

STATE OF WASHINGTON
OFFICE OF THE INSURANCE COMMISSIONER



FINANCIAL EXAMINATION
OF
DENTAL HEALTH SERVICES, INC.
SEATTLE, WASHINGTON

NAIC CODE 47490
December 31, 2011

Order No. 12-258
Dental Health Services, Inc.
Exhibit A

SALUTATION

Seattle, Washington
October 8, 2012

The Honorable Mike Kreidler, Commissioner
Washington State Office of the Insurance Commissioner (OIC)
Insurance Building-Capitol Campus
302 Sid Snyder Avenue SW, Suite 200
Olympia, WA 98504

Dear Commissioner Kreidler:

In accordance with your instructions, and in compliance with the statutory requirements of RCW 48.03.010, an examination was made of the corporate affairs and financial records of

Dental Health Services, Inc.

of

Seattle, Washington

hereinafter referred to as "DHS-WA" or the "Company" at the location of its home office, 936 North 34th Street, Suite 208, Seattle, Washington 98103. This report is respectfully submitted showing the financial condition and related corporate matters of DHS-WA as of December 31, 2011.

CHIEF EXAMINER'S AFFIDAVIT

I hereby certify I have read the attached Report of the Financial Examination of Dental Health Services, Inc. of Seattle, Washington. This report shows the financial condition and related corporate matters as of December 31, 2011.

Patrick H. McNaughton

Patrick H. McNaughton
Chief Examiner

10-8-12

Date

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SCOPE OF THE EXAMINATION

This examination covers the period January 1, 2007 through December 31, 2011 and comprises a risk focused review of the books and records of the Company. The examination followed statutory requirements contained in the Washington Administrative Code (WAC), the Revised Code of Washington (RCW), and the guidelines recommended by the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook (FCEH). The examination included identification and disposition of material transactions and events occurring subsequent to the date of examination through the end of fieldwork on August 23, 2012.

Corporate records, external reference materials, and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following section of this report. In addition, the Company's Certified Public Accountant's (CPA's) work papers were reviewed and utilized, where possible, to facilitate efficiency in the examination.

This examination was performed in compliance with the 2011 NAIC FCEH which requires the examiner to consider the Company's risk management process, corporate governance structure, and control environment. The examiners utilized the information obtained during the examination to assess DHS-WA's overall potential risks both currently and on an on-going basis, allowing the examiners to focus on the Company's greatest areas of risk, and providing assurance on the Company's financial statements as of the examination date.

INSTRUCTIONS

The examiners reviewed the Company's filed 2011 NAIC Annual Statement as part of the statutory examination. This review was performed to determine if the Company completed the NAIC Annual Statement in accordance with the NAIC Annual Statement Instructions and to determine if the Company's accounts and records were prepared and maintained in accordance with Title 48 RCW, Title 284 WAC, and the NAIC Statements of Statutory Accounting Principles (SSAP) as outlined in the NAIC Accounting Practices and Procedures Manual (AP&P).

The following summarizes the exceptions noted while performing this review:

1. NAIC Annual Statement Errors, Omissions, and Misclassification

The result of the examination disclosed two instances in which the Company's filing of the 2011 NAIC Annual Statement did not conform to the AP&P and the NAIC Annual Statement Instructions.

- The Company recorded a net receivable from Dental Health Services, California (DHS-CA) of \$34,000 as an offset to general administrative expense instead of a receivable from an affiliate as required.
- The Company reported a different amount for "Cash, cash equivalents, and short-term investments" in Note 1 of the Notes to Financial Statements than it reported on the Asset page of the 2011 NAIC Annual Statement.

The Company is instructed to comply with RCW 48.43.097 by filing its financial statements in accordance with the AP&P, and WAC 284-07-050(2) which requires adherence to the NAIC Annual Statement Instructions and the AP&P.

2. Authorization of Investments

The minutes of the Board of Directors' meetings did not document the Board's approval of the Company's investments, acquisitions and disposals. As a result, the Company was not in compliance with RCW 48.13.340.

RCW 48.13.340 states that all investments must be authorized or approved by the board or a committee charged by its board with the duty of making such investment. The minutes of the board meetings shall be recorded and reports thereof shall be submitted to the board for approval or disapproval.

DHS-WA is instructed to comply with RCW 48.13.340 by having all of the investments, acquisitions and disposals authorized or approved by the Board of Directors.

COMMENTS AND RECOMMENDATIONS

1. Conflict of Interest

DHS-WA does not have a written policy that requires Board members, officers and key employees to complete annual conflict of interest statements.

It is recommended the Company implement a policy requiring Board of Directors members, officers, and key employees to complete annual conflict of interest statements.

2. Fidelity Bond

Dental Health Services of America, Inc. (DHS-AM), the Company's parent, has adequate insurance coverage for fiduciary liability and crime. However, DHS-WA was not identified as a named insured company.

It is recommended the fiduciary liability and crime insurance policy also include DHS-WA as a named insured company.

COMPANY PROFILE

Company History

DHS-WA was incorporated in the state of Washington on June 15, 1984, and was originally registered as a health care service contractor on October 18, 1984. On May 30, 1991, the certificate of registration was amended to a limited health care service contractor. Dental Health Services of California (DHS-CA), organized in the state of California in May 1974, became 100% owner of DHS-WA on June 28, 1984. Dental Health Services of America, Inc. (DHS-AM or the Parent) purchased 100% of DHS-WA from DHS-CA in April 1986.

Capitalization

As of December 31, 2011, the Company had 10,000 shares of common stocks with a \$1 par value authorized, and 10,000 shares issued and outstanding.

Territory and Plan of Operations

The Company administers prepaid dental health care insurance in the state of Washington. The Company plans to expand into Oregon in 2012. Under this type of plan, dental care is provided on a contractual basis or a basic monthly subscription fee (capitation payments) which is received without regard to frequency, extent, or kind of services provided. The basic subscription fee is supplemented by additional co-payments for certain services. Co-payment amounts may vary with the services rendered, but are contractually agreed upon among the Company, participating providers, and group policyholders. Services are provided by dentists selected by the policyholder from a list of member dental professionals with whom the Company has entered into written provider agreements.

Growth of Company

The Company's growth, as reported in its filed NAIC Annual Statements, is illustrated below:

<u>Year</u>	<u>Admitted Assets</u>	<u>Liabilities</u>	<u>Capital & Surplus</u>	
2011	\$6,035,908	\$1,437,980	\$4,597,928	
2010	5,393,005	1,357,383	4,035,622	
2009	4,948,391	1,434,707	3,513,684	
2008	4,231,822	1,360,122	2,871,700	
2007	3,208,651	1,578,210	1,630,441	

<u>Year</u>	<u>Total Revenue</u>	<u>Net Underwriting Gain (Loss)</u>	<u>Net Investment Gain (Loss)</u>	<u>Net Income (Loss)</u>
2011	\$8,481,172	\$1,412,487	\$6,028	\$998,981
2010	8,253,598	1,401,897	4,865	912,562
2009	8,144,280	1,626,767	16,683	1,046,150
2008	8,074,176	1,110,276	77,523	768,658
2007	6,713,448	(2,086,212)	95,456	(1,412,266)

Affiliated Companies

Dental Health Services, California (DHS-CA)

DHS-CA, the first company organized by Godfrey Pernell, DDS, was organized in May 1974 to administer prepaid dental health care insurance in the state of California. DHS-CA organized DHS-WA in June 1984 to administer prepaid dental health care insurance in the state of Washington.

Dental Health Services of America, Inc. (DHS-AM)

DHS-AM was organized in the state of California in February 1985 by Godfrey Pernell, DDS, to become the parent company of current and ensuing affiliated companies engaged in providing dental health care insurance.

The following companies are 100% owned by the parent company, DHS-AM as of December 31, 2011:

Dental Health Services, Inc. (an Arizona Corporation) (Dormant)
Dental Health Services (a California Corporation)

Dental Health Services, Inc. (a Colorado Corporation) (Dormant)
Dental Health Services, Inc. (an Oregon Corporation) (Dormant)
Dental Health Services, Inc. (a Washington Corporation)
Custom Benefit Advisors, Inc.
DHS-WA-Insurance Services, Inc.
Dental Network Services

Intercompany Agreements

As of December 31, 2011, the Company had the following intercompany agreements in force:

Administrative Cost Sharing Agreement

This is an agreement providing services and cost sharing between the DHS-AM groups of companies. This includes but is not limited to; management, finance, data processing, sales, customer service and provider relations.

Tax Sharing Agreement

DHS-AM and its subsidiaries use a fiscal year end of April 30th for federal income tax purposes. DHS-AM files a consolidated tax return with its subsidiaries, pursuant to a tax allocation agreement. Pursuant to the agreement, federal income tax expense or benefit is allocated between the parties annually in the ratio of their respective individual taxable income or net operating loss.

MANAGEMENT AND CONTROL

Board of Directors (BOD)

Management of the Company is vested in a BOD of two persons elected at each annual meeting by the shareholders. The following have been directors since the Company was organized:

Godfrey Pernell, DDS
Gary Pernell

Officers

The officers of the Company are elected annually by the BOD. Officers of the Company as of December 31, 2011 were:

Godfrey Pernell, DDS	President
Gary Pernell	Secretary, Treasurer, and Chief Executive Officer
Josh Nace	Executive Vice President
Michael Fenton, CPA	Chief Financial Officer

Conflict of Interest

The Company has a code of conduct as part of its employee handbook, but does not have a formal written policy wherein it requires an annual disclosure of potential conflicts of interest from the BOD members, officers, and key employees. (See Comment and Recommendation No. 1.)

Fidelity Bond and Other Insurance

The named insured on the fiduciary liability and crime policy is DHS-AM. There is no mention of the affiliates. An aggregate loss limit of coverage in the amount of \$ 1,000,000 is provided. The aggregate amount of coverage meets the NAIC recommended level for the Company. (See Comments and Recommendations No. 2.)

Officers', Employees', and Agents' Welfare and Pension Plans

The Company is a participating employer in the DHS-AM's Employees Stock Ownership Plan. An employee becomes a participant in the plan as of the first day of the plan year in which the employee first completes 1,000 hours of service, provided the employee has attained age 18. DHS-AM funding policy for the plan is to contribute annually not less than the minimum required or more than the maximum amount that can be deducted for federal income tax purposes. The Company's contribution to the plan for the year ended December 31, 2011 was \$36,000.

CORPORATE RECORDS

Except for the approval of investments, our review of the minutes of the BOD indicated that the minutes supported the transactions of the Company. All BOD meetings were conducted with a quorum present. (See Instruction No. 2.)

UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES

The OIC health actuary reviewed the Company's actuarial report, claims unpaid, and other claim liabilities as of December 31, 2011. The review included examining the Company's reserving philosophy and methodologies to determine the reasonableness of the claim liabilities; verifying that claim liabilities include provisions for all components noted in SSAP No. 55, paragraphs 7 and 8, and SSAP No. 54 paragraphs 12, 13, 18 and 19; reviewing historical paid claims and loss ratios; checking the consistency of the incurred-paid data from the Company's system with the figures reported in the 2011 NAIC Annual Statement; and estimating claims unpaid for the valuation date of December 31, 2011. The OIC health actuary concluded that the reserves were in compliance with statutory requirements.

REINSURANCE

NONE

STATUTORY DEPOSITS

The Company maintained the following statutory deposit as of December 31, 2011:

<u>State</u>	<u>Type</u>	<u>Book Value</u>	<u>Fair Value</u>
Washington	U.S. Treasury securities	\$2,120,203	\$2,119,966

ACCOUNTING RECORDS AND INFORMATION SYSTEMS

The Company maintains its accounting records on a Generally Accepted Accounting Principles (GAAP) accrual basis of accounting and adjusts to Statutory Accounting Principles (SAP) basis for NAIC Annual Statement reporting. The Company was audited annually by the certified public accounting firm of Miller, Kaplan, Arase and Co., LLP. The Company received an unqualified opinion for all years under review. The Company's accounting procedures, internal controls, and transaction cycles were reviewed during the planning and testing phase of the examination and no exceptions or significant weaknesses were noted.

The Company's information technology (IT) environment was reviewed during the planning and testing phase of the examination, focusing on the following Control Objectives for Information Technology (COBIT) framework domains:

- Plan and Organize
- Acquire and Implement
- Deliver and Support
- Monitor and Evaluate

The IT system and controls were evaluated to gain an understanding of the IT general control risks and assess the effectiveness of these controls to determine if appropriate mitigating and internal controls have been implemented. Appropriate mitigating and internal controls have been implemented to reduce residual risk to appropriate levels. The Company has an effective Business Continuity Plan and Disaster Recovery Plan, which have been tested on a regular basis and includes the availability of an alternate site.

SUBSEQUENT EVENTS

NONE

FOLLOW UP ON PREVIOUS EXAMINATION FINDINGS

All previous report instructions and recommendations, except for the conflict of interest recommendation, were corrected and satisfactorily addressed. (See Comment and Recommendation No. 1.)

FINANCIAL STATEMENTS

The following financial statements show the financial condition of DHS-WA as of December 31, 2011:

Assets, Liabilities, Capital and Surplus
Statement of Revenue and Expenses
Five Year Reconciliation of Surplus

Dental Health Services, Inc.
Assets, Liabilities, Capital and Surplus
For the Year Ended December 31, 2011

	BALANCE PER COMPANY	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION
Assets			
Cash and short-term investments	\$5,945,605	\$0	\$5,945,605
Subtotals, cash and invested assets	5,945,605	0	5,945,605
Premiums and considerations:			
Uncollected premiums and agents' balances in course of collection	20,203		20,203
Net deferred tax asset	70,100		70,100
Total Assets	\$6,035,908	\$0	\$6,035,908
Liabilities, Capital and Surplus			
Claims unpaid	\$599,551	\$0	\$599,551
Unpaid claims adjustment expenses	30,000		30,000
Premiums received in advance	611,617		611,617
General expenses due or accrued	152,515		152,515
Current federal and foreign income tax payable and interest thereon	44,297		44,297
Total Liabilities	1,437,980	0	1,437,980
Common capital stock	10,000		10,000
Gross paid in and contributed surplus	2,018,442		2,018,442
Surplus notes	800,000		800,000
Unassigned funds (surplus)	1,769,486		1,769,486
Total capital and surplus	4,597,928	0	4,597,928
Total Liabilities, Capital and Surplus	\$6,035,908	\$0	\$6,035,908

Dental Health Services, Inc.
Statement of Revenue and Expenses
For the Year Ended December 31, 2011

	<u>BALANCE PER COMPANY</u>	<u>EXAMINATION ADJUSTMENTS</u>	<u>BALANCE PER EXAMINATION</u>
Member months	298,308		298,308
Net premium income	\$8,481,172	\$0	\$8,481,172
Total revenues	<u>8,481,172</u>	<u>0</u>	<u>8,481,172</u>
Hospital and Medical:			
Other professional services	4,614,086		4,614,086
Subtotal	<u>4,614,086</u>	<u>0</u>	<u>4,614,086</u>
Less:			
Total hospital and medical	4,614,086		4,614,086
Claims adjustment expenses	253,388		253,388
General administrative expenses	2,201,211		2,201,211
Total underwriting deductions	<u>7,068,685</u>	<u>0</u>	<u>7,068,685</u>
Net underwriting gain or (loss)	<u>1,412,487</u>	<u>0</u>	<u>1,412,487</u>
Net investment income earned	<u>6,028</u>		<u>6,028</u>
Net investment gains (losses)	<u>6,028</u>	<u>0</u>	<u>6,028</u>
Net income or (loss) after capital gains tax and before all other federal income taxes	1,418,515	0	1,418,515
Federal and foreign income taxes incurred	419,597		419,597
Net income (loss)	<u>\$998,918</u>	<u>\$0</u>	<u>\$998,918</u>

	<u>BALANCE PER COMPANY</u>	<u>EXAMINATION ADJUSTMENTS</u>	<u>BALANCE PER EXAMINATION</u>
<u>CAPITAL AND SURPLUS ACCOUNT</u>			
Capital and surplus prior reporting year	<u>\$4,035,622</u>	<u>\$0</u>	<u>\$4,035,622</u>
Net income (loss)	998,918		998,918
Change in nonadmitted assets	(22,153)		(22,153)
Change in surplus notes	(400,000)		(400,000)
Aggregate write-ins for gains or (losses) in surplus	(14,459)		(14,459)
Net change in capital and surplus	<u>562,306</u>	<u>0</u>	<u>562,306</u>
Capital and surplus end of reporting period	<u>\$4,597,928</u>	<u>\$0</u>	<u>\$4,597,928</u>

Dental Health Services, Inc.
Five Year Reconciliation of Surplus
For the Years Ended December 31,

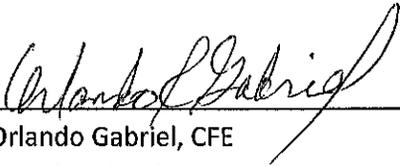
	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>
Capital and Surplus prior reporting year	\$4,035,622	\$3,513,684	\$2,871,700	\$1,630,441	\$905,167
Net income or (loss)	998,918	912,562	633,235	768,658	(1,412,266)
Changes in net unrealized capital gains and (losses)			1,046,150	(16,318)	(4,031)
Changes in nonadmitted assets	(22,153)	(11,040)	(1,886)	(16,460)	141,571
Change in surplus notes	(400,000)	(400,000)	(400,000)		2,000,000
Surplus adjustments: paid in				500,000	
Aggregate write-ins for gain or (losses) in surplus	(14,459)	20,416	(2,280)	5,379	
Net change in capital and surplus	<u>562,306</u>	<u>521,938</u>	<u>641,984</u>	<u>1,241,259</u>	<u>725,274</u>
Capital and Surplus end of reporting year	<u>\$4,597,928</u>	<u>\$4,035,622</u>	<u>\$3,513,684</u>	<u>\$2,871,700</u>	<u>\$1,630,441</u>

ACKNOWLEDGMENT

Acknowledgment is hereby made of the cooperation extended to the examiners by the officers and employees of Dental Health Services, Inc. and its affiliates during the course of this examination.

In addition to the undersigned, Michael V. Jordan, CPA, CFE, MHP, Assistant Chief Examiner; John Jacobson, AFE, CISA, AES, Automated Examination Specialist; Scott Fitzpatrick, FSA, MAAA, Health Actuary; Timothy F. Hays, CPA, JD, Investment Specialist; Susan Campbell, CPA, CFE, FLMI, ARA, Life Field Supervising Examiner and Terry Gates, Financial Examiner, all from the Washington State Office of the Insurance Commissioner, participated in the examination and in the preparation of this report.

Respectfully submitted,



Orlando Gabriel, CFE
Examiner-in-Charge
State of Washington

