



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

Financial Statements

June 30, 2010 and 2009

(With Independent Auditors' Report Thereon)

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

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KPMG LLP
Suite 1400
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, 2010 and 2009, 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 position of the City and County as of June 30, 2010 and 2009, 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, 2010 and 2009, 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, 2010, 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 9 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, 2010

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Management's Discussion and Analysis

June 30, 2010 and 2009

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, 2010 and 2009. 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)

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. 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. The PacifiCare Plan was no longer offered starting July 1, 2009.

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, 2010 and 2009. 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, 2010 and 2009.
- 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, 2010, there were \$14.2 million of net assets available to meet future health care obligations. This compares to \$13.4 million as of June 30, 2009 and \$23.6 million as of June 30, 2008.

The net assets available for health benefits increased by \$0.8 million in 2010. The components of the increase are:

- \$5.6 million decrease in the City Health Plan (stabilization subsidy per System Board approved policy of \$2.7 million and excess claims over premiums costs of \$2.9 million)
- \$3.2 million increase in the Blue Shield and Kaiser plans, excess premiums over plan payments, primarily resulting from increases in the rates for the close-out of the PacifiCare Maximum Premium Arrangement contract
- \$1.3 million decrease in the dental plans (fiscal year 2008 premium excess over costs applied as reduction to fiscal year 2009 rates of \$0.3 million and excess claims costs over premiums of \$1.0 million)
- \$0.8 million increase in the PacifiCare plan (lower costs over target premiums)

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- \$3.7 million in trust fund interest income, performance guarantee penalties and forfeitures, and increase in administrative fees.

| | <u>2010</u> | <u>2009</u> | <u>2008</u> | <u>Dollar change (10 - 09)</u> | <u>Percent change (10 - 09)</u> | <u>Dollar change (09 - 08)</u> | <u>Percent change (09 - 08)</u> |
|-------------------|----------------------|-------------------|-------------------|--|---|--|---|
| Total assets | \$ 94,650,587 | 89,854,083 | 79,275,503 | 4,796,504 | 5% | \$ 10,578,580 | 13% |
| Total liabilities | 80,424,161 | 76,453,637 | 55,718,767 | 3,970,524 | 5% | 20,734,870 | 37 |
| Net assets | \$ <u>14,226,426</u> | <u>13,400,446</u> | <u>23,556,736</u> | <u>825,980</u> | <u>6%</u> | <u>\$ (10,156,290)</u> | <u>(43)%</u> |

The net assets available for health benefits decreased by \$10.2 million in 2009. The components of the decrease are:

- \$5.5 million decrease in the City Health Plan (stabilization subsidy per System Board approved policy of \$2.9 million, and excess claims over premiums costs of \$2.6 million)
- \$0.1 million increase in the Blue Shield and Kaiser plans, minimal excess premiums over plan payments, primarily resulting from contract premium arrangement for new enrollees and termed members
- \$2.6 million decrease in the dental plans (fiscal year 2007 premium excess over costs applied as reduction to fiscal year 2009 rates of \$1.6 million and excess claims costs over premiums of 1.0 million)
- \$4.0 million decrease in the PacifiCare plan (excess costs over target premiums)
- \$1.8 million increase in trust fund interest income, performance guarantee penalties and forfeitures, and excess in administrative fees.

| | <u>2009</u> | <u>2008</u> | <u>2007</u> | <u>Dollar change (09-08)</u> | <u>Percent change (09-08)</u> | <u>Dollar change (08-07)</u> | <u>Percent change (08-07)</u> |
|-------------------|----------------------|-------------------|-------------------|--------------------------------------|---------------------------------------|--------------------------------------|---------------------------------------|
| Total assets | \$ 89,854,083 | 79,275,503 | 86,472,766 | 10,578,580 | 13% | (7,197,263) | (8)% |
| Total liabilities | 76,453,637 | 55,718,767 | 42,572,684 | 20,734,870 | 37 | 13,146,083 | 31 |
| Net assets | \$ <u>13,400,446</u> | <u>23,556,736</u> | <u>43,900,082</u> | <u>(10,156,290)</u> | <u>(43)%</u> | <u>\$ (20,343,346)</u> | <u>(46)%</u> |

Fiscal Year 2010

- Cash and investments held with City and County Treasurer as of June 30, 2010, totaled \$65.6 million compared to \$59.6 million as of June 30, 2009, an increase of 10%. The cash and investment balance fluctuates throughout the year depending on collections, claims, and timing of vendor payments. The monthly cash balance ranged between \$65.1 million and \$85.2 million during the year ended June 30, 2010.
- Contributions receivable from employer decreased from \$18.9 million to \$16.9 million, as of June 30, 2010, an 11% decrease. Contributions receivable from employees decreased from \$4.1 million to \$4.0 million, as of June 30, 2010, a 2% decrease. Changes in contributions receivable were due to not taking a deduction for the last three days of the fiscal year and a drop in active members and their dependents.

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- Reserves for claims under the City Health Plan and Delta Dental increased from \$12.1 million to \$12.4 million, a 2% 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, 2010.
- Premiums payable to health maintenance organizations, dental, and disability plans increased by \$3.9 million, from \$23.3 million to \$27.2 million, as of June 30, 2010. The increase reflects the annual rate increases including an additional increase to the rates to cover the close-out of the PacifiCare maximum premium contract.
- Unearned contributions represent health contributions received in advance of the period of benefit coverage. Unearned contributions decreased from \$40.9 million to \$40.8 million as of June 30, 2010, or a 0.3% decrease. This decrease is attributable to a decline in membership from fiscal year 2009 to fiscal year 2010.

Fiscal Year 2009

- Cash and investments held with City and County Treasurer as of June 30, 2009, totaled \$59.6 million compared to \$53.6 million as of June 30, 2008, an increase of 11%. The cash and investment balance fluctuates throughout the year depending on collections, claims, and timing of vendor payments. The monthly cash balance ranged between \$51.5 million and \$70.2 million during the year ended June 30, 2009.
- Contributions receivable from employer increased from \$15.4 million to \$18.9 million, as of June 30, 2009, a 23% increase. Contributions receivable from employees increased from \$3.3 million to \$4.1 million, as of June 30, 2009, a 27% increase. Changes in contributions receivable are due to the increase in premium rates and, on top of a typical one pay period receivable, an additional 20% of one pay period due to fiscal year end deduction split.
- Interest receivable decreased from \$0.2 million to \$0.1 million as of June 30, 2009, a 50% 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 \$10.9 million to \$12.1 million, an 11% 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, 2009.
- Premiums payable to health maintenance organizations, dental, and disability plans increased by \$13.8 million, from \$9.5 million to \$23.3 million, as of June 30, 2009. The increase is mainly due to a change in Blue Shield payment arrangement, from a current month due date based on estimates, to the month following based on actual eligibility data.
- Unearned contributions represent health contributions received in advance of the period of benefit coverage. Unearned contributions increased from \$35.3 million to \$40.9 million as of June 30, 2009, a 16% increase. This increase is attributable mainly to increase in premium rates.

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Financial Analysis – Condensed Financial Information

For the year ended June 30, 2010, there was a \$0.8 million increase in net assets during the year. This compares to a \$10.2 million decrease and a \$20.3 million decrease in net assets for the years ended June 30, 2009 and 2008 respectively. The highlights regarding the changes in net assets are as follows:

| | <u>2010</u> | <u>2009</u> | <u>2008</u> | <u>Dollar change (10-09)</u> | <u>Percent change (10 – 09)</u> | <u>Dollar change (09 – 08)</u> | <u>Percent change (09 – 08)</u> |
|--|-----------------------|---------------------|---------------------|--------------------------------------|---|--|---|
| Additions: | | | | | | | |
| Employee and retiree contributions | \$ 110,294,034 | 97,567,046 | 72,579,371 | 12,726,988 | 13% | \$ 24,987,675 | 34% |
| Employer contributions | 548,184,923 | 517,493,416 | 485,850,226 | 30,691,507 | 6% | 31,643,190 | 7 |
| Total contributions | 658,478,957 | 615,060,462 | 558,429,597 | 43,418,495 | 7% | 56,630,865 | 10 |
| Plan providers penalties and forfeitures | 1,623,775 | 957,007 | 678,206 | 666,768 | 70% | 278,801 | 41 |
| Total additions | <u>\$ 660,102,732</u> | <u>616,017,469</u> | <u>559,107,803</u> | <u>44,085,263</u> | <u>7%</u> | <u>56,909,666</u> | <u>10</u> |
| Deductions: | | | | | | | |
| City Health Plan Health maintenance organization | \$ 69,273,756 | 72,144,040 | 68,719,625 | (2,870,284) | -4% | 3,424,415 | 5 |
| Vision plan | 516,366,608 | 482,047,914 | 442,390,139 | 34,318,694 | 7% | 39,657,775 | 9 |
| Dental benefits | 4,093,377 | 4,294,245 | 4,407,463 | (200,868) | -5% | (113,218) | (3) |
| Disability and flexible benefits | 50,694,316 | 49,153,484 | 46,632,203 | 1,540,832 | 3% | 2,521,281 | 5 |
| | 19,786,339 | 19,283,194 | 18,708,689 | 503,145 | 3% | 574,505 | 3 |
| Total deductions | <u>\$ 660,214,396</u> | <u>626,922,877</u> | <u>580,858,119</u> | <u>33,291,519</u> | <u>5%</u> | <u>46,064,758</u> | <u>8%</u> |
| Change in net assets before investment earnings | \$ (111,664) | (10,905,408) | (21,750,316) | 10,793,744 | -99% | 10,844,908 | (50)% |
| Investment earnings | 937,644 | 749,118 | 1,406,970 | 188,526 | -11% | (657,852) | (47) |
| Change in net assets | <u>\$ 825,980</u> | <u>(10,156,290)</u> | <u>(20,343,346)</u> | <u>10,982,270</u> | <u>-108%</u> | <u>\$ 10,187,056</u> | <u>(50)%</u> |

Fiscal Year 2010

- Employees and retirees contributions totaled \$110.3 million during the year ended June 30, 2010, compared to \$97.6 million for the prior year, an increase of 13%. The increase was generally due to the increase in rates, offset slightly by a decrease in membership. Active employees contributed \$75 million and retirees contributed \$35 million of the \$110 million collected in FY 2010. Of the total contributions, \$95 million are for medical coverage, \$9 million for dental coverage, and \$6 million in flexible spending accounts.
- Employer contributions on behalf of active employees increased from \$367.8 million to \$388.7 million, an increase of 6% over the prior year. The primary factor for the \$20.9 million increase was an increase in the ten County Contribution amount from \$418.8 to \$449.37 per member per month, an increase of 7.3% 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

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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 \$149.7 million during the year ended June 30, 2009, to \$159.5 million for the year ended June 30, 2010, or 7%. The cost of the plan benefits, the retiree's number of dependents and Medicare status of the retiree and of the dependents determines the premium for retirees. The increase was due to premium and membership increases.
- City Health Plan, which covers medical and prescription drug expenses, decreased from \$72.1 million for the year ended June 30, 2009, to \$69.3 million for the year ended June 30, 2010, or 4%. This change is due to lower enrollment in the City Plan as members moved out of the City Plan to HMO plans. Total health maintenance organizations expenditures increased from \$482.0 million for the year ended June 30, 2009, to \$516.4 million for the year ended June 30, 2010, or 7%, due primarily to increases in contract rates and increases in enrollment.
- Investment earnings for the year ended June 30, 2010, were \$0.94 million compared to \$0.75 million in the prior year, or an increase of \$0.19 million due to an increase in fair market value of investments.
- The following changes to the pharmacy benefits for the City Health Plan and Blue Shield were effective July 1, 2009:
 - City Health Plan and Blue Shield HMO increase in the formulary prescription copay requirements from \$15 to \$20 for retail and from \$30 to \$40 for mail order.
 - City Health Plan and Blue Shield HMO increase in the non-formulary prescription copay requirements from \$25 to \$35 for retail and from \$50 to \$70 for mail order.
 - Blue Shield HMO Plan increase in the office visit copays from \$10 to \$15

Fiscal Year 2009

- Employees and retirees contributions totaled \$97.6 million during the year ended June 30, 2009, compared to \$72.6 million for the prior year, an increase of 34%. The increase was generally due to the increase in rates. Active employees contributed \$66.3 million and retirees contributed \$31.3 million of the \$97.6 million collected in FY 2009. Of the total contributions, \$83.0 million are for medical coverage, \$8.9 million for dental coverage, and \$5.7 million in flexible spending accounts.
- Employer contributions on behalf of active employees increased from \$343.3 million to \$367.8 million, an increase of 7% over the prior year. The primary factor for the \$24.5 million increase was an increase in the ten County Contribution amount from \$403.14 to \$418.8 per member per month, an increase of 3.9% 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 \$142.6 million during the year ended June 30, 2008, to \$149.7 million for the year ended June 30, 2009, or 5%. The cost of the plan benefits, the retiree's number of dependents and Medicare status of the retiree and of the dependents determines 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 \$68.7 million for the year ended June 30, 2008, to \$72.1 million for the year ended June 30, 2009, or 5%. This change is due to increase in the cost of medical and pharmacy claims.
- Total health maintenance organizations expenditures increased from \$442.4 million for the year ended June 30, 2008, to \$482.0 million for the year ended June 30, 2009, or 9%, due primarily to increases in contract rates.
- Investment earnings for the year ended June 30, 2009, were \$0.7 million compared to \$1.4 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 vision and dental benefits were effective July 1, 2008:
 - Vision Service Plan benefit enhancement which increased the network frame allowance from \$130 to \$150.
 - Delta Premier Plan for retirees added two new standard dental benefits, one is coverage for dental implants and the other is enhancements of certain benefits for pregnant women.
- No changes were made to City Health Plan, HMOs and dental benefits for the 2008-2009 plan year.

Request for Information

This 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, 2010. Questions regarding any of the information provided in this report or requests for additional information should be addressed to:

City and County of San Francisco
Health Service System
Catherine Dodd, Executive 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, 2010 and 2009

| | 2010 | 2009 |
|--|---------------|-------------|
| Assets: | | |
| Cash and investments held with City and County Treasurer | \$ 65,594,454 | 59,559,575 |
| Contributions receivable from: | | |
| Employer | 16,909,533 | 18,898,462 |
| Employees | 3,983,638 | 4,137,642 |
| Interest receivable | 26,949 | 99,638 |
| Other assets | 8,136,013 | 7,158,766 |
| Total assets | 94,650,587 | 89,854,083 |
| Liabilities: | | |
| Reserves for claims – City Health Plan, prescription drugs and dental | 12,424,047 | 12,142,688 |
| Health Maintenance Organization, dental, and disability premiums payable | 27,214,761 | 23,388,381 |
| Unearned contributions | 40,785,353 | 40,922,568 |
| Total liabilities | 80,424,161 | 76,453,637 |
| Net assets available for health benefits | \$ 14,226,426 | 13,400,446 |

See accompanying notes to financial statements.

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Statements of Changes in Net Assets Available for Health Benefits

Years ended June 30, 2010 and 2009

| | <u>2010</u> | <u>2009</u> |
|--|----------------------|--------------------|
| Additions: | | |
| Employee and retiree contributions | \$ 110,294,034 | 97,567,046 |
| Employer contributions for: | | |
| Active employees | 388,673,554 | 367,762,001 |
| Retired employees | <u>159,511,369</u> | <u>149,731,415</u> |
| Total contributions | <u>658,478,957</u> | <u>615,060,462</u> |
| Plan providers penalties and forfeitures | 1,623,775 | 957,007 |
| Investment earnings: | | |
| Net increase (decrease) in fair value of investments | 427,493 | 64,290 |
| Interest income | <u>510,151</u> | <u>684,828</u> |
| Total investment earnings | <u>937,644</u> | <u>749,118</u> |
| Total additions | <u>661,040,376</u> | <u>616,766,587</u> |
| Deductions: | | |
| City Health Plan health benefits | 69,273,756 | 72,144,040 |
| Health Maintenance Organization health benefits | 516,366,608 | 482,047,914 |
| Vision benefits | 4,093,377 | 4,294,245 |
| Dental benefits | 50,694,316 | 49,153,484 |
| Disability and flexible benefits | <u>19,786,339</u> | <u>19,283,194</u> |
| Total deductions | <u>660,214,396</u> | <u>626,922,877</u> |
| Change in net assets available for health benefits | 825,980 | (10,156,290) |
| Net assets available for health benefits: | | |
| Beginning of year | <u>13,400,446</u> | <u>23,556,736</u> |
| End of year | <u>\$ 14,226,426</u> | <u>13,400,446</u> |

See accompanying notes to financial statements.

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Notes to Financial Statements

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(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 (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)) – no longer offered as of July 1, 2009
- Kaiser Foundation Health Plan (Kaiser) (HMO)
- Blue Shield (HMO)

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. The PacifiCare HMO plan had 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 shared some risk on non capitated expenses. Target premiums were 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 fell below the target premiums, the System would be reimbursed the full difference. If actual expenses exceeded the target premiums, the System would 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

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Notes to Financial Statements

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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 tied to collective bargaining agreements for actives or Medicare eligibility for retirees. Member contributions do not accumulate or vest. During the year ended June 30, 2009, 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. However, the Health Service Board elected to discontinue the practice of using the Health Service Trust Fund to subsidize rates effective with the plan year ended June 30, 2010.

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation

The accompanying financial statements are prepared using the economic resources measurement focus and 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.

**CITY AND COUNTY OF SAN FRANCISCO
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Notes to Financial Statements

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(d) 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 the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(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, 2010 and 2009, the System's cash and investment balances were \$65.6 million and \$59.6 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 in months:

| Under 1 | 1 to less than 6 | 6 to less than 12 | 12 – 60 |
|----------------|-------------------------|--------------------------|----------------|
| 0.0% | 2.9% | 16.6% | 80.5% |

(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.

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Notes to Financial Statements

June 30, 2010 and 2009

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

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, 2010 and 2009:

| | <u>Medical benefits</u> | <u>Prescription drugs</u> | <u>Dental benefits</u> | <u>Total reserves</u> |
|---|-----------------------------|-------------------------------|----------------------------|---------------------------|
| Reserves as of June 30, 2008 | \$ 6,406,316 | 1,198,966 | 3,311,027 | 10,916,309 |
| Claim payments | (47,092,647) | (20,384,678) | (38,687,814) | (106,165,139) |
| Current year claims and changes in estimates | <u>48,258,131</u> | <u>20,592,603</u> | <u>38,540,784</u> | <u>107,391,518</u> |
| Reserves as of June 30, 2009 | 7,571,800 | 1,406,891 | 3,163,997 | 12,142,688 |
| Claim payments | (46,208,357) | (20,496,434) | (39,413,941) | (106,118,732) |
| Current year claims and changes in estimates | <u>46,364,646</u> | <u>20,520,714</u> | <u>39,514,731</u> | <u>106,400,091</u> |
| Reserves as of June 30, 2010 | <u>\$ 7,728,089</u> | <u>1,431,171</u> | <u>3,264,787</u> | <u>12,424,047</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 23,623 and 22,576 retirees as of June 30, 2010 and 2009, 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, 2010 and 2009, respectively, were \$11.1 million and \$10.8 million for City Health Plan and \$3.4 million and \$3.3 million for Delta Dental for active employees.



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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, 2010, and have issued our report thereon dated October 29, 2010. 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 deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, 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.

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 deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, 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 management, the Board of Supervisor's Finance and Audits Committee, the Health Service System Board, and others within the System, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

October 29, 2010