Puerto Rico Health Insurance Administration
(A Component Unit of the Commonwealth of Puerto Rico)

Basic Financial Statements and Required Supplemental Information as of and for the Year Ended June 30, 2011 and Independent Auditors' Report

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PARISSI P.S.C.
Certified Public Accountants, Tax & Business Advisors

Independent Auditors' Reports

To the Board of Directors of the
Puerto Rico Health Insurance Administration:

We have audited the accompanying basic financial statements of the Puerto Rico Health Insurance Administration (the Administration), a component unit of the Commonwealth of Puerto Rico, as of June 30, 2011 and for the year then ended, as listed in the table of contents. These basic financial statements are the responsibility of the Administration's management. Our responsibility is to express an opinion on these basic financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the basic financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the basic financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Puerto Rico Health Insurance Administration as of June 30, 2011 and the changes in financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As disclosed in Note 3, the Administration has a deficit of approximately $278 million and incurred in an increase in net deficit of approximately $31 million during the year ended June 30, 2011.

The management's discussion and analysis on pages 2 to 8 is not a required part of the basic financial statements but is supplementary information required by the accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Parissi, PSC

November 11, 2011
San Juan, Puerto Rico

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This section of the financial statements is classified by the Governmental Accounting Standards Board (GASB) as required supplementary information. It is intended to provide an objective and easily readable analyses of the government's financial activities. Along with the notes to the financial statements, the management discussion and analysis should provide the user with the most relevant information regarding the financial condition of the Puerto Rico Health Insurance Administration (the Administration) as of June 30, 2011 and 2010.

Overview of the Financial Statements

The annual report includes the management's discussion and analysis report, the independent auditors' report, and the basic financial statements. The financial statements also include notes that explain in more detail the information contained in the financial statements. The discussion will focus on major components of the financial statements.

Financial Analysis of the Administration as a Whole

The balance sheet and the statement of revenue, expenses, and changes in net assets present the net assets of and the changes in them. Net assets—the difference between assets and liabilities is one way to measure financial health or financial position. Increase or a decrease in net assets is one indicator of whether its financial health is improving or deteriorating. However, one will need to consider other nonfinancial factors such as changes in economic conditions and new or changes in government legislation.

The condensed net deficit information is presented as follows:

	June 30		Change	
	2011	2010	In dollars	Percentage
Current assets	$ 246,879,635	245,342,437	1,537,198	0.63%
Capital assets, net	166,934	210,419	(43,485)	(20.67)%
Total assets	$ 247,046,569	245,552,856	1,493,713	0.61%
Current liabilities	$ 285,655,006	492,704,009	(207,049,003)	(42.02)%
Non current liabilities	239,719,844	348,558	239,371,286	68,674.74%
Total liabilities	525,374,850	493,052,567	32,322,283	6.56%
Net deficit:				
Invested in capital assets, net of related debt	166,934	210,419	(43,485)	(20.67)%
Unrestricted deficit	(278,495,215)	(247,710,130)	(30,785,085)	12.43%
Total net deficit	(278,328,281)	(247,499,711)	(30,828,570)	12.46%
Total liabilities and net deficit	$ 247,046,569	245,552,856	1,493,713	0.61%

	June 30		Change	
	2010	2009	In dollars	Percentage
Current assets	$ 245,342,437	180,569,739	64,772,698	35.87%
Capital assets, net	210,419	208,854	1,565	0.75%
Total assets	$ 245,552,856	180,778,593	64,774,263	35.83%
Current liabilities	$ 492,704,009	357,927,384	134,776,625	37.65%
Non current liabilities	348,558	245,358	103,200	42.06%
Total liabilities	493,052,567	358,172,742	134,879,825	37.66%
Net deficit:				
Invested in capital assets, net of related debt	210,419	208,854	1,565	0.75%
Unrestricted deficit	(247,710,130)	(177,603,003)	(70,107,127)	39.47%
Total net deficit	(247,499,711)	(177,394,149)	(70,105,562)	39.52%
Total liabilities and net deficit	$ 245,552,856	180,778,593	64,774,263	35.83%

Analysis of Net Assets at June 30, 2011 and 2010

Total net deficit of $278 million is composed of $166,934, invested in capital assets, net of related debt; and an unrestricted net deficit of $278 million. Total deficit increased from $247.5 million to $278 million, a difference of approximately $31 million or 12%, mainly because operating revenues from municipalities decreased from the previous year.

Current assets increased from $245.3 million to $246.9 million, an increase of $1.5 million or 1% mainly due to a decrease in cash and cash equivalents that was compensated by a greater increase in accounts receivable.

Current liabilities decreased from $492.7 million to $285.7 million or approximately $207 million, mainly as a result of the Administration entering into a non-revolving line of credit agreement with the Government Development Bank to pay premiums due to health insurance companies. The line of credit balance at June 30, 2011 is $173 million, including interest. The line of credit will be payable in annual installments beginning in fiscal year 2014-2015 and is, therefore, recorded as non-current liabilities. The line of credit will be repaid from appropriations from the Legislature of Puerto Rico. In addition, during fiscal year 2010-2011, the Administration signed loan agreements with three insurance companies renegotiating payment terms, as a result, $64 million due to those insurance companies are recorded as non-current liabilities. The effect of opening the line of credit and renegotiating debt with the insurance companies reduced current liabilities by $237 million. This reduction was partially compensated by an increase in medical insurance premiums and claims incurred and health care costs of approximately $30 million.

Long-term liabilities increased from $348,558 to $239.7 million or approximately $239 million as a result of the effect the line of credit ($173 million) and the payment terms negotiation ($64 million) mentioned in the previous paragraph. In addition the Administration implemented an early retirement plan which had the effect of increasing non-current liabilities by $2 million. Please refer to Note 10 to the basic financial statements for further details.

Analysis of Net Assets at June 30, 2010 and 2009

Total net deficit of $247.5 million is composed of $210 thousand invested in capital assets, net of related debt; and an unrestricted net deficit of $247.7 million. Total deficit changed from $177.4 million to $247.5 million, an increase of approximately $70.1 million or 39.52%, mainly because during this fiscal year, the Administration did not receive the assigned funds of alcohol and cigarettes of $63 million. Current assets increased by approximately $64.8 million because at the end of the year, the Administration received an additional contribution from the Commonwealth of $103 million. Current liabilities increased by approximately $134.8 million because the Administration had not generated the payments of premiums of approximately two months.

The condensed changes in net deficit information are presented below:

	Year Ended June 30,		Change	
	2011	2010	In dollars	Percentage
Operating revenue:				
Contributions from: Department of Health of Puerto Rico, municipalities, employers and rebates	$ 764,425,586	721,864,201	42,561,385	5.90%
Non operating revenue:				
Interest income and transfers	1,222,040,036	1,170,582,718	51,457,318	4.40%
Total revenue	1,986,465,622	1,892,446,919	94,018,703	4.97%
Operating expenses:				
Medical insurance premiums	1,897,765,202	1,554,435,330	343,329,872	22.09%
Claims incurred and health care costs	96,782,956	370,106,750	(273,323,794)	(73.85)%
General and administrative	22,655,286	37,937,920	(15,282,634)	(40.28)%
Depreciation and amortization	90,748	72,481	18,267	25.20%
Total operating expenses	2,017,294,192	1,962,552,481	54,741,711	2.79%
Increase in net deficit	(30,828,570)	(70,105,562)	39,276,992	(56.03)%
Net deficit, beginning of year	(247,499,711)	(177,394,149)	(70,105,562)	39.52%
Net deficit, end of year	$ (278,328,281)	(247,499,711)	(30,828,570)	12.46%

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	Year Ended June 30,		Change	
	2010	2009	In dollars	Percentage
Operating revenue:				
Contributions from: Department of Health of Puerto Rico, municipalities, employers and rebates	$ 721,864,201	767,243,395	(45,379,194)	(5.91)%
Non operating revenue:				
Interest income and transfers	1,170,582,718	1,011,588,127	158,994,591	15.72%
Total revenue	1,892,446,919	1,778,831,522	113,615,397	6.39%
Operating expenses:				
Medical insurance premiums	1,554,435,330	1,563,847,759	(9,412,429)	(0.60)%
Claims incurred and health care costs	370,106,750	280,672,494	89,434,256	31.86%
General and administrative	37,937,920	16,354,062	21,583,858	131.98%
Depreciation and amortization	72,481	246,070	(173,589)	(70.54)%
Total operating expenses	1,962,552,481	1,861,120,385	101,432,096	5.45%
Increase in net deficit	(70,105,562)	(82,288,863)	12,183,301	(14.81)%
Net deficit, beginning of year	(177,394,149)	(95,105,286)	(82,288,863)	86.52%
Net deficit, end of year	$ (247,499,711)	(177,394,149)	(70,105,562)	39.52%

Year Ended June 30, 2011 and June 30, 2010

The Administration's revenue increased by approximately $94 million or 4.97 % mostly as a result of:

1. An increase of $51.5 million from Commonwealth and COFINA transfers.

2. A net increase of $42.5 million in operating revenues. This increase is the effect of an increase in federal funds of $92 million, mostly the result of the receipt of ARRA funds, offset by a decrease of $37.5 million in contributions from municipalities and a $12 million decrease from revenues from the pharmacy rebate program and contributions from employers.

The Administration's expenses increased by $54.7 million or 2.8% mostly as a result of:

1. An increase in medical insurance premiums of $343.3 million or 22%. This increase is the result of a decrease in the population under direct contracting projects from approximately 190,000 lives at June 30, 2010 to approximately 11,000 lives at June 30, 2011. This change in lives occurred effective October 1, 2010, when the Metro North direct contracting project was changed to an insurance premium model. In addition, the insured population, increased from approximately 1,473,000 lives at June 30, 2010 to over 1,500,000 lives at June 30, 2011.

2. The claims incurred and health care costs and other operating costs decreased by $288.6 million mostly due to a reduction of lives under the direct contracting project mentioned above.

Year Ended June 30, 2010 and June 30, 2009

The Administration's revenue increased by approximately $113.6 million or 6.39% mostly as a result of: an increase of $164 million from Commonwealth transfers due to additional contribution related to Puerto Rico Sales Tax Financing Corporation (COFINA) funds, an increase of $63 million from pharmacy rebate program due to a Ruling of the Department of Justice, effective at the beginning of the fiscal year, which established that 100% of the rebate funds should be retained by the Administration, an increase of $29 million in municipality contributions due to a retroactive adjustment recorded during the year, a decrease of $123 million in federal funds mainly because the Administration did not receive the American Recovery Reinvestment Act (ARRA) funds during this year, a decrease of $14 million in employers contributions because during prior year the Administration recorded a retroactive adjustment, and a decrease of $5 million in interest income and other.

The Administration's expenses increased by $101.4 million or 5.45% mostly as a result of the increase in claims and health care cost incurred of approximately $89.4 million mainly because the claims paid in the metro-north region increased, a decrease in medical insurance premiums of $9.4 million and an increase in general administrative expenses of $21.6 million due to the increase in the allowance for bad debts of $21 million. This was offset by a $174 thousand decrease in depreciation and amortization expenses.

Capital Assets

The Administration's investment in capital assets as of June 30, 2011 and 2010 amounted to $166,934 and $210,419, respectively, net of accumulated depreciation. Capital assets include equipment, furniture, and vehicles.

During the years ended June 30, 2011, and 2010, the Administration invested approximately $47,263 and $74,046 in capital assets, respectively.

Depreciation and amortization expense for the years ended June 30, 2011 and 2010 amounted to $90,748 and $72,481, respectively.

Debt Administration

On March 14, 2011, the Administration entered into a Credit Agreement with the Government Development Bank of Puerto Rico in order to meet its obligations incurred prior to fiscal year 2009-2010 to insurers. As of June 30, 2011, the principal outstanding balance amounted to $171,080,000 and the accrued interest amounted to $2,065,335. The Administration will pay the principal and interest with the appropriations made by the Legislature of Puerto Rico.

Direct Contracting Project

Starting on July 1st, 2003 and through today, the Administration has entered into direct contracting projects in different regions. The projects differ from the traditional model since the Administration bears most of the coverage risks.

At June 30, 2011, the Administration had limited the direct contracting project to cover the Municipalities of Vieques and Guaynabo. For the Vieques project, the Government assumes all the risk. A third party administrator (TPA), handles all the administrative work related to the operation such as payments of claims, some actuarial work, contracting service providers and general administration of the project.

On October 2007, the Administration entered into a contract with the Municipality of Guaynabo with 13,592 covered lives. Under this contract, the municipality of Guaynabo bears the risk of the basic and special coverage. A TPA handles all the administrative work related to the payment of claims of services provided outside the municipality's facilities. As a result of this arrangement, the Administration no longer received the municipality's contribution. This contract was modified effective May 2, 2011, and the Administration now bears the cost of the special, mental, dental, cardiovascular coverage, high tech laboratory services, among other services but up to 12,500 lives. The Administration will compensate the Municipality if the insured lives using Guaynabo's medical facility surpasses 12,000 lives and the Municipality will compensate the Administration if those lives fall below 11,000. The compensation in both cases will be $45.34 PMPM (per member per month). There are incentives for the TPA if the medical utilization is less than expected, as defined.

Financial arrangements for this project begin each month with the transfer of funds from one account to another within the Administration. According to the designated PMPM, money is transferred from the premiums account to the project account based on the actual number of subscribers enrolled as of the first day of the month. From this account, a capitation amount is paid to the Primary Medical Groups contracted. The remaining funds are maintained in the account for the payment of claims and are managed by the TPA.

Mi Salud Plan

Effective October 1, 2010, in compliance with the government plan, a new integrated health model named MI SALUD was developed with the following changes:

1. Set up a standard premium per region as established by the Administration.
2. Eliminate the referrals when the beneficiary needs the service of a specialist.
3. Better access to prescribed medicines without the authorization of the primary health provider.
4. Extended hours for health providers of basic services.
5. Tele-emergency services available 24 hours.
6. Integration of the physical health and mental health in one place.
7. The risk of the primary health provider in relation to medicines, emergency and preventive health test was decreased and was transferred to the health insurance companies.
8. Increase the coverage to include the middle class working force.
9. Set up a ceiling in relation to administrative expenses and gains of the health insurance companies.

Effective October 1, 2011, the Administration decided to expand the direct contracting project to cover (in addition to Vieques and Guaynabo) the West, the Metro North, the North, the San Juan, the Northeast and the Virtual Regions. These regions, previously covered by MCS Health Management Options, Inc. under a coverage for premium arrangement, will be managed by Triple-S Salud, Inc. as TPA starting on November 1, 2011.

In addition, the Administration will implement certain cost containment strategies to control costs. Among these strategies are establishing a co-payment that will apply for the unjustified use of emergency rooms, detection and control of prescription drug overuse, implementation of disease management program for respiratory conditions, modification in provider fees and better coordination of benefits for the population having other medical insurance.

Projections for fiscal year 2011-2012

The budget for fiscal year 2011-2012 projects that revenues will cover all projected costs. The most relevant assumptions are as follows:

- $867,570,000 from the legislative appropriation
- $934,027,000 from federal funds
- $193,210,000 from other sources
- $3,801,000 for operational expenses of the Administration and from the stabilization fund

On October 18, 2011, the Legislature approved Law Number 205. This Law authorizes the Administration to open a revolving line of credit either with the Government Development Bank or with a commercial bank for the sole purpose of paying health insurance premiums, health services providers and financing costs related to the line of credit. The amount of the line of credit will be limited to and guaranteed by the amount of federal funds to be received by Puerto Rico from the Federal Government's Medicaid Program as certified by the Administration's Board of Directors and by the Puerto Rico Medicaid Program. The Administration will be obliged to use any federal funds received to pay the line of credit. The Government of Puerto Rico will guarantee and will make the necessary appropriations to cover any balance of the line of credit in excess of federal funds received.

Contacting the Administration Financial Management

This financial report is designed to provide our customers and creditors with a general overview of the Administration's finances and to demonstrate the Administration's accountability for the money it receives. If you have questions about this report or need additional information, contact The Puerto Rico Health Insurance Administration, P.O. Box 195661 San Juan, Puerto Rico, 00926-2706.

Puerto Rico Health Insurance Administration
(A Component Unit of the Commonwealth of Puerto Rico)
Balance Sheet
June 30, 2011

Assets	
Current assets:	
Cash and cash equivalents	$ 125,761,460
Accounts receivable:	
Accounts receivable - net of allowance for doubtful accounts of $26,984,762	59,764,518
Accounts receivable from Municipalities - net of allowance for doubtful accounts of $34,386,989	23,743,445
Accounts receivable of pharmacy rebates	21,842,986
Total accounts receivable	105,350,949
Due from other governmental agencies	15,688,668
Prepaid expenses	78,558
Total current assets	246,879,635
Capital assets - net	166,934
Total assets	$ 247,046,569
Liabilities and Deficit	
Current liabilities:	
Premiums and pharmacy rebates payable	$ 239,078,046
Claims payable	35,453,795
Due to other governmental agencies	7,239,104
Accounts payable and accrued expenses	3,238,003
Accrued termination benefits	188,422
Accrued compensated absences	457,636
Total current liabilities	285,655,006
Non-current liabilities:	
Line of credit	171,080,000
Interest payable	2,065,335
Premiums payable	64,290,608
Accrued termination benefits	1,978,810
Accrued compensated absences	305,091
Total non-current liabilities	239,719,844
Total liabilities	525,374,850
Commitments and contingencies	
Net deficit:	
Invested in capital assets, net of related debt	166,934
Deficit	(278,495,215)
Total deficit	(278,328,281)
Total liabilities and deficit	$ 247,046,569

See accompanying notes to financial statements.

Puerto Rico Health Insurance Administration
(A Component Unit of the Commonwealth of Puerto Rico)
Statement of Revenue, Expenses and Changes in Net Deficit
Year Ended June 30, 2011

Operating revenue:	
Contributions from:	
Department of Health of Puerto Rico	$ 529,234,922
Municipalities	153,556,280
Employers	22,294,704
Pharmacy rebate program - net	59,339,680
Total operating revenue	764,425,586
Operating expenses:	
Medical insurance premiums	1,897,765,202
Claims incurred and health care costs	96,782,956
General and administrative	20,589,951
Interest expenses	2,065,335
Depreciation and amortization	90,748
Total operating expenses	2,017,294,192
Loss from operations	(1,252,868,606)
Non-operating revenue:	
Transfers from the Commonwealth of Puerto Rico	1,132,048,668
Transfers from COFINA	85,000,000
Interest income and other	4,991,368
Total non-operating revenue	1,222,040,036
Increase in net deficit	(30,828,570)
Net deficit at beginning of year	(247,499,711)
Net deficit at end of year	$ (278,328,281)

See accompanying notes to financial statements.

Puerto Rico Health Insurance Administration
(A Component Unit of the Commonwealth of Puerto Rico)
Statement of Cash Flows
Year Ended June 30, 2011

Cash flows from operating activities:	
Cash receipts from contributions	$ 636,598,404
Cash receipts from pharmacy rebate program	49,321,153
Cash payments of premiums	(1,971,365,137)
Cash payments to employees	(3,860,913)
Cash payments to vendors for goods and services	(60,031,715)
Cash payments to health care organizations and third party administrators	(120,781,954)
Net cash used in operating activities	(1,470,120,162)
Cash flows from non-capital and related financing activities:	
Transfers from the Commonwealth of Puerto Rico	1,132,048,668
Transfers from COFINA	85,000,000
Proceed from line of credit	171,080,000
Collections of other income	4,651,523
Net cash provided by non-capital and related financing activities	1,392,780,191
Purchase of capital assets and net cash used in capital and related financing activities	(47,263)
Interest collected and net cash provided by investing activities	339,845
Net decrease in cash and cash equivalents	(77,047,389)
Cash and cash equivalents, at beginning of year	202,808,849
Cash and cash equivalents, at end of year	$ 125,761,460

See accompanying notes to financial statements.

Puerto Rico Health Insurance Administration
(A Component Unit of the Commonwealth of Puerto Rico)
Statement of Cash Flows
Year Ended June 30, 2011

Reconciliation of operating loss to net cash used in operating activities:

Loss from operations	$ (1,252,868,606)
Adjustments to reconcile operating loss to net cash used in operating activities:	
Depreciation and amortization	90,748
Bad debt expense	5,632,278
Changes in operating assets and liabilities:	
Increase in:	
Accounts receivable	(68,449,639)
Due from other governmental agencies	(15,688,668)
Prepaid expenses	(78,558)
Increase (decrease) in:	
Premiums and pharmacy rebates payable	(73,599,935)
Claims payable	(23,998,999)
Due to agency fund	(2,278,534)
Accounts payable and accrued expenses	(43,004,147)
Interest payable	2,065,335
Accrued termination benefits	2,167,232
Accrued compensated absences	(108,669)
Net cash used in operating activities	$ (1,470,120,162)

See accompanying notes to financial statements.

Puerto Rico Health Insurance Administration
(A Component Unit of the Commonwealth of Puerto Rico)
Statement of Assets and Liabilities – Agency Fund
June 30, 2011

Assets	
Cash	$ 1,321,142
Total assets	$ 1,321,142
Liabilities	
Accounts payable	$ 1,321,142
Total liabilities	$ 1,321,142

See accompanying notes to financial statements.

1. REPORTING ENTITY

The Puerto Rico Health Insurance Administration (the Administration) is a governmental entity and a component unit of the Commonwealth of Puerto Rico (the Commonwealth), created by Act No. 72 (the Act), as amended, of the Legislature of the Commonwealth on September 7, 1993. The Administration commenced operations on February 1, 1994. The Administration is a public corporation with full autonomy.

The Administration is responsible for implementing, administering and negotiating a health insurance system, through contracts with insurance underwriters, to provide quality medical and hospital care to the Commonwealth residents regardless of their financial condition and capacity to pay. The Administration pays a monthly premium to such insurance underwriters based on a contracted premium and the number of members subscribed in the health plan. Funds to pay for such premiums are requested from the Commonwealth net of funds available for such purposes from all other sources. The Administration is exempt from taxation on taxes imposed by the Commonwealth of Puerto Rico.

The Single State Medicaid Agency is the Department of Health. Within the Department, the Officer of economic aid to the medically indigent has responsibility for the Medicaid Program.

Under the provisions of Act 105 of July 19, 2002, that amends Act No. 72 of 1993, the Administration was authorized to negotiate directly with health providers under a pilot program. The Administration has, since then, entered into different direct contracts to cover the insured population of different regions and municipalities. Since November 1, 2006 through September 1, 2010, the Administration directly contracted providers that served approximately 190,000 lives from the metro-north region. At June 30, 2011, the Administration has direct contracting projects with the Municipalities of Vieques and Guaynabo.

Effective October 1, 2010, in compliance with the government plan, a new integrated health model named MI SALUD was developed with the following changes:

1. Set up a standard premium per region as established by the Administration.
2. Eliminate the referrals when the beneficiary needs the service of a specialist.
3. Better access to prescribed medicines without the authorization of the primary health provider.
4. Extended hours for health providers of basic services.
5. Tele-emergency services available 24 hours.
6. Integration of the physical health and mental health in one place.
7. The risk of the primary health provider in relation to medicines, emergency and preventive health test was decreased and was transferred to the health insurance companies.
8. Increase the coverage to include the middle class working force.
9. Set up a ceiling in relation to administrative expenses and gains of the health insurance companies.

2. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Accounting

The financial statements are presented on the accrual basis of accounting in conformity with accounting principles generally accepted in the United States of America. Under this method, revenues are recognized when earned, regardless of when received, and expenses when incurred, regardless of when paid.

(b) Basis of Presentation

The financial statements are presented as an enterprise fund and conform to the provisions of Governmental Accounting Standards Board Statement No. 34 (GASB No. 34), *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments.* GASB No. 34, as amended, establishes standards for external financial reporting for all state and local governmental entities, which includes a statement of net assets, a statement of revenues, expenses and changes in net assets and a statement of cash flows.

The Administration applied the provisions of Governmental Accounting Standards Board Statement No. 20 (GASB No. 20), *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that use Proprietary Fund Accounting.* In applying GASB No. 20, the Administration applied all Statements and Interpretations of the Financial Accounting Standards Board, Accounting Principles Board Opinions and Accounting Research Bulletins of the Committee on Accounting Procedures issued before and after November 30, 1989, unless these pronouncements conflict with, or contradict, GASB pronouncements.

(c) Cash and Cash Equivalents

The Administration considers all highly liquid investments with maturities of three months or less to be cash equivalents.

(d) Allowance for Doubtful Accounts

The allowance for doubtful accounts is an amount that management believes will be adequate to absorb possible losses on existing accounts receivable that may become uncollectible based on evaluations of collectability of accounts receivable and prior credit loss experience. Because of uncertainties inherent in the estimation process, management's estimate of credit losses inherent in the existing accounts receivable and related allowance may change in the future.

(e) Transfers from the Commonwealth of Puerto Rico and COFINA

Transfers from the Commonwealth and COFINA represent legislative appropriations for the payment of administrative expenses and premiums.

(f) Contributions from the Department of Health of Puerto Rico

Contributions received from Department of Health represent reimbursement for Medicaid benefits received by Department of Health on behalf of the Puerto Rico Government related to beneficiaries also covered by the premiums of the Administration.

(g) Contributions from Municipalities

Contributions from Municipalities represent charges made by the Administration based on established percentages applied to the corresponding Municipality's operational budget for the preceding fiscal year. These contributions are withheld by the Municipality Revenue Collection Center from money assigned to the municipalities and remitted monthly to the Administration.

(h) Fund Accounting

The Commonwealth reports its financial position and results of operations in funds, which are considered separate accounting entities and discrete presentations of those component units which are not required to be blended. The operations of each fund are accounted for within a set of self-balancing accounts. Fund accounting segregates funds according to their intended purpose and is used to aid management in demonstrating compliance with legal, financial, and contractual provisions. The new model as defined in GASB No. 34 establishes criteria for the determination of major funds. The Administration reports the following major funds:

Proprietary Fund

This fund accounts for those activities for which the intent of management is to recover, primarily through premiums, the cost of providing health insurance services to the general public.

Agency Fund

Agency funds are custodial in nature (assets equal liabilities) and do not involve measurement of the results of operations.

(i) Use of Estimates

The process of preparing financial statements in conformity with accounting principles generally accepted in the United States of America requires the use of estimates and assumptions regarding certain types of assets, liabilities, revenues, and expenses. Such estimates primarily related to unsettled transactions and events as of the date of the financial statements. Accordingly, upon settlement, actual results may differ from those estimates.

(j) Revenue Recognition

The Administration distinguishes operating revenue from non-operating revenue. Revenue associated with the Department of Health of Puerto Rico, Municipalities, Employers and Pharmacy Rebate Programs are recorded as operating revenue. Revenue associated with transfers from the Commonwealth of Puerto Rico and interests are recorded as non-operating revenue.

(k) Capital Assets

Capital assets are stated at cost. Donated property is reported at estimated fair value at the date received. When assets are retired or otherwise disposed of, the cost and accumulated depreciation or amortization are removed from the accounts, and any resulting gain or loss is recorded in the operations for the period.

Expenditures for repairs and maintenance that do not extend the useful lives of the assets are charged to operations in the year incurred.

(l) Depreciation and Amortization

Depreciation is provided over the estimated useful life of each class of depreciable asset which range from four to ten years and is computed using the straight-line method.

(m) Compensated Absences

The employees of the Administration are granted thirty (30) days of vacation and eighteen (18) days of sick leave annually. Vacation time accumulated is fully vested to the employees from the first day of work. In the event of resignation, an employee is reimbursed for accumulated vacation days up to the maximum allowed. Separation of employment prior to the use of all or part of the sick leave terminates all rights for compensation except that, in the event of retirement, an employee is reimbursed for accumulated sick leave days up to the maximum allowed of ninety (90) days.

As per the Administration personnel protocol, the employee has the right to accumulate the excess of sixty (60) days in vacation and ninety (90) days in sick leave until December 31 of each year. The excess should be paid to the employee before March 31 of the following year.

Compensated absences are accrued when incurred using the pay or salary rates in effect at the date of the balance sheet.

(n) Risk Management

The Administration is exposed to various risks of loss from torts, theft of, damage to, and destruction of assets, errors and omissions, employee injuries and illnesses, natural disasters, and other losses. Commercial insurance coverage is obtained for claims arising from such matters.

The commercial insurance coverage is negotiated by the Department of Treasury of the Commonwealth of Puerto Rico and the cost is billed to the Administration.

(o) Statement of Cash Flows

The accompanying statement of cash flows is presented in accordance with the provisions of Governmental Accounting Standards Board Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities that Use Proprietary Fund Accounting.*

(p) Pharmacy Rebate Program

During the year 2002, the Administration established a governmental pharmacy program which allows contracting rebates and discounts with drug manufacturers.

The Administration contracted a private corporation for the implementation and management of this rebate program.

During fiscal year 2009, the income derived from this program (net of management fees) was distributed 75% to the health care provider and 25% is retained by the Administration. During the fiscal year 2010, the Administration retained 100% based on a Department of Justice Ruling.

(q) Accounting for Pension Costs

The Administration accounts for pension costs in accordance with the provisions of Governmental Accounting Standards Board Statement (GASB) No. 27, *Accounting for Pensions by States and Local Government Employers.*

The GASB No. 27 establishes standards of accounting and financial reporting for pension liabilities, pension assets, note disclosures, and required supplementary information in the financial reports of state and local governmental employers. The statement defines that the pension expense is equal to the statutory required contribution to the employees' retirement system. A pension liability or asset is reported equal to the cumulative difference between statutory required and actual contributions.

(r) Claims Payable

Claims payable represents the estimated amount to be paid to providers based on experience and accumulated statistical data under one of the direct contracting pilot project. The estimates of medical claims incurred but not reported and other medical expense payments is developed using actuarial methods and assumptions based upon payment patterns, inflation of medical costs, historical developments and other relevant factors. The Administration agrees with health care organizations certain medical care services provided to the beneficiaries.

The above liabilities are necessarily based on estimates and while management believes that the amounts are adequate, the ultimate liability maybe in excess of or less than the amounts provided. The methods for making such estimates and for establishing the resulting liability are continually reviewed, and any adjustments are reflected in the statement of revenues and expenses for the current year.

(s) Medical Cost Recognition

Medical costs include claim payments, capitation payments, and various other costs incurred to provide medical care to beneficiaries as well as estimates of future payments for medical care provided prior to the date of the statement of net assets. Capitation payments represent monthly prepaid fees disbursed to participating primary care physicians and other providers who are responsible for providing medical care to members. The estimates of future medical claims and other expense payments are developed using actuarial methods and assumptions based upon payment patterns, medical inflation, historical development and other relevant factors. Estimates of future payments relating to services incurred in the current and prior periods are continually reviewed by management and adjusted as necessary. Risks related to catastrophic diseases are assumed by the Administration.

(t) Subsequent Events

The Administration has evaluated the impact of subsequent events through November 11, 2011, which is the date these financial statements were issued. Refer to Note 12.

3. MANAGEMENT PLANS

As reflected in the accompanying basic financial statements, the Administration has a deficit of approximately $278 million and incurred in an increase in net deficit of approximately $31 million during the year ended June 30, 2011. Effective November 23, 2010, the Act No 72 of the Legislature of the Commonwealth was amended to authorize the Administration to incur in obligations up to $186 million in order to pay outstanding debts incurred prior to July 1, 2010. The obligation will be paid directly by the Office of Management and Budget.

The budget for fiscal year 2011-2012 projects that revenues will cover all projected costs. The most relevant assumptions are as follows:

- $867,570,000 from the legislative appropriation
- $934,027,000 from federal funds
- $193,210,000 from other sources
- $3,801,000 for operational expenses of the Administration and from the stabilization fund

In addition, the Legislature has approved a revolving line of credit from either Government Development Bank or a commercial bank to pay for health insurance premiums, claims incurred and other health costs and finance charges related to the line of credit. The line of credit will be guaranteed by federal grant awards. Please refer to Note 12 for further details.

4. CUSTODIAL CREDIT RISK - DEPOSITS

Custodial credit risk is the risk that, in an event of a bank failure, the Administration deposits might not be recovered. The Commonwealth requires that public funds deposited in commercial banks must be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral are held by the Secretary of the Treasury of the Commonwealth. Deposits at the Government Development Bank for Puerto Rico and the Economic Development Bank of Puerto Rico are uninsured and uncollateralized, as these entities, which are component units of the Commonwealth, are exempt from compliance with the collateralization requirement.

For the year ended June 30, 2011, the custodial risk of the administration amounted to $150 million, which is the bank balance of cash and cash equivalents deposited at the Government Development Bank for Puerto Rico. These deposits are exempt from the collateral requirement established by the Commonwealth.

5. ACCOUNTS RECEIVABLE

Accounts receivable and the allowance for doubtful accounts as of June 30, 2011 consist of the following:

Department of Health of Puerto Rico	$ 55,812,604
Governmental agencies	27,650,438
Municipalities	58,130,434
Pharmacy rebate program	21,842,986
Other	3,286,238
	166,722,700
Allowance for doubtful accounts	(61,371,751)
Account receivable, net	$ 105,350,949

Allowance for doubtful accounts is divided in three sections. The first section is related to governmental agencies for employer contributions for the medical health plan amounting to approximately $27 million. The second section of the reserve is related to municipalities based on a retroactive receivable amounting to approximately $34 million. The third one represents mainly uncollected premiums amounting to $31 thousand.

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6. CAPITAL ASSETS

The activities of the capital assets accounts of the Administration for the fiscal year ended June 30, 2011 was as follows:

	Beginning Balance	Additions	Retirements	Ending Balance
Equipment, computer and software	$ 1,221,619	4,874	(26,302)	1,200,191
Vehicles	78,459	—	—	78,459
Leasehold improvements	121,545		—	121,545
Furniture and others	242,135	42,389	(2,486)	282,038
	1,663,758	47,263	(28,788)	1,682,233
Accumulated depreciation	(1,453,339)	(90,748)	28,788	(1,515,299)
Capital assets, net	$ 210,419	(43,485)	—	166,934

7. LINE OF CREDIT

On March 14, 2011, the Administration entered into a Credit Agreement with the Government Development Bank for Puerto Rico in order to pay its obligations to insurers incurred prior to fiscal year 2009-2010.

The aggregate principal amount of the non revolving line of credit is $186,000,000 and will be payable in nine payments of $20,666,667 each due on March 14 of the years 2015 through 2023. Interest will be payable annually on each March at a fluctuating annual rate of interest equal to the greater of (1) 1.5% over prime rate, and (2) 6%. As of June 30, 2011, the outstanding principal balance amounted to $171,080,000.

The Administration will pay the principal and interest with the appropriations made by the Legislature of Puerto Rico pursuant to Act No. 173.

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8. PREMIUMS PAYABLE

During the fiscal year, the Administration signed loan agreements with three insurance companies renegotiating payment terms of recorded liabilities up to September 2010. Maturities of premium payable at June 30, 2011 are as follows:

June 30,	Amount
2012	$ 16,830,953
2013	16,830,953
2014	16,746,429
2015	13,882,273
	$ 64,290,608

9. RETIREMENT SYSTEM

Defined Benefit Pension Plan

The Employees' Retirement System of the Commonwealth and its instrumentalities (the Retirement System), created pursuant to Act No. 447 of May 15, 1951, as amended, is a cost-sharing multiple-employer defined benefit pension plan sponsored by, and reported as a component unit of the Commonwealth. All regular employees of the Administration hired before January 1, 2000 and under fifty five (55) years of age at the date of employment became members of the Retirement System as a condition to their employment. No benefits are payable if the participant receives a refund of his/her accumulated contributions.

The Retirement System provides retirement, death and disability benefits pursuant to legislation enacted by the Commonwealth's legislature. Retirement benefits depend upon age at retirement and the number of years of creditable service. Benefits vest after ten (10) years of plan participation. Disability benefits are available to members for occupational and non-occupational disability benefits.

Members who have attained at least fifty five (55) years of age and have completed at least twenty five (25) years of creditable service or members who have attained fifty eight (58) years of age and have completed at least ten (10) years of creditable service, are entitled to an annual benefit, payable monthly for life. The amount of the annuity shall be 1.5% of the average compensation, as defined, multiplied by the number of years of creditable service up to twenty (20) years, plus 2% of the average compensation, as defined, multiplied by the number of years of creditable service in excess of twenty (20) years. In no case will the annuity be less than $400 per month.

Participants who have completed at least thirty (30) years of creditable service are entitled to receive the Merit Annuity. Participants who have not attained fifty five (55) years of age will receive 65% of the average compensation, as defined; otherwise they will receive 75% of the average compensation.

Commonwealth legislation requires employees hired on or before March 31, 1990 to contribute 5.775% for the first $550 of their monthly gross salary and 8.275% for the excess over $550 of monthly gross salary. Employees hired on or after April 1, 1990 are required to contribute 8.275% of their monthly salary. The Administration is required by the same statute to contribute 9.275% of the participants' gross-salary.

Defined Contribution Plan

The Legislature of the Commonwealth enacted Act No. 305 on September 24, 1999, which amends Act No. 447, to establish, among others, a defined contribution savings plan program (the Program) to be administered by the Retirement System. All regular employees hired for the first time on or after January 1, 2000 and former employees who participated in the defined benefit pension plan, received a refund of their contribution and are rehired on or after January 1, 2000, become members of the Program as a condition to their employment. In addition, employees who at December 31, 1999 were participants of the defined benefit pension plan, had the option, up to March 31, 2000, to irrevocably transfer their prior contributions to the defined benefit pension plan plus interest thereon to the Program.

Act No. 305 requires employees to contribute 8.275% of their monthly gross salary to the Program. Employees may elect to increase their contribution up to 10% of their monthly gross salary. Employee contributions are credited to his/her individual account established under the Program. Participants have three options to invest their contributions to the Program. Investment income is credited to the participant account semi-annually.

The Administration is required by Act No. 305 to contribute 9.275% of the participant's gross salary. The Retirement System will use these contributions to increase its asset level and reduce the unfunded status of the defined benefit pension plan.

Upon retirement, the balance in the participant's account will be used to purchase an annuity contract, which will provide for monthly benefit during the participant's life and 50% of such monthly benefit to the participant's spouse in case of the participant's death. Participants with a balance of $10,000 or less at retirement will receive a lump-sum payment. In case of death, the balance in the participant's account will be paid in a lump sum to his/her beneficiaries. Participants have the option of a lump sum or purchasing an annuity contract in case of permanent disability.

Total employee contributions to the above mentioned plans during the year ended June 30, 2011 amounted to approximately $244,000.

Additional information on the Retirement System is provided in its financial statements for the year ended June 30, 2010, a copy of which can be obtained from the Retirement System Administration, P.O. Box 42003, San Juan, Puerto Rico, 00949.

10. EARLY TERMINATION BENEFITS

On July 2, 2010, the Commonwealth enacted Act No. 70 to establish a program that provides benefits for early retirement or economic incentives for voluntary employment termination to eligible employees, as defined, including employees of the Administration. Act No. 70 established that early retirement benefits will be provided to eligible employees that have completed between 15 to 29 years of creditable services and will consist of biweekly benefits ranging from 37.5% to 50% of each employee's salary, as defined. In this early retirement benefit program, the Administration will pay the employer contributions to the Retirement System and the corresponding pension until the employee complies with the age requirements and 30 years of creditable services applicable to the Retirement System. Economic incentives are available to eligible employees that qualify for retirement benefits. Economic incentives consist of a payment ranging from one to six months of salary. Additionally, eligible employees that choose to participate in this program, other than those qualifying for retirement benefits, are eligible to receive health plan coverage for up to 12 months in a health plan selected by management of the Commonwealth of Puerto Rico.

The implementation of this early retirement program had an impact in the Statement of Revenues, Expenses and Changes in Net Deficit of $2.1 million for the year ended June 30, 2011. At June 30, 2011, unpaid long-term benefits granted on this program were discounted at 3%.

11. COMMITMENTS AND CONTINGENCIES

Commitments

The Administration conducts its operations in a leased facility under a long-term operating lease agreement expiring during 2012. Rent expense for the year ended June 30, 2011 amounted to $411,592. Minimum future rental payments under the non-cancellable operating lease as of June 30, 2011 are $215,696.

Contingencies

The Administration is defendant and/or co-defendant in legal proceedings pertaining to matters incidental to the performance of its operations. With respect to the pending and threatened litigations, excluding the litigation mentioned in the above paragraph, the Administration, in consultation with legal counsel, has advised that at this stage of the proceedings they cannot offer an opinion as to the probable outcome. Accordingly, management does not consider necessary making any provision in its books for these cases and intends to contest them vigorously.

The Administration has been requested to repay the Puerto Rico Treasury Department approximately $103 million representing additional transfers of money from the central government during the fiscal years 2001-2003. After consultation with external legal counsel, the Administration is of the opinion that the money does not have to be repaid and believes that the likelihood of an unfavorable outcome is remote. Therefore, no reserve has been recorded in the Administration financial statements.

Federal Grants

The Administration receives financial assistance from the federal government passed through the Department of Health of Puerto Rico. Federal grants are subject to financial and compliance audits by grantor agencies in order to determine the Administration's compliance with the regulations and conditions of such grants. It is management's opinion that no additional material unrecorded liabilities will arise from audits previously performed or to be performed.

12. SUBSEQUENT EVENT

Effective October 1, 2011, the Administration decided to expand the direct contracting project to cover, in addition to Vieques and Guaynabo, the West, the Metro North, the North, the San Juan, the Northeast and the Virtual Regions. These regions, previously covered by MCS Health Management Options, Inc. under coverage for premium arrangement will be managed by Triple-S Salud, Inc. as TPA starting on November 1, 2011. Under this arrangement, Triple-S Salud, Inc. will receive a PMPM for performing administrative services. In addition, the Administration will implement certain cost containment strategies to control costs. Among these strategies are establishing a co-payment that will apply for the unjustified use of emergency rooms, detection and control of prescription drug overuse, implementation of disease management program for respiratory conditions, modification in provider fees and better coordination of benefits for the population having other medical insurance.

On October 18, 2011, the Legislature approved Law Number 205. This Law authorizes the Administration to open a revolving line of credit either with the Government Development Bank or with a commercial bank for the sole purpose of paying health insurance premiums, health services providers and financing costs related to the line of credit. The amount of the line of credit will be limited to and guaranteed by the amount of federal funds to be received by Puerto Rico from the Federal Government's Medicaid Program as certified by the Administration's Board of Directors and by the Puerto Rico Medicaid Program. The Administration will be obliged to use any federal funds received to pay the line of credit. The Government of Puerto Rico will guarantee and will make the necessary appropriations to cover any balance of the line of credit in excess of federal funds received.

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