

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract

Annual Financial Report

September 30, 2020



A Report to the Arizona Legislature

Lindsey A. Perry
Auditor General





The Arizona 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.

The Joint Legislative Audit Committee

Senator **Nancy Barto**, Chair
Senator **Rosanna Gabaldon**
Senator **David Livingston**
Senator **Juan Mendez**
Senator **Kelly Townsend**
Senator **Karen Fann** (ex officio)

Representative **Joanne Osborne**, Vice Chair
Representative **Tim Dunn**
Representative **Steve Kaiser**
Representative **Jennifer L. Longdon**
Representative **Pamela Powers Hannley**
Representative **Rusty Bowers** (ex officio)

Audit Staff

Donna Miller, Director
Victoria Fisher, Manager

Contact Information

Arizona Auditor General
2910 N. 44th St., Ste. 410
Phoenix, AZ 85018-7271

(602) 553-0333

contact@azauditor.gov

www.azauditor.gov



TABLE OF CONTENTS

Annual Financial Report

Independent auditors' report	1
-------------------------------------	---

Financial statements

Balance sheet—special revenue fund	3
------------------------------------	---

Statement of revenues, expenditures, and changes in fund balance—special revenue fund	4
---	---

Notes to financial statements	5
-------------------------------	---

Supplementary schedules	10
--------------------------------	----

Lag report for institutional care payments	11
--	----

Lag report for home- and community-based services payments	12
--	----

Lag report for acute care payments	13
------------------------------------	----

Related-party transactions	14
----------------------------	----

Report on Internal Control and on Compliance

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 <i>Government Auditing Standards</i>	15
--	----

Schedule of findings and recommendations	17
---	----

Financial statement findings	17
------------------------------	----

Department/Division response

Corrective action plan	
------------------------	--

ANNUAL FINANCIAL REPORT



LINDSEY A. PERRY
AUDITOR GENERAL

ARIZONA
AUDITOR GENERAL

MELANIE M. CHESNEY
DEPUTY AUDITOR GENERAL

Independent auditors' report

Members of the Arizona State Legislature

Michael Wisehart, 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 (Division), Arizona Long Term Care System Contract (ALTCS Contract), as of and for the year ended September 30, 2020, 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 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 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 ALTCS Contract as of September 30, 2020, and the respective changes in financial position thereof for the year then ended in accordance with U.S. generally accepted accounting principles.

Emphasis of matter

As discussed in Note 1 to the financial statements, the 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 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, 2020, and the changes in its financial position for the year then ended in conformity with U.S. generally accepted accounting principles. Our opinion is not modified with respect to this matter.

Other matters

Supplementary information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the 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 31, 2021, 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 A. Perry, CPA, CFE
Auditor General

March 31, 2021

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Balance sheet—special revenue fund
September 30, 2020

Assets

Investments held by the State Treasurer	\$ 169,126,850
Due from other state funds	1,550,702
Due from providers	<u>3,192,658</u>

Total assets \$ 173,870,210

Liabilities and fund balance

Liabilities:

Accrued administrative and payroll costs	\$ 7,453,634
Accrued medical and healthcare claims	105,515,655
Due to other state funds	<u>11,130,129</u>

Total liabilities 124,099,418

Fund balance:

Restricted for health and welfare	<u>49,770,792</u>
-----------------------------------	-------------------

Total liabilities and fund balance \$ 173,870,210

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
September 30, 2020

Revenues:	
Capitation	\$ 2,067,145,209
Investment earnings	4,592,444
Miscellaneous	<u>26,424,033</u>
Total revenues	<u>2,098,161,686</u>
Expenditures:	
Health and welfare:	
Aid to individuals	1,814,677,569
Allocated administrative expenditures	78,861,761
Case management	66,779,233
Professional and outside services	17,587,064
Sub-capitation block administrative	22,835,531
Premium tax	<u>42,902,732</u>
Total expenditures	<u>2,043,643,890</u>
Excess of revenues over expenditures	54,517,796
Other financing uses:	
Transfers to other state funds	<u>(49,334,275)</u>
Net change in fund balance	5,183,521
Fund balance, October 1, 2019	<u>44,587,271</u>
Fund balance, September 30, 2020	<u><u>\$ 49,770,792</u></u>

See accompanying notes to financial statements.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Notes to financial statements
September 30, 2020

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 U.S. 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 in-patient and out-patient 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.

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 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.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Notes to financial statements
September 30, 2020

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 non-spendable, 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 are 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, 2020, the ALTCS Contract's investments with the State Treasurer were as follows:

	Amount
State Treasurer's investment pool 3	\$169,126,850

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
September 30, 2020

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, 2020, the State Treasurer's weighted average to maturity of its internal pool 3 investments is .84 years.

Note 3 – Due to other state funds

Amounts due to other state funds at September 30, 2020 include:

- \$10,863,318 of premium tax payable to the Arizona Department of Insurance, and
- \$266,811 of assessments payable to the State's General Fund.

Note 4 - Accrued medical and healthcare claims

Accrued medical and healthcare claims totaling \$105,515,655 include IBNR medical claims.

Note 5 - Miscellaneous revenues

Miscellaneous revenues during the period ended September 30, 2020, include:

- \$8,419,899 of revenue for professional and dental provider cost increases as a result of the Access to Professional Services Initiative,
- \$17,362,911 of revenue for pediatric services provider cost increases as a result of the Pediatric Services Initiative, and
- \$641,223 of reinsurance revenue premium tax.

Note 6 - Acute care reinsurance

During the year ended September 30, 2020, the Division received reimbursements totaling \$31,419,899 from AHCCCS for acute care reinsurance expenditures for claims for enrollees incurred in the current 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 \$31,571,045 to the health plans during the year ended September 30, 2020.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Notes to financial statements
September 30, 2020

Note 7 - 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	\$ 218,449
Intermediate (intellectually or developmentally disabled)	24,739,580
Institutional care IBNR	<u>818,252</u>
Total institutional care	<u>25,776,281</u>
Home- and community-based services (HCBS):	
State-operated group home	\$ 7,104,755
Vendor-operated group home	456,753,249
Adult developmental home	66,866,014
Home-based services	773,825,803
HCBS IBNR	<u>103,807,466</u>
Total HCBS	<u>1,408,357,287</u>
Acute care:	
Acute care	379,520,887
Acute care IBNR	889,937
Reinsurance	31,571,045
Reinsurance reimbursement	(31,419,899)
Third party liability	<u>(17,969)</u>
Total acute care	<u>380,544,001</u>
Total aid to individuals expenditures	<u>\$1,814,677,569</u>

During the year ended September 30, 2020, the ALTCS Contract recorded allocated charges of \$35,840,698 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 8 - Allocated administrative expenditures

During the year ended September 30, 2020, the ALTCS Contract recorded allocated administrative charges of \$78,861,761 as expenditures for its share of the administrative and fiscal services the Department provided.

Note 9 – Sub-capitation block administrative expenditures

During the year ended September 30, 2020, the ALTCS Contract recorded sub-capitation block administrative expenditures of \$22,835,531 for its share of the administrative payments to the health plans. In prior contract years, this expenditure was reported in the acute care expenditures of aid to individuals.

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Notes to financial statements
September 30, 2020

Note 10 - 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 11 - Transfers

Transfers to other state funds during the year ended September 30, 2020, consisted of \$44,587,271 to the State's General Fund as a result of A.R.S. §36-2953(H); and \$4,747,004 of interest to the state-funded long-term care fund, as authorized by AHCCCS.

Note 12 - 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.

Note 13 - 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 14 – Related-party transactions

During the year ended September 30, 2020, the ALTCS Contract reimbursed the Division for \$35,840,698 of health and rehabilitative services provided to enrollees, including administrative costs. The ALTCS Contract also reimbursed the Division as well as other department divisions for \$78,861,761 of administrative and fiscal services and the Arizona Department of Insurance for \$42,902,732 of premium taxes due.

Supplementary schedules

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Lag report for institutional care payments
Year ended September 30, 2020

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	\$ 1,573,162	\$ 794,322	\$ 1,286					\$ 2,368,770
1 st Prior		1,642,114	921,498	\$ 21,988	\$ 2,468	\$ 197		2,588,265
2 nd Prior			1,688,992	904,412	77,205	32,438		2,703,047
3 rd Prior				1,826,608	1,251,544	17,272	\$ 164	3,095,588
4 th Prior					5,946,869	1,410,243	54,616	7,411,728
5 th Prior						5,688,500	1,589,584	7,278,084
6 th Prior							2,469,118	2,469,118
Total	<u>1,573,162</u>	<u>2,436,436</u>	<u>2,611,776</u>	<u>2,753,008</u>	<u>7,278,086</u>	<u>7,148,650</u>	<u>4,113,482</u>	<u>27,914,600</u>
Expenses reported	3,624,707	2,210,077	2,458,246	2,705,882	6,700,835	6,903,163	6,826,825	31,429,735
Adjustment (1)	<u>(1,268,988)</u>	<u>255,080</u>	<u>160,460</u>	<u>47,170</u>	<u>577,251</u>	<u>245,487</u>	<u>(2,713,343)</u>	<u>(2,696,883)</u>
Remaining liability	<u>\$ 782,557</u>	<u>\$ 28,721</u>	<u>\$ 6,930</u>	<u>\$ 44</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 818,252</u>

(1) Adjustment amounts each quarter fluctuate due to 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
 Year ended September 30, 2020

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	\$ 268,236,352	\$ 120,158,666	\$ 1,600,165	\$ 82,504	\$ (1,396)			\$ 390,076,291
1 st Prior		239,421,747	96,095,419	1,369,321	204,957	\$ 57,326	\$ (43,272)	337,105,498
2 nd Prior			221,366,170	98,930,330	1,374,024	149,386	64,059	321,883,969
3 rd Prior				216,360,996	113,535,382	1,090,966	73,997	331,061,341
4 th Prior					205,332,275	95,155,284	1,485,406	301,972,965
5 th Prior						195,925,055	92,187,162	288,112,217
6 th Prior							183,941,910	183,941,910
Total	<u>268,236,352</u>	<u>359,580,413</u>	<u>319,061,754</u>	<u>316,743,151</u>	<u>320,445,242</u>	<u>292,378,017</u>	<u>277,709,262</u>	<u>2,154,154,191</u>
Expenses reported	370,411,583	361,500,824	321,943,190	315,199,998	320,983,833	296,042,452	277,233,319	2,263,315,199
Adjustment (1)	<u>(3,695,736)</u>	<u>349,808</u>	<u>(1,181,998)</u>	<u>2,937,421</u>	<u>(574,545)</u>	<u>(3,664,435)</u>	<u>475,943</u>	<u>(5,353,542)</u>
Remaining liability	<u>\$ 98,479,495</u>	<u>\$ 2,270,219</u>	<u>\$ 1,699,438</u>	<u>\$ 1,394,268</u>	<u>\$ (35,954)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 103,807,466</u>

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

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Lag report for acute care payments
Year ended September 30, 2020

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	\$ 749,485	\$ 247,785	\$ 198,876	\$ 98,261	\$ (34,085)	\$ 145,297	\$ (30,055)	\$ 1,375,564
1 st Prior		188,574	338,548	137,313	244,799	94,135	98	1,003,467
2 nd Prior			121,568	467,231	314,350	21,319	21,423	945,891
3 rd Prior				301,024	946,517	170,497	101,241	1,519,279
4 th Prior					61,017,642	3,600,677	343,003	64,961,322
5 th Prior						69,693,963	103,323	69,797,286
6 th Prior							79,662,119	79,662,119
Total	<u>749,485</u>	<u>436,359</u>	<u>658,992</u>	<u>1,003,829</u>	<u>62,489,223</u>	<u>73,725,888</u>	<u>80,201,152</u>	<u>219,264,928</u>
Expenses reported (2)	1,391,653	988,585	968,575	1,600,415	77,020,933	77,231,658	79,605,264	238,807,083
Adjustment (1)	<u>(747,521)</u>	<u>(601,742)</u>	<u>(325,426)</u>	<u>(594,367)</u>	<u>(14,047,009)</u>	<u>(2,932,041)</u>	<u>595,888</u>	<u>(18,652,218)</u>
Remaining liability	<u>\$ (105,353)</u>	<u>\$ (49,516)</u>	<u>\$ (15,843)</u>	<u>\$ 2,219</u>	<u>\$ 484,701</u>	<u>\$ 573,729</u>	<u>\$ -</u>	<u>\$ 889,937</u>

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

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

Department of Economic Security
Division of Developmental Disabilities ALTCS Contract
Related-party transactions
September 30, 2020

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/Individuals with Intellectual Disabilities, 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	\$24,739,580
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	11,101,118
Department of Economic Security, Division of Developmental Disabilities and all other divisions	Administrative and fiscal services	Allocated departmental overhead costs	78,861,761
Department of Insurance	Compliance with A.R.S. §§36-2905 and 36-2944.01	Premium tax payments	42,902,732

INTERNAL CONTROL/COMPLIANCE REPORT



LINDSEY A. PERRY
AUDITOR GENERAL

ARIZONA
AUDITOR GENERAL

MELANIE M. CHESNEY
DEPUTY AUDITOR GENERAL

Independent auditors' report on internal control over financial reporting and on compliance and other matters based on an audit of basic financial statements performed in accordance with *Government Auditing Standards*

Members of the Arizona State Legislature

Michael Wisehart, 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 (Department), Division of Developmental Disabilities (Division), Arizona Long Term Care System Contract (ALTCS Contract), as of and for the year ended September 30, 2020, and the related notes to the financial statements, which collectively comprise the ALTCS Contract's financial statements, and have issued our report thereon dated March 31, 2021.

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) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the 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 ALTCS Contract's financial statements will not be prevented, or detected and corrected, on a timely basis. We consider the deficiency described in the accompanying schedule of findings and recommendations as item 2020-02 to be a material weakness.

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 2020-01 to be a significant deficiency.

Compliance and other matters

As part of obtaining reasonable assurance about whether the 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 financial statements. 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 were not subjected to the auditing procedures applied in the audit of the basic 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 A. Perry, CPA, CFE
Auditor General

March 31, 2021



SCHEDULE OF FINDINGS AND RECOMMENDATIONS

Financial statement findings

2020-01

The Department's deficiencies in its process for managing and documenting its risks may put its operations and IT systems and data at unintended and unnecessary risk

Condition—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.

Effect—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's policies and procedures were incomplete, and some developed policies and procedures were not fully implemented because of the Department's limited resources.

Criteria—The Department should follow guidance the Arizona Strategic Enterprise Technology Office established, which is based on the IT security framework of the National Institute of Standards and Technology to help effectively manage risk at the Department. Effectively managing risk includes an entity-wide risk assessment process that involves members of the Department's administration and IT management. The risk assessment should 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.

Recommendations—The Department should:

1. Complete its policies and procedures and allocate resources to implement critical controls.
2. 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.

3. 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 2019-01.

2020-02

The Department's control procedures over IT systems and data were not sufficient, which increases the risk that the Department may not adequately protect those systems and data

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

- **Restricting access**—Procedures did not consistently help prevent or detect unauthorized or inappropriate access to its IT systems and data.
- **Managing system configurations and changes**—Procedures did not ensure configuration settings were securely maintained and all IT system patches were adequately managed.
- **Securing systems and data**—IT security policies and procedures lacked controls to prevent unauthorized or inappropriate access or use, manipulation, damage, or loss.
- **Ensuring operations continue**—Contingency plan lacked key elements related to restoring operations in the event of a disaster or other system 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 failed to ensure its employees adhered to the policies and procedures during the fiscal year.

Criteria—The Department should follow guidance the Arizona Strategic Enterprise Technology Office established, which is based on the IT security framework of the National Institute of Standards and Technology to implement effective internal controls that protect its IT systems and help ensure the integrity and accuracy of the data it maintains, as follows:

- **Restricting access through 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.
- **Managing system configurations and changes through well-defined, documented configuration management process**—Ensures the Department's IT system configurations are documented and that patches 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.

- **Securing systems and data through 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.
- **Ensuring operations continue through a comprehensive, documented, and tested 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.

Recommendations—The Department should:

1. Make it a priority to periodically review procedures to ensure they are compliant with the Department’s written policies and inform Department employees of updates to the policies and procedures throughout the year to ensure they are being consistently followed.

Restricting access—To restrict access to its IT systems and data, implement processes to:

2. Assign and periodically review employee user access ensuring appropriateness and compatibility with job responsibilities.
3. Remove terminated employees’ access to IT systems and data.
4. Review all other account access to ensure it remains appropriate and necessary.
5. Evaluate the use and appropriateness of accounts shared by 2 or more users and manage the credentials for such accounts.
6. Enhance authentication requirements for IT systems.
7. Protect IT systems and data with session time-outs after defined period of inactivity.

Managing system configurations and changes—To configure IT systems securely and manage system changes, develop, document, and implement processes to:

8. Establish and follow a documented patch management process.
9. Maintain configurations for all system services, assets, and infrastructure; manage configuration changes; and monitor the system for unauthorized or unintended configuration changes.

Securing systems and data—To secure IT systems and data, develop, document, and implement processes to:

10. Provide all employees ongoing training on IT security risks and their responsibilities to ensure systems and data are protected.

Ensuring operations continue—To ensure operations continue, implement processes to:

11. Test 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 2019-02.

DEPARTMENT/DIVISION RESPONSE



DEPARTMENT OF ECONOMIC SECURITY

Your Partner For A Stronger Arizona

Douglas A. Ducey
Governor

Michael Wisehart
Director

March 25, 2021

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

Dear Mrs. 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,

Katherine Goldcamp
Division of Developmental Disabilities
Business Operations Administrator

Cc: Zane Garcia-Ramadan, DDD Assistant Director
Patrick Hays, DDD Chief Financial Officer
Sherri Wince, DDD Chief Strategy Officer
Pearlette Ramos, DDD Corporate Compliance
Nicolette Fidel, DDD Deputy Assistant Director
Stefanie Schwartz-Jacobs, DDD Deputy Assistant Director

Financial statement findings

2020-01

The Department's deficiencies in its process for managing and documenting its risks may put its operations and IT systems and data at unintended and unnecessary risk

Name of contact person and title: Mark Darmer, Chief Information Officer

Anticipated completion date: 6/30/2022

Agency's Response: Concur

Agency IT Risk Assessment –

- DES will provide inclusions within its IT Procedure for conducting an agency wide IT Risk Assessment and mitigations for the results – 12/31/2021
 - *DES will define out all the Critical Applications and Supporting Systems*
 - *DES will devise a strategy to mitigate system vulnerabilities*
 - *DES will fully utilize its Risk Management Program Plan*

Develop and Enforce Data Classification across the agency –

- DES will provide inclusions within its Data Classification Procedure for identifying and the handling of all data within the environment – 6/30/2022
 - *DES will define a plan to segregate restricted data systems on the network*
 - *DES will define a strategy (CIA) to protect all PII data when collected, processed, or stored*
 - *DES will train users on security practices for the data classifications we protect*

2020-02

The Department's control procedures over IT systems and data were not sufficient, which increases the risk that the Department may not adequately protect those systems and data

Name of contact person and title: Mark Darmer, Chief Information Officer

Anticipated completion date: 6/30/2022

Agency's Response: Concur

Access Control –

- DES will improve its Access Control Policy and Procedure to continue its protection of system access by defined authorized users – 12/31/2021
 - *DES will define and review Role Based access within the enterprise*
 - *DES will define an effective strategy for ensuring terminated employee accounts are addressed in a timely manner*
 - *DES will work across the agency to help define a process and procedure to review non-privileged accounts for appropriate access levels*
 - *DES will document and monitor non-human (shared) access accounts*

- *DES will define a process that provides more leadership oversight and authorization for any changes in user account access permission levels*

Configuration Management –

- DES will define in IT Policy and Procedure its standards and practices for handling system patch management across the environment – 6/30/2021
- DES shall maintain a robust Configuration Management Database – 6/30/2021
 - *DES will document and maintain a system baseline configuration management template*
 - *DES will monitor the Production systems for changes against the baseline configurations*

Security –

- DES will provide its Security personnel with specialized trainings that allow for continuous safeguarding of the IT environment – 6/30/2021
- DES shall define its process for ensuring the annual security awareness training is adhered to by all resources accessing the DES environment – 6/30/2021

Contingency Planning -

- DES will define a strategy to address the environmental and system needs in the event of incident or disaster – 6/30/2022
 - *DES will devise a cadence for testing the environment and the systems against various round table exercises*
 - *DES will utilize the results of round table exercises to define a real-time testing of our systems and environment in the event of an incident or disaster*
 - *DES will define processes to validate the integrity of any transactional systems during failure activities and document them within an IT Procedure*

