A REPORT
TO THE
ARIZONA LEGISLATURE

Financial Audit Division

Management Letter

Department of Economic Security

Division of Developmental Disabilities ALTCS Contract

Year Ended June 30, 2006

Debra K. Davenport
Auditor General

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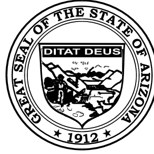

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

November 13, 2007

Tracy Wareing, Director
Department of Economic Security
1717 West Jefferson Street
Phoenix, AZ 85007

Dear Ms. Wareing:

In planning and conducting our audit of the Department of Economic Security (DES), Division of Developmental Disabilities (DDD), Arizona Long-Term Care System (ALTCS) Contract for the year ended June 30, 2006, we performed the following as required by U.S. generally accepted auditing standards and the *Arizona Administrative Code*, Title 9, Chapter 28, as detailed in the *Reporting Guide for ALTCS DES-DDD Program Contractor with the Arizona Health Care Cost Containment System:*

- Considered the Division's internal controls over financial reporting, and
- Tested its compliance with laws and regulations that could have a direct and material effect on the ALTCS Contract's financial statements.

Our audit disclosed internal control weaknesses and instances of noncompliance with laws and regulations. Management should correct these deficiencies to ensure that it fulfills its responsibility to establish and maintain adequate internal controls and comply with laws and regulations. Our recommendations are described in the accompanying summary.

This letter is intended solely for the information of the members of the Arizona State Legislature, the Arizona Health Care Cost Containment System (AHCCCS), and the Director of the DES and is not intended to be and should not be used by anyone other than the specified parties. However, this letter is a matter of public record, and its distribution is not limited.

Should you have any questions concerning its contents, please let us know.

Sincerely,

Dennis L. Mattheisen, CPA
Financial Audit Manager

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Division Response

The Division should establish effective internal control policies and procedures over its claims processing system

During fiscal year 2006, the Division spent more than $550 million for medical and long-term care services for program enrollees. Therefore, it is imperative that the Division maintain effective internal control policies and procedures over its claims process to help ensure claims are accurately paid, recorded, and reported. The System's adjudication process should be designed to efficiently and effectively evaluate claims for propriety and determine the amounts to be paid. However, the claims processing system did not meet this objective because it did not always identify duplicate claims, did not always apply proper pay rates, made some payments for uncovered services, and rejected some valid claims.

In February 2006, the Division implemented a new claims processing system to meet the Health Insurance Portability and Accountability Act (HIPAA) requirements for healthcare claims processors to accept provider claims that followed HIPAA electronic claim filing standards. However, as the implementation date approached, system developers were not able to complete a thorough testing of the system's capabilities and performance. As a result, soon after the new claims processing system was placed into operation, the Division learned that the system was denying a significant number of claims. In order for the Division to pay its providers, it started manually processing those claims rejected by the system. However, because the manual process could not perform all the verifications that the system was designed to do, manual payments were made for claims that had already been paid or were otherwise inappropriate. In total, the Division processed $55 million of manual payments during the fiscal year.

The Division continued correcting the system's problems, and as the problems were corrected, the Division reprocessed the claims that were paid manually and reconciled the reprocessed claims to the manual payments, investigated and resolved differences, and established receivables for overpayments to providers. As of mid-May 2007, the Division had reprocessed most of the claims from these manual payments; however, there were still more than $9.6 million of claims outstanding that still needed to be reprocessed. The Division also identified approximately $10.5 million of overpayments to providers, and as of mid-May 2007, almost $4 million of these overpayments had not yet been resolved.

Further, as a result of these deficiencies, the Division's records did not permit the auditors to apply auditing procedures sufficient to determine whether certain medical and long-term care services claims paid during the year were accurate, and the auditors' report on the Division's financial statements was modified. In addition, the Division could have similar problems in fiscal year 2007; therefore, the fiscal year 2007 ALTCS financial statements may require substantial analysis and corrections to be accurate, and could again result in a modification to the auditors' report.

To help strengthen control over claims processing, the Division should correct all system deficiencies and perform test procedures to help ensure that the system is accurately processing, recording, paying, and reporting claims. In addition, the Division should continue efforts to account for and recover provider overpayments, process all remaining claims through the system to identify other improper payments, and begin recovery efforts for any additional overpayments found.

The Division needs to ensure its financial statements are accurate and prepared in a timely manner

The DES and the Division's management depend on accurate financial information to fulfill their oversight responsibility and report accurate information to AHCCCS, the public, and other interested parties. To achieve this objective, the Division needs to improve internal control over its general ledger accounting to help ensure its accounting records and financial reports are accurate and complete. The Division used spreadsheets to account for and accumulate various financial transactions for financial reporting. However, this process was time-consuming and prone to error. Auditors noted several errors in the compilation process, which collectively could have materially misstated the financial statements. The Division adjusted its financial statements for all significant errors the auditors noted. In addition, the Division did not complete its financial statements until January 2007 because of problems with its claims processing system, as described above, delays in preparing reconciliations, and making adjustments to its accounting records.

To help ensure that the Division's financial statements are accurate, complete, and issued in a timely manner, the Division should:

- Implement an accounting system that can account for, accumulate, and accurately report all health plan financial transactions.

- Allocate the appropriate resources to ensure that the financial statements and supporting schedules are completed by the required dates.

The Division should report claim information to AHCCCS within required timelines

The Division's management is responsible for ensuring that long-term care, medical, and nursing facility claims are accurately reported to AHCCCS in a timely manner. AHCCCS depends on accurate and timely reporting of the claim information or encounter data to pay reinsurance benefits, set fee-for-service and capitation rates, and ensure compliance with performance standards. The Division is required to submit 95 percent of all encounter data to AHCCCS within 240 days of the end of the month when the service was provided. However, the Division was unable to provide AHCCCS complete encounter information within the required timelines because of problems with its claims processing system described above.

To help ensure that the Division complies with AHCCCS requirements for reporting encounter data within 240 days of the end of the month when the service was provided, the Division should correct all deficiencies in its claims processing system as described above. In addition, the Division should investigate and resolve all pending encounters and resubmit them to AHCCCS in a timely manner.

The Division should follow AHCCCS-approved methods to estimate its accrued long-term care costs

The Division's management is responsible for preparing accurate financial statements and demonstrating compliance with AHCCCS accounting and reporting requirements. As part of this objective, management should ensure that its accounting estimates for claims payable reported in the financial statements and supplementary schedules are reasonable, based on current information, and consistently follow the methods established by AHCCCS. However, the Division did not always have appropriate or reliable methods or information available because of the deficiencies with its claims processing system described above to estimate unreported liabilities for home- and community-based services, institutional care, acute care, and ventilator services. Specifically, for estimates of home-and community-based service and institutional care activities, the Division did not include all claim payments in the lag tables, which are used by the Division to track claims payment history. In addition, the Division has not developed an AHCCCS-approved methodology to estimate its unreported liabilities for acute care and ventilator dependent medical claims liability. As a result, the Division was unable to prepare the supplemental schedules for claims payable and lag reports that AHCCCS required to be included in ALTCS' financial statements.

While auditors were able to determine the reasonableness of the estimates, the Division should ensure that amounts reported for claims payable in the Division's financial statements and supplementary schedules are based on current information and follow the methods established by AHCCCS. In addition, the Division should develop and document logical estimation techniques for claims incurred but not reported to ensure consistent application. Further, the Division should periodically evaluate those techniques to help ensure they are current and effective, and are producing accurate results.

The Division should expend monies in accordance with state policies

The Division contracts with doctors and other individuals to provide healthcare services to plan enrollees. To help comply with Internal Revenue Service independent contractor requirements, the Division contracted with a fiscal intermediary to process payments to these individual providers. The contract with the fiscal intermediary required the fiscal intermediary to pay the individual service providers for services provided, then bill the Division for amounts paid within 5 days. In July 2005, the Division made a $1.5 million advance to the fiscal intermediary that may have violated Arizona Revised Statutes §35-181.01 and state purchasing policies and procedures. Specifically, the Arizona Department of Administration, General Accounting Office, issued Technical Bulletin 99-2 stating that state agencies should not make advances to nonpublic entities. The payment, which was labeled a one-time operating advance, was returned to the Division in October 2005.

The Division should not make advances to outside service providers. The nature and timing of all disbursements should follow the State's purchasing policies and procedures.

The Division should monitor its claims processing system to guard against fraud and abuse

Because of the potential for errors and fraud in provider-billed claims and in the processing of those claims, the Division has a responsibility to ensure that payments to providers are appropriate. Also, AHCCCS requires that the Division have a mandatory compliance program designed to guard against fraud and abuse that, among other things, should include provision for internal monitoring and auditing. To accomplish this objective, the Division had a review team to help evaluate the accuracy, validity, adequacy, and proprietary of the provider-billed claims. However, auditors noted that the review team had only conducted a limited number of reviews over the ASSISTS claims payments in the past 2 years and performed no reviews over claims processed through its FOCUS claims processing system.

To help ensure that provider-billed claims and provider billing procedures are appropriate, the Division should improve the effectiveness of its post-payment review team. In addition, the Division should develop monitoring tools that will allow the post-payment review team to perform risk-based analysis to identify potential errors in provider billings.

The Division should strengthen computer access controls

System access controls help ensure that only authorized users have access to the Division's computer systems. These controls are critical in preventing or detecting unauthorized use, damage, loss, or modification of programs and equipment, and misuse of sensitive information. System access controls restrict not only physical access to the Division's systems, but also logical access to those systems. Access to the Division's computer systems should be limited to those individuals authorized to process transactions or maintain a particular system.

However, the Division did not adequately limit logical access to its computer systems. Specifically, in many instances, division employees had incompatible capabilities, including the ability to authorize member services, modify member information, and authorize payments to providers. Further, auditors noted several generic user accounts that were not assigned to a specific employee and could be used to make unauthorized changes to the system. Several of these accounts had approval and update privileges.

The Division should strengthen its policies and procedures over system access to help prevent or detect unauthorized use, damage, loss, or modification of programs and equipment, and misuse of sensitive information. Only authorized users should have logical access to the Division's computer system. Logical access should be limited to essential employees only and should be compatible with each employee's job responsibilities. Further, all generic user accounts should be eliminated, and each user account should be assigned only to individual employees.

The Division should strengthen controls over computer program changes

To help ensure that an information system functions as designed, it is essential that modifications to the application software be properly authorized, tested, reviewed, and approved before modifications are implemented. However, the Division did not have a documented and approved process to ensure computer program changes met these objectives. Although the Division used an issue-tracking system to record

and report the progress of computer program changes, the Division did not retain documentation to support that program changes had been authorized, tested, and reviewed.

To help ensure that changes to its computerized system meet user needs and objectives, and are adequately developed, thoroughly tested, and properly applied, the Division should develop written policies and procedures that:

- Require users and management to authorize, review, and approve all program changes to information systems prior to implementation.
- Require management and users to review and approve the testing methods.
- Document expected testing results and whether these results were achieved.
- Monitor all program changes on its issue—tracking system to ensure that all requests have been authorized, assigned resources, tested, and approved.

ARIZONA DEPARTMENT OF ECONOMIC SECURITY

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Janet Napolitano
Governor

Tracy L. Wareing
Director

AUG 3 1 2007

Ms. Debbie Davenport
Auditor General
Office of the Auditor General
2910 North 44th Street, Suite 410
Phoenix, Arizona 85018

Dear Ms. Davenport:

Thank you for the opportunity to respond to the Department of Economic Security (DES), Division of Developmental Disabilities (DDD) Arizona Long Term Care System (ALTCS) Financial Audit for SFY 2006. We appreciate the professional approach and unwavering commitment the auditors took during the course of this review. The purpose of this letter is to forward the Department's written responses to the report.

As you are aware, in 2006 the Division implemented an enhanced data management system, FOCUS and immediately experienced problems with the claims payment system module. As a result, the auditors performed more extensive test work required by the scope and complexity of the audit. We welcome the Auditor General's review as a means to continue to enhance and refine the claims payment system module.

The Department agrees with the findings in the report and has identified and initiated work to implement the recommendations by December 2007. The Division anticipates that system enhancements will be on-going and has initiated change management procedures that will ensure that future enhancements are executing properly prior to production implementation.

If you have any questions, please contact Barbara Brent, Assistant Director for the Division of Developmental Disabilities at (602) 542-6857.

Sincerely,

Tracy L. Wareing
Director

Enclosure

DES Response - Arizona Long Term Care System (ALTCS)
Fiscal Year 2006 Contract Financial Audit Management Letter

FINDING 1 - The Division should establish effective internal control policies and procedures over its claims processing system

Recommendation
To help strengthen control over claims processing, the Division should correct all system deficiencies and perform test procedures to help ensure that the system is accurately processing, recording, paying, and reporting claims. In addition, the Division should continue efforts to account for and recover provider overpayments, process all remaining claims through the system to identify other improper payments, and begin recovery efforts for any additional overpayments found.

DES Response
The Department of Economic Security (Department) Division of Developmental Disabilities (Division) is committed to ensuring that all operations in the Department have effective internal control policies and procedures over claims processing systems and that they are implemented and monitored accordingly. The Department concurs with this finding and will continue to implement the audit recommendations.

The new automated system, FOCUS, includes approximately 150 system edits used to determine if a claim is accurate and recorded against the proper funding stream. This is a significant improvement over the 20 edits in the previous system, ASSISTS. However, when FOCUS was initially implemented in February 2006, not all of the 150 edits were executing properly. As the Division identified system deficiencies, corrective actions were initiated. All short-term corrections were prioritized and have been implemented. These corrections were tested by the auditors and found to be working correctly. Also components of rate validation are part of the current payment edits and additional enhancements are planned. The Division has a detailed work plan that includes test procedures. This improved process and management is resulting in confirmed improvements in the system. The Division will continue enhancing this application to strengthen controls over long-term care claims processing.

Of the $9.6 million of claims that the Auditor General identified as needing to be reprocessed, the Division has completed the analysis of all but $250,000 and will finish the remainder including processing these claims through FOCUS by October 2007. In addition, the Division has identified approximately $10.5 million of possible overpayments to providers as a result of payments made outside of the FOCUS system and developed a detailed plan for the complete reconciliation and recovery of all potential overpayments. As of July 2007 the Division has reconciled $8.1 million of this amount and will complete reconciliation by October 2007. Reconciliation concludes when all payments are entered and processed in FOCUS.

The Division holds itself accountable for the responsible use of public dollars and is committed to the reconciliation and recovery process.

FINDING 2 – The Division needs to ensure its financial statements are accurate and prepared in a timely manner.

Recommendation
To help ensure that the Division's financial statements are accurate, complete, and issued in a timely manner, the Division should:

- Implement an accounting system that can account for, accumulate, and accurately report all health plan financial transactions.
- Allocate the appropriate resources to ensure that the financial statements and supporting schedules are completed by the required dates.

DES Response
The Department concurs with the finding and is implementing the audit recommendations.

In June 2007, the Department purchased the Quick Books ledger accounting software program that will accumulate and accurately report all long-term care financial transactions including non-cash adjustments. This software is currently being utilized in the preparation of the FY 2007 financial statements.

Over the next six (6) months, the Division will document a standardized process that will be followed for monthly, quarterly and annual financial statement reconciliation and preparation. The Division will train additional staff in financial statement reconciliation and preparation. Because the process will be supported by multiple FTE at various levels, financial statements and supporting schedules will be completed within the required timelines.

FINDING 3 – The Division should report claim information to AHCCCS within required timelines.

Recommendation
To help ensure that the Division complies with AHCCCS requirements for reporting encounter data within 240 days of the end of the month when the service was provided, the Division should correct all deficiencies in its claims processing system as described above. In addition, the Division should investigate and resolve all pending encounters and resubmit them to AHCCCS in a timely manner.

DES Response
The Department concurs with the finding and has implemented the audit recommendation.

In February 2007, the Division began transmitting monthly encounter files to AHCCCS in a Health Insurance Portability and Accountability Act of 1996 (HIPAA) compliant format. The February 2007 transmission contained encounter records for dates of service between July 2004 and January 2007. As of August 2007, the Division is current with monthly encounter transmissions to AHCCCS.

Once AHCCCS has processed the monthly encounter file, the Division has 120 days to resolve pended encounters. In order to meet this expectation, the Division has developed and implemented a new resolution process. It requires a weekly working meeting with core management team members to determine how identified issues can be resolved. This process is

a structured system developed and implemented to ensure that core management team members are aware of issues as they are identified and that cross disciplines participate in the resolution process. When systemic issues are identified, they are documented and referred back to the FOCUS team for systems resolution.

FINDING 4 – The Division should follow AHCCCS-approved methods to estimate its accrued long-term care costs.

Recommendation
While auditors were able to determine the reasonableness of the estimates, the Division should ensure that amounts reported for claims payable in the Division's financial statements and supplementary schedules are based on current information and follow the methods established by AHCCCS. In addition, the Division should develop and document logical estimation techniques for claims incurred but not reported to ensure consistent application. Further, the Division should periodically evaluate those techniques to help ensure they are current and effective, and are producing accurate results.

DES Response
The Department concurs with the finding and is implementing the audit recommendation.

The Division acknowledges its responsibility for preparing accurate financial statements including accounting estimates for Home and Community Based Services (HCBS), Institutional activities and medical service claim liabilities. The quarterly lag schedules for HCBS and Institutional activities had been completed and will be part of the FY 2007 quarterly and annual financial statements.

The Division will be utilizing the same methodologies to establish estimates and schedules for medical claims liability. These methodologies and schedules are being developed and will be completed by the time of issuance of the FY 2007 annual financial statement. To ensure that estimate methodologies and lag schedules for all services are effective and producing accurate results, the Division will periodically review for reasonableness.

FINDING 5 – The Division should expend monies in accordance with state policies.

Recommendation
The Division should not make advances to outside service providers. The nature and timing of all disbursements should follow the State's purchasing policies and procedures.

DES Response
The Department concurs with the finding and has implemented the audit recommendation.

The Division initiated an internal Department audit conducted by the Audit and Management Services to determine if any other cash advances were issued preceding and during the FOCUS implementation. The audit report (#0402-006-07) finding #2 determined that the only cash advance issued was to the fiscal intermediary in July 2005. The Division is confident that this was an isolated incident. In subsequent fiscal years this incident did not occur.

FINDING 6 – The Division should monitor its claims processing system to guard against fraud and abuse.

Recommendation
To help ensure that provider-billed claims and provider billing procedures are appropriate, the Division should improve the effectiveness of its post-payment review team. In addition, the Division should develop monitoring tools that will allow the post-payment review team to perform risk-based analysis potential errors in provider billings.

DES Response
The Department concurs with the finding and is implementing the audit recommendation.

In order to emphasize fiscal responsibility the Division is developing a Financial Integrity Office. This office will be responsible for financial statement reconciliation and preparation, as well as the execution of an enhanced post payment review system. While current procedures are a good foundation, post payment reviews will be more aggressively pursued. Currently, the Division has one FTE identified for post payment reviews. In order to conduct more post payment reviews, the unit will require additional staff. In the interim, the Department's Audit Management Services has already provided additional assistance to ensure that post payment reviews are being pursued more aggressively. With this temporary reallocation of resources, post payment reviews will increase. This reallocation of resources can only be a temporary solution, however, because the Department relies on these internal audit staff for many other compliance activities. Funding for additional FTE for post payment reviews is required to fully and consistently implement this recommendation.

To maximize current post payment review efforts, the Division is creating a risk assessment tool to determine which providers and/or services should be reviewed. It will have established standards that will determine how often a provider and/or service should be reviewed based on the Division's greatest vulnerability. In addition, it will utilize current payment data and trends to identify potential errors and payment issues in provider billing activities.

FINDING 7 – The Division should strengthen computer access controls.

Recommendation
The Division should strengthen its policies and procedures over system access to help prevent or detect unauthorized use, damage, loss, or modification of programs and equipment, and misuse of sensitive information. Only authorized users should have logical access to the Division's computer system. Logical access should be limited to essential employees only and should be compatible with each employee's job responsibilities. Further, all generic user accounts should be eliminated, and each user account should be assigned only to individual employees.

DES Response
The Department concurs with the finding and is implementing the audit recommendation.

The Division originally established seven generic accounts, controlled by the Districts and Production Support, in the FOCUS application in order to facilitate day to day operations of

authorizations within the system. Specifically they were used to delegate specific authorizations when designated staff were temporarily out of the office (e.g. leave or vacancies).

Over the last several months, the Division has reviewed job roles and responsibilities throughout the personnel system and their corresponding access to FOCUS production data. As a result of the review, six of the seven generic accounts have been eliminated. The remaining account is limited to MIS Production Support and is closely monitored to ensure that there is no unauthorized use, damage, loss, or modifications of programs and equipment. Policies and procedures have been changed and strengthened to ensure enforcement of Department account policies and procedures. This will help prevent deviation from policy in new phases of the application.

FINDING 8 – The Division should strengthen controls over computer program changes.

Recommendation

To help ensure that changes to its computerized system meet user needs and objectives, and are adequately developed, thoroughly tested, and properly applied, the Division should develop written policies and procedures that:

- Require users and management to authorize, review, and approve all program changes to information systems prior to implementation.
- Require management and users to review and approve the testing methods.
- Document expected testing results and whether these results were achieved.
- Monitor all program changes on its issue tracking system to ensure that all requests have been authorized, assigned resources, tested, and approved.

DES Response

The Department concurs with the finding and is implementing the audit recommendation.

Effective July 1, 2007, the Division mandated that all computer program changes be accomplished in conformance with the DES Standard Development Methodology (1-38-0056). The Division is documenting change management procedures to ensure all computer program changes are adequately developed, thoroughly tested and properly applied. This methodology requires, for all program changes, development of documented user requirements, approved testing plans containing expected results, and user and/or management approval before production implementation. This process ensures that, during implementation, system changes and enhancements are executing accurately and efficiently.