal year 2006. The decrease is primarily the result of a $1.6 million loss from the transfer of certain telephone equipment to the Arizona Department of Administration's project to consolidate statewide telecommunications assets.

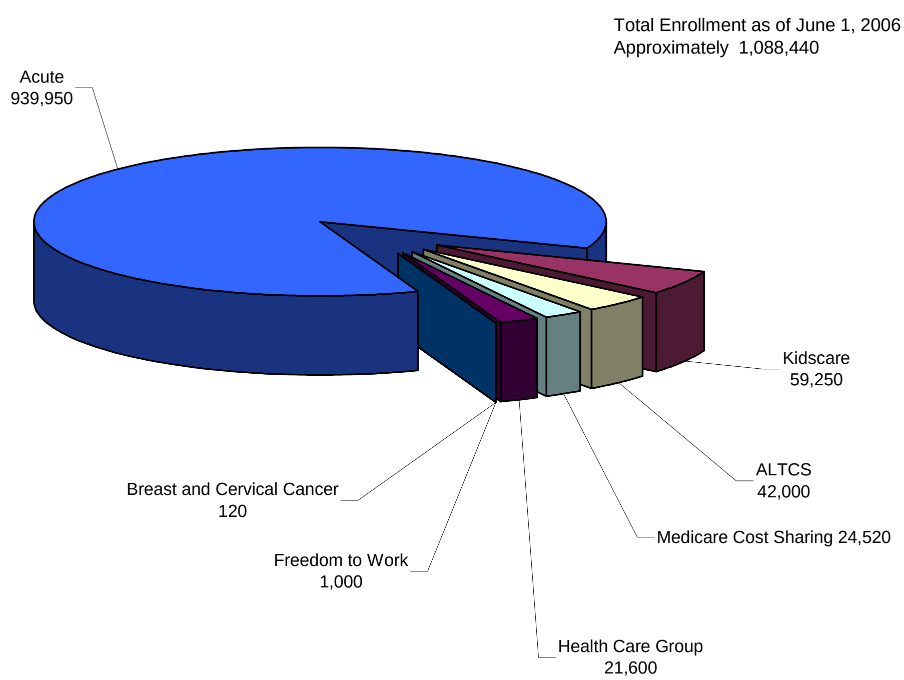
The overall program continued to see growth in program expenditures during fiscal year 2006. However, for the first time in five fiscal years, program enrollment decreased. The increase in program expenditures is primarily attributable to provider reimbursement inflation. The overall governmental activity population reached a high of 1,085,050 as of November 1, 2005 and steadily decreased through June 2006. Since March 1, 2001, just prior to the implementation of Proposition 204, the overall AHCCCS population has increased by 501,900 members to 1,088,440 as of June 1, 2006, including Healthcare Group, which equates to an 85.6 percent growth rate. Of this amount, 142,800 (28.5 percent of the total 85.6 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



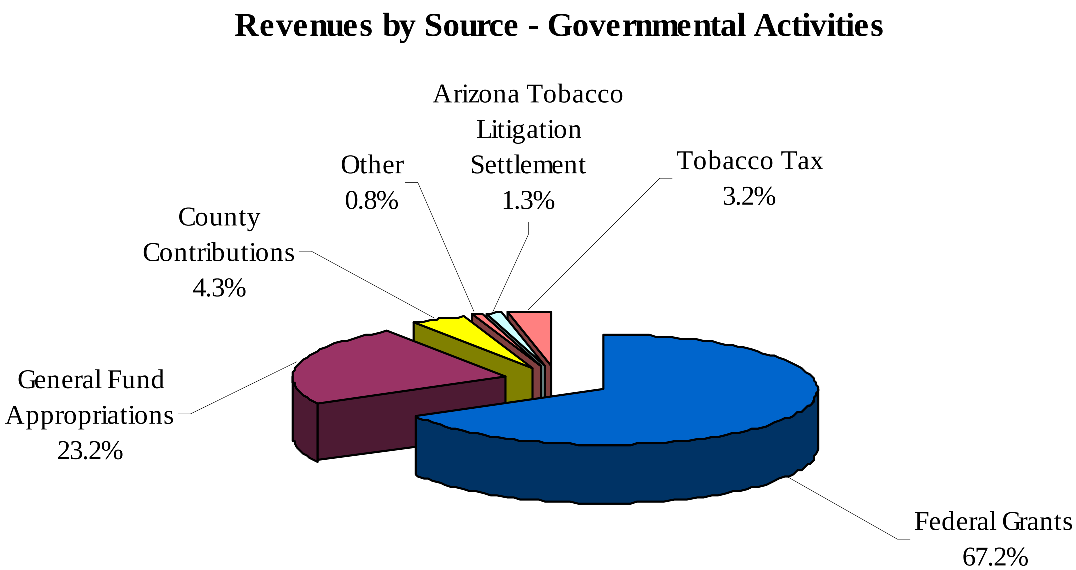
AHCCCS Enrollment by Program

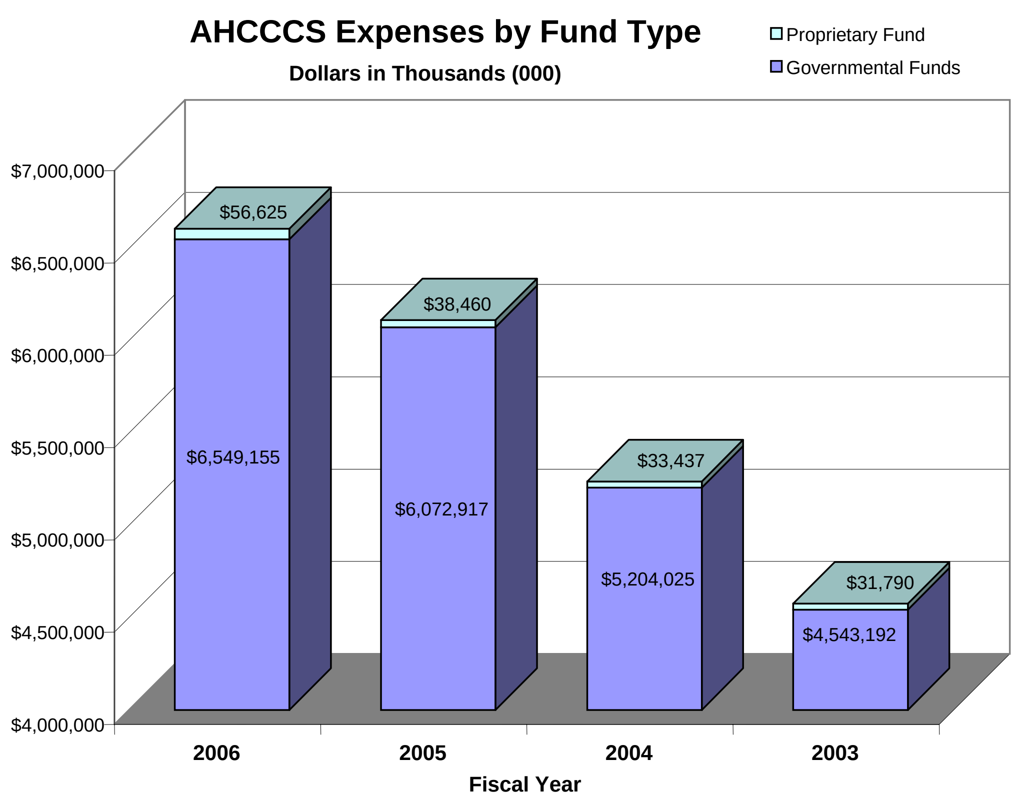


The cost of health care programs, including Title XIX Medicaid and Title XXI SCHIP, totaled $6,549.2 million in fiscal 2006, a $476.3 million increase over the $6,072.9 million reported in fiscal year 2005. As shown in the statement of activities, the amount of expenditures funded from federal grants through the Centers for Medicare and Medicaid Services (CMS) was $4,425.5 million (67.6 percent) in fiscal 2006 as compared to $4,189.7 million (68.6 percent) in fiscal 2005. Program funding in the form of federal financial participation is primarily determined through the Federal Medical Assistance Percentages (FMAP) used to provide the amount of federal matching for State medical assistance expenditures. The FMAP 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 decreased by 0.47 percent to 66.98 percent from the prior year's rate of 67.45 percent. This decrease resulted in a cost shift of approximately $30.8 million to State sources for fiscal year ended June 30, 2006. The overall increase in program expenditures can primarily be attributable to an average 6 percent capitation rate inflation growth across all capitated programs. Yearly capitation rate increases have averaged 7.6 percent over the last 5 years, with the lowest increase of 4.2 percent in fiscal year 2002 and the highest of 11.8 percent in fiscal year 2003.

State, county and miscellaneous funding sources combined to provide $2,156.0 million in State funding sources and appropriations in fiscal year 2006, a $238.0 million increase over the $1,918.0 million reported in fiscal year 2005. The following are the components of the State match funding sources. State General Fund revenues raised primarily in the form of income and sales taxes directed to AHCCCS amounted to $1,033.3 million and an additional $494.0 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 $281.1 million as determined by Statutory funding formulas and Session Law. Tax collections on tobacco products provided $212.2 million in State match funding. An additional $84.3 million in State revenue funding was provided by the annual payments to AHCCCS as administrator of the Tobacco Litigation Settlement Funds awarded to Arizona. These revenues are recorded in accordance with the Governmental Accounting Standards Board (GASB) Technical Bulletin No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues* which clarify how payments made to AHCCCS pursuant to the Master Settlement Agreement (MSA) with major tobacco companies are recorded. Payments are based on cigarette sales from the preceding year. AHCCCS has accrued $42.9 million for the period from January 1, 2006 through June 30, 2006 based on Arizona's Joint Legislative Budget Committee 2007 estimated payment. Tribal gaming receipts distributed to AHCCCS as determined by statutory formula and other sources provided an additional $50.9 million for payments to hospital emergency departments and level I trauma facilities.

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





Business-type Activities

The sole business-type activity for AHCCCS is the Healthcare Group (HCG). The HCG administers a 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. No subsidy was provided to Healthcare Group for fiscal year 2006. Additionally, employers must be without group health insurance for six months prior to being eligible for HCG coverage. Some hospitals that contract with HCG health plans have required higher reimbursement rates than AHCCCS fee for service rates. Hospital participation in HCG is not mandatory, and HCG health plans are not allowed to default to AHCCCS fee for service rates. HCG continues to adjust rates in an attempt to fully fund reinsurance payments to the participating health plans from premium collections. HCG is self funding its capital requirements from premiums collections. These rates are intended to eliminate the reliance on future State subsidies.

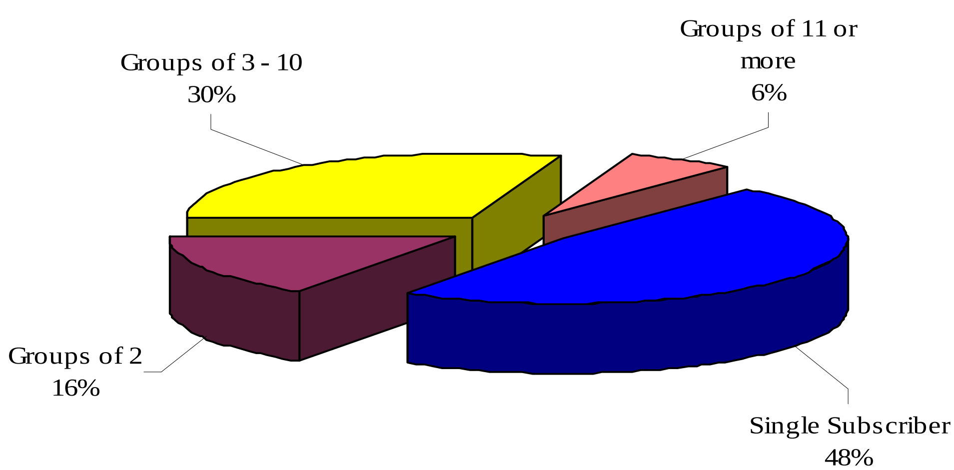
The HCG's projected final managed care plan's reinsurance expenses for the 2006 plan year comprise $8.63 million of the $9.018 million reported on the Statement of Revenues and Changes in Net Assets-Proprietary Fund. This is an increase of $4.69 million (119 percent) from the $3.94 million in reinsurance expenses in fiscal year 2005. 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 are reconciled on actual claims data rather than on accrued audited financial statements. A data warehouse has been developed to house the claims data and to facilitate the production of standard reporting. Reports are being generated to monitor medical cost trends and identify the cost drivers. Based on analysis of fiscal 2006 medical cost data, it is evident that the employer groups with only one subscriber member have generated a disproportionate medical cost in the first year of enrollment on the HCG health plan. In response to this trend, HCG created a separate employer group premium rate for these single subscriber member groups. This allows HCG to manage the adverse selection being experienced in the single subscriber groups separately from the groups with a larger number of subscriber members. Additionally, the six month bare period has also created a pent up demand phenomenon which has also exacerbated the medical cost associated with the new enrollment.

HCG offers a number of benefit and premium options and deductible plans. This allows employers and subscribers to choose their health plan network and premium rate. HCG has determined that some health plan benefits were adversely selected. Additionally, until the membership in HCG achieves enough critical mass, there will be large swings in medical cost trends in these new plans. While HCG membership is below that critical mass of enrollment, HCG will attempt to mitigate the adverse selection problem by combining several benefit management strategies with pricing changes. Finally, further development of the data warehouse analysis tools and capabilities is expected to enhance the development of pricing strategies, facilitate the medical management process, and therefore, reduce reinsurance expenses and the need for future subsidies. Currently, a percentage of premiums (ranging from 5 to 10 percent) are allocated to a stabilization reserve, which is used 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. The percentage is actuarially determined and may vary by product and health plan. Claims data is monitored, and reserve requirements are adjusted as necessary.

As previously noted, the business-type activity decreased AHCCCS' net assets by $5.7 million. The decrease resulted primarily from the increase in reinsurance expense mentioned above, along with startup costs and claims associated with the introduction of the new PPO product. The administrative business infrastructure, primarily personnel, was expanded (approximately 20 people) to generate and support fiscal 2006 enrollment growth. These resources were directed toward management of medical costs, new product development, and the expansion of provider networks statewide. The cost of the additional personnel necessary to support the PPO program operations and reconcile claims will initially be funded by amending the health plan contracts to include PPO program administrative operations and claim costs as authorized allocations from the stabilization reserves monies previously established to fund the stop loss reconciliations. In the future, these costs should be offset by reduced medical expenses due to the implementation of medical management strategies, as well as increased enrollment from rural counties previously not covered by HCG health plans and provider networks. If the projected enrollment growth, across-the-board premium increases planned for January 1, 2007, and benefit plan modifications are not sufficient to fund the reserves for past losses and future stop-loss and claims experience costs, then HCG will scale back and/or defer administrative expenditures to the level supported by actual enrollment and/or require health plan contractors to pick up a greater portion of the medical cost risk. Successful implementation of these management actions should mitigate the need for a subsidy from the General Fund to cover these operating costs. Based on premiums collected and allocated for administrative costs, an enrollment growth of 20 percent to 26,000 members by June 2007 is necessary to sustain the fiscal year 2007 overall administrative budget of $8.3 million. Should this enrollment growth not be achieved, HCG would scale back administrative expenditures to the level supported by actual enrollment. Implementation of HCG's marketing plan has reversed the declining enrollment trend from prior years. In fiscal year 2005/2006 enrollment in both HMO and PPO increased to 21,600, a 48 percent increase from the previous fiscal year's enrollment of 14,600. This is an improvement from the 30.4 percent increase in fiscal 2005 and a significant improvement from the 1.8 percent decline in the previous year. Dental and Vision programs were also introduced during fiscal year 2006. Enrollment at June 30, 2006 was 7,800 in the Dental program and 6,000 in the Vision Program. These two programs contributed $464,500 of program revenue during fiscal year 2006.

Medical Enrollment by Group Size as of June, 2006



Financial Analysis of AHCCCS' Governmental Funds

Governmental Funds

At the end of fiscal year 2006, AHCCCS' governmental funds reported combined ending fund balances totaling $2.343 million, a decrease of $808,000 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, contribution from Arizona counties and federal Title XIX and Title XXI revenue.

The Other Governmental Funds consist of six individual funds that have a combined total fund balance of $2.343 million available to meet future year obligations. The Other Governmental Fund's fiscal year-end available cash balance is $2.343 million and represents all of the total governmental fund's unrestricted fund balance and primarily consists of balances in the Hawaii Arizona PMMIS Alliance Fund and the Third Party Liability Fund. The balances for the two main funds that comprise the majority of the total 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 $5.879 million was used to offset the General Fund appropriation accrual for IBNR programmatic claims and, accordingly, reports a zero ending fund balance. Revenue from taxes on cigarettes and other related tobacco products increased 5 percent over fiscal year 2005 and generated $148.1 million for the current year and accounts for 83.2 percent of the total Other Governmental Funds revenues compared to 84.4 percent of the total Other Governmental Funds revenues in the prior fiscal year.

General Fund Budgetary Highlights

Differences totaling $18.984 million occurred between the original and the final amended administrative and programmatic expenditure budgets. A $16.2 million supplemental appropriation was provided for the Disproportionate Share Hospital program, and a $2.8 million supplemental appropriation increase for the general salary increase was provided during fiscal year 2006. 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:

- $13.69 million decrease to Acute Capitation
- $77.88 million decrease to Proposition 204 Capitation
- $ 9.02 million increase to Base and Proposition 204 Medicare
- $ 8.14 million increase to SCHIP and SCHIP Parents services
- $21.87 million increase to Proposition 204 fee-for-service payments
- $41.48 million increase to Base and Proposition 204 Reinsurance
- $17.03 million increase to all other Special Line Items
- $13.01 million increase to Administration – Medicare Clawback payments

At June 30, 2006, actual cash basis expenditures were $225.49 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, 2006 amount to $2.910 million, net of accumulated depreciation. This investment in capital assets includes furniture, vehicles and equipment. Land, buildings and improvements are under the management of the State and are accounted for on the State's comprehensive annual financial report. Purchases include the normal planned retirement and replacement of automated systems equipment and vehicles. The total decrease in AHCCCS' investment in capital assets for the current fiscal year was 44.1 percent or $2.292 million. The decrease primarily resulted from a loss of $1.6 million from the transfer of certain telephone equipment to the Arizona Department of Administration's project to consolidate statewide telecommunications assets.

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

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
Vehicles	$ 638	$ 355	$ 39	$ -	$ 677	$ 355
Furniture and equipment	2,120	4,654	113	193	2,233	4,847
Total net assets	$ 2,758	$ 5,009	$ 152	$ 193	$ 2,910	$ 5,202

Additional information on AHCCCS' capital assets can be found in Note 2 to the accompanying financial statements on pages 30-31.

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 four limit periods ended September 30, 2005, which is the last full reporting period, is 0.5 percent. As of June 30, 2006, reported date of service expenditures associated with the three periods ended September 30, 2005 are below the limit by $157.9 million, or 1.59 percent. The fifth (final) Budget Neutrality period under the current Waiver does not end until September 30, 2006. Through June 30, 2006, AHCCCS remains under the cumulative reporting limit threshold.

During the current fiscal year, enrollment growth decreased by less than 1 percent excluding the business-type activity. In fiscal year 2005, enrollment growth was 11.0 percent. Total enrollment at June 1, 2006 was 1,088,440 as compared to 1,090,500 at June 1, 2005, a decrease of 2,060 members. Projections prepared as part of the AHCCCS fiscal year 2008 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

The AHCCCS program experienced a slight decline in enrollment for the first time in the previous five fiscal years. Enrollment for all government-wide programs decreased at a rate of 0.2 percent during fiscal year 2006. The overall change was the net result of significant growth in the Title XXI KidsCare and KidsCare Parents programs (15.9 percent combined) and the business-type HCG (47.6 percent) programs offset by a considerable decrease of 2.4 percent in the Title XIX populations that comprise the majority of AHCCCS' program enrollment. AHCCCS expects enrollment to continue to decline for the key population groups through calendar year 2006 and is only projecting conservative growth through fiscal year 2007. Arizona's relatively healthy economic conditions appear to be a key factor in AHCCCS' enrollment decline. However, there could be an impact on the Arizona economy and caseload growth if the current real estate downturn does not achieve the projected "soft landing".

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 inpatient services (39 percent), physician services costs (20 percent), and pharmacy (10 percent). The contract year 2007 capitation rate increases resulted in a weighted average increase of 5.6 percent (5.9 percent for Acute Care, 4.8 percent for Long-Term Care). Additional issues that contributed to capitation costs in fiscal year 2007 included increases in rural health care costs due to physician and specialty shortages, inpatient reimbursement rate increases and new and more expensive health care technologies.

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, 2007. This program is providing health care to an estimated 14,900 Arizonans and contributes to reducing the uninsured in Arizona and encourages coverage of children by enrolling entire families. Ending this program may result in Arizona not maximizing its Title XXI SCHIP federal allotment.

AHCCCS' budget request for fiscal year 2008 submitted to the Governor in September 2006 includes a rebase of the fiscal year 2007 budget. Overall appropriations appear adequate for the fiscal year. Management is monitoring the favorable enrollment trends and the adequacy of fiscal year appropriations.

Request for Information

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

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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, 2006, as shown on pages 14 through 24. 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, 2006, 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, 2006, and the respective changes in financial position and cash flows, where applicable, thereof and the respective budgetary comparison for the general fund for the year then ended in conformity with U.S. generally accepted accounting principles.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated November 6, 2006 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 13 and the budgetary comparison information on page 19 are not a required part of the basic financial statements but are supplementary information required by U.S. generally accepted auditing standards and the Governmental Accounting Standards Board (GASB). We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

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

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

Mayer Hoffman McCann P.C.

Phoenix, Arizona
November 6, 2006

BASIC FINANCIAL STATEMENTS

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET ASSETS (DEFICIT)

June 30, 2006
(amounts expressed in thousands)

ASSETS	Governmental Activities	Business-type Activities	Total
CURRENT ASSETS			
Cash	$ 72,518	$ 14,338	$ 86,856
Restricted cash	20,621	-	20,621
Due from state and county governments	48,194	-	48,194
Due from the federal government	285,731	-	285,731
Tobacco settlement receivable	42,907	-	42,907
Receivables and other	186	15	201
TOTAL CURRENT ASSETS	470,157	14,353	484,510
CAPITAL ASSETS			
Furniture, vehicles and equipment, net of accumulated depreciation	2,758	152	2,910
TOTAL ASSETS	472,915	14,505	487,420
LIABILITIES			
CURRENT LIABILITIES			
Accounts payable	8,089	456	8,545
Other accrued liabilities	3,478	129	3,607
Deferred revenue	21,581	8,097	29,678
Due to federal, state and county governments	42,962	65	43,027
Accrued programmatic costs	388,457	7,249	395,706
Current portion of compensated absences	2,593	52	2,645
TOTAL CURRENT LIABILITIES	467,160	16,048	483,208
ACCRUED PROGRAMMATIC COSTS, less current portion	-	2,125	2,125
TOTAL LIABILITIES	467,160	18,173	485,333
COMMITMENTS AND CONTINGENCIES			
NET ASSETS (DEFICIT)			
INVESTED IN CAPITAL ASSETS	2,758	152	2,910
RESTRICTED NET ASSETS OTHER PURPOSES	-	62	62
UNRESTRICTED (DEFICIT)	2,997	(3,882)	(885)
TOTAL NET ASSETS (DEFICIT)	$ 5,755	$ (3,668)	$ 2,087

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF ACTIVITIES

Year Ended June 30, 2006
(amounts expressed in thousands)

		Program Revenues			Net (Expense) Revenue and Changes in Net Assets		
	Program Expenses	**Charges for Services**	**Federal Operating Grants**	**Other Operating Grants and Contributions**	**Governmental Activities**	**Business-type Activities**	**Total**
PROGRAMS							
Government activities:							
Health care programs	$ 6,549,155	$ 10,072	$ 4,425,397	$ 405,154	$ (1,708,532)	$ -	$ (1,708,532)
Business-type activities:							
Healthcare Group	56,625	50,392	80	108	-	(6,045)	(6,045)
TOTAL PROGRAMS	$ 6,605,780	$ 60,464	$ 4,425,477	$ 405,262	(1,708,532)	(6,045)	(1,714,577)
General revenues:							
State appropriations					1,527,406	-	1,527,406
Tobacco tax					212,221	-	212,221
Unrestricted investment earnings					1,178	313	1,491
					1,740,805	313	1,741,118
Transfers:							
Transfers in					610	-	610
Transfers out					(34,535)	-	(34,535)
Total general revenues and transfers					1,706,880	313	1,707,193
CHANGE IN NET ASSETS (DEFICIT)					(1,652)	(5,732)	(7,384)
NET ASSETS, BEGINNING OF YEAR					7,407	2,064	9,471
NET ASSETS (DEFICIT), END OF YEAR					$ 5,755	$ (3,668)	$ 2,087

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BALANCE SHEET - GOVERNMENTAL FUNDS

June 30, 2006
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
ASSETS			
Cash	$ 57,229	$ 15,289	$ 72,518
Restricted cash	19,326	1,295	20,621
Due from state and county governments	13,108	16,603	29,711
Due from the federal government	106,802	-	106,802
Due from other funds	16,050	-	16,050
Receivables and other	186	-	186
TOTAL ASSETS	$ 212,701	$ 33,187	$ 245,888
LIABILITIES			
Accounts payable	$ 7,027	$ 1,062	$ 8,089
Other accrued liabilities	3,239	239	3,478
Deferred revenue	20,675	906	21,581
Due to federal, state and county governments	42,644	317	42,961
Due to other funds	-	16,050	16,050
Accured programmatic costs	139,116	12,270	151,386
TOTAL LIABILITIES	212,701	30,844	243,545
COMMITMENTS AND CONTINGENCIES			
FUND BALANCES			
Unreserved	-	2,343	2,343
TOTAL FUND BALANCES	-	2,343	2,343
TOTAL LIABILITIES AND FUND BALANCES	$ 212,701	$ 33,187	

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

Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds.	$ 2,758
Governmental funds report capital outlays as expenditures. However, in the statement of activities the cost of these assets is allocated over their estimated useful lives and reported as depreciation expense. This is the amount by which depreciation $1,457 exceeded capital outlays ($803) in the current fiscal year.	654
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.	(2,593)
Long-term receivables, offsetting the above accrued paid time off liability, which are not receivable in the current fsical year and, therefore, are not reported in the funds.	2,593
Long-term accrued liabilities for programmatic costs are not due and payable from current financial resources and, therefore are not reported in the funds.	237,071
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.	(237,071)
NET ASSETS OF GOVERNMENTAL ACTIVITIES	$ 5,755

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

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

Year Ended June 30, 2006
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
REVENUES			
State government:			
Appropriations	$ 971,112	$ -	$ 971,112
Pass through funds	494,054	-	494,054
Federal government:			
Acute care	2,576,439	435	2,576,874
Long-term care	603,843	-	603,843
Pass through funds	1,066,799	-	1,066,799
County government:			
Acute care	62,636	-	62,636
Long-term care	214,892	-	214,892
Pass through funds	3,557	-	3,557
Tobacco litigation settlement revenue	86,231	-	86,231
Tobacco tax revenue	64,078	148,143	212,221
Gaming revenue	-	21,029	21,029
Intergovernmental agreement revenue	-	6,991	6,991
Premium revenue	10,072	-	10,072
Other	11,513	1,384	12,897
TOTAL REVENUES	6,165,226	177,982	6,343,208
PROGRAMMATIC EXPENDITURES			
Capitation:			
Acute care	2,673,203	99,344	2,772,547
Long-term care	1,466,193	-	1,466,193
Children's Rehabilitative Services	59,653	-	59,653
Mental health services	813,818	-	813,818
Fee-for-service:			
Acute care	481,635	3,896	485,531
Long-term care	74,213	-	74,213
Trauma center services	-	21,179	21,179
Disproportionate share	138,354	-	138,354
Graduate medical education	21,820	-	21,820
Reinsurance	91,251	367	91,618
Medicare:			
Acute care premiums	95,763	7,708	103,471
Long-term care premiums	26,736	-	26,736
Part D clawback payments	25,210	-	25,210
Payments to counties	4,826	-	4,826
TOTAL PROGRAMMATIC EXPENDITURES	5,972,675	132,494	6,105,169
ADMINISTRATIVE EXPENDITURES	184,462	9,366	193,828
ADMINISTRATIVE EXPENDITURES PASSED THROUGH	11,094	-	11,094
TOTAL EXPENDITURES	6,168,231	141,860	6,310,091
EXCESS OF REVENUES OVER EXPENDITURES	(3,005)	36,122	33,117
OTHER FINANCING SOURCES (USES)			
Transfers out:			
From Tobacco Product Tax 204 Protection	-	(2,395)	(2,395)
To Arizona Department of Economic Security		11	11
To Arizona Department of Health Services	-	(33,825)	(33,825)
To Arizona Department of Health Services Health Crisis Fund	-	(721)	(721)
Transfers in:			
From Governor Office	10	-	10
From Tobacco Product Tax 204 Protection	2,395		2,395
From Arizona Department of Health Services Health Crisis Fund	150	-	150
From Arizona Department of Health Services Project 211	450	-	450
TOTAL OTHER FINANCING SOURCES (USES)	3,005	(36,930)	(33,925)
NET CHANGE IN FUND BALANCES	-	(808)	(808)
FUND BALANCES, BEGINNING OF YEAR	-	3,151	3,151
FUND BALANCES, END OF YEAR	$ -	$ 2,343	$ 2,343

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, 2006
(amounts expressed in thousands)

Amounts reported for governmental activities in the statement of activities (page 17) are different because:

Net change in fund balance - total governmental funds (page 18)	$	(808)
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.		753
Governmental funds report capital assets as current year 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 net value (purchase price $1,996 less accumulated depreciation $399) for telecommunications equipment transfered to another State agency as part of a consolidation project.		(1,597)
Change in net assets of governmental activities (page 17)	$	(1,652)

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BUDGETARY COMPARISON SCHEDULE - GENERAL FUND

Year Ended June 30, 2006
(Unaudited)
(amounts expressed in thousands)

	Original Appropriation (Budget)	Final Appropriation (Budget)	Actual	Variance with Final Budget
REVENUES				
State appropriations	$ -	$ -	$ 1,028,797	$ -
State pass-through funds	-	-	554,086	-
Federal government	-	-	3,341,992	-
Federal pass-through funds	-	-	1,001,103	-
County government	-	-	287,438	-
County pass-through funds	-	-	-	-
Tobacco tax revenue	-	-	63,697	-
Tobacco litigation settlement	-	-	86,231	-
Other	-	-	12,487	-
Total revenues	-	-	6,375,831	-
OTHER FINANCING SOURCES				
Operating transfers in	-	-	11,155	-
TOTAL REVENUES AND OTHER FINANCING SOURCES	-	-	6,386,986	-
PROGRAMMATIC EXPENDITURES				
Acute capitation	1,629,013	1,615,322	1,615,030	292
Reinsurance	93,259	105,830	85,000	20,830
Acute fee-for-service	436,340	435,208	403,425	31,783
Proposition 204 capitation	973,089	895,213	890,268	4,945
Proposition 204 reinsurance	80,354	109,260	79,157	30,103
Proposition 204 fee-for-service	139,160	161,028	130,817	30,211
Proposition 204 Medicare premiums	15,972	16,097	15,962	135
Medicare premiums	70,550	79,441	79,430	11
Graduate medical education	21,820	21,820	21,820	-
Disproportionate share	122,192	138,354	112,207	26,147
Rural hospital reimbursement	12,158	12,158	12,158	-
Breast and cervical cancer	732	702	554	148
Critical access hospitals	1,700	1,702	1,700	2
Freedom to work	5,076	5,309	5,141	168
County hold harmless	4,826	4,826	4,826	-
Long-term care	999,657	994,278	925,170	69,108
CHIP - Services	84,747	88,637	88,325	312
CHIP - Parents	37,781	42,031	41,821	210
TOTAL PROGRAMMATIC EXPENDITURES	4,728,426	4,727,216	4,512,811	214,405
ADMINISTRATIVE EXPENDITURES	170,052	190,246	179,160	11,086
OPERATING TRANSFERS OUT	-	-	-	-
TOTAL APPROPRIATED EXPENDITURES	4,898,478	4,917,462	4,691,971	225,491
PRIOR YEAR APPROPRIATED EXPENDITURES	-	-	106,268	-
NON-APPROPRIATED EXPENDITURES	-	-	1,563,244	-
REVENUES AND OTHER FINANCING SOURCES OVER (UNDER) EXPENDITURES	-	-	25,503	-
FUND BALANCES, BEGINNING OF YEAR	-	-	43,754	-
FUND BALANCES, END OF YEAR	$ -	$ -	$ 69,257	$ -

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET ASSETS (DEFICIT) - PROPRIETARY FUND

June 30, 2006
(amounts expressed in thousands)

ASSETS		
CURRENT ASSETS		
Cash	$	14,338
Receivables and other		15
TOTAL CURRENT ASSETS		14,353
CAPITAL ASSETS		
Furniture, vehicles and equipment, net of accumulated depreciation		152
TOTAL ASSETS	$	14,505
LIABILITIES		
CURRENT LIABILITIES		
Accounts payable	$	456
Other accrued liabilities		129
Deferred revenue - premiums		8,097
Due to state general fund		65
Accrued programmatic costs		7,249
Compensated absences due within one year		52
TOTAL CURRENT LIABILITIES		16,048
ACCRUED PROGRAMMATIC COST, less current portion above		2,125
TOTAL LIABILITIES	$	18,173
COMMITMENTS AND CONTINGENCIES		
NET ASSETS (DEFICIT)		
INVESTED IN CAPITAL ASSETS	$	152
RESTRICTED NET ASSETS OTHER PURPOSES		62
UNRESTRICTED		(3,882)
TOTAL NET ASSETS (DEFICIT)	$	(3,668)

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

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

Year Ended June 30, 2006
(amounts expressed in thousands)

OPERATING REVENUES	
Premium revenue	$ 50,392
OPERATING EXPENSES	
Premiums paid to health plans	40,143
Reinsurance	9,018
Other programmatic	2,193
Salaries and employee benefits	2,462
Professional and outside services	2,019
Other	668
Loss on transfer of assets	96
Depreciation	26
TOTAL OPERATING EXPENSES	56,625
OPERATING LOSS	(6,233)
NONOPERATING REVENUE	
Investment income	313
Grant revenue	188
TOTAL NONOPERATING REVENUE	501
CHANGE IN NET ASSETS	(5,732)
NET ASSETS, BEGINNING OF YEAR	2,064
NET ASSETS (DEFICIT), END OF YEAR	$ (3,668)

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF CASH FLOWS - PROPRIETARY FUND

Year Ended June 30, 2006
(amounts expressed in thousands)

CASH FLOWS FROM OPERATING ACTIVITIES	
Receipts from customers	$ 51,769
Payments to health plans	(44,782)
Payments to providers	(1,141)
Payments to employees	(2,491)
Payments to suppliers	(2,570)
Net cash provided by operating activities	785
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
Operating subsidies from other funds	3,480
Grant revenue	188
Net cash provided by non-capital financing activities	3,668
CASH FLOWS FROM INVESTING ACTIVITIES	
Payments for capital assets	(82)
Interest	313
Net cash provided by investing activities	231
NET CHANGE IN CASH	4,684
CASH, BEGINNING OF YEAR	9,654
CASH, END OF YEAR	$ 14,338

RECONCILIATION OF OPERATING LOSS TO NET CASH USED IN OPERATING ACTIVITIES	
Operating loss	$ (6,233)
Adjustment to reconcile operating loss to net cash provided by operating activities:	
Depreciation	26
Loss on transfer of asset	96
Changes in operating net assets and liabilities:	
Increase in accounts payable and other accrued liabilities	121
Increase in deferred revenue - premiums	1,377
Increase in accrued programmatic costs	5,427
Decrease in accrued compensated absences	(29)
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 785

(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 ("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 program 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, individuals who are aged, blind or disabled, children who meet certain age requirements from families receiving food stamps, children and pregnant women whose household income meets eligibility requirements, certain single adults, childless couples, parents of SCHIP and Medicaid children under the Health Insurance Flexibility and Accountability Demonstration initiative, uninsured women needing active treatment for breast and/or cervical cancer and individuals with disabilities who want to work and who meet certain SSI eligibility criteria.

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

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

(1) Summary of significant accounting policies (continued)

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

Fund financial statements provide information about the Agency's funds. Separate financial statements are provided for the governmental and proprietary funds. The General Fund is the Agency's primary operating fund, and it accounts for all financial resources except those required to be accounted for in another fund. AHCCCS has one business-type activity, Healthcare Group. In fiscal year 2006, 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 medical services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

Proprietary fund revenues are recognized when they are earned, and expenses are recognized when they are incurred. Member premiums are due by the first day of the month preceding the month of coverage. At June 30, 2006, the proprietary fund deferred revenue of $8,097 consists of premium payments received for fiscal year 2007 as required by contract.

The governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, AHCCCS considers revenue to be available if they are collected within 31 days of the end of the current fiscal year. The governmental funds deferred revenue consists of county contributions for July 2006 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.

(1) Summary of significant accounting policies (continued)

In fiscal year 2006, 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.

c. The Healthcare Group fund, reported as a business-type activity, accounts for the activities of a 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 $107,477 at June 30, 2006 including restricted funds of $20,621.

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 $19,326 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 $1,295 for the Hawaii Arizona PMMIS Alliance (HAPA) Fund, as described in Note 4 and is offset by an equal amount of deferred revenue at June 30, 2006.

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, 2006, no bank overdraft existed.

(1) Summary of significant accounting policies (continued)

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 or risk sharing reconciliations.

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, 2006. AHCCCS reconciles the actual PPC medical costs to the PPC capitation paid during the contract year. The reconciliation limits the contractor's profits and losses to 2%. Accrued programmatic costs include approximately $13,311 at June 30, 2006 that represents 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 contract year. The reconciliation limits the contractor's profits or losses to 2%. At June 30, 2006, AHCCCS recorded as a receivable approximately $17,018 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. This reinsurance provides partial reimbursement of reinsurance eligible covered services and will reimburse 75% of eligible costs above the deductible level up to $650 of covered expenses and 100% thereafter. The deductible is the responsibility of the contracted health plan.

The reinsurance program also provides reimbursement for covered organ transplantation and catastrophic disorders such as certain brain injuries and blood related disorders. For transplants, payment is limited to 85% of the AHCCCS contract amount for the transplant services rendered or 85% of the health plans' paid amount, whichever is lower. There is no deductible for catastrophic reinsurance cases and AHCCCS reimburses the health plans at a percentage of the health plans' paid amount, less the coinsurance amount, unless the costs are paid under a subcapitated arrangement. AHCCCS pays 85% of the health plans' paid amount up to $650 of covered expenses and 100% thereafter for catastrophic reinsurance.

(1) Summary of significant accounting policies (continued)

G. Fee-for-service payments

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

The ESP provides for emergency medical care to persons who are not eligible for full AHCCCS coverage due to their lack of United States citizenship or lawful alien status. Outpatient medical services for the ESP and for members enrolled in a health plan for less than 30 days are reimbursed using the AHCCCS Outpatient Hospital Fee Schedule for dates-of-service after July 1, 2005. For dates-of-service prior to July 1, 2005, these services are reimbursed using the AHCCCS Outpatient Hospital Fee Schedule or at the state-wide cost to charge ratio. 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 $138,354 for the year ended June 30, 2006.

J. Taxes

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

(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

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, 2006, 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.

In January 2001, AHCCCS obtained a Waiver from CMS to receive federal funding for certain non-categorically linked populations including those made eligible by the passage of Proposition 204. The Waiver requires that over the term of the agreement the populations covered by the Waiver be budget neutral for CMS. The Waiver period for budget neutrality began April 1, 2001 and extends through federal fiscal year 2006, at which time any federal funds received by the State that exceed the negotiated budget neutrality limit must be returned to CMS. Because AHCCCS does not project expenditures in excess of the budget neutrality limit, no liability 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 $85,176 in April 2006 for the period from January 1, 2005 to December 31, 2005 and a supplemental payment in the amount of $1,055 in October 2005. Revenue and a related receivable of $42,907 was accrued for the period of January 1, 2006 through June 30, 2006 and is included in Tobacco Settlement Receivable and Other Operating Grants and Contributions 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, 2005	$ 5,202
Additions	884
Retirements	(1,786)
Depreciation	(1,390)
Balance, June 30, 2006	$ 2,910

(dollar amounts expressed in thousands)

(2) Capital assets (continued)

Net capital assets totaling approximately $1,693 were transferred to the Arizona Department of Administration as part of the telecommunication consolidation project in fiscal year 2006. This transfer was recorded as a loss on disposal and is included within program expenses in the accompanying Statement of Activities.

AHCCCS accounts for capital assets in accordance with the provisions of GASB Statement No. 42, Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries. GASB Statement No. 42 requires that capital assets be reviewed for impairment whenever events or changes in circumstances indicate a significant, unexpected decline in the service utility of a capital asset. If such assets are considered to be impaired and are still in use, the impairment can be recognized using the following methods: restoration cost approach, service unit approach, and a deflated depreciated replacement cost approach. If such assets are considered to be impaired and are no longer used, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. At June 30, 2006, management does not believe impairment indicators are present, and there were no idle capital assets.

(3) Compensated absences

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

Balance, June 30, 2005	$ 2,932
Additions	5,004
Reductions	(5,291)
Balance, June 30, 2006	$ 2,645

(4) Other governmental funds

At June 30, 2006, the other governmental fund balance of $2,343 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.

(dollar amounts expressed in thousands)

(4) Other governmental funds (continued)

- 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 provides data processing services for Hawaii's Medicaid program.

Other governmental funds earned, expended and transferred during the fiscal year ended June 30, 2006 were as follows:

	TTHCF - MNA	TPTF - EHSA	Third Party Liability Fund	Trauma and Emergency Services Fund	Miscel-laneous Funds	Total
Fund balances, June 30, 2005	$ -	$ -	$ 1,800	$ -	$ 1,351	$ 3,151
Receipts	117,763	30,381	1,154	21,029	7,286	177,613
Interest earned	50	52	74	150	44	370
Expenditures	(83,278)	(28,038)	(2,421)	(21,179)	(6,945)	(141,861)
Transfers in (out):						
Tobacco Product Tax 204 Protection		(2,395)	-	-	-	(2,395)
Arizona Dept of Health Services	(33,825)	-	-	-	-	(33,825)
ADHS Health Crisis Fund	(721)	-	-	-	-	(721)
Arizona Dept of Economics Security	11	-	-	-	-	11
Fund balances, June 30, 2006	$ -	$ -	$ 607	$ -	$ 1,736	$ 2,343

(5) Proprietary fund - operations

The Healthcare Group was established in 1988 by the State to administer medical coverage primarily to small, uninsured businesses with 1 to 50 employees and employees of political subdivisions. Healthcare Group Administration (HCG) contracted with three health plans from the existing network of AHCCCS health plans to enroll members and provide managed care services. HCG added a PPO option for fiscal year 2006 through a third party administrator. HCG conducts premium billing, collections, fund disbursement and data analysis. HCG is responsible for the regulatory oversight of the health plans.

In connection with the offering of new products, HCG has established a premium stabilization reserve funded by member premiums. The premium stabilization reserve is intended 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 cash balance in the premium stabilization reserve was approximately $4.646 at June 30, 2006.

(5) Proprietary fund – operations (continued)

Contracted health plans are paid on a capitated basis. Capitation is paid prospectively as well as for prior period coverage. The risk is shared by both the contracted health plans and AHCCCS for the contract year ended June 30, 2006. HCG reconciles the contracted health plans' actual medical expenses reported to capitation paid by HCG to the contracted health plans during the contract year. This stop loss reconciliation is used to determine any additional payments to be paid by HCG. Such amounts are limited based on the contracted health plan's medical loss ratio. Accrued programmatic costs include approximately $8.678 million at June 30, 2006 that represent estimated settlement payments due to contracted health plans based on the reconciliations prepared at June 30, 2006. Approximately $1.708 million of this total relates to two contracted health plans and will be paid in December 2006. However, due to HCG's declining financial condition (see Note 6) and the inadequacies of the premium stabilization reserve, HCG was required to negotiate payment terms with one contracted health plan to repay the amount due over the next two fiscal years. Under this payment arrangement which bears interest at 1%, HCG will pay approximately $4.845 million in fiscal 2007 and $2.125 million in fiscal 2008.

In fiscal year 2005, HCG received a $3.7 million transfer from the General Fund to subsidize HCG's administrative and reinsurance costs. There was no General Fund appropriation to subsidize HCG's operations in fiscal year 2006; thus HCG revised premium rates in an effort to cover the projected increase in administrative costs and fund the premium stabilization reserve. However, the increase in premium rates and stabilization reserve collections have not been sufficient to cover operating activities. This has resulted in a continued decrease in HCG's net assets. Future financial operations of HCG will be dependent on setting actuarially sound premium rates for the various plan options and sufficient enrollment growth. See further discussion at Note 6.

(6) Proprietary fund – decrease in net assets and liquidity

HCG incurred an operating loss of $6,233 in 2006 and $4,844 in 2005 and at June 30, 2006 had a net deficit of $3,668. Additionally, current liabilities exceeded current assets by $1,695 at June 30, 2006.

Three factors were the primary contributors to the decrease in net assets in 2006 and 2005. The most significant were the $8.629 stop-loss coverage reconciliation costs for the HMO model insurance contractors that are $4.0 in excess of the premium revenue set aside for the HMO benefit plans' stabilization reserve. The second was PPO model benefit claims that have been incurred but not yet received or paid in excess of the premium based reserves collected for the purpose of paying medical claims. The third factor contributing to the decrease in net assets in 2006 was a continuation from FY 2005 of the startup costs associated with the introduction of the new PPO product.

In response to the decreases in net assets and liquidity concerns described above, HCG has started the following intensive initiatives:

- HCG will conduct an organization-wide review of operating expenditures and will implement a plan which could include elimination of personnel and reengineering of job assignments and duties.
- Premium increases were implemented effective in July, 2006 for new HMO members and in September, 2006 for renewing HMO members. Analysis of FY 2006 claims experience indicates that groups with 1 employee consume disproportionately more healthcare services than the larger groups. Therefore HCG's pricing strategy includes the implementation of actuarially determined premium rates for groups with 1 employee which are designed to cover the costs of their disproportionate consumption of services. HCG began implementing this strategy for PPO "groups of 1" in Maricopa County in July, 2006. A second increase will be implemented in January, 2007 at which time the "group of 1" rate will be implemented across the State in both the HMO and the PPO.

(6) Proprietary fund – decrease in net assets and liquidity (continued)

- Beginning in January, 2007, co-payments associated with primary care, ambulatory care and hospitalization will be increased.

- Amend the contracted health plan contracts, effective July 1, 2006 to include PPO and HCG HMO program administrative costs and PPO claim costs as authorized allocations from the HMO stabilization reserve monies on an as needed basis.

- In March, 2007, HCG will introduce a Point-of-Service plan and begin tiering it's hospital network. When a member requires inpatient or outpatient care from a hospital provider, their coinsurance payment will be dependent upon the level or "tier" of the hospital they choose. Hospitals will be classified into tiers based on the discounts that they offer to HCG. Members will incur less out of pocket costs if they choose a Tier 1 hospital vs. a Tier 2 or Tier 3 hospital.

Management represents that successful implementation of these operating improvements will provide sufficient cash to fund operating expenses. However, there can be no assurance that these operating improvements will occur or will provide sufficient cash to fund operating expenses. Additionally, if the enrollment growth and across-the-board premium increases are not sufficient to fund the reserves for past losses and future stop-loss and claims experience costs, then HCG will be required to scale back administrative expenditures to the level supported by actual enrollment and or require a subsidy from the State General Fund to cover these operating costs. There can be no assurances that the Legislature will approve such a subsidy from the State General Fund. Accordingly, the accompanying financial statements have been prepared assuming that HCG will continue as a going concern. The matters discussed above raise substantial doubt about HCG's ability to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification of asset carrying amounts or the amount and classification of liabilities that might result should HCG be unable to continue as a going concern.

(7) Retirement plan

AHCCCS employees are covered by a defined benefit retirement plan administered by the Arizona State Retirement System Board. Benefits are established by State statute and provide retirement and long-term disability benefits to AHCCCS employees. The retirement plan is funded by payroll deductions from eligible employees' gross wages and matching amounts contributed by AHCCCS. These amounts satisfy the statutory requirement that employees and AHCCCS contributions must cover the actuarially determined current service costs of the retirement plan, plus amortization over a 30-year period of the unfunded past service liability. Payroll deductions as a percentage of employee wages were 6.9% for retirement and .5% for long-term disability for 2006. The matching amount contributed to the retirement plan by AHCCCS was $3,650 in 2006 and is included in administrative expenditures in the accompanying government-wide and governmental fund financial statements.

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

(dollar amounts expressed in thousands)

(8) Budgetary basis of accounting

The financial statements of AHCCCS are prepared in conformity with U.S. generally accepted accounting principles (GAAP). AHCCCS, like all other State agencies, prepares its annual budget on a basis that differs from the GAAP basis. The State's accounting system and Arizona Revised Statutes and policies provide for an additional accounting period (13^{th} month) to make payments for goods or services received or incurred by the end of the fiscal year and subsequently invoiced during the 13^{th} month. The budget basis expenditures reported in the financial statements include both the fiscal year paid and the 13^{th} month activity. The State does not have a legally adopted budget for revenues. Prior fiscal year expenditures of $106,268 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, 2006.

The following is a reconciliation of the GAAP Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds to the budgetary comparison schedules for the year ended June 30, 2006:

	General Fund Actual
Budgetary Basis Fund Balance, June 30, 2006	$ 69,257
Budgetary Basis of Accounting	
Increases to fund balance:	
Cash	57
Due from State and county governments	8,331
Due from the federal government	92,627
Due from other Fund	16,050
Receivables and other	186
Total increases	117,251
Decreases to fund balance:	
Deferred revenue	(20,675)
Due to State and county governments	(42,644)
Accrued programmatic costs	(120,164)
Payables and other	(3,025)
Total decreases	(186,508)
Total GAAP basis fund balance	$ -

Non-appropriated expenditures of $1,563,244 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. AHCCCS is claiming reimbursement from CMS on its Form CMS-64 for amounts representing additional reimbursement AHCCCS believes it is due for health care services provided to Native Americans off the reservation. At June 30, 2006, AHCCCS estimates this amount could be as much as $117 million. CMS has disallowed this claim through the March 2006 quarter and AHCCCS anticipates disallowance for the June 2006 claims. AHCCCS appealed this decision and the U.S. Department of Health and Human Services; Departmental Appeals Board upheld the disallowance on August 7, 2001. 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. There can be no assurances of the total recovery amount as the claim is subject to any other adjustments that may occur in the system. 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, 2006 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.

(9) Contingencies (continued)

Budget neutrality agreement – AHCCCS' Waiver from CMS provides federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204. The Waiver requires that over the term of the current agreement (April 1, 2001 through September 30, 2006), that the population covered by the Waiver be budget neutral for CMS. AHCCCS is negotiating a new Waiver with CMS that will extend budget neutrality for an additional period of five years. The Waiver extension will require that the ALTCS program be subject to budget neutrality beginning October 1, 2006. Under budget neutrality, CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions (STC) include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. It also established a diminishing annual threshold of the amount by which AHCCCS is able to exceed the budget neutrality limit on an interim basis before being required to submit a corrective action plan. The STC reporting limit thresholds are monitored on a Federal Fiscal Year basis. The limit threshold for the four limit periods ended September 30, 2005, which is the last full reporting period, is 0.5 percent. As of June 30, 2006, reported date of service expenditures associated with the four periods ended September 30, 2005 are below the limit by $157.9 million, or 1.59 percent. The fifth (final) Budget Neutrality period under the current Waiver does not end until September 30, 2006. Through June 30, 2006, AHCCCS remains 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. Although uncertainties surrounding these factors exist, AHCCCS management believes the budget neutrality limit will not be exceeded and that as of June 30, 2006, AHCCCS does not have any budget neutrality liability to CMS.

(10) Interfund receivables, payables and transfers

Interfund activity is defined as transactions between funds administered by AHCCCS. The interfund balances as of June 30, 2006 consist of transfers from the Other Funds to the General Fund in the amount of $2,395.

In the government-wide statement of activities, the interfund activity has been eliminated. The total net transfers out of $33,925 reported on the statement of activities represents transfer activities to other State agencies.

(11) Transactions with other State agencies and counties

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

Administrative services - The Arizona Department of Economic Security (ADES) charges AHCCCS to determine eligibility for certain Title XIX members. The Arizona Department of Administration charges AHCCCS for data center services 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 Board of Nursing charges AHCCCS for the cost of administering the nurse aid training program for nurse assistants. The Arizona Office of Administrative Hearings charges AHCCCS for administrative hearing services. These expenditures are included in administrative expenditures in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds.

(dollar amounts expressed in thousands)

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

The following is a summary of transactions with these State agencies for the services described above for the year ended June 30, 2006.

	Expenditures
Arizona Department of Economic Security	$ 82,333
Arizona Department of Administration	11,284
Arizona Department of Health Services	2,519
Arizona Board of Nursing	339
Arizona Office of Administrative Hearings	338
	$ 96,813

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

The amount passed through to ADES is classified as long-term care capitation and the amount passed through to ADHS is classified as capitation-mental health services and Children's Rehabilitative Services expenditures in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds. The following is a summary of transactions with these State agencies for the services described above for the year ended June 30, 2006.

	Expenditures
Arizona Department of Economic Security	$ 671,583
Arizona Department of Health Services	899,333
	$ 1,570,916

Revenues include $277,528 from Arizona counties during fiscal year 2006. 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, 2006, AHCCCS has accrued $19,080, 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.

(12) Other pass through funds

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

Arizona counties contributed $2,396 as determined by statutory calculation for administrative costs incurred by ADES for eligibility determinations and other operating costs of Proposition 204.

(dollar amounts expressed in thousands)

(12) Other pass through funds (continued)

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, 2006, AHCCCS recorded the following pass through revenue in the accompanying statement of revenues, expenditures and changes in fund balance - governmental funds:

	Funds Passed Through
Arizona School Districts	
Administrative Services Federal Funds	$ 8,902
Program Services Federal Funds	49,976
Arizona Department of Economic Security	
County Contribution for Administrative Costs	2,396
Arizona Department of Health Services	
Cost reimbursement from Civil Monetary Penalties	96
	$ 61,370

(13) New pronouncements

AHCCCS adopted the following pronouncement during fiscal year 2006:

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 were effective for financial statements for periods beginning after June 15, 2005. AHCCCS adopted this statement in fiscal 2006. Adoption of this statement did not have a significant impact on AHCCCS' financial statements.

ADDITIONAL INFORMATION

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2006
(amounts expressed in thousands)

Federal Grantor / Pass-Through Agency / Program	Federal CFDA Number	Federal Expenditures
U.S. Department of Health and Human Services		
Centers for Medicare and Medicaid Services		
Medicaid Program (Title XIX)	93.778	
Federal funds expended to vendors		$ 4,320,466
Federal funds expended to subrecipients		5,020
		4,325,486
Children's Health Insurance Program (Title XXI)	93.767	99,505
Hurricane Katrina Relief (Title XIX)	93.776	406
Health Resources and Services Administration		
State Planning Grant - Health Care Access for the Uninsured	93.256	80
TOTAL EXPENDITURES OF FEDERAL AWARDS		$ 4,425,477

See Independent Auditors' Report

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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, 2006 and for the year then ended, and have issued our report thereon dated November 6, 2006. 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.

Mayer Hoffman McCann P.C.

Phoenix, Arizona
November 6, 2006