

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract

Annual Financial Report

15 Months Ended
September 30, 2019



A Report to the Arizona Legislature

Lindsey A. Perry
Auditor General





The Arizona Office of the Auditor General's mission is to provide independent and impartial information and specific recommendations to improve the operations of State and local government entities. To this end, the Office provides financial audits and accounting services to the State and political subdivisions, investigates possible misuse of public monies, and conducts performance audits and special reviews of school districts, State agencies, and the programs they administer.

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ANNUAL FINANCIAL REPORT



MELANIE M. CHESNEY
DEPUTY AUDITOR GENERAL

ARIZONA AUDITOR GENERAL
LINDSEY A. PERRY

JOSEPH D. MOORE
DEPUTY AUDITOR GENERAL

Independent auditors' report

Members of the Arizona State Legislature

Cara Christ, Ph.D., Director
Department of Economic Security

Report on the financial statements

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 Contract (ALTCS Contract) as of and for the 15-month period ended September 30, 2019, and the related notes to the financial statements, which collectively comprise the Division's ALTCS Contract's financial statements as listed in the table of contents.

Management's responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' responsibility

Our responsibility is to express an opinion 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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the Division's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Division's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the Division's ALTCS Contract as of September 30, 2019, and the respective changes in financial position thereof for the 15-month period then ended in accordance with U.S. generally accepted accounting principles.

Emphasis of matters

As discussed in Note 1 to the financial statements, the Division's ALTCS Contract's financial statements 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 Division's ALTCS Contract's transactions. They do not purport to, and do not, present fairly the financial position of the State of Arizona as of September 30, 2019, and the changes in its financial position for the 15-month period then ended in conformity with U.S. generally accepted accounting principles. Our opinion is not modified with respect to this matter.

As discussed in Note 1 to the financial statements, the Division's ALTCS Contract's financial statements year-end changed from June 30 to September 30. Our opinion is not modified with respect to this matter.

Other matters

Supplementary information

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Division's ALTCS Contract's financial statements. The supplementary schedules listed in the table of contents are presented for purposes of additional analysis and are not required parts of the financial statements.

The supplementary schedules are management's responsibility and were derived from and relate directly to the underlying accounting and other records used to prepare the financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional 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 supplementary schedules are fairly stated, in all material respects, in relation to the financial statements as a whole.

Other reporting required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated March 4, 2020, on our consideration of the Division's 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 solely 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 effectiveness of the Division's internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Division's internal control over financial reporting and compliance.

Lindsey Perry, CPA, CFE
Auditor General

March 4, 2020

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Balance sheet—special revenue fund
As of the 15 months ended September 30, 2019

Assets

Investments held by the State Treasurer	\$ 171,714,213
Due from other state funds	1,822,859
Due from providers	<u>3,198,065</u>

Total assets	<u>\$ 176,735,137</u>
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Liabilities and fund balance

Liabilities:

Accrued administrative and payroll costs	\$ 7,215,779
Accrued medical and healthcare claims	124,659,381
Due to other state funds	<u>272,706</u>

Total liabilities	<u>132,147,866</u>
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Fund balance:

Restricted for health and welfare	<u>44,587,271</u>
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Total liabilities and fund balance	<u>\$ 176,735,137</u>
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See accompanying notes to financial statements.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Statement of revenues, expenditures, and changes in fund balance—
special revenue fund
For the 15 months ended September 30, 2019

Revenues:	
Capitation	\$ 2,090,955,415
Investment earnings	3,936,217
Miscellaneous	<u>37,205,102</u>
Total revenues	<u>2,132,096,734</u>
Expenditures:	
Health and welfare:	
Aid to individuals	1,860,838,648
Allocated administrative expenditures	87,307,416
Case management	80,662,857
Professional and outside services	12,897,984
Premium tax	<u>42,635,917</u>
Total expenditures	<u>2,084,342,822</u>
Excess of revenues over expenditures	47,753,912
Other financing uses:	
Transfers to other state funds	<u>(7,532,267)</u>
Net change in fund balance	40,221,645
Fund balance, July 1, 2018	<u>4,365,626</u>
Fund balance, September 30, 2019	<u>\$ 44,587,271</u>

See accompanying notes to financial statements.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Notes to financial statements
As of the 15 months ended September 30, 2019

Note 1 - Summary of significant accounting policies

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

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 ALTCS Contract's transactions. The Division is responsible for administering the ALTCS Contract. Control by the Division was determined on the basis of accountability. Fiscal responsibility for the Division remains with the Department 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.

The September 30, 2019, ALTCS Contract's financial statements reports a 15-month period because AHCCCS changed the ALTCS Contract's reporting period from a June 30 to a September 30 year-end.

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.

C. Basis of accounting

The ALTCS Contract's 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 collected 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 collected within 90 days of the end of the current fiscal year and considers all other revenues to be available if they are collected within 30 days of

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Notes to financial statements
As of the 15 months ended September 30, 2019

the end of the current fiscal year. All ALTCS Contract revenue sources are susceptible to accrual. Expenditures are recognized when the related fund liability is incurred.

D. Fund balance classifications

Fund balance is reported separately within classifications based on a hierarchy of the constraints placed on the use of those resources. The classifications are based on the relative strength of the constraints that control how the specific amounts can be spent. The classifications are nonspendable, restricted, and unrestricted, which includes committed, assigned, and unassigned fund balance classifications.

Restricted fund balances are those that have externally imposed restrictions on their usage by creditors, such as through debt covenants, grantors, contributors, or laws and regulations. Deficits in fund balance, if any, are reported as unassigned.

E. Capitation

The ALTCS Contract receives fixed capitation payments from AHCCCS based on certain rates for each AHCCCS member enrolled in the Division's ALTCS Contract program. The ALTCS Contract is required to provide all covered healthcare services to its members, regardless of the cost of care. If there are monies remaining, the ALTCS Contract retains the monies as profit; if the costs are higher than the amount of capitation payments from AHCCCS, the ALTCS Contract absorbs the loss.

F. Investment earnings

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

G. Incurred but not reported (IBNR) methodology

The liability and expenditures reported for accrued medical and healthcare claims include IBNR medical claims, which are estimated using lag data provided by the Department's information systems, with adjustments as necessary for events that are outside the lag patterns. Amounts are based on historical expenditure patterns.

Note 2 - Investments held by the State Treasurer

At September 30, 2019, the ALTCS Contract's investments with the State Treasurer were as follows:

	Amount
State Treasurer's investment pool 3	\$171,714,213

Arizona Revised Statutes (A.R.S.) require state agencies' monies be deposited with the State Treasurer and further requires those deposits to be invested in various pooled funds. Investments in the State Treasurer's investment pools are valued at the pool's share price multiplied by the number of shares the ALTCS Contract held. The fair value of a participant's position in the pools approximates the value of that participant's pool shares. The State Board of Investment provides oversight for the State Treasurer's investment pools.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Notes to financial statements
As of the 15 months ended September 30, 2019

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 September 30, 2019, the State Treasurer's weighted average to maturity of its internal pool 3 investments is 1.13 years.

Note 3 - Accrued medical and healthcare claims

Accrued medical and healthcare claims totaling \$124,659,381 include IBNR medical claims.

Note 4 - Miscellaneous revenues

Miscellaneous revenues during the 15-month period ended September 30, 2019, consisted of \$ 36,460,100 in one-time assistance for developmental disabilities provider cost increases resulting from Laws 2018, Second Regular Session, Chapter 276, Section 122, and \$745,002 of other revenues.

Note 5 - Acute care reinsurance

During the 15-month period ended September 30, 2019, the Division received reimbursements totaling \$27,955,523 from AHCCCS for acute care reinsurance expenditures for claims for enrollees incurred in the 15-month period ended September 30, 2019, and prior fiscal years. These reimbursements 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 15 months from the date of service.

The Division disbursed a total of \$22,543,528 to health plans during the 15-month period ended September 30, 2019.

Note 6 - Aid to individuals expenditures

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

Institutional care:	
Skilled nursing	\$ 3,423,346
Institutional care	16,244,899
Intermediate (intellectually or developmentally disabled)	14,906,925
Institutional care IBNR	<u>1,279,043</u>
Total institutional care	<u>35,854,213</u>

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Notes to financial statements
As of the 15 months ended September 30, 2019

Home- and community-based services (HCBS):	
State-operated group home	\$ 8,101,806
Vendor-operated group home	466,597,126
Adult developmental home	83,398,506
Home-based services	811,919,943
HCBS IBNR	<u>120,852,919</u>
Total HCBS	<u>1,490,870,300</u>
Acute care:	
Acute care	336,998,711
Acute care IBNR	2,527,419
Reinsurance	22,543,528
Reinsurance reimbursement	<u>(27,955,523)</u>
Total acute care	<u>334,114,135</u>
Total aid to individuals expenditures	<u>\$1,860,838,648</u>

During the 15-month period ended September 30, 2019, the ALTCS Contract recorded allocated charges of \$26,352,369 as expenditures for direct care services, including administrative costs the Division provided to clients. The expenditures were charged to the ALTCS Contract as aid to individuals expenditures based on a federally approved cost allocation plan.

Note 7 - Allocated administrative expenditures

During the 15-month period ended September 30, 2019, the ALTCS Contract recorded allocated administrative charges of \$87,307,416 as expenditures for its share of the administrative and fiscal services the Department provided.

Note 8 - Premium tax

Arizona Revised Statutes (A.R.S.) §§36-2905 and 36-2944.01 require AHCCCS to pay a 2 percent premium tax on all capitation and other reimbursements received. These premium taxes are reported as expenditures and are paid to the Arizona Department of Insurance.

Note 9 - Transfers

Transfers to other state funds during the 15-month period ended September 30, 2019, consisted of \$4,365,626 to the State's general fund as a result of A.R.S. §36-2953(H); and \$3,166,641 of interest to the state-funded long-term care fund, as authorized by AHCCCS.

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. Although there is a possibility that claims could be asserted that would require additional resources for the ALTCS Contract, in the Division management's opinion, the possibility is low that valid claims will be asserted and claim amounts cannot reasonably be estimated.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Notes to financial statements
As of the 15 months ended September 30, 2019

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 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 15-month period ended September 30, 2019, the ALTCS Contract reimbursed the Division for \$26,352,369 of health and rehabilitative services provided to enrollees, including administrative costs. The ALTCS Contract also reimbursed the Division as well as other divisions of the Department for \$87,307,416 of administrative and fiscal services and the Arizona Department of Insurance for \$42,635,917 of premium taxes.

Supplementary schedules

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Lag report for institutional care payments
For the 15 months ended September 30, 2019

Quarter in which service was provided

<u>Quarter of payment</u>	<u>Current</u>	<u>1st Prior</u>	<u>2nd Prior</u>	<u>3rd Prior</u>	<u>4th Prior</u>	<u>5th Prior</u>	<u>6th Prior</u>	<u>Total</u>
Current	\$ 5,946,869	\$ 1,410,243	\$ 54,616	\$ 1,822	\$ 345	\$ -	\$ -	\$ 7,413,895
1 st Prior		5,688,500	1,589,584	59,643	12,690	12,182	-	7,362,599
2 nd Prior			2,469,118	1,645,124	8,835	-	(3,593)	4,119,484
3 rd Prior				5,729,817	1,663,176	61,730	17,204	7,471,927
4 th Prior					6,644,679	1,878,381	98,124	8,621,184
5 th Prior						6,144,039	2,359,362	8,503,401
6 th Prior							6,210,737	6,210,737
Total	<u>5,946,869</u>	<u>7,098,743</u>	<u>4,113,318</u>	<u>7,436,406</u>	<u>8,329,725</u>	<u>8,096,332</u>	<u>8,681,834</u>	<u>49,703,227</u>
Expenses reported	6,700,835	6,903,163	6,826,825	6,920,596	8,502,794	9,617,829	7,532,444	53,004,486
Adjustment (1)	<u>159,003</u>	<u>555,643</u>	<u>(2,709,845)</u>	<u>518,159</u>	<u>(173,069)</u>	<u>(1,521,497)</u>	<u>1,149,390</u>	<u>(2,022,216)</u>
Remaining liability	<u>\$ 912,969</u>	<u>\$ 360,063</u>	<u>\$ 3,662</u>	<u>\$ 2,349</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,279,043</u>

(1) Adjustment amounts each quarter fluctuate because of unpredictable variables that affect the business cycle.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Lag report for home- and community-based services payments
For the 15 months ended September 30, 2019

Quarter in which service was provided

<u>Quarter of payment</u>	<u>Current</u>	<u>1st Prior</u>	<u>2nd Prior</u>	<u>3rd Prior</u>	<u>4th Prior</u>	<u>5th Prior</u>	<u>6th Prior</u>	<u>Total</u>
Current	\$ 205,332,275	\$ 95,155,284	\$ 1,485,406	\$ 61,152	\$ 47,771	\$ -	\$ -	\$ 302,081,888
1 st Prior		195,925,055	92,187,162	1,189,017	147,076	54,693	(3,735)	289,499,268
2 nd Prior			183,941,910	88,176,590	1,372,901	339,385	186,326	274,017,112
3 rd Prior				188,178,710	84,687,608	1,542,230	585,591	274,994,139
4 th Prior					188,595,331	88,053,026	2,193,402	278,841,759
5 th Prior						181,744,309	86,901,612	268,645,921
6 th Prior							171,646,344	171,646,344
Total	<u>205,332,275</u>	<u>291,080,339</u>	<u>277,614,478</u>	<u>277,605,469</u>	<u>274,850,687</u>	<u>271,733,643</u>	<u>261,509,540</u>	<u>1,859,726,431</u>
Expenses reported	320,983,833	296,042,452	277,233,319	279,095,675	280,998,090	282,916,135	274,248,124	2,011,517,628
Adjustment (1)	<u>(4,024,675)</u>	<u>(569,361)</u>	<u>3,274,639</u>	<u>453,678</u>	<u>(6,151,483)</u>	<u>(11,182,492)</u>	<u>(12,738,584)</u>	<u>(30,938,278)</u>
Remaining liability	<u>\$ 111,626,883</u>	<u>\$ 4,392,752</u>	<u>\$ 2,893,480</u>	<u>\$ 1,943,884</u>	<u>\$ (4,080)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 120,852,919</u>

(1) Expenses reported do not include \$36,516,931 of one-time payments for HCBS services relating to Laws 2018, Second Regular Session, Chapter 276, Section 122.

(2) Adjustment amounts each quarter fluctuate because of unpredictable variables that affect the business cycle.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Lag report for acute care payments
For the 15 months ended September 30, 2019

Quarter in which service was provided

Quarter of payment	Current	1 st Prior	2 nd Prior	3 rd Prior	4 th Prior	5 th Prior	6 th Prior	Total
Current	\$ 61,017,642	\$ 3,600,677	\$ 343,003	\$ 176,478	\$ 741,466	\$ -	\$ -	\$ 65,879,266
1 st Prior		69,693,963	103,323	3,103	3,537	16,500	4,700,929	74,521,355
2 nd Prior			79,662,119	672,134	532,223	17,632	66,056	80,950,164
3 rd Prior				69,770,284	1,619,335	52,883	117,750	71,560,252
4 th Prior					47,783,180	1,019,686	793,871	49,596,737
5 th Prior						45,193,512	839,671	46,033,183
6 th Prior							51,299,308	51,299,308
Total	<u>61,017,642</u>	<u>73,294,640</u>	<u>80,108,445</u>	<u>70,621,999</u>	<u>50,679,741</u>	<u>46,300,213</u>	<u>57,817,585</u>	<u>439,840,265</u>
Expenses reported (1)	77,020,933	77,231,658	79,605,264	73,742,501	54,469,303	50,793,763	51,299,307	464,162,730
Adjustment (2)	<u>(15,426,270)</u>	<u>(3,342,908)</u>	<u>1,053,367</u>	<u>(2,648,212)</u>	<u>(3,455,750)</u>	<u>(4,493,550)</u>	<u>6,518,278</u>	<u>(21,795,046)</u>
Remaining liability	<u>\$ 577,021</u>	<u>\$ 594,110</u>	<u>\$ 550,186</u>	<u>\$ 472,290</u>	<u>\$ 333,812</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,527,419</u>

(1) Acute Care Payments include fee for service, capitation, and reinsurance payments. Reinsurance reimbursements are not included.

(2) Adjustment amounts each quarter fluctuate because of unpredictable variables that affect the business cycle.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Related-party transactions
For the 15 months ended September 30, 2019

Related party and relationship	Service provided	Description of transactions or payment terms agreement	Amount
Department of Economic Security, Division of Developmental Disabilities, Intermediate Care Facility/Mentally Retarded, State Facilities	Health and rehabilitative services and administrative costs	Allocated by Title XIX case management time reporting, member days count, and modified total direct costs	\$14,906,925
Department of Economic Security, Division of Developmental Disabilities, State-Operated Group Homes, Home-Based Services, State Facilities	Health and rehabilitative services and administrative costs	Allocated by Title XIX case management time reporting, member days count, and modified total direct costs	11,445,444
Department of Economic Security, Division of Developmental Disabilities and all other divisions	Administrative and fiscal services	Allocated departmental overhead costs	87,307,416
Department of Insurance	Compliance with A.R.S. §§36-2905 and 36-2944.01	Premium tax payments	42,635,917

INTERNAL CONTROL/COMPLIANCE REPORT



MELANIE M. CHESNEY
DEPUTY AUDITOR GENERAL

ARIZONA AUDITOR GENERAL
LINDSEY A. PERRY

JOSEPH D. MOORE
DEPUTY AUDITOR GENERAL

Independent auditors' 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*

Members of the Arizona State Legislature

Cara Christ, Ph.D., Director
Department of Economic Security

We have audited, 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, the financial statements of the State of Arizona, Department of Economic Security, Division of Developmental Disabilities, Arizona Long Term Care System Contract (ALTCS Contract) as of and for the 15-month period ended September 30, 2019, and the related notes to the financial statements, which collectively comprise the Division's ALTCS Contract's financial statements, and have issued our report thereon dated March 4, 2020.

Internal control over financial reporting

In planning and performing our audit of the financial statements, we considered the Division's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the Division's ALTCS Contract's financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Division's internal control. Accordingly, we do not express an opinion on the effectiveness of the Division's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that have not been identified. However, as described in the accompanying schedule of findings and recommendations, we did identify certain deficiencies in internal control over financial reporting that we consider to be material weaknesses and significant deficiencies.

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 a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the Division's ALTCS Contract's financial statements will not be prevented, or detected and corrected, on a timely basis. We consider the deficiencies described in the accompanying schedule of findings and recommendation as items 2019-02 and 2019-03 to be material weaknesses.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiency described in the accompanying schedule of findings and recommendations as item 2019-01 to be a significant deficiency.

Compliance and other matters

As part of obtaining reasonable assurance about whether the Division's ALTCS Contract's financial statements are free from 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*.

Division response to findings

The Division's response to the findings identified in our audit are presented in its corrective action plan at the end of this report. The Division is responsible for preparing a corrective action plan to address each finding. Because the Division is part of the Department, which is ultimately responsible for designing, implementing, and maintaining internal control, the Division response includes a Department response for certain findings. The Department and Division response and corrective action plan was not subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we express no opinion on them.

Purpose of this report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Division's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Division's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Lindsey Perry, CPA, CFE
Auditor General

March 4, 2020



SCHEDULE OF FINDINGS AND RECOMMENDATIONS

Financial statement findings

2019-01

Managing risk

Condition and context—The Department of Economic Security’s (Department) process for managing and documenting its risks did not include an overall risk assessment process that included identifying, analyzing, and responding to the Department-wide information technology (IT) risks, such as potential harm from unauthorized access, use, disclosure, disruption, modification, or destruction of IT data and systems. Also, it did not include identifying, classifying, and inventorying sensitive information that might need stronger access and security controls.

Criteria—Effectively managing risk at the Department includes an entity-wide risk assessment process that involves members of the Department’s administration and IT management to determine the risks the Department faces as it seeks to achieve its objectives to not only report accurate financial information and protect its IT systems and data but to also carry out its overall mission and service objectives. The process should provide the basis for developing appropriate responses based on identified risk tolerances and specific potential risks to which the Department might be subjected. To help ensure the Department’s objectives can be met, an annual risk assessment should consider IT risks. For each identified risk, the Department should analyze the identified risk and develop a plan to respond within the context of the Department’s defined objectives and risk tolerances. The process of managing risks should also address the risk of unauthorized access and use, modification, or loss of sensitive information

Effect—Without correcting these deficiencies the Department’s administration and IT management may put the Department’s operations and IT systems and data at unintended and unnecessary risk.

Cause—The Department developed a process for assessing and managing IT risks, which included all areas except inventorying and protecting sensitive information, but had not fully implemented this process because of its limited resources.

Recommendations—The Department should identify, analyze, and reduce risks to help prevent undesirable incidents and outcomes that could impact business functions and IT systems and data. It also should plan for where to allocate resources and where to implement critical controls. To help ensure it has effective entity-wide policies and procedures to achieve these objectives, the Department should follow guidance from a credible industry source, such as the National Institute of Standards and Technology. Responsible administrative officials and management over finance, IT, and other entity functions should be asked for input in the Department’s process for managing risk. The Department should conduct the following as part of its process for managing risk:

- Perform an annual entity-wide IT risk assessment process that includes evaluating and documenting risks and safeguards. Such risks may include inappropriate access that would affect financial data, system changes that could adversely impact or disrupt system operations, and inadequate or outdated system security.
- Evaluate and manage the risks of holding sensitive information by identifying, classifying, and inventorying the information the Department holds to assess where stronger access and security controls may be needed to protect data in accordance with State statutes and federal regulations.

The Department's responsible officials' views and planned corrective action are in its corrective action plan included at the end of this report.

This finding is similar to prior-year finding 2018-01.

2019-02

Information technology (IT) controls—access, configuration and change management, security, and contingency planning

Condition and context—The Department of Economic Security's (Department) control procedures were not sufficiently designed, documented, and implemented to respond to risks associated with its IT systems and data. The Department lacked adequate procedures over the following:

- **Restricting access to its IT systems and data**—Procedures did not consistently help prevent or detect unauthorized or inappropriate access.
- **Configuring systems securely and managing system changes**—Procedures did not ensure all IT system changes were adequately managed and configuration settings maintained.
- **Securing systems and data**—IT security policies and procedures lacked controls to prevent unauthorized or inappropriate access or use, manipulation, damage, or loss.
- **Testing and updating the contingency plan**—Procedures did not require the contingency plan to be tested and updated annually to ensure the plan was sufficient to restore operations in the event of a disaster or other system interruption.

Criteria—The Department should have effective internal controls to protect its IT systems and help ensure the integrity and accuracy of the data it maintains.

- **Logical access controls**—Help to ensure systems and data are accessed by users who have a need, systems and data access granted is appropriate, and key systems and data access is monitored and reviewed.
- **Well-defined, documented configuration management process**—Ensures the Department's IT system configurations are documented and that changes to the systems are identified, documented, evaluated for security implications, tested, and approved prior to implementation. This helps limit the possibility of an adverse impact on the system's security or operation. Separating responsibilities is an important control for system changes; the same person who has authority to make system changes should not put the change into production. If those responsibilities cannot be separated, a post-implementation review should be performed to ensure the change was implemented as designed and approved.
- **IT security internal control policies and procedures**—Help prevent, detect, and respond to instances of unauthorized or inappropriate access or use, manipulation, damage, or loss to its IT systems and data.

- **Tested and updated contingency plan**—Provides the preparation necessary to place the plan in operation and helps to ensure business operations continue and systems and data can be recovered in the event of a disaster, system or equipment failure, or other interruption.

Effect—There is an increased risk that the Department may not adequately protect its IT systems and data, which could result in unauthorized or inappropriate access and/or the loss of confidentiality or integrity of systems and data. It also increases the Department’s risk of not being able to effectively continue daily operations and completely and accurately recover vital IT systems and data in the event of a disaster or system interruption.

Cause—The Department did not fully implement policies and procedures because it lacked the resources to do so.

Recommendations—To help ensure the Department has effective policies and procedures over its IT systems and data, the Department should follow guidance from a credible industry source such as the National Institute of Standards and Technology. To help achieve these control objectives, the Department should develop, document, and implement control procedures in each IT control area described below:

Access

- Assign and periodically review employee user access ensuring appropriateness and compatibility with job responsibilities.
- Remove terminated employees’ access to IT systems and data.
- Review all other account access to ensure it remains appropriate and necessary.
- Evaluate the use and appropriateness of accounts shared by 2 or more users and manage the credentials for such accounts.
- Enhance authentication requirements for IT systems.

Configuration management

- Maintain configurations for all system services, assets, and infrastructure; manage configuration changes; and monitor the system for unauthorized or unintended configuration changes.

Security

- Prepare and implement a security incident response plan clearly stating how to report and handle such incidents.
- Develop, document, and follow a process for awarding and subsequent monitoring of IT vendor contracts.

Contingency planning

- Test and update the contingency plan.

The Department’s responsible officials’ views and planned corrective action are in its corrective action plan included at the end of this report.

This finding is similar to prior-year finding 2018-02.

2019-03

The Division did not accurately report financial information, which increases the risk that those relying on the reported financial information could be misled

Condition and context—When preparing its fiscal-year 2019 financial report to be audited, the Department of Economic Security, Division of Developmental Disabilities (Division), overreported amounts due from other State funds and miscellaneous revenues by \$17,152,102. In addition, the Division underreported its aid to individuals expenditures, premium tax expenditures, and capitation revenues by \$12,518,836, \$722,524, and \$221,821, respectively, and overreported its cash on deposit with the State Treasurer by \$13,019,539.

Criteria—The Division should prepare its ALTCS Contract financial report in accordance with U.S. generally accepted accounting principles (GAAP). Accurate financial statements provide valuable information to those charged with governance, management, and other financial statement users to make important decisions about the Division's ALTCS Contract financial operations.

Effect—There is an increased risk that the ALTCS Contract financial statements and note disclosures could include significant misstatements and mislead those relying on the information. The Division made all necessary adjustments to correct the information in its financial statements and related note disclosures.

Cause—The Division used a highly manual process to prepare the ALTCS Contract financial statements, making the financial statements more susceptible to errors, and did not have comprehensive internal control policies and procedures needed to prepare accurate financial statements in accordance with GAAP. In addition, the Division's review was not sufficient to ensure the financial statements' accuracy.

Recommendations—To help ensure that the ALTCS Contract financial report does not include significant misstatements that could mislead those relying on the information, and they are prepared in accordance with GAAP, the Division should:

- Develop and implement comprehensive written policies and procedures over financial statement preparation, including instructions for closing the general ledger at fiscal year-end, preparing common year-end financial statement adjustments, and performing a detailed supervisory review over the draft financial statements, supporting schedules, and note disclosures. These procedures should also include detailed instructions for obtaining information from the accounting system and information not readily available from the accounting system but necessary for preparing financial statements, preparing supporting schedules, and documenting and reviewing adjustments necessary for preparing its financial statements.
- Require an employee who is independent of the person preparing the financial statements and knowledgeable of the ALTCS Contract operations and GAAP reporting requirements to review the statements and related note disclosures. This review should ensure that the amounts are accurate and complete, properly supported, and presented in accordance with GAAP.

The Division's responsible officials' views and planned corrective action are in its corrective action plan included at the end of this report.

DEPARTMENT/DIVISION RESPONSE



DEPARTMENT OF ECONOMIC SECURITY
Your Partner For A Stronger Arizona

Douglas A. Ducey
Governor

Cara M. Christ, MD, MS
Interim Director

March 3, 2020

Lindsey Perry
Auditor General
2910 N. 44th St., Ste. 410
Phoenix, AZ 85018

Dear Ms. Perry:

We have prepared the accompanying corrective action plan as required by the standards applicable to financial audits contained in *Government Auditing Standards*. Specifically, for each finding, we are providing you with our responsible officials' views, the names of the contact people responsible for corrective action, the corrective action planned, and the anticipated completion date.

Sincerely,

Patrick Hays
Division of Developmental Disabilities
Business Operations Administrator

- c: Zane Garcia-Ramadan, DDD Interim Assistant Director
Katherine Goldcamp, DDD Finance Manager
Pearlette Ramos, DDD Corporate Compliance Officer
Sherri Wince, DDD Chief Strategy Officer
Stephanie Schwartz-Jacobs, DDD Deputy Assistant Director
Nicolette Fidel, DDD Deputy Assistant Director

Financial statement findings

2019-01

Managing risk

Name of contact person and title: Todd Luther, Chief Information Security Officer

Anticipated completion date: April 1, 2020

Agency's Response: Concur

DES has defined a new IT Risk Management program over the last 10 months and is preparing to socialize it with the business program divisions and will begin implementation of new processes immediately afterwards. We have defined the IT Risk Management program with a plan directly adapted from NIST Special Publications. We will be rolling out a process for initial IT Risk Impact for any project request through a questionnaire. Risk Notification letters will be utilized for all notifications of IT Risk based on a finding or recommendation found through assessment or audit. IT Risk Assessments will be drafted for all major changes or new project requests. IT Risk acceptance or exception requests will be drafted based on assessment and evidence. An IT Risk Register will be maintained and monitored for all evidentiary artifacts defined for these processes to evaluate all IT Risks. Socialization is expected to begin Q1 of 2020.

2019-02

Information technology (IT) controls—access, configuration management, security, and contingency planning

Name of contact person and title: Todd Luther, Chief Information Security Officer

Anticipated completion date: Various – See below

Agency's Response: Concur

DES has defined over the last 10 months a well-defined list of security and privacy controls that will help the agency meet the requirements of its federal and state regulatory agency partners through NIST Special Publications. These controls are being internally audited for implementation requirements against the current state of the IT environment. Current user access rights and privileges are routinely under review for process updates and conformity to required control standards. Baseline configuration management standards are under review and updated as needed to meet standard requirements and expected to be finalized Q2 of 2020. Addressing the security concerns and practices are always growing and changing; the agency is continuously working to adapt and even proactively address these changing times with training, awareness, and tool efficiency and effectiveness. Certain plans for incident, vulnerability, and risk management are in draft state. In an effort to prepare for known and unknown disruption or disaster, the agency has made changes to its mainframe environment and looking to develop the distributed platform in a more secure and modern way. New resources have been acquired to help facilitate these changes within the agency culture and throughout the IT infrastructure. Several initiatives are underway and planned as skilled resources and funding become available.

These activities will be carried out through continuous effort for improvement throughout all of DTS.

- A. Control Assessments - actively in progress (POA&M review readiness anticipated by end of Q2)
- B. User Access and privileges - reviews are being looked at for process and implementation - actively in progress (full implementation by end of Q2)
- C. Baseline configuration - active and in final draft state (hardening standards are still in design)
- D. Security Practices - actively in progress - incident, vulnerability, and patch mgmt.
- E. Disaster Recovery - Mainframe migrated to IBM MFaaS (DR managed by IBM across 2 data centers in the US in different geographic locations) Distributed computing is still in the process of early analysis of cloud hosting. Design to begin by end of Q2.

2019-03

The Division did not accurately report financial information, which increases the risk that those relying on the reported financial information could be misled

Name(s) of contact person(s): Patrick Hays, DDD Business Operations Administrator

Anticipated completion date: *May 1, 2020*

Agency response:

The Department agrees with the finding and provides the following corrective action plan.

1. Strengthen and adhere to comprehensive written procedures for compiling and presenting financial data within the financial statements and accompanying notes, including detailed instructions for obtaining information not readily available from the accounting system but necessary for financial statement preparation.

Review and update spreadsheets used to account for and accumulate financial transactions to include timely schedule reconciliation.

Update Scope of Work procedures related to preparation and presentation of financial statements.

Document criteria, policy, and guidelines to ensure that proper reporting occurs each quarter in accordance with generally accepted accounting principles.

The Division will continue to review and update the documented procedures to ensure compliance.

2. Allocate the appropriate resources and monitor and enforce completion dates for compiling, preparing, and reviewing the financial statements and supporting schedules.

The Division will develop a standard timeline for compiling, preparing, and reviewing the financial statements and supporting schedules to allow appropriate review time for individuals with the Department.

3. Review work of staff to ensure transactions are processed/accounted for accuracy.

Once process and procedures are documented and implemented, the Division will cross-train staff to ensure multiple staff have the ability to complete the financial statements.

4. Have an appropriate employee who did not participate in the financial statements review them and the accompanying notes. The reviewer should make sure that the amounts are accurate and properly supported and the financial statements are presented in accordance with generally accepted accounting principles.

The Division will strengthen the review process after the completion of the financial statements to include individuals that possess the required technical knowledge who were not part of the preparation of the documents to review for accuracy. This process will be used to reduce mathematical error and noncompliance with generally accepted accounting principles.

