



**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Financial Statements and Reports Required by OMB Circular A-133,
Audits of States, Local Governments, and Non-Profit Organizations

Year ended June 30, 2013

(With Independent Auditors' Reports Thereon)

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Table of Contents

	Page
Financial Statements	
Independent Auditors' Report	1
Management's Discussion and Analysis (Unaudited)	3
Basic Financial Statements:	
Statement of Net Position	6
Statement of Revenue, Expenses, and Changes in Net Position	7
Statement of Cash Flows	8
Notes to the Financial Statements	9
Reports Required by OMB Circular A-133	
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
Independent Auditors' Report on Compliance for the Major Program; Report on Internal Control Over Compliance Required by OMB Circular A-133, <i>Audits of States, Local Governments, and Non-Profit Organizations</i>	17
Schedule of Expenditures of Federal Awards	19
Notes to Schedule of Expenditures of Federal Awards	20
Schedule of Findings and Questioned Costs	21



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Independent Auditors' Report

Board of Directors
California Health Benefit Exchange

Report on the Financial Statements

We have audited the accompanying financial statements of the California Health Benefit Exchange (Covered California) as of and for the year ended June 30, 2013, and the related notes to the financial statements, which collectively comprise Covered California's basic 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 auditing standards generally accepted in the United States of America 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 auditor considers internal control relevant to the entity'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 entity'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 financial position of Covered California as of June 30, 2013 and the changes in financial position and cash flows for the year then ended in accordance with U.S. generally accepted accounting principles.



Other Matters

Required Supplementary Information

U.S. generally accepted accounting principles require that the management’s discussion and analysis on pages 3–5 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management’s responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the basic financial statements that collectively comprise Covered California’s basic financial statements. The accompanying schedule of expenditures of federal awards, as required by the U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is presented for purposes of additional analysis and is not a required part of the basic financial statements. The accompanying schedule of expenditures of federal awards is the responsibility of management and was derived from and relate directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the schedule of expenditures of federal awards is fairly stated in all material respects in relation to the basic 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 26, 2014 on our consideration of Covered California’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 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 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 Covered California’s internal control over financial reporting and compliance.

KPMG LLP

Sacramento, California
March 26, 2014

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Management's Discussion and Analysis (Unaudited)

June 30, 2013

The following discussion and analysis of the California Health Benefit Exchange's (Covered California) financial performance provides an overview of financial activities for the fiscal year ended June 30, 2013. Please read it in conjunction with Covered California's financial statements that follow this section.

Financial Highlights

Covered California continues to rely on federal grant funding for its operations. Since September 2010, Covered California has been awarded grants totaling \$1.1 billion in federal funding to establish the organization and operate through December 2014. Under the statute that established Covered California, it cannot rely on State of California general funds to support operations. Starting January 1, 2015, upon the expiration of authority to spend federal grant funds, it must be fully self-sufficient based on revenue raised in its operations.

Covered California expenditures in fiscal year 2012-13 focused on essential goals related to establishing Covered California:

- Developing information technology infrastructure
- Preparing to promote Covered California and its products through public relations and communications activities
- Establishing and staffing the Service Center.

Financial Statements

These required statements offer short-term and long-term financial information about Covered California. The statement of net position provides information about the nature and amounts of investments in resources (assets) and obligations (liabilities) at the close of the fiscal year. All of the current year's revenues and expenses are accounted for in the statement of revenues, expenses, and changes in net position. This statement measures the success of Covered California's operations over the past year. The final required financial statement is the statement of cash flows. The primary purpose of this statement is to provide information about Covered California's cash receipts and cash payments during the reporting period. The statement reports cash receipts, cash payments, and net changes in cash resulting from operations, investing, and financing activities, and provides answers to such questions as where did cash come from and what was cash used for. The financial statements are prepared on the accrual basis in accordance with U.S. generally accepted accounting principles.

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Management's Discussion and Analysis (Unaudited)

June 30, 2013

Condensed Summary of Net Position

A summary of Covered California's net position is presented below:

	<u>June 30, 2013</u>	<u>June 30, 2012</u>	<u>\$ Change</u>	<u>% Change</u>
Current and other assets	\$ 49,926,183	2,144,766	\$ 47,781,417	2,227.8%
Capital assets	122,358,199	31,876	122,326,323	383,756.8%
Total assets	<u>172,284,382</u>	<u>2,176,642</u>	<u>170,107,740</u>	<u>7,815.1%</u>
Current liabilities	50,070,897	2,176,642	47,894,255	2,200.4%
Noncurrent liabilities	2,628,404	357,882	2,270,522	634.4%
Total liabilities	<u>52,699,301</u>	<u>2,534,524</u>	<u>50,164,777</u>	<u>1,979.3%</u>
Invested in capital assets	122,358,199	31,876	122,326,323	383,756.8%
Unrestricted (deficit)	(2,773,118)	(389,758)	(2,383,360)	611.5%
Total net position	<u>\$ 119,585,081</u>	<u>(357,882)</u>	<u>\$ 119,942,963</u>	<u>(33,514.7)%</u>

Condensed Summary of Changes in Net Position

A summary of Covered California's change in net position is presented below:

	<u>June 30, 2013</u>	<u>June 30, 2012</u>	<u>\$ Change</u>	<u>% Change</u>
Operating expenses	\$ 43,746,280	6,724,630	37,021,650	550.5%
Operating loss	<u>(43,746,280)</u>	<u>(6,724,630)</u>	<u>(37,021,650)</u>	<u>550.5%</u>
Nonoperating revenue	24,370,265	6,334,872	18,035,393	284.7%
Loss before capital contributions	(19,376,015)	(389,758)	(18,986,257)	4,871.3%
Capital contributions	<u>139,318,978</u>	<u>31,876</u>	<u>139,287,102</u>	<u>436,965.4%</u>
Changes in net position	119,942,963	(357,882)	120,300,845	(33,614.7)%
Total net position – beginning of year	<u>(357,882)</u>	<u>—</u>	<u>(357,882)</u>	<u>—</u>
Total net position – end of year	<u>\$ 119,585,081</u>	<u>\$ (357,882)</u>	<u>\$ 119,942,963</u>	<u>(33,514.7)%</u>

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Management's Discussion and Analysis (Unaudited)

June 30, 2013

Fiscal year 2012-13 was the first full year of operations for Covered California. During fiscal year 2012-13 the timing of significant expenditures occurred later than originally anticipated, which resulted in a delay of some expenditures to fiscal year 2013-14. Hiring occurred at a much slower pace than originally budgeted due principally to the delay and challenges associated with recruiting staff in the Service Center. Contractual spending also occurred at a slower pace primarily due to the timing of media campaigns, the timing of Service Center development, and other activities. Funds were also used for tasks such as recruiting and training staff, gathering stakeholder input, and establishing the Small Business Health Options Program (SHOP).

Capital Assets

During fiscal year 2012-13, Covered California began development of the California Healthcare Eligibility, Enrollment, and Retention System (CalHEERS), which is an automated system that will serve as the consolidated system support for eligibility, enrollment, and retention for the exchange, Medi-Cal, and Healthy Families. As of June 30, 2013, \$119.4 million of expenses have been capitalized as internally generated computer software.

Economic Outlook

In December 2012, Covered California submitted a plan to the federal government spelling out how it will operate in the years ahead. Regulations implementing the Affordable Care Act require this "blueprint" plan to be approved by the federal Department of Health and Human Services before the state is designated as having a state-based exchange. Covered California's Blueprint plan was conditionally approved in January 2013.

Consistent with federal requirements, Covered California demonstrated in its blueprint plan that it will be self-sustaining with sufficient funding to support ongoing operations on January 1, 2015. State law requires Covered California to assess a reasonable, necessary fee on Covered California health insurance companies to support operations and to ensure that expenditures do not exceed revenues.

At the Board's June 2013 meeting, it adopted guiding principles to steer its financial policies. Covered California will limit its cost of operations in order to minimize the impact of monthly fees on health insurance companies, while at the same time establishing a modest financial reserve. Financial activities will be monitored, controlled, and audited regularly to ensure funds are being used consistent with federal and state requirements.

An audit released in July 2013 by the California State Auditor found that: *"Covered California has included in its financial plan appropriate measures to ensure ongoing fiscal solvency, such as an annual minimum reserve target and an operating budget that is flexible enough to accommodate different enrollment levels."* Further, the auditor's report states that the unpredictability of enrollment in coverage may require changes in the future. As stated by the auditor, Covered California "engaged in a deliberate, thoughtful financial planning effort that attempts to anticipate the several contingencies it will face."

After December 2014, the principal funding source for Covered California will be the monthly fee assessed on health insurance companies for policies sold through the marketplace. Covered California has adopted a flexible financial planning approach that takes into account the uncertainties inherent with depending on revenue from an entirely new marketplace.

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Statement of Net Position

June 30, 2013

Assets

Current assets:	
Cash and cash equivalents	\$ 18,296,555
Grants receivable	14,623,439
Accounts receivable	17,004,769
Other current assets	1,420
	<hr/>
Total current assets	49,926,183
Noncurrent assets:	
Capital assets, net	122,358,199
	<hr/>
Total assets	172,284,382

Liabilities

Current liabilities:	
Accounts payable	49,768,436
Accrued liabilities	157,747
Compensated absences	144,714
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Total current liabilities	50,070,897
Noncurrent liabilities:	
Compensated absences	2,502,922
Other liabilities	125,482
	<hr/>
Total non-current liabilities	2,628,404
	<hr/>
Total liabilities	52,699,301

Net Position

Net investment in capital assets	122,358,199
Unrestricted (deficit)	(2,773,118)
	<hr/>
Total net position	\$ 119,585,081

See accompanying notes to financial statements.

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Statement of Revenues, Expenses, and Changes in Net Position

June 30, 2013

Operating expenses:	
Salaries, wages, benefits	\$ 9,224,157
Operating expenses and equipment	4,450,873
Professional services	27,703,332
Facilities operations	2,177,332
Communications	169,997
Depreciation expense	20,589
Total operating expenses	43,746,280
Operating loss	(43,746,280)
Nonoperating revenues:	
Operating grants	24,353,378
Interest income	16,887
Total nonoperating revenues	24,370,265
Loss before capital contributions	(19,376,015)
Capital contributions:	
Federal	122,326,323
State	16,992,655
Total capital contributions	139,318,978
Change in net position	119,942,963
Total net position – beginning of year	(357,882)
Total net position – end of year	\$ 119,585,081

See accompanying notes to financial statements.

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Statement of Cash Flows

June 30, 2013

Cash flows from operating activities:	
Payments to employees and for employee benefits	\$ (6,651,174)
Payments to suppliers	(1,570,605)
Net cash used in operating activities	<u>(8,221,779)</u>
Cash flows from noncapital financing activities:	
Operating grants	<u>12,935,801</u>
Cash flows from capital and related financing activities:	
Capital grants	119,794,960
Acquisition of capital assets	<u>(107,687,467)</u>
Net cash provided by capital and related financing activities	<u>12,107,493</u>
Cash flows from investing activities:	
Interest income	<u>16,887</u>
Net increase in cash and cash equivalents	16,838,402
Cash and cash equivalents – beginning of year	<u>1,458,153</u>
Cash and cash equivalents – end of year	<u>\$ 18,296,555</u>
Reconciliation of operating loss to net cash used in operating activities:	
Operating loss	\$ (43,746,280)
Adjustments to reconcile operating loss to net cash used by operating activities:	
Depreciation	20,589
Changes in assets and liabilities:	
Increase in other assets	(1,420)
Increase in accounts payable	32,932,349
Increase in accrued liabilities	157,747
Increase in compensated absences	2,289,754
Increase in other liabilities	<u>125,482</u>
Net cash used in operating activities	<u>\$ (8,221,779)</u>

See accompanying notes to financial statements.

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Notes to Financial Statements

June 30, 2013

(1) Summary of Significant Accounting Policies

(a) Organization

The California Health Benefit Exchange (Covered California) was created on September 30, 2010 as an independent public entity with the passage of Assembly Bill 1602, enacting the federal Patient Protection and Affordable Care Act (Affordable Care Act). Under the Affordable Care Act signed into law in March of 2010, states were required to decide whether to create a state-based health insurance exchange or participate in the federal multistate health insurance exchange. California elected to establish a state-based health insurance exchange. In 2010, state law was enacted to implement the provisions of the Affordable Care Act to reduce the number of uninsured Californians by creating an organized, transparent marketplace for Californians to purchase affordable, quality health care coverage offered in four categories, or tiers, each with a metal rating of Bronze, Silver, Gold and Platinum.

Covered California is not a component unit of the State of California (State). Covered California is a related organization.

(b) Basis of Presentation

The financial statements are prepared on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles. Under this method, revenues are recorded when earned and expenses are recorded when the related liability is incurred.

Operating revenue and expenses are those that result from providing services and producing and delivering goods and/or services. All revenues received that are not part of the normal business, such as capital and operating assistance grants and interest income are considered nonoperating revenues.

(c) Cash and Cash Equivalents

Cash and cash equivalents represent cash deposited in the Surplus Money Investment Fund (SMIF) and cash on hand with the State Treasurer.

(d) Grants and Accounts Receivable

Grants receivable represent amounts owed from the Federal government.

Accounts receivable represent amounts owed by the California Department of Health Care Services for its share of the costs related to California Healthcare Eligibility, Enrollment, and Retention System (CalHEERs).

(e) Capital Assets

Capital assets are defined as assets which have a unit cost of \$5,000 or greater and a useful life of more than one year. Capital assets are stated at cost. Depreciation on equipment is calculated using the straight-line method over the estimated useful life ranging from 2 to 20 years. When assets are retired or otherwise disposed of, the costs and related accumulated depreciation are removed from

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Notes to Financial Statements

June 30, 2013

the accounts, and any resulting gain or loss is recognized in the period of disposal. Amortization of leasehold improvements is computed using the straight-line method over the lease terms.

In accordance with Governmental Accounting Standards Board Statement No. 51, *Accounting and Reporting for Intangible Assets*, Covered California has recorded internally generated computer software that is in the development stage. Intangible assets are considered internally generated if they are created or produced by the department or an entity contracted by the department, or if they are acquired from a third party but require more than minimal incremental effort on the part of the department to begin to achieve their expected level of service capacity. The preliminary project Stage was completed in June 2012. Application development costs incurred from July 2012 through June 30, 2013 were \$119.4 million. The postimplementation stage is expected to begin January 31, 2014.

(f) *Compensated Absences Payable*

Vacation balances are accrued as a liability as earned.

(g) *Use of Estimates*

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(2) Cash and Cash Equivalents

Cash and cash equivalents are held as cash on hand by the State Treasurer and in pools managed by other State government units and are not evidenced by securities. Interest income earned on outstanding cash balances is allocated among pool participants based on average daily cash balances.

State treasury	\$ 9,331,555
Surplus money investment fund	<u>8,965,000</u>
Total	<u><u>\$ 18,296,555</u></u>

As of June 30, 2013, the carrying value of deposits in the SMIF represents the fair value. The SMIF consists of available cash and all special funds of the State which do not have investment authority of their own. Cash balances in excess of needs in any of these participating funds are invested by the State Treasurer. The Pooled Money Investment Board (PMIB) provides regulatory oversight over the State Treasurer's pooled investment program and is responsible for determining whether any cash balances of the participating funds are in excess of current needs and available for investment, or whether it is necessary to liquidate previous investments to meet current requirements. The PMIB is composed of the State Treasurer, as chairman; the State Controller; and the Director of Finance for the State of California.

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Notes to Financial Statements

June 30, 2013

All of the resources of the SMIF are invested through the Pooled Money Investment Account (PMIA). By law, PMIA monies can be invested only in the following categories; U.S. Government securities; securities of federally sponsored agencies; domestic corporate bonds; interest-bearing time deposits in California banks, savings and loan associations, and credit unions; prime-rated commercial paper; repurchase and reverse repurchase agreements; security loans; banker's acceptances; negotiable certificates of deposits; and loans to various bond funds.

(3) Capital Assets

Changes in capital assets for the year ended June 30, 2013 are as follows:

	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
Nondepreciable capital assets:				
Internally generated intangible assets-development costs	\$ —	119,353,083	—	119,353,083
Depreciable capital assets:				
Office furniture and equipment	31,876	2,877,790	—	2,909,666
Leasehold improvements	—	116,039	—	116,039
Total depreciable capital assets	<u>31,876</u>	<u>2,993,829</u>	<u>—</u>	<u>3,025,705</u>
Less accumulated depreciation:				
Office furniture and equipment	—	(5,393)	—	(5,393)
Leasehold improvements	—	(15,196)	—	(15,196)
Total accumulated depreciation	<u>—</u>	<u>(20,589)</u>	<u>—</u>	<u>(20,589)</u>
Total capital assets, net	<u>\$ 31,876</u>	<u>122,326,323</u>	<u>—</u>	<u>122,358,199</u>

(4) Leases

Covered California leases office space for its headquarters, Service Center, and training facilities under operating leases. The lease terms vary with the oldest expiring July 31, 2017.

The future minimum lease payments under operating leases as of June 30, 2013 are as follows:

For the year ending June 30:	
2014	\$ 2,030,730
2015	2,567,603
2016	1,645,846
2017	196,591

Rental expense for operating leases totaled \$743,525 for the year ended June 30, 2013.

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Notes to Financial Statements

June 30, 2013

(5) Retirement Planning And Other Postemployment Benefits

(a) Retirement Plan

Covered California contributes to the Public Employees' Retirement Fund administered by the California Public Employees Retirement System (CalPERS), an agent multiple-employer public employee defined benefit pension plan. CalPERS provides retirement benefits to plan members and beneficiaries. CalPERS acts as a common investment and administrative agent for participating public entities within the State and uses the accrual basis of accounting. Benefit provisions and all other requirements are established by state statute. Since all state agencies, including Covered California, are considered collectively to be a single employer, the actuarial present value of vested and nonvested accumulated plan benefits attributable to the Covered California's employees cannot be determined. Similarly, the net position available for benefits of Covered California employees cannot be determined.

CalPERS issues a separate comprehensive annual financial report that includes financial statements and required supplementary information. CalPERS' annual financial report may be obtained by writing to the California Public Employees' Retirement System, Fiscal Services Division, P.O. Box 942703, Sacramento, California 94229 or by visiting the CalPERS Web site at www.CalPERS.ca.gov.

Generally, full-time employees are eligible to participate as members of CalPERS and are eligible to retire at age 50 with at least five years of service or age 55 with at least 10 years of service depending on the plan selected by the employee. However, the Public Employees' Pension Reform Act, or PERA, was passed in 2012 and went into effect on January 1, 2013. This new law changed the terms of the pension plan for state workers first hired after January 1, 2013. Annual retirement benefits are determined based on age at retirement, the length of membership service, and the amount of earnings based on the highest or last 12 or 36 consecutive months' average compensation. Healthcare and dental benefits may be provided to members depending on the date hired and the years of credited service of a member. If members are not fully vested, the healthcare and dental contributions will be prorated based on the years of service.

Active plan members are required to contribute a percentage of their salary depending on their plan selection and employment classification. Employees' required contributions vary in amounts up to 11.0%. Covered California is required to contribute at an actuarially determined rate. Covered California's contributions are based on a percentage of annual covered payroll depending on the plan selected and member status. For the year ended June 30, 2013, Covered California's payroll for employees covered by CalPERS was approximately \$9.2 million and the total payroll for the period was approximately \$9.2 million. The contribution requirements of plan members and the Covered California are established and may be amended by CalPERS. Required employer contribution rates (expressed as a percentage of compensation) for the fiscal year ended June 30, 2013 is as follows:

State Miscellaneous Member First Tier	20.503%
State Miscellaneous Member Second Tier	20.457%

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Notes to Financial Statements

June 30, 2013

Covered California’s pension cost for the year ended June 30, 2013, was equal to Covered California’s required contributions which were determined as part of the most recent actuarial valuation performed by CalPERS dated June 30, 2012.

Three-year trend information for the Covered California:

Fiscal Year Ended	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation
6/30/11	\$ —	—	—
6/30/12	\$ 141,308	100%	—
6/30/13	\$ 1,041,768	100%	—

(b) Other Postemployment Benefits

Postretirement healthcare benefits are also provided to Covered California employees through the programs sponsored by the State as administered by CalPERS and the Department of Personnel Administration (DPS). As the postretirement healthcare plan is sponsored by the State, it is considered a single-employer plan.

Healthcare and dental benefits may be provided to members depending on the date hired and the member’s years of credited services. Postretirement health benefits include medical, prescription drug, and dental benefits and are currently funded on a pay-as-you-go basis. Employer contributions for health premiums during fiscal year 2012-13 maintained the 100/90 percent contribution formula established by Government Code. Under this formula, the State uses 100 percent of the weighted average premiums of the four largest health benefit plans in order to calculate the maximum amount the State will contribute toward the retiree’s health benefits. The State also contributes 90 percent of this average for the health benefits of each of the retiree’s dependents. The retiree is responsible for paying all health benefit plan costs that exceed the average of the four largest benefit plans. The monthly contribution maximums are \$566 for a single enrollee, \$1,074 for an enrollee and one dependent, and \$1,382 for an enrollee and two or more dependents. Dental premiums vary by plan and number of dependents. The contribution formulas are subject to approval and amendment by the legislature of the State. If members are not fully vested, the healthcare and dental contributions will be pro rated based on the years of service.

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Notes to Financial Statements

June 30, 2013

Covered California paid approximately \$125,000 for postretirement health and dental benefits for retired members for the year ended June 30, 2013. Covered California has adopted GASB 45 and has a zero net OPEB obligation (NOO). Covered California's annual OPEB cost (AOC) is calculated based on the annual required contribution (ARC). The AOC recorded by Covered California is calculated by the State and represents an allocation of the total ARC of the State, adjusted for interest and other adjustments. The allocation is based on Covered California's retiree health costs in relation to the total State retiree health costs. The ARC represents normal cost plus an amortization of the difference between the actuarial accrued liability and any asset available to pay benefits. The AOC for the year ended June 30, 2013 was \$192,915. The total NOO liability recorded as of June 30, 2013 was \$125,000.

The actuarial valuation report for OPEB can be obtained by writing to the Office of the State Controller, John Chiang, P.O. Box 942850, Sacramento, California 94250 or by visiting the State Controller's website at www.SCO.ca.gov.

(6) Commitments and Contingencies

As of June 30, 2013, Covered California has outstanding commitments of \$115,081,024 related primarily to information technology projects.

Covered California receives federal awards. Receipts from federal grants are subject to audit to determine if the funds were expended in accordance with appropriate statutes, grant terms, and regulations. Any disallowed expenditures resulting from such audits become a liability of Covered California. Management does not believe such adjustments, if any, would materially affect the financial condition or operations of Covered California.

(7) Risk Management

Covered California is self-insured through the State Department of General Services (DGS) office of Risk and Insurance Management (RIM) for risks of employee errors and omissions, business interruption, and comprehensive insurance. The Office of Risk and Insurance Management (ORIM) provides risk management and insurance services to state and other public entities on an ongoing or project-specific basis. There have been no significant reductions in insurance coverage from the prior year. In addition, no insurance settlement in the last three years has exceeded insurance coverage. All claims are on a "pay-as-you-go" basis.

Liabilities for workers' compensation costs are accrued based on estimates derived from the State Compensation Insurance Fund. This estimate is based on actuarial reviews of employee workers' compensation program and includes indemnity payments compensation benefits and leave benefits. The liability for workers' compensation is not material to the financial statements as a whole.



KPMG LLP
500 Capitol Mall, Ste 2100
Sacramento, CA 95814-4754

**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***

Board of Directors
California Health Benefit Exchange

We have audited, in accordance with the auditing standards generally accepted in the United States of America 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 California Health Benefit Exchange (Covered California), which comprise the statement of financial position as of June 30, 2013, and the related statements of revenue, expenses and changes in net position and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated March 26, 2014.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered Covered California's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Covered California's internal control. Accordingly, we do not express an opinion on the effectiveness of Covered California'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 were not identified. However, as described in the accompanying schedule of findings and questioned costs, we identified deficiencies in internal control 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 combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiency described as 2013-001 in the accompanying schedule of findings and questioned costs 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 questioned costs described as 2013-002 to be a significant deficiency.



Compliance and Other Matters

As part of obtaining reasonable assurance about whether Covered California's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Covered California's Response to Findings

Covered California's responses to the findings identified in our audit are described in the accompanying schedule of findings and questioned costs. Covered California's responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on the responses.

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 Covered California's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Covered California's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

KPMG LLP

Sacramento, California
March 26, 2014



KPMG LLP
500 Capitol Mall, Ste 2100
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**Independent Auditors' Report on Compliance for the Major Program;
Report on Internal Control Over Compliance Required by OMB Circular A-133,
*Audits of States, Local Governments, and Non-Profit Organizations***

Board of Directors
California Health Benefit Exchange

Report on Compliance for the Major Federal Program

We have audited the California Health Benefit Exchange's (Covered California) compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on Covered California's major federal program for the year ended June 30, 2013. Covered California's major federal program is identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its federal program.

Auditors' Responsibility

Our responsibility is to express an opinion on compliance for Covered California's major federal program based on our audit of the types of compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Covered California's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for the major federal program. However, our audit does not provide a legal determination of Covered California's compliance.

Opinion on the Major Federal Program

In our opinion, Covered California complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on its major federal program for the year ended June 30, 2013.



Report on Internal Control Over Compliance

Management of Covered California is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered Covered California's internal control over compliance with the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of Covered California's internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A material weakness in internal control over compliance is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. A significant deficiency in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of OMB Circular A-133. Accordingly, this report is not suitable for any other purpose.

KPMG LLP

Sacramento, California
March 26, 2014

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Schedule of Expenditures of Federal Awards

Year ended June 30, 2013

<u>Federal Grantor</u>	<u>Program Title</u>	<u>CFDA No.</u>	<u>Federal Expenditures</u>
U.S. Department of Health and Human Services	Cooperative Agreements to Support Establishment of State-Operated Health Insurance Exchanges and Human Services	93.525	\$ 151,863,331

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Notes to Schedule of Expenditures of Federal Awards

June 30, 2013

(1) Basis of Accounting

The accompany Schedule of Expenditures of Federal Awards is presented on the accrual basis.

(2) Relationship to Federal Financial Reports

The regulations and guidelines governing the preparation of federal financial reports vary by federal agency and among programs. Accordingly, the amounts reported in the federal financial reports do not necessarily agree with the amounts reported in the accompanying Schedule which is prepared on the basis explained in Note 1.

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Schedule of Findings and Questioned Costs

Year ended June 30, 2013

(1) Summary of Auditors' Results

- A. The type of report issued on the financial statements: **Unmodified opinion**
- B. Significant deficiencies in internal control disclosed by the audit of the financial statements: **Yes**
Material weaknesses: **Yes**
- C. Noncompliance that is material to the financial statements: **None**
- D. Significant deficiencies in internal control over major program: **None**
Material weaknesses: **None**
- E. The type of report issued on compliance for the major program: **Unmodified opinion**
- F. Any audit findings that are required to be reported under Section 0.510(a) of OMB Circular A-133: **None**
- G. Major program:
 - 93.525 Cooperative Agreements to Support Establishment of State-Operated Health Insurance Exchanges
- H. Dollar threshold used to distinguish between Type A and Type B programs: **\$300,000**
- I. Auditee qualified as a low-risk auditee under Section 0.530 of OMB Circular A-133: **No**

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Schedule of Findings and Questioned Costs

Year ended June 30, 2013

(2) Financial Statement Findings Section

Reference Number: 2013-001

Covered California lacks adequate controls to ensure revenue and accounts receivable are fairly presented. From inception through June 2013, California Department of Social Services performed accounting and grants management for the Covered California. Covered California took over accounting operations and grants management in June 2013. In addition, from inception Covered California had been considered a component unit of the State of California (State). In January 2014, upon adoption of Government Accounting Standards Board Statement No. 61, *The Financial Reporting Entity: Omnibus*, the State informed Covered California that it was a related organization. As a result, Covered California was required to prepare its own financial statements for the first time for fiscal year 2012-13 in February 2014.

Historically, Covered California reported its financial information based on its budgetary balances in the State's general ledger. When preparing its own financial statements for the first time, Covered California did not evaluate whether certain revenue and accounts receivable balances should have been reversed as they did not represent transactions that related to fiscal year 2012-13. Instead, these balances represented encumbrances on the grant award that would be expended and drawn down from the Federal government in fiscal year 2013-14. In other words, Covered California had not drawn on these funds in fiscal year 2012-13.

As a result of this error, Covered California had grossed up its statement of revenues and expenses by not eliminating \$115 million of revenue and accounts receivable. In addition, after recording capital assets, Covered California did not properly remove the capitalized expenditures from its operating expenses. As a result, operating expenses and accounts payable were overstated by \$94 million. Covered California adjusted its financial statements to reflect these corrections.

Recommendations

Covered California should develop policies and procedures to report revenue and accounts receivable in accordance with generally accepted accounting principles.

Covered California's View and Corrective Action Plan

We concur with this finding. Covered California has taken immediate action to begin augmenting existing accounting policies and procedures to ensure proper GAAP presentation of its revenue and accounts receivables. These actions include recruitment of a State GAAP financial statement experienced consultant, GAAP training for staff, and recruitment of vacant accounting positions with staff experienced and dedicated to governmental GAAP financial reporting requirements. We will include GAAP financial statement adjustments in the Accounting work plan to ensure completion of the various tasks related to the financial statement preparation process. We will monitor on a weekly basis the work progress on the GAAP financial statements so that policies and procedures are met. We will provide for quarterly evaluation of the implemented procedures and provide additional policy, guidance and training as appropriate.

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Schedule of Findings and Questioned Costs

Year ended June 30, 2013

Contact

John Hiber, Chief Financial Officer; (916) 228-8487

Implementation Date

Staff training is scheduled to begin in April 2014, recruitment efforts for consultant and state staff began March 2014, and policies and procedures will be complete by May 31, 2014.

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Schedule of Findings and Questioned Costs

Year ended June 30, 2013

Reference Number: 2013-002

Covered California lacks adequate controls to ensure its financial statements and Schedule of Expenditures of Federal Awards (SEFA) are accurate and complete. During our audit, we identified errors in the financial statements and Schedule of Expenditures of Federal Awards, which were corrected.

- Covered California did not properly evaluate transactions that took place by the end of the fiscal year to determine whether a liability existed at June 30, 2013. As a result, accounts payable and expenditure were understated by \$6.2 million. As a result of the errors in accounts payable, the Schedule of Expenditures of Federal Awards was understated by \$6.2 million.
- Covered California did not properly evaluate whether it needed to record a grant receivable and revenue to match expenditures that had been incurred but for which funds had not yet been drawn down from the Federal government. As a result, grant receivable and grant revenue were understated by \$14 million.
- During fiscal year 2012-13, Covered California was developing an information technology system that will facilitate the State's health insurance marketplace. While Covered California evaluated the relevant accounting standard and capitalized over \$120 million of capital assets, it did not properly evaluate \$12.4 million of training and other expenses that should not have been capitalized.
- Covered California misclassified \$9 million of cash equivalents as accounts receivable.

Recommendations

Covered California should develop policies and procedures and provide training to staff to ensure its financial statements and Schedule of Expenditures of Federal Awards are accurate and complete. Covered California should:

1. Implement procedures to identify and record accounts payable for goods and services received in the fiscal year but paid after year end.
2. Implement procedures to accrue grant receivable based on expenditures incurred but not yet drawn.
3. Evaluate individual contracts and invoices to ensure proper capitalization of the computer system.
4. Review the financial statements to ensure proper presentation of cash and cash equivalents.

Covered California's View and Corrective Action Plan

We concur with this finding. California has taken immediate action to begin augmenting existing accounting policies and procedures to ensure proper GAAP presentation. These actions include recruitment of a State GAAP financial statement experienced consultant, GAAP training for staff, and recruitment of vacant accounting positions with staff experienced and dedicated to governmental GAAP financial reporting requirements. We will include GAAP financial statement adjustments in the Accounting work plan to ensure completion of the various tasks related to the financial statement preparation process.

**CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)**

Schedule of Findings and Questioned Costs

Year ended June 30, 2013

1. Implement procedures to identify and record accounts payable for goods and services received in the fiscal year but paid after year end.

Corrective Action: Covered California is revising its policies and procedures to properly identify, accrue, and record expenditures in conformance with GAAP and guidance provided by the State Controller.

2. Implement procedures to accrue grant receivable based on expenditures incurred but not yet drawn.

Corrective Action: Covered California is revising its policies and procedures to properly accrue grant receivables when there is a matching expenditure and not based on encumbrances.

3. Evaluate individual contracts and invoices to ensure proper capitalization of the computer system.

Corrective Action: Covered California is revising its policies and procedures to ensure assets expenditures are properly recorded upon payment to ensure capitalization of such expenditures as assets.

4. Review the financial statements to ensure proper presentation of cash and cash equivalents.

Corrective Action: Covered California is revising its policies and procedures to properly identify and present cash and cash equivalents in conformance with GAAP and guidance provided by the State Controller.

We will monitor on a weekly basis the work progress on the GAAP financial statements so that policies and procedures are met. We will provide for quarterly evaluation of the implemented procedures and provide additional policy, guidance and training as appropriate.

Contact

John Hiber, Chief Financial Officer; (916) 228-8487

Implementation Date

Staff training is scheduled to begin in April 2014, recruitment efforts for consultant and state staff began March 2014, and policies and procedures will be complete by May 31, 2014.

(3) Federal Awards Findings Section

None