



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

Financial Statements

June 30, 2012 and 2011

(With Independent Auditors' Report Thereon)

**HEALTH SERVICE SYSTEM  
CITY AND COUNTY OF SAN FRANCISCO  
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KPMG LLP  
Suite 1400  
55 Second Street  
San Francisco, CA 94105

## Independent Auditors' Report

Members of the Health Service Board,  
The Honorable Mayor and Board of Supervisors  
City and County of San Francisco:

We have audited the accompanying financial statements of the 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, 2012 and 2011, 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 Company'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, 2012 and 2011, the changes in its financial position, or, where applicable, its cash flows for the years the 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, 2012 and 2011, 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 31, 2012, 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.



U.S. generally accepted accounting principles require that the MD&A, on pages 3 through 9, be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

KPMG LLP

October 31, 2012

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

Management's Discussion and Analysis

June 30, 2012 and 2011

The management of the Health Service System (the System), a department of the City and County of San Francisco is pleased to provide this overview and analysis of the financial performance as of and for the fiscal years ended June 30, 2012 and 2011. 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 three plan choices:

- City Health Plan (Preferred Provider Organization (PPO))
- Kaiser Foundation Health Plan (Fully insured HMO)
- Blue Shield of California (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.

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. Similar to 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.

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**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, 2012 and 2011. 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, 2012 and 2011.
- 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, 2012, there were \$53.2 million of net assets available to meet future health care obligations. This compares to \$27.5 million as of June 30, 2011 and \$14.2 million as of June 30, 2010.

The net assets available for health benefits increased by \$25.7 million in 2012. The components of the increase are:

- \$6.5 million increase in the City Health Plan (stabilization subsidy per System Board approved policy of \$5.4 million and excess premiums over claims costs of \$1.1 million)
- \$12.6 million increase in the Blue Shield and Kaiser plans, mainly from Blue Shield 2% pledge reducing plan payments by \$12.0 million
- \$4.1 million increase in the dental plans (stabilization subsidy per System Board approved policy of \$2.5 million and premium excess over claims of \$1.6 million)
- \$2.5 million in trust fund interest income, performance guarantee penalties and forfeitures.

	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>Dollar change (12 – 11)</u>	<u>Percent change (12 – 11)</u>	<u>Dollar change (11 – 10)</u>	<u>Percent change (11 – 10)</u>
Total assets	\$ 146,457,377	103,117,337	94,650,587	43,340,040	42%	\$ 8,466,750	9%
Total liabilities	93,238,368	75,630,909	80,424,161	17,607,459	23%	(4,793,252)	(6)%
Net assets	<u>\$ 53,219,009</u>	<u>27,486,428</u>	<u>14,226,426</u>	<u>25,732,581</u>	<u>94%</u>	<u>\$ 13,260,002</u>	<u>93%</u>

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The net assets available for health benefits increased by \$13.3 million in 2011. The components of the increase are:

- \$3.0 million decrease in the City Health Plan (stabilization subsidy per System Board approved policy of \$1.1 million and excess claims over premiums costs of \$1.9 million)
- \$10.7 million increase in the Blue Shield and Kaiser plans, resulting from increases in the rates for the close-out of the PacifiCare Maximum Premium Arrangement contract of \$1.1 million, Blue Shield 2% pledge reducing plan payments by \$6.9 million and reimbursement from the Early Retiree Reinsurance Program (ERRP) of \$2.7 million
- \$3.8 million increase in the dental plans (stabilization subsidy per System Board approved policy of \$1.3 million and premium excess over claims of \$2.5 million)
- \$1.8 million in trust fund interest income, performance guarantee penalties and forfeitures.

	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>Dollar change (11 – 10)</u>	<u>Percent change (11 – 10)</u>	<u>Dollar change (10 – 09)</u>	<u>Percent change (10 – 09)</u>
Total assets	\$ 103,117,337	94,650,587	89,854,083	8,466,750	9%	\$ 4,796,504	5%
Total liabilities	<u>75,630,909</u>	<u>80,424,161</u>	<u>76,453,637</u>	<u>(4,793,252)</u>	<u>(6)%</u>	<u>3,970,524</u>	<u>5%</u>
Net assets	<u>\$ 27,486,428</u>	<u>14,226,426</u>	<u>13,400,446</u>	<u>13,260,002</u>	<u>93%</u>	<u>\$ 825,980</u>	<u>6%</u>

***Fiscal Year 2012***

- Cash and investments held with City and County Treasurer as of June 30, 2012, totaled \$107.0 million compared to \$73.3 million as of June 30, 2011, an increase of 46%. The cash and investment balance fluctuates throughout the year depending on collections, claims, and timing of vendor payments. The monthly cash balance ranged between \$83.7 million and \$126.0 million during the year ended June 30, 2012.
- Contributions receivable from employer increased from \$16.6 million to \$30.9 million, as of June 30, 2012, an 86% increase. Contributions receivable from employees increased from \$3.2 million to \$5.0 million, as of June 30, 2012, a 56% increase. Changes in contributions receivable were due to the timing and processing of deductions for two pay periods pertaining to July 2012 benefit coverage.
- Reserves for claims under the City Health Plan and Delta Dental increased from \$8.7 million to \$9.4 million, an 8% 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, 2012.
- Premiums payable to health maintenance organizations, dental, and disability plans increased by \$0.6 million, from \$26.0 million to \$26.6 million, as of June 30, 2012.
- Unearned contributions represent health contributions received in advance of the period of benefit coverage. Unearned contributions increased from \$40.9 million to \$57.3 million as of June 30, 2012, or a 40% increase. This increase is attributable to the annual rate increases, and due to the timing and processing of deductions for two pay periods pertaining to July 2012 benefit coverage.

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***Fiscal Year 2011***

- Cash and investments held with City and County Treasurer as of June 30, 2011, totaled \$73.3 million compared to \$65.6 million as of June 30, 2010, an increase of 12%. The cash and investment balance fluctuates throughout the year depending on collections, claims, and timing of vendor payments. The monthly cash balance ranged between \$66.0 million and \$92.6 million during the year ended June 30, 2011.
- Contributions receivable from employer decreased from \$16.9 million to \$16.6 million, as of June 30, 2011, a 2% decrease. Contributions receivable from employees decreased from \$4.0 million to \$3.2 million, as of June 30, 2011, a 20% decrease. Changes in contributions receivable were due to not taking a deduction for the last six days of the fiscal year and a drop in active members and their dependents.
- Reserves for claims under the City Health Plan and Delta Dental decreased from \$12.4 million to \$8.7 million, a 30% decrease. The reserve is actuarially determined, and the decrease is attributable to the decrease in the volume of anticipated claims incurred but not reported at June 30, 2011.
- Premiums payable to health maintenance organizations, dental, and disability plans decreased by \$1.2 million, from \$27.2 million to \$26.0 million, as of June 30, 2011. The decrease reflects the close-out of the PacifiCare maximum premium contract in June 2010.
- Unearned contributions represent health contributions received in advance of the period of benefit coverage. Unearned contributions increased from \$40.8 million to \$40.9 million as of June 30, 2011, or a 0.3% increase. This increase is attributable to the annual rate increases.



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**Financial Analysis –Condensed Financial Information**

For the year ended June 30, 2012, there was a \$25.7 million increase in net assets during the year. This compares to a \$13.3 million increase and \$0.8 million increase in net assets for the years ended June 30, 2011 and 2010 respectively. The highlights regarding the changes in net assets are as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>Dollar change (12-11)</u>	<u>Percent change (12-11)</u>	<u>Dollar change (11 – 10)</u>	<u>Percent change (11 – 10)</u>
Additions:							
Employee and retiree contributions	\$ 109,735,070	119,430,273	110,294,034	(9,695,203)	(8)%	\$ 9,136,239	8%
Employer contributions	<u>612,742,957</u>	<u>583,340,612</u>	<u>548,184,923</u>	<u>29,402,345</u>	<u>5%</u>	<u>35,155,689</u>	<u>6%</u>
Total contributions	<u>722,478,027</u>	<u>702,770,885</u>	<u>658,478,957</u>	<u>19,707,142</u>	<u>3%</u>	<u>44,291,928</u>	<u>7%</u>
Plan providers penalties and forfeitures	<u>1,166,491</u>	<u>1,458,217</u>	<u>1,623,775</u>	<u>(291,726)</u>	<u>(20)%</u>	<u>(165,558)</u>	<u>(10)%</u>
Total additions	<u>723,644,518</u>	<u>704,229,102</u>	<u>660,102,732</u>	<u>19,415,416</u>	<u>3%</u>	<u>44,126,370</u>	<u>7%</u>
Deductions:							
City Health Plan health benefits	62,070,269	70,992,313	69,273,756	(8,922,044)	(13)%	1,718,557	2%
Health maintenance organization health benefits	559,852,122	546,066,398	516,366,608	13,785,724	3%	29,699,790	6%
Vision plan health benefits	4,342,912	4,052,520	4,093,377	290,392	7%	(40,857)	(1)%
Dental benefits	53,224,967	51,253,618	50,694,316	1,971,349	4%	559,302	1%
Disability and flexible benefits	<u>19,805,168</u>	<u>18,993,067</u>	<u>19,786,339</u>	<u>812,101</u>	<u>4%</u>	<u>(793,272)</u>	<u>(4)%</u>
Total deductions	<u>699,295,438</u>	<u>691,357,916</u>	<u>660,214,396</u>	<u>7,937,522</u>	<u>1%</u>	<u>31,143,520</u>	<u>5%</u>
Change in net assets before investment earnings	24,349,080	12,871,186	(111,664)	11,477,894	89%	12,982,850	11,627%
Investment earnings	<u>1,383,501</u>	<u>388,816</u>	<u>937,644</u>	<u>994,685</u>	<u>256%</u>	<u>(548,828)</u>	<u>(59)%</u>
Change in net assets	<u>\$ 25,732,581</u>	<u>13,260,002</u>	<u>825,980</u>	<u>12,472,579</u>	<u>94%</u>	<u>\$ 12,434,022</u>	<u>1,505%</u>

**Fiscal Year 2012**

- Employees and retirees contributions totaled \$109.7 million during the year ended June 30, 2012, compared to \$119.4 million for the prior year, a decrease of 8%. The decrease was due to an increase in the City contribution amounts discussed in the next paragraph. Active employees contributed \$67.8 million and retirees contributed \$41.9 million of the \$109.7 million collected in FY 2012. Of the total contributions, \$88.9 million are for medical coverage, \$14.1 million for dental coverage, and \$6.7 million in flexible spending accounts.

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- Employer contributions on behalf of active employees increased from \$401.3 million to \$423.6 million, an increase of 6% over the prior year. The primary factor for the \$22.3 million increase was an increase in the ten County Contribution amount from \$472.85 to \$503.94 per member per month, an increase of 7% 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 \$182.0 million during the year ended June 30, 2011, to \$189.2 million for the year ended June 30, 2012, or 4%. 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 \$71.0 million for the year ended June 30, 2011, to \$62.1 million for the year ended June 30, 2012, or 13%. This change is due to premium increases offset by lower enrollment in the City Plan as members moved out of the City Plan to HMO plans. Total health maintenance organizations expenditures increased from \$546.1 million for the year ended June 30, 2011, to \$559.9 million for the year ended June 30, 2012, or 3%, due primarily to increases in contract rates and increases in enrollment.
- Investment earnings for the year ended June 30, 2012, were \$1.4 million compared to \$0.4 million in the prior year, or an increase of \$1.0 million due to an increase in fair market value of investments.
- The following primary changes to medical benefits were effective July 1, 2011:
  - Blue Shield HMO Plan increase in mental health inpatient hospitalization copays from \$100 to \$150.
  - Blue Shield and Kaiser HMO Plans increase in the non-formulary drug copays from \$35 to \$45 and from \$70 to \$90 respectively for 30 day and 90 supply, and copays were eliminated for pre/post – natal care physician care.
  - VSP Vision Plan increase in the maximum contact lens fitting copays \$0 to a maximum of \$60.
  - Delta Dental for Actives implemented employee contributions unions that included this contribution within their MOU or agreement with the City, at \$5.00, \$10.00, \$15.00 per month depending upon member selected coverage tier.

***Fiscal Year 2011***

- Employees and retirees contributions totaled \$119.4 million during the year ended June 30, 2011, compared to \$110.3 million for the prior year, an increase of 8%. The increase was due to the increase in rates. Active employees contributed \$78 million and retirees contributed \$41 million of the \$119 million collected in FY 2011. Of the total contributions, \$102 million are for medical coverage, \$11 million for dental coverage, and \$6 million in flexible spending accounts.
- Employer contributions on behalf of active employees increased from \$388.7 million to \$401.3 million, an increase of 3% over the prior year. The primary factor for the \$12.6 million increase was an increase in the ten County Contribution amount from \$449.37 to \$472.85 per member per month, an increase of 5% over

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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 \$159.5 million during the year ended June 30, 2010, to \$182.0 million for the year ended June 30, 2011, or 14%. 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, increased from \$69.3 million for the year ended June 30, 2010, to \$71.0 million for the year ended June 30, 2011, or 2%. This change is due to premium increases offset by lower enrollment in the City Plan as members moved out of the City Plan to HMO plans. Total health maintenance organizations expenditures increased from \$516.4 million for the year ended June 30, 2010, to \$546.1 million for the year ended June 30, 2011, or 6%, due primarily to increases in contract rates and increases in enrollment.
- Investment earnings for the year ended June 30, 2011, were \$0.4 million compared to \$0.9 million in the prior year, or a decrease of \$0.5 million due to a decrease in fair market value of investments.
- The following changes to medical benefits were effective July 1, 2010:
  - Blue Shield HMO Plan increase in the office visit copays from \$15 to \$20.
  - Blue Shield and Kaiser HMO Plans increase in the emergency room copays from \$50 to \$100.
  - Kaiser HMO Plan increase in the office visit copays from \$10 to \$15.
  - VSP Vision Plan increase in the eye doctor visit copays from \$0 to \$5.

**Request for Information**

This report is designed to provide a general overview of the Health Service System's finances for the years ended June 30, 2012 and 2011. Questions regarding any of the information provided in this report or requests for additional information should be addressed to:

Health Service System  
City and County of San Francisco  
Tracey Loveridge, Chief Financial Officer  
1145 Market Street, Suite 200  
San Francisco, CA 94103-1523

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

Statements of Net Assets Available for Health Benefits

June 30, 2012 and 2011

	<b>2012</b>	<b>2011</b>
<b>Assets:</b>		
Cash and investments held with City and County Treasurer	\$ 106,969,056	73,310,631
Contributions receivable from:		
Employer	30,886,077	16,605,267
Employees	5,049,448	3,183,878
Interest receivable	48,169	—
Other assets	3,504,627	10,017,561
Total assets	146,457,377	103,117,337
<b>Liabilities:</b>		
Reserves for claims – City Health Plan, prescription drugs and dental	9,358,125	8,706,025
Health Maintenance Organization, dental, and disability premiums payable	26,570,119	26,035,398
Unearned contributions	57,310,124	40,853,675
Interest payable	—	35,811
Total liabilities	93,238,368	75,630,909
Net assets available for health benefits	\$ 53,219,009	27,486,428

See accompanying notes to financial statements.

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Statements of Changes in Net Assets Available for Health Benefits

Years ended June 30, 2012 and 2011

	<b>2012</b>	<b>2011</b>
Additions:		
Employee and retiree contributions	\$ 109,735,070	119,430,273
Employer contributions for:		
Active employees	423,573,655	401,292,191
Retired employees	189,169,302	182,048,421
Total contributions	722,478,027	702,770,885
Plan providers penalties and forfeitures	1,166,491	1,458,217
Investment earnings:		
Net increase (decrease) in fair value of investments	667,004	(85,591)
Interest income	716,497	474,407
Total investment earnings	1,383,501	388,816
Total additions	725,028,019	704,617,918
Deductions:		
City Health Plan health benefits	62,070,269	70,992,313
Health Maintenance Organization health benefits	559,852,122	546,066,398
Vision benefits	4,342,912	4,052,520
Dental benefits	53,224,967	51,253,618
Disability and flexible benefits	19,805,168	18,993,067
Total deductions	699,295,438	691,357,916
Change in net assets available for health benefits	25,732,581	13,260,002
Net assets available for health benefits:		
Beginning of year	27,486,428	14,226,426
End of year	\$ 53,219,009	27,486,428

See accompanying notes to financial statements.

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Notes to Financial Statements

June 30, 2012 and 2011

**(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 (2004), 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 (HSB) 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 HSB. 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 HSB 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.

On November 8, 2011, the San Francisco voters approved Proposition C (2011), which reconfigured the HSB by replacing one seat formerly filled by an elected member with a member appointed by the Controller. This change will be implemented at the conclusion of the May 2013 Health Service Board meeting. Once this reconfiguration is completed, the Board will be comprised of seven members, as follows: 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); one member appointed by the Controller; and three members elected by the members of the System.

Proposition C (2011) also changed the voting requirements, in order for the HSB to approve member health plans before sending them to the Board of Supervisors, from a super majority to a simple majority. Formerly five votes were needed by the HSB to approve member health plans; however, with the passage of Proposition C (2011), this was decreased to four votes. Proposition C (2011) also eliminated the requirement that the "10-County Survey" be conducted in January of each year, and allowed the HSB to shift from a fiscal plan year to a calendar plan year. This resulted in a short six-month "plan year" in 2012, from July 1, 2012 to December 31, 2012, with an open enrollment period in April 2012. The System's first calendar year plan year will be from January 1, 2013 to December 31, 2013, with an open enrollment period in October 2012.

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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 typical 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.

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 three plan choices:

- City Health Plan (Preferred Provider Organization (PPO))
- Kaiser Foundation Health Plan (Kaiser) (HMO)
- Blue Shield of California (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.

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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. Similar to the City Health Plan, 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.

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 WageWorks, Inc.

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.



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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 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.

In January 2012, the HSB adopted a \$5.2 million rate stabilization for the Blue Shield of California (HMO) plan for the short plan year of July 1, 2012 to December 31, 2012. This rate stabilization, which is an effort to minimize migration, was funded by the Blue Shield of California (HMO) pledge credit and applied to both employee and employer contributions.

**(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.

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In accordance with GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and External Investment Pools*, the City and County 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.

**(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 and County’s pool of cash and investments. The City and County investment pool is invested in an unrated pool pursuant to investment policy guidelines established by the City and County Treasurer. The objectives of the policy are, in order of priority, then preservation of capital, liquidity, and yield. The policy addresses soundness of financial institutions in which City and County 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, 2012 and 2011, the System’s cash and investment balances were \$107.0 million and \$73.3 million, which represented less than 2% of the City and County’s investment pool, respectively.

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

<b>Under 1</b>	<b>1 to less than 6</b>	<b>6 to less than 12</b>	<b>12 – 60</b>
1.9%	11.1%	8.0%	79.0%

**(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.

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June 30, 2012 and 2011

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.

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, 2012 and 2011:

	<u>Medical benefits</u>	<u>Prescription drugs</u>	<u>Dental benefits</u>	<u>Total reserves</u>
Reserves as of June 30, 2010	\$ 7,728,089	1,431,171	3,264,787	12,424,047
Claim payments	(45,307,235)	(27,397,521)	(39,206,758)	(111,911,514)
Current year claims and changes in estimates	<u>42,862,722</u>	<u>26,471,677</u>	<u>38,859,093</u>	<u>108,193,492</u>
Reserves as of June 30, 2011	5,283,576	505,327	2,917,122	8,706,025
Claim payments	(37,203,324)	(21,845,161)	(40,078,251)	(99,126,736)
Current year claims and changes in estimates	<u>36,995,235</u>	<u>22,430,470</u>	<u>40,353,131</u>	<u>99,778,836</u>
Reserves as of June 30, 2012	<u>\$ 5,075,487</u>	<u>1,090,636</u>	<u>3,192,002</u>	<u>9,358,125</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 24,836 and 24,182 retirees as of June 30, 2012 and 2011, respectively, is shown as employer contributions to the System in the accompanying financial statements.

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**(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 and the Delta Dental plan for active employees. 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, 2012 and 2011, respectively, were \$7.8 million and \$7.2 million for City Health Plan and \$3.7 million and \$3.7 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***

Members of the Health Service Board,  
The Honorable Mayor and Board of Supervisors  
City and County of San Francisco:

We have audited the financial statements of the 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 year ended June 30, 2012, and have issued our report thereon dated October 31, 2012. 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**

Management of the System is responsible for establishing and maintaining effective 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 was not designed to identify all deficiencies in internal control over financial reporting 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 31, 2012