



**HEALTH SERVICE SYSTEM  
OTHER EMPLOYEE BENEFIT TRUST FUND  
CITY AND COUNTY OF SAN FRANCISCO**

Financial Statements

June 30, 2016 and 2015

(With Independent Auditors' Report Thereon)

**HEALTH SERVICE SYSTEM  
OTHER EMPLOYEE BENEFIT TRUST FUND  
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 Other Employee Benefit Trust Fund (the Trust) (also referred to as the Health Service System Trust Fund), managed by the Health Service System (the System), a department of the City and County of San Francisco, California (the City), as of and for the years ended June 30, 2016 and 2015, and the related notes to the financial statements as listed in the table of contents.

### **Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### **Auditors' Responsibility**

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

### **Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Other Employee Benefit Trust Fund, managed by the Health Service System, a department of the City, as of June 30, 2016 and 2015, and the changes in financial position, for the years then ended in accordance with U.S. generally accepted accounting principles.



### **Emphasis of Matter**

As discussed in note 1, the financial statements of the Trust are intended to present the financial position and the changes in the financial position of only that portion of the City that is attributable to the transactions of the Trust. They do not purport to, and do not, present fairly the financial position of the City as of June 30, 2016 and 2015, and the changes in its financial position for the years then ended, in conformity with U.S generally accepted accounting principles.

### **Other Matters**

#### ***Required Supplementary Information***

U.S. generally accepted accounting principles require that the management's discussion and analysis on pages 3–8 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

#### **Other Reporting Required by Government Auditing Standards**

In accordance with *Government Auditing Standards*, we have also issued our report dated October 14, 2016 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, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the System's internal control over financial reporting and compliance.

**KPMG LLP**

San Francisco, California  
October 14, 2016

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Management's Discussion and Analysis

June 30, 2016 and 2015

The management of the Health Service System (the System), a department of the City and County of San Francisco (the City), is pleased to provide this overview and analysis of the financial performance as of and for the fiscal years ended June 30, 2016 and 2015. 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 that is reflected as an Other Employee Benefit Trust Fund (the Trust) (also referred to as the Health Service System Trust Fund), in the City's Comprehensive Annual Financial Report (CAFR). The System 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, the San Francisco Unified School District, the San Francisco Community College District, and the San Francisco Superior Court. The System is governed by the Health Service Board (HSB) 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 (flex-funded plan with fully insured, capitated, and self-insured components)

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 HMO plan is a traditional fully insured external health maintenance organization, where the risk of loss due to excess claims for a given fiscal year is borne by the health maintenance organization. The Blue Shield of California Plan is a flex-funded plan. The flex-funded plan has a fully insured, capitated component for professional services provided in physician offices. Hospital and pharmacy services are self-insured, where the risk of loss due to claims in excess of revenues is borne by the Health Service System Trust Fund.

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

- Delta Dental (PPO)
- Delta Care (PMI, DMO)
- Pacific Union (DMO)

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 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 Trust's financial statements, which consist of the statements of net position available for health benefits, the statements of changes in net position available for health benefits, and notes to financial statements.

- The statements of net position available for health benefits are a snapshot of account balances as of June 30, 2016 and 2015. They show assets, liabilities, and net position available for health benefits as of those dates.
- The statements of changes in net position available for health benefits show additions and deductions to the Trust's net position during the plan years ended June 30, 2016 and 2015.
- 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 Trust presents financial statements reflecting full accrual basis accounting.

**Financial Analysis – Condensed Schedule of Net Position Available for Health Benefits**

As of June 30, 2016, there was \$68.6 million of net position available to meet future health care obligations. This compares to \$81.5 million as of June 30, 2015 and \$92.8 million as of June 30, 2014.

	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>Dollar change (16 – 15)</u>	<u>Percent change (16 – 15)</u>	<u>Dollar change (15 – 14)</u>	<u>Percent change (15 – 14)</u>
Total assets	\$ 108,863,994	131,025,181	179,577,247	(22,161,187)	(17)%	\$ (48,552,066)	(27)%
Total liabilities	40,260,796	49,495,424	86,756,337	(9,234,628)	(19)%	(37,260,913)	(43)%
Net position	<u>\$ 68,603,198</u>	<u>81,529,757</u>	<u>92,820,910</u>	<u>(12,926,559)</u>	<u>(16)%</u>	<u>\$ (11,291,153)</u>	<u>(12)%</u>

***Fiscal Year 2016***

The net position available for health benefits decreased by \$12.9 million in 2016. The components of the decrease are:

- \$10.8 million decrease in the City Health Plan (excess claim costs over premium equivalents of \$0.1 million, and \$10.7 million in claim stabilization, per HSB approved policy)
- \$7.3 million decrease in the Blue Shield flex-funded plan (excess claim costs over premium equivalents of \$4.6 million, premium credit of \$4.4 million from the Blue Shield 2 Percent Profit Pledge offset by claim stabilization, per HSB approved policy, of \$1.7 million)
- \$3.8 million increase in the dental plans (excess premium equivalents over claim costs of \$4.4 million offset by claim stabilization, per HSB approved policy, of \$0.6 million)

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- \$0.2 million increase in Blue Shield fully insured and Kaiser plans from contract premium arrangements for new enrollees, termed members, and members eligible for Medicare
- \$0.2 million increase in administrative savings
- \$0.2 million decrease in flexible spending account contributions over claim reimbursements
- \$1.2 million increase in Trust Fund interest income, performance guarantee penalties, and forfeitures.

***Fiscal Year 2015***

The net position available for health benefits decreased by \$11.3 million in 2015. The components of the decrease are:

- \$0.8 million decrease in the City Health Plan (excess premium equivalents over claim costs of \$4.8 million offset by claim stabilization, per HSB approved policy, of \$4.9 million and the Trust funded premium subsidy of \$0.7 million)
- \$17.1 million decrease in the Blue Shield flex-funded plan (excess claim costs over premium equivalents of \$10.1 million, premium credit of \$5.4 million from the Blue Shield 2 Percent Profit Pledge, Early Retiree Reinsurance Program [ERRP] Funds of \$1.1 million, claim stabilization, per HSB approved policy, of \$0.5 million)
- \$3.2 million increase in the dental plans due to premium equivalents excess over claims
- \$1.2 million increase in Blue Shield fully insured and Kaiser plans from contract premium arrangements for new enrollees, termed members, and members eligible for Medicare
- \$0.4 million increase in administrative savings
- \$0.7 million increase of flexible spending account contributions exceeding claim reimbursements
- \$1.1 million increase in Trust Fund interest income, performance guarantee penalties, and forfeitures.

***Fiscal Year 2016***

- Cash and investments held with the City Treasurer as of June 30, 2016 totaled \$87.6 million compared to \$109.8 million as of June 30, 2015, a decrease of 20.2 percent. The cash and investment balance fluctuates throughout the year depending on collections, claims, and timing of vendor payments. The monthly cash balance ranged between \$87.6 million and \$116.0 million during the year ended June 30, 2016. In addition, per HSB approved policy, additional stabilization reserve was used to reduce 2016 rates as described in note 6(b).
- Contributions receivable from employer increased from \$16.1 million, as of June 30, 2015 to \$17.1 million as of June 30, 2016, a 6.01 percent increase. Contributions receivable from employees increased from \$2.9 million, as of June 30, 2015 to \$3.2 million as of June 30, 2016, a 7.5 percent increase. This is due to the timing of health premium collections and elimination of advance premium collection requirement effective January 2015.

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- Reserves for claims under the City Health Plan, Blue Shield flex-funded plan, and Delta Dental did not change from \$29.3 million as of June 30, 2015 to June 30, 2016. The reserve is actuarially determined.
- Premiums payable to health maintenance organizations, dental, and disability plans decreased by 53.0 percent, from \$18.5 million as of June 30, 2015 to \$8.7 million as of June 30, 2016. This is due to the timing of payments to health care providers.
- Unearned contributions represent health contributions received in advance of the period of benefit coverage. Unearned contributions increased from \$1.7 million as of June 30, 2015 to \$2.2 million as of June 30, 2016, or a 33.5 percent increase. This is due to the timing and processing of deductions for a pay period pertaining to July 2016 benefit coverage.

***Fiscal Year 2015***

- Cash and investments held with the City Treasurer as of June 30, 2015 totaled \$109.8 million compared to \$137.6 million as of June 30, 2014, a decrease of 20.2 percent. The cash and investment balance fluctuates throughout the year depending on collections, claims, and timing of vendor payments. The monthly cash balance ranged between \$102.5 million and \$167.8 million during the year ended June 30, 2015.
- Contributions receivable from employer decreased from \$34.0 million as of June 30, 2014 to \$16.1 million, as of June 30, 2015, a 52.6 percent decrease. Contributions receivable from employees decreased from \$5.9 million as of June 30, 2014 to \$2.9 million, as of June 30, 2015, a 50.8 percent decrease. This is due to the timing of health premium collections and elimination of advance premium collection requirement effective January 2015.
- Reserves for claims under the City Health Plan, Blue Shield flex-funded plan, and Delta Dental increased from \$29.2 million as of June 30, 2014 to \$29.3 million as of June 30, 2015, a 0.3 percent increase. The reserve is actuarially determined, and the increase is attributable to the increase in the volume of anticipated claims incurred but not reported on June 30, 2015.
- Premiums payable to health maintenance organizations, dental, and disability plans increased by 40.2 percent, from \$13.2 million as of June 30, 2014 to \$18.5 million as of June 30, 2015. This is due to the timing of payments to health care providers and a 3.0% increase in covered lives.
- Unearned contributions represent health contributions received in advance of the period of benefit coverage. Unearned contributions decreased from \$44.4 million as of June 30, 2014 to \$1.7 million as of June 30, 2015, or a 96.2 percent decrease. This is due to the elimination of the advance premium collection requirement, effective January 2015.



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**Financial Analysis – Condensed Financial Information**

For the year ended June 30, 2016, there was a \$12.9 million decrease in net position during the year. This compares to an \$11.3 million decrease and \$15.5 million increase in net position for the years ended June 30, 2015 and 2014, respectively. The highlights regarding the changes in net position are as follows:

	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>Dollar change (16-15)</u>	<u>Percent change (16-15)</u>	<u>Dollar change (15-14)</u>	<u>Percent change (15-14)</u>
Additions:							
Employee and retiree contributions	\$ 124,504,149	120,467,997	118,469,378	4,036,152	3.4%	\$ 1,998,619	1.7%
Employer contributions	<u>674,555,731</u>	<u>656,402,769</u>	<u>644,053,941</u>	<u>18,152,962</u>	<u>2.8%</u>	<u>12,348,828</u>	<u>1.9%</u>
Total contributions	799,059,880	776,870,766	762,523,319	22,189,114	2.9%	14,347,447	2.0%
Plan providers penalties and forfeitures	<u>843,772</u>	<u>467,479</u>	<u>443,201</u>	<u>376,293</u>	<u>80.5%</u>	<u>24,278</u>	<u>5.5%</u>
Total additions	<u>799,903,652</u>	<u>777,338,245</u>	<u>762,966,520</u>	<u>22,565,407</u>	<u>2.9%</u>	<u>14,371,725</u>	<u>1.9%</u>
Deductions:							
City Health Plan health benefits	54,045,453	49,648,775	47,635,818	4,396,678	8.9%	2,012,957	4.2%
Health maintenance organization health benefits	679,726,937	663,123,088	628,791,452	16,603,849	2.5%	34,331,636	5.5%
Vision plan health benefits	4,988,617	4,810,681	4,584,217	177,936	3.7%	226,464	4.9%
Dental benefits	57,499,941	56,656,927	52,214,587	843,014	1.5%	4,442,340	8.5%
Disability and flexible benefits	<u>16,902,239</u>	<u>15,039,162</u>	<u>15,338,757</u>	<u>1,863,077</u>	<u>12.4%</u>	<u>(299,595)</u>	<u>(2.0)%</u>
Total deductions	<u>813,163,187</u>	<u>789,278,633</u>	<u>748,564,831</u>	<u>23,884,554</u>	<u>3.0%</u>	<u>40,713,802</u>	<u>5.4%</u>
Change in net position before investment earnings	(13,259,535)	(11,940,388)	14,401,689	(1,319,147)	11.0%	(26,342,077)	(182.9%)
Investment earnings	<u>332,976</u>	<u>649,235</u>	<u>1,054,864</u>	<u>(316,259)</u>	<u>(48.7)%</u>	<u>(405,629)</u>	<u>(38.5)%</u>
Change in net position	<u>\$ (12,926,559)</u>	<u>(11,291,153)</u>	<u>15,456,553</u>	<u>(1,635,406)</u>	<u>14.5%</u>	<u>\$ (26,747,706)</u>	<u>(173.1)%</u>

***Fiscal Year 2016***

- Employees and retirees contributions totaled \$124.5 million during the year ended June 30, 2016, compared to \$120.5 million for the prior year, an increase of 3.4 percent. Active employees contributed \$81.2 million and retirees contributed \$43.3 million of the \$124.5 million collected in fiscal year 2016. The number of covered lives increased 3% from the 2015 levels. Of the total contributions, \$96.9 million are for medical and vision coverage, \$17.9 million for dental coverage, and \$9.7 million for flexible spending accounts.
- Employer contributions on behalf of active employees increased from \$460.3 million during the year ended June 30, 2015 to \$480.7 million during the year ended June 30, 2016, an increase of 4.4 percent over the prior year. The primary factors for the \$20.4 million increase was an increase in rates, and the conversion from the 10 County Average Survey to a percentage based employee premium contribution model.
- Employer contributions on behalf of retirees decreased from \$196.1 million for the year ended June 30, 2015, to \$193.8 million for the year ended June 30, 2016, or 1.2 percent. The cost of the plan benefits,

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retiree's number of dependents and Medicare status of the retiree and dependents determines the premium for retirees. The decrease was due to the use of stabilization reserves reflected as a reduction to premiums. The 10 County Average Survey is still used to calculate the retiree rates.

- City Health Plan health benefits, which covers medical and prescription drug expenses, increased from \$49.6 million for the year ended June 30, 2015, to \$54.0 million for the year ended June 30, 2016, or 8.9 percent. This change is due to premium increases in the Employer Group Waiver Plan (EGWP) for retirees. The total expenditures for health maintenance organizations increased from \$663.1 million for the year ended June 30, 2015, to \$679.7 million for the year ended June 30, 2016, or 2.5 percent, due primarily to increases in contract rates, medical and pharmacy claims, and increases in enrollment.
- Dental Benefits totaled \$57.5 million for the year ended June 30, 2016 compared to \$56.7 million for the year ended June 30, 2015, for an increase of \$0.8 million or 1.5 percent due to an increase in contract rates and enrollment.
- Investment earnings totaled \$0.3 million for the year ended June 30, 2016 compared to \$0.6 million for the year ended June 30, 2015, for a decrease of \$0.3 million due to decreases in the fair market value of investments and interest income. Per GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and External Investment Pools*, financial statements must contain the fair market value of the investments as if they were liquidated on June 30<sup>th</sup>.
- There were no changes in health plan benefits in fiscal year 2016.

***Fiscal Year 2015***

- Employees and retirees contributions totaled \$120.5 million during the year ended June 30, 2015, compared to \$118.5 million for the prior year, an increase of 1.7 percent. Active employees contributed \$77.1 million and retirees contributed \$43.4 million of the \$120.5 million collected in fiscal year 2015. The number of covered lives increased 3.0 from the 2014 levels. Of the total contributions, \$93.9 million are for medical coverage, \$17.2 million for dental coverage, and \$9.4 million for flexible spending accounts.
- Employer contributions on behalf of active employees increased from \$445.2 million during the year ended June 30, 2014 to \$460.3 million during the year ended June 30, 2015, an increase of 3.4 percent over the prior year. The primary factors for the \$15.1 million increase was an increase in rates, and the conversion from the 10 County Average Survey to a percentage based employee premium contribution model.
- Employer contributions on behalf of retirees decreased from \$198.9 million for the year ended June 30, 2014, to \$196.1 million for the year ended June 30, 2015, or 1.4 percent. The cost of the plan benefits, retiree's number of dependents and Medicare status of the retiree and of the dependents determines the premium for retirees. The decrease was due to premium decreases. The 10 County Average Survey is still used to calculate the retiree rates.
- City Health Plan health benefits, which covers medical and prescription drug expenses, increased from \$47.6 million for the year ended June 30, 2014, to \$49.6 million for the year ended June 30, 2015, or 4.2 percent. This change is due to premium increases in the Employer Group Waiver Plan (EGWP).

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Total health maintenance organizations expenditures increased from \$628.8 million for the year ended June 30, 2014, to \$663.1 million for the year ended June 30, 2015, or 5.5 percent, due primarily to increases in contract rates, medical and pharmacy claims, and increases in enrollment.

- Dental Benefits totaled \$56.7 million for the year ended June 30, 2015 compared to \$52.2 million for the year ended June 30, 2014, for an increase of \$4.5 million or 8.6 percent due to an increase in contract rates and enrollment.
- Investment earnings totaled \$0.6 million for the year ended June 30, 2015 compared to \$1.1 million for the year ended June 30, 2014, for a decrease of \$0.5 million due to decreases in the fair market value of investments and interest income. Per GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and External Investment Pools*, financial statements must contain the fair market value of the investments as if they were liquidated on June 30<sup>th</sup>.
- There were no changes in health plan benefits in fiscal year 2014 – 2015.

**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, 2016 and 2015. 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  
Pamela Levin, Chief Financial Officer  
1145 Market Street, Suite 300  
San Francisco, CA 94103-1523

**HEALTH SERVICE SYSTEM  
OTHER EMPLOYEE BENEFIT TRUST FUND  
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Statements of Net Position Available for Health Benefits

June 30, 2016 and 2015

	<b>2016</b>	<b>2015</b>
<b>Assets:</b>		
Cash and investments held with City and County Treasurer	\$ 87,628,111	\$ 109,835,621
Contributions receivable from:		
Employer	17,099,557	16,130,447
Employees	3,165,274	2,943,300
Interest receivable	67,451	82,681
Other assets	903,601	2,033,132
Total assets	108,863,994	131,025,181
<b>Liabilities:</b>		
Reserves for claims – medical, prescription drugs and dental Health Maintenance Organization, dental, and disability premiums payable	29,346,617	29,342,770
Unearned contributions	8,675,494	18,475,271
	2,238,685	1,677,383
Total liabilities	40,260,796	49,495,424
Total net position	\$ 68,603,198	\$ 81,529,757

See accompanying notes to financial statements.

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Statements of Changes in Net Position Available for Health Benefits

Years ended June 30, 2016 and 2015

	<b>2016</b>	<b>2015</b>
Additions:		
Employee and retiree contributions	\$ 124,504,149	\$ 120,467,997
Employer contributions for:		
Active employees	480,737,677	460,327,725
Retired employees	193,818,054	196,075,044
Total contributions	799,059,880	776,870,766
Plan providers penalties and forfeitures	843,772	467,479
Investment earnings:		
Net change in fair value of investments	(48,423)	(23,137)
Interest income	381,399	672,372
Total investment earnings	332,976	649,235
Total additions	800,236,628	777,987,480
Deductions:		
City Health Plan health benefits	54,045,453	49,648,775
Health Maintenance Organization health benefits	679,726,937	663,123,088
Vision benefits	4,988,617	4,810,681
Dental benefits	57,499,941	56,656,927
Disability and flexible benefits	16,902,239	15,039,162
Total deductions	813,163,187	789,278,633
Change in net position available for health benefits	(12,926,559)	(11,291,153)
Net position:		
Beginning of year	81,529,757	92,820,910
End of year	\$ 68,603,198	\$ 81,529,757

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

The System is reflected as an Other Employee Benefit Trust Fund (the Trust) (also referred to as the Health Service System Trust Fund) and is an integral part of the City, and the accompanying financial statements are included as part of the primary government in the Comprehensive Annual Financial Report (CAFR) prepared by the City. The financial statements present only the Trust and do not purport to, and do not, present fairly the financial position of the City, as of June 30, 2016 and 2015, the changes in its financial position for the years then ended in accordance with U.S. generally accepted accounting principles. The Trust's cash balances are deposited with, and managed by, the Office of the Treasurer and Tax Collector.

The System, a City department, is overseen by the City's Health Service Board (HSB). Under Charter Section A8.422, the HSB is responsible for adopting a plan or plans for providing medical care to members of the System. The overarching principles in setting the rates and benefits are to provide quality health care, reduce costs, and stabilize insurance premiums for the members and the employer. The HSB must consider the increased cost resulting from the Patient Protection and Affordable Care Act (ACA) in determining the plan designs and premiums. Two direct fees (Patient Centered Research Institute Fee and the Transitional Reinsurance Fee) and one Health Insurance Tax were in place in fiscal year 2014. In addition, the HSB has considered the impact of the 2018 Excise Tax on High Cost Health Plans in the benefit design for 2015 and 2016.

The composition of the seven-member HSB includes a seated member of the City's Board of Supervisors (the Board), appointed by the Board President; an individual who regularly consults in the health care field, appointed by the Mayor; a doctor of medicine, appointed by the Mayor; a member nominated by the Controller and approved by the HSB, and three members of the Health Service System, active or retired, elected from among their members. The HSB is responsible for appointing a full-time Administrator, who serves at the pleasure of the HSB and sets the policy for and oversees the administration of the System.

Under Charter Section A8.423, the City's contribution towards the System's medical plans is determined by the results of an annual survey of the amount of premium contributions provided by the 10 most populous counties in California (other than the City). The survey is commonly called the Ten-County Average Survey (Average) and used to determine "the average contribution made by each such county toward the providing of health care plans, exclusive of dental care, for each employee of

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such county.” Under Charter Section A8.423, the City is required to contribute to the Health Service System Trust Fund an amount equal to the “average contribution” for each City Beneficiary.

In the June 2014 collective bargaining for the 2015 Plan Year, the impact of the “average contribution” on rates was eliminated in the calculation of premiums for almost all active employees represented by most unions, in exchange for a percentage based employee premium contribution model. It is anticipated that the long-term impact of the premium contribution model will be the reduction in the relative proportion of the projected increases in the City’s contributions for healthcare, stabilization of the medical plan membership and maintenance of competition among plans. The contribution amounts are paid by the City into the Health Service System Trust Fund. The Average is still used as a basis for calculating all retiree premiums and premiums for the San Francisco Superior Court, San Francisco Unified School District, and San Francisco Community College District. If the annual medical premiums exceed the contribution made by the City as required by the Charter and union agreements, the balance is the member’s responsibility to pay. The Ten County Average Survey is still used as a basis for calculating all retiree premiums.

Membership in the System is available to (i) all active permanent employees, as well as eligible retired employees, of the City, and of the San Francisco Unified School District, San Francisco Community College District, and the San Francisco Superior Court; (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 provisions of the ACA, HSS implemented, effective January 2015, the employer mandate that requires that “large employers” (i.e., employers with 50 or more full-time employees or full-time equivalents) offer affordable coverage that provides minimum value to all full-time employees and their dependents. ACA defined a full-time employee as one who works on average 30 hours a week. However, a threshold of 20 hours or more over a 12-month period was implemented.

Pursuant to the Charter, most administrative costs of the System are paid for by the City, 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) and flex-funded plan (Blue Shield for active employees and early retirees) are included in the respective premium rates for those plans.

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**(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) (Fully insured HMO)
- Blue Shield of California (flex-funded plan with fully insured, capitated, and self-insured components)

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). In 2013, the System implemented the Employer Group Waiver Plan (EGWP) for retirees with Medicare as a fully insured pharmacy plan. In 2016, UHC offered a fully insured National PPO plan for retirees with Medicare.

The Kaiser HMO is a fully insured external health maintenance organization, where the risk of loss due to excess claims for a given fiscal year is borne by the health maintenance organization. On January 1, 2013, the Blue Shield of California Plan was converted from a fully insured external health maintenance plan to a flex-funded plan. The flex-funded plan has a fully insured, capitated component for professional services provided in physician offices. Hospital and pharmacy services are self-insured, where the risk of loss due to claims in excess of revenues is borne by the Health Service System Trust Fund.

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

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

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 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 annual negotiation process that includes participation of the System's independent actuary and consultants. Premium rates for the self-insured plans are set based on recommendations and certification of such actuaries and consultants.



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The System offers two types of flexible spending accounts for all City employees: a health care reimbursement account and a dependent care reimbursement account. Most of the administration for these accounts is provided through a third-party administrator, whose fees are provided by the City through the System. The administrator in fiscal year 2015 was WageWorks, Inc. and P & A Group in 2016.

The System utilizes a third-party administrator to provide most of the administration for a 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 through the System. The current administrator is Employee Benefits Specialists, Inc.

In addition, the City 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. The current plan provider is Aetna Life and Casualty.

The City also provides group term life insurance to most employee groups. All costs for the life insurance are paid by contributions from the City. The current plan provider is Aetna Life and Casualty.

**(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, the San Francisco Unified School District, the San Francisco Community College District, and the San Francisco Superior Court as set forth below. Prior to 2015, the respective contributions of each of these groups are generally received in advance of the benefit period. Effective January 1, 2015, member premiums are received at the time 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, some in exchange for the Ten County Average amount (the Average). In the June 2014 collective bargaining for the 2015 and 2016 Plan Years, the impact of the “average contribution” on rates was eliminated in the calculation of premiums for almost all active employees represented by most unions, in exchange for a percentage based employee premium contribution model. The Average is still used as a basis for calculating all retiree premiums and premiums for the San Francisco Superior Court, San Francisco Unified School District, and San Francisco Community College District.

Employers contribute toward the costs for retired employees such that a retired employee pays no more than an active employee for the same benefits. 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

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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 HSB 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.

**(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 (GASB).

**(b) Effects of New Pronouncements**

In fiscal year 2016, the Trust adopted GASB Statement No. 72, *Fair Value Measurement and Application*, which requires the Trust to use valuation techniques which are appropriate under the circumstances and are consistent with the market approach, the cost approach or the income approach. GASB Statement No. 72 establishes a hierarchy of inputs used to measure fair value consisting of three levels. Level 1 inputs are quoted prices in active markets for identical assets or liabilities. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs.

GASB Statement No. 72 also contains note disclosure requirements regarding the hierarchy of valuation inputs and valuation techniques that were used for the fair value measurements. As of June 30, 2016 and 2015, the Trust did not have cash and investments outside of the City's pooled investments.

For those investments held with the City Treasury, the City discloses the requirements regarding the hierarchy of valuation inputs and techniques used for the fair value measurements at the City-wide level. However, such disclosure is not required at the department level for those investments held with the City Treasury.

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**(c) *Cash and Investments Held by the City***

The Trust maintains its cash and investments as part of the City's pool of cash and investments. The Trust's portion of this pool is displayed on the balance sheet as "Cash and investments held with City and County Treasurer." Interest income arising from pooled investments is allocated monthly to the System based on the System's 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 position and recognizes the corresponding change in fair value of investments in the year in which the change occurred. The System reports its investments at fair value based on market information provided by the City and County Treasurer.

**(d) *Unearned Contributions***

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

**(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 Treasurer***

The Trust maintains its cash and investments as part of the City's pool of cash and investments. The City investment pool is an unrated pool pursuant to investment policy guidelines established by the City Treasurer. The objectives of the policy are, in order of priority, preserve capital, meet the daily cash flow demands of the City, and provide a market rate of return while conforming to all state and local statutes governing the investment of public funds. The policy addresses soundness of financial institutions in which the 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, 2016 and 2015, the System's cash and investment balances were \$87.6 million and \$109.8 million, respectively, which represented less than 2% of the City's investment pool.

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

<b>Under 1 month</b>	<b>1 month to less than 6 months</b>	<b>6 months to less than 12 months</b>	<b>12 months to 60 months</b>
18.4%	23.2%	20.3%	38.1%

**(4) Reserves for Claims—City Health Plan, Blue Shield Health Plan, and Delta Dental Plan**

Reserves for claims, including medical, prescription drugs, and dental, 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 position of the Trust is 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 actuarially determined reserves are adequate to cover the ultimate cost of all claims incurred but unpaid at year end.

The City Health Plan, excluding the Employer Group Waiver Plan (EGWP) and the National PPO Plan, and the hospital and pharmacy services for employees and early retirees under the Blue Shield Health Plan, are self-funded plans. Should deductions from the net position of the self-funded plans exceed related additions to net position and reserves, the System would be required to seek additional funds from members. The City, San Francisco Unified School District, San Francisco Community College District, and the San Francisco Superior Court are not legally obligated to provide additional funds under these circumstances. The City’s contributions to the Trust 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.

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The following summarizes the changes in the reserves for claims of the System's City Health Plan, Blue Shield Health Plan (medical benefits and prescription drug benefits), and the Delta Dental Plan during the years ended June 30, 2016 and 2015:

	<u>Medical benefits</u>	<u>Prescription drugs</u>	<u>Dental benefits</u>	<u>Total reserves</u>
Reserves as of June 30, 2014	\$ 24,267,778	1,928,421	2,959,581	\$ 29,155,780
Claim Payments	(176,030,243)	(49,079,394)	(40,959,198)	(266,068,835)
Current Year Claims and Changes in Estimates	<u>175,598,302</u>	<u>49,658,715</u>	<u>40,998,808</u>	<u>266,255,825</u>
Reserves as of June 30, 2015	23,835,837	2,507,742	2,999,191	29,342,770
Claim Payments	(178,618,135)	(54,302,201)	(41,434,269)	(274,354,605)
Current Year Claims and Changes in Estimates	<u>178,678,338</u>	<u>54,475,415</u>	<u>41,204,699</u>	<u>274,358,452</u>
Reserves as of June 30, 2016	<u>\$ 23,896,040</u>	<u>\$ 2,680,956</u>	<u>\$ 2,769,621</u>	<u>\$ 29,346,617</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 27,126 and 26,454 retirees as of June 30, 2016 and 2015, respectively, is shown as employer contributions to the System in the accompanying financial statements.

**(6) Commitments and Contingencies**

**(a) Contingency Reserve Policy**

The HSB has adopted a Contingency Reserve Policy for the self-funded health plans including the City Health Plan, the Delta Dental self-funded plan and the Blue Shield Flex-funded Plan. The contingency reserve is an actuarially determined amount, based on historical claims experience required to cover the exposure of excess losses above anticipated claims expenses. The amount is established for the self-funded plans and is calculated on a fiscal year basis. It is presently set at a 99 percent confidence interval of the statistical variance of the historical claims experience. The contingency reserve amounts as of June 30, 2016 and 2015, were \$5.7 million and \$5.2 million, respectively, for the City Health Plan; \$15.1 million and \$14.9 million, respectively, for the Blue Shield Flex-funded Plan; and \$3.6 million and \$3.7 million, respectively, for the Delta Dental self-funded plan.

**(b) Stabilization Reserve**

The HSB has adopted a Self-Funded Plans' Stabilization Policy for the self-funded health plans, including the City Health Plan and the Delta Dental Plan for active employees, and the Flex-Funded/Self-Funded HMO Plans. The objective of a stabilization reserve is to spread any

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underwriting gains and losses into the following year's premium calculation in an even-handed manner such that the employers and membership are not subject to volatile year-over-year changes in premium. Pursuant to this policy, the stabilization reserves as of June 30, 2016 and 2015, were \$11.4 million and \$25.8 million, respectively, for the City Health Plan, \$(15.5) million and \$(13.5) million for Blue Shield Flex Plan, and \$7.1 and \$3.9 million for Delta Dental Plan. In May 2015, the HSB approved additional subsidy of \$5.4 million from the City Health Plan Stabilization Reserve to lower the premiums for the employees and early retirees in the plan year 2016. The negative reserve amounts for Blue Shield Flex Plan will be recovered through premium increases in subsequent years. In fiscal year 2016, the Health Service Board approved the use of the Stabilization Reserve for City Health Plan (\$10.8 million), and Delta Dental (\$1.8 million) to stabilize premium increases in fiscal year 2017.

**(c) *Contingent Incentive Obligations***

Based on calendar plan year 2014 results, the System calculated incentive obligation payments to medical groups under the Blue Shield Accountable Care Organization (ACO) network. The System's actuarial consultant negotiates an annual plan year cost target with the HMO and each participating ACO provider partnership group. In fiscal year 2015, the Trust paid out \$176,000 for plan year 2014. In fiscal year 2016, the obligation is \$729,128 for plan year 2015. Incentive payments are only distributed if underwriting gains are achieved at or above the negotiated target.

**(d) *Early Retiree Reinsurance Program (ERRP) Funds***

The American Recovery Act of 2012 included a provision that established the temporary ERRP which provided reimbursement to eligible sponsors of employment-based plans for a portion of the costs of providing health coverage to early retirees. The total ERRP funds received by the Trust and earned interest on these funds of \$3.8 million reduced 2014 plan year participant premium contributions for all plans. The program ended on December 31, 2014, so no funds were available for 2015 and 2016 plan years, but impacted the first six months of fiscal year 2015.

**(e) *Trust Funded Premium Subsidy***

In June 2013, the HSB adopted a \$3.4 million premium subsidy for employee-only enrollees with the Blue Shield and City Health Plans, available to unions who agreed to a 2015 flat premium contribution strategy. This subsidy prevented further migration to Kaiser and supports the Trust's ACO efforts. The subsidy reduced 2014 plan year participant premium contributions for the first six months of fiscal year 2015.

In the 2015 plan year, the Trust Fund premium subsidy was only for the Blue Shield Plan for employers and employees. The subsidy was funded from the remaining balance of the Blue Shield 2 Percent Profit Pledge, received in 2012, which is located in the Stabilization Reserve. The subsidy impacted the second six months of fiscal year 2015 and the first six months of fiscal year 2016.



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**Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance  
and Other Matters Based on an Audit of Financial Statements Performed in Accordance With  
*Government Auditing Standards***

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

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the financial statements of the Other Employee Benefit Trust Fund (the Trust) (also referred to as the Health Service System Trust Fund), managed by the Health Service System (the System), a department of the City and County of San Francisco, California (the City), which comprise the statement of financial position as of June 30, 2016, and the related statement of changes in net position available for health benefits, and the related notes to the financial statements, and have issued our report thereon dated October 14, 2016.

**Internal Control Over Financial Reporting**

In planning and performing our audit of the financial statements, we considered the Trust's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Trust's internal control. Accordingly, we do not express an opinion on the effectiveness of the Trust's internal control.

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

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.



### **Compliance and Other Matters**

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

### **Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the System's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Trust's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

**KPMG LLP**

San Francisco, California  
October 14, 2016