STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

State of Arizona

REPORT
HIGHLIGHTS
FINANCIAL STATEMENT AUDIT

Subject

The State of Arizona issues a Comprehensive Annual Financial Report. The State is responsible for preparing financial statements, maintaining strong internal controls, and demonstrating accountability for its use of public monies. As the auditors, our job is to determine whether the State has met its responsibilities.

Our Conclusion

The information in the State's financial statements is fairly stated in all material respects and the financial statements can be relied on. However, an explanatory paragraph was included in the auditors' report due to the uncertainty of whether the Healthcare Group of Arizona will be able to continue operations. See page 3 for further information. Our audit covers all state operations with the exception of agencies and departments that are audited by public accounting firms. The Department of Transportation, Arizona Health Care Cost Containment System, State Lottery, the retirement plans, and component units are audited by other auditors. Our conclusion is based, in part, on the work of those auditors.

2006

Year Ended June 30, 2006

General Fund Financial Condition Improves

During fiscal year 2006, General Fund revenues and other financing sources totaled approximately $18.9 billion, and expenditures and other financing uses totaled approximately $17.9 billion. As a result, the State's General Fund balance increased $956 million from the prior year. This represents an increase of approximately 72.9 percent.

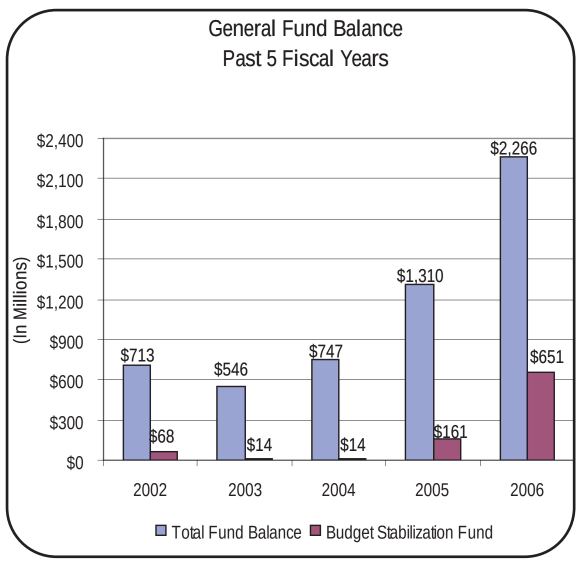
General Fund revenues and other financing sources increased $1.5 billion, or 8.8 percent, between fiscal years 2005 and 2006, primarily as a result of the following:

- Income tax revenues increased by approximately $1 billion, or 28.5 percent. Taxes paid by individuals increased by approximately $813 million, and taxes paid by businesses increased approximately $194 million.
- Sales tax revenues increased approximately $881 million, or 19.4 percent, because of an improving economy and increasing population. The majority of this increase, $641 million, was from sales taxes paid by retail stores and construction contractors.
- Intergovernmental revenues increased $399 million, or 5.6 percent, due mainly to an increase in monies received for health and welfare programs from the federal and local governments.

General Fund expenditures and other financing uses increased $1.1 billion, or 6.7 percent, between fiscal years 2005 and 2006, primarily as a result of the following:

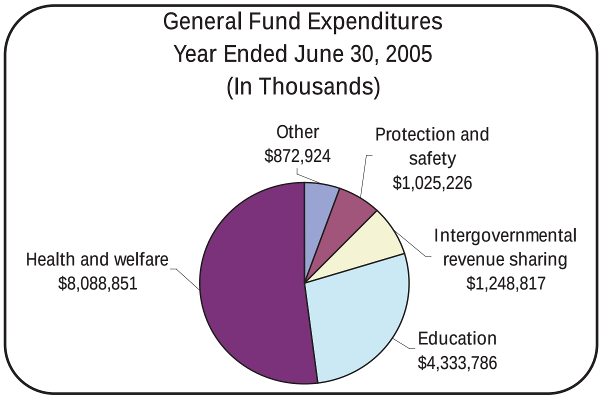
- Health and welfare expenditures increased $569 million, or 7 percent, mainly because of growth in Title XIX and XXI programs and inflationary factors.
- Education expenditures increased $380 million, or 8.8 percent, due to rising student enrollment, which resulted in increased state aid to schools, increased expenditures for full-day kindergarten, and increased federal aid passed through to schools.

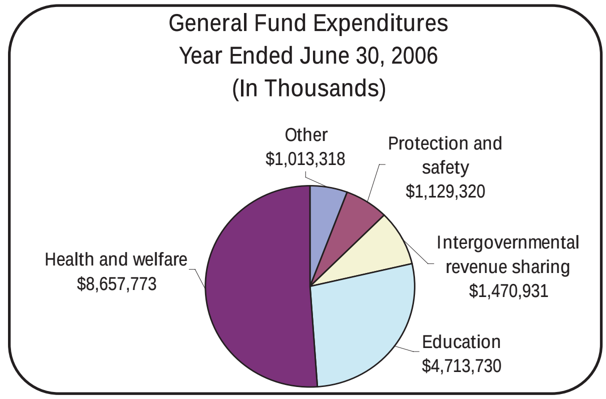
As shown in the graph below, from June 30, 2002 through June 30, 2003, the General Fund's fund balance declined by approximately $167 million. However, from June 30, 2003 through June 30, 2006, the fund balance increased by approximately $1.7 billion, ending with $1.4 billion in unreserved fund balance and an $831 million reserved fund balance for a total fund balance of $2.3 billion. Included in the $831 million reserved fund balance is $651 million for the Budget Stabilization Fund. The Budget Stabilization Fund is a form of "Rainy Day Fund" the Legislature established in 1991.



Summary of General Fund Expenditures

For fiscal year 2006, education, health and welfare, protection and safety, and intergovernmental revenue-sharing expenditures accounted for 94 percent of General Fund expenditures. The graphs below detail General Fund expenditures for fiscal years 2005 and 2006.





Lack of Effective Controls over the Department of Economic Security's Division of Developmental Disabilities' Arizona Long-Term Care Contract will Result in a Modified Auditors' Report on its Separately Issued Financial Statements

The Department of Economic Security's Division of Developmental Disabilities (Division) is a contractor with the Arizona Health Care Cost Containment System (AHCCCS) to provide medical and long-term care 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 the program's eligible enrollees. During fiscal year 2006, the Division spent more than $550 million for medical and long-term care services for program enrollees. Therefore, it is imperative that the Division maintain effective internal control policies and procedures over its claims process to help ensure claims are accurately paid, recorded, and reported. Annually, AHCCCS requires the Division to prepare and issue audited financial statements for the ALTCS program. The results of that audit follow.

During the fiscal year, the Division implemented a new claims processing system to meet the federal Health Insurance Portability and Accountability Act (HIPAA) requirements for health care claims processors to accept provider claims that followed HIPAA electronic claim filing standards. However, due to insufficient testing of the new system and a poor implementation plan, the system did not always identify duplicate claims, did not always apply proper pay rates, made some payments for uncovered services, and rejected some valid claims.

Consequently, the Division's records did not permit the auditors to apply auditing procedures sufficient to determine whether certain medical and long-term care services claims paid during the year, totaling $20 million, were accurate and the auditors' report on the Division's separately issued ALTCS Contract financial statements will be modified.

The Division could have similar problems in fiscal year 2007; therefore, the fiscal year 2007 ALTCS financial statements may require substantial analysis and corrections to be accurate, and could again result in a modification to the auditors' report.

Summary of the State's Government-wide Financial Data

The State's government-wide financial statements are designed to provide readers with a broad overview of the State's finances in a manner similar to private-sector businesses. These statements report the financial activities of the overall government, except for fiduciary activities.

The tables below present a summarized version of the government-wide Statement of Net Assets and Statement of Activities reported in the Comprehensive Annual Financial Report for the State's primary government, which includes all governmental and business-type activities, excluding component units.

The Statement of Net Assets presents information on all state assets and liabilities, with the difference between the two reported as net assets. The Statement of Activities presents information showing how net assets changed during the most recent fiscal year.

Statement of Net Assets
June 30, 2006
(In Thousands)

	Total Governmental and Business-type Activities
Current and other assets	$11,021,169
Capital assets	17,874,425
Total assets	28,895,594
Current liabilities	2,697,404
Noncurrent liabilities	6,228,807
Total liabilities	8,926,211
Net assets	
Invested in capital assets, net of related debt	14,022,525
Restricted net assets	4,961,323
Unrestricted net assets	985,535
Total net assets	$19,969,383

Statement of Activities
Year Ended June 30, 2006
(In Thousands)

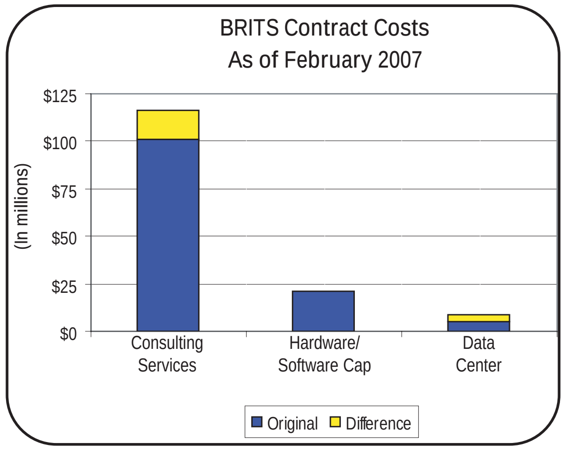
	Total Governmental and Business-type Activities
Program revenues:	
Governmental activities	$ 9,051,628
Business-type activities	2,789,309
General and other revenues:	
Governmental activities	14,583,128
Business-type activities	158,345
Total revenues	26,582,410
Expenses:	
Governmental activities	19,988,524
Business-type activities	3,481,011
Total expenses	23,469,535
Change in net assets	3,112,875
Net assets—beginning	16,856,508
Net assets—ending	$19,969,383

Healthcare Group of Arizona May Not Be Able to Continue Operations

The Healthcare Group Fund was established at the Arizona Health Care Cost Containment System (AHCCCS) in 1988 to administer medical coverage primarily to small, uninsured businesses and employees of the State's political subdivisions. The Healthcare Group of Arizona (HCG) contracts with three managed healthcare plans from the existing AHCCCS network, and has also contracted with a third party administrator to provide a Preferred Provider Organization option. The funding sources of the Healthcare Group include premiums paid by small employers and eligible employees; gifts, grants, and donations; and legislative appropriations. The HCG is accounted for as a nonmajor enterprise fund and is included as part of the State's business-type activities and aggregate remaining fund information. During fiscal years 2005 and 2006, the HCG incurred operating losses of $4.844 million and $6.137 million, respectively, and had a net fund deficit of $3.696 million at June 30, 2006, that raise substantial doubt about its ability to continue operations. The HCG management is in the process of implementing operating changes, including increasing premiums for plan members, to help provide sufficient cash to pay for operations. However, there is no assurance that these changes will provide sufficient cash to pay for operations or that the Legislature will approve subsidies. For further information, see Note 8 in the State of Arizona's Comprehensive Annual Financial Report.

The Department of Revenue Continues to Address BRITS Implementation Issues

In August 2002, the State contracted with a management consulting and technology services company to help improve the Department of Revenue's tax collection processes and the effectiveness of its enforcement programs by developing an integrated tax information system known as BRITS (Business Reengineering Integrated Tax System). The system has been developed and implemented in phases, with the individual income tax release scheduled for December 2007.



BRITS contract costs

The contract cost was originally budgeted for $128.06 million, plus estimated interest costs of $11 million. As of February 2007, the total contract costs were $146.73 million, plus estimated interest costs of $7 million, reflecting an increase to the contract of 10.55 percent. These contract changes can be explained by the following:

- $15.28 million increase for consulting services as a result of additional costs associated with the implementation.
- $3.39 million increase for an addition to the contract to provide a data center location for the new system.
- $4 million decrease to the estimated interest costs.

Hardware and software costs have been capped at $21.41 million; however, this amount may not reflect all necessary hardware and software needs.

As the individual income tax release is scheduled for implementation in December 2007, additional contract costs may be necessary to complete the project.

System Management & Operations

The vendor is providing the majority of application support for BRITS and the Department is training existing staff on the new system. However, upon completing a workforce assessment, the Department identified staff shortfalls and is seeking an appropriation to hire additional IT resources. Until the Department has secured the additional resources, it may need to continue amending the BRITS contract for continued vendor support.

Billing issues

Because of data conversion and processing errors encountered while implementing BRITS, the Department delayed billings to prevent erroneous statements from being sent to taxpayers. However, delayed billings resulted in a substantial backlog during fiscal year 2004 of unbilled accounts totaling $49.59 million. While the Department has worked to significantly reduce the backlog since the initial implementation, they continue to have $11.83 million in unbilled accounts as of June 2006.

TO OBTAIN MORE INFORMATION

A copy of the full report can be obtained by calling
(602) 553-0333

or by visiting our Web site at:
www.azauditor.gov

Contact person for this report:
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