

**Department of Economic Security**  
Division of Developmental Disabilities ALTCS Contract

Annual Financial Report

September 30, 2021



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.

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# 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, 2021, 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 ALTCS Contract as of September 30, 2021, 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, 2021, 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 an opinion 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, 2022, 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*

Lindsey A. Perry, CPA, CFE  
Auditor General

March 31, 2022

**Department of Economic Security**  
**Division of Developmental Disabilities ALTCS Contract**  
**Balance sheet—special revenue fund**  
**September 30, 2021**

**Assets**

Investments held by the State Treasurer	\$ 237,047,035
Due from other state funds	950,766
Due from providers	<u>3,115,283</u>

Total assets \$ 241,113,084

**Liabilities and fund balance**

Liabilities:

Accrued administrative and payroll costs	\$ 7,255,293
Accrued medical and healthcare claims	117,649,929
Due to other state funds	<u>273,519</u>

Total liabilities 125,178,741

Fund balance:

Restricted for health and welfare	<u>115,934,343</u>
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Total liabilities and fund balance \$ 241,113,084

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, 2021**

Revenues:	
Capitation	\$ 2,337,996,134
Investment earnings	1,173,749
Miscellaneous	<u>48,719,826</u>
Total revenues	<u>2,387,889,709</u>
Expenditures:	
Health and welfare:	
Aid to individuals	2,019,465,665
Allocated administrative expenditures	83,542,668
Case management	66,154,589
Professional and outside services	23,297,802
Sub-capitation block administrative	24,161,983
Health insurers provider fee	4,751,643
Premium tax	<u>48,647,450</u>
Total expenditures	<u>2,270,021,800</u>
Excess of revenues over expenditures	117,867,909
Other financing uses:	
Transfers to other state funds	<u>(51,704,358)</u>
Net change in fund balance	66,163,551
Fund balance, October 1, 2020	<u>49,770,792</u>
Fund balance, September 30, 2021	<u>\$ 115,934,343</u>

See accompanying notes to financial statements.



**Department of Economic Security**  
**Division of Developmental Disabilities ALTCS Contract**  
**Notes to financial statements**  
**September 30, 2021**

**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.

**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 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, 2021**

**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 Division's information systems, with adjustments as necessary for events that are outside the lag patterns. Amounts are based on historical expenditure patterns.

**Note 2 - Investments held by the State Treasurer**

At September 30, 2021, the ALTCS Contract's investments with the State Treasurer were as follows:

	Amount
State Treasurer's investment pool 3	\$237,047,035

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, 2021**

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, 2021, the State Treasurer's weighted average to maturity of its internal pool 3 investments is .78 years.

### **Note 3 - Accrued medical and healthcare claims**

Accrued medical and healthcare claims totaling \$117,649,929 include IBNR medical claims.

### **Note 4 - Miscellaneous revenues**

Miscellaneous revenues during the period ended September 30, 2021, include:

- \$8,136,190 of revenue for professional and dental provider cost increases as a result of the Access to Professional Services Initiative,
- \$11,978,424 of revenue for pediatric services provider cost increases as a result of the Pediatric Services Initiative,
- \$27,550,078 of revenue for hospital reimbursement rate increases of dental and physician fees as a result of the Hospital Enhanced Access Leading to Health Improvements Initiative, and
- \$1,055,134 of reinsurance revenue premium tax.

### **Note 5 - Acute care reinsurance**

During the year ended September 30, 2021, the Division received reimbursements totaling \$30,339,166 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 \$22,039,065 to the health plans during the year ended September 30, 2021.

**Department of Economic Security**  
**Division of Developmental Disabilities ALTCS Contract**  
**Notes to financial statements**  
**September 30, 2021**

**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:	
Intermediate (intellectually or developmentally disabled)	\$ 24,446,194
Institutional care IBNR	<u>929,813</u>
Total institutional care	<u>25,376,007</u>
Home- and community-based services (HCBS):	
State-operated group home	7,813,673
Vendor-operated group home	481,940,076
Adult developmental home	71,940,457
Home-based services	865,533,624
HCBS IBNR	<u>114,929,569</u>
Total HCBS	<u>1,542,157,399</u>
Acute care:	
Acute care	458,445,878
Acute care IBNR	1,790,547
Reinsurance	22,039,065
Reinsurance reimbursement	(30,339,166)
Third party liability	<u>(4,065)</u>
Total acute care	<u>451,932,259</u>
Total aid to individuals expenditures	<u>\$2,019,465,665</u>

During the year ended September 30, 2021, the ALTCS Contract recorded allocated charges of \$39,601,216 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 year ended September 30, 2021, the ALTCS Contract recorded allocated administrative charges of \$83,542,668 as expenditures for its share of the administrative and fiscal services the Department provided.

**Note 8 - Sub-capitation block administrative expenditures**

During the year ended September 30, 2021, the ALTCS Contract recorded sub-capitation block administrative expenditures of \$24,161,983 for its share of the administrative payments to the health plans. In prior contract years, this expense 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, 2021**

**Note 9 - 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 10 - Transfers**

Transfers to other state funds during the year ended September 30, 2021, consisted of \$49,770,792 to the State's General Fund as a result of A.R.S. §36-2953(H); and \$1,933,566 of interest to the state-funded long-term care fund, as authorized by AHCCCS.

**Note 11 - 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 12 - 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 Annual Comprehensive Financial Report*.

**Note 13 - Related-party transactions**

During the year ended September 30, 2021, the ALTCS Contract reimbursed the Division for \$39,601,216 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 \$83,542,668 of administrative and fiscal services and the Arizona Department of Insurance for \$48,647,450 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, 2021**

Quarter in which service was provided

Quarter of payment	Current	1 <sup>st</sup> Prior	2 <sup>nd</sup> Prior	3 <sup>rd</sup> Prior	4 <sup>th</sup> Prior	5 <sup>th</sup> Prior	6 <sup>th</sup> Prior	Total
Current	\$ 1,698,842	\$ 860,905						\$ 2,559,747
1 <sup>st</sup> Prior		1,670,572	\$ 966,693	\$ 74,854	\$ 100			2,712,219
2 <sup>nd</sup> Prior			1,529,909	819,049				2,348,958
3 <sup>rd</sup> Prior				1,733,037	795,761	\$ 1,217		2,530,015
4 <sup>th</sup> Prior					1,573,162	794,322	\$ 1,286	2,368,770
5 <sup>th</sup> Prior						1,642,114	945,954	2,588,068
6 <sup>th</sup> Prior							2,670,609	2,670,609
Total	<u>1,698,842</u>	<u>2,531,477</u>	<u>2,496,602</u>	<u>2,626,940</u>	<u>2,369,023</u>	<u>2,437,653</u>	<u>3,617,849</u>	<u>17,778,386</u>
Expenses reported	2,386,037	2,564,606	2,156,511	3,113,437	3,624,707	2,210,077	2,458,246	18,513,621
Adjustment (1)	<u>241,198</u>	<u>(31,709)</u>	<u>340,091</u>	<u>(486,497)</u>	<u>(1,255,684)</u>	<u>227,576</u>	<u>1,159,603</u>	<u>194,578</u>
Remaining liability	<u>\$ 928,393</u>	<u>\$ 1,420</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 929,813</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, 2021

Quarter in which service was provided

Quarter of payment	Current	1 <sup>st</sup> Prior	2 <sup>nd</sup> Prior	3 <sup>rd</sup> Prior	4 <sup>th</sup> Prior	5 <sup>th</sup> Prior	6 <sup>th</sup> Prior	Total
Current	\$ 267,280,367	\$ 116,073,604	\$ 3,018,561	\$ 155,716	\$ 80,795			\$ 386,609,043
1 <sup>st</sup> Prior		255,217,847	119,190,675	1,141,805	153,179	\$ 71,204	\$ (14,666)	375,760,044
2 <sup>nd</sup> Prior			257,043,856	105,941,333	1,348,123	78,563	95,845	364,507,720
3 <sup>rd</sup> Prior				235,627,485	103,791,137	1,178,981	33,325	340,630,928
4 <sup>th</sup> Prior					268,236,352	120,158,666	1,681,273	390,076,291
5 <sup>th</sup> Prior						239,421,747	97,669,697	337,091,444
6 <sup>th</sup> Prior							321,670,524	321,670,524
Total	<u>267,280,367</u>	<u>371,291,451</u>	<u>379,253,092</u>	<u>342,866,339</u>	<u>373,609,586</u>	<u>360,909,161</u>	<u>421,135,998</u>	<u>2,516,345,994</u>
Expenses reported	389,786,084	373,231,171	377,996,892	342,825,121	370,411,583	361,500,824	321,943,190	2,537,694,865
Adjustment (1)	<u>(17,276,235)</u>	<u>1,519,467</u>	<u>4,793,368</u>	<u>2,761,516</u>	<u>3,181,437</u>	<u>(591,663)</u>	<u>99,192,808</u>	<u>93,580,698</u>
Remaining liability	<u>\$ 105,229,482</u>	<u>\$ 3,459,187</u>	<u>\$ 3,537,168</u>	<u>\$ 2,720,298</u>	<u>\$ (16,566)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 114,929,569</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, 2021**

Quarter in which service was provided

Quarter of payment	Current	1 <sup>st</sup> Prior	2 <sup>nd</sup> Prior	3 <sup>rd</sup> Prior	4 <sup>th</sup> Prior	5 <sup>th</sup> Prior	6 <sup>th</sup> Prior	Total
Current	\$ 452,763	\$ 700,520	\$ 589,274	\$ 149,454	\$ 81,735	\$ 15,169	\$ 29,731	\$ 2,018,646
1 <sup>st</sup> Prior		287,129	954,636	588,586	602,554	166,535	30,878	2,630,318
2 <sup>nd</sup> Prior			(2,207,998)	940,446	650,693	56,570	58,886	(501,403)
3 <sup>rd</sup> Prior				545,923	3,853,773	369,258	168,183	4,937,137
4 <sup>th</sup> Prior					749,485	247,785	263,052	1,260,322
5 <sup>th</sup> Prior						188,574	720,660	909,234
6 <sup>th</sup> Prior							903,149	903,149
Total	<u>452,763</u>	<u>987,649</u>	<u>(664,088)</u>	<u>2,224,409</u>	<u>5,938,240</u>	<u>1,043,891</u>	<u>2,174,539</u>	<u>12,157,403</u>
Expenses reported (2)	1,972,978	2,479,860	2,101,985	4,684,870	1,391,653	988,585	968,575	14,588,506
Adjustment (1)	<u>(557,276)</u>	<u>(986,136)</u>	<u>(2,919,041)</u>	<u>(2,265,048)</u>	<u>4,803,814</u>	<u>77,167</u>	<u>1,205,964</u>	<u>(640,556)</u>
Remaining liability	<u>\$ 962,939</u>	<u>\$ 506,075</u>	<u>\$ (152,968)</u>	<u>\$ 195,413</u>	<u>\$ 257,227</u>	<u>\$ 21,861</u>	<u>\$ -</u>	<u>\$ 1,790,547</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, 2021**

<b>Related party and relationship</b>	<b>Service provided</b>	<b>Description of transactions or payment terms agreement</b>	<b>Amount</b>
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	\$24,477,055
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	15,124,161
Department of Economic Security, Division of Developmental Disabilities and all other divisions	Administrative and fiscal services	Allocated departmental overhead costs	83,542,668
Department of Insurance	Compliance with A.R.S. §§36-2905 and 36-2944.01	Premium tax payments	48,647,450

# 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 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, 2021, 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, 2022.

### **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 2021-02 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 2021-01 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 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*

Lindsey A. Perry, CPA, CFE  
Auditor General

March 31, 2022



# SCHEDULE OF FINDINGS AND RECOMMENDATIONS

## Financial statement findings

### 2021-01

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 of potential harm

**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 systems and data. 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 reported its policies and procedures were incomplete, and some developed policies and procedures were not fully implemented because of limited resources.

**Criteria**—The Department is required to follow the State's IT policies the Arizona Strategic Enterprise Technology Office established 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. Identify, analyze, and reduce risks to help prevent undesirable incidents and outcomes that could impact business functions and IT systems and data.
2. Plan for where to allocate resources and where to implement critical controls.
3. Ask responsible administrative officials and management over finance, IT, and other entity functions for input in the Department's process for managing risk.

4. 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.
5. 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 corrective action plan at the end of this report includes the views and planned corrective action of its responsible officials. We are not required to audit and have not audited these responses and planned corrective actions and therefore provide no assurances as to their accuracy.

This finding is similar to prior-year finding 2020-01.

## 2021-02

**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 developed, documented, and 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 changes 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 reported its policies and procedures were incomplete, and some developed policies and procedures were not fully implemented because of limited resources. In addition, the Department failed to ensure its employees adhered to those policies and procedures it had in place during the fiscal year.

**Criteria**—The Department is required to follow the State's IT policies the Arizona Strategic Enterprise Technology Office (ASET) established to implement effective internal controls that protect its IT systems and ensure the integrity and accuracy of the data it maintains, as follows:

- **Restrict 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.
- **Manage system configurations and changes through 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.
- **Secure 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.
- **Ensure 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 develop and document comprehensive IT policies and procedures and develop a process to ensure the procedures are being consistently followed.
2. Monitor Department employees’ adherence to the IT policies and procedures on a periodic basis to ensure they are consistently followed and inform employees of updates to the policies and procedures throughout the year.
3. Work with ASET on the ways to implement audit recommendations.

**Restrict access**—To restrict access to its IT systems and data, develop, document, and implement processes to:

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

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

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

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

11. Perform proactive key user and system activity logging and log monitoring, particularly for users with administrative access privileges.
12. Provide all employees ongoing training on IT security risks and their responsibilities to ensure systems and data are protected.



**Ensure operations continue**—To ensure operations continue, implement processes to:

13. Test the contingency plan.

The Department's corrective action plan at the end of this report includes the views and planned corrective action of its responsible officials. We are not required to audit and have not audited these responses and planned corrective actions and therefore provide no assurances as to their accuracy.

This finding is similar to prior-year finding 2020-02.

# DEPARTMENT/DIVISION RESPONSE



DEPARTMENT OF ECONOMIC SECURITY

*Your Partner For A Stronger Arizona*

Douglas A. Ducey  
Governor

Michael Wisehart  
Director

March 16, 2022

Lindsey Perry  
Auditor General  
2910 N 44<sup>th</sup> 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,

A handwritten signature in black ink, appearing to read 'Kag'.

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

### 2021-01

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 of potential harm

Name of contact person and title: Mark Darmer, CIO

Anticipated completion date: June 2023

Agency's response: Concur

The Department of Economic Security (Department/DES) will continue efforts to address the audit recommendations, as follows:

1. Identify, analyze, and reduce risks to help prevent undesirable incidents and outcomes that could impact business functions and IT systems and data.

The Department's risk assessment policy will address this finding and meets the Department's requirements to perform IT Risk Assessments. Further the DES/DTS, Security Risk and Compliance (SRC) Section, Governance Risk and Compliance (GRC) Unit is in place and is tasked with executing IT Risk Planning protocols, Assessment and Monitoring activities that meet this requirement. The Department plans to implement this recommendation as part of the annual entity-wide IT risk assessment process by June 2023.

2. Plan for where to allocate resources and where to implement critical controls.

The Department will continue efforts to implement this recommendation, through its Information Security Program Plan (ISPP) and associated policies and procedures. These activities will be facilitated and directed by the DES/DTS Chief Information Officer (CIO) and Chief Information Security Officer (CISO), who are responsible for planning, implementing, and executing the requirements of these guiding resources and controls.

3. Ask responsible administrative officials and management over finance, IT, and other entity functions for input in the Department's process for managing risk.

The Department will obtain input from three sections/units as part of its process for managing risk:

- DES Division of Technology Services (DTS) Security, Risk and Compliance (SRC), Governance, Risk and Compliance (GRC) Unit, which addresses IT Risk Assessments and manages compliance responsibilities for the IT sector of DES.
- The DES Office of the Inspector General (OIG), Internal Audit Administration, which is responsible for assessing risk and compliance at the Department level and for auditing activities related to risk and compliance for the Department.
- The DES Division of Financial Operations, which is responsible for managing finances for the Department.

4. 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.

The Department plans to implement this recommendation by June 2023. DES/DTS Security, Risk and Compliance (SRC), Governance, Risk and Compliance (GRC) Unit is responsible for conducting IT Risk Assessments for DES Systems and Applications and overall IT posture for DES. The section began the process of reviewing and completing risk assessments on DES applications in August 2020. The effort involved meeting with all the Division IT staff at that time to determine their readiness to move forward with this effort. The section (DTS/SRC/GRC) has experienced numerous significant challenges in staffing management of this unit but has since filled the management position for GRC and is currently committed to moving this effort forward when the unit is fully staffed in order to have the resources to continue ongoing and critical Risk Assessment efforts of all DES applications.

5. 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 is currently working on enhancing its Data Classification Taxonomy Program for the purposes of the classification of all DES data. All DES areas will be performing the data classification exercises. The DDD ALTCS Program data and information assets and the assets that manage information will be reviewed and have an estimated completion of June 2023.

## 2021-02

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, CIO

Anticipated completion date: June 2023

Agency's response: Concur

The Department of Economic Security (Department/DES) will continue efforts to address the audit recommendations, as follows:

### General

1. Make it a priority to develop and document comprehensive IT policies and procedures and develop a process to ensure the procedures are being consistently followed.

DES has a full and robust library of Information Technology (IT) policies, standards and procedures available to DES users. All DES IT policies, standards and procedures are designed, controlled, updated, and documented according to both Department level processes and requirements and in accordance with the National Institute of Standards and Technology (NIST), Special Publication, Security and Privacy Controls for Information Systems and Organizations, Revision 5; IRS Publication 1075; and other

federally recognized requirements (CMS MARSe, CJJIS, PCI DCS) where applicable. DES also has an assigned Documentation Manager (IT Policy Manager) for this function and the position is a part of/reports to DES/DTS Security, Risk and Compliance (SRC) Section, Governance Risk and Compliance (GRC) Unit. DES will also continue efforts to ensure procedures are consistently followed through audits, an annual review, and the annual risk assessment process.

2. Monitor Department employees' adherence to the IT policies and procedures on a periodic basis to ensure they are consistently followed and inform employees of updates to the policies and procedures throughout the year.

The Department will continue to monitor DES users given access to the DES network to ensure adherence to security policies and procedures through required annual security awareness training and also by documenting and monitoring each employee's adherence to Security policies and procedures through the annual employee review process via the MAP as required by ADOA.

3. Work with ASET on the ways to implement audit recommendations.

DES IT Policies, Standards and Procedures meet the guidelines and requirements as set forth by the ASET Library of Policies and Procedures. The DES Chief Information Officer (CIO) and Chief Information Security Officer (CISO) maintains a relationship with the ASET Team and are advised of critical and non-critical issues that DES must address. The Department will continue to work with ASET as necessary on updates or recommendations of IT issues.

#### Restricting access

4. Assign and periodically review employee user access ensuring appropriateness and compatibility with job responsibilities.

DES has policies and procedures to support user access requirements and protocols. The Department will continue to monitor user access through automated and manual auditing of user access account credentialing. The Department will regulate and perform audits of user access accounts on a regular schedule and take actions to remove access when the user no longer meets the role/responsibility or there is any non-use of their assigned applications.

5. Remove terminated employees' access to IT systems and data.

DES has policies and procedures supporting activities around separated users/employees. The Department will continue towards improvement through manual and automated audits of separated users access account credentials. It will also continue to fine tune the process in place by which automated audits take place and user access credentials are disabled and deleted when the user is separated, no longer meets the role/responsibility or there is any non-use of the user's assigned applications for a designated period of time.

6. Review all other account access to ensure it remains appropriate and necessary.

The Department will continue efforts to review all other account access in conjunction with efforts to

address recommendations 4 and 5.

7. Evaluate the use and appropriateness of accounts shared by 2 or more users and manage the credentials for such accounts.

DES has policies and procedures to support user access requirements and protocols. Currently, DES does not allow the assignment of more than one login credential per user per account as sharing accounts credentials is strictly prohibited. The Department will continue improvements through reviewing the results provided as part of this audit and future regular auditing of user accounts, user credentials to ensure department policies and procedures are followed. Training for users on this issue will be developed by June 2023.

8. Enhance authentication requirements for IT systems.

The Department has made significant improvements as it currently uses multi-factor authentication but will also continue improvements as the Department evolves its multi-factor authentication process. It also has associated policies and procedures.

#### Managing system configurations and changes

9. Establish and follow a documented patch management process.

The Department will continue efforts to fully implement this recommendation by June 2023. DES has an established and documented patch management process in its policies and procedures. In addition, DES will perform a risk assessment to identify further enhancements to this process.

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

The Department has partially implemented this recommendation and will continue to improve its processes and protocols around configuration management. DES has a mature process for managing change, that includes a Change Advisory Board, and changes are thoroughly documented and managed. These efforts are supported by a series of policies and procedures.

#### Securing systems and data

11. Perform proactive key user and system activity logging and log monitoring, particularly for users with administrative access privileges.

The Department will continue efforts to implement this recommendation and will perform regular audits on administrative user access accounts by June 2023. The Department has associated policies and procedures.

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

Consistent with DES policy and the standard statewide security awareness training process supported by ADOA/ASET, DES requires annual security awareness training of all registered DES users. DES also has policies and procedures that outline the acceptable use of its system and network. Each user is required to complete an acknowledgement of their understanding of the acceptable use of the DES Network. The Department will continue to monitor user compliance with Security Awareness through security-related activities, trainings and other protocols so users can expand their understanding of their responsibility to protect DES information and data.

Ensuring operations continue

13. Test the contingency plan.

The Department plans to test the contingency plan by June 2023 and has associated policies and procedures.



