CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)

Financial Statements and Reports Required by OMB Uniform Guidance,
Audits of States, Local Governments, and Non-Profit Organizations

Year ended June 30, 2016

(With Independent Auditors' Reports Thereon)

CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors
California Health Benefit Exchange
Sacramento, California

Report on the Financial Statements

We have audited the accompanying financial statements of California Health Benefit Exchange (Covered California) as of and for the year ended June 30, 2016, 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 accounting principles generally accepted in the United States of America; 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.

Auditor's Responsibility

Our responsibility is to express opinions 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 auditor's 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 opinions.

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of Covered California as of June 30, 2016, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

LSL
CPAs AND ADVISORS

To the Board of Directors
California Health Benefit Exchange
Sacramento, California

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis, the schedule of proportionate share of Net Pension Liability and the schedule of plan contributions 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.

Other Information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Covered California's basic financial statements. The schedule of expenditures of federal awards is presented for purposes of additional analysis as required by Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*, and is not a required part of the basic financial statements.

The schedule of expenditures of federal awards is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. The 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 February 14, 2018, on our consideration of the 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.

Lance, Soll & Lunghard, LLP

Brea, California
February 14, 2018

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, 2016. Please read it in conjunction with Covered California's financial statements that follow this section.

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.

Notes to Financial Statements

The notes provide additional information that is essential to the full understanding of the data provided in the financial statements. The notes to financial statements can be found on pages 14 through 26 of this report.

The required supplementary information section includes pension schedules, related to Covered California's proportionate share of net pension liability and pension contributions, as required by GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*.

Condensed Summary of Net Position

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

		June 30, 2016	June 30, 2015
Current and other assets	$	390,563,418	297,114,950
Capital assets		228,884,477	245,650,865
Total assets		619,447,895	542,765,815
Deferred outflows of resources		16,277,279	11,090,990
Total assets and deferred outflows of resources		635,725,174	553,856,805
Current liabilities		51,784,434	91,123,868
Noncurrent liabilities		19,306,855	8,544,873
Net pension liability		121,049,500	53,473,665
Total liabilities		192,140,789	153,142,406
Deferred inflows of resources		2,642,443	10,560,585
Total liabilities and deferred outflows of resources		194,783,232	163,702,991
Investment in capital assets		228,884,477	245,650,865
Unrestricted		212,057,465	144,502,949
Total net position	$	440,941,942	390,153,814

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Condensed Summary of Changes in Net Position

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

		June 30, 2016	June 30, 2015
Operating revenues	$	224,124,047	207,446,678
Operating expenses		357,075,624	399,815,350
Operating loss		(132,951,577)	(192,368,672)
Nonoperating revenue		146,512,773	306,986,449
Income before capital contributions		13,561,196	114,617,777
Capital contributions		15,040,848	27,669,396
Changes in net position		28,602,044	142,287,173
Total net position – beginning of year, as previously stated		390,153,814	307,859,843
Cumulative effect of accounting change			(59,993,202)
Prior period adjustment - see note 7		22,186,084	
Total net position – beginning of year, as restated		412,339,898	-
Total net position – end of year	$	440,941,942	390,153,814

The accounting change adjustment to the beginning of year total net position in fiscal year 2014-15 was due to the implementation of GASB 68, *Accounting and Financial Reporting for Pensions*. Fiscal year 2015-16 net position is adjusted to reflect the reconciliation of grant revenue.

Fiscal Year 2015-16

Financial Highlights

Covered California's funding for the fiscal year ended June 30, 2016 included federal grant funds and monthly fees assessed on qualified health plans. The Board approved budget incorporated resources to transition from federal establishment funds to operating funds generated from plan assessments as envisioned by the Affordable Care Act and the legislative intent behind California establishing an independent and financially self-sufficient state-based marketplace. Covered California was awarded grants totaling $1.1 billion to establish and operate the organization through December 2014. However, Covered California received federal approval to use unspent grant funds for establishment expenditures through September 30, 2016. The approval of the federal grant extension gave Covered California more time to establish the organization as it worked toward its goal of establishing the most efficient and cost-effective structure possible. The remaining grant funds were spent in the fiscal year just ended.

Under the statute that established Covered California, it cannot rely on State of California General Funds to support operations. Fiscal year 2016-17 marks the first year Covered California will rely solely on fee revenue collected from health plans. In accordance with state law, Covered California assesses enrollment fees on health insurance companies for policies sold to individuals and small businesses.

For FY 2015-16, Covered California's budget and expenditures were aligned with the overall mission and vision, as well as with our guiding principles:

- Controlling costs in order to deliver products and services that offer high value to consumers
- Providing a reliable and predictable level of resources to support ongoing cost-effective operations
- Maintaining flexibility to accommodate changing business priorities
- Providing careful stewardship of public resources
- Offering transparency into the management of Covered California's finances
- Maintaining a reserve that is sufficient to cover financial obligations and allow for time to adjust revenue and expenditures in the event of an unanticipated fiscal event

The expenditures in Budgetary Legal basis before GAAP adjustments for FY 2015-16 are lower than the Board approved budget of $335 million. This is primarily the result of lower-than-budgeted expenditures in all functional areas, in particular in the Service Center and in Outreach, Sales and Marketing.

Expenditure Summary by Major Areas

- Service Center — expenditures were lower than budgeted due to salary savings, general expenses and contract savings.
- Outreach, Sales and Marketing — expenditures for these programs were lower than budgeted, largely due to a savings in the paid media contract, and less funding for postage and printing.
- Plan Management and Evaluation —expenditures were lower than budgeted, primarily due to contract savings associated with the analytics program, and salary savings.
- Administration — expenditures were lower than budgeted primarily due to salary savings.
- Enterprise Shared Costs — expenditures were lower than budgeted largely due to lower than anticipated expenditures on Pro-Rata and Statewide Cost Allocation Plan (SWCAP).

Covered California's total net position increased by $28.6 million in FY 2015-16. The increase in FY 2015-16 over the prior fiscal year was due to an increase in operating revenues from enrollment fees from health insurance carriers and a decrease in professional services expenditures.

Covered California's total net investment in capital assets was $228.9 million and $245.7 million at June 30, 2016 and 2015, respectively. The decrease in FY 2015-16 of 7% over the FY 2014-15 was due to the revised cost allocation methodology for the share of the cost consistent with longstanding federal policy and practice and as set forth in Office of Management and Budget (OMB) Circular A-87, in those cases where Covered California shares

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functionalities with Medicaid and the Children's Health Insurance Program (CHIP). Those programs are required to pay their share to develop and implement the California Healthcare Eligibility, Enrollment and Retention System (CalHEERS). Previously the cost allocation was 82% Covered California and 18% Department of Health Care Services (DHCS). The cost allocation was changed to 17.9% Covered California and 82.1% DHCS effective October 1, 2014. And was again changed to 13.97% Covered California and 86.03% DHCS effective October 1, 2015. Covered California's total accumulated depreciation was $38.4 million and $35.4 million at June 30, 2016 and 2015, respectively. Additional costs will be capitalized and depreciated as Covered California moves towards final system completion.

Covered California's assets exceeded liabilities by $440.9 million and $390.2 million at the close of the fiscal years ended June 30, 2016 and 2015, respectively. In FY 2015-16, total current assets included cash and cash equivalents of $351.9 million, enrollment fees receivable of $11.9 million due from health insurance carriers and small businesses, and receivables from other state agencies of $4.2 million for reimbursements due from the DHCS. Capital assets included the capitalized cost required for the continued implementation of CalHEERS as well as office furniture and equipment and leasehold improvements. Current liabilities included accounts payable for unpaid goods and services of $41.1 million. Noncurrent liabilities included net pension liability of $121.0 million.

In FY 2014-15, current and other assets included enrollment fees receivable of $41.8 million from health insurance carriers and small businesses, and receivables from other state agencies of $14.3 million for reimbursements due from the DHCS. Capital assets included the capitalized cost required for the development and implementation of CalHEERS as well as office furniture and equipment and leasehold improvements. Current liabilities included accounts payable for unpaid goods and services of $59.3 million.

Economic Outlook

The current enrollment and revenue forecast in the FY 2017-18 Budget Book was informed by modeling done by PricewaterhouseCoopers (PwC) in partnership with the University of California. The forecast relies on the experience gained from 37 months of active enrollment through the fourth open-enrollment period that ended on January 31, 2017. The enrollment activity achieved during this open enrollment was consistent with the FY 2016–17 forecast, which projected that Covered California had entered a phase of stable enrollment. Open enrollment for the 2017 benefit year resulted in enrollment in line with the Base Estimate of approximately 1.4 million enrollees. The Base Estimate used for the FY 2017–18 forecast projected a stable enrollment outlook going forward, but Covered California has modeled alternate enrollment to reflect the uncertainty of the political environment.

The Base Estimate takes into consideration two factors that affect the overall enrollment trend. Covered California has adopted a policy of pre-verification of qualifying life events that allows individuals to enroll during special enrollment. Based on survey evidence, this policy could notably dampen the pace of enrollment outside of open enrollment. Conversely, based on a market analysis completed by PwC in 2016, the scheduled increase in California's minimum wage anticipates additional enrollment by boosting income for those near the subsidy-eligibility range that could shift people from Medi-Cal to Covered California.

Effective January 2017, Covered California's assessment fee switched from a flat per-member, per-month fee to a percentage assessment on total premiums paid. Currently at 4%, this fee is being assessed on Covered California's

1.4 million enrollees. In addition, there are approximately 800,000 people in the individual market who benefit from the rates negotiated by Covered California, even though they are not directly enrolled through the exchange. The Affordable Care Act requires the rates for these on- and off-exchange plans be the same. Since the specific health plan products offered by Covered California represent approximately 62% of the total enrollment in individual coverage, the Affordable Care Act assessment essentially requires the health plans to spread the assessment fee across the entire individual market. To the extent that carriers have members who do not purchase through Covered California, but who pay the same rate, the actual assessment is spread across the entire individual market for those health plans offered by Covered California. With this budget, Covered California will maintain the 4% on-exchange assessment, which converts to an estimate that the actual average effective assessment rate is approximately 2.5% across the entire individual market.

Forecasting Potential Enrollment

The 2016 enrollment forecast was based on the experience and lessons learned in 2015 as well as insights from the market analysis completed by PwC and the University of California. Adding to these insights, the 2017 forecast reflected the experience of an additional year of enrollment history. Based on the 2016 benefit year and the 2017 open-enrollment experience, Covered California's Base Estimate was stable enrollment going forward with the exception of the impact of more stringent pre-verification of qualifying life events beginning with 2018 special enrollment.

Individual Market Forecast

The projection in the FY 2017-18 Budget Book begins after the fourth open enrollment period and takes into account the following factors, each of which is then described in more detail:

- The number of new consumers who chose health plans during open enrollment.
- The pace that new enrollees acquired coverage through Covered California during 2016 special enrollment and the likely impact of pre-verification.
- The rate at which enrolled individuals leave Covered California through termination or by failing to renew coverage.
- The likelihood that an individual who selects a plan will pay his or her premium.
- The impact of rising minimum wage on the subsidy-eligible population.
- Potential medical cost trends reflected in premiums.

The revenue forecast reflects the shift to a percent of premium assessment in 2017, with a rate of 4% of gross health insurance premiums through 2018, which equates to 2.6% across the entire individual market for plans controlled by Covered California. The base forecast currently projects its assessment rate to gradually decrease to 3.25% by 2021, which equates to 2.1% across the entire individual market for the plans contracted by Covered California.

The projected premium growth for the Base Estimate assumes an underlying 7% per-year medical trend driven by annual cost increases in hospital services, professional medical services and pharmaceuticals. In 2018, the renewal of the health insurance provider fee will boost that growth rate to 9% for that year only. The assumed cost, and thus premium, growth trend in the forecast is 7% per-year thereafter.

Covered California for Small Business Forecast

The enrollment outlook of Covered California for Small Business (CCSB) builds on the operational improvements (e.g., group onboarding at, or better than, industry standard; timely commission payments; quickly resolving account maintenance issues), and better support from our agents and brokers. The CCSB program anticipates that enrollment will continue to grow in 2018. The sales and operations teams are continuing to improve and maintain better relationships with brokers. The focus continues to be on expanding activities such as implementation of agency-level agreements and strategic technology implementations. They continue to focus on group retention by improving communication outreach.

Because of these anticipated improvements and the trends seen over the past year, overall CCSB enrollment is expected to rise modestly through FY 2020–21. Similar to the individual market enrollment projections, a Base Estimate enrollment forecast was developed. The updated forecast is built on the experience of the past three years and takes into account the overall size and expected growth of the small business exchange market in California. CCSB currently represents about 8% of the exchange market. The base forecast assumes that expected program improvements will grow CCSB market share to 9% in 2019. Thereafter, CCSB enrollment growth will keep pace with the anticipated growth of the small business exchange market.

Beginning in 2017, the Covered California assessment rate was based on a percentage of gross health plan premium at 5.2%. For plan year 2018, this rate will be continued at 5.2%.

Covered California's Multi-Year Forecast and Reserves

Covered California began its current fiscal year with a healthy operating reserve. Consistent with its guiding financial principles, the reserve amount is based on maintaining a level that is sufficient to assure an adequate balance to address uncertainties and to allow for timing lags needed to adjust revenue and expenditures. Adjustments in the plan assessment, for example, take nine to 18 months to have an impact on plan-assessment revenue. For these reasons, it is necessary to develop projections within the framework of a multi-year plan.

The FY 2017-18 multi-year forecast is displayed below. Revenues, which include both the individual and CCSB markets, are calculated on a cash basis that reflects the actual timing of the collection of revenue.

Dollars in Millions

	FY 2016-17	FY 2017-18	FY 2018-19	FY 2019-20	FY 2020-21
Effectuated Enrollment (fiscal year end)	1,371,949	1,321,919	1,305,646	1,311,360	1,333,280
Opening Balance	$325.1	$288.9	$289.0	$297.8	$308.8
Plan Assessments-Cash Basis	$237.6	$314.4	$325.8	$331.0	$331.9
Expenditures Projected	($273.8)	($314.3)	($317.0)	($320.0)	($323.0)
Year-End Operating Reserve	$288.9	$289.0	$297.8	$308.8	$317.7
Number of months of reserve	**11.0**	**10.9**	**11.2**	**11.5**	**11.7**

Plan Year	2018	2019	2020	2021
Plan Assessment Rate	4.00%	3.75%	3.50%	3.25%
Plan Assessment Rate On/Off Exchange	2.49%	2.33%	2.17%	2.03%
Premium Growth Assumptions	9.00%	7.00%	7.00%	7.00%

The plan assessment is at a level of 4 % of premium for 2018, at 3.75% in 2019, 3.5% in 2020 and 3.25% in 2021. CCSB plan assessments are at a level of 5.2% of premium for the duration of the forecast. The forecast includes revenue from family dental coverage, which is assessed at the same rates as the medical coverage offered on the individual and CCSB markets. To the extent enrollment varies from the Base Estimate forecast, Covered California would be able to adjust its revenue by increasing or decreasing the plan assessment, or by adjusting its budgeted expenditures. It is important to note that each year a new multi-year forecast will be completed based on the most current information, so the estimates presented here could change.

Targeted Reserve Position

Numerous analyses have been conducted to identify the appropriate level of reserves necessary to provide sufficient time to make fiscal adjustments in the event of a decline in enrollment. Specifically, an analysis performed at the end of 2016 indicated that given the ability to reduce both contractual and personnel expenditures (the latter primarily through attrition), Covered California's existing reserve position at the time of nine to 10 months was adequate to cover a significant reduction in enrollment.

The analysis also indicated that should Covered California's reserve position fall below the nine-to-10-month level, there is some risk that reserves, in conjunction with reductions to expenditures, may not be adequate to maintain solvency in the event of possible enrollment reductions. Because of this, the analysis concluded that Covered California should implement a reserve strategy that maintains reserves at a slightly higher level of nine to 12 months in the near term.

Given the uncertainties facing Covered California's enrollment outlook stemming from the potential for federal legislative action to change key provisions of the Affordable Care Act, it is prudent to maintain reserves at the high end of this range.

CALIFORNIA HEALTH BENEFIT EXCHANGE

(COVERED CALIFORNIA)

Statement of Net Position

June 30, 2016

Assets and Deferred Outflows		**2016**
Current assets:		
Cash and cash equivalents	$	351,875,226
Receivables:		
Grant receivable		20,980,314
Enrollment fees (net of allowance for cancelled enrollments)		11,865,663
Receivables from state agencies		4,181,351
Other receivables		992,550
Total receivables		38,019,878
Other current assets		668,314
Total current assets		390,563,418
Noncurrent assets:		
Capital assets, net		228,884,477
Total assets		619,447,895
Deferred Outflows of Resources		16,277,279
Total assets and deferred outflows of resources		635,725,174
Liabilities and Deferred Inflows		
Current liabilities:		
Accounts payable		41,100,698
Grants received in advance		-
Accrued liabilities		2,135,061
Deferred revenue		4,799,506
Compensated absences		3,749,169
Total current liabilities		51,784,434
Noncurrent liabilities:		
Compensated absences		2,418,023
Other liabilities		-
Other postemployment benefits		16,888,832
Net pension liability		121,049,500
Total noncurrent liabilities		140,356,355
Total liabilities		192,140,789
Deferred Inflows of Resources		2,642,443
Total liabilities and deferred inflows of resources		194,783,232
Net Position		
Net investment in capital assets		228,884,477
Unrestricted		212,057,465
Total net position	$	440,941,942

See accompanying notes to financial statements.

CALIFORNIA HEALTH BENEFIT EXCHANGE

(COVERED CALIFORNIA)

Statement of Revenues, Expenses, and Changes in Net Position

Year ended June 30, 2016

Operating revenues:		**2016**
Enrollment fees-individual	$	217,956,554
Enrollment fees-CCSB		6,167,493
Total operating revenues		224,124,047
Operating expenses:		
Salaries, wages, benefits	$	156,028,686
Operating expenses and equipment		12,703,022
Professional services		131,191,294
Enrollment assistance fees		11,588,900
Facilities operations		6,882,307
Communications		254,731
Depreciation expense		38,426,684
Total operating expenses		357,075,624
Operating loss		(132,951,577)
Nonoperating revenues:		
Federal grants		141,674,658
State - reimbursements		3,646,925
Interest income		1,069,106
Other income		122,084
Total nonoperating revenues		146,512,773
Income before capital contributions		13,561,196
Capital contributions:		
Federal		15,040,848
Total capital contributions		15,040,848
Change in net position		28,602,044
Total net position – beginning of year, as previously stated		390,153,814
Prior period adjustment - see note 7		22,186,084
Total net position – beginning of year, as restated		412,339,898
Total net position – end of year	$	440,941,942

See accompanying notes to financial statements.

CALIFORNIA HEALTH BENEFIT EXCHANGE

(COVERED CALIFORNIA)

Statement of Cash Flows

Year ended June 30, 2016

		2016
Cash flows from operating activities:		
Receipts from enrollment fees	$	255,599,130
Payments to employees and for employee benefits		(90,656,241)
Payments to suppliers		(187,338,684)
Net cash used in operating activities		(22,395,795)
Cash flows from noncapital financing activities:		
Operating grants		158,080,600
State - reimbursements		3,827,273
Net cash provided by noncapital financing activities		161,907,873
Cash flows from capital and related financing activities:		
Capital grants		9,781,023
Acquisition of capital assets		(37,879,624)
Net cash provided by capital and related financing activities		(28,098,601)
Cash flows from investing activities:		
Interest income		786,254
Net increase in cash and cash equivalents		112,199,731
Cash and cash equivalents – beginning of year		239,675,495
Cash and cash equivalents – end of year	$	351,875,226
Reconciliation of operating loss to net cash used in operating activities:		
Operating loss		(132,951,577)
Adjustments to reconcile operating loss to net cash used by operating activities:		
Depreciation		38,426,684
Changes in assets and liabilities:		
Decrease in accounts receivable		31,475,083
Increase in other assets		(636,593)
Increase in pension obligations		(13,104,431)
Decrease in accounts payable and grants received in advance		(24,081,837)
Increase in accrued liabilities		67,876,407
Increase in compensated absences		450,655
Increase in other postemployment benefits		10,734,616
Decrease in other liabilities		(584,803)
Net cash used in operating activities	$	(22,395,796)

Supplemental disclosure of non-cash activities:

Capital asset purchases included in accounts payable	$	6,724,900

See accompanying notes to financial statements.

(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 2010, states were required to decide whether to create a state-based health insurance exchange or participate in the federal multistate health insurance exchange. The State of California (the State) 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 healthcare 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. 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.

(c) Revenue Recognition

Revenues are classified as operating or nonoperating in the accompanying Statement of Revenues, Expenses and Changes in Net Position. Operating revenues began in fiscal year 2013-14, and result from monthly enrollment fees assessed on health insurance companies for policies sold through the marketplace for the individual and Covered California for Small Business (CCSB) markets.

In the individual market, Covered California charges the health insurance carriers a per-member-per-month fee, which is set annually for effectuated members. For fiscal year 2015-16, the per-member-per-month fee was $13.95 per medical enrollee and $0.83 per dental enrollee.

In the CCSB market, Covered California charges the health insurance carriers a per-member-per-month fee, which is set annually for effectuated members. For fiscal year 2015-16, the per-member-per-month fee was $18.60 per medical enrollee and $0.83 per dental enrollee.

Covered California recognizes individual and CCSB enrollment fee revenues when effectuated enrollment occurs and the fees are earned from the health insurance carriers. All revenues received that are not part of the ongoing operations, such as Federal grants and interest income, are classified as nonoperating revenues.

(d) 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.

(e) Receivables

Grants receivable represents amounts owed from the Federal government.

Receivables represent amounts owed by the California DHCS for its share of the costs related to California Healthcare Eligibility, Enrollment, and Retention System (CalHEERS) of $4.2 million as of June 30, 2016. Receivables also include amounts due from health insurance carriers for enrollment fees and small businesses for premiums in the amount of $11.9 million, which is net of cancelled enrollments of approximately $2.9 million, and amounts due from employees of $143,628.

(f) 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. Depreciation on internally generated software and purchased software is calculated using the straight-line method over the estimated useful life of 10 and 5 years, respectively. When assets are retired or otherwise disposed of, the costs and related accumulated depreciation are removed from 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 shorter of the lease term or the useful life.

In accordance with Governmental Accounting Standards Board (GASB) Statement No. 51, *Accounting and Reporting for Intangible Assets*, Covered California has recorded internally generated computer software that went live on October 1, 2013. Intangible assets are considered internally generated if they are created or produced by Covered California or an entity contracted by Covered California, or if they are acquired from a third party but require more than minimal incremental effort on the part of Covered California 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 2015 through June 30, 2016 were $20.2 million. Depreciation of the intangible assets began on October 1, 2013, and totaled $37 million for fiscal year 2015-16.

(g) Accounts Payable

Accounts payable represents amounts owed by Covered California to third parties.

(h) Compensated Absences Payable

Vacation balances are accrued as a liability.

(i) Enrollment Assistance Fees

Covered California entered into a contract with DHCS whereby DHCS compensates certified enrollment entities and agents for successful consumer enrollment and effectuation in Medi-Cal. The compensation is either $58 or $29 depending on enrollment factors. Covered California pays these fees on behalf of DHCS. The funds to pay these fees are collected in advance from DHCS.

(j) 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.

(k) Pensions

Covered California has adopted GASB Statement No. 68, *Accounting and Financial Reporting for Pensions* and GASB Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date*. GASB Statement No. 68 revises existing standards for measuring and reporting pension liabilities. This statement requires recognition of a liability equal to the net pension liability, which is measured as the total pension liability, less the amount of the pension plan's fiduciary net position. The total pension liability is determined based upon discounting projected benefit payments based on the benefit terms and legal agreements existing at the pension plan's fiscal year end. Projected benefit payments are required to be discounted using a single rate that reflects the expected rate of return on investments, to the extent that plan assets are available to pay benefits. This Statement requires that most changes in the net pension liability be included in pension expense in the period of the change.

For purpose of measuring the net pension liability, deferred outflows and inflows of resources related to pensions, and pension expense, information contained within Covered California has been determined on the same basis as they are reported by the California Public Employees' Retirement System (CalPERS) Financial Office and the State Controller's Office.

(l) Deferred Outflows of Resources and Deferred Inflows of Resources

Changes in net pension liability not included in pension expense are reported as deferred outflows of resources or deferred inflows of resources. Employer contributions subsequent to the measurement date of the net pension liability are reported as deferred outflows of resources. The unamortized net difference between projected and actual earnings on investments are recorded as deferred inflows of resources.

(2) Cash and Cash Equivalents

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

		2016
State treasury	$	16,605,226
Surplus money investment fund (SMIF)		335,270,000
Total	$	351,875,226

As of June 30, 2016, the carrying value of deposits in the SMIF represents the fair value. The SMIF consists of the available cash of 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.

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.

At June 30, 2016, the allocation of the deposits held by Covered California in the SMIF was estimated as follows:

		Covered California's Share of SMIF
U.S. Treasury Securities	$	150,590,501
Federal Agency Debt		44,498,076
Supranational Debentures		2,668,955
Bank Notes		3,558,709
Certificates of Deposit		73,732,037
Commercial Paper		33,301,187
Time Deposits		24,686,053
AB 55 and General Fund Loans		2,234,482
Total	$	335,270,000

The value of the deposits in the State Treasurer's pooled investment program, including the SMIF, is equal to the dollars deposited in the program. The fair value of the position in the program may be greater or less than the value of the deposits, with the difference representing the unrealized gain or loss. As of June 30, 2016, this difference was immaterial to the valuation of the deposits held by Covered California in the SMIF.

Covered California's share in the interest earnings of the PMIA is based on its ratio of dollar-day contributions to the total dollar-day investments of the PMIA. The overall return on investment for the PMIA was 0.43% for the year ended June 30, 2016.

Additional disclosures regarding investment risks, interest rate risk, credit risk, custodial credit risk and concentration of credit risk, are presented in the financial statements of the State of California for the year ended June 30, 2016.

(3) Capital Assets

Changes in capital assets for the year ended June 30, 2016 are as follows:

	Balance July 1, 2015	Increases	Decreases	Balance June 30, 2016
Depreciable assets-development costs:				
Internally developed software	$ 235,527,298	$ 18,538,495	—	$ 254,065,793
Hardware	22,762,937	483,783	—	23,246,720
Licenses and purchased software	40,829,628	1,128,284	—	41,957,912
Total depreciable assets development costs	$ 299,119,863	$ 20,150,562	—	$ 319,270,425
Depreciable capital assets:				
Office furniture and equipment	4,520,030	1,477,937	—	5,997,967
Leasehold improvements	2,768,016	31,797	—	2,799,813
Total depreciable capital assets	$ 7,288,046	$ 1,509,734	—	$ 8,797,780
Less accumulated depreciation:				
Asset development costs	(59,048,414)	(37,026,050)	—	(96,074,464)
Office furniture and equipment	(1,405,017)	(1,003,575)	—	(2,408,592)
Leasehold improvements	(303,613)	(397,059)	—	(700,672)
Total accumulated depreciation	$ (60,757,044)	$ (38,426,684)	—	$ (99,183,728)
Total capital assets, net	$ 245,650,865	$ (16,766,388)	—	$ 228,884,477

(4) Leases

Covered California leases office space for its headquarters and Service Centers under operating leases. The lease terms vary, with the oldest expiring April 30, 2022.

The future minimum lease payments under current operating leases as of June 30, 2016 are as follows:

For the year ending June 30:		
2017	$	6,206,468
2018		6,199,412
2019		6,192,356
2020		5,219,102
2021		3,608,591
Thereafter		2,902,717

Rental expense for operating leases totaled $6.1 million for the year ended June 30, 2016.

(5) Retirement Planning and Other Postemployment Benefits

(a) Retirement Plan

Covered California adopted GASB 68 during the 2014-15 fiscal year. GASB 68 requires that the reported results pertain to liability and asset information within certain defined timeframes. For this report, the following timeframes are used:

Valuation date (VD)	June 30, 2014
Measurement date (MD)	June 30, 2015
Measurement period (MP)	July 1, 2014 to June 30, 2015

At the time provisions of GASB 68 were adopted, Covered California did not have the necessary pension information to determine the amounts of all deferred outflows and inflows of resources related to pensions, so it was not practical to restate the prior period financial statements.

Plan Description, Benefits Provided, and Employees Covered

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. Covered California has employees who are enrolled in the State Miscellaneous Plan (First Tier and Second Tier). 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.

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 ten years of service, depending on the plan selected by the employee. However, the Public Employees' Pension Reform Act, or PEPRA, 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.

Contributions

Section 20814 (c) of the California Public Employees' Retirement Law (PERL) requires that the employer contribution rates for all public employers are determined on an annual basis by the actuary and shall be effective on the July 1 following notice of a change in the rate. The total plan contributions are determined through the CalPERS' annual actuarial valuation process. The actuarially determined rate is the estimated amount necessary to finance the costs of benefits earned by employees during the year, with an additional amount to finance any unfunded accrued liability. The employer is required to contribute the difference between the actuarially determined rate and the contribution rate of employees. For the Miscellaneous Plan measurement period ended June 30, 2015, the active employee contribution rate is 8% to 10% of annual pay for Tier 1 and 3.75% of annual pay for Tier 2, and the employer's contribution rate is 25.150% of annual payroll for Tier 1 and 25.278% of annual payroll for Tier 2. These rates reflect PERL Section 20683.2, which mandates that certain employees contribute more as of July 1, 2013. Furthermore, any reduction in employer contributions due to the increase in the employee contributions must be paid by the employer towards the unfunded liability. It is the responsibility of the employer to make necessary accounting adjustments to reflect the impact due to any employer-paid member contributions or situations where members are paying a portion of the employer contribution.

Discount Rate

In preparation for implementing GASB 68, CalPERS prepared the GASB 68 Accounting Valuation Reports (AVRs) for the State of California for the eight plans (including the State Miscellaneous Plan) in which the State participates. CalPERS utilized a discount rate of 7.65%, which includes the plans' administrative expenses.

Pension Liabilities, Pension Expense, and Deferred Outflows and Deferred Inflows of Resources Related to Pensions

The State Controller's Office (SCO) used a calculated percentage based on Covered California's share of the pensionable compensation to the State's total pensionable compensation amounts for the State Miscellaneous Plan, to provide Covered California's net pension liability and related GASB 68 accounting elements. Covered California's calculated percentage was 0.428616% for the State Miscellaneous Plan. Covered California's net pension liability for the State Miscellaneous Plan was $53.5 million at the beginning of the measurement period (MP) and $121.0 million at the end of the MP.

As of the start of the measurement period, July 1, 2014, the net pension liability was $53,473,665.

For the measurement period, June 30, 2015 (the measurement date), Covered California Fund incurred a non-cash pension expense of $68,537,957.

As of the measurement date of June 30, 2015, Covered California had deferred outflows and deferred inflows of resources related to pensions as follows:

	Deferred Outflows of Resources	Deferred Inflows of Resources
Pension contributions subsequent to measurement date	$ 14,066,553	$ -
Difference between Expected and Actual Experience	2,210,726	-
Net Difference between Projected and Actual Earnings on Pension Plan Investments	-	(2,642,443)
Total	**$ 16,277,279**	**$ (2,642,443)**

Exclusive of deferred outflows related to payments after the measurement date, the net amount of deferred outflows (inflows) of resources related to pensions that will be recognized in pension expense during the next five years and thereafter is as follows:

Measurement Period ended June 30:	Deferred Outflows/(Inflows) of Resources
2016	$ (86,343.40)
2017	$ (86,343.40)
2018	$ (86,343.40)
2019	$ (86,343.40)
2020	$ (86,343.40)
Thereafter	$ -
Total	$ (431,717.00)

Actuarial Methods and Assumptions Used to Determine Total Pension Liability

The total pension liability was based on an actuarial valuation as of June 30, 2014, rolled forward to June 30, 2015, based on the following actuarial methods and assumptions:

Actuarial Cost Method:	Entry Age Normal in accordance with the requirements of GASB Statement No. 68
Amortization Method/Period:	Actuarial Policy ACT-96-05E specifies that all changes in liability due to plan amendments, changes in actuarial assumptions, or changes in actuarial methodology are amortized separately over a 20-year period. In addition, all gains or losses are tracked and the net unamortized gain or loss is amortized as a rolling 30-year amortization with the exception of gains and losses in fiscal years 2008-09, 2009-10 and 2010-11 in which years' gains or losses will be isolated and amortized over fixed and declining 30-year periods (as opposed to the current rolling 30-year amortization). Also, if a plan's accrued liability exceeds the actuarial value of assets, the annual contribution with respect to the total unfunded liability may not be less than the amount produced by a 30-year amortization of the unfunded liability. Finally, all plans are subject to a minimum employer contribution rate equal to the employer normal cost plus a 30-year amortization or surplus, if any.
Asset Valuation Method:	Fair Value
Inflation:	2.75%
Salary Increases:	Varies by entry age and service
Payroll Growth:	3.00%
Investment Rate of Return:	7.65%
Retirement Age:	The probabilities of retirement are based on the 2010 CalPERS Experience Study for the period from 1997 to 2007
Mortality Rate Table:	The probabilities of mortality are based on the 2010 CalPERS Experience Study for the period from 1997 to 2007. Pre-retirement and post-retirement mortality rates include 5 years of projected mortality improvement using Scale AA published by the Society of Actuaries.
Post Retirement Benefit Increase:	Contract COLA up to 2.75% until purchasing power protection allowance floor on purchasing power applies.

(Continued)

The Mortality Rate Table used was developed based on CalPERS specific data. The table includes 20 years of mortality improvements using Society of Actuaries Scale BB. For more details on the Mortality Rate Table, please refer to the 2014 experience study report.

All other actuarial assumptions used in the June 30, 2014, valuation were based on the results of an actuarial experience study for the period from 1997 to 2011, including updates to salary increase, mortality and retirement rates. The Experience Study report can be obtained at a CalPERS website under Forms and Publications.

The long-term expected rate of return on pension plan investments was determined using a building-block method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class.

In determining the long-term expected rate of return, CalPERS' staff took into account both short-term and long-term market return expectations as well as the expected pension fund cash flows. Such cash flows were developed assuming that both members and employers will make their required contributions on time and as scheduled in all future years. Using historical returns of all the funds' asset classes, expected compound (geometric) returns were calculated over the short-term (first 10 years) and the long-term (11-60 years) using a building-block approach. Using the expected nominal returns for both short-term and long-term, the present value of benefits was calculated for each fund. The expected rate of return was set by calculating the single equivalent expected return that arrived at the same present value of benefits for cash flows as the one calculated using both short-term and long-term returns. The expected rate of return was then set equivalent to the single equivalent rate calculated above and rounded down to the nearest one quarter of one percent.

The table below reflects long-term expected real rate of return by asset class. The rate of return was calculated using the capital market assumptions applied to determine the discount rate and asset allocation. An expected inflation rate of 2.5% was used for real return years 1-10. For real return years 11+, an inflation rate of 3.0% was used. These geometric rates of return are net of administrative expenses.

Global equity	51.00%	5.25%	5.71%
Global fixed income	19.00%	0.99%	2.43%
Inflation sensitive	6.00%	0.45%	3.36%
Private equity	10.00%	6.83%	6.95%
Real Estate	10.00%	4.50%	5.13%
Infrastructure and forestland	2.00%	4.50%	5.09%
Liquidity	2.00%	(0.55%)	(1.05%)
Total	100.00%		

Sensitivity of the Net Pension Liability to Changes in the Discount Rate

The following presents the net pension liability of Covered California as of June 30, 2015, calculated using the discount rate of 7.65%, as well as what the pension liability would be if it were calculated using a discount rate that is 1 percentage-point lower (6.65%) or 1 percentage-point higher (8.65%) than the current rate:

	Discount Rate -1% (6.65%)	Current Discount Rate (7.65%)	Discount Rate + 1% (8.65%)
Miscellaneous Plan	$170,965,841	$121,049,500	$79,169,693

Pension Plan Fiduciary Net Position

Each plan's fiduciary net position disclosed in the accounting valuation report provided by CalPERS may differ from the plan's assets reported in the funding actuarial valuation report due to several reasons; the accounting valuation report must keep items such as deficiency reserves, fiduciary self-insurance, and OPEB expenses included as assets. These amounts are excluded for rate setting purposes in the funding actuarial valuation report.

(b) Other Postemployment Benefits

Postretirement healthcare benefits are also provided to Covered California retirees through the programs sponsored by the State as administered by CalPERS and the California Department of Human Resources (CalHR). As the postretirement healthcare plan is sponsored by the State, it is considered a single-employer plan. The total other postemployment benefits (OPEB) actuarial accrued liability is reported at the State level.

Healthcare and dental benefits may be provided to members depending on the date hired and the member's years of credited service. 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 2015-16 maintained the 100/90% contribution formula established by Government Code. Under this formula, the State uses 100% 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% 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 $705 for a single enrollee, $1,343 for an enrollee and one dependent, and $1,727 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 prorated based on the years of service.

Covered California paid approximately $2.5 million for postretirement health and dental benefits for retired members for the year ended June 30, 2016. Covered California has adopted GASB Statement No. 45. 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 benefit costs in relation to the total State retiree health benefit costs. The ARC represents normal cost plus an amortization of the difference between the actuarial accrued liability and any asset available to pay benefits. For the year ended June 30, 2016, Covered California's AOC was \$16.6 million and Covered California's total net OPEB obligation (NOO) was \$16.9 million. The following table shows the components of Covered California for the year ended June 30, 2016 and the previous three fiscal years.

Net OPEB obligation (NOO), July 1, 2013	$	125,482
Allocated annual OPEB cost (AOC)		1,632,434
Fund allocated contributions		(578,440)
Net OPEB obligation (NOO), July 1, 2014		1,179,476
Allocated annual OPEB cost (AOC)		7,991,912
Fund allocated contributions		(3,017,172)
Net OPEB obligation (NOO), June 30, 2015		6,154,216
Allocated annual OPEB cost (AOC)		16,580,792
Fund allocated contributions		(5,846,176)
Net OPEB obligation (NOO), June 30, 2016	$	16,888,832

The actuarial valuation report for OPEB can be obtained by writing to the Office of the State Controller, 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, 2016, Covered California has outstanding commitments of \$35.5 million 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) Prior-Period Adjustment

During the fiscal year ended June 30, 2016, a prior-period adjustment was necessary to properly reflect amounts related to federal grant revenue. During its start-up phase, grant funds were provided to Covered California to be spent on eligible expenses, such as payroll costs. Any unspent funds were either to be remitted back to the federal granting agency or to be spent on future eligible costs. However, as unspent funds were subsequently exhausted, the related grant revenue was not properly adjusted, resulting in a restatement. Grant draws and federal expenditures during the 15-16 fiscal year are properly stated and not impacted by this restatement.

(8) Risk Management

Covered California is self-insured through the State Department of General Services (DGS) Office of Risk and Insurance Management (ORIM) for risks of employee errors and omissions, business interruption, and comprehensive insurance. The 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.

CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)

Required Supplementary Information

June 30, 2016

SCHEDULE OF COVERED CALIFORNIA'S PROPORTIONATE SHARE OF THE NET PENSION LIABILITY

	2015	2016
Covered California's Proportion of the Net Pension Liability	0.224583%	0.428616%
Covered California's Proportionate Share of the Net Pension Liability	$ 53,473,665	$ 121,049,500
Covered California's Covered-Employee Payroll	$ 22,502,642	$ 45,608,536
Covered California's Proportionate Share of the Net Pension Liability as a Percentage of its Covered-Employee Payroll	237.63%	265.41%
Plan Fiduciary Net Position as a Percentage of the Total Pension Liability	74.17%	70.68%

(1) Amounts presented were determined as of June 30th of the prior fiscal year.
(2) Data is being accumulated annually to present 10 years of the reported information.

CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)

Required Supplementary Information

June 30, 2016

SCHEDULE OF PLAN CONTRIBUTIONS

	2015	2016
Actuarially Determined Contribution	$ 11,090,990	$ 14,066,553
Contribution in Relation to the Actuarially Determined Contribution	(11,090,990)	(14,066,553)
Contribution Deficiency (Excess)	$ -	$ -
Covered-Employee Payroll	$ 22,506,125	$ 45,608,536
Contributions as a Percentage of Covered-Employee Payroll	49.28%	30.84%

(1) Data is being accumulated annually to present 10 years of the reported information.

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*

To the Board of Directors
California Health Benefit Exchange
Sacramento, California

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), as of and for the year ended June 30, 2016, and the related notes to the financial statements, which collectively comprise Covered California's basic financial statements and have issued our report thereon dated February 14, 2018.

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 opinions 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.

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 entity's financial statements will not be prevented or detected and corrected on a timely basis. 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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section 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. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify certain deficiencies in internal control, described in the accompanying schedule of findings and questioned costs that we consider to be significant deficiencies. Refer to findings 2016-001 through 2016-004.

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CPAs AND ADVISORS

To the Board of Directors of the
California Health Benefit Exchange
Sacramento, California

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

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.

Lance, Soll & Lunghard, LLP

Brea, California
February 14, 2018

LSL
CPAs AND ADVISORS

INDEPENDENT AUDITORS' REPORT ON COMPLIANCE FOR EACH MAJOR PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE; AND REPORT ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS REQUIRED BY THE UNIFORM GUIDANCE

To the Board of Directors
California Health Benefit Exchange
Sacramento, California

Report on Compliance for Each Major Federal Program

We have audited the California Health Benefit Exchange (Covered California)'s compliance with the types of compliance requirements described in the *OMB Compliance Supplement* that could have a direct and material effect on each of Covered California's major federal programs for the year ended June 30, 2016. Covered California's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with federal statutes, regulations, and the terms and conditions of its federal awards applicable to its federal programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of Covered California's major federal programs 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 the audit requirements of Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Those standards and the Uniform Guidance 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 each major federal program. However, our audit does not provide a legal determination of Covered California's compliance.

Opinion on Each 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 each of its major federal programs for the year ended June 30, 2016.

CPAs AND ADVISORS

To the Board of Directors
California Health Benefit Exchange
Sacramento, California

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 the Uniform Guidance, 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. 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 the Uniform Guidance. Accordingly, this report is not suitable for any other purpose.

Report on Schedule of Expenditures of Federal Awards Required by the Uniform Guidance

We have audited the financial statements of Covered California, as of and for the year ended June 30, 2016, and the related notes to the financial statements, which collectively comprise Covered California's basic financial statements. We issued our report thereon dated February 14, 2018, which contained unmodified opinions on those financial statements. Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the basic financial statements. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by the Uniform Guidance and is not a required part of the basic financial statements.

To the Board of Directors
California Health Benefit Exchange
Sacramento, California

Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. The 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 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.

Lance, Soll & Lunghard, LLP

Brea, California
February 14, 2018

CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE FISCAL YEAR ENDED JUNE 30, 2016

Federal Grantor/Program Title	Federal CFDA Number	Pass-Through Grantor's Number	Expenditures	Passed Through to Subrecipients
U.S. Department of Health and Human Services				
Direct Programs:				
State Planning and Establishment Grants for the Affordable Care Act (ACA)'s Exchanges	93.525	N/A	$ 156,715,506	$ -
Total U.S. Department of Health and Human Services			**156,715,506**	**-**
Total Federal Expenditures			**$ 156,715,506**	**$ -**

Note a: Refer to Note 1 to the schedule of expenditures of federal awards for a description of significant accounting policies used in preparing this schedule.

Note b: There were no federal awards expended in the form of noncash assistance and insurance in effect during the year.

The accompanying notes are an integral part of this schedule.

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS FOR THE YEAR ENDED JUNE 30, 2016

Note 1: Summary of Significant Accounting Policies Applicable to the Schedule of Expenditures of Federal Awards

a. Scope of Presentation

The accompanying schedule presents only the expenditures incurred by California Health Benefit Exchange (Covered California), that are reimbursable under federal programs of federal financial assistance. For the purposes of this schedule, federal awards include both federal financial assistance received directly from a federal agency, as well as federal funds received indirectly by Covered California from a non-federal agency or other organization. Only the portion of program expenditures reimbursable with such federal funds is reported in the accompanying schedule. Program expenditures in excess of the maximum federal reimbursement authorized or the portion of the program expenditures that were funded with state, local or other non-federal funds are excluded from the accompanying schedule.

b. Basis of Accounting

The expenditures included in the accompanying schedule were reported on the accrual basis of accounting. Covered California has elected not to use the ten percent *de minimis* indirect cost rate allowed under the Uniform Guidance.

c. Indirect Cost Rate

Covered California has elected not to use the ten percent *de minimis* indirect cost rate allowed under the Uniform Guidance.

Note 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
FOR THE FISCAL YEAR ENDED JUNE 30, 2016

SECTION I - SUMMARY OF AUDITORS' RESULTS

Financial Statements

Type of auditors' report issued: Unmodified Opinion

Internal control over financial reporting:

• Significant deficiencies identified?	__X__ yes	_____ no
• Material weaknesses identified?	_____ yes	__X__ none reported
Noncompliance material to financial statements noted?	_____ yes	__X__ no

Federal Awards

Internal control over major programs:

• Significant deficiencies identified?	_____ yes	__X__ no
• Material weaknesses identified?	_____ yes	__X__ none reported

Type of auditors' report issued on compliance for major programs: Unmodified Opinion

Any audit findings disclosed that are required to be reported in accordance with the Uniform Guidance?	_____ yes	__X__ no

Identification of major programs:

CFDA Number(s)	Name of Federal Program or Cluster
93.525	State Planning and Establishment Grants for the Affordable Care Act (ACA)'s Exchanges

Dollar threshold used to distinguish between type A and type B program: $3,000,000

Auditee qualified as low-risk auditee?	_____ yes	__X__ no

SECTION II - FINANCIAL STATEMENT FINDINGS

Financial Reference Number: 2016-001

As a result of our audit procedures, a net position restatement relating to grant-funded revenue was discovered in the amount of $22,186,084. During the entity's start-up phase, grant funds were provided to Covered California to be spent on eligible expenses, such as payroll costs. Any unspent funds were either to be remitted back to the federal granting agency or to be spent on future eligible costs. However, as unspent funds were subsequently exhausted the related grant revenue was not properly adjusted, resulting in a restatement.

Covered California's View and Corrective Action

Covered California continues to implement corrective actions to better identify needed entries to convert the Budgetary/Legal modified accrual basis financial statements to GAAP full accrual financial statements. Additionally, Covered California is implementing the new Financial Information System for California (FI$Cal) accounting system, which will strengthen general ledger reconciliations.

Financial Reference Number: 2016-002

As a result of our audit procedures, we noted Covered California has not established a well-defined process over financial reporting as it relates to reporting balances in accordance with generally accepted accounting principles (GAAP). We identified through the initial final draft of the trial balance that there was difficulty in completing a finalized trial balance in a timely fashion due to correcting adjustments included in the Budgetary Legal basis-to-GAAP conversion process.

Recommendation

We recommend Covered California perform a detailed review of adjustments recorded to report balances in accordance with GAAP prior to the beginning of the audit.

Covered California's View and Corrective Action

Covered California continues to implement corrective actions to better identify needed entries to convert the Budgetary/Legal modified accrual basis financial statements to GAAP full accrual financial statements. Covered California has obtained additional accounting staff that are solely dedicated to assisting in preparation of the GAAP financial statements.

Financial Reference Number: 2016-003

As a result of our audit procedures, various capitalized payroll costs were identified that lacked proper substantiation. While Covered California made all supporting information available, the support and rationale given for the reason and amount being capitalized was difficult to substantiate due to lack of time cards being kept.

Recommendation

We recommend Covered California perform a thorough review of all capitalized assets to ensure all items have proper supporting documentation and support a proper business rationale, as well as track payroll costs relating to improvements to the CalHEERS system separately.

Covered California's View and Corrective Action

Covered California will work to strengthen and substantiate supporting documentation to adequately support the capitalized project payroll costs, including exploring functionality available via the new FI$Cal accounting system.

Financial Reference Number: 2016-004

As a result of our audit procedures, we noted Covered California did not have a comprehensive capital assets schedule with each asset's identifying information readily available. As a result, Covered California may not be able to prevent and detect whether assets are being depreciated past their useful life, creating a negative book value.

Recommendation

We recommend a comprehensive listing be maintained and updated annually by Covered California to properly track all components of capital assets.

Covered California's View and Corrective Action

In preparation for conversion to the new FI$Cal accounting system, Covered California reconciled asset records including depreciation schedules to the comprehensive capital assets schedule. The comprehensive listing that was compiled revealed there were no negative book values.

SECTION III - FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

No matters were reported.

CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)

SCHEDULE OF PRIOR YEAR FINDINGS AND QUESTIONED COSTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2015

SECTION I - FINANCIAL STATEMENT FINDINGS

Financial Reference Number: 2015-001

During the audit for fiscal year 2013-14, it was reported that Covered California lacked adequate controls to ensure its financial statements were accurate and complete. In fiscal year 2014-15, it was found that Covered California continued to lack adequate controls to ensure its financial statements were fairly presented in accordance with generally accepted accounting principles (GAAP). During the audit, it was found that Covered California does not have adequate controls in place to review the top-side journal entries made to report amounts in accordance with generally accepted accounting principles. The following errors were identified in the financial statements which were corrected by Covered California.

Revenue:

1. At June 30, 2015, Covered California did not properly update its financial statement amounts to reduce per-member, per-month (PMPM) revenue for actual members effectuated, resulting in an overstatement of accounts receivable and revenues by approximately $2.2 million.

2. Covered California erroneously reduced Federal Grant Receivable and Revenue by $6.9 million in compiling top-side journal entries for GAAP purposes, and therefore, the ending grant receivable balance did not agree to actual amounts owed by the Federal Government.

3. Covered California erroneously double-booked a receivable from the Federal Government to reflect additional expenditures incurred at year-end, resulting in an overstatement of Federal Grant Revenue and Receivable of approximately $1.0 million.

4. Covered California erroneously reversed prior year top-side accrual entries in the current year for Accounts Receivable and Accounts Payable, resulting in an understatement of $1.4 million in each of these balance sheet accounts, and the related revenue and expense.

Capital Assets:

1. Covered California had a formula error in the spreadsheet used to calculate annual depreciation on intangible assets, resulting in an understatement of accumulated depreciation and depreciation expense of approximately $3.0 million.

2. Covered California had approximately $2.3 million of capital asset improvements that were expensed and not capitalized during the year, resulting in an understatement of capital assets and an overstatement of operating expenses.

Other State Agencies:

1. Covered California did not properly update its financial statements to reflect amounts billed for revenue from the Department of Healthcare Services (DHCS) and understated its receivables and revenues by approximately $2.1 million.

2. Invoices from other State Agencies related to prior periods in the amount of $1.2 million were not received by Covered California until late in fiscal year 2014-15. Covered California recognized this $1.2 million in the current year that should have been reported in the prior period.

Recommendations

Covered California should develop policies to ensure the financial statements are accurately presented in accordance with generally accepted accounting principles. Specifically, Covered California should:

- Perform periodic reconciliations to the general ledger for amounts billed for PMPM revenue.
- Perform a detailed review of all top-side entries and related support to ensure the accuracy of these entries.
- Review spreadsheets used in making calculations to ensure all data points are properly captured.
- Evaluate operating expenses to ensure they do not meet the criteria for capitalization.
- Evaluate invoices with DHCS to ensure the revenue and receivable balances are accurately reported.
- Continue working with other State Agencies to ensure invoices are received timely in order to reflect the activity with the proper period.

Covered California's View and Corrective Action Plan

Covered California immediately implemented corrective actions for identified top-side journal entries. Covered California is performing reconciliations to the general ledger for its revenue accounts, continues to review GAAP entries for accuracy including calculations. Covered California has also engaged in dialog with other state agencies to obtain timely invoices.

Implementation Date

Continuous implementation.

Status of Prior Period Finding

This finding is considered to be resolved.

SECTION II - FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

Reference Number:	2015-002
Awarding Agency:	U.S. Department of Health and Human Services
Program Name:	State Planning and Establishment Grants for the Affordable Care Act (ACA)'s Exchange
CFDA No.	93.525
Federal Award Year:	2014-15
Federal Award Number:	HBEIE130148-01-09
Category of Finding:	Activities Allowed or Unallowed/Allowable Costs/Cost Principles
Type of Finding:	Significant Deficiency and Instance of Noncompliance

Criteria

2 CFR Part 225, Cost Principles for State, Local, and Indian Tribal Governments (OMB Circular A-87), Appendix B to Part 225 – Selected Items of Cost

16. Fines and penalties. Fines, penalties, damages, and other settlements resulting from violations (or alleged violations) of, or failure of the governmental unit to comply with, Federal, State, local, or Indian tribal laws and regulations are unallowable except when incurred as a result of compliance with specific provisions of the Federal award or written instructions by the awarding agency authorizing in advance such payments.

U.S. GOVERNMENT OFFICE OF MANAGEMENT AND BUDGET CIRCULAR A-133 – AUDITS OF STATES, LOCAL GOVERNMENTS, AND NON-PROFIT ORGANIZATIONS (OMB Circular A-133), Subpart C – Auditees, Section 300 – Auditee Responsibilities. (b) The auditee shall maintain internal control over federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements related to each of its federal programs.

Condition

In testing expenses for allowable costs/cost principles, it was noted that grant funds were used to pay a legal settlement to a former employee. The settlement costs were paid in lieu of incurring litigation proceeding costs, and Covered California used grant funds to pay this expenditure. Such settlement costs are not allowable under OMB Circular A-87, and Covered California lacked adequate expenditure review controls to identify this before they claimed them as Federal expenditures. As a result, Covered California has incurred unallowable costs under the terms of the grant agreement.

Questioned Costs

$55,000

Recommendation

Covered California should reimburse the disallowed costs to the Federal Government. In addition, Covered California should use its sustainability funds to cover future such expenses.

Covered California's View and Corrective Action Plan

We concur with this finding. The Financial Management Division (FMD) reviewed expenditures through FY 15-16 to ensure no costs resulting from violations of, alleged violations of, or failure to comply with, Federal, state, tribal, local or foreign laws and regulations were charged to the Federal grant. For the specific questioned cost, the expenditure was corrected and charged against sustainability funds.

Covered California concurs that a transaction for a single payment in the amount of $55,000 was posted to the incorrect fund. Covered California disagrees that an error for a single payment is indicative of a lack of adequate expenditure review controls.

Implementation Date

Implementation began on July 26, 2015 and is complete.

Auditor's Conclusion

The identification of questioned costs when performing audit procedures indicates that expenditure review controls need to be improved.

Status of Prior Period Finding

This finding is considered to be resolved.

Reference Number:	2015-003
Awarding Agency:	U.S. Department of Health and Human Services
Program Name:	State Planning and Establishment Grants for the Affordable Care Act (ACA)'s Exchanges
CFDA No.:	93.525
Federal Award Year:	2014-15
Federal Award Number:	HBEIE130148-01-09
Category of Finding:	Activities Allowed or Unallowed/Allowable Costs/Cost Principles
Type of Finding:	Significant Deficiency and Instance of Noncompliance

Criteria

U.S. OFFICE OF MANAGEMENT AND BUDGET CIRCULAR A-133 – AUDITS OF STATES, LOCAL GOVERNMENTS, AND NON-PROFIT ORGANIZATIONS (OMB Circular A-133), Subpart C – Auditees, Section 300 – Auditee Responsibilities. (b) The auditee shall maintain internal control over federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements related to each of its federal programs.

Section 1311. AFFORDABLE CHOICES OF HEALTH BENEFIT PLANS

(5) Funding Limitations

(A) NO FEDERAL FUNDS FOR CONTINUED OPERATIONS. – In establishing an Exchange under this section, the State shall ensure that such Exchange is self-sustaining beginning on January 1, 2015, including allowing the Exchange to charge assessments or user fees to participating health insurance issuers, or to otherwise generate funding, to support its operations.

OMB Circular A-87 Revised Cost Principles for State, Local, and Indian Tribal Governments, Section C. Basic Guidelines:

1. Factors affecting allowability of costs. To be allowable under Federal awards, costs must meet the following general criteria:

   a. Be necessary and reasonable for proper and efficient performance and administration of Federal awards.

   b. Be allocable to Federal awards under the provisions of this Circular.

Condition

During fiscal year 2014-15, Covered California claimed certain expenditures that were not allowable under the provisions of Section 1311 of the Affordable Care Act and OMB Circular A-87. Beginning January 1, 2015, Covered California was required to comply with Section 1311 (5)(A) of the Affordable Care Act which provides for the use of sustainability funds to cover ongoing operating expenditures. Covered California did not have adequate expenditure review controls in place to identify these expenditures prior to claiming them with the Federal Government. Based on discussions with Covered California management and audit testing performed, Covered California identified approximately $9.7 million of grant expenditures incurred subsequent to January 1, 2015 and claimed thereafter that were identified as unallowable costs as they related to ongoing operations. Covered California management identified the unallowable costs based on the Frequently Asked Questions guidance issued by the Centers for Medicare & Medicaid (CMS) in June 2015, and has indicated that the Federal Government was reimbursed for such costs through a reduction of draws submitted subsequent to its 2014-15 fiscal year end. In addition, Covered California identified approximately $2.4 million of other expenditures that should have been funded with sustainability funds instead of grant funds.

Questioned Costs

$12,164,509

Recommendation

Covered California should strengthen its existing monitoring controls surrounding charges in allowability requirements to ensure that all expenditures claimed under the grant meet grant requirements.

Covered California's View and Corrective Action Plan

Covered California disagrees with this finding. The Condition statement above does not provide sufficient timing detail regarding the advice received on allowable costs from CMS on June 8, 2015 that was retroactive to January 1, 2015; therefore, the suggested recommendation of strengthening monitoring controls would not have avoided the adjustments noted above. At the time that the expenditures occurred, the costs were allowable and Covered California was in compliance with Section 1311 (5) (A). However, on June 8, 2015, three weeks before the end of the state fiscal year, and six months after the beginning of the self-sustainability period cited in Section 1311 (5) (A), CMS released, "FAQs on the Clarification of the Use of 1311 funds for Establishment Activities," which described allowable uses of 1311 funds after January 1, 2015 for establishment activities that were specifically described in the grantee's approved work plan. Based on this new information, Covered California reviewed expenditures and made timely adjustments. All expenditure adjustments were completed before the end of the 2014-15 state fiscal year and no corrective action is necessary.

Further, the CMS confirmed that the June 8, 2015 FAQs were issued as additional guidance to assist States on continuing ACA activities. Due to the timing of the FAQs, CMS expected that State based marketplaces would require some accounting adjustments consistent with the additional guidance. Covered California's expenditure adjustments and subsequent offsets to grant draws was a reasonable and appropriate effort to mitigate the impact of the June 8, 2015 guidance.

Covered California was proactive and had appropriate expenditure reviews in place prior to claiming Federal expenditures. Covered California could not have predicted that CMS would provide additional guidance six months after the sustainability period began. At the time that the expenditures occurred, the costs were allowable and Covered California was in compliance with Section 1311 (5) (A).

Implementation Date

Review of the FAQs began in June 2015 and expenditure corrections were completed. No further action is necessary.

Auditor's Conclusion

The additional guidance provided by CMS in its publication of the Frequently Asked Questions further clarified the types of expenditures that were no longer allowable under the grant as of January 1, 2015. As the Affordable Care Act included a requirement to use sustainability funds to cover ongoing operating expenditures, we concluded that the questioned costs above were not allowable during the reporting period from January 1, 2015 to June 30, 2015.

Status of Prior Period Finding

This finding is considered to be resolved.

CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)

SINGLE AUDIT REPORT

JUNE 30, 2016

CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)

SINGLE AUDIT REPORT

JUNE 30, 2016

CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)

JUNE 30, 2016

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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*

To the Board of Directors
California Health Benefit Exchange
Sacramento, California

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), as of and for the year ended June 30, 2016, and the related notes to the financial statements, which collectively comprise Covered California's basic financial statements and have issued our report thereon dated February 14, 2018.

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 opinions 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.

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 entity's financial statements will not be prevented or detected and corrected on a timely basis. 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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section 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. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify certain deficiencies in internal control, described in the accompanying schedule of findings and questioned costs that we consider to be significant deficiencies. Refer to findings 2016-001 through 2016-004.

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CPAs AND ADVISORS

To the Board of Directors of the
California Health Benefit Exchange
Sacramento, California

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

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.

Lance, Soll & Lunghard, LLP

Brea, California
February 14, 2018

LSL
CPAs AND ADVISORS

INDEPENDENT AUDITORS' REPORT ON COMPLIANCE FOR EACH MAJOR PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE; AND REPORT ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS REQUIRED BY THE UNIFORM GUIDANCE

To the Board of Directors
California Health Benefit Exchange
Sacramento, California

Report on Compliance for Each Major Federal Program

We have audited the California Health Benefit Exchange (Covered California)'s compliance with the types of compliance requirements described in the *OMB Compliance Supplement* that could have a direct and material effect on each of Covered California's major federal programs for the year ended June 30, 2016. Covered California's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with federal statutes, regulations, and the terms and conditions of its federal awards applicable to its federal programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of Covered California's major federal programs 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 the audit requirements of Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Those standards and the Uniform Guidance 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 each major federal program. However, our audit does not provide a legal determination of Covered California's compliance.

Opinion on Each 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 each of its major federal programs for the year ended June 30, 2016.

203 N. Brea Blvd., Suite 203 | Brea, CA 92821 | Phone: 714.672.0022

To the Board of Directors
California Health Benefit Exchange
Sacramento, California

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 the Uniform Guidance, 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. 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 the Uniform Guidance. Accordingly, this report is not suitable for any other purpose.

Report on Schedule of Expenditures of Federal Awards Required by the Uniform Guidance

We have audited the financial statements of Covered California, as of and for the year ended June 30, 2016, and the related notes to the financial statements, which collectively comprise Covered California's basic financial statements. We issued our report thereon dated February 14, 2018, which contained unmodified opinions on those financial statements. Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the basic financial statements. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by the Uniform Guidance and is not a required part of the basic financial statements.

To the Board of Directors
California Health Benefit Exchange
Sacramento, California

Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. The 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 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.

Lance, Soll & Lunghard, LLP

Brea, California
February 14, 2018

CALIFORNIA HEALTH BENEFIT EXCHANGE
(COVERED CALIFORNIA)

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE FISCAL YEAR ENDED JUNE 30, 2016

Federal Grantor/Program Title	Federal CFDA Number	Pass-Through Grantor's Number	Expenditures	Passed Through to Subrecipients
U.S. Department of Health and Human Services				
Direct Programs:				
State Planning and Establishment Grants for the Affordable Care Act (ACA)'s Exchanges	93.525	N/A	$ 156,715,506	$ -
Total U.S. Department of Health and Human Services			**156,715,506**	**-**
Total Federal Expenditures			**$ 156,715,506**	**$ -**

Note a: Refer to Note 1 to the schedule of expenditures of federal awards for a description of significant accounting policies used in preparing this schedule.

Note b: There were no federal awards expended in the form of noncash assistance and insurance in effect during the year.

The accompanying notes are an integral part of this schedule.

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS FOR THE YEAR ENDED JUNE 30, 2016

Note 1: Summary of Significant Accounting Policies Applicable to the Schedule of Expenditures of Federal Awards

a. Scope of Presentation

The accompanying schedule presents only the expenditures incurred by California Health Benefit Exchange (Covered California), that are reimbursable under federal programs of federal financial assistance. For the purposes of this schedule, federal awards include both federal financial assistance received directly from a federal agency, as well as federal funds received indirectly by Covered California from a non-federal agency or other organization. Only the portion of program expenditures reimbursable with such federal funds is reported in the accompanying schedule. Program expenditures in excess of the maximum federal reimbursement authorized or the portion of the program expenditures that were funded with state, local or other non-federal funds are excluded from the accompanying schedule.

b. Basis of Accounting

The expenditures included in the accompanying schedule were reported on the accrual basis of accounting. Covered California has elected not to use the ten percent *de minimis* indirect cost rate allowed under the Uniform Guidance.

c. Indirect Cost Rate

Covered California has elected not to use the ten percent *de minimis* indirect cost rate allowed under the Uniform Guidance.

Note 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
FOR THE FISCAL YEAR ENDED JUNE 30, 2016

SECTION I - SUMMARY OF AUDITORS' RESULTS

Financial Statements

Type of auditors' report issued: Unmodified Opinion

Internal control over financial reporting:

• Significant deficiencies identified?	__X__ yes	_____ no
• Material weaknesses identified?	____ yes	__X__ none reported
Noncompliance material to financial statements noted?	____ yes	__X__ no

Federal Awards

Internal control over major programs:

• Significant deficiencies identified?	____ yes	__X__ no
• Material weaknesses identified?	____ yes	__X__ none reported

Type of auditors' report issued on compliance for major programs: Unmodified Opinion

Any audit findings disclosed that are required to be reported in accordance with the Uniform Guidance?	____ yes	__X__ no

Identification of major programs:

CFDA Number(s)	Name of Federal Program or Cluster
93.525	State Planning and Establishment Grants for the Affordable Care Act (ACA)'s Exchanges

Dollar threshold used to distinguish between type A and type B program $3,000,000

Auditee qualified as low-risk auditee?	_____ yes	__X__ no

SECTION II - FINANCIAL STATEMENT FINDINGS

Financial Reference Number: 2016-001

As a result of our audit procedures, a net position restatement relating to grant-funded revenue was discovered in the amount of $22,186,084. During the entity's start-up phase, grant funds were provided to Covered California to be spent on eligible expenses, such as payroll costs. Any unspent funds were either to be remitted back to the federal granting agency or to be spent on future eligible costs. However, as unspent funds were subsequently exhausted the related grant revenue was not properly adjusted, resulting in a restatement.

Covered California's View and Corrective Action

Covered California continues to implement corrective actions to better identify needed entries to convert the Budgetary/Legal modified accrual basis financial statements to GAAP full accrual financial statements. Additionally, Covered California is implementing the new Financial Information System for California (FI$Cal) accounting system, which will strengthen general ledger reconciliations.

Financial Reference Number: 2016-002

As a result of our audit procedures, we noted Covered California has not established a well-defined process over financial reporting as it relates to reporting balances in accordance with generally accepted accounting principles (GAAP). We identified through the initial final draft of the trial balance that there was difficulty in completing a finalized trial balance in a timely fashion due to correcting adjustments included in the Budgetary Legal basis-to-GAAP conversion process.

Recommendation

We recommend Covered California perform a detailed review of adjustments recorded to report balances in accordance with GAAP prior to the beginning of the audit.

Covered California's View and Corrective Action

Covered California continues to implement corrective actions to better identify needed entries to convert the Budgetary/Legal modified accrual basis financial statements to GAAP full accrual financial statements. Covered California has obtained additional accounting staff that are solely dedicated to assisting in preparation of the GAAP financial statements.

Financial Reference Number: 2016-003

As a result of our audit procedures, various capitalized payroll costs were identified that lacked proper substantiation. While Covered California made all supporting information available, the support and rationale given for the reason and amount being capitalized was difficult to substantiate due to lack of time cards being kept.

Recommendation

We recommend Covered California perform a thorough review of all capitalized assets to ensure all items have proper supporting documentation and support a proper business rationale, as well as track payroll costs relating to improvements to the CalHEERS system separately.

Covered California's View and Corrective Action

Covered California will work to strengthen and substantiate supporting documentation to adequately support the capitalized project payroll costs, including exploring functionality available via the new FI$Cal accounting system.

Financial Reference Number: 2016-004

As a result of our audit procedures, we noted Covered California did not have a comprehensive capital assets schedule with each asset's identifying information readily available. As a result, Covered California may not be able to prevent and detect whether assets are being depreciated past their useful life, creating a negative book value.

Recommendation

We recommend a comprehensive listing be maintained and updated annually by Covered California to properly track all components of capital assets.

Covered California's View and Corrective Action

In preparation for conversion to the new FI$Cal accounting system, Covered California reconciled asset records including depreciation schedules to the comprehensive capital assets schedule. The comprehensive listing that was compiled revealed there were no negative book values.

SECTION III - FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

No matters were reported.

SCHEDULE OF PRIOR YEAR FINDINGS AND QUESTIONED COSTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2015

SECTION I - FINANCIAL STATEMENT FINDINGS

Financial Reference Number: 2015-001

During the audit for fiscal year 2013-14, it was reported that Covered California lacked adequate controls to ensure its financial statements were accurate and complete. In fiscal year 2014-15, it was found that Covered California continued to lack adequate controls to ensure its financial statements were fairly presented in accordance with generally accepted accounting principles (GAAP). During the audit, it was found that Covered California does not have adequate controls in place to review the top-side journal entries made to report amounts in accordance with generally accepted accounting principles. The following errors were identified in the financial statements which were corrected by Covered California.

Revenue:

1. At June 30, 2015, Covered California did not properly update its financial statement amounts to reduce per-member, per-month (PMPM) revenue for actual members effectuated, resulting in an overstatement of accounts receivable and revenues by approximately $2.2 million.

2. Covered California erroneously reduced Federal Grant Receivable and Revenue by $6.9 million in compiling top-side journal entries for GAAP purposes, and therefore, the ending grant receivable balance did not agree to actual amounts owed by the Federal Government.

3. Covered California erroneously double-booked a receivable from the Federal Government to reflect additional expenditures incurred at year-end, resulting in an overstatement of Federal Grant Revenue and Receivable of approximately $1.0 million.

4. Covered California erroneously reversed prior year top-side accrual entries in the current year for Accounts Receivable and Accounts Payable, resulting in an understatement of $1.4 million in each of these balance sheet accounts, and the related revenue and expense.

Capital Assets:

1. Covered California had a formula error in the spreadsheet used to calculate annual depreciation on intangible assets, resulting in an understatement of accumulated depreciation and depreciation expense of approximately $3.0 million.

2. Covered California had approximately $2.3 million of capital asset improvements that were expensed and not capitalized during the year, resulting in an understatement of capital assets and an overstatement of operating expenses.

Other State Agencies:

1. Covered California did not properly update its financial statements to reflect amounts billed for revenue from the Department of Healthcare Services (DHCS) and understated its receivables and revenues by approximately $2.1 million.

2. Invoices from other State Agencies related to prior periods in the amount of $1.2 million were not received by Covered California until late in fiscal year 2014-15. Covered California recognized this $1.2 million in the current year that should have been reported in the prior period.

Recommendations

Covered California should develop policies to ensure the financial statements are accurately presented in accordance with generally accepted accounting principles. Specifically, Covered California should:

- Perform periodic reconciliations to the general ledger for amounts billed for PMPM revenue.
- Perform a detailed review of all top-side entries and related support to ensure the accuracy of these entries.
- Review spreadsheets used in making calculations to ensure all data points are properly captured.
- Evaluate operating expenses to ensure they do not meet the criteria for capitalization.
- Evaluate invoices with DHCS to ensure the revenue and receivable balances are accurately reported.
- Continue working with other State Agencies to ensure invoices are received timely in order to reflect the activity with the proper period.

Covered California's View and Corrective Action Plan

Covered California immediately implemented corrective actions for identified top-side journal entries. Covered California is performing reconciliations to the general ledger for its revenue accounts, continues to review GAAP entries for accuracy including calculations. Covered California has also engaged in dialog with other state agencies to obtain timely invoices.

Implementation Date

Continuous implementation.

Status of Prior Period Finding

This finding is considered to be resolved.

SECTION II - FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

Reference Number:	2015-002
Awarding Agency:	U.S. Department of Health and Human Services
Program Name:	State Planning and Establishment Grants for the Affordable Care Act (ACA)'s Exchange
CFDA No.	93.525
Federal Award Year:	2014-15
Federal Award Number:	HBEIE130148-01-09
Category of Finding:	Activities Allowed or Unallowed/Allowable Costs/Cost Principles
Type of Finding:	Significant Deficiency and Instance of Noncompliance

Criteria

2 CFR Part 225, Cost Principles for State, Local, and Indian Tribal Governments (OMB Circular A-87), Appendix B to Part 225 – Selected Items of Cost

16. Fines and penalties. Fines, penalties, damages, and other settlements resulting from violations (or alleged violations) of, or failure of the governmental unit to comply with, Federal, State, local, or Indian tribal laws and regulations are unallowable except when incurred as a result of compliance with specific provisions of the Federal award or written instructions by the awarding agency authorizing in advance such payments.

U.S. GOVERNMENT OFFICE OF MANAGEMENT AND BUDGET CIRCULAR A-133 – AUDITS OF STATES, LOCAL GOVERNMENTS, AND NON-PROFIT ORGANIZATIONS (OMB Circular A-133), Subpart C – Auditees, Section 300 – Auditee Responsibilities. (b) The auditee shall maintain internal control over federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements related to each of its federal programs.

Condition

In testing expenses for allowable costs/cost principles, it was noted that grant funds were used to pay a legal settlement to a former employee. The settlement costs were paid in lieu of incurring litigation proceeding costs, and Covered California used grant funds to pay this expenditure. Such settlement costs are not allowable under OMB Circular A-87, and Covered California lacked adequate expenditure review controls to identify this before they claimed them as Federal expenditures. As a result, Covered California has incurred unallowable costs under the terms of the grant agreement.

Questioned Costs

$55,000

Recommendation

Covered California should reimburse the disallowed costs to the Federal Government. In addition, Covered California should use its sustainability funds to cover future such expenses.

Covered California's View and Corrective Action Plan

We concur with this finding. The Financial Management Division (FMD) reviewed expenditures through FY 15-16 to ensure no costs resulting from violations of, alleged violations of, or failure to comply with, Federal, state, tribal, local or foreign laws and regulations were charged to the Federal grant. For the specific questioned cost, the expenditure was corrected and charged against sustainability funds.

Covered California concurs that a transaction for a single payment in the amount of $55,000 was posted to the incorrect fund. Covered California disagrees that an error for a single payment is indicative of a lack of adequate expenditure review controls.

Implementation Date

Implementation began on July 26, 2015 and is complete.

Auditor's Conclusion

The identification of questioned costs when performing audit procedures indicates that expenditure review controls need to be improved.

Status of Prior Period Finding

This finding is considered to be resolved.

Reference Number:	2015-003
Awarding Agency:	U.S. Department of Health and Human Services
Program Name:	State Planning and Establishment Grants for the Affordable Care Act (ACA)'s Exchanges
CFDA No.:	93.525
Federal Award Year:	2014-15
Federal Award Number:	HBEIE130148-01-09
Category of Finding:	Activities Allowed or Unallowed/Allowable Costs/Cost Principles
Type of Finding:	Significant Deficiency and Instance of Noncompliance

Criteria

U.S. OFFICE OF MANAGEMENT AND BUDGET CIRCULAR A-133 – AUDITS OF STATES, LOCAL GOVERNMENTS, AND NON-PROFIT ORGANIZATIONS (OMB Circular A-133), Subpart C – Auditees, Section 300 – Auditee Responsibilities. (b) The auditee shall maintain internal control over federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements related to each of its federal programs.

Section 1311. AFFORDABLE CHOICES OF HEALTH BENEFIT PLANS

(5) Funding Limitations

(A) NO FEDERAL FUNDS FOR CONTINUED OPERATIONS. – In establishing an Exchange under this section, the State shall ensure that such Exchange is self-sustaining beginning on January 1, 2015, including allowing the Exchange to charge assessments or user fees to participating health insurance issuers, or to otherwise generate funding, to support its operations.

OMB Circular A-87 Revised Cost Principles for State, Local, and Indian Tribal Governments, Section C. Basic Guidelines:

1. Factors affecting allowability of costs. To be allowable under Federal awards, costs must meet the following general criteria:

   a. Be necessary and reasonable for proper and efficient performance and administration of Federal awards.

   b. Be allocable to Federal awards under the provisions of this Circular.

Condition

During fiscal year 2014-15, Covered California claimed certain expenditures that were not allowable under the provisions of Section 1311 of the Affordable Care Act and OMB Circular A-87. Beginning January 1, 2015, Covered California was required to comply with Section 1311 (5)(A) of the Affordable Care Act which provides for the use of sustainability funds to cover ongoing operating expenditures. Covered California did not have adequate expenditure review controls in place to identify these expenditures prior to claiming them with the Federal Government. Based on discussions with Covered California management and audit testing performed, Covered California identified approximately $9.7 million of grant expenditures incurred subsequent to January 1, 2015 and claimed thereafter that were identified as unallowable costs as they related to ongoing operations. Covered California management identified the unallowable costs based on the Frequently Asked Questions guidance issued by the Centers for Medicare & Medicaid (CMS) in June 2015, and has indicated that the Federal Government was reimbursed for such costs through a reduction of draws submitted subsequent to its 2014-15 fiscal year end. In addition, Covered California identified approximately $2.4 million of other expenditures that should have been funded with sustainability funds instead of grant funds.

Questioned Costs

$12,164,509

Recommendation

Covered California should strengthen its existing monitoring controls surrounding charges in allowability requirements to ensure that all expenditures claimed under the grant meet grant requirements.

Covered California's View and Corrective Action Plan

Covered California disagrees with this finding. The Condition statement above does not provide sufficient timing detail regarding the advice received on allowable costs from CMS on June 8, 2015 that was retroactive to January 1, 2015; therefore, the suggested recommendation of strengthening monitoring controls would not have avoided the adjustments noted above. At the time that the expenditures occurred, the costs were allowable and Covered California was in compliance with Section 1311 (5) (A). However, on June 8, 2015, three weeks before the end of the state fiscal year, and six months after the beginning of the self-sustainability period cited in Section 1311 (5) (A), CMS released, "FAQs on the Clarification of the Use of 1311 funds for Establishment Activities," which described allowable uses of 1311 funds after January 1, 2015 for establishment activities that were specifically described in the grantee's approved work plan. Based on this new information, Covered California reviewed expenditures and made timely adjustments. All expenditure adjustments were completed before the end of the 2014-15 state fiscal year and no corrective action is necessary.

Further, the CMS confirmed that the June 8, 2015 FAQs were issued as additional guidance to assist States on continuing ACA activities. Due to the timing of the FAQs, CMS expected that State based marketplaces would require some accounting adjustments consistent with the additional guidance. Covered California's expenditure adjustments and subsequent offsets to grant draws was a reasonable and appropriate effort to mitigate the impact of the June 8, 2015 guidance.

Covered California was proactive and had appropriate expenditure reviews in place prior to claiming Federal expenditures. Covered California could not have predicted that CMS would provide additional guidance six months after the sustainability period began. At the time that the expenditures occurred, the costs were allowable and Covered California was in compliance with Section 1311 (5) (A).

Implementation Date

Review of the FAQs began in June 2015 and expenditure corrections were completed. No further action is necessary.

Auditor's Conclusion

The additional guidance provided by CMS in its publication of the Frequently Asked Questions further clarified the types of expenditures that were no longer allowable under the grant as of January 1, 2015. As the Affordable Care Act included a requirement to use sustainability funds to cover ongoing operating expenditures, we concluded that the questioned costs above were not allowable during the reporting period from January 1, 2015 to June 30, 2015.

Status of Prior Period Finding

This finding is considered to be resolved.