



**CITY AND COUNTY OF SAN FRANCISCO
HEALTH SERVICE SYSTEM**

Financial Statements

June 30, 2008 and 2007

(With Independent Auditors' Report Thereon)

**CITY AND COUNTY OF SAN FRANCISCO
HEALTH SERVICE SYSTEM**

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KPMG LLP
55 Second Street
San Francisco, CA 94105

Independent Auditors' Report

The Honorable Mayor and Board of Supervisors
City and County of San Francisco:

We have audited the accompanying financial statements of the City and County of San Francisco Health Service System (the System), a department of the City and County of San Francisco, California (the City and County), as of and for the years ended June 30, 2008 and 2007, as listed in the table of contents. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits 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 of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in note 1, the financial statements of the System are intended to present the financial position, and the changes in the financial position of only that portion of the City and County that is attributable to the transactions of the System. They do not purport to, and do not, present fairly the financial positions of the City and County as of June 30, 2008 and 2007, the changes in its financial position, or, where applicable, its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for health benefits of the System as of June 30, 2008 and 2007, and its changes in net assets available for health benefits for the years then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued a report dated October 29, 2008, on our consideration of the System's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, grants, 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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 3 through 10 is not a required part of the basic financial statements, but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

October 29, 2008

**CITY AND COUNTY OF SAN FRANCISCO
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Management's Discussion and Analysis

June 30, 2008 and 2007

The management of the City and County of San Francisco Health Service System (the System) is pleased to provide this overview and analysis of the financial performance as of and for the fiscal years ended June 30, 2008 and 2007. We encourage readers to consider the information presented below in conjunction with the financial statements and notes, which follow.

The System is a department of the City and County that is reflected as an Other Employee Benefit Trust Fund in the City and County's Comprehensive Annual Financial Report. The System became an independent department of the City and County on July 1, 2005, and is the primary purchaser and administrator of health, dental and other non-retirement benefits for employees and retirees (and their respective eligible dependents) of the City and County of San Francisco, the San Francisco Unified School District, the San Francisco Community College District and the San Francisco Superior Court. Since July 1, 2005, the System is governed by the Health Service Board as described in note 1. Prior to July 1, 2005, governance of the System was divided between the Health Service Board and the Department of Human Resources as described in note 1.

Medical benefits during the fiscal years are provided to members of Health Service System through four plan choices:

- City Health Plan (Preferred Provider Organization (PPO))
- PacifiCare Plan (Health Maintenance Organization (Flex-funded HMO))
- Kaiser Foundation Health Plan (Kaiser) (Fully insured HMO)
- Blue Shield (Fully insured HMO)

The PacifiCare HMO replaced the Health Net HMO starting July 1, 2007.

Each of the above plan choices includes a vision benefit provided through Vision Service Plan (VSP). The City Health Plan, which includes medical and prescription drug benefits, is a self-insured indemnity plan, where the risk of loss due to claims in excess of revenues is borne by the Health Service System Trust Fund. The City Health Plan is administered by United HealthCare (UHC). The Kaiser and Blue Shield HMO plans are traditional fully insured external health maintenance organizations, where the risk of loss due to excess claims for a given fiscal year is borne by the health maintenance organization carriers. The PacifiCare HMO plan has a somewhat different funding arrangement which is referred to as "flex-funded". Under this flex-funding arrangement, the health maintenance organization and the Health Service System Trust Fund share some risk on non capitated expenses. Target premiums are paid to PacifiCare monthly in advance (as with other HMO plans) with a subsequent retrospective reconciliation of actual expenses against target premiums. To the extent actual expenses fall below the target premiums, the System will be reimbursed the full difference. If actual expenses exceed the target premiums, the System will pay the additional expense, limited to 120% of the target premiums.

Dental benefits during the fiscal years are provided through three plan choices:

- Delta Dental
- Delta Care (PMI)
- Pacific Union

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The Delta Dental plan provided to active employees is a self-insured indemnity plan, administered by Delta Dental. Unlike the City Health Plan, however, the risk of loss due to claims in excess of revenues is borne by the City and County of San Francisco and any other participating employers. The Delta Dental plan offered to retired employees is a fully insured plan, where the risk of loss for a given fiscal year is borne by Delta Dental. The Delta Care (PMI) and Pacific Union dental plans are managed care dental plans, and are fully-insured with respect to both active and retired employees.

Overview of Financial Statements

The following discussion is intended to serve as an introduction to the System's financial statements, which consist of the statements of net assets available for health benefits, the statements of changes in net assets available for health benefits, and notes to financial statements.

- The statements of net assets available for health benefits are a snapshot of account balances as of June 30, 2008 and 2007. They show assets, liabilities, and net assets available for health benefits as of those dates.
- The statements of changes in net assets available for health benefits show additions and deductions to the System's net assets during the plan years ended June 30, 2008 and 2007.
- Notes to financial statements provide additional information that is essential to a full understanding of the numbers in the financial statements.

The financial statements and accompanying notes are presented in all material respects in accordance with the basis of accounting and accounting principles, as explained in note 2. The System presents financial statements reflecting full accrual basis accounting.

Financial Analysis – Condensed Schedule of Net Assets Available for Health Benefits

As of June 30, 2008, there were \$23.6 million of net assets available to meet future health care obligations. This compares to \$43.9 million as of June 30, 2007 and \$42.5 million as of June 30, 2006.

The net assets available for health benefits decreased by \$20.3 million in 2008. The components of the decrease are:

- (\$10.2) million in the City Health Plan (System Board approved subsidy of \$8 million, and excess claims costs over premiums of \$2 million)
- (\$2.6) million in the Blue Shield and Kaiser plans (System Board approved subsidy)
- (\$2.0) million in the dental plans (fiscal year 2006 premium excess over costs applied as reduction to fiscal year 2008 rates)
- (\$7.8) million in the PacifiCare plan (excess costs over target premiums)

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- \$2.3 million in trust fund interest income, performance guarantee penalties and forfeitures, and excess in administrative fees.

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>Dollar change (08-07)</u>	<u>Percent change (08-07)</u>	<u>Dollar change (07-06)</u>	<u>Percent change (07-06)</u>
Total assets	\$ 79,275,503	86,472,766	82,087,589	(7,197,263)	(8)%	\$ 4,385,177	5%
Total liabilities	<u>55,718,767</u>	<u>42,572,684</u>	<u>39,547,638</u>	<u>13,146,083</u>	<u>31</u>	<u>3,025,046</u>	<u>8</u>
Net assets	<u>\$ 23,556,736</u>	<u>43,900,082</u>	<u>42,539,951</u>	<u>(20,343,346)</u>	<u>(46)%</u>	<u>\$ 1,360,131</u>	<u>3%</u>

Fiscal Year 2008

- Cash and investments held with City and County Treasurer as of June 30, 2008, totaled \$53.6 million compared to \$63.6 million as of June 30, 2007, a decrease of 16%. The cash and investment balance fluctuates throughout the year depending on collections, claims, and timing of vendor payments. The monthly cash balance ranged between \$53.8 million and \$75.2 million during the year ended June 30, 2008.
- Contributions receivable from employer increased from \$13.3 million to \$15.4 million, as of June 30, 2008, a 16% increase. Contributions receivable from employees increased from \$2.3 million to \$3.3 million, as of June 30, 2008, a 44% increase. Changes in contributions receivable are due to the increase in premium rates, the change in premium collection from bi-weekly to semi monthly for City and County active employees, and increase in membership.
- Interest receivable decreased from \$0.7 million to \$0.2 million as of June 30, 2008, a 71% decrease due to the decline in the fund balance and lower interest rates.
- Reserves for claims under the City Health Plan and Delta Dental increased from \$10 million to \$10.9 million, a 9% increase. The reserve is actuarially determined, and the increase is attributable to the increase in the volume of anticipated claims incurred but not reported at June 30, 2008.
- Premiums payable to health maintenance organizations, dental, and disability plans increased by \$8.1 million, from \$1.4 million to \$9.5 million, as of June 30, 2008. The increase is mainly due to PacifiCare additional payment and accrual, with actual expenses exceeding target premiums.
- Unearned contributions represent health contributions received in advance of the period of benefit coverage. Unearned contributions increased from \$31.1 million to \$35.3 million as of June 30, 2008, a 14% increase. This increase is attributable mainly to increase in premium rates, the change in premium collection from bi-weekly to semi monthly for City and County active employees, and increase in membership.

Fiscal Year 2007

- Cash and investments held with City and County Treasurer as of June 30, 2007, totaled \$63.6 million compared to \$68.4 million as of June 30, 2006, a decrease of 7%. The cash and investment balance fluctuates throughout the year depending on collections, claims, and timing of vendor payments. The monthly cash balance ranged between \$63.6 million and \$78.9 million during the year ended June 30, 2007.

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- Contributions receivable from employer increased from \$9.8 million to \$13.3 million, as of June 30, 2007, a 36% increase. Contributions receivable from employees increased from \$1.8 million to \$2.3 million, as of June 30, 2007, a 28% increase. Changes in contributions receivable are due to the increase in premium rates and a change in year-end posting of premium payments from the San Francisco Unified School District.
- Other Assets increased from \$1.7 million to \$6.6 million, as of June 30, 2007. Of the increase, \$2.7 million is a receivable on Medicare Part D Pharmacy for City Health Plan. This is a new federal program that provides a subsidy on eligible Medicare retiree prescription drug costs for a qualified employer sponsored drug plan. Of the remaining increase, \$1.6 million is a receivable from UHC representing required, daily minimum demand deposit bank balance, to cover City Health Plan claim payments. And similarly, a \$0.25 million receivable from Delta Dental represents agreed pre-funding for the self-insured active members claim payments.
- Reserves for claims under the City Health Plan and Delta Dental increased from \$8.9 million to \$10 million, a 12% increase. The reserve is actuarially determined, and the increase is attributable to increased in the volume of anticipated claims incurred but not reported at June 30, 2007.
- Premiums payable to health maintenance organizations, dental, and disability plans decreased by \$0.4 million or 24%, as of June 30, 2007, compared to the prior year. The decrease is due to the last Delta Dental weekly payment for the year posted two days earlier compared to its equivalent for prior year.
- Unearned contributions represent health contributions received in advance of the period of benefit coverage. Unearned contributions as of June 30, 2007 at \$31.1 million are a slight increase from prior year.

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Financial Analysis –Condensed Financial Information

For the year ended June 30, 2008, there was a \$20.3 million decrease in net assets during the year. This compares to a \$1.4 million increase and a \$4.2 million decrease in net assets for the years ended June 30, 2007 and 2006 respectively. The highlights regarding the changes in net assets are as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>Dollar change (08-07)</u>	<u>Percent change (08-07)</u>	<u>Dollar change (07-06)</u>	<u>Percent change (07-06)</u>
Additions:							
Employee and retiree contributions	\$ 72,579,371	75,102,291	70,125,646	(2,522,920)	(3)%	\$ 4,976,645	7%
Employer contributions	<u>485,850,226</u>	<u>444,104,490</u>	<u>404,708,928</u>	<u>41,745,736</u>	<u>9</u>	<u>39,395,562</u>	<u>10</u>
Total contributions	558,429,597	519,206,781	474,834,574	39,222,816	8	44,372,207	9
Plan providers penalties and forfeitures	<u>678,206</u>	<u>1,512,425</u>	<u>407,026</u>	<u>(834,219)</u>	<u>(55)</u>	<u>1,105,399</u>	<u>272</u>
Total additions	<u>\$ 559,107,803</u>	<u>520,719,206</u>	<u>475,241,600</u>	<u>38,388,597</u>	<u>7</u>	<u>45,477,606</u>	<u>10</u>
Deductions:							
City Health Plan Health maintenance organization	\$ 68,719,625	59,495,007	53,993,444	9,224,618	16	5,501,563	10
Vision plan	442,390,139	400,301,457	369,117,704	42,088,682	11	31,183,753	8
Dental benefits	4,407,463	4,320,098	3,889,515	87,365	2	430,583	11
Disability and flexible benefits	46,632,203	42,867,225	41,293,909	3,764,978	9	1,573,316	4
	<u>18,708,689</u>	<u>14,805,770</u>	<u>13,413,674</u>	<u>3,902,919</u>	<u>26</u>	<u>1,392,096</u>	<u>10</u>
Total deductions	<u>\$ 580,858,119</u>	<u>521,789,557</u>	<u>481,708,246</u>	<u>59,068,562</u>	<u>11</u>	<u>40,081,311</u>	<u>8</u>
Change in net assets before investment earnings	\$ (21,750,316)	(1,070,351)	(6,466,646)	(20,679,965)	1,932	5,396,295	(83)
Investment earnings	<u>1,406,970</u>	<u>2,430,482</u>	<u>2,281,094</u>	<u>(1,023,512)</u>	<u>(42)</u>	<u>149,389</u>	<u>7</u>
Change in net assets	<u>\$ (20,343,346)</u>	<u>1,360,131</u>	<u>(4,185,552)</u>	<u>(21,703,477)</u>	<u>(1,596)%</u>	<u>\$ 5,545,684</u>	<u>(132)%</u>

Fiscal Year 2008

- Employees and retirees contributions totaled \$73 million during the year ended June 30, 2008, compared to \$75 million for the prior year, a decrease of 3%. The decrease was generally due to the decreases in employee share of contributions. Active employees contributed \$47 million and retirees contributed \$26 million of the \$73 million collected in FY 2008. Of the total contributions, \$59 million are for medical coverage, \$8 million for dental coverage, and \$6 million in flexible spending accounts.
- Employer contributions on behalf of active employees increased from \$311.9 million to \$343.3 million, an increase of 10% over the prior year. The primary factor for the \$31.4 million increase was an increase in the ten County Contribution amount from \$365.66 to \$403.14 per member per month, an increase of 10% over the prior year. The ten County Contribution rate is determined pursuant to the Charter, by an average contribution made on the behalf of the 10 largest counties (by population, excluding San Francisco) in the State of California for providing medical plan coverage to employees. In addition, the City and County contributes to the medical costs of employees and their dependents according to amounts determined in Memoranda of Understanding with bargaining units and employee unions.

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- Employer contributions on behalf of retirees increased from \$132.2 million during the year ended June 30, 2007, to \$142.6 million for the year ended June 30, 2008, or 8%. The cost of the plan benefits, the retiree's number of dependents and Medicare status of the retiree and of the dependents determine the premium for retirees. The increase was due to premium and membership increases.
- City Health Plan covers medical and prescription drug expenses, an increase from \$59.5 million for the year ended June 30, 2007, to \$68.7 million for the year ended June 30, 2008, or 16%. The increase is the result of increase in the cost of medical and pharmacy claims.
- Total health maintenance organizations expenditures increased from \$400.3 million for the year ended June 30, 2007, to \$442.4 million for the year ended June 30, 2008, or 11%, due primarily to increases in contract rates.
- Investment earnings for the year ended June 30, 2008, were \$1.4 million compared to \$2.4 million in the prior year. The decrease in investment earnings is due to the decline in cash balances and lower interest rates.
- The following changes to the health plans were effective July 1, 2007:
 - Health Net HMO was no longer offered to the System members, replaced by PacifiCare HMO.
 - All HMOs increased the emergency room co-payment from \$35 to \$50 per visit.
 - All HMOs added a \$100 per admission co-payment for inpatient hospital stays.
 - Kaiser reduced the days supply of prescription drugs associated with single co-payment from 100 days to 30 days, to align their pharmacy benefits with other HMOs.

No changes were made to City Health Plan, vision and dental benefits for the 2007-2008 plan year.

Fiscal Year 2007

- Employees and retirees contributions totaled \$75 million during the year ended June 30, 2007, compared to \$70 million for the prior year, an increase of 7%. The increase was generally due to increases in rates and a 2% rise in enrollment. Active employees contributed \$49 million and retirees contributed \$26 million of the \$75 million collected in FY 2007. Of the total contributions, \$63 million are for medical coverage, \$8 million for dental coverage, and \$4 million in flexible spending accounts.
- Employer contributions on behalf of active employees increased from \$289.4 million to \$311.9 million, an increase of 8% over the prior year. The primary factor for the \$22.5 million increase was an increase in the ten County Contribution amount from \$345.53 to \$365.66 per member per month, an increase of 5.8% over the prior year. The ten County Contribution rate is determined pursuant to the Charter by an average contribution made on the behalf of the 10 largest counties (by population, excluding San Francisco) in the State of California for providing medical plan coverage to employees. In addition, the City and County contributes to the medical costs of employees and their dependents according to amounts determined in Memoranda of Understanding with bargaining units and employee unions.
- Employer contributions on behalf of retirees increased from \$115.3 million during the year ended June 30, 2006, to \$132.2 million for the year ended June 30, 2007, or 14%. The cost of the plan, the retiree's

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number of dependents and Medicare status of the retiree and of the dependents determine the premium for retirees. Of the 14% increase, 6% was due to premium and membership increases, whereas the remaining 8% is due to the fiscal year ending June 30, 2006 including only eleven months of revenues, rather than twelve months, as a result of an alignment of financial reporting with actual operating revenue recognition implemented that year.

- City Health Plan covers medical and prescription drug expenses, an increase from \$54.0 million for the year ended June 30, 2006, to \$59.5 million for the year ended June 30, 2007, or 10%. The increase is the result of increase in the cost of medical and pharmacy claims.
- Total health maintenance organizations expenditures increased from \$369.1 million for the year ended June 30, 2006, to \$400.3 million for the year ended June 30, 2007, or 8%, due primarily to increases in contract rates.
- Investment earnings for the year ended June 30, 2007, were \$2.4 million compared to \$2.3 million in the prior year. The minimal increase in investment earnings is primarily attributable to stable interest rates and cash balances.
- The following changes to the health plans were effective July 1, 2006:
 - HSS members and their dependents are no longer allowed to be enrolled in two medical and/or dental plans at the same time, called dual coverage.
 - Members enrolled in Kaiser Senior Advantage received vision coverage through Vision Service Plan (VSP). All System members received vision benefits from VSP.
 - Health Net Seniority Plus network expanded to include Solano, Sonoma and San Mateo Counties.

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June 30, 2008 and 2007

Requests for Information

This Financial report is designed to provide a general overview of the City and County of San Francisco Health Service System's finances for the year ended June 30, 2008. Questions regarding any of the information provided in this report or requests for additional information should be addressed to:

City & County of San Francisco
Health Service System
Bart Duncan, Director
1145 Market Street Suite 200
San Francisco, CA 94103-1523

**CITY AND COUNTY OF SAN FRANCISCO
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Statements of Net Assets Available for Health Benefits

June 30, 2008 and 2007

	2008	2007
Assets:		
Cash and investments held with City and County Treasurer	\$ 53,578,304	63,635,418
Contributions receivable from:		
Employer	15,410,951	13,343,278
Employees	3,263,182	2,252,136
Interest receivable	180,627	685,787
Other assets	6,842,439	6,556,147
Total assets	79,275,503	86,472,766
Liabilities:		
Reserves for claims – City Health Plan and Delta Dental Plan Health Maintenance Organization, dental, and disability premiums payable	10,916,309	10,024,962
Unearned contributions	9,550,988	1,419,407
	35,251,470	31,128,315
Total liabilities	55,718,767	42,572,684
Net assets available for health benefits	\$ 23,556,736	43,900,082

See accompanying notes to financial statements.

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Statements of Changes in Net Assets Available for Health Benefits

Years ended June 30, 2008 and 2007

	<u>2008</u>	<u>2007</u>
Additions:		
Employee and retiree contributions	\$ 72,579,371	75,102,291
Employer contributions for:		
Active employees	343,277,934	311,916,107
Retired employees	142,572,292	132,188,383
Total contributions	<u>558,429,597</u>	<u>519,206,781</u>
Plan providers penalties and forfeitures	678,206	1,512,425
Investment earnings:		
Net increase (decrease) in fair value of investments	(186,400)	19,975
Interest income	1,593,370	2,410,507
Total investment earnings	<u>1,406,970</u>	<u>2,430,482</u>
Total additions	<u>560,514,773</u>	<u>523,149,688</u>
Deductions:		
City Health Plan health benefits	68,719,625	59,495,007
Health Maintenance Organization health benefits	442,390,139	400,301,457
Vision benefits	4,407,463	4,320,098
Dental benefits	46,632,203	42,867,225
Disability and flexible benefits	18,708,689	14,805,770
Total deductions	<u>580,858,119</u>	<u>521,789,557</u>
Change in net assets available for health benefits	(20,343,346)	1,360,131
Net assets available for health benefits:		
Beginning of year	<u>43,900,082</u>	<u>42,539,951</u>
End of year	<u>\$ 23,556,736</u>	<u>43,900,082</u>

See accompanying notes to financial statements.

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Notes to Financial Statements

June 30, 2008 and 2007

(1) Description of Health Service System

(a) General

The City and County of San Francisco (the City and County) established the City and County of San Francisco Health Service System (the System) in March 1937, by amendment of the City and County Charter. A new City and County of San Francisco Charter was adopted on November 7, 1995, and became effective July 1, 1996. The provisions related to the Health Service System are substantially unchanged in the new Charter. The City and County provides health care benefits to substantially all of its active and retired employees through the System. The System also provides health care benefits to active and retired employees of the San Francisco Unified School District, the San Francisco Community College District and the San Francisco Superior Court.

On November 2, 2004, the San Francisco voters approved Proposition C, which removed the Health Service System from the department of Human Resources, making it a separate City department effective July 1, 2005. Proposition C also reconfigured the seven member Health Service Board by replacing the seat formerly occupied by the City Attorney (or his or her designee) with an additional seat elected by members of the System. As reconfigured, the System Board consists of: one member of the Board of Supervisors, to be appointed by the President of the Board of Supervisors; two members appointed by the Mayor, one of whom shall be an individual who regularly consults in the health care field, and the other a doctor of medicine; and four members elected by the members of the System. Proposition C also changed the governance functions of the Health Service Board. Previously, the Human Resources Director was responsible for appointing a full-time administrator, who served at the pleasure of the Human Resource Director, and the Human Resources Department was responsible for administering the System. As a result of Proposition C, the Health Service Board is now responsible for appointing a full-time administrator, who serves at the pleasure of the Board, and the Board both sets the policy for and oversees the administration of the System.

Membership in the System is available to (i) all active permanent employees, as well as eligible retired employees, of the City and County, and of the San Francisco Unified School and Community College Districts; (ii) temporary employees who meet eligibility requirements; (iii) eligible dependents of members; and (iv) certain dependents of deceased and retired employees. Eligibility terminates when a member leaves employment for reasons other than retirement. The System is responsible for designing health care benefits, selecting and managing plan providers and determining some aspects of benefit eligibility to supplement the eligibility rules contained in the Charter and applicable ordinances. In addition, the System is responsible for administration of health care benefits, including maintaining employee membership and financial accounting records.

Pursuant to the Charter, most administrative costs of the System are paid for by the City and County, the Unified School District and the Community College District and are reflected in the respective financial statements of those entities. Certain expenses related to the annual open enrollment and member marketing and communications are, however, paid from the Health Service System Trust Fund pursuant to Section A8.423 of the charter. In addition, third-party claims administration costs for the self-funded plans (City Health Plan and Delta Dental for active employees) are included in the respective premium rates for those plans.

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The System is reflected as an Other Employee Benefit Trust Fund and is an integral part of the City and County of San Francisco, and the accompanying financial statements are included as part of the primary government in the Comprehensive Annual Financial Report prepared by the City and County. The System's cash balances are deposited with, and managed by, the Treasurer of the City and County.

(b) *Types of Benefits and Premium Rates*

Medical benefits during the fiscal years are provided to members of Health Service System through four plan choices:

- City Health Plan (Preferred Provider Organization (PPO))
- PacifiCare (Health Maintenance Organization (HMO))
- Kaiser Foundation Health Plan (Kaiser) (HMO)
- Blue Shield (HMO)

The PacifiCare HMO replaced the Health Net HMO starting July 1, 2007.

Each of the above plan choices includes a vision benefit provided through Vision Service Plan (VSP). The City Health Plan, which includes medical and prescription drug benefits, is a self-insured indemnity plan, where the risk of loss due to claims in excess of revenues is borne by the Health Service System Trust Fund. The City Health Plan is administered by United HealthCare (UHC). The Kaiser and Blue Shield plans are fully insured external health maintenance organizations, where the risk of loss due to excess claims for a given fiscal year is borne by the health maintenance organization carriers. The PacifiCare HMO plan has a somewhat different funding arrangement which is referred to as "flex-funded". Under this flex-funding arrangement, the health maintenance organization and the Health Service System Trust Fund share some risk on non capitated expenses. Target premiums are paid to PacifiCare monthly in advance (as with other HMO plans) with a subsequent retrospective reconciliation of actual expenses against target premiums. To the extent actual expenses fall below the target premiums, the System will be reimbursed the full difference. If actual expenses exceed the target premiums, the System will pay the additional expense, limited to 120% of the target premiums.

Dental benefits during the fiscal years are provided through three plan choices:

- Delta Dental
- Delta Care (PMI)
- Pacific Union

The Delta Dental plan provided to active employees is a self-insured indemnity plan, administered by Delta Dental. Unlike the City Health Plan, however, the risk of loss due to claims in excess of revenues is borne by the City and County of San Francisco and any other participating employers. The Delta Dental plan offered to retired employees is a fully insured plan, where the risk of loss for a

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given fiscal year is borne by Delta Dental. The Delta Care (PMI) and Pacific Union dental plans are managed care dental plans, and are fully insured with respect to both active and retired employees.

Premium rates for the fully insured plans are set through periodic competitive solicitation of carriers and an interim annual negotiation process that includes participation of the System's independent actuaries and consultants. Premium rates for the self-insured plans are set based on recommendations and certification of such actuaries and consultants.

The System also offers two types of flexible spending accounts for all City and County employees: a medical reimbursement account and a dependent care account. Most of the administration for these accounts is provided through a third-party administrator, whose fees are provided by the City and County through the System. The current administrator is Fringe Benefits Management Company.

The System also utilizes a third-party administrator to provide most of the administration for a complex cafeteria plan offered to employees represented by the Municipal Executives Association, elected officials and certain unrepresented employees. The fees of this administrator are provided by the City and County through the System. The current administrator is Employee Benefits Specialists, Inc.

In addition, the City and County provides a long term disability plan to most of its employees. All costs of the long term disability plan are paid by contributions from the City and County. The plan provider is Unum Life Insurance Company of America.

The City and County also provides group term life insurance to most employee groups. All costs for the life insurance are paid by contributions from the City and County. The plan provider is ING Employee Benefits.

(c) *Determination of Employer and Member Contributions*

The overall cost of benefits is determined using ongoing periodic member eligibility data and the premium rates referred to above. The costs are allocated among members, the City and County, the Unified School District, the Community College District and the San Francisco Superior Court as set forth below. The respective contributions of each of these groups are generally received in advance of the benefit period.

Employer contributions for health benefits are determined annually in accordance with Charter requirements and the applicable collective bargaining agreements with various employee organizations. The Charter-based contributions are determined using a formula surveying similar contributions made by the ten most populous counties in California, not including San Francisco. In addition, most active employee groups have collectively bargained for enhanced contributions for single coverage as well as employer subsidized dependent health coverage.

Employers contribute toward the costs for retired employees such that a retired employee pays no more than an active employee for the same benefits. Additionally, pursuant to Proposition E, which passed in the November 2000 election; beginning July 1, 2001, employers pay for one half of the amount that the retiree would ordinarily have paid out of pocket for his or her own coverage, as well

**CITY AND COUNTY OF SAN FRANCISCO
HEALTH SERVICE SYSTEM**

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June 30, 2008 and 2007

as one half of the amount that the retiree would ordinarily have paid for his or her first dependent. The employers' liability for providing health care benefits is limited to its annual contribution.

The medical and dental plans and costs are determined annually by the Health Service Board and approved by the Board of Supervisors. Any costs of the plans not paid for by the employer are borne by the member. Member contribution rates therefore vary depending on the number of dependents, the cost of the plans selected by the member and differing employer contribution levels depending on the employee's status as an active employee or a retiree and the application of employer subsidies ties to collective bargaining agreement for actives or Medicare eligibility for retirees. Member contributions do not accumulate or vest. During the period in question, the Health Service Board elected to pay for some of the costs for medical plans through subsidies from the Health Service Trust Fund, thereby reducing the contributions borne by employers and employees.

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation

The accompanying financial statements are prepared on the accrual basis of accounting. The preparation of the financial statements in conformity with the U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

The System follows U.S. generally accepted accounting principles as promulgated by the *Government Accounting Standards Board*.

(b) Cash and Investments Held by City and County

The System maintains its cash and investments as part of the City and County's pool of cash and investments. The System's portion of this pool is displayed on the balance sheet as "Cash and investments held with City and County Treasurer." Income earned or a loss arising from pooled investments is allocated monthly to the System based on its average daily cash balance.

In accordance with GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and External Investment Pools*, the City reports certain investments at fair value in the statement of net assets and recognizes the corresponding change in fair value of investments in the year in which the change occurred, and the System reports its investments at fair value based on quoted market information obtained from fiscal agents or other sources.

(c) Unearned Contributions

Unearned contributions represent monies received or receivable from members and from the City and County, San Francisco Unified School District, and San Francisco Community College District prior to year end for benefits in future periods, as contributions are generally received in advance.

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(3) Cash and Investments Held with City and County Treasurer

The System maintains its cash and investments as part of the City’s pool of cash and investments. The City’s investment pool is invested in an unrated pool pursuant to investment policy guidelines established by the City Treasurer. The objectives of the policy are, in order of priority, preservation of capital, liquidity, and yield. The policy addresses soundness of financial institutions in which City will deposit funds, types of investment instruments, as permitted by the California Government Code, and the percentage of the portfolio which may be invested in certain instruments with longer terms of maturity. As of June 30, 2008 and 2007, the System’s cash and investment balances were \$53.6 million and \$63.6 million, which represented less than 2% of the City’s investment pool, respectively.

The following table shows the percentage distribution of the City’s pooled investments by maturity:

Investment maturities (in months)			
Under 1	1 – 6	6 – 12	12 – 18
6.9%	52.7%	11.6%	28.8%

(4) Reserves for Claims—City Health Plan and Delta Dental Plan

Reserves for claims, which have been actuarially determined, represent estimates of claims reported and in process of payment, and estimates of claims incurred but not yet reported. Reserves for medical claims are based on actual claim lag reports and historical payment patterns. The net assets of the System are available to be used as directed by the Health Service Board and may be used to minimize the impact of possible future adverse experience. Management believes that the reserves are adequate to cover the ultimate cost of all claims incurred but unpaid at year end.

The System’s City Health Plan is a self funded plan. Should deductions from net assets of the City Health Plan program exceed related additions to net assets and reserves, the System would be required to seek additional funds from members. The City and County, San Francisco Unified School District, and the Community College District are not legally obligated to provide additional funds under these circumstances.

The City and County’s contributions to the Health Service System for employees in the Delta Dental Plan are made on an estimated basis during the year and any over or under payment will be reflected in the subsequent year’s rate. The reserves for dental benefits are actuarially determined based on actual claim payment patterns.

Reserves for prescription drug benefits are also actuarially determined based on claim payment patterns.

**CITY AND COUNTY OF SAN FRANCISCO
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The following summarizes the changes in the reserves for claims of the System's City Health Plan, (medical benefits and prescription drug benefits), and the Delta Dental Plan during the years ended June 30, 2008 and 2007:

	<u>Medical benefits</u>	<u>Prescription drugs</u>	<u>Dental benefits</u>	<u>Total reserves</u>
Reserves as of June 30, 2006	\$ 5,076,880	921,113	2,890,064	8,888,057
Claim payments	(42,346,802)	(14,904,518)	(33,788,313)	(91,039,633)
Currents year claims and changes in estimates	<u>43,617,175</u>	<u>14,989,316</u>	<u>33,570,047</u>	<u>92,176,538</u>
Reserves as of June 30, 2007	6,347,253	1,005,911	2,671,798	10,024,962
Claim payments	(47,245,726)	(18,370,764)	(35,848,615)	(101,465,105)
Currents year claims and changes in estimates	<u>47,304,789</u>	<u>18,563,819</u>	<u>36,487,844</u>	<u>102,356,452</u>
Reserves as of June 30, 2008	<u>\$ 6,406,316</u>	<u>1,198,966</u>	<u>3,311,027</u>	<u>10,916,309</u>

(5) Postretirement Health Benefits

Medical benefits for eligible retired employees feature the same basic plan design as those for active employees, and such benefits are paid for by both the former employer and the retiree (note 1).

The total employer cost of providing benefits for 22,135 and 21,558 retirees as of June 30, 2008 and 2007, respectively, is shown as employer contributions to the System in the accompanying financial statements.

(6) Contingency Margin

In October 2007, the System Board adopted a Contingency Margin Policy for the self funded health plans including the City Health Plan, the Delta Dental plan for active employees, and the flex-funded PacifiCare Plan for actives and nonmedicare retirees. The contingency margin represents the targeted level of net assets available for health benefits. The contingency margins were developed for each plan and are defined to be a fixed multiple of the calculated Risk Based Capital (RBC) requirement for the plans. Pursuant to this policy, the contingency margins as of June 30, 2008 are \$10.2 million for City Health Plan and \$3 million for Delta Dental for active employees. Pursuant to the policy, a contingency margin for the PacifiCare Plan will be calculated and provided for in fiscal year 2008-2009.



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**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***

Honorable Mayor and Board of Supervisors
City and County of San Francisco:

We have audited the financial statements of the City and County of San Francisco Health Services System (the System), a department of the City and County of San Francisco, California (the City and County) as of and for the year ended June 30, 2008, and have issued our report thereon dated October 29, 2008. 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.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the System's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing an opinion on the financial statements but not for the purpose of expressing an opinion on the effectiveness of the System's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the System's internal control over financial reporting.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weakness, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the System's financial statements are free of 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*.

This report is intended solely for the information and use of the Board of Supervisor's Finance and Audits Committee, the Health Services Board, and management, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

October 29, 2008