ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

FINANCIAL STATEMENTS AND ADDITIONAL INFORMATION

Year Ended June 30, 2011

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MANAGEMENT’S DISCUSSION AND ANALYSIS

Management's Discussion and Analysis

For the Fiscal Year Ended June 30, 2011

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, 2011. 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.

<u>Financial Highlights</u>

Government-Wide

- The assets of AHCCCS exceeded its liabilities at fiscal year ended June 30, 2011 by $48.2 million. AHCCCS' net assets at June 30, 2011 are comprised of an unrestricted net asset of $46.6 million and $1.6 million invested in capital assets.

- AHCCCS net assets increased by $55.0 million during fiscal year 2011. Net assets of governmental activities increased by $49.0 million, while the net deficit of the business-type activity decreased by $6.0 million.

- On March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act (PPACA). The PPACA includes multiple provisions that significantly impact the Medicaid program including extending prescription drug rebates to managed care programs and increases to the rebate amount drug manufacturers are required to pay under the Medicaid prescription drug rebate program. AHCCCS received CMS approval and began collecting rebates for drugs dispensed under managed care and fee-for-service programs in fiscal year 2011. AHCCCS' contracted vendor began processing rebate invoices in March of 2011. AHCCCS recorded prescription drug rebate expenditure reimbursements in the amount of $287.0 million including an accrued receivable of $118.4 million. Of the $287.0 million, an estimated $207.8 will be returned to the federal government, and an estimated $79.2 is available to offset a portion of current fiscal year and future fiscal year General Fund expenditures with a legislative appropriation.

- The American Recovery and Reinvestment Act (ARRA) of 2009 increased Federal Medical Assistance Payments by $667.0 million during fiscal year 2011. These payments reduced the amount of state funds normally required to match federal funds. The ARRA increased rate terminated on June 30, 2011, except for certain qualifying adjustments to prior period payments made during the recession period.

Fund Level

- As of the close of fiscal year 2011, AHCCCS' total governmental funds reported an ending fund balance of $31.3 million, an increase of $31.1 million. The increase is attributable to Medicaid prescription drug rebate receipts and an increase in the Hospital Residency Loan Fund. The change is comprised of a $31.0 million balance in the Prescription Drug Rebate Fund from receipts in excess of the fiscal year 2011 legislative appropriation and a $100,000 repayment received in fiscal year 2011 on the hospital residency loan program receivable. The prescription drug rebate receipts received in fiscal year 2011 represent the billing periods of March 2010 through March 2011 that were invoiced in May 2011. These receipts were recognized as available per the governmental funds revenue recognition criteria which include receipts collected within 31 days of the end of the current fiscal year.

- Business-type activities during fiscal year 2011 resulted in operating income of $4.9 million compared to the operating income of $2.0 million in the prior fiscal year. The operating income continues a positive turn-around trend in the net deficit balance that began in fiscal year 2008. Overall operating results decreased the net deficit to $3.0 million at June 30, 2011 as compared to the $9.0 million net deficit balance at June 30, 2010. Additionally, in fiscal year 2011, HCG recorded a forgiveness of debt relating to a reconciliation liability carried over from fiscal year 2009. The reconciliation liability was forgiven by $1.3 million in consideration of payments of $1.5 million. Other cash payments, reinsurance recoveries and adjustments reduced the liability by $2.8 million for a total reduction of $5.6 million.

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

Overview of the Financial Statements

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

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

The Government-Wide Financial Statements are designed to provide readers with a broad overview of AHCCCS' finances that are comparable to a private-sector business. The Statement of Net 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) (page 20) 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 (page 21) 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, prescription drug rebate receipts, business-type activity managed care health plans' target medical loss ratio reconciliations, and earned but unused vacation leave).

Both statements report activity for 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 primarily consist of programs authorized by the Social Security Act Titles XIX (Medicaid) and XXI (Children's Health Insurance Program (CHIP)) that are concentrated on the health needs of the citizens of Arizona. The majority of AHCCCS' activities are reported in this category.

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

The government-wide financial statements can be found on pages 20 and 21.

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 22 through 24 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, Breast & Cervical Cancer, Freedom-to-Work 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 (Children's Health Insurance Program). In addition to the appropriation expenditure authority approved by the Legislature, AHCCCS also expends continuously appropriated funds for capitation from prescription drug rebate reimbursement receipts, for other third party liability recovery and cost avoidance program activities, supplemental payments to county hospitals, electronic health records infrastructure development and certain payments to hospitals for unfunded emergency department readiness costs and level 1 trauma center costs. The expenditures for unfunded emergency department readiness costs and level 1 trauma center costs are financed by revenues specifically collected for those purposes and are by statute continuously appropriated. A budgetary comparison statement has been provided for the General Fund to demonstrate compliance with the budget on page 25.

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 26 through 28 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 29 to 50.

Government-Wide Financial Analysis

As noted earlier, the net assets (deficit) 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	
	2011	2010	2011	2010	2011	2010
Current assets	$ 776,477	$ 973,220	$ 8,941	$ 9,154	$ 785,418	$ 982,374
Noncurrent assets	700	800	-	-	700	800
Capital assets	1,663	1,004	3	24	1,666	1,028
Total assets	778,840	975,024	8,944	9,178	787,784	984,202
Current liabilities	727,631	972,804	7,282	5,738	734,913	978,542
Long-term liabilities	-	-	4,651	12,450	4,651	12,450
Total liabilities	727,631	972,804	11,933	18,188	739,564	990,992
Net assets (deficit):						
Invested in capital assets, net of depreciation	1,663	1,004	3	24	1,666	1,028
Unrestricted (deficit)	49,546	1,216	(2,992)	(9,034)	46,554	(7,818)
Total net assets (deficit)	$ 51,209	$ 2,220	$ (2,989)	$ (9,010)	$ 48,220	$ (6,790)

For AHCCCS, assets exceeded liabilities by $48.2 million at June 30, 2011 as compared to liabilities exceeding assets by $6.8 million at June 30, 2010.

Total entity-wide unrestricted net assets increased by $54.4 million to $46.6 million net of the business-type activity net deficit of $3.0 million during fiscal year 2011. The increase is primarily due to the $49.2 million carry-forward balance of prescription drug rebate receipts. The $4.9 million current year operating income combined with the debt forgiveness, interest and other income decreased the business-type activity net deficit by $6.0 million to a $3.0 million unrestricted net deficit. The operating income is the result of successfully managing both program and administrative costs where premium rates were set to fund projected medical and administrative costs and to provide payments to health plans that are owed reconciliation amounts for prior fiscal years.

A $49.5 million unrestricted net asset balance for governmental operations fully offsets the $3.0 million business-type activity unrestricted net deficit. The primary component of the governmental balance primarily consists of a prescription drug rebate carry-forward balance of $49.2 million. This amount is only available for future spending with a legislative appropriation. An additional component is $700,000 in hospital residency program loans receivable that are due and available in future periods upon collection of the loans. During the year, governmental unrestricted net assets increased by $48.3 million primarily driven by the PPACA expansion of prescription drug rebates to Medicaid managed care organizations. The net assets is also aided by $1.7 million of net assets invested in capital assets. AHCCCS uses these capital assets to provide services to its members.

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

	Governmental Activities		Business-Type Activities		Total	
	2011	2010	2011	2010	2011	2010
Revenues						
Program Revenues						
Charges for services	$ 5,595	$ 10,506	$ 38,428	$ 47,487	$ 44,023	$ 57,993
Other operating grants and contributions	406,025	394,687	-	-	406,025	394,687
Federal operating grants	6,865,613	7,311,204	-	-	6,865,613	7,311,204
General revenues						
State appropriations	1,995,616	1,676,132	-	-	1,995,616	1,676,132
Tobacco tax	138,432	139,061	-	-	138,432	139,061
Forgiveness of debt	-	-	1,330	-	1,330	-
Unrestricted investment earnings	60	118	50	83	110	201
Total revenues	9,411,341	9,531,708	39,808	47,570	9,451,149	9,579,278
Expenses						
Health Care	9,322,800	9,491,221	33,334	45,426	9,356,134	9,536,647
Excess before transfers	88,541	40,487	6,474	2,144	95,015	42,631
Transfers, net	(39,552)	(42,012)	(453)	(365)	(40,005)	(42,377)
Increase (decrease) in net Assets (deficit)	48,989	(1,525)	6,021	1,779	55,010	254
Net assets (deficit) – beginning of year	2,220	3,745	(9,010)	(10,789)	(6,790)	(7,044)
Net assets (deficit) – end of year	$ 51,209	$ 2,220	$ (2,989)	$ (9,010)	$ 48,220	$ (6,790)

At June 30, 2011, the governmental activities reported positive balances such that assets for the Agency as a whole ended in a positive net asset position. The combined business-type activity and government-wide activities closed the fiscal year with a net asset balance compared to the net deficit balance in the prior fiscal year. The prior fiscal year overall Agency net deficit was decreased by $55.0 million, or 810.2 percent from the $6.8 million net deficit at June 30, 2010.

Governmental activities in fiscal year 2011 contributed $49.0 million that entirely eliminated the AHCCCS net deficit reported in the prior fiscal year. The net deficit decrease is primarily attributable to Medicaid prescription drug rebate receipts. The prescription drug rebate receipts was the result of a catch-up period of four quarters between the March 2010 effective date of the PPACA and when AHCCCS' contracted vendor began invoicing drug manufacturers. Business-type activities decreased the net deficit by $6.0 million that is primarily attributable to annual operating results that generated $4.9 million in operating income, a $1.3 million forgiveness of prior fiscal year medical loss ratio reconciliation liability debt, and other miscellaneous collections offset by legislative mandated transfers to the State General Fund of $453,000. These operating results allowed HCG to continue the positive trend of decreasing its net deficit position to $3.0 million at June 30, 2011 compared to $9.0 million in the prior fiscal year.

American Recovery & Reinvestment Act of 2009

During fiscal year 2011, AHCCCS continued to receive fiscal relief provided by the American Recovery and Reinvestment Act (ARRA or the Act) of 2009. The Act, among other items, provides fiscal relief to states in the form of an increase in the FMAP rate to protect and maintain State Medicaid programs. The ARRA period was originally slated to cover 9 quarters (3 in state fiscal year 2009; 4 in state fiscal year 2010; and 2 in state fiscal year 2011) by helping States, the District of Columbia and Territories meet their health care needs. However, the President signed HR 1586 that included a $16 billion extension for increased Medicaid FMAP rates for 2 additional quarters through June 30, 2011. AHCCCS estimates that it will receive an additional $252 million in ARRA Medicaid funds when the accrued claiming tail is completed for the Title XIX Medicaid program including pass through funds to other state agencies and political subdivisions. As a condition of accepting the increased FMAP, AHCCCS must continue to comply with the following ARRA maintenance of effort requirements:

- States are ineligible for increased FMAP if eligibility standards, methodologies, or procedures are more restrictive than what was in effect July 1, 2008. There were provisions that allowed states to reverse changes made prior to the passage of ARRA and still be able to receive the increased FMAP.
- States must comply with prompt payment requirements to providers and must submit a quarterly report that it is in compliance with this provision.
- States cannot deposit or credit any reserve or rainy day funds with revenue from increased FMAP and will be required to report on how the increased FMAP dollars are spent.
- States are ineligible for the increased FMAP if it requires political subdivisions to pay a greater percentage of the non-federal share for quarters during the recession adjustment period than the percentage that would have been required by the State under such plan on September 2008.

The ARRA and subsequent extension provides for an increase to the FMAP rate for the recession adjustment period of October 1, 2008 to June 30, 2011. The increased FMAP is based on three components consisting of a maintenance of FMAP, a hold harmless provision that maintains the federal fiscal year 2008 rate of 66.20 percent, an increased unemployment adjustment provision, and a general 6.2 percent increase provision that was phased-down to 3.2 percent in the quarter ended March 32, 2011 and to 1.2 percent in the quarter ended June 30, 2011 of the extension period. The increased unemployment adjustment variable component resulted in AHCCCS qualifying for the tier 2 rate for the December 2008 and March 2009 quarters and the higher tier 3 rate for the June 2009 quarter. AHCCCS continued to be eligible for the tier 3 rate through June 30, 2011. The following table shows the projected FMAP and increased rate amounts for the ARRA recession adjustment period:

Arizona ARRA FMAP Increase Percentages

Federal Fiscal Year	Current FMAP	Tier Adj FMAP	Actual Rate	Increase
2009 Q-1&2	65.77%	75.01%	75.01%	9.24%
2009 Q-3&4	65.77%	75.93%	75.93%	10.16%
2010	65.75%	75.93%	75.93%	10.18%
2011 Q-1	65.85%	75.93%	75.93%	10.08%
2011 Q-2	65.85%	73.10%	73.10%	7.25%
2011 Q-3	65.85%	71.22%	71.22%	5.37%

This FMAP increase resulted in a cost shift of approximately $667.0 million of additional Federal revenue funds and a corresponding reduction in State matching funds for fiscal year 2011.

Funding for disproportionate share hospital (DSH) payments are not eligible for the increased FMAP rate. However, the ARRA provided for a temporary 2.5% increase in the state DSH allotment for fiscal years 2009 and 2010 with no increase for fiscal year 2011.

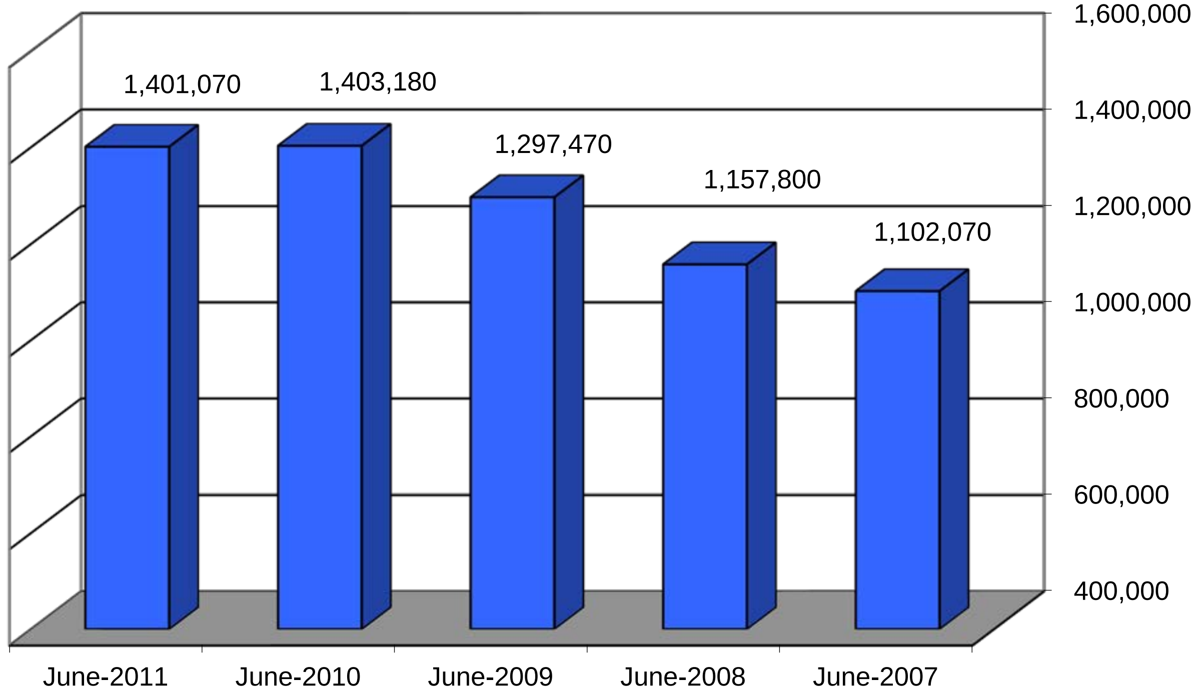
Governmental Activities

Fiscal year 2011 governmental activities increased the net assets by $48.989 million. This increase is primarily related to the Medicaid prescription drug rebate program that was extended to managed care organizations under the PPACA in March 2010. The AHCCCS program provides health care coverage to the majority of its members under a Section 1115 waiver for a managed care program and accordingly only began receiving prescription drug rebate receipts in the current fiscal year.

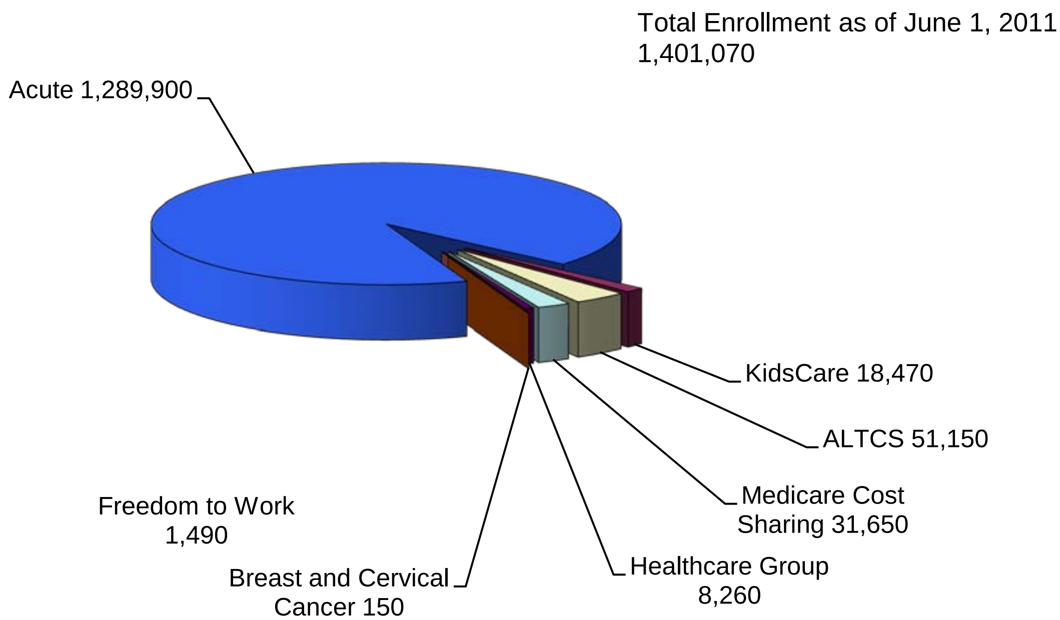
Enrollment in AHCCCS programs continued the slowing trend that had begun beginning with the final six months of fiscal year 2010 and stabilized through the first ten months of fiscal year 2011. From July 2010 to April 2011, Title XIX full service enrollment actually decreased in six of the ten months. However, the final two months of fiscal year 2011 experienced significant growth that may have been the result of member applications prior to implementation of planned enrollment freezes. This period of relative enrollment stability followed 40 months of growth where 392,182 Title XIX full service members were added for a 44.7 percent increase from 879,720 to 1,272,902. Enrollment at June 1, 2011 is 1,401,070, a decrease of 2,110 members over June 1, 2010 or 0.2 percent as compared to the increase in members of 105,710 or 8.2 percent during fiscal year 2010. The overall enrollment decrease impact on total fiscal year 2011 expenditures was minimal as slight increases in higher cost childless adult populations offset decreases in lower cost populations such as KidsCare. The cap and freeze on the enrollment for the KidsCare program population was effective January 1, 2010 and continued through fiscal year 2011. During fiscal year 2011, the KidsCare program enrollment declined by over 13,750 members.

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

AHCCCS Membership Growth



AHCCCS Enrollment by Program



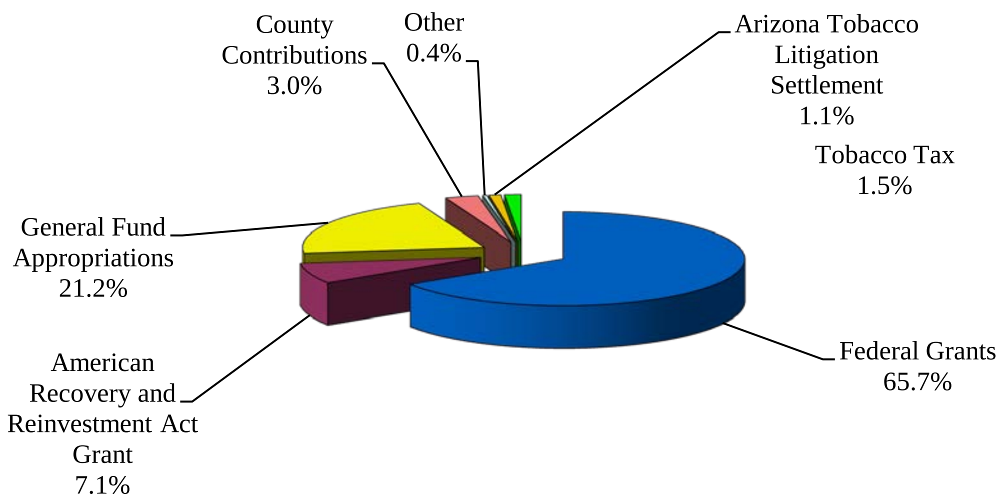
The cost of health care programs, including Title XIX Medicaid and Title XXI CHIP, totaled $9,322.8 million in fiscal year 2011, a $168.0 million decrease from the $9,491.2 million reported in fiscal year 2010. As shown in the statement of activities, the amount of expenditures funded from federal grants through the Centers for Medicare and Medicaid Services (CMS) was $6,865.6 million (73.6 percent) in fiscal 2011 as compared to $7,311.2 million (77.0 percent) in fiscal 2010. Program funding in the form of federal financial participation is primarily determined through the FMAP rate used to provide the amount of federal matching funds for State medical assistance expenditures. The FMAP is based on the relationship between Arizona's per capita personal income and the national average per capita personal income over three calendar years. The FMAP is recalculated each year and was scheduled to decrease by 0.10 percent to 65.85 percent from the prior year's rate of 65.75 percent. However, ARRA, as extended, provides for an increase to the FMAP rate for the recession adjustment period of October 1, 2008 to June 30, 2011. This FMAP increase attributable to ARRA resulted in a cost shift of approximately $667.0 million of additional Federal revenue funds and a corresponding reduction to state matching funds for fiscal year 2011.

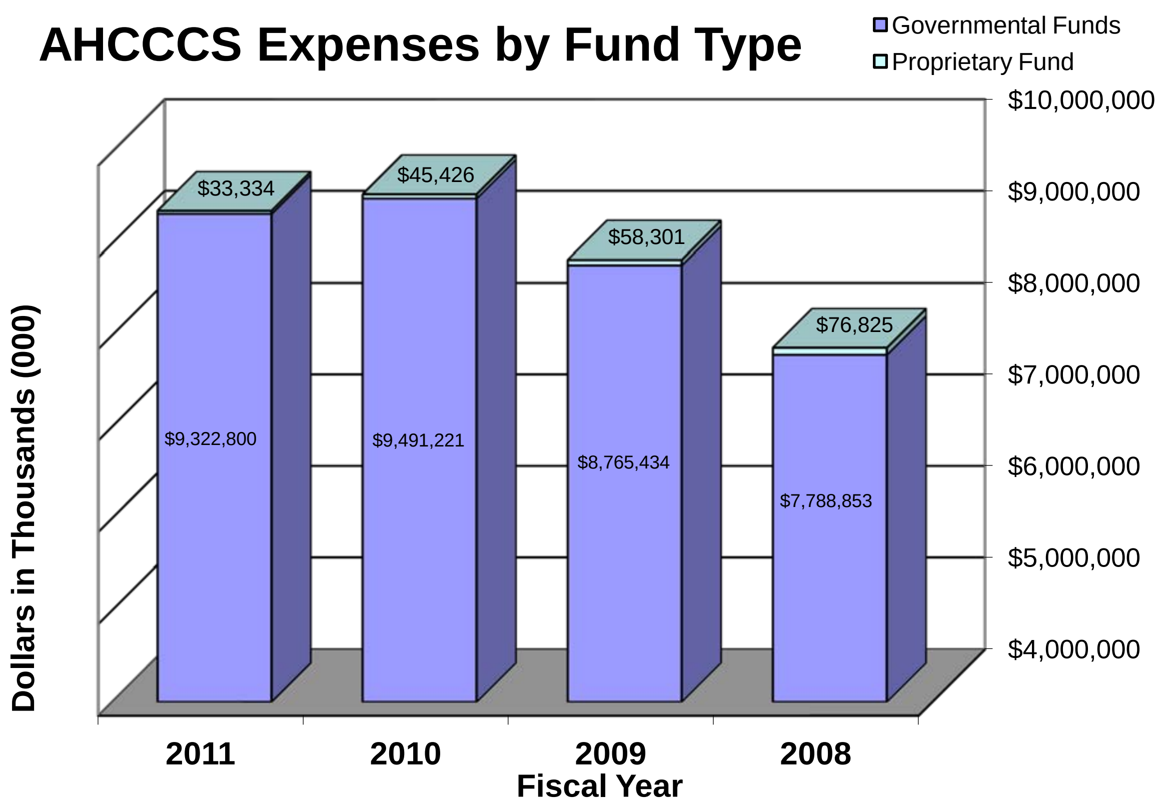
The decrease in program expenditures in fiscal year 2011 is attributable to the nearly steady enrollment and certain provider rate reductions effective April 2011 and a full fiscal year of provider rate reductions for certain fee-for-service provider rates that were implemented in the prior fiscal year.

State, county and miscellaneous funding sources combined to provide $2,545.7 million in State funding sources and appropriations in fiscal year 2011, a $325.2 million increase over the $2,220.5 million reported in fiscal year 2010 primarily related to the decrease in federal funding from the phased-down ARRA FMAP increase over the prior fiscal year. 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 $1,367.2 million and an additional $628.4 million was passed through from other State agencies in order to provide the State's share for Title XIX Medicaid and Title XXI CHIP eligible medical assistance expenditures. Arizona counties contributed $277.7 million as determined by Statutory funding formulas and Session Law as adjusted by the political subdivision maintenance of contribution ARRA requirement and other intergovernmental agreements. Tax collections on tobacco products provided $138.4 million in State match funding. The tobacco tax year-over-year decrease experienced in the prior three fiscal years leveled off to a $629,000 or 0.5 percent decrease compared to the $11.5 million or 7.7 percent decrease in fiscal year 2010. An additional $99.1 million in State revenue funding was provided by Arizona's share of Tobacco Litigation Settlement Funds. 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 clarifies how payments made to AHCCCS pursuant to the Master Settlement Agreement (MSA) with major tobacco companies, are recorded. Payments are based on cigarette and other tobacco product sales from the preceding year. AHCCCS has accrued $54.1 million for the period January 1, 2011 through June 30, 2011 based on Arizona's Joint Legislative Budget Committee 2011 estimated payment. In addition to the annual payment described above, AHCCCS continues to receive the Strategic Contribution Fund (SCF) payment through April 15, 2017. The amounts of the payments are dependent upon several adjustments, the magnitude of which will not be fully known until an independent auditor provides its calculations in February or March of each year. Other factors could also affect the MSA Payment amount that AHCCCS ultimately receives, including default or bankruptcy by one or more tobacco companies and other unforeseen withheld payment amounts. Tribal gaming receipts distributed to AHCCCS as determined by statutory formula and other sources provided an additional $34.9 million. Hospital emergency departments and level 1 trauma facilities benefited from $20.0 million in tribal gaming receipts.

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

Revenues by Source - Governmental Activities





Business-Type Activities

The sole proprietary fund business-type activity for AHCCCS is the Healthcare Group (HCG). HCG was established in 1988 by the State to administer health care services primarily to small, uninsured businesses with 2 to 50 employees and employees of political subdivisions. HCG contracts with two health plans from the existing network of AHCCCS Managed Care Organization (MCOs) health plans to provide managed care medical services. HCG's administrative responsibilities include enrollment/renewal, fulfillment, premium billing, customer service, collections, fund disbursement and data analysis. HCG also is responsible for regulatory oversight and providing reinsurance to the health plans.

Performance

HCG reported operating income in fiscal year 2011 of $4.9 million and an increase in net assets of $6.0 million. This continues a positive turn-around trend that began in fiscal year 2008 when HCG began successfully managing both program and administrative costs through a series of cuts, changes, realignments, and premium adjustments to match revenues with expenses. Premium rates were adjusted to fund projected medical and administrative costs and to provide payments to health plans that are owed reconciliation amounts for prior fiscal years.

In addition to being profitable for the last four fiscal years, HCG is self sustaining and since fiscal year 2010, receives no General Fund subsidies. Additionally, in fiscal year 2011 HCG made a $453,100 cash transfer to the General Fund. Overall, fiscal year 2011 results decreased HCG's net deficit to $3.0 million at June 30, 2011 as compared to the $9.0 million net deficit balance at June 30, 2010.

Reconciliation Liability

In the first two quarters of fiscal year 2009 and in years prior, HCG reconciled the medical costs experienced by the Plans above a contractual target medical loss ratio (stop loss target) that was based on the capitation paid annually to each plan. This stop loss payment was made for the difference in medical losses above the target medical loss ratio. If medical costs exceeded capitation, HCG paid the plans from available reconciliation reserves. At June 30, 2011, HCG continues to carry a reconciliation liability balance from fiscal years 2007 and 2008. This reconciliation balance for the last five years is shown below:

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

The reconciliation liability carried over from prior fiscal years has been reduced by $15.7 million since June 30, 2007. The liability was reduced by $5.6 million in fiscal year 2011 from a beginning balance at June 30, 2010 of $12.4 million to an ending balance of $6.8 million at June 30, 2011. The reconciliation balance has been reduced using a combination of cash generated from operations, General Fund subsidies, reinsurance and forgiveness of debt.

The following table summarizes reconciliation liability activity for fiscal year 2011:

Healthcare Group Reconciliation Liability as of June 30, 2011
Fiscal Year 2011 Activity
(in thousands of dollars)

	Reconciliation		
	FY 07	**FY 08**	**Total**
Balance June 30, 2010	$ 8,683	$ 3,699	$ 12,382
Payments made	(2,915)	(55)	(2,970)
Adjustments	(2,447)	(191)	(2,638)
Balance June 30, 2011	$ (3,321)	$ 3,453	$ 6,774

The remaining reconciliation liability will be paid by allocating 2% or more of medical premium revenues for a reconciliation reserve from residual earnings. Additionally, payments may be generated from residual earnings.

Effective January 1, 2009, HCG's health plans agreed, in contract, that no future reconciliation costs will be recognized by HCG except for adjustments to the existing reconciliation for services rendered through December 31, 2008. HCG contractors are now being compensated for attaining Nationally Recognized Utilization Management Standards, as mandated by Laws 2008, Chapter 288. The performance standards are developed by Milliman Inc., customized to each health plans' unique member population and further stratified by the level of medical management such as well managed, moderately managed, and loosely managed. The compensation amount will be no more than 2% of total premium collected. After the end of the fourth quarter, if the contractors perform well, each will receive a payment. If a health plan performs poorly, it will forfeit the reserved amount and HCG will retain the amount and apply it to any existing liabilities. As of June 30, 2011, HCG has in reserves $580,330 for potential payout with a scheduled disbursement in December 2011. This reserve amount is included in the $2.7 million Statement of Net Assets (Deficit) current accrued programmatic costs amount.

Enrollment

Since lifting the July 2008 legislatively mandated enrollment freeze, enrollment has declined in each fiscal year since 2008; however, fiscal year 2011 had the lowest year over year enrollment decline since 2008. The table below shows the year to year changes for June 2010 and 2011.

Year to Year Enrollment Change				
Group Size	**2010 vs 2009**	**% Change**	**2011 vs 2010**	**% Change**
1	**(1,208)**	**(33)%**	**(637)**	**(26)%**
2+	**(259)**	**(15)%**	**(311)**	**(22)%**
Total	**(1,467)**	**(27)%**	**(948)**	**(24)%**

By the end of fiscal year 2011, HCG's group enrollment had decreased approximately 24 percent from the prior year; however, due to the rate increase in September 2010, premium revenues declined by only 19 percent. Average total revenue per member per month in August 2010 was $327; in September 2010, it was $365, thus increasing average per member profitability. Along with enrollment, revenue has declined in every fiscal year since 2008. Similar to membership, fiscal year 2011 had the lowest year over year revenue decline since 2008.

Going Concern Matters

HCG has achieved operating income each fiscal year since 2008 and management currently projects that the positive trend will continue. However, a $3.0 million net deficit remained at June 30, 2011 due to the outstanding reconciliation liability owed to the MCOs for prior fiscal years. HCG anticipates continued profitability and the ability to eliminate the outstanding reconciliation liabilities as management anticipates that future operations should generate sufficient cash flow to entirely pay off the remaining deficit by April 2013.

Should HCG be required to accelerate payments for prior year reconciliation liabilities before HCG has sufficient funds to provide such payments and new terms are not negotiated and the Legislature does not provide HCG with additional subsidies to make those accelerated payments, it raises substantial doubt about HCG's ability to remain as a going concern. However, until the aforementioned events present themselves, HCG plans to continue operations and to continue to pay down the outstanding liability. Accordingly, the accompanying financial statements have been prepared assuming that HCG will continue as a going concern.

Financial Analysis of AHCCCS' Governmental Funds

Governmental Funds

At the end of fiscal year 2011, AHCCCS' governmental funds reported combined ending fund balances totaling $31.3 million, an increase of $31.1 million from the prior year. The increase is primarily due to prescription drug rebate collections received in excess of the $10 million spending authority provided in a legislative supplemental appropriation during the fiscal year.

The General Fund is the chief operating fund of the AHCCCS Acute Care, KidsCare, Breast & Cervical Cancer, Freedom-to-Work and Long-Term Care programs. These programs primarily utilize a State general fund appropriation and revenue sources from the annual tobacco litigation settlement proceeds, taxes on tobacco products, contributions from Arizona counties, certified public expenditure methodologies, and beginning in fiscal year 2011, prescription drug rebate collections to provide the required state matching funds for federal Title XIX and Title XXI revenue.

The Other Governmental Funds consist of eight individual funds that have a combined total fund balance of $321,000 available to meet future year obligations. The Other Governmental Fund's fiscal year 2011 fund balances consist of assigned miscellaneous fund balances in the amount of $121,000 and committed funds of $200,000. Revenue from taxes on cigarettes and other related tobacco products declined 0.48 percent from fiscal year 2010 and generated $96.4 million for the current year compared to $96.9 million in fiscal year 2010. Total tobacco tax collections account for 76.1 percent of the total Other Governmental Funds revenues in fiscal year 2011 compared to 74.6 percent of the total Other Governmental Funds revenues in fiscal year 2010.

General Fund Budgetary Highlights

Differences totaling $226.2 million occurred between the original and the final amended administrative and programmatic expenditure budgets. The AHCCCS program incurred a net $226.2 million supplemental appropriation reduction in fiscal year 2011. The reduction included a $225.6 million program decrease and a $629,000 reduction to administrative line items. The program supplemental appropriation reduction was the result of enrollment stabilization leading to case load savings over the appropriated case load growth projection. In addition, AHCCCS processed $53.8 million of administrative adjustments to pay claims with prior fiscal year dates of service from carry forward balances. Other differences relate to special line item adjustments that utilized surpluses from one line item to offset shortfalls in another line item. These appropriation transfers are approved by the Governor's Office of Strategic Planning and Budgeting and are in accordance with legislative authority. The major special line item supplemental reductions and revisions are briefly summarized as follows:

- $138.2 million decrease to the combined Acute Care Base and Proposition 204 Capitation Special Line Items comprised of a $106.5 million supplemental reduction and $31.7 million in Special Line Item appropriation transfers
- $36.4 million decrease to the combined Acute Care Base and Proposition 204 Reinsurance Special Line Items primarily comprised of a $31.7 million supplemental reduction and $4.7 million in Special Line Item appropriation transfers
- $34.3 million decrease to the Capitation Deferral Special Line Item comprised of a Special Line Item appropriation transfer
- $47.2 million decrease to the Arizona Long Term Care program comprised of a $60.8 million supplemental reduction and $13.6 million in Special Line Item appropriation transfers
- $7.0 million increase to the combined Acute Care Base and Proposition 204 Fee-for-Service Line Items comprised of a $27.0 million supplemental decrease and a $34.0 million Special Line Item appropriation transfers to other line items
- $15.4 million increase to the combined Acute Care Base and Proposition 204 Medicare Special Line Items from appropriation transfers

- $7.5 million increase to the KidsCare CHIP program from Special Line Items appropriation transfers

At June 30, 2011, actual cash basis appropriated program expenditures were $407.0 million less than budgetary estimates primarily consisting of surplus federal expenditure authority.

Capital Asset Administration

AHCCCS' investment in capital assets for its governmental and business-type activities as of June 30, 2011 amounts to $1.666 million, net of accumulated depreciation. This investment in capital assets includes furniture, vehicles, equipment and internally generated software for projects started after June 30, 2009. Land, buildings and improvements are under the management of the State and are accounted for on the State's comprehensive annual financial report. Total assets, net, increased $638,000 or 62.1 percent over the prior fiscal year even though normal automated systems equipment replacement purchases continued to be held to a minimum in fiscal year 2011 due to the State's budgetary position. The primary increase relates to an increase in internally generated software in the amount of $554,000 for the continuing development of the next mandated versions of the electronic Transaction and Code Set (TCS) standards under the Health Insurance Portability and Accountability Act. The balance is the result of an increase in vehicles, furniture and equipment of $84,000 for replacement of servers and related IT equipment items.

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

	Governmental Activities		Business-Type Activities		Total	
	2011	2010	2011	2010	2011	2010
Vehicles	$ 287	$ 286	$ -	$ 7	$ 287	$ 293
Furniture and equipment	602	498	3	17	605	515
Software under development	774	220	-	-	774	220
Total net assets	$ 1,663	$ 1,004	$ 3	$ 24	$ 1,666	$ 1,028

Additional information on AHCCCS' capital assets can be found in Note 2 to the accompanying financial statements on pages 37 and 38.

Contingent Liabilities

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) was extended to September 30, 2011 and required that the population covered by the Waiver be budget neutral for CMS over the term of the agreement. Budget neutral means that CMS will not pay more for medical services with the Waiver than it would have without the Waiver. The Waiver Special Terms and Conditions (STC) 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 nine limit periods (April 1, 2001 through September 30, 2010) is 0.25 percent. The threshold for the tenth limit period (October 1, 2010 to September 30, 2011) is zero percent. As of June 30, 2011, reported date of service expenditures associated with the nine periods ended September 30, 2010 are below the limit by $807.1 million, or 2.23 percent. AHCCCS remains under the cumulative reporting limit threshold through June 30, 2011 and projects that it will not exceed the budget neutrality limit due to favorable medical inflation rate trends. Accordingly, Management is projecting that as of June 30, 2011, AHCCCS does not have any liability to CMS related to the budget neutrality agreement and 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. Subsequent to June 30, 2011, the Waiver was renewed through September 30, 2016. The Waiver continues to include a budget neutrality provision through September 30, 2016.

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

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

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

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

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

Internal counsel has indicated that it is reasonably possible that some additional amount will be disallowed and recouped by CMS. However, AHCCCS cannot, at this stage, reasonably estimate an amount, and no repayment liability for the disputed extrapolated amount has been recorded in the financial statements as of June 30, 2011.

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

In August 2008, the TPA identified that the prospective implementation failed to include all of the recommendations having a direct impact on the claims paid from December 2005 through December 2007. AHCCCS has requested that the TPA either return the approximate $2.3 million maximum overpayment or recalculate what the payments should have been and return the resulting overpayment.
CMS has instructed AHCCCS to refund the $9.3 million in overpayments. The refund will be requested

from the LEAs or deducted from future payments in accordance with the intergovernmental agreement. The amount due from the LEAs may be reduced by any recovery from the TPA as identified above unless an appropriation from the Legislature is obtained by the LEAs. The recoupment liability of $9.3 million is included in the due to the federal government with a corresponding receivable in the due from the state and local governments of $9.3 million in the accompanying financial statements.

In February 2010, the Department of Health and Human Services, Office of Inspector General, Office of Audit Services (OIG) commenced an audit of the buy-in of Medicare Part B premiums. The OIG audit period covered Part B premiums paid by the State and claimed for Federal reimbursement for the quarters ended December 31, 2007, through September 30, 2009. Based on the OIG findings, CMS has also reviewed the Medicare Part B eligibility categories and Federal claiming for the all four quarters in fiscal year 2011. CMS has made the determination that AHCCCS has not complied with Federal requirements and formally issued grant award deferral letters for certain claimed amounts for the four quarters ended June 2011. In addition, AHCCCS anticipates receiving a disallowance for the three quarters ended December 31, 2009, March 31, 2010 and June 30, 2010.

AHCCCS based Federal claiming on two separate State Medicaid Directors Letters where CMS has stated that, at the State's option, FFP is available for the cost of Part B premiums for the eligibility category in question. The questioned category is individuals eligible for both Medicaid and Medicare, but who were not cash recipients, deemed cash recipients, Qualified Medicare Beneficiaries, Specified Low-Income Medicare Beneficiaries, or Qualified Individuals 1 and are covered as a State option. AHCCCS intends to file an appeal to the CMS Departmental Appeals Board at the point when CMS moves the deferred amounts to a formal disallowance. AHCCCS' Internal counsel has indicated that it is reasonably possible that some portion of the deferred amount may be disallowed and recouped by CMS. However, AHCCCS received a waiver that allows FFP for the cost of Part B premiums for this eligibility category prospectively effective October 22, 2011. Accordingly, a liability of $18.4 million is included in the due to the federal government in the accompanying financial statements for the period from October 1, 2009 through June 30, 2011.

Economic Factors and Next Year's Budgets and Rates

Enrollment in AHCCCS programs continued the slowing trend that had begun with the final six months of fiscal year 2010 and stabilized through the first ten months of fiscal year 2011. From July 2010 to April 2011, Title XIX full service enrollment actually decreased in six of the ten months. However, the final two months of fiscal year 2011 experienced significant growth that may have been the result of member applications prior to implementation of planned enrollment freezes. This period of relative enrollment stability followed 40 months from March 2007 to June 2010 of significant growth where 392,182 members were added resulting in a 44.7 percent increase for the time period. The economic outlook for Arizona continues to be impacted by the housing market decline although there have been positive signals with declining unemployment and increases in retail sales. Accordingly, AHCCCS is projecting that populations not subject to the enrollment freezes will continue to grow at more historical levels of under 5 percent. Finally, the impact of the passage of the PPACA to population growth prior to its implementation in January 2014 remains unclear and difficult to project.

The AHCCCS fiscal year 2012 appropriation compared to the fiscal year 2011 appropriation has been reduced by $1.464 billion by the Legislature to adjust the State's Medicaid program to declining State revenues. This reduction is planned to be attained through a series of program changes in the form of enrollment freezes, provider rate reductions, and medical service limits. CMS has approved the majority of the reform plan, however, a component population of the enrollment freezes has been challenged in the courts. As of the date of this publication, the legal challenge has been denied, but is still being appealed to the State Appellant Court and will most likely be decided by the State Supreme Court. AHCCCS continues to evaluate the overall impact to fiscal year 2012 funding. Additionally, the Legislature has provided the Agency with the authority to adopt rules to implement a program within its available appropriations.

Legislation passed in the 2011 session provides AHCCCS with the authority to reduce provider rates by up to 5 percent for the 2012 contract year, which begins October 1, 2011. The contract year 2012 Acute Care capitation rates assume a 7.69 percent decrease. This decrease includes the 5 percent provider rate decrease as well as experience adjustments. The contract year 2012 Arizona Long Term Care System (ALTCS Elderly and Physically Disabled) capitation rates assume a 9.25 percent decrease that also includes the 5 percent provider rate decrease. Many providers have incurred rate reductions of 15 percent over the past three years and for the fourth consecutive contract year, hospital fee-for-service rates have been either frozen or decreased. Due to the reductions and freezes in reimbursement rates to health plans, hospitals, and other providers made during the past years and in recognition that the program must increase capitation rates to reflect changes in medical utilization, the fiscal year 2013 budget request includes capitation rate increases of 2 percent across the board for both prior and prospective payments for contract year 2013. AHCCCS plans to pursue means other than future rate reductions to maintain the viability of the provider system.

In fiscal year 2011, AHCCCS made 13 monthly capitation payments including the June 2010 payment that was paid in July 2010. AHCCCS, with legislative notice paid, the June 2011 capitation payment by June 30, 2011 to maximize the increased FMAP rate from the ARRA prior to the increased FMAP rate's July 1, 2011 termination. Legislation for fiscal year 2012 continues the requirement for AHCCCS to suspend $344.3 million of monthly capitation payments until July 2012 in fiscal year 2013 resulting in 11 planned payments for fiscal year 2012. The AHCCCS budget request for fiscal year 2013 continues the payment deferral funding strategy and assumes only 12 payments, which requires a fiscal year 2013 payment be deferred with interest, until fiscal year 2014. Additionally, in accordance with legislation, various medical and health services for adults such as hospital stays and respite care will have benefit limits as AHCCCS implements the program within available appropriations.

Beginning in fiscal year 2012, AHCCCS will implement a provision of ARRA that includes a 100 percent federally funded financial aid to qualifying hospitals and certain healthcare providers for the development of information technology infrastructure for electronic health records. AHCCCS projects federal payments of $106 million in fiscal year 2012 and $49.4 million in fiscal 2013 to Arizona facilities and healthcare providers that are eligible for the Medicaid incentive payments. Additionally, AHCCCS continues to review the Medicaid provisions of the PPACA to evaluate impacts and responsibilities under the new federal healthcare plan. Other significant impacts are staffing for information technology (IT) changes for the transformation from paper to electronic patient health records and the additional staff required to build and maintain the necessary internal infrastructure. AHCCCS is planning to participate, in conjunction with multiple funding sources, in the development and operation of the Medicaid share of the State of Arizona health information exchange. AHCCCS continues to receive CMS approval for 90 percent enhanced federal funding for the implementation phases relating to electronic health records.

AHCCCS' budget request for fiscal year 2013, submitted to the Governor in September 2011 included a rebase of the fiscal year 2012 budget that projects a General Fund and Other Fund shortfall. The shortfall can be addressed by utilizing projected prescription drug rebate receipts in excess of the current fiscal year 2012 $20 million appropriation. Additionally, the Legislature has provided the Agency with the authority to adopt rules to implement a program within its available appropriations. Accordingly, AHCCCS does not anticipate the need for a General Fund supplemental appropriation, but does project the need for supplemental appropriations for federal expenditure authority and surplus prescription drug rebate fund collections for fiscal year 2012 based on current projections. However, factors such as CMS decisions, legal decisions, case load changes compared to projections may influence the need for or amount of a supplemental appropriation. Management will closely monitor these factors and the adequacy of the fiscal year 2012 appropriation.

Request for Information

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

INDEPENDENT AUDITORS' REPORT

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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 as of and for the year ended June 30, 2011, as shown on pages 20 through 28 as listed in the table of contents. 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 opinion.

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, 2011, 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, 2011, and the respective changes in financial position and cash flows, where applicable, 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 years and significant net deficit 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 November 22, 2011 on our consideration of AHCCCS' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on 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.

U.S. generally accepted accounting principles require that the management's discussion and analysis on pages 1 through 17 and budgetary comparison information on page 25 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with U.S. generally accepted auditing standards, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audit was performed for the purpose of forming an opinion on the financial statements that collectively comprise AHCCCS' 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 financial statements. The Schedule of Expenditures of Federal Awards is the responsibility of management and was derived from and relate directly to the underlying accounting and other records used to prepare the financial statements. This schedule has been subjected to the auditing procedures applied in the audit of the financial statements and certain other procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with U.S. generally accepted auditing standards. In our opinion, the schedule of expenditures of federal awards is fairly stated in a material respects in relation to the financial statements as a whole.

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

Mayer Hoffman McCann P.C.

Phoenix, Arizona
November 22, 2011

BASIC FINANCIAL STATEMENTS

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET ASSETS (DEFICIT)

June 30, 2011
(amounts expressed in thousands)

	Governmental Activities	Business-type Activities	Total
ASSETS			
CURRENT ASSETS			
Cash	$ 98,897	$ 8,941	$ 107,838
Restricted cash	34,562	-	34,562
Due from state and local governments	109,513	-	109,513
Due from the federal government	210,438	-	210,438
Tobacco settlement receivable	54,106	-	54,106
Receivables and other	268,961	-	268,961
TOTAL CURRENT ASSETS	776,477	8,941	785,418
Hospital residency program loans	700	-	700
Furniture, vehicles and equipment, net of accumulated depreciation	1,663	3	1,666
TOTAL NONCURRENT ASSETS	2,363	3	2,366
TOTAL ASSETS	778,840	8,944	787,784
LIABILITIES			
CURRENT LIABILITIES			
Accounts payable	2,838	54	2,892
Other accrued liabilities	4,496	67	4,563
Deferred revenue	22,788	4,383	27,171
Due to federal, state and county governments	137,690	-	137,690
Accrued programmatic costs	556,500	2,700	559,200
Compensated absences	3,319	78	3,397
TOTAL CURRENT LIABILITIES	727,631	7,282	734,913
ACCRUED PROGRAMMATIC COSTS, less current portion	-	4,651	4,651
TOTAL LIABILITIES	727,631	11,933	739,564
COMMITMENTS AND CONTINGENCIES			
NET ASSETS (DEFICIT)			
INVESTED IN CAPITAL ASSETS	1,663	3	1,666
UNRESTRICTED NET ASSETS (DEFICIT)	49,546	(2,992)	46,554
TOTAL NET ASSETS (DEFICIT)	$ 51,209	$ (2,989)	$ 48,220

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF ACTIVITIES

Year Ended June 30, 2011
(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	$ 9,322,800	$ 5,595	$ 6,865,613	$ 406,025	$ (2,045,567)	$ -	$ (2,045,567)
Business-type activities:							
Healthcare Group	33,334	38,428	-	-	-	5,094	5,094
TOTAL PROGRAMS	$ 9,356,134	$ 44,023	$ 6,865,613	$ 406,025	(2,045,567)	5,094	(2,040,473)
General revenues:							
State appropriations					1,995,616	-	1,995,616
Tobacco tax					138,432	-	138,432
Forgiveness of debt					-	1,330	1,330
Unrestricted investment earnings					60	50	110
					2,134,108	1,380	2,135,488
Transfers:							
Transfers out					(39,552)	(453)	(40,005)
Total general revenues and transfers					2,094,556	927	2,095,483
CHANGE IN NET ASSETS (DEFICIT)					48,989	6,021	55,010
NET ASSETS (DEFICIT), BEGINNING OF YEAR					2,220	(9,010)	(6,790)
NET ASSETS (DEFICIT), END OF YEAR					$ 51,209	$ (2,989)	$ 48,220

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BALANCE SHEET - GOVERNMENTAL FUNDS

June 30, 2011
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
ASSETS			
Cash	$ 84,114	$ 14,783	$ 98,897
Restricted cash	32,966	1,596	34,562
Due from state and local governments	91,844	12,141	103,985
Due from the federal government	80,300	217	80,517
Due from other funds	11,800	-	11,800
Receivables and other	58,405	-	58,405
TOTAL ASSETS	$ 359,429	$ 28,737	$ 388,166
LIABILITIES			
Accounts payable	$ 2,424	$ 414	$ 2,838
Other accrued liabilities	4,422	74	4,496
Deferred revenue	21,512	1,276	22,788
Due to federal, state and county governments	137,271	419	137,690
Due to other funds	-	11,800	11,800
Accrued programmatic costs	162,780	14,433	177,213
TOTAL LIABILITIES	328,409	28,416	356,825
COMMITMENTS AND CONTINGENCIES			
FUND BALANCES			
Committed	31,020	200	31,220
Assigned	-	121	121
TOTAL FUND BALANCES	31,020	321	31,341
TOTAL LIABILITIES AND FUND BALANCES	$ 359,429	$ 28,737	

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.	1,663
Governmental funds report capital outlays as expenditures. However, in the statement of activities the cost of these assets is allocated over their estimated useful lives and reported as depreciation expense. This is the amount by which capital outlays $1,083 exceeded depreciation ($424) in the current fiscal year.	(659)
Future drug rebate receivables are not available for current period expenditures and, therefore, are not reported in the governmental funds.	18,164
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.	(3,319)
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.	3,319
Long-term accrued liabilities for programmatic costs are not due and payable from current financial resources and, therefore are not reported in the funds.	(379,287)
Long-term receivables, offsetting the above accrued programmatic liability, which is not due and receivable in the current fiscal year and, therefore, are not reported in the funds.	379,287
Long-term receivables, for the Hospital Residency Loan program are not due and receivable in the current fiscal year, and therefore, are not reported in the funds.	700
	$ 51,209

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

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

Year Ended June 30, 2011
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
REVENUES			
State government:			
Appropriations	$ 1,383,770	$ -	$ 1,383,770
Pass through funds	628,409	-	628,409
Federal government:			
Acute care	4,275,129	2,207	4,277,336
Long-term care	858,108	-	858,108
Pass through funds	1,941,947	49	1,941,996
County and other local government:			
Acute care	55,913	-	55,913
Long-term care	188,287	-	188,287
Pass through funds	33,463	-	33,463
Tobacco litigation settlement revenue	99,130	-	99,130
Tobacco tax revenue	42,027	96,405	138,432
Gaming revenue	-	19,799	19,799
Intergovernmental agreement revenue	-	6,486	6,486
Premium revenue	5,595	-	5,595
Other	1,344	1,663	3,007
TOTAL REVENUES	9,513,122	126,609	9,639,731
PROGRAMMATIC EXPENDITURES			
Capitation:			
Acute care	4,158,299	60,201	4,218,500
Long-term care	1,957,650	-	1,957,650
Children's rehabilitative services	106,424	-	106,424
Mental health services	1,315,817	-	1,315,817
Fee-for-service:			
Acute care	873,768	353	874,121
Long-term care	127,138	-	127,138
Trauma center services	-	19,818	19,818
Disproportionate share	141,294	-	141,294
Graduate medical education	59,854	-	59,854
Reinsurance	327,806	-	327,806
Medicare:			
Acute care premiums	168,774	-	168,774
Long-term care premiums	40,077	-	40,077
Part D clawback payments	47,954	-	47,954
TOTAL PROGRAMMATIC EXPENDITURES	9,324,855	80,372	9,405,227
ADMINISTRATIVE EXPENDITURES	147,954	9,066	157,020
ADMINISTRATIVE EXPENDITURES PASSED THROUGH	6,867	49	6,916
TOTAL EXPENDITURES	9,479,676	89,487	9,569,163
EXCESS OF REVENUES OVER EXPENDITURES	33,446	37,122	70,568
OTHER FINANCING SOURCES (USES)			
Transfers out:			
To State General Fund	-	(1,268)	(1,268)
To AHCCCS General Fund	-	(691)	(691)
To Arizona Department of Economic Security	(3,117)	-	(3,117)
To Arizona Department of Health Services	-	(35,167)	(35,167)
Transfers in:			
From AHCCCS Other Fund	691	-	691
Repayments under the hospital residency loan program	-	100	100
TOTAL OTHER FINANCING SOURCES (USES)	(2,426)	(37,026)	(39,452)
NET CHANGE IN FUND BALANCES	31,020	96	31,116
FUND BALANCES, BEGINNING OF YEAR	-	225	225
FUND BALANCES, END OF YEAR	$ 31,020	$ 321	$ 31,341

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, 2011
(amounts expressed in thousands)

Amounts reported for governmental activities in the statement of activities (page 21) are different because:

Net change in fund balance - total governmental funds (page 23)	$	31,116
Drug rebate revenues reported in the Statement of Activities are not currently available, and are not reported as revenue in governmental funds.		18,164
Repayment of loaned funds under the Hospital Residency Loan Program provides current financial resources of governmental funds. This amount represents the loan repayments received in the current fiscal year and is recorded as a current financial resource in the governmental funds.		(100)
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 depreciation exceeded capital outlays in the prior period.		(191)
Change in net assets of governmental activities (page 21)	$	48,989

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BUDGETARY COMPARISON SCHEDULE - GENERAL FUND

Year Ended June 30, 2011
(Unaudited)
(amounts expressed in thousands)

	Original Appropriation (Budget)	Final Appropriation (Budget)	Actual	Variance with Final Budget
REVENUES				
State appropriations	$ -	$ -	$ 1,365,966	$ -
State pass-through funds	-	-	732,326	-
Federal government	-	-	5,414,062	-
Federal pass-through funds	-	-	1,805,143	-
County government	-	-	233,864	-
County pass-through funds	-	-	50,165	-
Tobacco tax revenue	-	-	41,819	-
Tobacco litigation settlement	-	-	99,130	-
Other	-	-	9,539	-
Total revenues	-	-	9,752,014	-
OTHER FINANCING SOURCES				
Operating transfers in	-	-	7,523	-
TOTAL REVENUES AND OTHER FINANCING SOURCES	-	-	9,759,537	-
PROGRAMMATIC EXPENDITURES				
Acute capitation	2,378,375	2,385,606	2,187,143	198,463
Acute reinsurance	163,430	142,344	130,047	12,297
Acute fee-for-service	590,694	554,344	540,326	14,018
Proposition 204 capitation	2,059,441	1,914,014	1,759,215	154,799
Proposition 204 reinsurance	95,374	79,986	77,850	2,136
Proposition 204 fee-for-service	265,777	309,164	302,172	6,992
Proposition 204 Medicare premiums	34,234	43,624	41,936	1,688
Capitation deferral	344,345	310,022	310,022	-
Medicare premiums	122,536	128,506	126,152	2,354
Disproportionate share	13,487	13,487	4,202	9,285
Rural hospital reimbursement	12,158	12,731	12,171	560
Breast and cervical cancer	1,803	1,689	961	728
Critical access hospitals	1,700	1,764	1,700	64
Freedom to work	7,149	8,195	7,969	226
Medicare clawback payments	23,084	22,184	22,126	58
Long-term care	1,279,629	1,230,598	1,229,589	1,009
ALTCS clawback	14,075	15,911	15,911	-
LTC board of nursing	210	210	210	-
CHIP - Services	49,943	57,443	55,095	2,348
TOTAL PROGRAMMATIC EXPENDITURES	7,457,444	7,231,822	6,824,797	407,025
ADMINISTRATIVE EXPENDITURES	173,246	172,617	141,166	31,451
TOTAL APPROPRIATED EXPENDITURES	7,630,690	7,404,439	6,965,963	438,476
PRIOR YEAR APPROPRIATED EXPENDITURES	-	-	72,113	-
NON-APPROPRIATED EXPENDITURES	-	-	2,697,336	-
REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES	-	-	24,125	-
FUND BALANCES, BEGINNING OF YEAR	-	-	89,192	-
FUND BALANCES, END OF YEAR	$ -	$ -	$ 113,317	$ -

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET ASSETS (DEFICIT) - PROPRIETARY FUND

June 30, 2011
(amounts expressed in thousands)

ASSETS	
CURRENT ASSETS	
Cash	$ 8,941
CAPITAL ASSETS	
Furniture, vehicles and equipment, net of accumulated depreciation	3
TOTAL ASSETS	$ 8,944
LIABILITIES	
CURRENT LIABILITIES	
Accounts payable	$ 54
Other accrued liabilities	67
Deferred revenue - premiums	4,383
Accrued programmatic costs	2,700
Compensated absences due within one year	78
TOTAL CURRENT LIABILITIES	7,282
ACCRUED PROGRAMMATIC COST, less current portion above	4,651
TOTAL LIABILITIES	$ 11,933
COMMITMENTS AND CONTINGENCIES	
NET ASSETS (DEFICIT)	
INVESTED IN CAPITAL ASSETS	$ 3
UNRESTRICTED (DEFICIT)	(2,992)
TOTAL NET ASSETS (DEFICIT)	$ (2,989)

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, 2011
(amounts expressed in thousands)

OPERATING REVENUES	
Premium revenue	$ 38,428
OPERATING EXPENSES	
Payments to health plans and providers	31,713
Reinsurance	110
Salaries and employee benefits	1,237
Professional and outside services	172
Other	260
Depreciation	16
TOTAL OPERATING EXPENSES	33,508
OPERATING INCOME	4,920
NONOPERATING REVENUES (EXPENSES)	
Debt forgiveness	1,330
Other income	185
Investment income	50
Loss on transfer of assets	(5)
Other loss	(6)
INCOME BEFORE TRANSFERS	6,474
TRANSFERS OUT	
To State General Fund	(453)
CHANGE IN NET ASSETS (DEFICIT)	6,021
NET ASSETS (DEFICIT), BEGINNING OF YEAR	(9,010)
NET ASSETS (DEFICIT), END OF YEAR	$ (2,989)

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF CASH FLOWS - PROPRIETARY FUND

Year Ended June 30, 2011
(amounts expressed in thousands)

CASH FLOWS FROM OPERATING ACTIVITIES	
Receipts from customers	$ 37,749
Payments to health plans	(36,114)
Refunds from providers	115
Payments to employees	(1,263)
Payments to suppliers	(476)
Net cash provided by operating activities	11
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
Transfer to State General Fund	(453)
Net cash used by non-capital financing activities	(453)
CASH FLOWS FROM INVESTING ACTIVITIES	
Settlement income	185
Other loss	(6)
Investment income	50
Net cash provided by investing activities	229
NET CHANGE IN CASH	(213)
CASH, BEGINNING OF YEAR	9,154
CASH, END OF YEAR	$ 8,941
RECONCILIATION OF OPERATING INCOME TO NET CASH USED BY OPERATING ACTIVITIES	
Adjustment to reconcile operating income to net cash provided by operating activities:	$ 4,920
Depreciation	16
Changes in operating net assets and liabilities:	
Decrease in accounts receivables and other	
Decrease in accounts payable and other accrued liabilities	(44)
Decrease in deferred revenue - premiums	(679)
Decrease in accrued programmatic costs	(4,176)
Decrease in accrued compensated absences	(26)
NET CASH OPERATING ACTIVITIES	$ 11
SUPPLEMENTAL DISCLOSURE OF NON-CASH ACTIVITIES	
Debt forgiveness	$ 1,330

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2011

(dollar amounts expressed in thousands)

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

A. Reporting entity

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

The Arizona Legislature ("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, extended through September 30, 2011 and was subsequently renewed through September 30, 2016. AHCCCS receives quarterly federal grants from CMS (as matching funds) to cover a portion of the health care costs of the residents of the State eligible for the Title XIX Medicaid program and Title XXI Children's Health Insurance Program ("CHIP"). State appropriations and county funding levels are based on annual budgets as dictated by the Legislature and specified by Arizona Statutory funding formula and Session Law.

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

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

AHCCCS also has the Healthcare Group line of business, which provides medical coverage primarily to small businesses. The activities of Healthcare Group are included in the proprietary fund. See Notes 5 and 6 for information on the 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 (deficit) 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 2011, 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 2 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, 2011, the proprietary fund deferred revenue of $4,383 consists of premium payments received for fiscal year 2012 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 paid in the 31-day period following the end of the fiscal year. Actual results for accrued programmatic costs may differ from such estimates. These differences are recorded in the period in which they are identified. However, expenditures related to compensated absences and claims and judgments are recorded only when payment is due.

(1) Summary of significant accounting policies (continued)

In fiscal year 2011, AHCCCS reports the following significant funds:

a. The general fund is the primary operating fund for the Title XIX Medicaid program and the Title XXI State Children's Health Insurance Program.

b. Special revenue funds, reported as other governmental funds, account for various health and administrative programs.

c. The Healthcare Group fund, reported as a business-type activity, accounts for the activities of a medical coverage program primarily for small, uninsured businesses with 2 to 50 employees and employees of political subdivisions.

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 $142,400 at June 30, 2011, including restricted funds of $34,562.

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 $32,966, $26,537 for the Interagency Service Agreement (ISA) Fund and $6,429 for the AHCCCS and Long Term Care Funds. The ISA Fund is used to properly account for, control, and report receipts and disbursements associated with ISAs which are not required to be reported in other funds. Fund receipts consist of monies received from other entities and are utilized to match federal funding under the Medicaid and CHIP programs under the terms stated in the ISAs. The cash restricted in the AHCCCS and Long Term Care Funds represents amounts payable to the counties to comply with section 5001(g)(2) of the American Recovery and Reinvestment Act of 2009. Cash in the Other Governmental Funds is legally restricted in the amount of $1,596 for the Hawaii Arizona PMMIS Alliance (HAPA) Fund, as described in Note 4 and is offset by accrued expenditures of $320 and deferred revenue of $1,276 at June 30, 2011.

(1) Summary of significant accounting policies (continued)

In accordance with the Federal Cash Management Improvement Act of 1990 guidelines, AHCCCS may only request federal funds under specified funding techniques. These techniques require that AHCCCS draw down or request funds such that the timing of the receipt of the funds is interest neutral to both the State and Federal governments. For disbursements made through electronic fund transfers, funds must be drawn such that they are received by the State on the same day as the disbursement. For disbursements made through issuance of a check, funds must be drawn such that they are received by the State in accordance with its historical average check clearance pattern. The timing difference that occurs, due to drawing down funds after the issuance of checks, may result in bank overdrafts to AHCCCS at various times during the year. At June 30, 2011, no bank overdraft existed.

E. Net assets / fund balance

The difference between fund assets and liabilities is “Net Assets” on the government-wide and proprietary fund statements and “Fund Balance” on the governmental fund statements. Net assets are reported in three categories:

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

Effective July 1, 2010, AHCCCS adopted GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*. GASB Statement No. 54 provides more clearly defined fund balance categories to make the nature and extent of the constraints placed on a government’s fund balance more transparent. GASB Statement No. 54 also clarifies the existing governmental fund type definitions to improve the comparability of governmental fund financial statements and help financial statement users to better understand the purpose for which governments have chosen to use particular funds for financial reporting. The classifications are based primarily on the extent to which AHCCCS is bound to honor constraints on the specific purposes for which the amounts in those funds can be spent. In the governmental fund financial statements, fund balances are classified as nonspendable, restricted, committed, assigned and unassigned, and are defined as follows:

Nonspendable fund balance includes amounts that cannot be spent because they are either not spendable in form (such as inventory) or legally or contractually required to be maintained intact (such as endowments). At June 30, 2011, AHCCCS had no nonspendable fund balance.

Spendable Fund Balance

<u>Restricted Fund Balance</u> – this includes amounts that can be spent only for specific purposes stipulated by legal requirements imposed by other governments, external resource providers, or creditors. AHCCCS imposed restrictions do not create restricted fund balance unless the legal document that initially authorized the revenue (associated with that portion of fund balance) also included language that specified the limited use for which the authorized revenues were to be expended. At June 30, 2011, AHCCCS had no restricted fund balance.

(1) Summary of significant accounting policies (continued)

Committed Fund Balance – this includes amounts that can only be used for specific purposes pursuant to constraints imposed by formal action of the Legislature. Those committed amounts cannot be used for any other purpose unless the Legislature removes or changes the specified use by taking the same type of action (for example, resolution, ordinance, minutes action, etc.) that it employed to previously commit those amounts. If the Legislature action that limits the use of the funds was separate from the action that initially created the revenues that form the basis for the fund balance, then the resultant fund balance is considered to be committed, not restricted. AHCCCS considers a resolution, an ordinance, or a minutes action to constitute a formal action of the Legislature for the purposes of establishing committed fund balance. At June 30, 2011, AHCCCS' committed fund balance totaled $31,220.

Assigned Fund Balance – this includes amounts constrained by the Legislature for specific purposes. Assigned fund balances include all remaining amounts (except negative amounts) that are reported in the governmental funds, other than the general fund, that are not classified as nonspendable and are neither restricted nor committed and amounts in the general fund that are intended to be used for a specific purpose. By reporting particular amounts that are not restricted or committed in a special revenue fund, AHCCCS has assigned those amounts to the purpose of the respective funds. At June 30, 2011, AHCCCS' assigned fund balance totaled $121.

Unassigned Fund Balance – this includes the remaining spendable amounts which are not included in one of the other classifications. At June 30, 2011, AHCCCS had no unassigned fund balance.

As of July 1, 2010, AHCCCS analyzed all funds and determined that no fund balance reclassifications were required to address the changes required by this new standard. AHCCCS has neither adopted a minimum fund balance policy nor any agency specific policy for the order of spending fund balances; rather, it follows the policies of the State and adheres to the purpose of legislative appropriations or Federal grant regulations. AHCCCS' fund balances classified as committed include balances that can only be used for specific purposes pursuant to constraints imposed by formal action of the Legislature. AHCCCS fund balances classified as assigned include balances that are constrained for specific purposes, and are not committed.

F. Capitation payments

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

Capitation is paid prospectively as well as for prior period coverage (PPC). The PPC period generally is from the effective date of eligibility to the day a member is enrolled with a contracted health plan. The risk under PPC is shared by both the contracted health plans and AHCCCS for the contract year. AHCCCS reconciles the actual PPC medical costs to the PPC net capitation paid during the contract year. The reconciliation limits the contractor's profits and losses to 2%. Accrued programmatic costs are net of approximately $34,971 at June 30, 2011 that represents estimated settlement payments due from 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.

(1) Summary of significant accounting policies (continued)

Similar risk sharing is in place for medical costs incurred by contracted health plans for the Title XIX Waiver Group (TWG) (MED and non-MED) members. AHCCCS reconciles the contractors' medical costs net of reinsurance to the total net capitation payments and delivery supplemental payments paid for the contract year. The reconciliation limits the contractors' profits or losses to 3% for the MED and 2% for the non-MED population. Accrued programmatic costs are net of approximately $115,505 at June 30, 2011 that represents estimated settlement payments due from contracted health plans for the TWG MED and non-MED reconciliations. Actual results may differ from this estimate and such differences will be recorded in the period in which they are identified.

G. Reinsurance payments

AHCCCS provides a stop-loss reinsurance program for its contracted health plans for partial reimbursement, after a deductible is met, of reinsurable covered medical services incurred for members. The program includes a deductible, which varies based on the health plan's enrollment. AHCCCS reimburses the health plans based on a coinsurance amount for reinsurable covered services incurred above the deductible. This reinsurance provides partial reimbursement of reinsurance eligible covered services and will reimburse 75% of eligible costs above the deductible level up to $650 of covered expenses and 100% thereafter.

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

H. Fee-for-service payments

The AHCCCS program is responsible for the cost of providing medical services on a fee-for-service basis to three populations: persons enrolled in the Emergency Services Program (ESP), persons enrolled in a health plan for less than 30 days, and American Indian members enrolled with 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, members enrolled in a health plan for less than 30 days and American Indian enrolled members that receive services at a non-IHS\638 facility are reimbursed using the AHCCCS Outpatient Hospital Fee Schedule. Inpatient medical services for these populations are reimbursed based on the category of service provided and an inpatient per-diem reimbursement rate system or at the outlier reimbursement rate. Professional and non-hospital services for these populations are reimbursed at the AHCCCS fee for service rates.

(1) Summary of significant accounting policies (continued)

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

I. Incurred but not reported programmatic expenditures

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

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

J. 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 $141,294 for the year ended June 30, 2011.

K. Taxes

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

L. Management's use of estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities, and the reported amounts of revenues and expenditures at June 30, 2011. Actual results may differ from these estimates.

M. 100% federal poverty level expansion and CMS Waiver

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

(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

In January 2001, AHCCCS obtained a Waiver from CMS to receive federal funding for certain non-categorically linked populations including those made eligible by the passage of Proposition 204. The Waiver requires that over the term of the agreement the populations covered by the Waiver be budget neutral for CMS. The Waiver period for budget neutrality began April 1, 2001 and 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, 2011, 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 the litigation settlement and/or legislation. Annual settlement payments, based on cigarette sales from the preceding calendar year are made in April. In addition, supplemental payments may be received as tobacco companies enter into the tobacco master settlement agreement. AHCCCS received annual and strategic contribution fund payments of $99,130 in fiscal year 2011 for the period from January 1, 2010 to December 31, 2010. Revenue and a related receivable of $54,106 were accrued for the period of January 1, 2011 through June 30, 2011 and are included in Tobacco Settlement Receivable and Other Operating Grants and Contributions in the accompanying Statement of Net Assets and Statement of Activities.

N. Hospital Residency Loan Program

The hospital residency loan program was established to loan monies for the establishment of start-up and ongoing costs for residency programs in accredited hospitals. The hospital loans are interest-free and are due and will become available in future periods when certain criteria are met triggering repayment or beginning in fiscal year 2013 with five annual installments after the execution date whichever is earlier. Payment of the loans may be made in advance of the due date and, as such, AHCCCS received an advance payment of $100 in fiscal year 2011.

Annual maturities of the loan receivable as of June 30, 2011 are as follows:

Years Ending September 30,	
2012	$ -
2013	60
2014	160
2015	160
2016	160
Thereafter	160
Total	$ 700

(dollar amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

O. Prescription Drug Rebate Program

The Patient Protection and Affordable Care Act of 2010 (PPACA) included a provision to extend drug rebates to managed care programs and to increase the rebate amount drug manufacturers are required to pay under the Medicaid drug rebate program. AHCCCS received CMS approval on January 26, 2011 to participate in the drug rebate program, both managed care and fee-for-service, for drugs dispensed on or after March 23, 2010. AHCCCS' contractor began invoicing drug manufacturers in March of 2011 and received rebate reimbursements in the amount of $168,600 as of June 30, 2011. Of this amount, $125,200 will be returned to the federal government and $43,400 is available to offset a portion of General Fund current and future fiscal year expenditures. The unpaid invoice balance of $118,400 as of June 30, 2011 is included in receivables. Of this amount, $82,600 will be returned to the federal government and is netted against the due from the federal government in the accompanying financial statements and $35,800 is available to offset future fiscal year expenditures, which is netted against the due from state and local governments in the accompanying financial statements.

(2) Capital assets

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

Balance, June 30, 2010	$	1,028
Additions		1,083
Retirements		(26)
Depreciation		(419)
Balance, June 30, 2011	$	1,666

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, 2011, management does not believe impairment indicators are present, and there were no idle capital assets.

(dollar amounts expressed in thousands)

(2) Capital assets (continued)

At June 30, 2011, AHCCCS had incurred approximately $774 of costs related to internally generated computer software, which is included in capital assets. Internally generated software represents AHCCCS' continuing development of the next mandated version of the electronic Transaction and Code Set (TCS) standards under the Health Insurance Portability and Accountability Act. The total costs associated with the internally generated computer software are estimated to be approximately $1,127. The software is projected to be completed by June 30, 2012. AHCCCS accounts for internally generated computer software in accordance with GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. In accordance with Statement No. 51, outlays associated with activities in the preliminary project stage should be expensed as incurred. Outlays related to activities in the application development stage are capitalized. Capitalization of such outlays will cease no later than the point at which the computer software is substantially complete and operational.

(3) Compensated absences

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

Balance, June 30, 2010	$ 3,450
Additions	4,366
Reductions	(4,419)
Balance, June 30, 2011	$ 3,397

(4) Other governmental funds

At June 30, 2011, the other governmental fund balance of $321 included activity within the following funds:

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

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

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

(dollar amounts expressed in thousands)

(4) Other governmental funds (continued)

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

- Miscellaneous Funds - These funds account for various grants and other money received for specific purposes including the Hawaii Arizona PMMIS Alliance (HAPA) and the Hospital Loan Residency Fund. HAPA represents AHCCCS' project with Hawaii whereby AHCCCS provides data processing services for Hawaii's Medicaid program. The Hospital Loan Residency Fund 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. The hospital loans are interest-free and are due and will become available in future periods when certain criteria are met triggering repayment or beginning in fiscal year 2013 with five annual installments after the execution date whichever is earlier.

Other governmental funds earned, expended and transferred during the fiscal year ended June 30, 2011 were as follows:

	TTHCF - MNA	TPTF - EHSA	Trauma and Emergency Services Fund	Third Party Liability Fund	Miscel- laneous Funds	Total
Fund balances, June 30, 2010	$ -	$ -	$ -	$ -	$ 225	$ 225
Receipts	76,392	20,013	19,799	1,937	8,432	126,573
Interest earned	1	6	19	3	7	36
Expenditures	(41,226)	(19,328)	(19,818)	(1,440)	(7,675)	(89,487)
Transfers in (out):						
State General Fund	-	-	-	(500)	(768)	(1,268)
Tobacco Products Tax Proposition 204 Protection Fund	-	(691)	-	-	-	(691)
Arizona Dept of Health Services	(35,167)	-	-	-	-	(35,167)
Hospital Loan Residency Fund	-	-	-	-	100	100
Fund balances, June 30, 2011	$ -	$ -	$ -	$ -	$ 321	$ 321

(5) Proprietary fund - operations

Healthcare Group (HCG) was established in 1988 by the State to administer health care services primarily to small, uninsured businesses with 1 to 25 employees and employees of political subdivisions. That range was later changed to 2 to 50 employees. HCG contracts with two health plans from the existing network of AHCCCS health plans (HMOs) to provide managed care medical services. HCG offered a PPO/PPOS product from fiscal year 2006 to fiscal year 2010. Enrollment in the program was too low, and the program was terminated effective June 30, 2010 with existing membership being migrated to one of HCG's two existing plans.

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

(5) Proprietary fund – operations (continued)

The HMO contracted health plans are prepaid on a "per member, per month" (PMPM) basis. Capitation payments are made prospectively. In the first two quarters of fiscal year 2009 and in years prior, HCG reconciled the medical costs experienced by the plans above a contractual target medical loss ratio (stop loss target) that was based on the capitation paid annually to each plan. This stop loss payment was made for the difference in medical losses above the target medical loss ratio. If medical costs exceeded capitation, HCG paid the plans this reconciliation from available reconciliation reserves. Due to very high losses and HCG's financial condition (Note 6), HCG negotiated payment terms with the contracted health plans to repay the remaining liabilities owed from fiscal years 2007 and 2008 over the next several fiscal years. Additionally, in fiscal year 2011, HCG recorded a forgiveness of debt of $1,330 relating to the remaining reconciliation liability. This forgiveness of debt was in consideration of payments of $1,500 to the contracted health plans. At June 30, 2011, HCG continued to carry reconciliation liability balances totaling $6,774; which are included in current accrued programmatic costs of $2,700 and the non-current accrued programmatic costs of $4,651.

Effective January 1, 2009, HCG's health plans agreed, in contract, that no future reconciliation costs will be recognized by HCG. In addition to capitation payments, HCG contractors are now compensated for attaining Nationally Recognized Utilization Management Standards, as mandated by Laws 2008, Chapter 288. The performance standards are developed by Milliman Inc., customized to each health plan's unique member population and further stratified by the level of medical management such as well managed, moderately managed, and loosely managed. The compensation amount will be no more than 2% of total premiums collected. After the end of the fiscal year, if the contractors meet performance standards, each will receive a payment. If a health plan performs poorly, it will forfeit the reserved amount, and HCG will retain the amount and apply it to any existing liabilities. By compensating the health plans based on a set amount of reserves already collected from member premiums, HCG eliminates the potential for any unanticipated losses (or gains) from variation in HMO utilization. As of June 30, 2011 HCG has in reserves $580 for potential payout with a scheduled disbursement in December 2011. This reserve amount is included in the $2,700 current accrued programmatic costs at June 30, 2011. See further discussion in Note 6.

(6) Proprietary fund – decrease in net deficit and turnaround from prior fiscal year

In fiscal year 2011, HCG reported operating income of $4,920 and an increase in net assets of $6,021. This continues a positive turn-around trend that began in fiscal year 2008 when HCG began successfully managing both program and administrative costs through a series of cuts, changes, realignments, and premium adjustments to match revenues with expenses. Overall, fiscal year 2011 operating results decreased HCG's net deficit to $2,989 at June 30, 2011 as compared to the $9,010 net deficit balance at June 30, 2010.

Prior to fiscal year 2008, HCG was unable to cover its costs due to net medical losses (medical costs exceeded premiums received). Since ending fiscal year 2007 with a liability of $22,509, HCG has reduced this balance by $15,735 using a combination of cash generated from operations, General Fund subsidies, reinsurance and forgiveness of debt. Since 2010, HCG has not received General Fund subsidies to offset prior year losses. Additionally, in fiscal year 2010 and 2011 HCG made a cash transfer to the General Fund in the amounts of $365 and $453 mandated by Laws 2009, Chapter 11 and Laws 2011, Chapter 24, respectively.

(dollar amounts expressed in thousands)

(6) Proprietary fund – decrease in net deficit and turnaround from prior fiscal year (continued)

The following table summarizes HCG's reconciliation liability activity for fiscal year 2011:

Healthcare Group Reconciliation Liability as of June 30, 2011
Fiscal Year 2011 Activity

	Reconciliation Period		
	FY 07	FY 08	Total
Balance June 30, 2010	$ 8,683	$ 3,699	$ 12,382
Payments made	(2,915)	(55)	(2,970)
Adjustments	(2,447)	(191)	(2,638)
Balance June 30, 2011	$ 3,321	$ 3,453	$ 6,774

There was no reconciliation liability for fiscal year 2009.

The remaining reconciliation liability will be paid by allocating 2% of medical premium revenues for a reconciliation reserve, from residual earnings, and from any State subsidies provided by the Legislature. The balance of the reconciliation liability has decreased in every year since fiscal year 2007.

There can be no assurance that operating improvements realized over the past four fiscal years will continue to occur or will provide sufficient cash to fund operating expenses. Additionally, if there is an unexpected and adverse change in enrollment and premium increases are not sufficient to fund the reserves for past losses, then HCG will be required to further scale back administrative expenditures to a level supported by actual enrollment. Should HCG be required to accelerate payments for prior year reconciliation liabilities before it has sufficient funds to provide such payments and new terms are not negotiated, or the Legislature does not provide HCG with additional subsidies, it raises substantial doubt about HCG's ability to continue as a going concern.

In conclusion, even though management currently projects that the positive financial trend will continue, $2,989 remained as a net deficit at June 30, 2011 due to the outstanding reconciliation liability owed to the HMOs for prior fiscal years. It is, however, anticipated that operations will generate sufficient cash flow in the future to entirely pay off the remaining deficit by April 2013.

HCG plans to continue operations and to continue to pay down the outstanding liability. Accordingly, the accompanying financial statements have been prepared assuming that HCG will 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.

(dollar amounts expressed in thousands)

(7) Retirement plan

AHCCCS employees are covered by a defined benefit retirement plan administered by the Arizona State Retirement System Board. Benefits are established by State statute and provide retirement and long-term disability benefits to AHCCCS employees. The retirement plan is funded by payroll deductions from eligible employees' gross wages and matching amounts contributed by AHCCCS. These amounts satisfy the statutory requirement that employees and AHCCCS contributions must cover the actuarially determined current service costs of the retirement plan, plus amortization over a 30-year period of the unfunded past service liability. Payroll deductions as a percentage of employee wages were 9.6 percent for retirement and 0.25 percent for long-term disability for fiscal year 2011. The matching amount contributed to the retirement plan by AHCCCS was $3,696 in fiscal year 2011 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 other State agencies, prepares its annual operating budget on a basis that differs from the GAAP basis. Encumbrances as of June 30th can be liquidated during a four week administrative period known as the 13th month. The budget basis expenditures reported in the financial statements include both the fiscal year paid and the 13th month activity. The State does not have a legally adopted budget for revenues. Prior fiscal year expenditures of $72,113 paid in the current fiscal year in accordance with the administrative adjustment procedures as authorized by Arizona Revised Statutes are reported as a separate amount. AHCCCS' controlling statute for programmatic payments administrative adjustment procedures varies from the statutory requirement of other State agencies. AHCCCS is permitted to pay for approved system covered medical services presented after the close of the fiscal year in which they were incurred with either remaining prior year or current year available appropriations. Unexpended prior year available appropriations for programmatic payments revert on December 31, 2011.

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, 2011:

	General Fund Actual
Budgetary Basis Fund Balance, June 30, 2011	$ 113,317
Budgetary Basis of Accounting	
Increases to fund balance:	
Cash	310
Due from State and county governments	89,748
Due from the federal government	82,395
Due from other Fund	11,800
Receivables and other	58,405
Total increases	242,658

(dollar amounts expressed in thousands)

(8) Budgetary basis of accounting (continued)

Decrease to fund balance:	
Deferred revenue	(21,512)
Due to State and county governments	(137,271)
Accrued programmatic costs	(162,780)
Payables and other	(3,392)
Total decreases	(324,955)
Total GAAP basis fund balance	$ 31,020

Non-appropriated expenditures of $2,697,336 in the General Fund consist of federal and state matching pass-through payments to other agencies.

(9) Contingencies

Litigation and investigations - AHCCCS has been named as a defendant in a variety of litigation, all of which are being defended by in-house and contracted legal counsel. One case alleges AHCCCS failed to adjust the hospital tier rates concurrent with changes made to the outlier thresholds from 1994 to 1998. It is reasonably possible that the hospitals will prevail; however, AHCCCS cannot reasonably estimate an amount, and no liability has been recorded as of June 30, 2011. Another case challenges the legality of a freeze on the enrollment of childless adults into the portion of the AHCCCS program added in 2000 pursuant to Proposition 204. On August 10, 2011 Maricopa County Superior Court entered judgment on behalf of the State. The plaintiffs are expected to appeal. It is the opinion of AHCCCS, upon consultation with legal counsel, that none of these claims are likely to have a material adverse effect on its 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.

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

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

(9) Contingencies (continued)

Budget neutrality agreement – In January 2001, AHCCCS obtained a Section 1115 Waiver from CMS that provides federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204. The Waiver requires that over the term of the agreement (April 1, 2001 through September 30, 2011), that the population covered by the Waiver be budget neutral for CMS. Budget neutral means that CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions (STC) include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. The budget neutrality calculation is dependent on a number of variables including the number of members, the eligibility category of members and the general economy and its impact on unemployment, medical inflation and policy decisions that may impact program costs made by the Legislature. In accordance with the Waiver, AHCCCS has 2 years subsequent to September 30, 2011 to report expenditures related to the budget neutrality period. Through June 30, 2011, AHCCCS remains under the cumulative reporting limit threshold. Accordingly, the accompanying financial statements have not been adjusted for the impact of any liability AHCCCS may have related to the Waiver budget neutrality agreement. Subsequent to June 30, 2011, the Waiver was renewed through September 30, 2016. The Waiver continues to include a budget neutrality provision through September 30, 2016.

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

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

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

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

Out of the $32 in federal dollars paid to the LEAs for the selected claims, OIG identified a potential overpayment of approximately $6.8 which represents an error rate of approximately 21%. OIG has extrapolated the error rate and has issued a draft report recommending that CMS recoup approximately $21,000 of program costs previously passed through to the LEAs under the DSC program. AHCCCS conducted a review and validation of the data set supporting the OIG findings and responded to CMS regarding the final OIG audit report and extrapolated finding amount on September 21, 2010. AHCCCS disagrees with the audit report and disputes approximately $4 or 59 percent of the identified overpayment amount of approximately $6.8.

(9) Contingencies (continued)

AHCCCS has returned $2.7 based on the claims that AHCCCS does not dispute. Internal counsel has indicated that it is reasonably possible that some additional amount will be disallowed and recouped by CMS. However, AHCCCS cannot, at this stage, reasonably estimate an amount and no repayment liability has been recorded as of June 30, 2011.

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

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

CMS has instructed AHCCCS to refund the $9,300 in overpayments. The refund will be requested from the LEAs or deducted from future payments in accordance with the intergovernmental agreement. The amount due from the LEAs may be reduced by any recovery from the TPA as identified above. The recoupment liability of $9,300 is included in the due to the federal government with a corresponding receivable in the due from the state and local governments in the accompanying financial statements.

Medicare Part B premium buy-in - In February 2010, the Department of Health and Human Services, Office of Inspector General, Office of Audit Services (OIG) commenced an audit of the buy-in of Medicare Part B premiums. The OIG audit period covered Part B premiums paid by the State and claimed for Federal reimbursement for the quarters ended December 31, 2007, through September 30, 2009. Based on the OIG findings, CMS has also reviewed the Medicare Part B eligibility categories and Federal claiming for all four quarters in fiscal year 2011. CMS has made the determination that AHCCCS has not complied with Federal requirements and formally issued grant award deferral letters for certain claimed amounts for the four quarters ended June 2011. In addition, AHCCCS anticipates receiving a disallowance for the three quarters ended December 31, 2009, March 31, 2010 and June 30, 2010.

AHCCCS bases Federal claiming on two separate State Medicaid Directors Letters where CMS has stated that, at the State's option, FFP is available for the cost of Part B premiums for the eligibility category in question. The questioned category is individuals eligible for both Medicaid and Medicare, but who were not cash recipients, deemed cash recipients, Qualified Medicare Beneficiaries, Specified Low-Income Medicare Beneficiaries, or Qualified Individuals 1 and are covered as a State option. AHCCCS intends to file an appeal to the CMS Departmental Appeals Board if CMS issues a formal disallowance. Internal counsel has indicated that it is reasonably possible that some portion of the deferred amount may be disallowed and recouped by CMS. However, AHCCCS received a waiver that allows FFP for the cost of Part B premiums for this eligibility category prospectively effective October 22, 2011. Accordingly, a liability of $18,400 is included in the due to the federal government in the accompanying financial statements for the period from October 1, 2009 through June 30, 2011.

(dollar amounts expressed in thousands)

(10) Interfund receivables, payables and transfers

Interfund activity is defined as transactions between funds administered by AHCCCS. The interfund balances as of June 30, 2011 consist of transfers from the Other Funds to the General Fund in the amount of $11,800.

In the government-wide statement of activities, the interfund activity has been eliminated. The total net transfers out of $40,005 reported on the statement of activities represents transfer activities to other State agencies.

(11) Transactions with other State agencies and counties

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

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

The following is a summary of transactions with these State agencies for the administrative services described above for the year ended June 30, 2011.

	Expenditures
Arizona Department of Economic Security	$ 69,441
Arizona Department of Administration	13,633
Arizona Department of Health Services	2,350
Arizona Board of Nursing	210
Arizona Office of Administrative Hearings	299
	$ 85,933

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

(dollar amounts expressed in thousands)

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

The amount passed through to ADES is classified as acute and 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, 2011.

	Expenditures
Arizona Department of Economic Security	$ 990,279
Arizona Department of Health Services	1,389,668
	$ 2,379,947

Revenues include $244,200 from Arizona counties during fiscal year 2011. This amount has been adjusted to reflect the reduction in county contributions required by the political subdivision contribution limitations of the American Recovery and Reinvestment Act of 2009 in the amount of $6,429. See Note 13. 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, 2011, county and State contributions did not exceed related expenditures.

(12) Other pass through funds

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

Arizona county and local governments contributed $50,500 to qualify for matching federal funds for the Graduate Medical Education and Disproportionate Share Hospital program payments and for the provision of qualifying services to hospitalized inmates. These amounts are included within county pass through funds in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds.

Arizona counties contributed $3,117 as determined by statutory calculation for administrative costs incurred by ADES for eligibility determinations and other operating costs associated with Proposition 204.

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

(dollar amounts expressed in thousands)

(12) Other pass through funds (continued)

At June 30, 2011, 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	$ 4,506
Program Services Federal Funds	28,866
Arizona Department of Economic Security	
County Contribution for Administrative Costs	3,117
Arizona Department of Health Services	
Cost reimbursement from Civil Monetary Penalties	719
	$ 37,208

(13) American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 (ARRA) provides fiscal relief to States to protect and maintain State Medicaid programs. This relief is granted in the ARRA, Title V, Section 5001 and 5002 in the form of temporary increases in the federal matching assistance percentage (FMAP) rates, and increases to the Disproportionate Share Hospital (DSH) allotments. The FMAP rate increases vary based upon the maintenance of FMAP and unemployment rate provisions of the ARRA. The FMAP rate increased in fiscal year 2011 from 65.75% to 75.93% in the quarter ended September 30, 2010 and from 65.85% to 75.93%, 73.10% and 71.22% in the subsequent three quarters of fiscal year 2011.

In order for states to be eligible to receive the increased FMAP, states must comply with the following maintenance of effort requirements:

- States are ineligible for increased FMAP if eligibility standards, methodologies, or procedures are more restrictive than what was in effect July 1, 2008. There are provisions that allow states to reverse changes made prior to the passage of ARRA and still be able to receive the increased FMAP.
- States must comply with prompt payment requirements to providers and must submit a quarterly report that it is in compliance with this provision.
- States cannot deposit or credit any reserve or rainy day funds with revenue from increased FMAP and will be required to report on how the increased FMAP dollars are spent.
- States are ineligible for the increased FMAP if it requires political subdivisions to pay a greater percentage of the non-federal share for quarters during the recession adjustment period than the percentage that would have been required by the State under such plan on September 30, 2008.

(dollar amounts expressed in thousands)

(13) American Recovery and Reinvestment Act of 2009 (continued)

Arizona counties contribute to the non-federal share of the Acute Base Capitation program and the Arizona Long-Term Care (LTC), Elderly and Physically Disabled (EPD) program; therefore, with the application of the political subdivision maintenance of effort provision, the required county contributions decreased in fiscal year 2011 by $5,812 for the Acute Base Capitation program and $617 for the LTC, EPD program.

State agencies and political subdivisions benefited from the increased FMAP rates for claimed federal expenditures for fiscal year 2011 as follows:

Arizona Health Care Cost Containment System	$ 551,861
Arizona Department of Health Services	113,475
Arizona Department of Economic Security	86,240
Arizona Department of Corrections	396
Arizona School Districts	2,155
Arizona Counties	86
	$ 754,213

(14) New pronouncements

The Governmental Accounting Standards Board (GASB) issued several pronouncements prior to June 30, 2011 with effective dates within or after the fiscal year ending June 30, 2011. Management believes the impact of these statements does not affect current or future financial presentations by AHCCCS. AHCCCS adopted the following pronouncement during fiscal year 2011:

In February 2009, the GASB issued Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions* for reporting periods beginning after June 15, 2010. GASB Statement No. 54 provides more clearly defined fund balance categories to make the nature and extent of the constraints placed on a government's fund balance more transparent. GASB Statement No. 54 also clarifies the existing governmental fund type definitions to improve the comparability of governmental fund financial statements and help financial statement users to better understand the purpose for which governments have chosen to use particular funds for financial reporting. The classifications are based primarily on the extent to which the State is bound to honor constraints on the specific purposes for which the amounts in those funds can be spent. Adoption of this statement did not have a significant impact on AHCCCS' financial statements.

(15) Subsequent events

Enrollment in AHCCCS programs continued the slowing trend that had begun beginning with the final six months of fiscal year 2010 and stabilized through the first ten months of fiscal year 2011. From July 2010 to April 2011, Title XIX full service enrollment actually decreased in six of the ten months. However, the final two months of fiscal year 2011 experienced significant growth that may have been the result of member applications prior to implementation of planned enrollment freezes. This period of relative enrollment stability followed 40 months from March 2007 to June 2010 of significant growth where 392,182 members were added resulting in a 44.7 percent increase. AHCCCS continues to review the Medicaid provisions of the PPACA of 2010 to evaluate impacts and responsibilities under the new Federal healthcare plan.

(15) Subsequent events (continued)

The AHCCCS fiscal year 2012 appropriation has been reduced by $1,464,000 by the Legislature to adjust the State's Medicaid program to declining State revenues. This reduction is planned to be attained through a series of program changes in the form of enrollment freezes, provider rate reduction, and medical service limits. These reforms are subject to CMS approval and the enrollment freezes have been challenged in the courts. As of the date of this publication, the legal challenge has been denied; however, the lower court decision is expected to be appealed to the State Appellant Court and will most likely be decided by the State Supreme Court. CMS has approved significant components of the proposed program changes and AHCCCS continues to evaluate the overall impact to fiscal year 2012 funding. Additionally, the Legislature has provided the Agency with the authority to adopt rules to implement a program within its available appropriations. Accordingly, AHCCCS does not anticipate the need for a General Fund Supplemental appropriation, but does project the need for supplemental appropriations for federal expenditure authority and surplus prescription drug rebate fund collections for fiscal year 2012 based on current projections. However, factors such as CMS decisions on the deferrals, legal decisions, and case load changes compared to projections may influence the need for supplemental appropriations.

ADDITIONAL INFORMATION

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2011
(amounts expressed in thousands)

Federal Grantor/Pass Through Agency/Program	Federal CFDA Number	Expenditures	
U.S. Department of Health and Human Services			
Centers for Medicare and Medicaid Services			
Medicaid Program (Title XIX)			
Federal funds expended to vendors	93.778	$ 6,154,230	
American Recovery and Reinvestment Act	93.778-R	666,751	
Federal funds expended to subrecipients	93.778	2,687	
		6,823,668	*
Children's Health Insurance Program (Title XXI)	93.767	40,418	*
State Planning and Establishment Grant	93.525	141	
Medicaid Infrastructure Grant	93.768	1,413	
TOTAL EXPENDITURES OF FEDERAL AWARDS		$ 6,865,640	

*major programs

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2011

(dollar amounts expressed in thousands)

(1) Basis of presentation

The accompanying schedule of expenditures of federal awards includes the federal grant activity of ***Arizona Health Care Cost Containment System*** and is presented on the accrual basis of accounting. The information in this schedule is presented in accordance with the requirements of *U.S. Office of Management and Budget (OMB) Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in, the preparation of the basic financial statements.

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

The program titles and CFDA numbers were obtained from the 2011 *Catalog of Federal Domestic Assistance*.

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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)** as of and for the year ended June 30, 2011 and have issued our report thereon dated November 22, 2011. We conducted our audit in accordance with U.S. generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of the ***Arizona Health Care Cost Containment System*** is responsible for establishing and maintaining effective 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 deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, 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.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the ***Arizona Health Care Cost Containment System's*** financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance 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
November 22, 2011