ARIZONA HEALTH CARE
COST CONTAINMENT SYSTEM

FINANCIAL STATEMENTS
AND ADDITIONAL INFORMATION

Year Ended June 30, 2007

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MANAGEMENT'S DISCUSSION AND ANALYSIS

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For the Fiscal Year Ended June 30, 2007

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, 2007. The intent of this discussion and analysis is to look at AHCCCS' performance as a whole. We encourage readers to consider this information in conjunction with the basic financial statements and related footnotes that follow this section.

Financial Highlights

Government-Wide:

- The liabilities of AHCCCS exceeded its assets (presented as "net deficit") at fiscal year ended June 30, 2007 by $16.0 million. AHCCCS' net deficit at June 30, 2007 is comprised of an unrestricted net deficit of $18.7 million, restricted net assets of $12,000 and the amount invested in capital assets of $2.7 million.

- AHCCCS' total net assets decreased by $18.1 million during fiscal year 2007. Net assets of governmental activities increased by $1.9 million, while net assets of the business-type activity decreased by $20.0 million.

Fund Level:

- As of the close of fiscal year 2007, AHCCCS' total governmental funds reported an ending fund balance of $4.9 million, an increase of $2.6 million. Approximately 53% of the combined fund balances, or $2.6 million, is attributable to two programs established during fiscal year 2007.

- Business-type activities during fiscal year 2007 generated a loss of $20.0 million, increasing the net deficit to $23.7 million at June 30, 2007. Losses were driven by higher medical costs per member than projected, higher utilization of medical services per member and higher membership - particularly in groups of one. Member months increased 35% for Health Maintenance Organization (HMO) and Preferred Provider Organization (PPO) products in fiscal year 2007 versus 2006, 26% in the HMO product and 408% in the PPO product.

More detailed information regarding the government-wide financial statements and fund level financial statements can be found beginning on page 2.

Overview of the Financial Statements

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

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

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

The Statement of Net Assets (Deficit) presents information on all of AHCCCS' assets and liabilities, with the difference between the two reported as "net assets" or in instances where liabilities exceed assets "net deficit."

Over time, increases or decreases in net assets or net deficits, along with other financial information, serve as indicators of AHCCCS' financial position and whether it is improving or deteriorating.

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

Both statements report two categories:

- Governmental Activities - State appropriations along with federal, county intergovernmental revenues and member premium collections primarily support the activities in this category. The governmental activities of AHCCCS 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 (HCG) operations. Members/customers of Healthcare Group are charged a premium that is used to fund the health care coverage provided and administrative functions.

The government-wide financial statements can be found on pages 19 and 20.

Fund Financial Statements (Reporting AHCCCS' Major Funds)

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

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

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the State's near-term financial decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities. The basic governmental funds financial statements and related reconciliations can be found on pages 21 through 23 of this report.

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

Annually, the Legislature adopts an appropriated budget for AHCCCS for the acute care, (includes separate line item appropriations for the Acute Care Base, Proposition 204, KidsCare, KidsCare Parents, Breast & Cervical Cancer, Freedom-to-Work and SSDI-TMC populations and supplemental payments to hospitals), long-term care and AHCCCS administration programs. The annual appropriation is made separately for both the State funds and federal financial participation funds from the Social Security Act Titles XIX (Medicaid) and XXI (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 24.

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 25 through 27 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 28 to 43.

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	
	2007	2006	2007	2006	2007	2006
Current assets	$ 654,949	$ 470,157	$ 12,568	$ 14,353	$ 667,517	$ 484,510
Capital assets	2,587	2,758	129	152	2,716	2,910
Total assets	657,536	472,915	12,697	14,505	670,233	487,420
Current liabilities	649,856	467,160	18,383	16,048	668,239	483,208
Long-term liabilities	-	-	18,031	2,125	18,031	2,125
Total liabilities	649,856	467,160	36,414	18,173	686,270	485,333
Net assets (deficit):						
Invested in capital assets, net of depreciation	2,587	2,758	129	152	2,716	2,910
Restricted net assets	-	-	12	62	12	62
Unrestricted (deficit)	5,093	2,997	(23,858)	(3,882)	(18,765)	(885)
Total net assets (deficit)	$ 7,680	$ 5,755	$ (23,717)	$ (3,668)	$ (16,037)	$ 2,087

For AHCCCS, liabilities exceeded assets by $16.0 million at June 30, 2007 as compared to assets exceeding liabilities by $2.1 million at June 30, 2006.

The largest portion of the AHCCCS total net deficit (147.9%) is due to a $23.7 million net deficit for the Healthcare Group, the sole AHCCCS business-type activity. During fiscal year 2007, the Healthcare Group net deficit increased by $20.0 million. This increase is primarily due to medical loss experience being greater than premium revenue.

A $5.1 million unrestricted net asset balance for governmental operations partially offsets the business-type activity unrestricted net deficit. During the year, governmental operations unrestricted net assets increased by $2.1 million. This increase is primarily due to ending fund balances of $1.6 million in the Temporary Medical Coverage Fund and $1.0 million in the Hospital Loan Residency Fund, two new funds created during the 2006 legislative session. The balances in the two funds are available for future spending for those program's expenses.

The net deficit in unrestricted net assets is also offset by net assets of $2.7 million invested in capital assets. AHCCCS uses these capital assets to provide services to its members. In addition, Healthcare Group's net deficit is partially offset by a $12,000 of assets restricted for specific activities related to a private grant.

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

	Governmental Activities		Business-type Activities		Total	
	2007	2006	2007	2006	2007	2006
Revenues						
Program Revenues						
Charges for services	$ 12,197	$ 10,072	$ 70,007	$ 50,392	$ 82,204	$ 60,464
Other operating grants and contributions	420,602	405,154	35	108	420,637	405,262
Federal operating grants	4,727,031	4,425,397	171	80	4,727,202	4,425,477
General revenues						
State appropriations	1,761,301	1,527,406	-	-	1,761,301	1,527,406
Tobacco tax	193,421	212,221	-	-	193,421	212,221
Unrestricted investment earnings	2,196	1,178	446	313	2,642	1,491
Total revenues	7,116,748	6,581,428	70,659	50,893	7,187,407	6,632,321
Expenses						
Health Care	7,065,549	6,549,155	90,708	56,625	7,156,257	6,605,780
Excess (deficiency) before transfers	51,199	32,273	(20,049)	(5,732)	31,150	26,541
Transfers, net	(49,274)	(33,925)	-	-	(49,274)	(33,925)
Increase (decrease) in net assets	1,925	(1,652)	20,049	(5,732)	(18,124)	(7,384)
Net assets (deficit) – beginning of year	5,755	7,407	(3,668)	2,064	2,087	9,471
Net assets (deficit) – end of year	$ 7,680	$ 5,755	$ (23,717)	$ (3,668)	$ (16,037)	$ 2,087

At June 30, 2007, the governmental activities ended with a positive net asset position. The combined business-type activity and government-wide activities closed the fiscal year with a deficit net assets balance. This is the second consecutive fiscal year that the business-type activity has reported a deficit asset balance. Due to the magnitude of the deficit in the business-type activity, AHCCCS is now reporting a government-wide net deficit for the Agency as a whole. Overall, net assets decreased by $18.124 million, or 868.4 percent from net assets at June 30, 2006.

Governmental activities increased AHCCCS' net assets by $1.925 million during fiscal year 2007. The increase is primarily from General Fund appropriations transferred into new funds established to provide temporary medical health coverage (two year maximum period) to a specific member group and to provide loans that expand or start up hospital residency programs in rural areas. The excess is the result of lower enrollment for the program's first year of operations and the time to develop rules prior to providing any actual loans. Business-type activities decreased net assets by $20.049 million. The decrease is primarily due to higher medical costs, higher utilization of services at enrollment due to the 60 month "bare period", higher costs for groups of one along with an increase in overall medical loss ratios and a 35% growth in membership. For fiscal year 2007, health plan claims losses and contractual stop/loss reconciliation costs continue to be in excess of premium collections. Medical costs for the Preferred Provider Organization option were $11.542 million, including medical claim payments and accrued liabilities to providers, as compared to gross PPO premium revenue collections of approximately $8.285 million. Additionally, HCG administrative infrastructure costs of $8.147 million were in excess of the $4.712 million administrative fee collected from premiums that are designated to fund administrative costs.

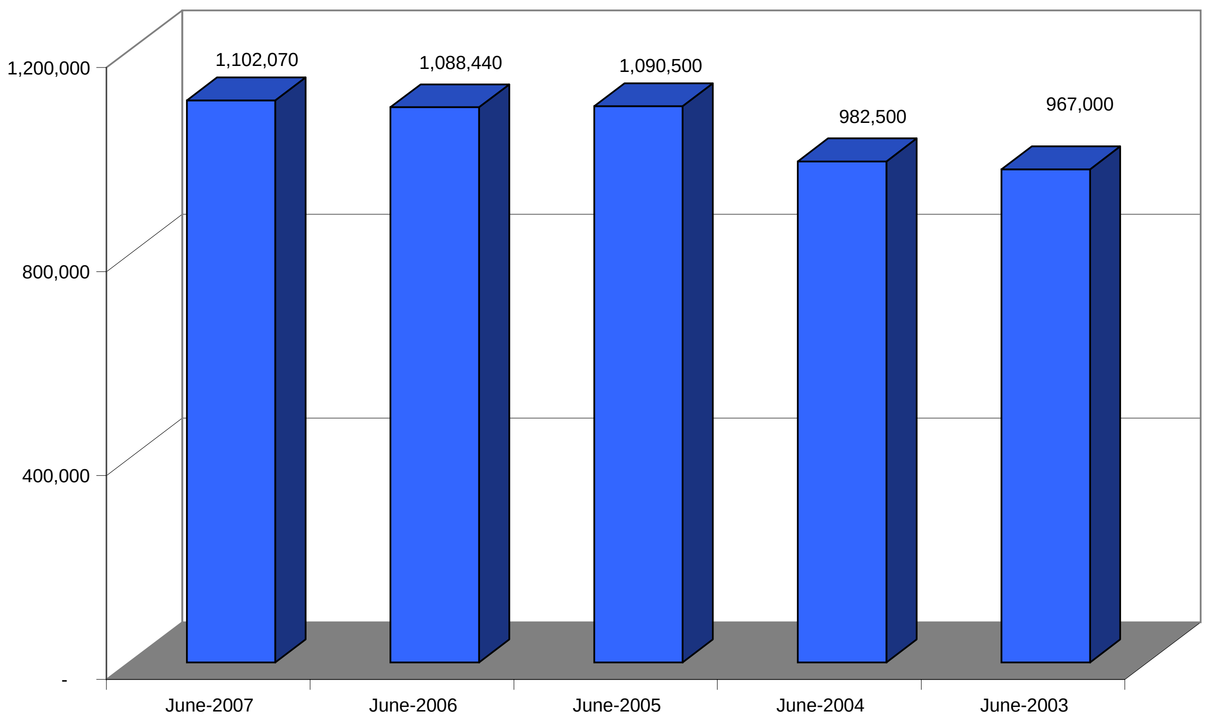
Governmental Activities

Governmental activities provided for an increase of $1.925 million in AHCCCS' net assets during fiscal year 2007. The increase is primarily from General Fund appropriations transferred into new funds established to provide temporary medical health care coverage (two year maximum period) to a specific member group and to provide loans that expand or start up hospital residency programs in rural areas. The excess is the result of lower enrollment for the program's first year of operations and the time to develop rules prior to providing any actual loans.

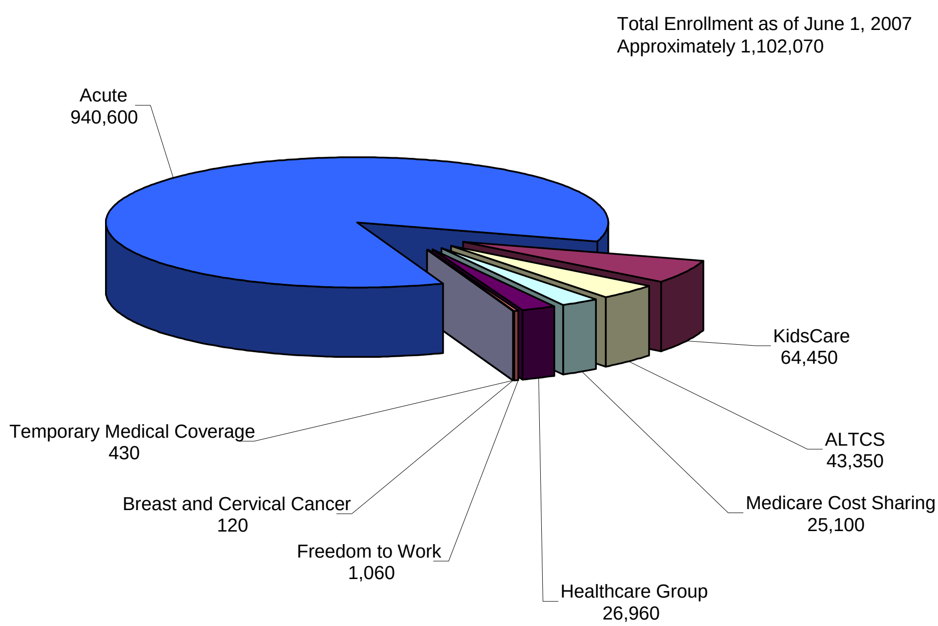
The overall program continued to see growth in program expenditures during fiscal year 2007. Enrollment has increased for five out of the past six fiscal years. The single year of decline was in fiscal year 2006. The increase in program expenditures in fiscal year 2007 is attributable to provider reimbursement inflation and the moderate enrollment increase. AHCCCS' overall governmental activity population ended at 1,102,070 as of June 1, 2007. Since March 1, 2001, just prior to the implementation of Proposition 204, the overall AHCCCS population has increased by 515,539 including Healthcare Group, which equates to an 87.9 percent growth rate. Of this amount, 141,800 (27.5 percent of the total 87.9 percent growth rate) are members who were made eligible by the Proposition 204 program expansion 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



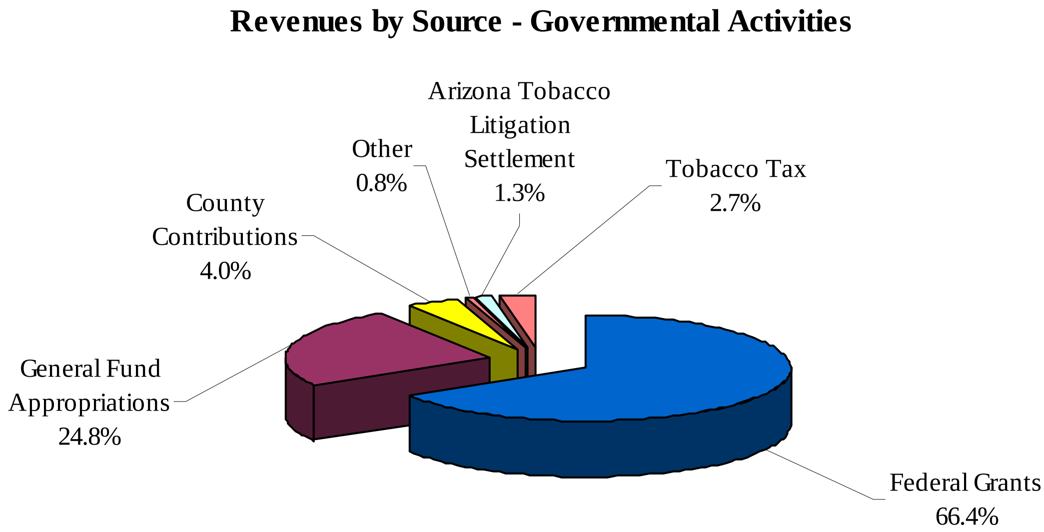
AHCCCS Enrollment by Program

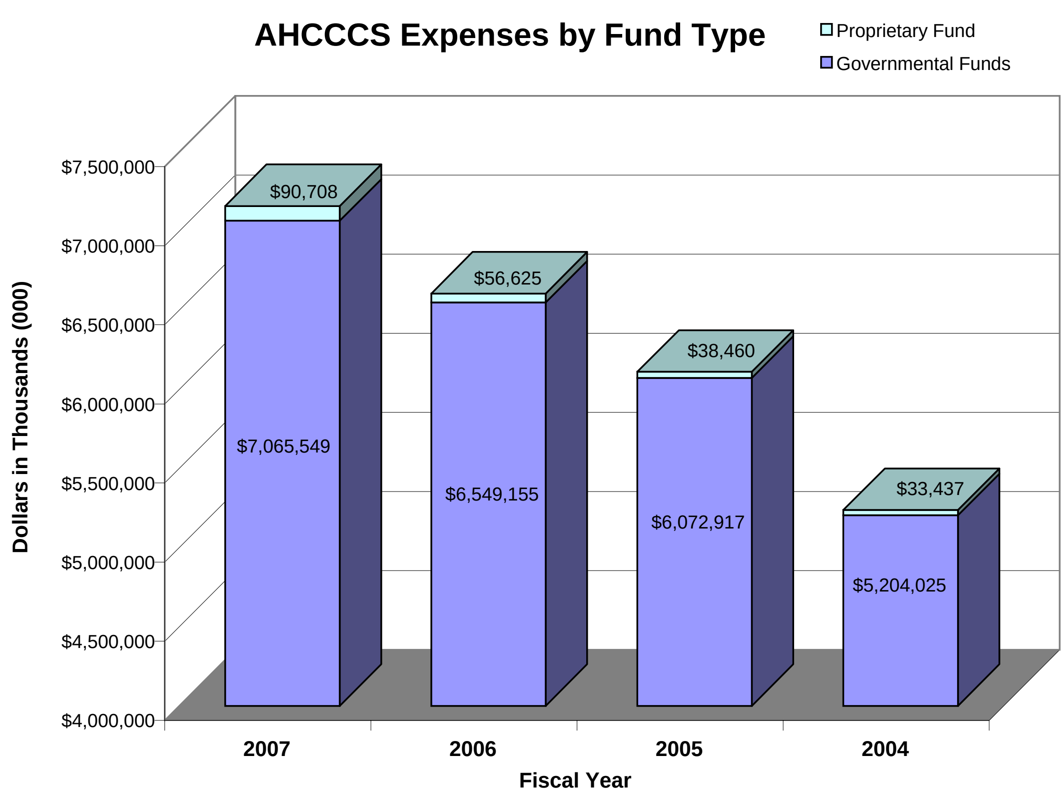


The cost of health care programs, including Title XIX Medicaid and Title XXI SCHIP, totaled $7,065.5 million in fiscal 2007, a $516.3 million increase over the $6,549.2 million reported in fiscal year 2006. As shown in the statement of activities, the amount of expenditures funded from federal grants through the Centers for Medicare and Medicaid Services (CMS) was $4,727.0 million (66.9 percent) in fiscal 2007 as compared to $4,425.5 million (67.6 percent) in fiscal 2006. 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 0.51 percent to 66.47 percent from the prior year's rate of 66.98 percent. This decrease resulted in a cost shift of approximately $36 million to State sources for fiscal year 2007. The overall increase in program expenditures can primarily be attributed to an average 5.6 percent capitation rate inflation growth across all capitated programs. Yearly capitation rate increases have averaged 7.0 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. Other increases in governmental expenditures include $39.6 million for reinsurance payments to capitated health plans, $12.6 million for expansion of the Graduate Medical Education program, and $20.5 million for the annualized expenditures related to Medicare Clawback payments made to CMS.

State, county and miscellaneous funding sources combined to provide $2,389.7 million in State funding sources and appropriations in fiscal year 2007, a $233.7 million increase over the $2,156.0 million reported in fiscal year 2006. 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 $1,222.0 million and an additional $539.3 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 $282.8 million as determined by Statutory funding formulas and Session Law. Tax collections on tobacco products provided $193.4 million in State match funding. An additional $93.4 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 $46.0 million for the period from January 1, 2007 through June 30, 2007 based on Arizona's Joint Legislative Budget Committee 2008 estimated payment. Tribal gaming receipts distributed to AHCCCS as determined by statutory formula and other sources provided an additional $58.9 million for payments to hospital emergency departments and level 1 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 proprietary fund business-type activity for AHCCCS is the Healthcare Group (HCG). Healthcare Group was established in 1988 by the State to administer health care services primarily to small, uninsured businesses with 1 to 25 employees and employees of political subdivisions. That range was later increased to 1 to 50 employees. HCG contracts with three health plans from the existing network of AHCCCS health plans (HMOs) to provide managed care medical services. In fiscal year 2006, HCG started offering a PPO option through a third party administrator. HCG's administrative responsibilities include member and group enrollment, premium billing and collections, fund disbursement and data analysis. Also, HCG is responsible for providing reinsurance for certain HMO losses and regulatory oversight of the HMOs and the third party administrator.

The Business-Type activities net deficit increased by $20.0 million during fiscal year 2007. Key factors contributing to the loss and actions being taken by HCG management to better align revenues with operating expenses are detailed below.

Historical Premium Rate Changes: HCG has diligently adjusted rates, as depicted in the following table, to fully fund the projected medical cost payments to the participating health plans from premium collections. Between June 2006 and July 2007, the following premium increases have been implemented.

Average Historical Rate Increases by Product

HMO	July 2006	September 2006	January 2007			
			Group of 1	Group 2-50	Group of 1	Group 2-50
Members Affected	New	Renewing	New	New	Renewing	Renewing
Average Increase	11.9%	11.9%	16.5%	7.6%	7.9%	3.7%

PPO/PPOS	July-06	September-06	January 2007			
	Group of 1	Group of 1	Group of 1	Group 2-50	Group of 1	Group 2-50
Members Affected	New	Renewing	New	New	Renewing	Renewing
Average Increase	38.0%	38.0%	26.7%	19.2%	18.9%	13.0%

Between June 2006 and July 2007, the following premium increases have been implemented.

Average Rate Increases Implemented July 1, 2006 through June 30, 2007

	HMO		PPO/PPOS	
	Groups of One	Groups 2 - 50	Groups of One	Groups 2 - 50
Sep-06	11.9%	11.9%	38.0%	38.0%
Jan-07	7.9%	3.7%	18.9%	13.0%
Change	19.8%	15.6%	56.9%	51.0%

The HMO renewal rates in January 2007, shown in the table, added to the rate increases in July and September 2006, resulted in HMO rates that were 15.6% to 19.8% higher than the rates at the start of the fiscal year and PPO rates that are 51.0% to 56.9% higher.

While rate increases have been routinely implemented to cover the projected medical and administrative costs, they were insufficient to meet the pace of rising costs of care due to the following factors:

Higher Medical Costs: Hospital participation in HCG is not mandatory. Therefore, hospitals do not have to contract with HCG. Until 2005, HCG health plans were permitted to pay non-contracted hospitals the rates that were in place between the hospital and AHCCCS if members received services at the non-contracted hospital. This practice is often referred to as paying at the "default rate." That right was removed by the Legislature in 2005. Thereafter, the health plans in HCG had to pay higher rates to the non-contracted hospitals up to full charges. The costs related to this change have increased faster than projected at the time rate setting was done. Furthermore, because HCG is the only health care coverage option that is guaranteed issue for groups of one, the program has experienced a higher than expected medical risk profile compared to other small business health care coverage.

Higher Utilization of Services: Currently, to be eligible for enrollment in HCG, employers must be without group health insurance for six months prior to being eligible for HCG coverage. This "bare period" provision, instituted in 2005, results in higher costs as new members who have been without continuous coverage, utilize services upon enrollment at a higher rate than members who had continuous coverage. The costs associated with this change ran ahead of the projection at the time premium rate increases were being set.

Higher Costs and Increased Members in Groups of One: On a consolidated basis, medical costs for employer groups with only one employee are significantly higher than medical costs for groups with more than one employee. Overall admissions per 1,000 members were 13% higher for groups of one than for all other group sizes in the first quarter of fiscal year 2007. Inpatient costs per member, per month (pmpm) were 32% higher and medical claims per member per month (pmpm) were 49% higher for groups of one than for all other group sizes.

From fiscal year 2006 to fiscal year 2007, total groups increased by 1,904 with 68% of those in the groups of one category. In addition, of the 382 new groups of two, many are former groups of one who have migrated to the group of two status by adding a spouse as an employee.

Group Size	2006	2007	Pct	Increase	% Incr	% Tot Incr
1	5815	7111	**74%**	1296	22%	**68%**
2	952	1334	14%	382	40%	20%
3-10	860	1080	11%	220	26%	12%
11+	56	62	1%	6	11%	0%
Total	7683	9587	100%	**1904**	25%	**100%**

At the time that rates were being established, it was impossible to predict the growth in groups of one and resulting higher medical costs that would result from contracted brokers referring a higher percent of high risk groups of one to HCG. HCG has cancelled broker contracts on a go forward basis to reduce adverse referrals from contracted brokers.

Rate Change Implementation: While costs were rising, premium rate setting was being devised to adjust for the projected increases in medical costs. The plans were given input to the proposed rates. Healthcare Group originally set premium rates based on the utilization standards commonly referred to in the industry as "Moderately Managed" medical management standards, which includes certain medical management protocols such as, but not limited to, pre-authorizations for certain procedures and pre-authorizations for access to specialists. There is also a lower level of medical management referred to as "loosely managed" which has some preadmission certification, concurrent review, and hospital audit. There is also a higher level of medical management which is referred to as "well managed" which has well developed inpatient standards with close conformity to those standards. The HMOs did not all achieve what is considered to be "moderately managed" medical management as measured by the actuarial firm of Milliman. The utilization of one of the HCG health plans mirrored the performance of a loosely managed health plan utilization performance, which effected medical losses. In addition, the lead time to institute premium rate increases is approximately nine months. The delay in addressing dramatic medical cost increases in fiscal year 2007 took nine months to be approved and implement premium increase by all stakeholders. In the past, the impact of rate increases was further delayed because premium rates were only adjusted at the group's renewal date, which varied for each employer group. As such, it would be 9 months to institute plus 12 months before every member received the rate increase. Thus, it was 21 months from inception of the rate increase to the time when every member had received it. For example, the additional revenue received from a 6% rate increase, would be perhaps 3% in the first year of implementation. Only at the end of the second year would the full 6% example be reflected in revenue. Starting in July 2006, HCG began to experience a dramatic medical loss trend by all the health plans. It took several months to evaluate the trend and set rates that reflected the new medical trend rates. To reduce this cycle HCG has instituted a once a year across the board rate increase for all groups and mid-year rate adjustment by group size (e.g. groups of one) as necessary to mitigate financial reconciliation deficits.

Historical Subsidies: HCG is intended to be self-funded. However, the program has incurred operating losses in the past and has historically required subsidies from the State to cover those operating losses.

In 1998, a subsidy of $8 million was received from the General Fund. From fiscal year 1999 to fiscal year 2005 the Legislature provided an average of $5.8 million a year in subsidies for the program for a total of $43 million. It was the intent of the Legislature to eliminate the need for general fund subsidy for HCG. To replace the general fund subsidy and protect the long term financial stability of the health plan contractors, HCG agreed to create a financial stability reserve from future premium revenue collection that would be paid to the plans as the reserves were built up. For fiscal years 2006 and 2007, operating costs ran ahead of premiums as discussed above. Because of this, the financial stability reserve could not build adequate funds to fully reconcile the plans, resulting in erosion of the net assets and a significant increase in the net deficit position of the fund for reconciliation payment owed against future revenues by the close of fiscal year 2007. HCG requested a subsidy late in fiscal year 2007 to assist with the reduction of the growing deficit. HCG received a subsidy of $8 million from the Legislature in fiscal year 2008. While HCG is working to achieve a break-even or near break-even position in fiscal year 2008, there will still be additional assistance required to retire the debt accumulated during fiscal year 2007.

Reconciliation Liability: HCG reconciles the medical costs experienced by the plans above a contractual target medical loss ratio (stop loss target) that is based on the capitation paid annually to each plan. This stop loss payment is made for the difference in medical losses above the target medical loss ratio. If medical costs exceed capitation, HCG pays the plans starting each December 31st from the reconciliation reserves that are available. If reserves are inadequate to pay out the full amount owed on December 31st of each year, then HCG will make best efforts to increase premiums and pay off plans for previous year medical losses on a quarterly basis. The HCG's health plan reconciliation liability for health plan medical costs in excess of monthly capitation payments as of June 30, 2006 was $8.6 million. A portion of the stop loss payment was made from reconciliation reserves and a portion was carried over as a liability at June 30, 2007. Payments and adjustments of $3.6 million reduced the fiscal year 2006 liability to $5.0 million as of June 30, 2007, which was paid to the health plans after year end, utilizing a portion of the $8.0 million General Fund subsidy dollars received for fiscal year 2008. Excess costs during fiscal year 2007 added $17.5 million to the liability, bringing the ending balance at June 30, 2007 to $22.5 million. HCG's goal is to set premiums over the next fiscal year to breakeven by December 2009.

GOING CONCERN MATTERS

During the 2007 legislative session the Arizona Legislature made several changes to the program after being notified by HCG management in April 2007 that the program was experiencing increased losses. These changes include:

1. An $8.0 million General Fund subsidy was authorized for fiscal year 2008.
2. HCG was provided with the authority to pay 114% (plus additional amounts for peer group and other modifiers) of the AHCCCS fee for service rates to non-contracted hospitals – in an effort to reduce projected hospital costs for non-contracted hospitals.
3. An enrollment cap and freeze was enacted and no new groups were allowed to enroll in the program on or after September 19, 2007 through July 31, 2008 – intended to limit enrollment until costs can be stabilized.

In addition to those actions listed above taken by the Legislature**,** HCG management has identified the following steps that are being taken to address the financial challenges:

1. Reduce overall administrative costs in fiscal year 2008 by approximately $3.0 million from fiscal year 2007.

2. Increase premiums and cost sharing for members.
3. Shift some of the medical cost risk to the contracted health plans in a shared arrangement, rather than HCG bearing full risk. For example: Plans could be asked to bear their own medical costs up to (for example) 125% - 150% of the capitation they receive. Above that threshold, the plans would be required to carry 50% of the medical costs incurred, and HCG would reimburse the other 50%. In this way the plans have an incentive to keep medical costs at the level they are capitated for, which should be achievable by the plans if they manage at the moderately managed level of care.
4. Self-funding its capital requirements from premium collections.

The fiscal year 2008 rate setting strategy is intended to significantly reduce or eliminate the reliance on future State subsidies. In addition, effective September 1, 2007 (or date indicated), HCG implemented the following actions to reduce program losses:

- **Increase Member Premiums:** HCG increased premiums by approximately 18%, overall, in an effort to bring premiums into balance with rapidly rising healthcare costs.

Average Rate Increases by Product

HMO	September 2007			
	Group 1	Group 2-50	Group 1	Group 2-50
Impact:	Jan07-Sept07 renewals		Sept06-Sept07 renewals	
Average Increase	12.9%	8.4%	31.7%	16.9%

PPO/POS*	September 2007			
	Group 1	Group 2-50	Group 1	Group 2-50
Impact:	New	New	Renew	Renew
Average Increase	24.0%	24.0%	24.6%	22.7%

** The PPO plan was terminated on 8/31/07 and replaced with the POS plan 9/1/07.*

- **Increased Member Co-payments and Coinsurance:** Members will make a larger contribution for their consumption of medical services in the form of coinsurance and co-payments. The projected impact is 7% - 8% of the costs of HMO members affected and 16% for PPO members affected.
- **Eliminated Zero Deductible Plans:** The members in this high cost option who have not elected another option will be transitioned to other deductible options (effective January 1, 2008), thereby requiring a higher share of cost. Deductibles are waived when seeking evaluative care through their PCP, Urgent Care, preventive services, or for basic lab and x-ray, encouraging utilization where the cost of care is lower.
- **Rated Groups of One Separately:** Groups of one often experience higher medical utilization and therefore increase the costs of providing coverage to the larger group. For this reason, all groups of one have been placed together in a pool and community rated as a large pool resulting in more appropriate premiums.
- **Established a Uniform Date for Premium Increases:** Historically, HCG has implemented a premium rate increase that is applied to each business at their annual renewal. As a result, HCG does not receive the full benefit from a rate increase until all businesses have renewed their policy, taking 23 months for a full twelve months of the new premium to be fully realized. In September 2007, HCG implemented a rate increase to all members to bring all members within the same age band, and enrolled in the same benefit and health plan, to the same premium.
- **Maternity Benefit:** A first year limit of $500 was placed on the maternity benefit.
- **POS Benefit Limit:** A $100,000 benefit cap was instituted for the first 12 months of coverage effective January 2007.
- **Reduced Staff:** A 45% reduction in staff was implemented between March and October 2007.
- **Reduced Plan Administrative Costs:** Plan contracts were amended to increase the stop loss reconciliation threshold to reduce the HCG reconciliation fund liability.

- **Reduced Pharmaceutical Costs:** Plan formularies were customized between March and November 2007 by eliminating many high cost brand name drugs and increasing utilization of generics.
- **Increased Member Retention:** Implemented retention strategies to migrate members to higher deductible plans for a lower premium in order to reduce member fall out due to premium increases.

Despite these measures, there are no assurances that the strategies and changes implemented and the future plan benefit and enrollment changes will provide all the cash necessary in a timely fashion to fund operating expenses and fulfill outstanding and ongoing medical liabilities.

Due to the premium increases, elimination of the $0 deductible plans and the freeze on new group enrollment, overall enrollment in HCG is projected to decrease approximately 20% in fiscal year 2008. However, Gross Premium Revenue is projected to increase $8.2 million, or 12%. Despite the increase in premium revenue, HCG is projecting a net loss of $2-8 million in fiscal year 2008. It is difficult to determine the exact level of net loss for fiscal year 2008 because of factors listed above and the negative changes in enrollment, significant benefit changes and premium increase implemented in September 2007 have not taken full effect on medical loss trends, and the effect of changes in the balance of group of one membership as HCG loses enrollment.

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.

The Legislature and the Governor will determine the conditions under which HCG will continue to provide health care coverage to small businesses in the State of Arizona. HCG is currently negotiating payment terms with the 3 contracted health plans to repay the remaining liabilities owed relating to fiscal year 2007 over the next two to three fiscal years. Also the Legislature could choose to reduce the reconciliation debt owed by providing a General Fund subsidy again in fiscal year 2008. Each HCG health plan contractor will have to make its own decision as to whether their health plan organization is willing to carry the medical loss liability from the HCG line of business until or if premiums revenues are adequate to recover their prior year medical losses.

Financial Analysis of AHCCCS' Governmental Funds

Governmental Funds

At the end of fiscal year 2007, AHCCCS' governmental funds reported combined ending fund balances totaling $4.923 million, an increase of $2.580 million from the prior year balance.

The General Fund is the chief operating fund of the AHCCCS Acute Care, KidsCare, KidsCare Parents, Breast & Cervical Cancer, Freedom-to-Work, SSDI-TMC and Long-Term Care programs. These programs primarily utilize a State general fund appropriation and revenue sources from the annual tobacco litigation settlement proceeds as well as taxes on tobacco products and contributions from Arizona counties to provide the required state matching funds for federal Title XIX and Title XXI revenue.

The Other Governmental Funds consist of seven individual funds that have a combined total fund balance of $3.295 million available to meet future year obligations. The Other Governmental Fund's fiscal year-end available balance is $3.295 million and represents 66.9 percent of the total governmental fund's unrestricted fund balance and primarily consists of balances in the Hawaii Arizona PMMIS Alliance Fund and the Hospital Loan Residency Fund. These two main funds comprise the majority of the total and are available for certain expenditures. A total of $2.2 million is available for administrative expenditures for information technology activities and a total of $1 million is available for interest–free loans for one accredited hospital per Arizona County to fund start-up and ongoing costs for newly created and/or expanded residency programs. Revenue from taxes on cigarettes and other related tobacco products declined 9 percent over fiscal year 2006 and generated $135 million for the current year and accounts for 77.1 percent of the total Other Governmental Funds revenues compared to 83.2 percent of the total Other Governmental Funds revenues in the fiscal year 2006.

General Fund Budgetary Highlights

There were no differences between the total original and the final total amended administrative and programmatic expenditure budgets. All 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 Arizona Department of Administration'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:

- $5.02 million decrease to Acute Base Special Line Items
- $4.00 million decrease to Acute Proposition 204 Special Line Items
- $3.02 million increase to Acute Hospital and other Special Line Items
- $1.00 million increase to SCHIP and SCHIP Parents services
- $5.00 million increase to Administration

At June 30, 2007, actual cash basis appropriated expenditures were $305.31 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, 2007 amount to $2.716 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 6.7 percent or $194,000 and is attributable to the normal depreciation of information technology equipment and vehicles.

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

	Governmental Activities		Business-type Activities		Total	
	2007	2006	2007	2006	2007	2006
Vehicles	$ 945	$ 638	$ 31	$ 39	$ 976	$ 677
Furniture and equipment	1,642	2,120	98	113	1,740	2,233
Total net assets	$ 2,587	$ 2,758	$ 129	$ 152	$ 2,716	$ 2,910

Additional information on AHCCCS' capital assets can be found in Note 2 to the accompanying financial statements on page 34.

Long-Term Contingent Liability

In January 2001, AHCCCS obtained a Section 1115 Waiver ("Waiver") from CMS to receive federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204. The original Waiver period (April 1, 2001 through September 30, 2006) has been extended to September 30, 2011 and requires that the population covered by the Waiver be budget neutral for CMS over the term of the agreement. In addition, the Waiver was amended to include the Arizona Long Term Care program expenditures making it subject to budget neutrality. 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 demonstration year's financial results on a quarterly basis. It also established a diminishing annual threshold of the amount that AHCCCS is able to exceed the calculated cumulative Budget Neutrality limit on an interim basis before being required to submit a corrective action plan. The STC reporting limit thresholds are monitored on a Federal Fiscal Year basis. The STC limit threshold for the first six limit periods (April 1, 2001 through September 30, 2007) is 1.0 percent. The threshold declines by 0.25 percent for limit periods seven through nine and is zero percent for the limit period ended September 30, 2011. As of June 30, 2007, reported date of service expenditures associated with the five periods ended September 30, 2006 are below the limit by $154.3 million, or 1.17 percent. Through June 30, 2007, AHCCCS remains under the cumulative reporting limit threshold. The budget neutrality calculation is dependent on a number of variables including the number of members, the eligibility category of members and the general economy and its impact on unemployment, medical inflation and policy decisions that may impact program costs made by the Legislature. Given the uncertainty surrounding these factors, AHCCCS is not presently able to determine if the budget neutrality limit will be exceeded or if it is exceeded that CMS will require repayment of the excess. Management believes that as of June 30, 2007, AHCCCS does not have any liability to CMS related to the budget neutrality agreement. Accordingly, the accompanying basic financial statements have not been adjusted for the impact of any liability AHCCCS may have related to the Waiver budget neutrality agreement.

Economic Factors and Next Year's Budgets and Rates

The AHCCCS program experienced modest growth in enrollment again in fiscal year 2007 following the only year of declining enrollment out of the previous six fiscal years. Enrollment for all government-wide programs grew at a rate of 1.2 percent during fiscal year 2007. The overall change was primarily due to growth in the Title XXI KidsCare and KidsCare Parents programs (5.9 percent combined) and the business-type HCG (24.8 percent) program along with a minor increase of 0.2 percent in the Title XIX populations that comprise the majority of AHCCCS' program enrollment. AHCCCS expects enrollment to grow in all of the populations through fiscal year 2008. Arizona's previously healthy economy is showing signs of decline and will be a key contributing factor in AHCCCS' enrollment growth. Employment growth has slowed and construction jobs have begun to decline as the homebuilding industry remains in recession with no prospect for improvement in the near to mid-term. From May 2007 to August 2007, a significant segment of the program population that had previously experienced declines in fiscal year 2007 grew by over 8,500 members. As such, AHCCCS is projecting a membership growth rate that is at least equal to the 3.1% population growth projected by the Arizona Department of Economic Security.

AHCCCS capitation rates are required to be actuarially sound pursuant to the Federal Balanced Budget Act of 1997. Utilization and inflationary trends for health care costs are incorporated in the rate development process. The issues which resulted in rate inflation for capitation rates continue to be increases in transportation costs, dental rates, cesarean births, rural healthcare costs due to physician and specialty shortages and new and more expensive health care technologies. The contract year 2008 capitation rate increases resulted in a weighted average increase of 6.7 percent (6.9 percent for Acute Care, 3.7 percent for Long-Term Care) as compared to 5.6 percent (5.9 percent for Acute Care, 4.8 percent for Long-Term Care) for contract year 2007. Although growth in health care costs has slowed in recent years, increases in medical costs are still outpacing inflation. The National Health Expenditure actuary report prepared by the United States Department of Health and Human Services projects the average annual growth in health care spending to hold steady at 6.9 percent through 2016.

The Title XXI SCHIP Federal program was scheduled to expire under its current form as of September 30, 2007 and has been extended through March 2009. Significant differences exist between the reauthorization version in both funding amount and program design passed by Congress and what the President proposes. Congress has passed legislation to continue the program through March 2009. AHCCCS' KidsCare program will continue under the current format with any changes to program design contingent upon the final reauthorized version of the program and the Arizona Title XXI SCHIP federal allotment.

AHCCCS' budget request for fiscal year 2009 submitted to the Governor in September 2007 includes a rebase of the fiscal year 2008 budget. The revised projection indicates a potential fiscal year 2008 Acute Care shortfall of $194.6 million. This shortfall can be partially mitigated by applying $186.7 million of unused fiscal year 2007 appropriation authority to claims paid in fiscal year 2008 with dates of service prior to July 1, 2007. Other factors that may influence the need for a supplemental appropriation include unfavorable enrollment trends and unfavorable tobacco revenue collections. Management is closely monitoring these trends and the adequacy of fiscal year appropriations.

Request for Information

This financial report is designed to provide a general overview of AHCCCS' finances for the State's citizens and taxpayers, and 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, 2007, as shown on pages 19 through 27. 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, 2007, 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, 2007, 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 three 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 asset carrying amounts or the amount and classification of liabilities that might result should Healthcare Group be unable to continue as a going concern.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 21, 2008 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 16 and the budgetary comparison information on page 24 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
March 21, 2008

BASIC FINANCIAL STATEMENTS

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET ASSETS (DEFICIT)

June 30, 2007
(amounts expressed in thousands)

ASSETS	Governmental Activities	Business-Type Activities	Total
CURRENT ASSETS			
Cash	$ 68,918	$ 12,543	$ 81,461
Restricted cash	37,011	-	37,011
Due from state and county governments	98,849	-	98,849
Due from the federal government	403,982	-	403,982
Tobacco settlement receivable	46,002	-	46,002
Receivables and other	187	25	212
TOTAL CURRENT ASSETS	654,949	12,568	667,517
CAPITAL ASSETS			
Furniture, vehicles and equipment, net of accumulated depreciation	2,587	129	2,716
TOTAL ASSETS	657,536	12,697	670,233
LIABILITIES			
CURRENT LIABILITIES			
Accounts payable	35,516	892	36,408
Other accrued liabilities	3,694	104	3,798
Bank overdraft	116	-	116
Deferred revenue	1,700	10,054	11,754
Due to federal, state and county governments	70,272	-	70,272
Accrued programmatic costs	535,165	7,224	542,389
Compensated absences	3,393	109	3,502
TOTAL CURRENT LIABILITIES	649,856	18,383	668,239
ACCRUED PROGRAMMATIC COSTS, less current portion	-	18,031	18,031
TOTAL LIABILITIES	649,856	36,414	686,270
COMMITMENTS AND CONTINGENCIES			
NET ASSETS (DEFICIT)			
INVESTED IN CAPITAL ASSETS, net	2,587	129	2,716
RESTRICTED NET ASSETS	-	12	12
UNRESTRICTED (DEFICIT)	5,093	(23,858)	(18,765)
TOTAL NET ASSETS (DEFICIT)	$ 7,680	$ (23,717)	$ (16,037)

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF ACTIVITIES

Year Ended June 30, 2007
(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	$ 7,065,549	$ 12,197	$ 4,727,031	$ 420,602	$ (1,905,719)	$ -	$ (1,905,719)
Business-type activities:							
Healthcare Group	90,708	70,007	171	35	-	(20,495)	(20,495)
TOTAL PROGRAMS	$ 7,156,257	$ 82,204	$ 4,727,202	$ 420,637	$ (1,905,719)	$ (20,495)	$ (1,926,214)
General revenues:							
State appropriations					1,761,301	-	1,761,301
Tobacco tax					193,421	-	193,421
Unrestricted investment earnings					2,196	446	2,642
					1,956,918	446	1,957,364
Transfers:							
Transfers in					19	-	19
Transfers out					(49,293)	-	(49,293)
Total general revenues and transfers					1,907,644	446	1,908,090
CHANGE IN NET ASSETS (DEFICIT)					1,925	(20,049)	(18,124)
NET ASSETS (DEFICIT), BEGINNING OF YEAR					5,755	(3,668)	2,087
NET ASSETS (DEFICIT), END OF YEAR					$ 7,680	$ (23,717)	$ (16,037)

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BALANCE SHEET - GOVERNMENTAL FUNDS

June 30, 2007
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
ASSETS			
Cash	$ 56,342	$ 12,576	$ 68,918
Restricted cash	35,467	1,544	37,011
Due from state and county governments	44,746	13,217	57,963
Due from the federal government	156,925	-	156,925
Due from other funds	8,087	2,682	10,769
Receivables and other	187	-	187
TOTAL ASSETS	$ 301,754	$ 30,019	$ 331,773
LIABILITIES			
Accounts payable	$ 34,710	$ 806	$ 35,516
Other accrued liabilities	3,432	262	3,694
Bank overdraft	116	-	116
Deferred revenue	464	1,236	1,700
Due to federal, state and county governments	70,057	215	70,272
Due to other funds	2,682	8,087	10,769
Accrued programmatic costs	188,665	16,118	204,783
TOTAL LIABILITIES	300,126	26,724	326,850
COMMITMENTS AND CONTINGENCIES			
FUND BALANCES			
Unreserved	1,628	3,295	4,923
TOTAL FUND BALANCES	1,628	3,295	4,923
TOTAL LIABILITIES AND FUND BALANCES	$ 301,754	$ 30,019	

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.	$ 2,587
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 $1,274 exceeded capital outlays ($1,104) in the current fiscal year.	170
Long-term liabilities for accrued paid time off are not due and payable in the current fiscal year and, therefore, are not reported in the funds.	(3,393)
Long-term receivables, offsetting the above accrued paid time off liability, which are not receivable in the current fiscal year and, therefore, are not reported in the funds.	3,393
Long-term accrued liabilities for programmatic costs are not due and payable from current financial resources and, therefore are not reported in the funds.	(330,383)
Long-term receivables, offsetting the above accrued programmatic liability, which are not due and receivable in the current fiscal year and, therefore, are not reported in the funds.	330,383
NET ASSETS OF GOVERNMENTAL ACTIVITIES	$ 7,680

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

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

Year Ended June 30, 2007
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
REVENUES			
State government:			
Appropriations	$ 1,139,835	$ -	$ 1,139,835
Pass through funds	539,297	-	539,297
Federal government:			
Acute care	2,728,452	8,026	2,736,478
Long-term care	642,448	-	642,448
Pass through funds	1,102,576	96	1,102,672
County government:			
Acute care	54,433	-	54,433
Long-term care	225,009	-	225,009
Pass through funds	3,318	-	3,318
Tobacco litigation settlement revenue	90,258	-	90,258
Tobacco tax revenue	58,428	134,993	193,421
Gaming revenue	-	23,630	23,630
Intergovernmental agreement revenue	-	7,430	7,430
Premium revenue	12,197	-	12,197
Other	14,783	843	15,626
TOTAL REVENUES	6,611,034	175,018	6,786,052
PROGRAMMATIC EXPENDITURES			
Capitation:			
Acute care	2,785,346	86,242	2,871,588
Long-term care	1,564,180	-	1,564,180
Children's rehabilitative services	63,945	-	63,945
Mental health services	838,161	-	838,161
Fee-for-service:			
Acute care	572,112	1,301	573,413
Long-term care	85,862	-	85,862
Trauma center services	-	23,880	23,880
Disproportionate share	143,477	-	143,477
Graduate medical education	34,478	-	34,478
Reinsurance	130,863	-	130,863
Medicare:			
Acute care premiums	101,998	8,721	110,719
Long-term care premiums	29,559	-	29,559
Part D clawback payments	45,730	-	45,730
Part D drug co-pay	2,161	-	2,161
MMA one time transaction cost	190	6,054	6,244
Payments to counties	4,826	-	4,826
TOTAL PROGRAMMATIC EXPENDITURES	6,402,888	126,198	6,529,086
ADMINISTRATIVE EXPENDITURES	186,887	9,919	196,806
ADMINISTRATIVE EXPENDITURES PASSED THROUGH	8,209	97	8,306
TOTAL EXPENDITURES	6,597,984	136,214	6,734,198
EXCESS OF REVENUES OVER EXPENDITURES	13,050	38,804	51,854
OTHER FINANCING SOURCES (USES)			
Transfers out:			
To Tobacco Product Tax 204 Protection Fund	-	(217)	(217)
To State General Fund	(5,728)	-	(5,728)
To AHCCCS Other Fund	(1,000)	-	(1,000)
To Arizona Department of Economic Security	(4,927)	(200)	(5,127)
To Arizona Department of Health Services	(3)	(37,925)	(37,928)
To Arizona Department of Health Services Health Crisis Fund	-	(510)	(510)
Transfers in:			
From AHCCCS General Fund	-	1,000	1,000
From Tobacco Product Tax Emergency Health Services Fund	217	-	217
From Arizona Department of Health Services Project 211	19	-	19
TOTAL OTHER FINANCING SOURCES (USES)	(11,422)	(37,852)	(49,274)
NET CHANGE IN FUND BALANCES	1,628	952	2,580
FUND BALANCES, BEGINNING OF YEAR	-	2,343	2,343
FUND BALANCES, END OF YEAR	$ 1,628	$ 3,295	$ 4,923

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, 2007
(amounts expressed in thousands)

Amounts reported for governmental activities in the statement of activities (page 20) are different because:

Net change in fund balance - total governmental funds (page 22)	$	2,580
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.		(655)
Change in net assets of governmental activities (page 20)	$	1,925

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BUDGETARY COMPARISON SCHEDULE - GENERAL FUND

Year Ended June 30, 2007
(Unaudited)
(amounts expressed in thousands)

	Original Appropriation (Budget)	Final Appropriation (Budget)	Actual	Variance with Final Budget
REVENUES				
State appropriations	$ -	$ -	$ 1,167,572	$ -
State pass-through funds	-	-	623,694	-
Federal government	-	-	3,501,356	-
Federal pass-through funds	-	-	1,062,670	-
County government	-	-	264,124	-
County pass-through funds	-	-	3,191	-
Tobacco tax revenue	-	-	60,210	-
Tobacco litigation settlement	-	-	90,258	-
Other	-	-	22,281	-
Total revenues	-	-	6,795,356	-
OTHER FINANCING SOURCES				
Operating transfers in	-	-	15,295	-
TOTAL REVENUES AND OTHER FINANCING SOURCES	-	-	6,810,651	-
PROGRAMMATIC EXPENDITURES				
Acute capitation	1,711,219	1,714,719	1,709,788	4,931
Reinsurance	99,109	113,272	91,612	21,660
Acute fee-for-service	447,376	461,376	403,153	58,223
Proposition 204 capitation	959,422	875,075	867,807	7,268
Proposition 204 reinsurance	84,147	114,147	73,590	40,557
Proposition 204 fee-for-service	148,205	198,549	150,674	47,875
Proposition 204 Medicare premiums	18,974	18,974	17,796	1,178
Medicare premiums	120,730	84,045	84,033	12
Graduate medical education	34,513	38,542	22,513	16,029
Disproportionate share	143,477	143,477	143,477	-
Hospital loan residency program	1,000	1,000	1,000	-
Rural hospital reimbursement	12,158	12,158	12,158	-
Breast and cervical cancer	1,252	869	858	11
Critical access hospitals	1,700	1,702	1,700	2
Freedom to work	4,766	5,714	5,697	17
Part D copay subsidy	1,030	1,630	1,538	92
Medicare clawback payments	27,082	24,781	24,781	-
SSDI temporrary medical coverage	6,500	6,500	1,915	4,585
County hold harmless	4,826	4,826	4,826	-
Long-term care	1,080,691	1,080,871	994,595	86,276
CHIP - Services	104,276	105,798	105,487	311
CHIP - Parents	44,802	44,227	43,793	434
TOTAL PROGRAMMATIC EXPENDITURES	5,057,255	5,052,252	4,762,791	289,461
ADMINISTRATIVE EXPENDITURES	201,864	206,867	184,519	22,348
OPERATING TRANSFERS OUT	-	-	6,500	(6,500)
TOTAL APPROPRIATED EXPENDITURES	5,259,119	5,259,119	4,953,810	305,309
PRIOR YEAR APPROPRIATED EXPENDITURES	-	-	183,328	-
NON-APPROPRIATED EXPENDITURES	-	-	1,685,459	-
REVENUES AND OTHER FINANCING SOURCES OVER (UNDER) EXPENDITURES	-	-	(11,946)	-
FUND BALANCES, BEGINNING OF YEAR	-	-	69,257	-
FUND BALANCES, END OF YEAR	$ -	$ -	$ 57,311	$ -

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET ASSETS (DEFICIT) - PROPRIETARY FUND

June 30, 2007
(amounts expressed in thousands)

ASSETS		
CURRENT ASSETS		
Cash	$	12,543
Receivables and other		25
TOTAL CURRENT ASSETS		12,568
CAPITAL ASSETS		
Furniture, vehicles and equipment, net of accumulated depreciation		129
TOTAL ASSETS	$	12,697
LIABILITIES		
CURRENT LIABILITIES		
Accounts payable	$	892
Other accrued liabilities		104
Deferred revenue - premiums		10,054
Accrued programmatic costs		7,224
Compensated absences due within one year		109
TOTAL CURRENT LIABILITIES		18,383
ACCRUED PROGRAMMATIC COST, less current portion above		18,031
TOTAL LIABILITIES	$	36,414
COMMITMENTS AND CONTINGENCIES		
NET ASSETS (DEFICIT)		
INVESTED IN CAPITAL ASSETS	$	129
RESTRICTED NET ASSETS OTHER PURPOSES		12
UNRESTRICTED (DEFICIT)		(23,858)
TOTAL NET ASSETS (DEFICIT)	$	(23,717)

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, 2007
(amounts expressed in thousands)

OPERATING REVENUES	
Premium revenue	$ 70,007
OPERATING EXPENSES	
Premiums paid to health plans	51,409
Reinsurance	19,317
Other programmatic	11,836
Salaries and employee benefits	3,114
Professional and outside services	3,546
Other	1,437
Depreciation	49
TOTAL OPERATING EXPENSES	90,708
OPERATING LOSS	(20,701)
NONOPERATING REVENUE	
Investment income	446
Grant revenue	206
TOTAL NONOPERATING REVENUE	652
CHANGE IN NET ASSETS (DEFICIT)	(20,049)
NET ASSETS (DEFICIT), BEGINNING OF YEAR	(3,668)
NET ASSETS (DEFICIT), END OF YEAR	$ (23,717)

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF CASH FLOWS - PROPRIETARY FUND

Year Ended June 30, 2007
(amounts expressed in thousands)

CASH FLOWS FROM OPERATING ACTIVITIES	
Receipts from customers	$ 71,963
Payments to health plans	(57,122)
Payments to providers	(9,541)
Payments to employees	(3,057)
Payments to suppliers	(4,599)
Net cash used in operating activities	(2,356)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
Operating subsidies from other funds	(65)
Grant revenue	206
Net cash provided by non-capital financing activities	141
CASH FLOWS FROM INVESTING ACTIVITIES	
Payments to purchase property and equipment	(26)
Investment income	446
Net cash provided by investing activities	420
NET CHANGE IN CASH	(1,795)
CASH, BEGINNING OF YEAR	14,338
CASH, END OF YEAR	$ 12,543
RECONCILIATION OF OPERATING LOSS TO NET CASH USED IN OPERATING ACTIVITIES	
Operating loss	$ (20,701)
Adjustment to reconcile operating loss to net cash used in operating activities:	
Depreciation	49
Changes in operating net assets and liabilities:	
Increase in prepaid rent	(17)
Increase in accounts payable and other accrued liabilities	411
Increase in deferred revenue - premiums	1,956
Increase in accrued programmatic costs	15,889
Increase in accrued compensated absences	57
NET CASH USED IN OPERATING ACTIVITIES	$ (2,356)

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

A. Reporting entity

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

The Arizona Legislature (“Legislature”) established AHCCCS in November 1981 to administer health care for the State’s indigent population. AHCCCS is a State agency managed by an independent cabinet level administration created by the Legislature and is funded by a combination of federal, State and county funds. The federal portion is funded through the Centers for Medicare and Medicaid Services (“CMS”) of the U.S. Department of Health and Human Services under a Section 1115 Waiver (“Waiver”) approved by CMS, which exempts the AHCCCS program from certain requirements of conventional Medicaid programs. Approval of the Waiver, by CMS, extends through September 30, 2011. AHCCCS receives quarterly federal grants from CMS (as matching funds) to cover a portion of the health care costs of the residents of the State eligible for the State’s Title XIX Medicaid program and Title XXI State Children’s Health Insurance Program (“SCHIP”). State appropriations and county funding levels are based on annual budgets as dictated by the Legislature and specified by Arizona Statutory funding formula and Session Law.

AHCCCS provides acute and long-term health care coverage to eligible residents of Arizona. Eligible residents include those who qualify under Section 1931(b) of the Social Security Act, individuals who are aged, blind or disabled, children who meet certain age requirements from families receiving food stamps, children and pregnant women whose household income meets eligibility requirements, certain single adults, childless couples, parents of SCHIP and Medicaid children under the Health Insurance Flexibility and Accountability Demonstration initiative, uninsured women needing active treatment for breast and/or cervical cancer, individuals with disabilities who want to work and who meet certain SSI eligibility criteria and disabled individuals who receive Social Security Disability Income (“SSDI”) payments, are not eligible for Medicare, and are no longer eligible for other AHCCCS programs.

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 2007, AHCCCS did not have any major funds; accordingly, all governmental funds other than the General Fund are aggregated and reported as other governmental funds.

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

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

Proprietary funds distinguish between operating revenues and expenses from non-operating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. The principal operating revenues of the Healthcare Group are premiums charged to small, uninsured businesses with 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, 2007, the proprietary fund deferred revenue of $10,054 consists of premium payments received for fiscal year 2008 as required by contract.

The governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, AHCCCS considers revenue to be available if they are collected within 31 days of the end of the current fiscal year. The governmental funds deferred revenue consists of revenue received in advance for services not yet provided. Expenditures generally are recorded when a liability is incurred, as under accrual accounting. Accrued programmatic costs include estimates for incurred but not reported (IBNR) claims 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 compensated absences and claims and judgments are recorded only when payment is due.

(1) Summary of significant accounting policies (continued)

In fiscal year 2007, 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 for 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 $118,472 at June 30, 2007 including restricted funds of $37,011.

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 $35,467 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 ISAs, which are not required to be reported in other funds. Fund receipts consist of monies received from other entities and are utilized to match federal funding under the Medicaid and SCHIP programs under the terms stated in the ISAs. Cash in the Other Governmental Funds is legally restricted in the amount of $1,544 for the Hawaii Arizona PMMIS Alliance (HAPA) Fund, as described in Note 4 and is offset by an equal amount of accrued expenditures and deferred revenue at June 30, 2007.

(1) Summary of significant accounting policies (continued)

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, 2007, a bank overdraft of $116 existed which represented the excess of checks issued over federal funds deposited.

E. Capitation payments

AHCCCS' contracted health plans receive fixed capitation payments, generally in advance, based on actuarially determined rates for each AHCCCS member enrolled with the plan. The plans are required to provide all covered health care services to their members, regardless of the cost of care. If there are funds remaining, the plan retains the funds as profit; if the costs are higher than the amount of capitation payments 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. 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 $43,145 at June 30, 2007 that represents estimated settlement payments due to contracted health plans for the PPC reconciliation. Actual results may differ from this estimate, and such differences will be recorded in the period in which they are identified.

Similar risk sharing is in place for medical costs incurred by contracted health plans for the Title XIX Waiver Group (TWG) members. AHCCCS reconciles the contractor's medical costs to the total capitation payments, hospitalized supplemental payments, delivery supplemental payments and HIV/AIDS supplemental payments paid for the contract year. The reconciliation limits the contractor's profits or losses to 2%. Accrued programmatic costs include approximately $16,209 at June 30, 2007 that represents estimated settlement payments due to contracted health plans for the TWG reconciliation. Actual results may differ from this estimate, and such differences will be recorded in the period in which they are identified.

F. Reinsurance payments

AHCCCS provides a stop-loss reinsurance program for its contracted health plans for partial reimbursement, after a deductible is met, of reinsurable covered medical services incurred for members with an acute medical condition. The program includes a deductible, which varies based on the health plan's enrollment and the eligibility category of the members. AHCCCS will adjust the deductible levels based upon enrollment levels and, in some cases; the contracted health plan with a higher deductible level may elect a lower deductible level. AHCCCS reimburses the health plans based on a coinsurance amount for reinsurable covered services incurred above the deductible. This reinsurance provides partial reimbursement of reinsurance eligible covered services and will reimburse 75% of eligible costs above the deductible level up to $650 of covered expenses and 100% thereafter.

(1) Summary of significant accounting policies (continued)

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

G. Fee-for-service payments

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

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

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

H. Incurred but not reported programmatic expenditures

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

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

(1) Summary of significant accounting policies (continued)

I. Disproportionate share hospital payments

CMS and the Legislature authorized AHCCCS to make disproportionate share payments to Arizona hospitals that provided care to a disproportionate share (as defined) of the State's indigent population. Expenditures for disproportionate share totaled $143,477 for the year ended June 30, 2007.

J. Taxes

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

K. Management's use of estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities, and the reported amounts of revenues and expenditures at June 30, 2007. Actual results may differ from these estimates.

L. 100% federal poverty level expansion and CMS Waiver

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

In January 2001, AHCCCS obtained a Waiver from CMS to receive federal funding for certain non-categorically linked populations including those made eligible by the passage of Proposition 204. The Waiver requires that over the term of the agreement the populations covered by the Waiver be budget neutral for CMS. The Waiver period for budget neutrality began April 1, 2001 and extends through federal fiscal year 2011, at which time any federal funds received by the State that exceed the negotiated budget neutrality limit must be returned to CMS. Management believes that as of June 30, 2007, AHCCCS does not have any liability to CMS related to the budget neutrality agreement and, accordingly, no liability is recorded in the accompanying financial statements. See Note 9.

AHCCCS has classified the Arizona Tobacco Litigation Settlement Fund, created by ballot Proposition 204, as part of its General Fund. These funds are restricted for use as specified in 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 $88,770 in April 2007 for the period from January 1, 2006 to December 31, 2006 and supplemental payments in the amount of $791 and $697 in December 2006 and June 2007 respectively. Revenue and a related receivable of $46,002 was accrued for the period of January 1, 2007 through June 30, 2007 and is included in Tobacco Settlement Receivable and Other Operating Grants and Contributions in the accompanying Statement of Net Assets and Statement of Activities.

(dollar amounts expressed in thousands)

(2) Capital assets

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

Balance, June 30, 2006	$ 2,910
Additions	1,130
Retirements	(39)
Depreciation	(1,285)
Balance, June 30, 2007	$ 2,716

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, 2007, management does not believe impairment indicators are present, and there were no idle capital assets.

(3) Compensated absences

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

Balance, June 30, 2006	$ 2,645
Additions	6,314
Reductions	(5,457)
Balance, June 30, 2007	$ 3,502

(dollar amounts expressed in thousands)

(4) Other governmental funds

At June 30, 2007, the other governmental fund balance of $3,295 was comprised of the following funds:

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

- Tobacco Products Tax Fund, Emergency Health Services Account (TPTF-EHSA) - The Arizona Department of Revenue allocates the tobacco tax revenue to the TPTF-EHSA which is used solely for the reimbursement of uncompensated care, primary care services and trauma centers readiness costs. Revenue sources for the TPTF-EHSA include tobacco tax proceeds and investment income.

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

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

- Miscellaneous Funds - These funds account for various grants and other money received for specific purposes including the Hawaii Arizona PMMIS Alliance (HAPA) and the Hospital Loan Residency Fund. HAPA represents AHCCCS' project with Hawaii whereby AHCCCS provides data processing services for Hawaii's Medicaid program. The Hospital Loan Residency Fund is established consisting of legislative appropriations and loan repayment monies for the establishment of a hospital loan program to fund start-up and ongoing costs for residency programs in accredited hospitals.

Other governmental funds earned, expended and transferred during the fiscal year ended June 30, 2007 were as follows:

	TTHCF - MNA	TPTF - EHSA	Third Party Liability Fund	Trauma and Emergency Services Fund	Miscel-laneous Funds	Total
Fund balances, June 30, 2006	$ -	$ -	$ 607	$ -	$ 1,736	$ 2,343
Receipts	107,162	27,831	1,693	23,630	14,262	174,578
Interest earned	46	77	23	250	44	440
Expenditures	(68,573)	(27,691)	(2,323)	(23,880)	(13,747)	(136,214)
Transfers in (out):						
Tobacco Product Tax 204 Protection	-	(217)	-	-	-	(217)
AHCCCS General Fund	-	-	-	-	1,000	1,000
Arizona Dept of Health Services	(37,925)	-	-	-	-	(37,925)
ADHS Health Crisis Fund	(510)	-	-	-	-	(510)
Arizona Dept of Economics Security	(200)	-	-	-	-	(200)
Fund balances, June 30, 2007	$ -	$ -	$	$ -	$ 3,295	$ 3,295

(5) Proprietary fund - operations

The Healthcare Group was established in 1988 by the State to administer health care services primarily to small, uninsured businesses with 1 to 25 employees and employees of political subdivisions; later increased to 1 to 50 employees. HCG contracted with three health plans from the existing network of AHCCCS health plans (HMOs) to enroll members and provide managed care services. During fiscal year 2006, HCG started offering a PPO option through a third party administrator in order to provide health care coverage statewide. HCG conducts enrollment/renewal, fulfillment, premium billing, collections, fund disbursement and data analysis. HCG also is responsible for the regulatory oversight of the health plans and the third party administrator.

The HMO contracted health plans are prepaid on a "per member, per month" (PMPM) basis. Capitation payments are made prospectively. Pursuant to contractual agreement, HCG reconciles the health plans' actual medical expenses reported to the capitation payments made by HCG during the contract year to determine if any additional payments are required. Such additional payments are subject to the contracted health plan's medical loss ratio as wells as the availability of funds in HCG to fund such payments.

Accrued programmatic costs include approximately $22.5 million of estimated settlement payments due to contracted health plans based on the reconciliations prepared as of June 30, 2007. Approximately $5.0 million of this total relates to fiscal year 2006 liabilities to two contracted health plans and were paid prior to October 1, 2007, utilizing a General Fund subsidy appropriated for fiscal year 2008. Due to HCG's declining financial condition (see Note 6) and the inadequacies of reserves, HCG is currently negotiating payment terms with the 3 contracted health plans to repay the remaining liabilities owed over the next two to three fiscal years.

Relating to the PPO option, Gross PPO Premium Revenue for 2007 was $8.3 million and medical expenses were $11.5 million, including medical claim payments and accrued liabilities to providers. PPO program claims payable (including IBNR) was $2.7 million at June 30, 2007.

Similar to fiscal year 2006, there was no General Fund appropriation to subsidize HCG's operations in fiscal year 2007. In fiscal year 2007, HCG raised premium rates twice in an effort to fund medical losses, cover administrative costs and fund the premium stabilization reserve. However, the rate increases were not sufficient to cover the large increase in medical costs and normal operating activities. This has resulted in a $20.0 million increase in the HCG net deficit to $23.7 million. Future financial operations of HCG will be dependent on setting actuarially sound premium rates for the various plan options and stable enrollment. See further discussion at Note 6.

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

HCG incurred an operating loss of $20,701 in 2007 and $6,233 in 2006. As of June 30, 2007 there was a net deficit of $23,717. Additionally, current liabilities exceeded current assets by $5,815 at June 30, 2007.

Two factors were the primary contributors to the decrease in net assets in 2007 and 2006. The most significant were the $17,458 in HMO medical costs in excess of capitation paid (reconciliation costs) for the HMO model insurance contractors in 2007 and the $3,257 PPO medical expense in excess of PPO premium revenue.

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

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

- In March 2007, HCG introduced a Point-of-Service (POS) plan and began "tiering" its 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.
- Premium, deductible and co-payment increases were implemented effective September 1, 2007 for new and renewing HMO members, for all health plan options and tiers, with a continued emphasis on increasing the actuarially determined premium rates for groups with 1 employee, in order to cover the costs of their historically disproportionate consumption of services.
- HCG reviewed and tightened pharmacy formularies and Pharmacy Benefit Managers (PBMs) at one health plan and for the PPO to encourage use of generic and lower cost drugs.
- HCG implemented strategies to mitigate member migration/fall out due to the premium increase, elimination of $0 deductible, and increases to co-payments and coinsurance.
- HCG eliminated 49% of administrative full time equivalent positions as of February 2008 due to an enrollment freeze passed by the Legislature effective September 19, 2007 – through reengineering of job assignments and duties.
- Contract negotiations are underway with the health plans to address increasing medical loss ratios, improve medical management practices and include incentives for medical management by the health plan.
- HCG is conducting ongoing and concurrent review of premium revenue and plan benefit design for implementation.

Management represents that successful implementation of these operating improvements will improve the financial performance of HCG for fiscal year 2008; however, they anticipate a continued operating deficit of $2 - $8 million.

There can be no assurance that these operating improvements will occur or will provide sufficient cash to fund operating expenses. Additionally, if there is an adverse change in enrollment and the premium increases are not sufficient to fund the reserves for past losses and future medical claims experience costs, then HCG will be required to further scale back administrative expenditures to the level supported by actual enrollment 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 8.6% for retirement and .5% for long-term disability for 2007. The matching amount contributed to the retirement plan by AHCCCS was $4,837 in 2007 and is included in administrative expenditures in the accompanying government-wide and governmental fund financial statements.

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

(8) Budgetary basis of accounting

The financial statements of AHCCCS are prepared in conformity with U.S. generally accepted accounting principles (GAAP). AHCCCS, like all other State agencies, prepares its annual budget on a basis that differs from the GAAP basis. The State's accounting system and Arizona Revised Statutes and policies provide for an additional accounting period (13^{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 $183,328 paid in the current fiscal year in accordance with the administrative adjustment procedures as authorized by Arizona Revised Statutes are reported as a separate amount. AHCCCS' controlling statute for programmatic payments administrative adjustment procedures varies from the statutory requirement of other State agencies. AHCCCS is permitted to pay for approved system covered medical services presented after the close of the fiscal year in which they were incurred with either remaining prior year or current year available monies. Unexpended prior year available monies for programmatic payments revert on December 31, 2007.

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, 2007:

(dollar amounts expressed in thousands)

(8) Budgetary basis of accounting (continued)

	General Fund Actual
Budgetary Basis Fund Balance, June 30, 2007	$ 57,311
Budgetary Basis of Accounting	
Increases to fund balance:	
Due from State and county governments	44,746
Due from the federal government	156,925
Due from other Fund	5,405
Receivables and other	187
Total increases	207,263
Decreases to fund balance:	
Deferred revenue	(464)
Due to State and county governments	(70,057)
Accrued programmatic costs	(188,665)
Payables and other	(3,760)
Total decreases	(262,946)
Total GAAP basis fund balance	$ 1,628

Non-appropriated expenditures of $1,685,459 in the general fund consist of federal and state matching 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. CMS has disallowed this claim through the June 2007 quarter. AHCCCS appealed this decision and the U.S. Department of Health and Human Services; Departmental Appeals Board upheld the disallowance on August 7, 2001. Additionally, AHCCCS 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. Subsequent to the balance sheet date, the Ninth District Court of Appeals reversed the district court decision and ruled in CMS' favor. AHCCCS has declined to seek further court review of the decision. At June 30, 2007 no receivable or payable amounts have been recorded on the accompanying financial statements related to this litigation.

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.

(9) Contingencies (continued)

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

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

Budget neutrality agreement - AHCCCS' 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 agreement (April 1, 2001 through September 30, 2011), that the population covered by the Waiver be budget neutral for CMS. AHCCCS negotiated an extension of the Waiver with CMS that extends the budget neutrality for an additional period of five years. In addition, the Waiver was amended to include the Arizona Long Term Care program expenditures making them subject to budget neutrality beginning October 1, 2006. Under budget neutrality, CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions (STC) include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. It also established a diminishing annual threshold of the amount by which AHCCCS is able to exceed the budget neutrality limit on an interim basis before being required to submit a corrective action plan. The STC reporting limit thresholds are monitored on a Federal Fiscal Year basis. The STC limit threshold for the first six limit periods (April 1, 2001 through September 30, 2007) is 1.0 percent. The threshold declines by 0.25 percent for limit periods seven through nine and is zero percent for the limit period ended September 30, 2011. As of June 30, 2007, reported date of service expenditures associated with the five periods ended September 30, 2006 are below the limit by $154.3 million, or 1.17 percent. Through June 30, 2007, AHCCCS remains under the cumulative reporting limit threshold. The budget neutrality calculation is dependent on a number of variables including the number of members, the eligibility category of members and the general economy and its impact on unemployment, medical inflation and policy decisions that may impact program costs made by the Legislature. Given the uncertainty surrounding these factors, AHCCCS is not presently able to determine if the budget neutrality limit will be exceeded or if it is exceeded that CMS will require repayment of the excess. Management believes that as of June 30, 2007, AHCCCS does not have any liability to CMS related to the budget neutrality agreement. Accordingly, the accompanying basic financial statements have not been adjusted for the impact of any liability AHCCCS may have related to the Waiver budget neutrality agreement.

(10) Interfund receivables, payables and transfers

Interfund activity is defined as transactions between funds administered by AHCCCS. The interfund balances as of June 30, 2007 consist of transfers from the Other Funds to the General Fund in the amount of $5,405.

In the government-wide statement of activities, the interfund activity has been eliminated. The total net transfers out of $49,274 reported on the statement of activities represents transfer activities to other State agencies.

(dollar amounts expressed in thousands)

(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.

The following is a summary of transactions with these State agencies for the administrative services described above for the year ended June 30, 2007.

	Expenditures
Arizona Department of Economic Security	$ 84,011
Arizona Department of Administration	10,207
Arizona Department of Health Services	1,866
Arizona Board of Nursing	355
Arizona Office of Administrative Hearings	408
	$ 96,847

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, 2007.

	Expenditures
Arizona Department of Economic Security	$ 745,217
Arizona Department of Health Services	932,774
	$ 1,677,991

(dollar amounts expressed in thousands)

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

Revenues include $279,442 from Arizona counties during fiscal year 2007. 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, 2007, AHCCCS has accrued $28,929, 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 $2,532 as determined by statutory calculation for administrative costs incurred by ADES for eligibility determinations and other operating costs of Proposition 204.

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

At June 30, 2007, 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	$ 6,789
Program Services Federal Funds	32,829
Arizona Department of Economic Security	
County Contribution for Administrative Costs	2,532
Arizona Department of Health Services	
Cost reimbursement from Civil Monetary Penalties	188
	$ 42,338

(13) New pronouncements

The Governmental Accounting Standards Board (GASB) issued several pronouncements prior to June 30, 2007 with effective dates within or after the fiscal year ending June 30, 2007. Management believes the impact of these statements does not affect current or future financial presentations by AHCCCS. In addition, AHCCCS adopted no new pronouncements in the fiscal year ending June 30, 2007.

(14) Subsequent events

Beginning in March 2007, enrollment began increasing and reversed a downward trend in which enrollment declined in ten of the fifteen prior months. For the first seven months of fiscal year 2008, Title XIX capitated enrollment has grown by 35,365 members or 4.6%, which is higher than the 1.9% growth rate used for the fiscal year 2008 appropriation. Based on the recent upward trend for acute care caseload, AHCCCS' management is projecting that a supplemental appropriation in fiscal year 2008 will be required. The accompanying basic financial statements have not been adjusted for any changes that might result from the outcome of this uncertainty.

ADDITIONAL INFORMATION

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2007
(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		$ 4,600,831
Federal funds expended to subrecipients		4,955
		4,605,786
Children's Health Insurance Program (Title XXI)	93.767	114,295
Medicaid Infrastructure Grant	93.768	50
Hurricane Katrina Relief	93.776	46
Medicaid Transformation Grants	93.793	297
Reimbursement of State Costs for Provision of Part D Drugs	93.794	6,244
Social Services Research and Demonstration	93.647	1
Health Resources and Services Administration		
State Planning Grant - Health Care Access for the Uninsured	93.256	171
Total U.S. Department of Health and Human Services		4,726,890
U.S. Department of Homeland Security		
Disaster Grants - Public Assistance	97.036	312
TOTAL EXPENDITURES OF FEDERAL AWARDS		$ 4,727,202

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, 2007 and for the year then ended, and have issued our report thereon dated March 21, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the **Arizona Health Care Cost Containment System's** internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the **Arizona Health Care Cost Containment System's** internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the **Arizona Health Care Cost Containment System's** internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

<u>Compliance and Other Matters</u>

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

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

Mayer Hoffman McCann P.C.

Phoenix, Arizona
March 21, 2008