



A REPORT  
TO THE  
ARIZONA LEGISLATURE

Financial Audit Division

Financial Statement Audit

# Department of Economic Security

Division of Developmental  
Disabilities ALTCS Contract  
Year Ended June 30, 2006



**Debra K. Davenport**  
Auditor General

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Department of Economic Security  
Division of Developmental Disabilities  
ALTCS Contract  
Report on Audit of Financial Statements  
Year Ended June 30, 2006

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**STATE OF ARIZONA  
OFFICE OF THE  
AUDITOR GENERAL**

**DEBRA K. DAVENPORT, CPA**  
AUDITOR GENERAL

**WILLIAM THOMSON**  
DEPUTY AUDITOR GENERAL

## Independent Auditors' Report

Members of the Arizona State Legislature

Tracy Wareing, Director  
Department of Economic Security

We have audited the accompanying financial statements of the State of Arizona, Department of Economic Security, Division of Developmental Disabilities, Arizona Long-Term Care System ALTCS Contract (ALTCS Contract) as of and for the year ended June 30, 2006, as listed in the table of contents. These financial statements are the responsibility of the Department and its Division of Developmental Disabilities' management. Our responsibility is to express an opinion on these financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with U.S. generally accepted auditing standards. 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.

The ALTCS Contract had inadequate internal controls over processing, recording, and reporting certain medical and long-term care service claims for payments made to providers. As a result, the Division's records did not permit us to apply auditing procedures sufficient to determine whether claims totaling \$20 million, which were included in aid to individuals expenditures, were accurate and whether any related assets or liabilities resulted.

As discussed in Note 1, the financial statements of the ALTCS Contract are intended to present the financial position and the changes in financial position of only that portion of the governmental activities and major fund of the State of Arizona that is attributable to the transactions of the ALTCS Contract. They do not purport to, and do not, present fairly the financial position of the State of Arizona as of June 30, 2006, and the changes in its financial position, for the year then ended in conformity with U.S. generally accepted accounting principles.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding expenditures for certain medical and long-term care service claims payments, the financial statements referred to above present fairly, in all material respects, the financial position of the Department of Economic Security, Division of Developmental Disabilities, ALTCS Contract as of June 30, 2006, and the changes in financial position thereof for the year then ended in conformity with U.S. generally accepted accounting principles.

Debbie Davenport  
Auditor General

May 16, 2007

Department of Economic Security  
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Balance Sheet—Special Revenue Fund  
June 30, 2006

Assets	
Cash and investments held by the State Treasurer	\$59,386,325
Due from other state funds	3,381,639
Due from providers	<u>8,930,892</u>
Total assets	<u>\$71,698,856</u>
Liabilities and Fund Balance	
Liabilities:	
Accrued administrative and payroll costs	\$ 3,500,193
Accrued medical and healthcare claims	49,529,955
Due to other state funds	<u>1,721,838</u>
Total liabilities	<u>54,751,986</u>
Fund balance:	
Unreserved fund balance	<u>16,946,870</u>
Total liabilities and fund balance	<u>\$71,698,856</u>

See accompanying notes to financial statements.

Department of Economic Security  
 Division of Developmental Disabilities  
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 Statement of Revenues, Expenditures, and Changes in  
 Fund Balance—Special Revenue Fund  
 Year Ended June 30, 2006

Revenues:	
Capitation	\$620,451,383
Ventilator dependent	14,859,193
Fee for service	866,436
Investment earnings	<u>3,477,415</u>
Total revenues	<u>639,654,427</u>
Expenditures	
Health and welfare:	
Aid to individuals	557,888,568
Allocated administrative expenditures	43,398,291
Case management	30,446,066
Professional and outside services	<u>7,944,067</u>
Total expenditures	<u>639,676,992</u>
Deficiency of revenues under expenditures	(22,565)
Other financing uses:	
Transfers to other state funds	<u>(7,148,841)</u>
Net change in fund balance	(7,171,406)
Fund balance, July 1, 2005	<u>24,118,276</u>
Fund balance, June 30, 2006	<u>\$ 16,946,870</u>

See accompanying notes to financial statements.

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Note 1 - Summary of Significant Accounting Policies

The accounting policies of the Department of Economic Security, Division of Developmental Disabilities (Division), Arizona Long-Term Care System ALTCS Contract (ALTCS Contract) conform to generally accepted accounting principles applicable to governmental units adopted by the Governmental Accounting Standards Board (GASB). A summary of the Division's more significant accounting policies follows.

A. Reporting Entity

For financial reporting purposes, the ALTCS Contract includes only that portion of the State's general fund that is attributable to the transactions of the ALTCS Contract. The Division is responsible for administering the ALTCS Contract. Fiscal responsibility for the Division remains with the Department of Economic Security and, ultimately, with the State. The Division is a contractor with the Arizona Health Care Cost Containment System (AHCCCS) to provide medical and healthcare services to eligible enrollees of the AHCCCS Arizona Long-Term Care System (ALTCS) program for the developmentally disabled. This program provides inpatient and outpatient medical and nursing services in addition to managed institutional and home- and community-based, long-term care services to eligible enrollees of the AHCCCS ALTCS program. The Division receives monthly premiums from AHCCCS for all eligible enrollees under the AHCCCS ALTCS program for the developmentally disabled.

B. Fund Accounting

The Division's accounts are maintained in accordance with the principles of fund accounting to ensure that limitations and restrictions on the Division's available resources are observed. The principles of fund accounting require that resources be classified for accounting and reporting purposes into funds in accordance with the activities or objectives specified for those resources. Each fund is considered a separate accounting entity, and its operations are accounted for in a separate set of self-balancing accounts that comprise its assets, liabilities, fund balance, revenues, and expenditures.

The ALTCS Contract's financial transactions are reported as a special revenue fund since the proceeds are from specific revenue sources that are legally restricted to expenditures for specified purposes.

Although the ALTCS Contract is considered a special revenue fund when reported on individually, it becomes a part of the State's General Fund at the combined state-wide level.

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### C. Basis of Accounting

The ALTCS Contract financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Under this method, revenues are recognized when they become 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, the Division considers capitation revenues to be available if they are received within 90 days of the end of the current fiscal period, and considers all other revenues to be available if they are collected within 30 days of the end of the current fiscal period. Expenditures are recognized when the related fund liability is incurred.

All ALTCS Contract revenues were susceptible to accrual and have been recognized as revenues of the current fiscal period.

### D. Investment Earnings

Investment earnings is composed of interest earned on the ALTCS Contract's portion of monies deposited with the State Treasurer.

### E. Incurred But Not Recorded (IBNR) Methodology

IBNR medical claims are calculated for aid to individuals expenditures using lag data provided by the Division's information systems, with adjustments as necessary for events that are outside the lag patterns. Amounts are based on historical expenditure patterns.

## Note 2 - Cash and Investments Held by the State Treasurer

Arizona Revised Statutes (A.R.S.) requires state agencies' monies to be deposited with the State Treasurer, and further requires those deposits to be invested in various pooled funds. Cash and investments held by the State Treasurer represent the ALTCS Contract's portion of those monies. The State Treasurer invests idle contract monies in an internal investment pool (Pool 3) and distributes interest to the ALTCS Contract. Interest earned from these invested monies is allocated monthly based on the average daily balance. Participant shares in the pool are purchased and sold based on the Net Asset Value of the shares. As a result, the ALTCS Contract's portion of the pool is not identified with specific investments. The ALTCS Contract's portion of these deposits and investments is reported at fair value, measured on a monthly basis, which approximates the Contract's value of participant pool shares.

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The State Treasurer's internal investment pool 3 is not required to be registered and is not registered with the Securities and Exchange Commission under the Investment Company Act of 1940. The activities and performance of the pool is reviewed monthly by the State Board of Investments in accordance with A.R.S. §35-311.

At June 30, 2006, the ALTCS Contract's deposits with the State Treasurer were as follows:

	Amount
State Treasurer's investment pool 3	\$29,613,039
Cash deposits (projected liquidity needs)	<u>29,773,286</u>
	<u>\$59,386,325</u>

**Credit Risk**—Credit risk is the risk that an issuer or counterparty to an investment will not fulfill its obligations. The Department of Economic Security does not have a formal investment policy with respect to credit risk. The State Treasurer's investment pool 3 is unrated.

**Interest Rate Risk**—Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The Department of Economic Security does not have a formal interest rate risk policy. As of June 30, 2006, the State Treasurer's weighted average to maturity of its investments is 1.58 years.

Note 3 - Due from Other State Funds

Amounts due from other state funds at June 30, 2006, include \$344,305 of interest earned, \$96,226 of premium tax overpayments due from the Arizona Department of Insurance, \$1,592,119 of capitation receivables due from AHCCCS, \$299,526 of payments due from other DES funds, and \$1,049,463 in share of costs receivable from AHCCCS for the State-funded Long-Term Care Program.

Note 4 - Due from Providers

Amounts due from providers resulted from overpayments made by a new medical and long-term care service claims processing system implemented in February 2006. The amount due from providers of \$8,930,892 includes \$8,636,396 of duplicate payments, \$1,872,296 of claims paid manually and subsequently denied by the new system for reasons other than duplicate payments, and an allowance for uncollectible accounts of \$1,577,800.

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Note 5 - Accrued Medical and Healthcare Claims

Accrued medical and healthcare claims totaling \$49,529,955 includes reported but unpaid claims (RBUC) of \$1,944,203 and estimated incurred but not reported (IBNR) medical claims of \$47,585,752. The RBUCs are identified for medical services only. The automated claims payment system for the other types of services does not have the capability to identify RBUCs. Therefore, the RBUC claims for these services have been reported as IBNR.

Note 6 - Acute Care Reinsurance

During the year ended June 30, 2006, the Division received reimbursements totaling \$1,412,872 from AHCCCS for acute care reinsurance expenditures incurred for enrollees for claims incurred in prior fiscal years. These revenues are recorded as a reduction of aid to individuals expenditures.

The Division subcontracts with various health plans to provide acute care services to ALTCS enrollees. These health plans must submit clean reinsurance claims to the Division within 12 months from the date of service.

The Division disbursed a total of \$2,248,075 to the health plans during the year ended June 30, 2006, and had RBUCs of \$980,576 and IBNR claims of \$2,554,528 for total acute care reinsurance expenditures of \$5,783,179, which has been included in aid to individuals expenditures.

Note 7 - Aid to Individuals Expenditures

Aid to individuals expenditures consists of the following expenditures summarized by type of service setting or service provided, as applicable:

Institutional care:	
Skilled nursing	\$ 2,286,821
Intermediate (mentally retarded)	19,346,481
Institutional care IBNR	<u>1,071,358</u>
Total institutional care	<u>22,704,660</u>
Home- and community-based services (HCBS):	
State-operated group home	8,892,388
Vendor-operated group home	164,127,215
Adult developmental home	18,665,136
Home-based services	210,130,250

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HCBS IBNR	\$ 40,639,417
Total HCBS	<u>442,454,406</u>
Acute care:	
Acute care	75,644,241
Acute care RBUC	280,975
Acute care IBNR	819,027
Reinsurance	2,248,075
Reinsurance RBUC	980,576
Reinsurance IBNR	2,554,528
Reinsurance reimbursement	<u>(1,412,872)</u>
Total acute care	<u>81,114,550</u>
Other:	
Ventilator dependent (including nonacute and acute care)	8,430,878
Other RBUC (ventilator dependent acute care)	682,652
Other IBNR (ventilator dependent nonacute and acute care)	<u>2,501,422</u>
Total other	<u>11,614,952</u>
Total aid to individuals expenditures	<u>\$557,888,568</u>

During the year ended June 30, 2006, the ALTCS Contract recorded allocated charges of \$23,097,641 as expenditures for direct care services provided to clients by the Division. The expenditures were charged to the ALTCS Contract as aid to individual expenditures based on a federally approved cost allocation plan.

#### Note 8 - Allocated Administrative Expenditures

During the year ended June 30, 2006, the ALTCS Contract recorded allocated administrative charges of \$43,398,291 as expenditures for its share of services provided by the Department, including \$13,174,649 in premium taxes.

A.R.S. §§36-2905 and 36-2944.01 require AHCCCS to pay a 2 percent premium tax on all capitation and other reimbursements paid to ALTCS. These premium taxes are included in capitation revenue when received from AHCCCS and are reported as expenditures when remitted to the Arizona Department of Insurance.

#### Note 9 - Transfers to Other State Funds

Transfers out during the year ended June 30, 2006, included \$7,148,841 to the state-funded Long-Term Care program as authorized by AHCCCS.

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Note 10 - Commitments and Contingencies

The State has the ultimate fiscal responsibility for the ALTCS Contract. Accordingly, any claims requiring additional resources require the Legislature's approval. While there is a possibility that claims could be asserted that would require additional resources to become available to the ALTCS Contract, in management's opinion, the possibility that valid claims will be asserted and claim amounts cannot reasonably be estimated.

Note 11 - Risk Management

The Division is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; medical malpractice; and natural disasters. The Department is a participant in the State's self-insurance program, and in the division management's opinion, any unfavorable outcomes from these risks would be covered by that self-insurance program. Accordingly, the Department of Economic Security has no risk of loss beyond adjustments to future years' premium payments to the State's self-insurance program. All estimated losses for the State's unsettled claims and actions are determined on an actuarial basis and are included in the *State of Arizona Comprehensive Annual Financial Report*.

Note 12 - Related Party Transactions

During the year ended June 30, 2006, the ALTCS Contract reimbursed the Division for \$23,097,641 of health and rehabilitative services provided to enrollees, other department divisions for \$30,223,642 of administrative and fiscal services, and the Arizona Department of Insurance for \$13,174,649 of premium taxes due.