

STATE OF OREGON

DEPARTMENT OF CONSUMER AND BUSINESS SERVICES

INSURANCE DIVISION

REPORT OF FINANCIAL EXAMINATION

OF

**HEALTHGUARD SERVICES, INC. dba SELECTCARE  
EUGENE, OREGON**

**NAIC COMPANY CODE 95680**

AS OF

DECEMBER 31, 1994

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July 11, 1995

Honorable Deborah Senn  
Washington State Insurance Commissioner  
Washington State Insurance Commissioner's Office  
PO Box 40255  
Olympia, Washington 98504

Honorable Kerry Barnett, Director  
Department of Consumer and Business Services  
State of Oregon  
350 Winter Street NE, Room 440-4  
Salem, Oregon 97310

Dear Directors:

In accordance with your instructions and pursuant to ORS 731.300, we have examined the business affairs and financial condition of

**HealthGuard Services, Inc., dba SelectCare  
600 Country Club Road  
Eugene, Oregon 97401**

**NAIC Company Code 95680**

hereinafter referred to as the "Company." The following report of examination is respectfully submitted.

## **SCOPE OF EXAMINATION**

This regular triennial examination of the Company was conducted as of December 31, 1994, covering the three-year period then ended, and included a review of material transactions or events which occurred subsequent to the examination date. Special emphasis was given to claims, reserves and subordinated surplus notes due to concerns discussed below. The primary examination concerns were solvency of the Company and compliance with the insurance laws and regulations of the states of Oregon and Washington. During the month of January 1995, the Company informed the Insurance Division that it experienced a substantial net loss for the calendar year 1994.

In view of that information and the year end financial statement filed by the Company, it was determined during the examination that the 3rd quarter financial statement did not fully reflect the Company's financial condition and results of operations. The claims payable liability was understated by approximately \$3 million (see actuarial comments on page 31). As a result, the examiners placed "Special Emphasis" on the entire examination.

Those financial statements are summarized as follows:

### **As of September 30, 1994**

<b><u>Assets</u></b>	<b><u>Liabilities</u></b>	<b><u>Net Worth</u></b>	<b><u>Net Income</u></b>
\$27,569,459	\$20,759,717	\$6,809,733	\$1,879,336

### **As of December 31, 1994**

<b><u>Assets</u></b>	<b><u>Liabilities</u></b>	<b><u>Net Worth</u></b>	<b><u>Net loss</u></b>
\$28,175,031	\$27,363,823	\$811,208	\$(3,982,954)

The examination was conducted pursuant to ORS 731.300 and in accordance with procedures and guidelines prescribed by the National Association of Insurance Commissioners (NAIC) for the purpose of determining the Company's financial condition; ability to fulfill and the manner of fulfillment of its obligations; the nature of its operations; and compliance with the Insurance Code. Accounting methods, internal control procedures, records, and other supporting evidence were examined to the extent deemed necessary for the type, volume, and complexity of the accounting system and operations utilized by the Company. The examination included, but was not limited to, assets, liabilities, income and expense related items. In addition, a review was made of the corrective actions taken by the Company with respect to comments and/or recommendations in the previous report of examination as of December 31, 1991.

The examiners reviewed work papers prepared by Arthur Andersen, the Company's independent auditors, in their examination of the Company's accounts for the year ended December 31, 1994. A portion of the auditors' work papers have been incorporated into the work papers of the examiners, and have been utilized in determining the scope and areas of emphasis in conducting this examination.

A management affirmation attesting to the Company's compliance with Oregon laws relating to location of accounts and records; conduct of the Company's affairs in a nonhazardous manner, and exercise of managerial control by a duly qualified and constituted Board of Directors was signed and received from the Chairman of the Board of Directors.

Catherine R. Turner, FSA, MAAA, consulting life and health actuary for the Oregon Department of Consumer and Business Services, participated in this examination by evaluating various liabilities. The results of her analysis are found under the relevant sections in this report.

Concurrent with this examination, a separate market conduct examination of the Company was also performed. A separate report will be issued for the market conduct examination of the Company.

### **PROFILE OF THE COMPANY**

The Company is the successor to Lane Group Health Services, Inc., dba SelectCare. The latter operated as a health care service contractor from November 1, 1979 until July 27, 1983, and was qualified under the provisions of the Health Maintenance Organization Act (HMO) of 1973. On June 27, 1983, HealthGuard Services, Inc. (HGS), filed a plan with the Oregon Insurance Division which provided for the acquisition of substantially all the assets of Selectcare. HGS was incorporated on March 14, 1983, under the Oregon Nonprofit Corporation Act. On July 27, 1983, HealthGuard Services, Inc., was issued a Certificate of Authority by the Oregon Insurance Division to transact business as a health care service contractor in the State of Oregon. HGS's sole member is Sisters of St. Joseph of Peace Health and Hospital Services. In 1994, the name was changed to PeaceHealth. HGS has operated under the name of Selectcare subsequent to the acquisition.

On November 10, 1987, the Company was admitted in the State of Washington to operate as a Health Maintenance Organization (HMO). At that time the Company opened its first branch office in Longview, Washington, to service the needs of the communities in the lower Columbia service area (Southern Washington and Northern Oregon). In 1989, the Company expanded its service area in Oregon to include Linn and Benton counties.

### **AFFILIATED COMPANIES**

HealthGuard Services, Inc., dba Selectcare is affiliated with several other companies. All of these companies are ultimately owned by PeaceHealth. The organizational chart attached to the end of this report depicts the composition of the group.

## **MANAGEMENT AND CONTROL**

### **Board of Directors**

The Board of Directors is comprised of 6 directors. The members of the Board of Directors serve staggered 2 year terms and are approved by PeaceHealth. One-third of the Board of Directors are appointed from among consumers who are not practicing doctors, employees or trustees of a participant healthcare provider. For the period examined, the Board of Directors complied with the provisions of ORS 750.015(1).

Members of the Board of Directors, duly elected and serving as of December 31, 1994 were:

<b><u>Name and Address</u></b>	<b><u>Principal Affiliation</u></b>	<b><u>Term Expires</u></b>
David L. Slade* 600 Country Club Road Eugene, OR 97440	SelectCare President	June 1995
John C. Walkush PO Box 2069 Longview, WA 98632	Norpac Vice President	June 1996
Howard W. Kriz PO Box 1479 Eugene, OR 97401	PeaceHealth Sr. Vice President	June 1995
Charles L. Kampmann 11443 SE Stevens Road Portland, OR 97266	Retired CPA	June 1996
Mervin L. Rexius 750 Chambers Eugene, OR 97401	Rexius Forests By-Products, Inc. President	June 1996
Mark A. Litchman, MD 3556 Black Oak Road Eugene, OR 97401	Physician	June 1995

\*Chairman of the Board

Subsequent to year end 1994, David L. Slade resigned as Chairman of the Board and president of the Company. Effective May 1, 1995, Mr. Laurence Abramson was appointed by the Board as the new president and Chairman.

## **Officers**

Operating management of the Company as of December 31, 1994, was under the direction of the following principal officers:

<b><u>Name</u></b>	<b><u>Office</u></b>
David L. Slade	President Chief Executive Officer
Francis P. Cross	Vice President Chief Financial Officer
Kathleen W. Howard	Vice President Provider Support
Mark A. Litchman, MD	Secretary

As noted above, Mr. Slade terminated his employment as president of the Company on April 17, 1995. On April 30, 1995, Mr. Cross tendered his resignation as chief financial officer and underwriting vice president of the Company. Also, effective May 1, 1995, Mr. Laurence Abramson was appointed by the Board as the new president of the Company. Janice James was elected treasurer and charged with carrying out the duties previously performed by Mr. Cross as chief financial officer. Given the significant changeover in management and the relative lack of direct insurance company management experience by certain key officials, we recommend the Company take the necessary steps to immediately hire or train key management personnel with sufficient qualifications and insurance company managerial experience pursuant to the provisions of ORS 731.386(1).

**MANAGEMENT AFFIRMATION**

## **CONFLICT OF INTEREST**

A resolution of the Board of Directors requires that any officer, director, or responsible employee disclose to the Board of Directors any material interest or affiliation which conflicts with the duties of such person on behalf of the Company. Each officer, director or responsible employee is required to complete a questionnaire yearly. The questionnaires are reviewed by the Board of Directors. No exceptions were noted in a review of such forms for the period under examination.

## **CORPORATE RECORDS**

### **Board Minutes**

Regular Board meetings are held quarterly. Minutes of the Board of Directors meetings were reviewed for the period under examination. Although, the meetings were held in accordance with the Company's Bylaws and a quorum was achieved at all meetings, the minutes did not support the transactions of the Company and the actions taken by its officers. As an example, between August 30, 1994 and October 13, 1994, the Company was experiencing cash flow problems and an officer of the Company authorized the sale of bonds in the amount of \$6,650,000 (at par value, this amount represents approximately 25% of the investment portfolio). The bonds were sold and a capital loss was recorded in the amount of \$296,197. This transaction was not shown as being specifically approved in the minutes. This is contrary to the provisions of ORS 733.730.

We recommend future Board of Directors minutes be written to reflect the transactions and action taken by the Board and hereafter comply with the provisions of ORS 733.730.

### **Articles of Incorporation and Bylaws**

The Articles of Incorporation and Bylaws appeared to be in conformance with Oregon statutes. No amendments were made to either the articles or bylaws during the period covered by this examination.

## **FIDELITY BOND AND OTHER INSURANCE COVERAGES**

The Company is insured up to \$600,000 per occurrence against losses from acts of dishonesty and fraud by its employees. It was noted that the Company does not carry the NAIC suggested minimum level of fidelity bond coverage for the size and volume of its operations. The \$600,000 bond should be increased to \$800,000 to afford adequate protection for the Company. This recommendation has been made pursuant to the provisions of ORS 731.574(6), 733.210 and the NAIC Examiners Handbook. In addition, the Company, through its parent, is covered against directors' and officers' liability for \$10,000,000.

Other insurance coverages in force at December 31, 1994, were as follows:

Commercial property	Workers' compensation
Commercial general liability	Umbrella
Auto	

With the exception of fidelity bond coverage, all coverages were found to be adequate as of December 31, 1994.

## **RETIREMENT PLANS AND OTHER POST-RETIREMENT BENEFITS**

The Company offers a defined contribution retirement plan (the plan) that covers all full-time employees with one year or more of service. Contributions are determined as a percentage of the eligible employees' salaries. Costs of the plan are charged to the current operations. It should be noted that the plan has not been audited since 1992.

The Company does not provide any other post-retirement benefits (other than pension) to its employees.

## **TERRITORY AND PLAN OF OPERATION**

The Company has approximately 130,000 members in the states of Oregon and Washington. As of 1994, the Company's service area included the counties of Linn, Lane, Marion, Douglas, Polk, Benton, Columbia, Clatsop and Coos in Oregon and Cowlitz, Wahkiakum, Lewis, and Pacific in the State of Washington. In addition to the above, the Company operates in Multnomah, Clackamas and Washington counties under a reinsurance agreement with Sisters of Providence Physician Interhospital Health Plan (See reinsurance section for more details).

The Company is an Individual Practice Association (IPA) plan that contracts with doctors and specialists who practice out of their own offices and hospitals, to provide care to members. The Company's HMO product utilizes a primary care physician system whereby members are offered services through these select physicians.

Benefits offered by the Company include hospital services, emergency services, maternity care, home health & hospice care, prescription drugs, and other health care services.

## **INTERCOMPANY ADMINISTRATIVE SERVICE AGREEMENT**

There is an intercompany service agreement which was amended in July 1994 between Sacred Heart Health System (SHHS) and the Company. SHHS agreed to provide the services necessary for the business operations of the Company. These services include marketing, financial services, personnel services, medical cost management, and data processing. In exchange, the Company agreed to reimburse SHHS in accordance with a fee schedule, which is a part of the agreement. It was noted during the examination that the Company did not reimburse SHHS in accordance with the terms of the agreement. Over a period of 2 years the Company made an overpayment in the amount of \$642,193 (or 18.79%). We recommend the Company comply with terms of the above agreement filed pursuant to the provisions of ORS 732.574.

## **GROWTH OF THE COMPANY**

The following exhibit reflects the growth of the Company since 1987. The stated amounts were compiled from copies of the Company's filed annual statements and, where indicated, from the current and previous examination reports.

<u><b>Year</b></u>	<u><b>Assets</b></u>	<u><b>Liabilities</b></u>	<u><b>Net Worth</b></u>	<u><b>Net Income</b></u>
1987	\$6,488,063	\$5,795,219	\$ 692,844	\$ 247,442
1988*	6,929,355	6,045,465	883,890	4,870
1989	7,347,603	6,847,603	500,000	(2,746,947)
1990	11,471,158	9,477,826	1,993,332	812,248
1991*	11,065,742	8,550,699	2,515,043	1,002,366
1992	16,124,558	12,184,585	3,939,973	1,978,061
1993	20,641,878	15,460,663	5,181,215	2,355,257
1994	26,447,639	26,899,400	(451,761)	(4,442,506)

\*Per examination

The Company's reported net worth decreased by \$5,632,976 between December 31, 1993 and December 31, 1994. It decreased by \$7,261,494 between September 30, 1994 and December 31, 1994. ***For an explanation - see below - the comments made in the Claims Experience section.***

## **CLAIMS EXPERIENCE**

The following exhibit reflects the annual underwriting results of the Company since 1987.

The amounts were compiled from copies of the Company's filed annual statements.

<b>Year</b>	<b>(1) Medical &amp; Hospital Expenses</b>	<b>(2) Net Premiums Earned</b>	<b>(1/2) Loss Ratio</b>
1987	\$17,719,519	\$20,344,565	87.1%
1988	23,084,002	25,975,649	88.9%
1989	38,749,622	41,610,982	93.1%
1990	42,844,799	50,691,333	84.5%
1991	46,771,803	56,385,786	82.9%
1992	56,355,413	68,071,299	82.7%
1993	68,435,067	82,607,152	82.8%
1994	162,889,274	163,014,206	99.9%

The loss ratio increased from 82.8% in 1993 to 99.9% in 1994. It was concluded by the examiners and the actuary that the cause of the increase in the loss ratio was the result of unfavorable experience with several employer groups.

**INVESTMENTS**

	<b>(1)</b>	<b>(2)</b>	<b>(3)</b>	<b>(3)(1)</b>
	<b>Bonds</b>	<b>Bonds</b>	<b>Total</b>	
<b><u>Year</u></b>	<b><u>Book Value</u></b>	<b><u>Market Value</u></b>	<b><u>Noninvestment</u></b>	<b><u>Percentage of</u></b>
			<b><u>Grade Bonds*</u></b>	<b><u>Portfolio</u></b>
1992	\$ 8,315,190	\$ 8,315,190	\$ -0-	0%
1993	15,510,252	15,469,106	-0-	0%
1994	20,406,694	18,911,439	-0-	0%

\*Investment grade is defined by the NAIC as those securities with an NAIC Securities Valuation Office (SVO) rating of "1" or "2".

All investments were held within the State of Oregon as required by the provisions of ORS 732.245.

No investment transactions were specifically approved by the Board of Directors pursuant to the provisions of ORS 733.730. (See page 11 - Corporate Records - Board Minutes section)

Invested assets of \$21,600,947, or 76.67%, of the total assets were invested in amply secured obligations of the United States, a state or a political subdivision of this state as of December 31, 1994. This amount exceeds the amount required for investment of required capitalization by the provisions of ORS 733.580.

### **HOLDING COMPANY REGISTRATION**

A holding company registration statement was filed on behalf of the Company by PeaceHealth, pursuant to the provisions of ORS 732.551 and OAR 836-27-010. No exceptions were noted in the registration statement.

### **STATUTORY DEPOSIT**

As of the date of the examination, the Company maintained a deposit with the Oregon Insurance Division, Department of Consumer and Business Services, in the sum of \$275,000 (US Treasury notes - statement value \$223,016 and Certificate of Deposit - \$50,000) pursuant to the provisions of ORS 750.045(2). The deposit was verified from the records of the Insurance Division.

In addition, the Company also maintains a deposit in the amount of \$150,000 with the Washington State Insurance Commissioner's office.

### **DIVIDENDS**

The Company is a non-profit organization and therefore, dividends are not paid or declared.

### **REINSURANCE**

The Company has one primary excess of loss reinsurance treaty with Allianz Life Insurance Company of North America. The treaty indemnifies the Company for losses in excess of \$75,000 per member for each contract year, not to exceed \$2,000,000 for lifetime per member for eligible hospital expenses.

Once the deductible of \$75,000 has been satisfied, the percentage of indemnity for organ and bone marrow treatment is 80% if services are performed in a per diem hospital or 50% for any other hospital.

Allianz Life Insurance Company of North America is authorized to transact HMO reinsurance business within the State of Oregon.

**Insolvency Clause**

The reinsurance contract, for the period under examination, did not contain an acceptable insolvency clause. Pursuant to the provisions of ORS 731.508(3), in order to take credit as an admitted asset or deduction against liability, an insurer must have an insolvency clause which stipulates that in the event of the insolvency of the ceding insurer, the reinsurer must remain fully liable for its share of losses to the receiver or statutory successor. During the course of the examination the Company executed a new reinsurance agreement which includes a proper insolvency clause.

At December 31, 1994, the Company was not in compliance with ORS 731.504(1), with respect to retention of risk on any one subject of insurance in an amount exceeding 10% of its net worth. The reinsurance contract requires a retention of \$75,000. At December 31, 1994, the Company had a deficit, per examination, of \$(451,761) and could not retain any risk. Subsequent to the date of this examination, the Company's net worth was increased by \$6,000,000 (see subsequent events). Therefore, the Company is currently in compliance with ORS 731.504(1).

At December 31, 1994, the Company ceded to Sisters of Providence Physician Interhospital Health Plan (GHP), an Oregon health care service contractor, a certain portion of the business associated with one major employer group. The Company ceded this business without a formal reinsurance agreement. We recommend the Company immediately execute a formal reinsurance agreement with GHP which includes all requirements set forth by the provisions of the NAIC Examiners Handbook, ORS 733.210, ORS 731.504 and ORS 731.508. Subsequent to the date of this examination, such an agreement was executed.

## **ACCOUNTS AND RECORDS**

Records are kept on a system of desktop and main frame computers at the Company's home office in Eugene, Oregon. Disbursements were evidenced by bills, invoices, or statements pursuant to the provisions of ORS 732.320.

As of December 31, 1994, the Company did not have a management contract or exclusive agency contract in effect. Such contracts may be prohibited by the provisions of ORS 732.215 and ORS 732.220.

During the course of this examination the following violations of Oregon insurance law were noted:

### **Funds Subject To Escheat**

The Company has never filed the required reports on abandoned property with the Oregon Division of State Lands (the Division) or with any other jurisdiction. Personnel of the Company stated that the Company has never had any unclaimed checks and therefore, did not file unclaimed property reports with the Division. Pursuant to the provisions of OAR 141-45-041(5), all organizations doing business in Oregon have to submit Form 1A to the Division, on or before October 1 of each year, even if they have nothing to report. We recommend the Company comply with the provisions of OAR 141-45-041(5).

### **Reinsurance Recoverable**

A review of the method of calculating reinsurance recoverables on paid claims reveals that claims subject to reinsurance are specifically identified for billing to the reinsurer. A claim form is prepared along with the bills paid that are subject to reinsurance. In addition, an estimate of the amount due is prepared based upon the nature of each claim and the provisions of the treaty. A summary report of these amounts is used to record the amounts recoverable by the accounting department.

A discussion with the personnel involved revealed that there is a lack of coordination among departments to ensure that amounts due are timely billed to the reinsurer and reported to the accounting department. If timely billing and accurate reporting had occurred, the recoverable would have been approximately \$1,700,000 rather than the \$713,937 allowed by examination (see note 4 for more detail). We recommend a timely follow-up and proper review of such accruals to provide proper control and collection of amounts owed to the Company pursuant to the provisions of ORS 731.574(6), 733.210, the NAIC Examiners Handbook instructions, and the Company's own reinsurance agreement. The need is re-emphasized to establish functional communication between the accounting, reinsurance, and claims departments. Timely follow-up on claims paid in excess of Company's retention limit will allow for submission of the claims to the reinsurer to expedite the receipt of entitled amounts and strengthen Company cash flows.

In addition, it was noted the Company has been using a relatively aggressive assumption in determining reinsurance recoverable by billing 90% of all hospital claims in excess of its retention. The actual reinsurance agreement specifies differing coverage percentages, ranging from 50% to 90%, depending on the hospital being used. Hospital information was clearly available at the time the receivable estimates were being made and the Company did not use it. We recommend such information be factored into future estimates if such estimates are to be used in offsetting a portion of unpaid claim totals to comply with the provisions of ORS 733.030.

### **Investments**

At December 31, 1994, the Company had a safekeeping agreement with Bank of California that applied to all securities not on deposit with the Washington State Insurance Department. This agreement has been in effect since 1992. As of December 31, 1994, it did not contain the following safeguards to the Company that are set forth in the NAIC Examiners Handbook:

That the bank is obligated to indemnify the Company for any loss of securities in the bank's custody, except that, unless domiciliary state law require a stricter standard, the Bank shall not be so obligated to the extent that such loss was caused by other than the negligence or dishonesty of the bank.

In the event that there is a loss of securities for which the bank is obligated to indemnify the Company, the securities shall be promptly replaced or the value of the securities and the value of any loss of rights resulting from such a loss shall be promptly replaced.

We recommend the safekeeping agreement with Bank of California be modified to incorporate the clauses described above in order to comply with the provisions of ORS 731.574(6), 733.210, and the NAIC Examiners Handbook. Subsequent to year end December 31, 1994, the Company modified the agreement and, as of the date of this report, was in compliance with the above requirement.

On December 30, 1994, a company officer authorized the purchase of a small amount (\$100,000) of common stock, which was held by brokers, in violation of the provisions of ORS 731.574(6), 733.210 and the NAIC Examiners Handbook. According to the NAIC Examiners Handbook, pages 3-7, section 6.d, ORS 731.574(6) and ORS 733.210, the Company is obligated to keep all investments with a bank or trust company, regulated by the Securities and Exchange Commission, the Federal Reserve System, and the banking authorities in its state of domicile under a custodial agreement. In addition, this transaction was not specifically recorded as being approved in the Board of Directors minutes. This is contrary to the provisions of ORS 733.720. Since the Company already has a custodial agreement, we recommend the above investments be moved to the Bank of California and hereafter comply with the provisions of ORS 731.574(6), 733.210 and ORS 733.720. Subsequent to year end December 31, 1994, the stock was sold and as of the date of this report, the Company is in compliance with the above code sections.

In addition, it was noticed during a review of restricted cash that a small amount of bonds were reported at cost. In accordance with ORS 733.160(1)(A) and the NAIC Securities

Valuation Manual, bonds should be reported in the financial statements at amortized cost. No adjustment was made to this account since the amount was not material. We recommend the Company record and report bonds at amortized cost to comply with the provisions of ORS 733.160(1)(A), 733.210 and the NAIC Securities Valuation Manual.

### **Premiums, Premiums Receivable and Unearned Premiums**

A review of the previous examination work papers indicated that the records for premiums receivable were confusing. It is the finding of this examination that the method of recording receivables continues to be unnecessarily complex and error prone. As an example, the Company records premium revenues as a by-product of the reconciliation of the accounts receivable reconciliation process. Entries are made to force the accounts receivable, unearned premiums, and other accounts to agree to the reconciled detail shown on the subsequent receipt reports with offsetting entries to premium revenues. There was no attempt to reconcile the premium revenue accounts in the general ledger to the DISCorp. system. This practice appears to cause fluctuations in the revenue accounts from month to month due to timing differences.

This process for recording revenues, receivables, and unearned premiums is complex and cumbersome. The effort to reconcile and correct errors on a timely basis are impacted by this process. We strongly recommend management devote competent staff and resources to simplify and improve the revenue and billing process to comply with the provisions of ORS 733.170.

### **Claims and Claims Payable**

The following weaknesses were noted during our review of the claims system:

1. Overpayments - In our review of claim payments, it was noted that the Company made a number of material overpayments. This problem was extensively researched

by Arthur Andersen (the Company's independent auditor), which estimated overpayments to be in excess of \$1 million. We recommend the management implement policies and procedures to track and minimize claims overpayments.

In addition, a discussion with claims department personnel revealed that Company policy regarding payment of claims permits claims processors to make a system payment up to \$50,000 without the need for a supervisor approval code. We recommend the Company implement program changes to the system to limit claims processor's authority to \$10,000 per claim. All system payments in excess of \$10,000 should require a supervisor approval code. This should reduce the risk of significant overpayments.

2. Pharmacy Claims - Most of the Company's pharmacy claims are processed by a third party administrator (TPA). Currently, the Company wires funds to the TPA in advance of the receipt of the claim documentation. Upon receipt of the claim information, the Company inputs the data into the claims system, where it is ultimately reflected on the lag schedules. The difference in the timing of the input of the data and the cash payment makes the reconciliation of the lag schedules to the general ledger significantly more complex. As of the date of this examination, the lag schedules were overstated by \$692,333 compared to the general ledger. In addition, advancing the TPA funds reduces their incentive to process the claims in a timely manner and therefore, increases the risk that inappropriate or unauthorized claims might be paid.

We recommend that future contracts be worded to base claim payment on receipt of actual claim information. This will require Information Systems department support to transfer claims data to the Company's database. This should eliminate the timing differences and the reconciliations discussed above. In addition, this should provide the TPA with the incentive to process claims as quickly as possible.

3. COB Recoveries - It was noted during calendar year 1994, the recovery of amounts collected under Coordination of Benefits (COB) dropped as a percentage of paid and incurred claims versus the preceding year. We recommend a tracking mechanism be developed to monitor the monthly fluctuations with COB and help with early identification of recovery problems.
  
4. Off System Payments - It was noted there was a large number of manual, off system payments. There was a very high volume of manual checks being drafted due to the DISCorp system being unable to properly pay the claims because of unrealistic payment commitments; corrections of errors; and the backlog of claims for certain products. In addition, capitation payments are primarily prepared manually; refunds, double payments, corrections, etc. are poorly tracked and have become routine. This creates an environment where the risk of data loss is very high and the reconciliation of claims payments with the general ledger is very difficult. We strongly recommend the Company review the need for these off system payments. In particular, capitation and pharmacy are 2 areas that should be completely automated as soon as possible.

These recommendations have been made pursuant to the provisions of ORS 733.030, ORS 733.170, ORS 733.210 and the NAIC Examiners Handbook.

### **Various Databases**

As a part of the examination, a review was performed to evaluate and reconcile the data and reports used to underwrite business with the data and reports used to present the financial statement of the Company. This review revealed the following:

1. At any point in time there are timing differences between the financial data and underwriting data. As of the date of examination, these differences were not considered material however there is a potential that these differences could be significant if a periodic review is not performed.
2. There are differences due to independent data entry in each database.
3. The underwriting database is continually revised and corrected on a retroactive basis. The financial database is frozen for a period of time.

It was noted that the Company did not reconcile these databases in a timely manner. We recommend such a reconciliation be performed at least monthly to comply with the provisions of ORS 733.170.

### **Liabilities and Income Statement**

In the "Statement of Revenue, Expenses and Net Worth" of the annual statement, the Company reported claims amounts for all categories except "Emergency Room and Out-of-Area." In addition, in the "Statement of Revenue, Expenses and Net Worth," and "Statement of Asset Liabilities and Net Worth," the Company did not report any amounts for the "Uncovered" liabilities and expenses. We recommend the Company properly disclose uncovered expenses and liabilities to comply with the provisions of ORS 731.574, ORS 733.170, ORS 733.210, and annual statement instructions.

### **Real Estate**

Real estate consists of the Company's home office. Originally, the building was purchased by Sisters of St. Joseph of Peace, Health and Hospital Services (PeaceHealth) from the State Accident Insurance Fund Corporation (SAIF Corporation) on December 4, 1989. A new statutory warranty deed signed on September 1, 1991, transferred 45% ownership

rights to the Company. This deed was not recorded with Lane County Assessor's office until May 5, 1995. It was noted that the Company reported the building as an admitted asset since April 1, 1990 even though it did not have the clear title to 45% of the building until 1995. This is a violation of the provisions of ORS 731.574, ORS 733.010, and ORS 733.170, which provide, in part, the financial statements be true and correct, records and source data be kept in such a manner that in the determination of the financial condition of an insurer the Director can readily determine its financial condition, and there shall be allowed as assets only such assets as are owned by the insurer. The account balance has been left uncorrected due to the fact the Company acquired title to the building subsequent to the date of this examination. Without this corrective action, reduction in assets and net worth in the amount of \$1,098,506 would have been required. We strongly recommend that in the future the Company comply with the provisions of ORS 731.574, ORS 733.010, and ORS 733.170.

A review of real estate records revealed that all related permanent documents were located in Washington state. The documents include but are not limited to appraisals, lease agreements, trust deeds and evidence of title insurance. This is contrary to the provisions of ORS 732.245 which requires that every domestic insurer shall keep, in the State of Oregon, accurate and complete accounts and records of its assets, transactions and affairs. Furthermore, the provisions of ORS 733.170 require, in part, that an insurer shall keep its books, records, accounts and transactions, and source data in such a manner that the Commissioner may readily verify its statements of financial condition. We recommend the Company immediately comply with the above code sections and maintain such compliance at all times.

Also, the examination of newly acquired or constructed assets found that such assets are depreciated based on the useful life of the attached building instead of depreciating the asset over the lesser of its individual useful life or the remaining duration of a lease in

accordance with IRS guidelines. This has the effect of understating depreciation expense and overstating assets by an immaterial amount in the first year. It should be noted however, that if left uncorrected, the aggregate of these small amounts could be material. In addition, in the year that such assets are retired, any undepreciated asset balance would need to be written off, potentially resulting in a significant loss on disposal. No adjustment was made to this account since the amount was not material. We recommend the Company use the IRS guidelines for all additions to the fixed assets to comply with the provisions of ORS 731.574(6), ORS 733.170, ORS 733.210, and the Accounting Practices and Procedure manual.

It was also noted during a review of the real estate records that at December 31, 1994, the title insurance was in the name of PeaceHealth. Subsequent to December 31, 1994 and before completion of this examination, a new title insurance policy was obtained in the name of the Company.

The Company also acquired a mortgage loan in the amount of \$786,384 as a result of the above transaction. However, the Company has been showing this encumbrance as a surplus note which was never approved by the Insurance Division. For more discussion see page 35 under the caption "Net Worth."

Although the Company owns 45% of the building, as of December 31, 1994, it occupied the entire building under an operating lease agreement with PeaceHealth. Subsequent to December 31, 1994, the 7 year operating lease was converted into a 30 year capital lease. It was noted during the examination that the Company pays for all capital improvements and reports them as real estate improvements. Since 55% of the building is occupied under a lease agreement, we recommend the Company report 55% of the improvements as leasehold improvements and depreciate them over the life of the lease to comply with the

provisions of ORS 733.170, ORS 733.210, ORS 733.574(6) and annual statement instructions. As a result, an examination reclassification in the amount of \$133,506 has been made to this account (see Note 8 for more details).

As noted above, the Company owns 45% of the building where its offices are located. Pursuant to the provisions of ORS 733.210 and Accounting Practices and Procedures Manual, an insurer occupying its own building must charge itself adequate rent for its own occupancy. Income from such rent is to be included in real estate income. We recommend the Company comply with the provisions of ORS 731.574(6), 733.170 and 733.210.

### **Cash Surrender Values of Life Insurance**

Cash surrender value in the amount of \$79,450 (see note 6) was reported as an admitted asset in the December 31, 1994 annual statement. A review of the policies revealed that the owner of each policy is the employee subject to a collateral assignment to PeaceHealth and not to the Company. This is a violation of the provisions of ORS 733.010 which states, in part, that in any determination of the financial condition of an insurer, there shall be allowed as assets only such assets as are owned by the insurer. The account balance has been nonadmitted for the purpose of this examination. We strongly recommend in the future the Company comply with the provisions of ORS 733.010 at all times.

### **Inventory of Fixed Assets**

The Company does not physically inventory its Electronic Data Processing (EDP) equipment. We recommend the Company physically inventory all EDP equipment on an annual basis to account for and safeguard assets in accordance with the provisions of ORS 731.574(6), 733.170, 733.210 and the NAIC Examiners Handbook.

## **Computer Security System**

Several weaknesses were noted regarding the computer security system of the Company:

1. One wall of the computer room, facing the parking lot, is partially windowed and could serve as a means of illegal entry. We recommend the window be secured in some manner or the wall be replaced with panels.
2. The Company does not have an EDP disaster recovery plan to provide for the continuity of business operations in the event of a disaster. The requirement for such a plan was brought to the Company's attention during the previous examination and no corrective measures have been taken since then. Once again, we strongly recommend the Company immediately formalize and adopt an EDP disaster recovery plan.
3. It was noted during a review of internal controls that the night computer operator has no direct supervision. We recommend the Company make arrangements to periodically monitor the night operator.
4. There is no supervisory review of the console log to detect operator problems, unauthorized interventions or unauthorized use of computer time, particularly on shifts outside the normal working hours. We recommend the console log be examined once a week by operating supervisors within the EDP department. In cases where the processing volume prohibits effective manual review, the console message should be recorded on machine readable media and edited by a program designed for that purpose.
5. It was noted during the review of internal controls that Information System Department programmers have access to DISCorp source code and, on occasions,

make changes directly to production data. This means there is no separation of duties and it also exposes potentially sensitive production data to programmers. We recommend programmers be restricted from using production data and the Company should find alternate methods for correcting bad data.

All the above recommendations were made pursuant to the provisions of ORS 731.574(6), 733.210 and NAIC Examiners Handbook.

### **Internal Controls**

The following recommendations are based upon our review of internal controls:

1. It was noted during the course of this examination that the executive office manager has the authority to approve the "expense accounts" and "travel expenses" for all senior management. In addition, the president approved his own expenses. We recommend the Company consider changing this policy whereby all expenses relating to the company president, be approved by the Board and the president approve expenses for the senior management.
2. During the examination of cash disbursements, it was noted that some manual checks in excess of \$50,000 were issued without dual signatures, even though the Company's policy requires all checks in excess of \$50,000 have dual signatures. We recommend all manual checks be preprinted with a restriction voiding the check if not double signed.
3. It was noted that the billing analyst may write-off accounts receivable balances by entering a billing code "94" adjustment. The Company's policy regarding write offs permits analysts to write off outstanding balances of up to \$1,000 without the need

for prior authorization. Write offs in excess \$1,000 require the signature of the assistant controller. Currently there is no control in place to limit the amount a billing analyst may write off. Further, a detailed review of the billing adjustments posted to the system is not routinely performed; nor are the customer service teams being provided with accounts receivable data with which to measure the effectiveness of their collection efforts. We recommend the Company implement program changes to the billing system to prohibit balance write offs in excess of \$1,000 without supervisory approval.

4. It was noted that the Company has no limitation on the amount of paid time off an employee can accrue nor an established policy for mandatory usage of paid time off hours accrued. We recommend the Company establish both accrual limits for paid time off hours as well as policies to define mandatory payout provisions for accumulated hours on an annual basis. The requirement that employees take earned vacation serves to improve the internal control environment by causing periodic rotation of duties to other employees and ensures that employees are able to work at their maximum potential.
  
5. Currently, the Company has an internal audit department but it was noted that the role of the internal audit department within Company is not well defined. We recommend the Company redefine the purpose, authority, and responsibilities of this department and develop a comprehensive methodology for conducting annual and interim audits of various departments within the Company and sending the resultant reports directly to the Board of Directors.

All the above recommendations were made pursuant to the provisions of ORS 731.574(6), 733.210 and NAIC Examiners Handbook.

## **Actuarial Examination**

Examination of the adequacy of the amount of the liabilities for claims payable and the accrued medical incentive pool was performed by Catherine R. Turner, FSA, MAAA, consulting life and health actuary for the Oregon Department of Consumer and Business Services. There were several adjustments and recommendations that resulted from her examination. In summary, they are as follows:

1. The pattern of unpaid claim reserves filed with quarterly statements throughout 1994 showed a dip of over \$12/member at September 30, 1994, (13% of previous reserves) with reserves at that time about \$3 million lower than the estimates developed from the Company's loss development spreadsheets or its own actuary's projection. The Company explained the low statement reserves at the end of that quarter as incorporating judgmental adjustments for a known decrease in claims backlog and for excess Plus Plan payments to Sacred Heart General Hospital that were due to be recaptured when the Company tried up to the capitated claims basis of the contract. However, there was no detailed documentation to support the specific adjustments made and the amount of reserves reported at September 30, 1994 was too low in light of subsequent experience. This is a direct violation of the provisions of ORS 731.574, ORS 733.030, ORS 733.210 and the annual statement instructions. We strongly recommend the Company document all of its adjustments and here after comply with the provisions of ORS 731.574, ORS 733.030 and ORS 733.210.
2. The future actuarial certifications of the Company's annual statements must include the traditional unpaid claims line; the medical incentive pool accrual amount and any other aspect of the balance relating to amounts expected to be paid on previous incurrals under the terms of either the member contracts or the provider agreements. There is too much overlap between the estimation of incurred

claims and provider accruals for a meaningful certification to be made on the unpaid claim portion only. In addition, because of the identified problems with data reconciliation and the developing experience under changing provider contracts and reporting system, Ms. Turner is recommending actuarial certifications be filed with future quarterly and annual statements. She is also requesting a supporting actuarial memorandum to accompany the 1995 year end statement. Such a memorandum would address the methodology used to establish the statement reserves; how the relevant items in the Actuarial Standards of Practice on Incurred Health Claims Liabilities and Actuarial Practice Concerning HMO's were addressed; and any specific considerations or reservations regarding the accuracy of the data used or the resulting liabilities.

3. Although no material adjustments to medical incentive pool accruals were identified, other than those mentioned in the Note 11 to the financial statements, it was noted that there were several instances where the terms of the provider agreements were not being followed exactly in the calculations and where final settlements under such agreements had not been made as promptly as called for by the contracts. This situation generally arises because of the multiplicity and complexity of the agreements and inadequate reporting and system support in place to carry out the terms of those contracts. Ms. Turner has recommended that the Company put procedures in place to remedy this situation, within the next year.

All these recommendations were made pursuant to the provisions of ORS 731.574(6), ORS 733.030 and OAR 836-31-640.

### **Anticipated Losses for 1995**

The Company's independent auditors determined that losses were likely to occur for calendar year 1995 (pursuant to AICPA FAS 60 and SOP 89-5), primarily due to adverse

experience from one major employer group contract with rates guaranteed for the full calendar year. Because this rate commitment was made during 1994, and because the contract constitutes a significant portion of the Company's business, Ms. Turner considered whether a statutory reserve as of December 31, 1994 should have been established to cover such an anticipated deficiency. She concluded that such a reserve was not required in this specific situation. The independent auditors' projected 1995 loss was based on actual experience through March 31, 1995 and the Company's most recent projection for the balance of the year. In her opinion, it did not appear that sufficient information was available at December 31, 1994 for an objective, determinable anticipated loss to have been calculated at that time.

The recent losses have been addressed by the Insurance Division on a short term basis through a requirement for an immediate additional contribution of capital from PeaceHealth with an ongoing requirement that net worth be maintained at a level significantly higher than statutory minimums. As part of a minimum capitalization agreement between the Company, PeaceHealth, and the Insurance Division during the course of this examination, it was agreed the Company will maintain its financial condition and operating relationships at least as good as would have been if the \$6,000,000 capital contribution had been infused and reported in the 1994 annual statement. As of December 31, 1994, the financial ratios would have been as follows:

Premium to net-worth ratio:

Premiums earned (A)	\$163,014,206
Net worth [(\$451,761) + \$6,000,000] (B)	5,548,293
Premium to net worth ratio (A/B)	29:1

Average number of months for claims payments:

Claims payable (A)	\$ 18,698,896
Examined net worth (B)	(451,761)
Capital contributions (C)	6,000,000
Required capitalization (D)	500,000
Accrued medical incentive pool (E)	1,550,914
Total paid claims for 1994 (F) (Schedule H Sec. III Col. 1 and Col. 2)	141,444,633
Total number of months (G)	12
Average number of months $[A+B+C-D+E]/(F/G)$	2.15

Therefore, we recommend the Company maintain a minimum of 2 months average claims paid and a premium to net worth ratio of no greater than 29:1 at all times.

Ms. Turner has recommended that in the future, the Company should consider establishing additional liabilities for any situation where future premiums for the duration of a contract are anticipated to be materially less than the combined medical and administrative expenses of the contract pursuant to AICPA FAS 60 and SOP 89-5. She also recommended that the Company file quarterly reports with the Insurance Division on the status of changes being implemented in premium rates and provider contracts to return underwriting results to a positive level.

All of these recommendations were made pursuant to the provisions of ORS 731.296, 731.574, 733.030, and 733.170.

**Annual Statement Filing**

The 1994 annual statement was inaccurate and erroneous in numerous respects especially with regard to the summary of operations, cash, real estate, investments, reinsurance, accrued medical incentive pool, claims, net worth, schedule B and schedule K. In addition, as a result of the examination adjustments, the Company actually had a negative net worth of (\$451,761) at December 31, 1994 as opposed to the positive \$811,208 reported by

the Company. Since the December 31, 1994 statement was materially misstated, we recommend the Company file amended annual and quarterly statements with Oregon and Washington Insurance departments for the period ending December 31, 1994 and March 31, 1995, respectively, and hereafter comply with the provisions of ORS 731.260, 731.574, and OAR 836-13-000 by filing complete and accurate statements in accordance with the instructions provided.

### **Net Worth**

Net worth reported as of December 31, 1994 included 4 surplus notes as follows:

- a. Series A Surplus Note - This note was issued in the amount of \$723,697 in exchange for a nonadmitted asset, i.e. goodwill. As of December 31, 1994, the Company has been making interest only payments on this surplus note.
  
- b. Series B Surplus Note - This note was issued in the amount of \$2,377,096 in exchange for cash transferred into the Company's bank account in April of 1992. Once again, the Company has been making interest only payments on this surplus note.
  
- c. Real Estate Surplus Note - Originally, this note was written for \$967,025 on March 31, 1990 in exchange for real estate. The Company has been making both principal and interest payments on the note. As of December 31, 1994, the Company reported a balance of \$786,384 in the annual statement for it.
  
- d. Electronic Data Processing (EDP) Equipment Surplus Note - Originally, this note was issued for \$706,973 on March 31, 1990 and in exchange for EDP equipment. The Company has been making both principal and interest payments on the note. As of December 31, 1994, the Company reported an unpaid balance of \$58,234 in the annual statement.

There were several adjustments and recommendations that resulted from our review of net worth. In summary, they are as follows:

1. Pursuant to the provisions of ORS 733.210 and NAIC Accounting Practices and Procedures Manual, proceeds from this type of surplus acquisition must be in the form of cash, cash equivalents or other assets having a readily determinable value satisfactory to the domiciliary commissioner. The insurer must clearly report the transaction in its "Notes to the Financial Statement" including the fact that payment of interest and repayment of principal is subject to the domiciliary jurisdiction's approval. As noted above, the consideration for one of the surplus notes was goodwill, a nonadmitted asset. In addition, the Company did not obtain regulatory approval to issue any of the surplus notes and most certainly did not obtain regulatory approval to make repayments which is a mandatory provision to allow such notes to be reported as net worth rather than as a liability. It was also noted that the Company had originally recorded both series A and B surplus notes in June 1990 and reported them in financial statements. However, the actual surplus notes were not executed until June 1991. This is a direct violation of the provisions of ORS 731.260, 731.574, 733.010, 733.170, 733.210 and the NAIC Accounting Practices and Procedures Manual. (For further explanation and examination adjustment relating to this item, see Note 13.) We recommend, in the future, the Company not record any surplus notes unless they are approved by the Insurance Division. Subsequent to year end, and before the last day of this examination, all notes were combined into one. This note was approved by the Insurance Division (See subsequent events, page 55). Without this corrective action, an adjustment to reduce net worth in the amount of \$3,221,714 would have been required. However, the amount associated with the Series B note was not properly secured, and has been nonadmitted in this examination (see Notes 12 and 13 for more detail).

2. Series A and B surplus notes were shown as contributed capital. Proper treatment would be to reclassify them as surplus notes and list them individually on Schedule K of the annual statement. We recommend, in the future, the Company record such notes in accordance with the provisions of ORS 731.574, 733.210 and the NAIC Accounting Practices and Procedures Manual (See Note 13 for reclassification).

As noted in the "Profile of the Company" section of this report, on June 27, 1983, HealthGuard Service, Inc. (HGS), filed a plan with the Oregon Insurance Division which provided for the acquisition of substantially all the assets of Selectcare. The purchase price was the assumption by HGS of substantially all of the obligations of Lane Group Health Services, Inc. (LGH), including various notes payable to the Department of Health and Human Services totalling \$1,896,000. Since 1983, these notes were reported as surplus notes. During 1993, the Board of Directors authorized the payment of these notes, which had a balance of \$1,374,324. Since the notes were paid in 1993 and had no impact on the net worth reported as of December 31, 1994, no further comment is warranted.

**HEALTHGUARD SERVICES, INC., DBA SELECTCARE  
STATEMENT OF ASSETS, LIABILITIES AND NET WORTH  
AS OF DECEMBER 31, 1994**

<b><u>ASSETS</u></b>	<b><u>Total Assets</u></b>	<b><u>Nonadmitted Assets</u></b>	<b><u>Net Admitted Assets</u></b>
<b><u>Current Assets</u></b>			
Cash & equivalents(Notes 1&2)	\$ 771,237	\$ (93)	\$ 771,144
Short-term investments(Notes 1&3)	20,406,694	(20,406,694)	
Premiums receivable	2,044,049		2,044,049
Investment income receivables	336,303		336,303
Health care receivable(Note 4)	1,001,724	(287,787)	713,937
Amounts due from affiliates(Note 5)	1,360,155	(1,360,155)	
Aggregate write-ins current assets(Note 6)	<u>262,753</u>	<u>(262,753)</u>	<u>0</u>
Total Current Assets	<u>26,182,915</u>	<u>(22,317,482)</u>	<u>3,865,433</u>
<b><u>Other Assets</u></b>			
Restricted cash	423,016		423,016
Long-term investments(Notes 1&7)		20,406,787	20,406,787
Aggregate write-ins for other assets	<u>2,003,673</u>	<u>(2,003,673)</u>	<u>0</u>
Total Other Assets	<u>2,426,689</u>	<u>18,403,114</u>	<u>20,829,803</u>
<b><u>Property and Equipment</u></b>			
Land, buildings & improvements (Note 8)	1,098,738	(133,506)	965,232
Furniture & equipment	1,904,169	(1,250,504)	653,665
Lease hold improvements(Note 9)	<u>42,852</u>	<u>90,654</u>	<u>133,506</u>
Total Property and Equipment	3,045,759	(1,293,356)	1,752,403
TOTAL ASSETS	<u>\$31,655,363</u>	<u>(\$5,207,724)</u>	<u>\$26,447,639</u>

**THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE FINANCIAL  
STATEMENTS**

**HEALTHGUARD SERVICES, INC., DBA SELECTCARE**  
**STATEMENT OF ASSETS, LIABILITIES AND NET WORTH**  
**AS OF DECEMBER 31, 1994**  
**(Continued)**

**LIABILITIES AND NET WORTH**

**Current Liabilities**

Accounts payable	\$ 1,519,972
Claims payable <b>(Note 10)</b>	18,698,896
Accrued medical incentive pool <b>(Note 11)</b>	1,550,914
Unearned premiums	1,599,378
Amounts due to affiliates <b>(Note 12)</b>	1,957,463
Aggregate write-ins for other liabilities	<u>1,572,777</u>
Total Liabilities	<u>\$26,899,400</u>

**Net Worth**

Contributed capital <b>(Note 13)</b>	\$ 0
Surplus notes <b>(Note 13)</b>	3,221,714
Contingency reserves <b>(Note 13)</b>	500,000
Retained earnings fund balance <b>(Note 13)</b>	(4,173,475)
Total Net Worth	<u>\$ (451,761)</u>
TOTAL LIABILITIES AND NET WORTH	<u>\$26,447,639</u>

**THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE FINANCIAL STATEMENTS**

**HEALTHGUARD SERVICES, INC., DBA SELECTCARE  
STATEMENT OF REVENUE, EXPENSES AND NET WORTH  
FOR THE YEAR ENDED DECEMBER 31, 1994**

**REVENUE**

Premiums	\$136,966,088
Title XVIII Medicare	7,878,317
Title XIX Medicaid	18,169,801
Investment	860,453
Aggregate write-ins for other assets	<u>10,258</u>
Total Revenue	<u>163,884,917</u>

**EXPENSES**

Medical and Hospital:

Physicians services	64,769,179
Other professional services	4,446,943
Outside referrals	11,429,855
Inpatient	50,473,917
Aggregate write-ins for other medical/hospital expenses <b>(Note 14)</b>	32,147,972
Reinsurance expenses net of recoveries <b>(Note 15)</b>	388,029

Less:

COB and subrogation	<u>(13,320,059)</u>
Total Medical and Hospital	<u>150,335,836</u>

Administration:

Compensation	8,287,220
Interest expenses	460,450
Occupancy, depreciation, and amortization	2,036,049
Marketing	3,110,507
Aggregate write-ins for administration expenses	<u>4,097,361</u>
Total Administration	<u>17,991,587</u>
Total Expenses	<u>\$168,327,423</u>
NET LOSS	<u>\$ (4,442,506)</u>

**THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE FINANCIAL  
STATEMENTS**

**HEALTHGUARD SERVICES, INC., DBA SELECTCARE  
STATEMENT OF REVENUE, EXPENSES AND NET WORTH  
FOR THE YEAR ENDED DECEMBER 31, 1994  
(Continued)**

**NET WORTH**

Net worth beginning of year 1993	\$5,181,215
Decrease in contributed capital	(3,634,657)
Increase in surplus notes	2,167,970
Increase in contingency reserves	300,000
Net income	(4,442,506)
Decrease in nonadmitted assets	(367,641)
Aggregate write-ins	<u>343,858</u>
Net worth end of year 1994	<u>\$ (451,761)</u>

**THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE  
FINANCIAL STATEMENTS**

**HEALTHGUARD SERVICES, INC., DBA SELECTCARE  
RECONCILIATION OF EXAMINATION CHANGES  
FOR THE YEAR ENDED DECEMBER 31, 1994**

After evaluation of the assets and providing for the known liabilities and net worth, the following reflect examination changes to the net worth as of December 31, 1994.

Net worth per Company at December 31, 1994 \$ 811,208

<u>Examination Changes</u>	<u>Increase</u>	<u>Decrease</u>	
<b><u>ASSETS</u></b>			
Cash (Note 2)		( 93)	
Short-term investments (Note 3)		(20,406,694)	
Health care receivable (Note 4)		(287,787)	
Amounts due from affiliates (Note 5)		(1,360,155)	
Aggregate write-ins current asset (Note 6)		(79,450)	
Long term investment (Note 7)	20,406,787		
Land building and improvements (Note 8)		(133,506)	
Lease hold improvements (Note 9)	133,506		
<b><u>LIABILITIES</u></b>			
Claims payable (Note 10)	798,036		
Accrued medical incentive (Note 11)	390,354		
Amounts due to affiliates (Note 12)	<u>0</u>	( 723,967)	
TOTAL CHANGE	<u>21,728,683</u>	<u>(22,991,652)</u>	<u>( 1,262,969)</u>
Net worth per examination at December 31, 1994			<u>(\$ 451,761)</u>

As a result of the examination adjustments, the Company had a deficit of (\$451,761) at December 31, 1994. This amount is below the minimum net worth of \$500,000 pursuant to the provisions of ORS 750.045(1). Therefore, as of December 31, 1994, the Company was impaired in the amount of (\$951,761) as defined by ORS 734.014(4).

In addition, pursuant to the provisions of the Revised Code of Washington (RCW 48:46:235), the Company is required to maintain, on a Washington basis, a minimum net worth of \$3,130,000. As a result, the Company was impaired in Washington in the amount of \$3,581,761.

Presented below is a list of additional adjustments which were not made because satisfactory corrective measures were taken before the last day of the examination:

Real estate	\$1,098,506 (see page 31)
Surplus notes	<u>3,221,714</u> (see page 44)
Total	<u>\$4,320,220</u>

Without corrective actions, adjustments in the amount of \$4,320,220 would have been required. This would have resulted in an impairment of \$5,271,981 and \$7,901,981 in Oregon and Washington respectively.

We recommend the Company incorporate all these financial changes, whether reclassification or adjustments in all future annual and quarterly statements pursuant to the provisions of ORS 731.574.

## NOTES TO FINANCIAL STATEMENTS

### **Note 1 - Location of the Invested Assets**

Cash, long-term investments, and restricted cash, which accounts for 76.67% of the total assets, was located as follows:

#### **Cash**

U.S. Bancorp-PFA PO Box 5060 Portland, OR 97208-5060	\$ 2,261,479 (A)
Wilmington Trust Company-CDA 1100 N. Market Street Wilmington, DE 97401	( 2,117,002) (A)
U.S. Bank PO Box 10308 Eugene, OR 97401	525,362
Bank of California 407 SW Broadway Portland, OR 97205	99,907
Columbia State Bank 1338 Commerce Avenue Longview, WA 98632	623
Petty Cash	775
Total Cash	<u>771,144</u>

#### **Long-Term Investments**

Bank of California 407 SW Broadway Portland, OR 92507	<u>20,406,787</u> (B)
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#### **Restricted Cash**

##### Deposit with Oregon Insurance Division

U.S. National Bank of Oregon PO Box 3168 Portland, OR 97208	273,016
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Deposit with the Washington State Insurance Commissioner's Office

U.S. National Bank of Washington 50,000  
PO Box 1339  
Longview, WA 98632

West One Bank of Washington 100,000  
121 West Holly Street  
Bellingham, WA 98225

Total Restricted Cash 423,016

TOTAL INVESTED ASSETS \$21,600,947

A. The Company has an "Out-of-State Disbursement Account Agreement" with U.S. Bank. According to the agreement the Company has to maintain a "Primary Funding Account" (PFA) with U.S. Bank and a "Controlled Disbursement Account" (CDA) with Wilmington Trust Company in Delaware. The PFA account is used to cover checks clearing the CDA account. According to the agreement, the Company is obligated to adequately fund the PFA to maintain the CDA at a zero balance.

B. At December 31, 1994, the bonds had a total market value of \$19,011,438 as compared to the amortized book value of \$20,406,787.

**Note 2 - Cash**

Balance per company		\$771,237
Examination reclassification (Note 7)	(100,000)	
Examination reclassification (Note 3)	<u>99,907</u>	<u>( 93)</u>
Examined Balance		<u>\$771,144</u>

Mutual funds in the amount of \$100,000 were incorrectly reported as cash. Pursuant to the provisions of ORS 733.210 and the annual statement instructions such amounts should be reported as a part of long-term investments. As a result, this amount has been reclassified to long-term investments.

In addition to the above, bank money market funds in the amount of \$99,907 were reported as short-term investments. Once again pursuant to the provisions of ORS 733.210 and the annual statement instructions such amounts should have been reported as cash. As a result this amount has been reclassified from short-term investments to cash.

**Note 3 Short-Term Investments**

Balance per company		\$20,406,694
Examination reclassification (Note 7)	20,306,787	
Examination reclassification (Note 3)	<u>99,907</u>	<u>(20,406,694)</u>
Examined Balance		<u>\$ 0</u>

Bonds in the amount of \$20,306,787 were incorrectly reported as short-term investments. Pursuant to the provisions of ORS 733.210 and the annual statement instructions such amounts should be reported as long-term investments. This amount has been reclassified to long-term investments.

Bank money market funds in the amount of \$99,907 were reclassified to cash (see Note 2).

**Note 4 - Health Care Receivable**

Balance per company	\$1,001,724
Examination adjustment <b>(Note 5)</b>	<u>( 287,787)</u>
Examined balance	<u>\$ 713,937</u>

A review of reinsurance recoverable revealed that four amounts included in the inventory had not been billed to the reinsurer as of December 31, 1994. Therefore, these amounts should not be included. Also, a review of subsequent receipts revealed that other amounts included in the receivable were overstated. As a result, an examination adjustment in the amount of \$287,787 has been made.

**Note 5 - Amounts Due From Affiliates**

Balance per company	\$1,360,155
Examination reclassification <b>(Note 11)</b>	<u>(1,360,155)</u>
Examined balance	<u>\$ 0</u>

The Company has attempted to split its medical incentive pool accruals between an amount due from affiliated providers (largest being Sacred Heart General Hospital) and the balance, associated with all other providers. Ms. Turner has recommended that all amounts arising from provider reconciliations be incorporated in the medical incentive pool accruals, to properly show the total effect of provider agreements on hospital and medical expenses. As a result, a reclassification in the amount of \$1,360,155 has been made from this account to medical incentive pool liability.

**Note 6 - Aggregate Write-Ins for Current Assets**

General ledger balance	\$262,753
Nonadmitted by the Company	<u>(183,303)</u>
Balance reported by the Company	79,450
Examination adjustment	<u>( 79,450)</u>
Examined balance	<u>\$ 0</u>

This balance includes the cash surrender values of 5 life insurance policies totaling \$79,450. As noted in the accounts and record section, the owner of the life insurance policy is the employee and in addition, the collateral assignment is in the name of PeaceHealth, therefore, this amount was nonadmitted. In addition, an unsecured receivable in the amount of \$722 was nonadmitted pursuant to the provisions of ORS 733.020.

### **Note 7 - Long-Term Investments**

Balance per company		\$	0
Examination reclassification (Note 3)	20,306,787		
Examination reclassification (Note 2)	<u>100,000</u>		<u>20,406,787</u>
Examined balance			<u>\$20,406,787</u>

See notes 2 and 3 for more detail.

### **Note 8 - Land, Buildings & Improvements**

Balance per company	\$1,098,738
Examination reclassification (Note 9)	<u>( 133,506)</u>
Examined balance	<u>\$ 965,232</u>

As reported in the accounts and records section, although the Company owns 45% of the building, it occupies the entire building under a capital lease agreement. It was noted during the examination that the Company pays for all capital improvements, and reports them as real estate improvements. Since 55% of the building is occupied under a lease agreement, the Company should report 55% of the improvements as leasehold improvements and depreciate them over the life of the lease. As a result, an examination reclassification, in the amount of \$133,506, has been made to this account.

### **Note 9 - Lease Hold Improvements**

General ledger balance	\$ 42,852
Nonadmitted by the Company	<u>(42,852)</u>
Balance reported by the Company	0
Examination reclassification (Note 8)	<u>133,506</u>
Examined balance	<u>\$133,506</u>

The reported balance represents lease hold improvements in the Longview office. Since this lease is a 5 year operating lease, the entire balance was nonadmitted by the Company.

A reclassification in the amount of \$133,506 has been made to this account (see Note 8)

### **Note 10 - Claims Payable**

Balance per company		\$19,496,932
Examination adjustment:		
Pharmacy rebates (Note 14)	591,209	
reinsurance recoverable (Note 15)	<u>206,827</u>	<u>(798,036)</u>
Examined balance		<u>\$18,698,896</u>

The reduction in claims payable reflects 2 receivable items that were not accounted for by the Company in the unpaid claims development. Pharmacy rebates in the amount of \$591,209 were received and reinsurance recoverable in the amount of \$206,827 that was billed to the reinsurer subsequent to the year end December 31, 1994.

### **Note 11 - Accrued Medical Incentive Pool**

Balance per company	\$1,941,268
Examination adjustment ( <b>Note 14</b> )	969,801
Examination reclassification ( <b>Note 5</b> )	<u>(1,360,155)</u>
Examined balance	<u>\$1,550,914</u>

Subsequent to the year end December 31, 1994, it was discovered that certain supplemental benefit items had been considered in the accrual calculation to be part of the providers' risk. Correction of this item increased the net amount previously calculated as due and accrued to providers by \$969,801.

See Note 5 for reclassification in the amount of \$1,360,155.

### **Note 12 - Amounts Due to Affiliates**

Balance reported by the Company	\$1,233,496
Examination adjustment ( <b>Note 13</b> )	<u>723,967</u>
Examined balance	<u>\$1,957,463</u>

See note 13 for more details.

### **Note 13 - Net Worth**

The Company reported a net worth in the amount of \$811,208 as of December 31, 1994 which was comprised of following amounts:

	<b><u>Balance per Company</u></b>	<b><u>Adjustment</u></b>	<b><u>Balance per Examination</u></b>
Contributed capital (A)	\$3,744,921	(\$3,744,921)	\$ 0
Surplus notes (B)	844,618	2,377,096	3,221,714
Contingency reserves (C)	423,016	76,984	500,000
Retained earning (D)	<u>(4,201,347)</u>	<u>27,872</u>	<u>(4,173,475)</u>
Net worth	<u>\$ 811,208</u>	<u>(\$1,262,969)</u>	<u>\$ (451,761)</u>

**Contributed capital (A)** This amount consists of following items:

Series A surplus note	(\$2,377,096)
Series B surplus note	(723,967)
Contributed capital	(650,000)
Aggregate write-ins	<u>6,142</u>
Total	<u>(\$3,744,921)</u>

### **Series A Surplus Note**

Series A surplus note was shown as contributed capital. Proper treatment is to classify it as a surplus note and list it on Schedule K of the annual statement. As a result, a reclassification in the amount of \$2,377,096 was made from contributed capital to surplus notes.

### **Series B Surplus Note and Debt Forgiven**

The original transaction regarding the series B surplus certificate relates to the acquisition of Eugene Clinic Health Corporation by the Company's affiliate, Sacred Heart General Hospital (SHGH) on January 1, 1989. From this acquisition, Select Care was given an intangible asset which was assigned a goodwill value of \$1,650,000. Sacred Heart General Hospital then forgave \$650,000 of this goodwill debt (Since goodwill is a nonadmitted asset, this entry had no net-worth impact). The Company paid \$276,033 in cash to SHGH and the remaining balance due was established as a surplus note (series B) for \$723,967.

The following journal entries summarize the acquisition of the Eugene Clinic:

Debit Goodwill/Nonadmitted Asset	\$1,650,000	
Cr Contributed capital		\$650,000
Cr Surplus Notes		723,967
Cr Cash (payments between 89 &90)		267,033

It was determined that the series B note was backed by an intangible asset and was improperly reported as contributed capital. As a result, an adjustment in the amount of \$723,967 has been made from this account to "amounts due to affiliates" (see note 12).

The Company reported \$650,000 as contributed capital. This does not meet the definition of contributed capital and has been written off. Following is the adjusting journal entry:

Debit contributed capital	\$650,000	
Cr Change in nonadmitted assets		650,000

The Company had reported a debit balance of \$6,142 as uncollected contributed capital from its affiliate. This amount was determined to be uncollectible and it was not admitted.

Surplus Notes (B) - It is summarized as follows:

<b><u>Item</u></b>	<b><u>Balance Reported per Company</u></b>	<b><u>Reclass.</u></b>	<b><u>Balance per Examination</u></b>
Real estate note	\$786,384	\$ 0	\$ 786,384
EDP note	58,234	0	58,234
Reclass series A	<u>0</u>	<u>2,377,096</u>	<u>2,377,096</u>
Total	<u>\$844,618</u>	<u>\$2,377,096</u>	<u>\$3,221,714</u>

Surplus notes secured by real estate and EDP equipment were issued in June 1990, as a part of a recapitalization agreement with PeaceHealth. The Company has been making both principal and interest payments on these notes without obtaining the necessary approval from the Director. The above amounts represent the remaining unpaid balances as of December 31, 1994.

### **Contingency Reserve (C)**

The Company is reporting funds held on deposit with the states of Oregon and Washington as a contingency reserve in the amount of \$423,016. Contingency reserves should include only the minimum required net worth of \$500,000 pursuant to the provisions of ORS 750.045. As a result, a reclassification in the amount of \$76,984 has been made from retained earnings to contingency reserves to bring the balance up to the required \$500,000 minimum net worth.

### **Retained Earnings (D)**

Retained earnings represent the undistributed and unappropriated amount of net worth. The Company reported retained earnings in the amount (\$4,201,347). The aggregate examination adjustments resulted in a net change of \$27,872 to retained earnings and are summarized as follows:

Balance reported by the Company		(\$4,201,347)
Note 4 adjustment	(\$287,787)	
Note 6 adjustment	(79,450)	
Note 10 adjustment	798,036	
Note 11 adjustment	( 969,801)	
Note 13 (A) reclassification	650,000	
Note 13 (A) reclassification	(6,142)	
Note 13 (C) reclassification	<u>(76,984)</u>	<u>27,872</u>
Examination balance		<u>(\$4,173,475)</u>

### **Note 14 - Aggregate Write-ins for Medical and Hospital Expenses**

Balance per company	\$31,769,380
Examination adjustment ( <b>Note 11</b> )	969,801
Examination adjustment ( <b>Note 10</b> )	<u>(591,209)</u>
Examined balance	<u>\$32,147,972</u>

See notes 10 and 11 for more details.

### **Note 15 - Reinsurance Expenses Net of Recoveries**

Balance per company		\$307,069
Examination adjustment ( <b>Note 10</b> )	(206,827)	
Examination adjustment ( <b>Note 4</b> )	<u>287,787</u>	<u>80,960</u>
Examined balance		<u>\$388,029</u>

See notes 4 and 10 for more details.

## **SUMMARY OF COMMENTS AND RECOMMENDATIONS**

The Company has complied with all recommendations made in the previous examination except as it relates to formalizing and adopting a disaster recovery plan. The following are issues and concerns that should be brought to management's attention as a result of this examination.

### Page

- 9 We recommend the Company immediately hire or train key management personnel with sufficient qualifications and insurance company managerial experience pursuant to the provisions of ORS 731.386(1).
- 11 We recommend future Board of Directors minutes be written to reflect the transactions and action taken by the Board and hereafter comply with the provisions of ORS 733.730.
- 12 We recommend the \$600,000 bond should be increased to \$800,000 to afford adequate protection for the Company pursuant to the provisions of ORS 731.574(6), 733.210 and the NAIC Examiners Handbook.
- 13 We recommend the Company comply with terms of the intercompany agreement pursuant to the provisions of ORS 732.574.
- 18 We recommend the Company comply with the provisions of OAR 141-45-041(5) by filing form 1A with the Oregon Division of State Lands.
- 19 We recommend timely follow-up and a proper review of reinsurance recoverable to provide proper control over amounts owed to the Company pursuant to the provisions of ORS 731.574(6), 733.210 and the NAIC Examiners Handbook instructions. Also, we reemphasize the need for functional communication between the accounting, reinsurance and claims department.
- 19 We recommend information concerning reinsurance contracts be factored into future estimates if they are to be used in offsetting a portion of the unpaid claim total to comply with the provisions of ORS 733.030.
- 21 We recommend the Company record and report bonds at amortized cost to comply with the provisions of ORS 733.160(1)(A), 733.210 and the NAIC Securities Valuation Manual.
- 21 We strongly recommend the management devote competent staff and resources to simplify and improve the revenue and billing process to comply with the provisions of ORS 733.170.
- 22 We recommend the management implement policies and procedures to track claims overpayments to comply with the provisions of ORS 733.030 and 733.170.

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- 22 We recommend the Company implement program changes to the system to limit claims processor's authority to \$10,000 per claim. All system payments in excess of \$10,000 should require a supervisor approval code to comply with the provisions of ORS 731.574(6), 733.170, 733.210, and the NAIC Examiners Handbook.
- 22 We recommend future contracts be worded to base claim payments on receipt of actual claim information as it relates to pharmacy claims pursuant to the provisions of ORS 733.170 and 733.030.
- 23 We recommend a tracking mechanism be developed to monitor the monthly fluctuations with COB and help with early identification of recovery problems pursuant to the provisions of ORS 733.030 and 733.170.
- 23 We strongly recommend the Company review the need for off system payments. In particular, capitation and pharmacy are 2 areas that should be completely automated as soon as possible in order to have a sound record keeping practice to comply with the provisions of ORS 733.170.
- 24 We recommend the underwriting and the financial databases be reconciled at least monthly to comply with the provisions of ORS 733.170.
- 24 We recommend the Company properly disclose uncovered expenses and liabilities to comply with the provisions of ORS 731.574, 733.170, 733.210 and annual statement instructions.
- 25 We strongly recommend the Company comply with the provisions of ORS 731.574, 733.010, and 733.170 at all times by reporting only such assets (i.e. real estate) on the financial statements as are owned by the Company.
- 25 We recommend the Company comply with the provisions of ORS 732.245 and ORS 733.170 by maintaining all records in the State of Oregon at all times.
- 26 We recommend the Company use the IRS depreciation guidelines for all additions to the fixed assets to comply with the provisions of ORS 731.574(6), 733.170, 733.210 and the Accounting Practices and Procedure manual.
- 26 We recommend the Company report 55% of the improvements as leasehold improvements and depreciate them over the life of the lease to comply with the provisions of ORS 731.574(6), 733.170, 733.210 and annual statement instructions.
- 27 We recommend the Company comply with the provisions of ORS 731.574(6), 733.170, 733.210 and the Accounting Practices and Procedure Manual by charging itself adequate rent for its own occupancy.
- 27 We strongly recommend the Company comply with the provisions of ORS 733.010 at all times by reporting only such assets (i.e. cash surrender values) on the financial statements as are owned by the Company.

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- 27 We recommend the Company physically inventory all EDP equipment on an annual basis to account for and safeguard assets in accordance with the provisions of ORS 731.574(6), 733.170, 733.210 and the NAIC Examiners Handbook.
- 28 We recommend the window wall in the computer room be replaced with panels. This recommendation has been made pursuant to the provisions of ORS 731.574(6), 733.210 and the NAIC Examiners Handbook.
- 28 We strongly recommend the Company immediately formalize and adopt an EDP disaster recovery plan to comply with the provisions of ORS 731.574(6), 733.210 and the NAIC Examiners Handbook.
- 28 We recommend the Company make arrangements to periodically monitor the night operator to comply with the provisions of ORS 731.574(6), 733.210 and the NAIC Examiners Handbook.
- 28 We recommend the console log be examined once a week by operating supervisors within the EDP department to comply with the provisions of ORS 731.574(6), 733.210 and the NAIC Examiners Handbook.
- 29 We recommend programmers be restricted from using production data and the Company should find alternate methods for correcting bad data in order to comply with the provisions of ORS 731.574(6), 733.210 and the NAIC Examiners Handbook.
- 29 We recommend the Company consider changing the policy whereby all expenses as they relate to the company president, be approved by the Board and the president approve expenses for the senior management pursuant to the provisions of ORS 731.574(6), 733.210 and the NAIC Examiners Handbook.
- 29 We recommend all manual checks in excess of \$50,000 be preprinted with a restriction voiding the check if not double signed pursuant to the provisions of ORS 731.574(6), 733.210 and the NAIC Examiners Handbook.
- 30 We recommend the Company implement program changes to the billing system to prohibit balance write offs in excess of \$1,000 without supervisory approval pursuant to the provisions of ORS 731.574(6), 733.210 and the NAIC Examiners Handbook.
- 30 We recommend the Company establish both accrual limits for paid time off hours as well as policies to define mandatory payout provisions for accumulated hours on an annual basis pursuant to the provisions of ORS 731.574(6), 733.210 and the NAIC Examiners Handbook.
- 30 We recommend the Company redefine the purpose, authority, and responsibilities of the internal audit department and develop a comprehensive methodology for conducting annual and interim audits of various departments within the Company pursuant to the provisions of ORS 731.574(6), 733.210 and the NAIC Examiners Handbook.

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- 31 We strongly recommend the Company document all its adjustments concerning unpaid claims estimates and here after comply with the provisions of ORS 731.574(6), 733.030 and 733.210.
- 32 We recommend future actuarial certifications include the traditional unpaid claims line, the medical incentive pool accrual amount, and any other aspect of the balances relating to amounts expected to be paid on previous incurrals under the terms of either the member contracts or the provider agreements pursuant to the provisions of OAR 836-31-640.
- 32 We recommend actuarial certifications with all future quarterly as well as annual statements because of problems with data reconciliation and the developing experience under changing provider contracts and reporting system. We also request a supporting actuarial memorandum to accompany the 1995 year end statement pursuant to the provisions of ORS 733.030 and OAR 836-31-640.
- 32 We recommend the Company put procedures in place to ensure that terms of the provider contract be followed pursuant to the provisions of ORS 731.574, 733.030 and 733.170.
- 34 We recommend the Company maintain a minimum of 2 months average claims paid and a premium to net worth ratio of no greater than 29:1 at all times.
- 34 We recommend that in the future, the Company should consider establishing additional liabilities for any situation where future premiums for the duration of a contract are anticipated to be materially less than the combined medical and administrative expenses of the contract pursuant to the provisions of ORS 731.574, 733.030 and 733.170.
- 34 We recommend the Company file quarterly reports with the Insurance Division on the status of changes being implemented in premium rates and provider contracts to return underwriting gains to a positive level pursuant to the provisions of ORS 731.296 and 733.030.
- 35 We recommend the Company hereafter comply with the provisions of ORS 731.260, 731.574 and OAR 836-13-000 by filing complete and accurate annual statements in accordance with the instructions provided.
- 36 We recommend in the future, the Company not record any surplus notes unless they are approved by the Insurance Division pursuant to the provisions of ORS 731.260, 731.574, 733.010, 733.170, and 733.210 and the NAIC Accounting Practices and Procedures Manual.
- 37 We recommend, in the future, the Company record surplus notes in accordance with the provisions of ORS 731.574, 733.210, OAR 836-13-000 and the NAIC Accounting Practices and Procedures Manual.

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- 43 We recommend the Company incorporate all examination changes, whether reclassification or adjustments, in all future annual and quarterly statements pursuant to the provisions of ORS 731.574.
- 57 We recommend the Company immediately draw upon the credit line with PeaceHealth in the amount of \$4,000,000 in the form of a new surplus note to comply with the provisions of ORS 733.210 and NAIC Accounting Practice and Procedure Manual and hereafter assure such compliance by maintaining the required ratios.

**CONCLUSION**

During the three year period covered by this examination, the net worth of the Company has decreased from \$2,515,043 as presented in the December 31, 1991 report of examination to (\$451,761) as shown in this report of examination.

The comparative assets and liabilities are shown below:

	<b><u>December 31,</u></b>		
	<b><u>1994</u></b>	<b><u>1991</u></b>	<b><u>Change</u></b>
Assets	\$26,447,639	\$11,065,742	\$15,381,897
Liabilities	(26,899,400)	(8,550,699)	(18,348,701)
Surplus	(\$451,761)	\$ 2,515,043	(\$2,966,804)

**SUBSEQUENT EVENTS**

**New Master Surplus Note**

As noted above, at December 31, 1994, the Company had a statutory net worth of \$(451,761), which was below the statutory minimum surplus in the states of Oregon and Washington. Subsequent to December 31, 1994, the Company received a capital contribution in the amount of \$6,000,000 from PeaceHealth, which returned the Company's statutory capital to a level above the minimum requirements. This capital contribution was in the form of a new subordinated surplus note. In addition to the

new surplus note, PeaceHealth has authorized an additional \$6,000,000 subordinated line of credit. As a part of the recapitalization agreement between the Company and Oregon Insurance Division, the Company will draw upon this line, in the form of new subordinated surplus notes, sufficient funds so as to ensure that the Company maintains, based upon a review of previous month's financial statements and subject to review by the Director, a minimum of 2 months average claims paid and a premium to net worth ratio of no greater than 29:1 at all times.

As noted in the "Accounts and Records" section of this report, at December 31, 1994, the Company had 4 surplus notes which were never approved by the Oregon Insurance Division. Subsequent to December 31, 1994, these surplus notes were combined with the new surplus note contribution (as stated above for \$6,000,000) from PeaceHealth to form a new master surplus note. A new surplus note was written on January 27, 1995 in the amount of \$9,228,769 and was approved by the Insurance Division on June 23, 1995. The master surplus note is summarized as follows:

Contributed capital in January 1995	\$6,000,000
Series A surplus note	2,377,096
Accrued interest on Series A note	18,819
Surplus note real estate	782,434
Accrued interest on real estate note	6,226
Surplus note EDP	43,847
Accrued interest on EDP note	<u>347</u>
Total new surplus note as of January 27, 1995	<u>\$9,228,769</u>

#### Minimum Net Worth Requirement

As noted earlier, the Company is required to maintain a minimum of 2 months average claims paid and a premium to net worth ratio of no greater than 29:1 at all times. As of March 31, 1995, the ratios were as follows:

Premium to Net Worth Ratio:

Premiums earned annualized (\$39,236,730 x 4) (A)	\$156,946,920
Net worth	5,548,293
Premium to net worth ratio (A/B)	28:1

Average Number of Months for Claims Payments:

Claims payable (A)	\$ 17,492,896
Examined net worth (B)	5,548,293
Required capitalization (C)	500,000
Accrued medical incentive pool (D)	2,073,543
Total paid claims for the preceding 12 months (E)	159,758,638
Total number of month (F)	12
Average number of months [(A+B+-C+D)/(E/F)]	1.85

As of March 31, 1995, the Company was in compliance with the requirement for premium to net worth ratio, however, it needs approximately \$4,000,000 capital infusion in order to maintain a minimum of 2.15 months average claims paid.

We recommend the Company immediately draw upon the credit line in the amount of \$4,000,000, in the form of a new surplus note, to comply with the provisions of ORS 733.210 and the NAIC Accounting Practice and Procedure Manual and hereafter assure such compliance by maintaining the required ratios.

It should be noted that net worth of \$5,755,555 was compiled from the Company's March 31, 1995 filed quarterly statement and this number has not been examined.

On June 28, 1995, the Company received only \$3,000,000 capital contributions from the parent company and as of the date of this report, it was in the process of securing a new surplus note for the same amount.

### Management Changes

Subsequent to the year end December 31, 1995, Mr. Slade terminated his employment as president of the Company and Mr. Cross resigned as chief financial officer and underwriting vice president of the Company (See page 10 for more discussion regarding management evaluation).

### Turnaround Plan

In addition to the facts discussed above, the Company has instituted a turnaround plan (the Plan). The Company has prepared 2 financial projection scenarios to show management's anticipated financial picture based upon actions to be taken to return the Company to profitability. These scenarios were based upon different assumptions regarding:

- Membership
- Pricing
- Medical Costs
- Administrative Costs

In summary, profit may increase due to strategic price increases on unprofitable business aimed at either eliminating the associated membership or obtaining a reasonable return. Costs may be reduced through management actions to increase reimbursements due to coordination of benefits with other carriers; recovery of claims overpayments, and better case management.

Due to the renewal cycle, losses will continue to emerge at least until the 1st quarter of 1996, when most of the groups are up for renewal.

The plans described above must be viewed in light of the following:

1. The external environment may become extremely competitive as several large companies in the region are merging and it can be anticipated that these companies will be using price competition to gain market share.
2. Reliability of the data that was used to project the financial results.
3. Key managers of the Company are new and the management is currently using the expertise of consultants to help determine the steps necessary to turn the Company around.

## **ACKNOWLEDGMENT**

The cooperation and assistance extended by the officers and employees of the Company during the examination process are gratefully acknowledged.

In addition to the undersigned, Michael P. Phillips, CPA, CFE, and David L. Daulton, AFE, insurance examiners for the State of Oregon, Department of Consumer and Business Services, Insurance Division, and Catherine R. Turner, FSA, MAAA, consulting actuary, for the State of Oregon, Department of Consumer and Business Services participated in the examination.

Respectfully submitted,

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Neeraj Gupta, CFE  
Supervising Insurance Examiner  
Examiner-in-charge  
Insurance Division  
Department of Consumer and Business Services  
State of Oregon

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Leman D. McLean, CFE, CPA, FLMI  
Insurance Examiner IV  
Company Supervision  
Washington State Insurance Commissioner's Office  
State of Washington



