PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES

INDEPENDENT AUDITORS' REPORT

and

CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTAL INFORMATION

YEARS ENDED DECEMBER 31, 2012 AND 2011

5/16/13

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES

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KERNUTTSTOKES

INDEPENDENT AUDITORS' REPORT

To the Board of Trustees of
PacificSource Health Plans and Subsidiaries:

We have audited the accompanying consolidated financial statements of PacificSource Health Plans and Subsidiaries (the Company), which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive (loss) income, fund balance and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of PacificSource Health Plans and Subsidiaries as of December 31, 2012 and 2011, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Supplementary Information

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidated schedules of general and administrative expenses are presented for purposes of additional analysis and are not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and related directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Kernutt Stokes LLP

Eugene, Oregon
April 15, 2013

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES

Consolidated Balance Sheets

	December 31 2012	December 31 2011
ASSETS		
Investments	$ 164,025,128	$ 157,773,378
Cash and cash equivalents	20,986,414	25,849,704
Trust funds	4,973,929	4,549,629
Accounts receivable	38,337,136	21,755,372
Prepaid expenses and deposits	4,051,375	4,094,227
Prepaid income taxes	3,039,313	1,014,700
Property, net	43,162,333	50,015,825
Goodwill	12,611,772	12,611,772
Intangible assets, net	9,354,136	8,989,732
Deferred tax assets	4,523,000	-
Group life insurance and purchased annuities	1,890,523	1,950,895
Total	$ 306,955,059	$ 288,605,234
LIABILITIES AND FUND BALANCE		
LIABILITIES:		
Unpaid claims and claims adjustment expenses	$ 94,908,633	$ 76,902,301
Book overdraft	15,225,651	4,664,460
Line of credit	8,087,428	2,420,660
Accounts payable	9,612,371	6,126,305
Accrued expenses	6,121,527	6,483,726
Accrued pension liability	2,645,133	4,714,111
Unearned premiums	7,652,996	7,508,388
Incentive compensation payable under managed care plans	388,733	2,706,986
Accrued retro settlements	2,730,751	1,290,224
Collections for others	4,973,929	4,549,629
Deferred compensation payable to member physicians	1,890,523	1,950,895
Deferred tax liabilities	-	2,612,177
Notes payable	10,632,735	11,073,231
Total	164,870,410	133,003,093
FUND BALANCE:		
Fund balance, unrestricted	143,186,664	162,151,267
Accumulated other comprehensive loss	(1,511,596)	(6,923,261)
Noncontrolling interests	409,581	374,135
Total	142,084,649	155,602,141
Total	$ 306,955,059	$ 288,605,234

See accompanying notes.

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES
Consolidated Statements of Operations

	Year Ended December 31	
	2012	**2011**
PREMIUMS:		
Commercial premiums	$ 725,325,309	$ 652,038,430
Medicare premiums	166,134,084	118,468,331
Medicaid premiums	131,038,229	126,604,314
Total	1,022,497,622	897,111,075
CLAIMS EXPENSE:		
Commercial	679,238,568	569,511,211
Medicare	129,519,593	87,179,015
Medicaid	121,194,281	120,086,201
Commissions on premiums	22,925,105	18,281,981
Premium taxes and OMIP assessments	18,390,890	14,762,492
Total	971,268,437	809,820,900
EXCESS OF PREMIUMS OVER CLAIMS EXPENSE	51,229,185	87,290,175
ADMINISTRATIVE REVENUES	9,434,993	13,719,211
GENERAL AND ADMINISTRATIVE EXPENSES	98,967,742	93,212,978
UNDERWRITING (LOSS) GAIN	(38,303,564)	7,796,408
OTHER INCOME (EXPENSE):		
Investment income	9,652,612	6,722,674
Interest expense	(675,816)	(1,134,168)
Charitable contributions	(1,750,776)	(1,135,634)
Miscellaneous expense	(360,276)	(86,962)
Total	6,865,744	4,365,910
(LOSS) INCOME BEFORE INCOME TAXES	(31,437,820)	12,162,318
INCOME TAX (BENEFIT) EXPENSE	(12,538,276)	4,442,526
TOTAL (LOSS) INCOME	(18,899,544)	7,719,792
LESS INCOME ATTRIBUTABLE TO NONCONTROLLING INTERESTS	65,059	65,006
NET (LOSS) INCOME	$ (18,964,603)	$ 7,654,786

See accompanying notes.

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES
Consolidated Statements of Comprehensive (Loss) Income

	Year Ended December 31 2012	2011
NET (LOSS) INCOME	$ (18,964,603)	$ 7,654,786
OTHER COMPREHENSIVE (LOSS) INCOME, NET OF TAXES:		
Unrealized appreciation and depreciation of investments:		
Unrealized appreciation and depreciation arising during year	5,969,543	(2,760,395)
Reclassification adjustment for gains and losses realized in net (loss) income	173,094	151,920
	6,142,637	(2,608,475)
Deferred income taxes	(2,408,000)	822,000
Unrealized appreciation and depreciation of investments, net	3,734,637	(1,786,475)
Defined benefit pension plan:		
Net gain (loss) arising during year	3,925,475	(6,896,740)
Prior service cost due to curtailment	(972,975)	-
Amortization of prior service cost	(165,472)	(165,472)
	2,787,028	(7,062,212)
Deferred income taxes	(1,110,000)	2,780,000
Defined benefit pension plan, net	1,677,028	(4,282,212)
Total other comprehensive income (loss)	5,411,665	(6,068,687)
COMPREHENSIVE (LOSS) INCOME	$ (13,552,938)	$ 1,586,099

See accompanying notes.

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES

Consolidated Statements of Fund Balance

	Fund Balance	Accumulated Other Comprehensive Income (Loss): Unrealized Appreciation and Depreciation on Investments	Accumulated Other Comprehensive Income (Loss): Defined Benefit Pension Plan	Noncontrolling Interests	Total
BALANCE, January 1, 2011	$ 154,496,481	$ 5,245,450	$ (6,100,024)	$ 323,407	$ 153,965,314
Net income	7,654,786	-	-	65,006	7,719,792
Other comprehensive loss	-	(1,786,475)	(4,282,212)	-	(6,068,687)
Redèmption of IPN common stock	-	-	-	(14,278)	(14,278)
BALANCE, December 31, 2011	162,151,267	3,458,975	(10,382,236)	374,135	155,602,141
Net (loss) income	(18,964,603)	-	-	65,059	(18,899,544)
Other comprehensive income	-	3,734,637	1,677,028	-	5,411,665
Redemption of IPN common stock	-	-	-	(29,613)	(29,613)
BALANCE, December 31, 2012	$ 143,186,664	$ 7,193,612	$ (8,705,208)	$ 409,581	$ 142,084,649

See accompanying notes.

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Change in Cash and Cash Equivalents

	Year Ended December 31 2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Premiums collected	$ 1,006,060,466	$ 894,500,433
Claims paid	(954,139,831)	(807,017,266)
General and administrative expenses paid	(76,257,490)	(83,291,997)
Investment income received	5,079,916	5,296,200
Other revenue received	9,434,993	13,719,211
Interest paid	(676,780)	(1,135,067)
Income taxes paid	(139,514)	(47,499)
Net cash (used in) provided by operating activities	(10,638,240)	22,024,015
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from sale of investments	218,591,383	112,073,582
Investments purchased	(214,127,800)	(145,015,481)
Proceeds from sale of Trusteed Plans Service Corporation (TPSC), net of cash disposed	-	608,523
Proceeds from sale of property	9,400	15,810
Purchase of customer list	(1,215,000)	-
Property purchased	(2,679,692)	(5,093,622)
Net cash provided by (used in) investing activities	578,291	(37,411,188)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net proceeds from line of credit	5,666,768	2,420,660
Payments on notes payable	(440,496)	(3,698,768)
Redemption of common stock	(29,613)	(14,278)
Net cash provided by (used in) financing activities	5,196,659	(1,292,386)
CHANGE IN CASH AND CASH EQUIVALENTS	(4,863,290)	(16,679,559)
CASH AND CASH EQUIVALENTS, beginning of year	25,849,704	42,529,263
CASH AND CASH EQUIVALENTS, end of year	$ 20,986,414	$ 25,849,704

(Continued)

See accompanying notes.

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Continued)

Reconciliation of Net (Loss) Income to Net Cash (Used in) Provided by Operating Activities

	Year Ended December 31 2012	2011
NET (LOSS) INCOME	$ (18,964,603)	$ 7,654,786
ADJUSTMENTS TO RECONCILE NET (LOSS) INCOME TO NET CASH (USED IN) PROVIDED BY OPERATING ACTIVITIES:		
Income attributable to noncontrolling interest	65,059	65,006
Depreciation and amortization	10,333,890	10,237,547
Deferred tax (benefit) expense	(10,653,177)	1,983,868
Gain on sale of investments	(4,690,880)	(1,162,082)
Loss on disposal of property	40,490	845,225
Adjustments resulting from changes in:		
Accounts receivable	(16,581,764)	(3,482,513)
Accrued investment income	118,184	(264,392)
Prepaid income taxes	(2,024,613)	2,411,159
Accrued pension liability	718,050	(1,463,039)
Prepaid expenses and deposits	42,852	663,424
Unpaid claims and claims adjustment expenses	18,006,332	1,367,867
Book overdraft	10,561,191	3,814,494
Accounts payable	3,486,066	(2,676,631)
Unearned premiums	144,608	871,871
Incentive compensation payable	(2,318,253)	1,272,114
Accrued retro settlements	1,440,527	163,653
Accrued expenses	(362,199)	(278,342)
NET CASH (USED IN) PROVIDED BY OPERATING ACTIVITIES	$ (10,638,240)	$ 22,024,015

Supplemental Schedule of Noncash Investing and Financing Activities

At December 31, 2012, there was unrealized appreciation and depreciation of investments, net of reclassification adjustments, of $6,142,637 with deferred taxes of $(2,408,000). At December 31, 2011, there was unrealized appreciation and depreciation of investments, net of reclassification adjustments, of $(2,608,475) with deferred taxes of $822,000.

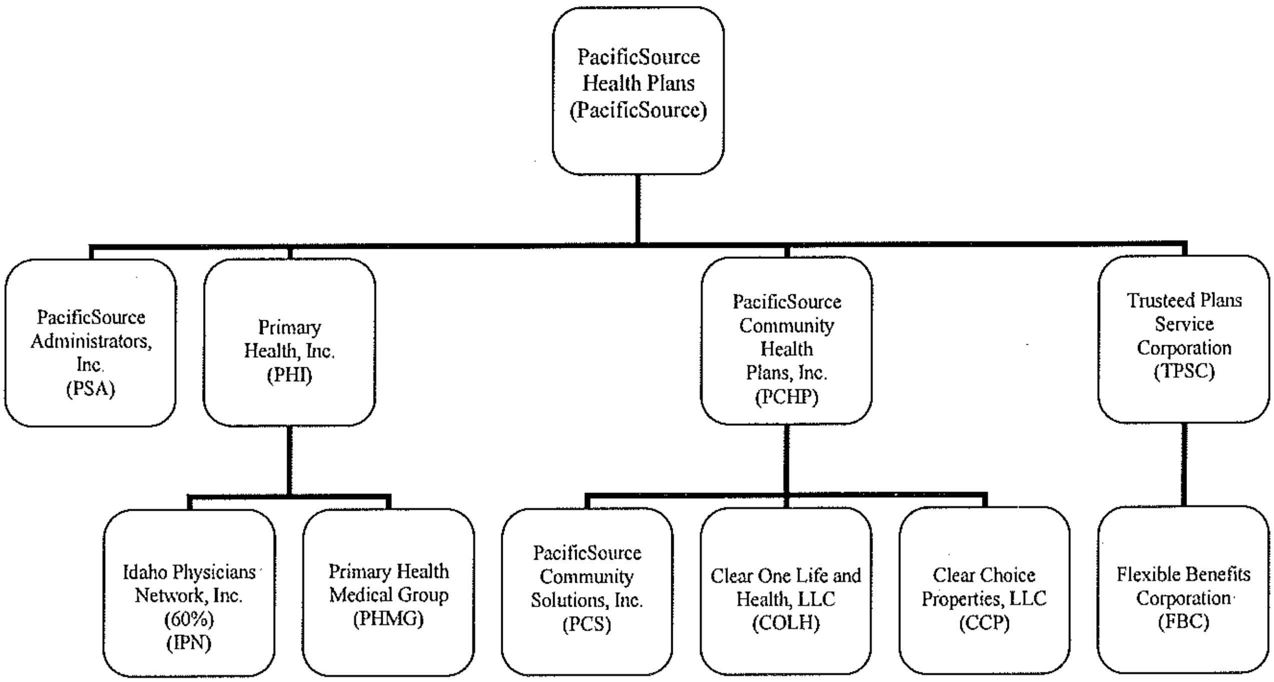
At December 31, 2012, there were defined benefit pension plan adjustments of $2,787,028 with deferred taxes of $(1,110,000). At December 31, 2011, there were defined benefit pension plan adjustments of $(7,062,212) with deferred taxes of $2,780,000.

During 2011, the Company sold the stock of TPSC for $1,000,000 in cash ($608,523 net of cash disposed) and received a note receivable for $300,000.

See accompanying notes.

1. Organization and Summary of Significant Accounting Policies

PacificSource and its subsidiaries are organized as follows:



The relative proportion of gross revenue attributable to each entity for the years ended December 31 is as follows:

	2012		2011	
PacificSource	$ 727,760,163	70.5%	$ 648,541,945	71.2%
PCHP and subsidiaries	297,484,459	28.9%	250,297,460	27.5%
PSA	4,226,449	0.4%	4,715,315	0.5%
TPSC and subsidiary	-	0.0%	4,885,949	0.5%
PHI and subsidiaries	2,461,544	0.2%	2,389,617	0.3%
Gross revenue	$ 1,031,932,615	100.0%	$ 910,830,286	100.0%

Principles of Consolidation. The accompanying financial statements of PacificSource Health Plans (PacificSource) are consolidated with their wholly owned subsidiaries (collectively the Company). PacificSource owns 100% of the stock of four subsidiary corporations. These entities are: PSA, PHI, PCHP and TPSC. TPSC was sold effective November 30, 2011. All significant intercompany balances and transactions have been eliminated in the consolidation.

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1. Organization and Summary of Significant Accounting Policies (Continued)

PacificSource is an independent, not-for-profit community health plan offering commercial medical and dental plans in Oregon, Idaho, Montana and Washington.

PCHP is a health insurance company licensed in the states of Oregon, Idaho and Montana. They offer Medicare Advantage and, through their subsidiary PCS, Medicaid plans. COLH sells life, disability, dental, vision and voluntary benefit programs in Oregon, Idaho, Montana and Washington. CCP owns the building located in Bend, Oregon.

PSA is a third-party administrator specializing in administration of self-funded employee health benefit plans, flexible spending accounts, health reimbursement arrangements and COBRA administration based in Oregon.

PHI is a shell corporation which owns 60% of the outstanding shares of IPN, an Idaho based for-profit non-insurance entity and 100% of PHMG, an inactive company holding no assets or liabilities. IPN is a physician contracting network.

TPSC is a full-service third-party administrator and benefits consulting firm providing administration of self-funded employee benefit health plans, flexible spending accounts, health reimbursement arrangements and COBRA administration based in Washington. TPSC is the 100% owner of FBC, a Washington based for-profit non-insurance entity. On November 30, 2011, the Company sold its 100% ownership interest in TPSC. The sale was for $1 million in cash and a note receivable for $300,000, with payments due over three years and interest at 4.5%.

Basis of Presentation. The accompanying financial statements have been prepared in accordance with generally accepted accounting principles (GAAP) that differ from statutory accounting principles (SAP) used by regulatory authorities.

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1. Organization and Summary of Significant Accounting Policies (Continued)

Investments. Investments in debt securities, equity securities and mutual funds are classified as available-for-sale and are reported at fair value. Realized gains and losses on investments are recognized on the specific identification basis and recorded using the original cost of the security. Changes in fair value of investments are recorded as unrealized depreciation or appreciation directly in the fund balance as other comprehensive income or loss and have no effect on net income or loss. Certificates of deposit had a maturity of more than three months at the time of acquisition and are carried at cost, which approximates fair value.

Investments in other invested assets are accounted for using the equity method. Other invested assets consist of investments in partnerships. The equity method of accounting for investments requires the Company to recognize its pro rata share of the income or loss and distributions of the investments and to increase or decrease the carrying value of the investment accordingly.

Statutory Deposit. PacificSource and PCHP maintain statutory deposits as required by regulatory authorities. At December 31, 2012, the deposits were in the form of certificates of deposit maturing at various dates through August 2013 and were included in investments on the consolidated balance sheets. The fair value of the statutory deposit was $2,611,738 at December 31, 2012 and 2011.

Cash Equivalents. For purposes of the consolidated statements of cash flows, the Company considers all highly liquid debt instruments purchased with maturities of three months or less at the time of purchase to be cash equivalents. Substantially all of the cash and cash equivalents are maintained at various banks whose deposits exceed federally insured limits. The Company has not experienced any losses on such accounts.

Trust Funds. Under the terms of administrative agreements related to self-insurance and third-party administrator services, the Company is required to maintain separate cash trust accounts for benefit administration services received for various employers.

Accounts Receivable. Uncollected premiums represent amounts receivable from policyholders. Amounts receivable relating to uninsured health plans are amounts collectible from groups under administrative service contracts. Pharmacy rebates are receivable based upon pharmacy claims expenses of the Company. Other receivables are claims refunds collectible from providers, insureds and third parties based upon coordination of benefits under healthcare plans. All receivables of the Company are unsecured. Management determines and evaluates past due balances on an account by account basis, and if amounts become uncollectible, they will be charged to operations when that determination is made. As of December 31, 2012 and 2011, management considered receivables to be fully collectible; accordingly, no allowance for doubtful accounts was considered necessary,

(Continued)

1. Organization and Summary of Significant Accounting Policies (Continued)

As of December 31, 2012 and 2011, pharmacy rebates were approximately \$2.8 million and \$6.1 million, respectively, which will be collected over the next two years in the normal course of business in accordance with contract terms and industry standards.

Property. Property is stated at cost. Depreciation is computed on the straight-line method based on the estimated useful lives of the assets. Property additions and improvements are capitalized, while repairs and maintenance are charged to expense as incurred.

Goodwill. The Company assesses goodwill for impairment annually and whenever events or changes in circumstances indicate it may be impaired. When an impairment is indicated, any excess of carrying value over fair value of goodwill is recorded as an operating loss. The Company completed annual tests for impairment at December 31, 2012 and 2011, and determined that the fair value of goodwill exceeded the carrying value, thus goodwill is not considered impaired.

Intangible Assets. Intangible assets with finite lives are amortized on a straight-line basis over their estimated useful lives. Trade names and trademarks, customer relationships and contract arrangements are amortized over ten to twenty years; other intangible assets are amortized over fifteen years; loan fees are amortized over the life of the loan, which is five years. Estimated useful lives of intangible assets are periodically reviewed by management to determine if events or circumstances warrant a change in the remaining useful life of the asset.

The Company assesses the recoverability of intangibles whenever events or changes in circumstances indicate they may be impaired. When an impairment is indicated, any excess of carrying value over fair value of intangibles is recorded as an operating loss. The Company completed tests for impairment at December 31, 2012 and 2011, and determined that the fair value of intangibles exceeded the carrying value, thus intangibles are not considered impaired.

Liability for Unpaid Claims and Claims Adjustment Expenses. The Company establishes a liability, based on actuarial models, for unpaid claims and related administrative costs. The Company does not discount its liability for unpaid claims. The liability is an estimate, and while the Company believes that the amount is adequate, the ultimate liability may be in excess of or less than the amount provided. The estimate is continually reviewed and adjusted as necessary as experience develops or new information becomes known; such adjustments are included in the period in which the revisions are determined. Actual payments will differ from the original estimates and may result in material adjustments to claims expense recorded in future periods.

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1. Organization and Summary of Significant Accounting Policies (Continued)

Incentive Compensation Payable Under Managed Care Plans. The Company has entered into arrangements with certain medical provider groups that involve risk sharing of gains or losses. Providers are paid a per capita fee for providing services to insureds and a portion of certain other payments to providers are withheld (incentive pools). Based on an annual review of performance and utilization, such amounts are either retained by the Company or paid to providers.

Deferred Compensation - Management. The Company provides key employees a non-qualified deferred compensation plan whereby participants can elect to make voluntary contributions to the plan. The Company, at the discretion of the Board of Trustees, can also make contributions to the plan on behalf of key employees. The assets are payable to participants upon retirement or termination of employment. The Company includes in its assets the estimated present value of annuity contracts under the plan; there is an associated liability for the plan as the contracts are payable to participants. Plan assets were $525,591 and $373,943 at December 31, 2012 and 2011, respectively, and are recorded in prepaid expenses and deposits on the consolidated balance sheets. The Company contributed $30,463 and $27,906 to the plan for 2012 and 2011, respectively.

Income Taxes. PacificSource is incorporated in Oregon as a not-for-profit health care service contractor; it is a taxable entity as a result of the Tax Reform Act of 1987. Income taxes are provided for the tax effects of transactions reported in the financial statements and consist of taxes currently due plus deferred taxes. Deferred income taxes arise principally from temporary differences relating to the deferred compensation plan, defined benefit pension plan, unrealized appreciation and depreciation of investments, depreciation, certain accrued and prepaid expenses, group life insurance and annuity contracts, premium deficiency reserve, discounting of the claims provision, partnership differences, goodwill, bad debts, alternative minimum tax credit carryforwards, charitable contribution carryforwards and federal and state net operating loss carryforwards. PacificSource files consolidated federal income tax returns with its subsidiaries in accordance with applicable tax law.

The Company files income tax returns in the U.S. federal jurisdiction and multiple state and local jurisdictions. The Company is not subject to federal, state or local income tax examinations by tax authorities for years prior to 2009 in jurisdictions where tax returns have been filed, as the statute of limitations has expired on those years.

Revenue Recognition. Premiums are recognized on a monthly basis over the policy term. Administrative revenues include the operations of the non-insurance subsidiaries. Revenues are recognized in the month that the service is performed.

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1. Organization and Summary of Significant Accounting Policies (Continued)

Assessments. State mandated assessments are accrued at the time the events occur on which assessments are expected to be based.

Advertising. Costs for advertising are expensed as incurred. Advertising expense was $3,511,368 and $2,579,446 for 2012 and 2011, respectively.

Fair Value Measurements. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value framework requires the categorization of assets and liabilities into three levels based upon the ability to observe the assumptions (inputs) used to value the assets and liabilities. Level One provides the most reliable and observable measure of fair value, whereas Level Three generally requires significant judgment. When valuing assets or liabilities, GAAP requires the most observable inputs to be used.

The fair value hierarchy is categorized into three levels based on the inputs as follows:

Level One - Unadjusted, quoted prices in active markets for identical assets and liabilities.

Level Two - Observable inputs, other than those included in Level One. For example, quoted prices for similar assets or liabilities in active markets or quoted prices for identical assets or liabilities in inactive markets.

Level Three - Unobservable inputs reflecting assumptions about the inputs used in pricing the asset or liability.

The fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

Estimates. The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Business Risks and Uncertainties. The Company's investments are primarily comprised of debt and equity securities. Significant changes in prevailing interest rates and market conditions may adversely affect the timing and amount of cash flows on such investments and their related values. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the value of investment securities, it is at least reasonably possible that changes in values in the near-term could materially affect the Company's consolidated balance sheets and the amounts reported in the consolidated statements of operations.

(Continued)

1. Organization and Summary of Significant Accounting Policies (Continued)

The Company invests in mortgage backed securities (MBS) and other securities subject to prepayment and call risk. Significant changes in prevailing interest rates may adversely affect the timing and amount of cash flows on such securities. In addition, the amortization of market premium and accretion of market discount on MBS is based on historical experience and estimates of future payments on the underlying mortgage loans. Actual prepayments will differ from the original estimates and may result in material adjustments to amortization or accretion recorded in future periods.

Recently Adopted Accounting Pronouncements. Effective for the Company's 2012 financial statements, the Company adopted new guidance issued by the Financial Accounting Standards Board related to disclosures of other comprehensive income. The new guidance requires presentation of reclassification adjustments out of accumulated other comprehensive income for the period. Adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

Effective for the Company's 2012 financial statements, the Company adopted new guidance issued by the Financial Accounting Standards Board which clarifies the application of fair value measurement and disclosure. Adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

Subsequent Events. Management evaluates events occurring subsequent to the date of the consolidated financial statements in determining the accounting for and disclosure of transactions and events that affect the consolidated financial statements. Subsequent events have been evaluated through April 15, 2013, which is the date the consolidated financial statements were available to be issued.

Reclassifications. Certain 2011 amounts have been reclassified to conform with 2012 presentation. The reclassifications had no effect on previously reported net income.

2. Investments

Investments by major class consisted of the following at December 31:

	2012	2011
Debt securities	$ 118,539,871	$ 116,922,980
Equity securities and mutual funds	36,324,238	30,968,056
Certificates of deposit	2,611,738	2,611,738
Other invested assets	5,778,535	6,381,674
Accrued investment income	770,746	888,930
Total	$ 164,025,128	$ 157,773,378

Investments in Debt and Equity Securities. The Company classifies the following investments as available-for-sale and records them at fair value.

The cost and fair value of the investments at December 31, 2012 are as follows:

	Cost	Fair Value	Unrealized Appreciation	Tax Effect	Net Unrealized Appreciation
U.S. Government debt securities	$ 12,647,188	$ 13,146,733	$ 499,545	$ (196,000)	$ 303,545
Mortgage/asset backed securities	39,591,373	41,513,282	1,921,909	(753,000)	1,168,909
Corporate debt securities	61,256,516	63,879,856	2,623,340	(1,028,000)	1,595,340
Debt securities	113,495,077	118,539,871	5,044,794	(1,977,000)	3,067,794
Equity securities and mutual funds	33,201,056	36,324,238	3,123,182	(1,225,000)	1,898,182
Total	$ 146,696,133	$ 154,864,109	$ 8,167,976	$ (3,202,000)	$ 4,965,976

The unrealized appreciation of debt securities of $5,044,794 for 2012 consisted of unrealized gains of $5,159,936 and unrealized losses of $115,142. The unrealized appreciation of equity securities and mutual funds of $3,123,182 for 2012 consisted of unrealized gains of $3,224,818 and unrealized losses of $101,636. Approximately $4.7 million of gross realized gains and $18,000 of gross realized losses were included in investment income on the consolidated statements of operations for 2012.

(Continued)

2. Investments (Continued)

The cost and fair value of the investments at December 31, 2011 are as follows:

	Cost	Fair Value	Unrealized Appreciation (Depreciation)	Tax Effect	Net Unrealized Appreciation (Depreciation)
U.S. Government debt securities	$ 13,356,646	$ 14,060,871	$ 704,225	$ (276,000)	$ 428,225
Mortgage/asset backed securities	45,828,390	47,190,368	1,361,978	(533,000)	828,978
Corporate debt securities	54,731,222	55,671,741	940,519	(369,000)	571,519
Debt securities	113,916,258	116,922,980	3,006,722	(1,178,000)	1,828,722
Equity securities and mutual funds	31,949,439	30,968,056	(981,383)	384,000	(597,383)
Total	$ 145,865,697	$ 147,891,036	$ 2,025,339	$ (794,000)	$ 1,231,339

The unrealized appreciation of debt securities of $3,006,722 for 2011 consisted of unrealized gains of $4,224,565 and unrealized losses of $1,217,843. The unrealized depreciation of equity securities and mutual funds of $981,383 for 2011 consisted of unrealized gains of $1,442,980 and unrealized losses of $2,424,363. Approximately $3 million of gross realized gains and $1 million of gross realized losses were included in investment income on the consolidated statements of income for 2011.

Management evaluates securities for other-than-temporary impairment at least on an annual basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer and the intent and ability of the Company to retain its investment for a period of time sufficient to allow for any anticipated recovery in fair value.

(Continued)

2. Investments (Continued)

The aggregate fair values of securities, by category, that had gross unrealized losses at December 31, 2012, and the securities that were in a loss position at December 31, 2011 that were still in a loss position at December 31, 2012, are as follows:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Debt securities	$ 8,079,295	$ (80,389)	$ 1,575,195	$ (34,753)	$ 9,654,490	$ (115,142)
Equity securities/ mutual funds	1,265,739	(11,897)	7,289,766	(89,739)	8,555,505	(101,636)
	$ 9,345,034	$ (92,286)	$ 8,864,961	$ (124,492)	$ 18,209,995	$ (216,778)

As of December 31, 2012, the Company had 38 securities in an unrealized loss position. All of these securities had a percentage decline of less than 16%. At December 31, 2012 and 2011, the Company did not hold any less-than-investment grade corporate debt securities.

At December 31, 2012, debt securities were scheduled to mature as follows:

	Cost	Fair Value	Unrealized Appreciation
Due in one year or less	$ 900,545	$ 904,016	$ 3,471
Due in one to five years	51,554,384	53,781,490	2,227,106
Due in five to ten years	46,591,609	48,989,827	2,398,218
Due after ten years	14,448,539	14,864,538	415,999
Total	$ 113,495,077	$ 118,539,871	$ 5,044,794

See Note 7 regarding investment securities pledged to secure the line of credit at December 31, 2012.

(Continued)

2. Investments (Continued)

The change in unrealized appreciation in fair value of securities available-for-sale is as follows:

	Cost	Fair Value	Unrealized Appreciation	Tax Effect	Net Unrealized Appreciation
December 31, 2012	$ 146,696,133	$ 154,864,109	$ 8,167,976	$ (3,202,000)	$ 4,965,976
Less December 31, 2011	145,865,697	147,891,036	2,025,339	(794,000)	1,231,339
Change in unrealized appreciation			$ 6,142,637	$ (2,408,000)	$ 3,734,637

Investment expense was approximately $343,000 and $301,000 for the years ended December 31, 2012 and 2011, respectively.

Other Invested Assets. Other invested assets consist of investments in partnerships that are accounted for using the equity method, which approximates fair market value. The percentage of the Company's ownership in each of these investments varies based upon total investment in the secondary market.

During 2007, the Company purchased, for $3,486,406, an interest in Jefferies Special Opportunities Partners, LLC, of which $170,289 was sold during 2010. The Company's pro rata share of gain was $286,000 and $23,000 in 2012 and 2011, respectively; cumulative loss prior to 2011 was $120,117.

During 2007, the Company purchased, for $19,780,256, an interest in Phoenix Fixed Income Fund, L.P. (formerly Azure Fixed Income Fund, L.P.) Standard Units 2, of which $11,672,464 was sold during 2007, $1,348,736 was sold during 2010, $1,279,124 was sold during 2011 and $266,316 was sold during 2012. PacificSource's pro rata share of the limited partnership loss was $622,827 and $174,656 in 2012 and 2011, respectively; cumulative loss prior to 2011 was $2,142,598.

3. Property

Major classes of property at December 31 consisted of the following:

	2012	2011
Land	$ 3,172,078	$ 3,172,078
Buildings	20,368,750	20,358,271
Furniture and fixtures	8,681,700	8,335,109
Electronic data processing equipment	8,944,911	8,316,071
Software	48,881,833	47,531,150
Automobiles	240,185	240,185
Leasehold improvements	2,099,413	2,018,215
Work-in-process	459,366	316,335
	92,848,236	90,287,414
Less accumulated depreciation	16,359,784	13,537,920
Less accumulated amortization - software	33,326,119	26,733,669
Total	$ 43,162,333	$ 50,015,825

4. Intangible Assets

Major classes of intangible assets at December 31 consisted of the following:

	2012	2011
Customer relationships	$ 6,083,630	$ 4,868,630
Contractual arrangements	4,858,055	4,858,055
Trade names and trademarks	600,000	600,000
Other intangible assets	126,273	130,163
Loan fees	97,904	97,904
	11,765,862	10,554,752
Less accumulated amortization	2,411,726	1,565,020
Total	$ 9,354,136	$ 8,989,732

During 2012, PacificSource purchased the customer list of New West Health Services, a Montana insurance provider, for $1,215,000.

Intangible assets with finite lives are amortized using the straight-line method over their estimated useful lives, which range from five to twenty years. Amortization expense is expected to be as follows for each of the succeeding five years: 2013, $864,377; 2014, $849,705; 2015, $849,705; 2016, $849,705; 2017, $849,705; and $5,090,939 thereafter.

5. Group Life Insurance and Purchased Annuities

The Company includes in its assets the cash value of a group life insurance contract and the estimated present value of purchased annuities. The contracts were purchased with the proceeds of a deferred compensation plan with member physicians which was offered from 1966 through 1991. The plan is considered an unfunded, non-qualified, deferred compensation arrangement not subject to ERISA requirements. The insurance contracts are subject to claims by general creditors and are, therefore, considered a part of the Company's general assets. The contracts are payable to the member physicians and are, therefore, recorded as a liability.

As of December 31, 2012 and 2011, the single-premium group life insurance contract consisted of aggregate paid-up life insurance of $2,129,250 and a cash value of $1,204,290 and $1,673,491, respectively.

At a triggering event (such as the retirement or disability of a participant), a partial surrender of the group life insurance contract is requested and an annuity contract is purchased. The net present value of the annuity contracts was $686,233 and $277,404 at December 31, 2012 and 2011, respectively.

The agreements with the participating physicians generally do not commit the Company to obtain a specific rate of return on the deferred amounts. The following is a summary of transactions in the deferred compensation plan:

	Group Life Insurance Contract	Annuity Contracts	Total
Balance at December 31, 2010	$ 1,633,613	$ 359,346	$ 1,992,959
Earnings on contracts, net	39,878	16,534	56,412
Payments to annuitants	-	(98,476)	(98,476)
Balance at December 31, 2011	1,673,491	277,404	1,950,895
Earnings on contracts, net	49,563	23,410	72,973
Purchase of annuity	(518,764)	518,764	-
Payments to annuitants	-	(133,345)	(133,345)
Balance at December 31, 2012	$ 1,204,290	$ 686,233	$ 1,890,523

6. Liability for Unpaid Claims and Claims Adjustment Expenses

The liability for unpaid claims and claims adjustment expenses is based on the estimated amount payable on claims reported prior to the consolidated balance sheets date that have not yet been settled, claims reported subsequent to the consolidated balance sheets date that have been incurred during the period then ended and an estimate based on prior experience of incurred but unreported claims relating to such period.

Activity in the liability for unpaid claims and claims adjustment expenses is summarized as follows:

	2012	2011
Unpaid claims and claims adjustment expenses, January 1	$ 76,902,301	$ 75,534,434
Less reinsurance receivable	(722,258)	(1,104,602)
Net balance	76,180,043	74,429,832
Incurred related to:		
Current year	950,405,189	799,677,007
Prior years	7,417,809	2,199,365
Total incurred	957,822,998	801,876,372
Paid related to:		
Current year	(860,564,353)	(722,392,362)
Prior years	(84,320,110)	(77,733,799)
Total paid	(944,884,463)	(800,126,161)
Net balance	89,118,578	76,180,043
Plus reinsurance receivable	5,790,055	722,258
Unpaid claims and claims adjustment expenses, December 31	$ 94,908,633	$ 76,902,301

As a result of changes in estimates of insured events in prior years, the liability for unpaid claims and claims adjustment expenses (net of reinsurance recoveries of $5,790,055 and $722,258) increased by $7,417,809 and $2,199,365 in 2012 and 2011, respectively. The Company records a liability for unpaid claims and claims adjustment expenses that includes an allowance for potential shock claims.

7. Line of Credit

During 2010, the Company obtained a line of credit from a bank, which provides for maximum borrowings of $40,000,000. The balance on the line of credit was $8,087,428 and $2,420,660 at December 31, 2012 and 2011. The line of credit bears interest at the Daily One Month LIBOR Rate plus 1.00% (an effective rate of 1.21% at December 31, 2012) and matures in August 2013. Certain investment accounts are assigned as collateral. The bank requires securities in the amount of twice the outstanding balance of the line and letters of credit to be pledged to secure the line of credit. Securities pledged were $16,174,856 at December 31, 2012. The line of credit is subject to certain covenants, which the Company was in compliance with at December 31, 2012.

8. Notes Payable

Notes payable consisted of the following at December 31:

	2012	2011
Note payable to bank, due in monthly installments of $71,329, including interest at 5.94% per annum, collateralized by real property, due in full at maturity April 2016.	$ 9,548,093	$ 9,823,368
Notes payable to individuals, due in monthly installments of $20,634, including interest at the prime rate plus 2% adjusted annually, not to be less than 7% or exceed 10% (effective rate of 7% at December 31, 2012), collateralized by business assets, matures March 2018.	1,084,642	1,249,863
Total	$ 10,632,735	$ 11,073,231

The note payable to the bank is subject to certain covenants, which the Company was in compliance with at December 31, 2012.

(Continued)

8. Notes Payable (Continued)

The estimated aggregate amounts of notes payable maturities are as follows:

2013	$ 474,266
2014	505,210
2015	538,188
2016	8,820,135
2017	234,350
Thereafter	60,586
	$ 10,632,735

9. Retirement Plans

The Company has a non-contributory pension plan and a participatory retirement plan (401(k)), both of which cover substantially all employees.

The non-contributory pension benefits are based on years of service and the employee's compensation during employment. The Company contributes at least the minimum funding required annually. Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future. Effective December 31, 2012, the benefits associated with the plan were frozen.

The following table sets forth the plan's funded status and amounts recognized in the Company's consolidated financial statements at December 31:

	2012	2011
Projected benefit obligation for service rendered to date	$ (32,291,157)	$ (30,317,898)
Plan assets at fair value	29,646,024	25,603,787
Funded status	$ (2,645,133)	$ (4,714,111)
Change in projected benefit obligation:		
Projected benefit obligation, beginning of year	$ 30,317,898	$ 20,565,252
Service cost	3,140,174	2,691,623
Interest cost	1,387,128	1,254,709
Curtailment gain	(8,090,897)	-
Benefits paid and administrative expenses	(1,001,370)	(355,759)
Actuarial loss	6,538,224	6,162,073
Projected benefit obligation, end of year	$ 32,291,157	$ 30,317,898

(Continued)

9. Retirement Plans (Continued)

	2012	2011
Change in fair value of plan assets:		
Fair value of plan assets, beginning of year	$ 25,603,787	$ 21,450,314
Actual return on plan assets	3,043,607	9,232
Employer contributions	2,000,000	4,500,000
Benefits paid	(1,001,370)	(308,539)
Administrative expenses	-	(47,220)
Fair value of plan assets, end of year	$ 29,646,024	$ 25,603,787
Net periodic benefit cost:		
Service cost	$ 3,140,174	$ 2,691,623
Interest cost	1,387,128	1,254,709
Expected return on plan assets	(1,905,861)	(1,612,260)
Amortization of loss	1,235,056	868,361
Amortization of prior service credits	(165,472)	(165,472)
Curtailment gain	(972,975)	-
Total net periodic benefit cost	$ 2,718,050	$ 3,036,961
Amounts recognized in accumulated other comprehensive income:		
Net loss	$ 10,209,471	$ 14,134,946
Prior service credit	-	(1,138,447)
Total accumulated other comprehensive income	$ 10,209,471	$ 12,996,499
Changes in other comprehensive income:		
Net (gain) loss	$ (3,925,475)	$ 6,896,740
Prior service cost as a result of curtailment	972,975	-
Amortization of prior service credit	165,472	165,472
Total recognized in other comprehensive income	$ (2,787,028)	$ 7,062,212
Accumulated benefit obligation, end of year	$ 32,291,157	$ 24,282,983

The Company estimates net loss, prior service cost and transition obligation for the defined benefit pension plan that will be amortized into periodic benefit cost in 2013 to be $790,527, $0 and $0, respectively.

(Continued)

9. Retirement Plans (Continued)

As a result of the pension plan being frozen, the Company expects to contribute $150,000 to its pension plan in 2013. Future anticipated benefit payments from the defined benefit pension plan are as follows: 2013, $873,375; 2014, $1,145,438; 2015, $2,448,194; 2016, $820,626; 2017, $1,056,425; and from 2018 to 2022, $19,374,347.

Assumptions used in the accounting for the defined benefit pension plan were as follows at December 31:

	2012	2011
Assumptions used for net periodic benefit costs:		
Discount rate used in determining present values	4.7%	5.5%
Annual increase in future compensation levels	3.5	3.5
Expected long-term rate of return on assets	7.25	7.25
Assumptions used to determine benefit obligation:		
Discount rate used in determining present values	4.2%	4.7%
Annual increase in future compensation levels	NA	3.5
Measurement date	December 31	December 31

The plan assets are invested in the following asset classes:

Debt investments	49%	45%
Equity investments	38	35
Cash equivalents	3	13
Other	10	7
Total	100%	100%

The plan assets are invested in a variety of bond and equity mutual funds. The targeted composition is set by the Company and reallocated periodically. The Company's expected rate of return on plan assets is determined by the plan assets' historical long-term investment performance, current asset allocation and estimates of future long-term returns by asset class.

The participatory retirement plan (401(k)), which was adopted in 1984, provides for voluntary employee contributions with employer matching. The plan requires a 50% Company match on eligible elective deferrals. Elective deferrals in excess of 6% of eligible employee compensation are not eligible to receive a match. Company contributions under the plan were $809,602 and $750,345 in 2012 and 2011, respectively. The Company has committed to a 3% contribution for all eligible employees, in addition to the annual matching contributions noted above, for 2013.

10. Income Taxes

The Company files a consolidated federal income tax return with its subsidiaries on the basis of its annual GAAP financial statements adjusted for the tax regulations. The Company files state income tax returns based on its annual statement that is filed with the insurance regulatory authorities for PacificSource and PCHP. The Company files on the basis of its annual GAAP financial statements adjusted for the state tax regulations for the remaining subsidiaries. The allocation methodology under the adopted tax allocation agreement applies the projected consolidated group income tax rate to the entities based on pre-tax net income. Federal income taxes are settled between PacificSource and its subsidiaries based on the tax sharing agreement.

The provision for income taxes consists of the following:

	2012	2011
Current income tax (benefit) expense:		
Federal	$ (1,926,065)	$ 2,539,176
State	40,966	285,218
Total current income tax (benefit) expense	(1,885,099)	2,824,394
Deferred tax (benefit) expense	(10,653,177)	1,618,132
Total income tax (benefit) expense	$ (12,538,276)	$ 4,442,526

The reconciliation between federal taxes at the statutory rate and the Company's income taxes are as follows:

	2012	2011
Tax (benefit) expense computed at statutory rate	$ (10,689,000)	$ 4,135,000
State tax expense, net of federal income tax benefit	(1,369,000)	530,000
Permanent and other differences	(203,276)	39,526
Dividend received deduction	(277,000)	(262,000)
Total income tax (benefit) expense	$ (12,538,276)	$ 4,442,526

(Continued)

10. Income Taxes (Continued)

Deferred income tax assets and liabilities at December 31 are as follows:

	2012	2011
Deferred tax assets:		
Federal and state net operating loss carryforwards	$ 7,286,000	$ 3,450,631
Alternative minimum tax credit carryforwards	4,872,000	1,560,000
Accruals	1,315,000	1,368,000
Contribution carryforwards	1,261,000	1,178,000
Defined benefit pension plan	1,038,000	1,045,000
Partnership difference	574,000	663,000
Deferred compensation	561,000	575,000
Discount of claims provision	534,000	516,000
Unrealized losses	90,000	1,430,000
Goodwill	13,000	17,000
Capital loss carryforward	-	258,000
Operating lease impairment	-	14,000
Total deferred tax assets	17,544,000	12,074,631
Deferred tax liabilities:		
Property	(8,742,000)	(11,128,808)
Unrealized gains	(3,292,000)	(2,225,000)
Prepaids	(940,000)	(1,291,000)
Subsidiary equity income	(47,000)	(42,000)
Total deferred tax liabilities	(13,021,000)	(14,686,808)
Net deferred tax assets (liabilities)	$ 4,523,000	$ (2,612,177)

As of December 31, 2012, the Company recognized a deferred tax asset of $7,286,000, for the anticipated utilization of federal and state net operating loss carryforwards. Federal net operating loss carryforwards of $13,124,247 will expire on various dates through 2032, if not used before then. State net operating loss carryforwards of $55,419,398 will expire on various dates through 2032. Contribution carryforwards of $3,216,852 will expire on various dates through 2016. Alternative minimum tax credit carryforwards of $4,871,938 have no expiration date.

(Continued)

10. Income Taxes (Continued)

The Company is required to record a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of the deferred tax assets depends on the ability to generate sufficient taxable income in the future. Based on its profitable operating results in previous years, together with management's intention and active pursuit of strategies to remain successful in the health insurance industry, no valuation account has been recorded because it appears more likely than not that the full tax benefit of deferred tax assets will be realized.

11. Reinsurance

Commercial business was reinsured against inpatient hospital costs and ancillary outpatient services under the terms of an excess liability policy. The following is a summary of the coverage levels at December 31, 2012 in order of their application:

Commercial	Retention	Deductible	Aggregate Limit
Layer 1	10% up to $135,000	$ 650,000	$1,350,000 per member
Layer 2	10% up to $300,000	$ 2,000,000	$3,000,000 per member
Layer 3	$ -	$ 5,000,000	$5,000,000 per member
Layer 4	$ -	$ 10,000,000	$10,000,000 per member
Layer 5	$ -	$ 20,000,000	Unlimited

Medicare and Medicaid business were reinsured against inpatient hospital costs and ancillary outpatient services under the terms of an excess liability policy. The following is a summary of the coverage levels at December 31, 2012:

Medicare	Retention	Deductible	Aggregate Limit
Layer 1	10%	$ 250,000	Unlimited
Medicaid	**Retention**	**Deductible**	**Aggregate Limit**
Layer 1	10%	$ 400,000	Unlimited

Premiums ceded under the terms of the reinsurance policies were $5,912,157and $5,027,828 in 2012 and 2011, respectively. The reinsurance contracts do not relieve the Company from its primary obligation to policyholders. Amounts recorded related to reinsured business are accounted for on bases consistent with those used in accounting for the original policies issued and the terms of the reinsurance contract.

12. Leases

Effective January 2008, the Company entered into a real property lease for the Tigard, Oregon sales office under a seven-year operating agreement expiring December 31, 2014. The Company is responsible for substantially all executory costs. Minimum payments under the lease, which are subject to annual adjustment, are $21,055 per month. Future minimum lease payments are as follows: 2013, $260,259; 2014, $268,030.

Effective August 1, 2009, PHI assigned its interest in their Idaho Falls, Idaho real property lease to the Company. It is a five-year lease expiring July 2013 based on the original commencement date of August 2008. Minimum payments under the lease, which are subject to annual adjustments, are $2,469 per month. The Company is responsible for substantially all executory costs. Future minimum lease payments are $17,281 for 2013.

Effective October 2010, the Company entered into a real property lease for the Boise, Idaho office under a seven-year operating agreement expiring September 2017. In November 2012, the Company signed an addendum to the lease agreement for additional office space. The lease contains an option to renew the lease for an additional five-year term. The Company is responsible for substantially all executory costs. Minimum payments under the lease, which are subject to annual adjustment, are $41,096 per month. Future minimum lease payments are as follows: 2013, $486,269; 2014, $506,799; 2015, $519,412; 2016, $523,298; 2017, $392,474.

Effective August 2011, the Company entered into a real property lease for an additional Springfield, Oregon office under a three-year operating agreement expiring July 2014. The lease contains an option to renew the lease for an additional two year, month-to-month term. The Company is responsible for substantially all executory costs. Minimum payments under the lease, which are subject to annual adjustment, are $15,962 per month. Future minimum lease payments are as follows: 2013, $203,154; 2014, $104,479.

(Continued)

12. Leases (Continued)

Effective September 2012, the Company entered into a real property lease for the Medford, Oregon office under a five-year operating agreement expiring August 2017. The Company is responsible for substantially all executory costs. Minimum payments under the lease, which are subject to annual adjustment, are $4,000 per month. Future minimum lease payments are as follows: 2013, $48,320; 2014, $49,288; 2015, $50,276; 2016, $51,280; 2017, $34,640.

Effective October 2012, the Company entered into a real property lease for the Helena, Montana office under a seven-year operating agreement expiring September 2019. The lease contains an option to renew the lease for an additional five-year term. The Company is responsible for substantially all executory costs. Minimum payments under the lease, which are subject to annual adjustment, are $7,720 per month. Future minimum lease payments are as follows: 2013, $92,640; 2014, 92,640; 2015, $94,520; 2016, $98,280; 2017, $99,560; thereafter, $170,200.

Amounts charged to rent expense for the various leases were $1,011,144 and $1,229,140 for 2012 and 2011, respectively.

13. Administrative Service Contracts

Administrative service contracts between the Company and certain groups require the groups to pay the actual costs of claims incurred, plus administrative service costs. In addition, the groups have the option to pay premiums for stop loss coverage, and the Company pays such excess claims on the same basis as its other indemnity contracts.

14. Commitments

The 1995, the Oregon Legislature enacted Senate Bill 152, which created individual portability plans that must be offered by all health insurers as a condition of transacting group insurance in the State of Oregon. The law, which became effective October 1, 1996, requires insurers to offer individuals who lose group coverage a choice of one of two individual portability policies. Benefits included in the policies are established by Oregon Administrative Rules. The policies are guaranteed issue and guaranteed renewable; individuals who meet eligibility criteria may not be excluded due to health conditions or pre-existing conditions. The formula for establishing and increasing rates is prescribed by law. The Company had premiums of approximately $5,137,000 for the year ended December 31, 2012, for policies issued under the provisions of the law, with associated claims expense of $7,025,000. The Company believes that any premium deficiency that may be realized on these policies is built into the rates of their other lines of business.

(Continued)

14. Commitments (Continued)

The 1991, the Oregon Legislature enacted Senate Bill 1076, which created a Basic Health Plan that must be offered by all health insurers as a condition of transacting insurance in the State of Oregon. Senate Bill 1076, which became effective December 31, 1992, and Senate Bill 152, which was updated in 2007 by House Bill 2002, establishes rules for all small group plans. In such plans, no employee may be excluded due to health condition or pre-existing condition, the plan must be guaranteed issue and guaranteed renewable, and the amount and timing of rate increases is prescribed by law. As of December 31, 2012, the Company has reflected profits on the aggregate policies issued under the provisions of these laws with respect to small group plans. The Company believes that its financial position, together with its reinsurance arrangements, provides a firm base to mitigate any significant adverse impact of these requirements.

In March 2010, the President of the United States signed into law the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010. This legislation includes a number of provisions that impact the health insurance industry, including provisions on increasing the number of insured members, new rules on guaranteed issue contracts, elimination of lifetime annual maximum caps on policy payments, coverage of dependent children on the parents' policy until age 26 and many others. The Company has calculated expected costs as a result of the reform and has adjusted premium rates accordingly. In addition, this legislation created health insurance exchanges. The Company is in the process of developing its rates for submission of plans across its market areas in the exchanges.

In February 2011, Oregon Legislature enacted Senate Bill 1580 that allows for the establishment of Coordinated Care Organizations (CCOs). During 2012, the Company was awarded the CCO contract with the state which covers the Central Oregon and Gorge regions.

15. Litigation and Contingent Liabilities

The Company, consistent with the insurance industry in general, is subject to litigation in the normal course of business. The Company's management does not believe that such litigation will have a material effect on its financial position.

During 2009, as part of the acquisition of PHI, an escrow account was established for $2,000,000. The escrow account was established to cover a contingent liability of PHI due to litigation. Upon settlement of the lawsuit by PHI, Hudson, its malpractice insurance company, will pay up to $2,000,000 with the balance of the possible settlement covered by the escrow fund. In 2012, PHI and Hudson entered into litigation regarding the excess payment of $2,000,000 from the escrow fund. The litigation went to trial in March 2013 with a resulting favorable award to PHI of $2,400,000 in bad faith claims and $7,200,000 in punitive damages. These amounts are subject to further appeal action by Hudson and the ultimate court mandated payment will be shared with the prior owners of PHI.

16. Related Party Transactions

The Board of Trustees formed the PacificSource Charitable Foundation, Inc. (the Foundation). Certain trustees of the Company are also officers of the Foundation. As of December 31, 2012 and 2011, total assets (unaudited), consisting primarily of cash equivalents and marketable securities, were approximately $5,735,000 and $5,950,000, respectively. The Foundation is a public benefit corporation organized for the purpose of providing funds for the health and welfare of the poor and needy. It qualifies as a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code. During 2012 and 2011, the Company made contributions of $600,000 and $0 to the Foundation, respectively.

17. Fair Value of Financial Instruments

The following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at December 31, 2012. Valuation techniques utilized to determine fair value are consistently applied.

The carrying amounts of financial instruments including accounts receivable, accounts payable and other short-term assets and liabilities approximate fair value, because of the relatively short maturity of these instruments. Certificates of deposit are carried at cost, which approximates fair value.

The carrying values of notes payable approximate fair value, as their interest rates approximate current market rates.

Investments in equity securities are classified as available-for-sale and are reported at fair value. These securites are traded in active markets and are valued at quoted market prices. They are generally categorized in Level One of the fair value hierarchy.

Investments in debt securities are classified as available-for-sale and are reported at fair value. The fair value of corporate debt instruments is estimated using recently executed transactions, market price quotations (where observable), bond spreads or credit default swap spreads. The spread data used are for the same maturity as the bond. If the spread data does not reference the issuer, then data that references a comparable issuer is used. Where observable price quotations are not available, fair value is determined based on cash flow models with yield curves, bond or single-name credit default swap spreads and recovery rates based on collateral values as key inputs. They are generally categorized in Level Two of the fair value hierarchy.

Other invested assets consist of investments in partnerships that are accounted for using the equity method, which approximate fair market value. These investments generally trade in the secondary market and are categorized in Level Two of the fair value hierarchy.

(Continued)

17. Fair Value of Financial Instruments (Continued)

Fair values of assets and liabilities measured on a recurring basis are as follows:

	Fair Value Measurement at December 31, 2012			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale debt securities:				
U.S. Government debt securities	$ 13,146,733	$ -	$ 13,146,733	$ -
Mortgage/asset backed debt securities	41,513,282	-	41,513,282	-
Corporate debt securities	63,879,856	-	63,879,856	-
Total debt securities	118,539,871	-	118,539,871	-
Available-for-sale equity securities:				
Mutual funds	36,324,238	36,324,238	-	-
Other invested assets	5,778,535	-	5,778,535	-

(Continued)

17. Fair Value of Financial Instruments (Continued)

	Fair Value Measurement at December 31, 2011			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale debt securities:				
U.S. Government debt securities	$ 14,060,871	$ -	$ 14,060,871	$ -
Mortgage/asset backed debt securities	47,190,368	-	47,190,368	-
Corporate debt securities	55,671,741	-	55,671,741	-
Total debt securities	116,922,980	-	116,922,980	-
Available-for-sale equity securities:				
Mutual funds	30,968,056	30,968,056	-	-
Other invested assets	6,381,674	-	6,381,674	-

(Continued)

17. Fair Value of Financial Instruments (Continued)

The following presents a summary of the Company's defined benefit plan investment assets measured at fair value:

	Fair Value Measurement at December 31, 2012			
Description	**Total**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Registered investment companies:				
Fixed income funds	$ 11,174,692	$ 11,174,692	$ -	$ -
Balanced funds	6,919,907	6,919,907	-	-
Growth funds	5,339,468	5,339,468	-	-
Value funds	3,794,339	3,794,339	-	-
Money market funds	848,995	848,995	-	-
Real estate funds	1,568,623	1,568,623	-	-
Total	$ 29,646,024	$ 29,646,024	$ -	$ -

	Fair Value Measurement at December 31, 2011			
Description	**Total**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Registered investment companies:				
Fixed income funds	$ 9,034,326	$ 9,034,326	$ -	$ -
Balanced funds	4,612,013	4,612,013	-	-
Growth funds	4,044,528	4,044,528	-	-
Value funds	3,337,838	3,337,838	-	-
Money market funds	3,257,966	3,257,966	-	-
Real estate funds	1,317,116	1,317,116	-	-
Total	$ 25,603,787	$ 25,603,787	$ -	$ -

(Continued)

17. Fair Value of Financial Instruments (Continued)

The following is a description of the valuation methodologies used for the Company's defined benefit plan investment assets measured at fair value.

Registered investment companies are valued at quoted market prices. They are generally categorized in Level One of the fair value hierarchy.

The fair value of guaranteed accounts is calculated by discounting the related cash flows based on current yields of similar instruments with comparable durations. They are generally categorized in Level Three of the fair value hierarchy.

The following table presents additional information about Level Three assets measured at fair value. Both observable and unobservable inputs may be used to determine the fair value of positions that the Plan has classified within the Level Three category. As a result, the unrealized gains and losses from assets within the Level Three category may include changes in fair value that were attributable to both observable and unobservable inputs.

Fair Value Measurement Using Significant Unobservable Inputs (Level 3) - Guaranteed Interest Fund

Description	Fair Value
Level 3 balance, December 31, 2010	$ 5,256,339
Interest	72,507
Purchases, issuances and settlements	1,000,000
Distributions and fees	(6,328,846)
Level 3 balance, December 31, 2011	$ -

18. Statutory Financial Information

PacificSource and PCHP, which are domiciled in Oregon, prepare their statutory basis financial statements in accordance with accounting principles and practices prescribed or permitted by the State of Oregon, Department of Consumer and Business Services, Insurance Division (Insurance Division). Oregon has adopted the NAIC's statutory accounting practices (NAIC SAP) as the basis of its statutory accounting practices.

PacificSource and PCHP follow the NAIC's SAP and do not have permitted practices that deviate from NAIC SAP. PacificSource and PCHP's statutory capital and surplus were sufficient to satisfy regulatory requirements at December 31, 2012.

SUPPLEMENTAL INFORMATION

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES

Consolidated Schedules of General and Administrative Expenses

	Year Ended December 31	
	2012	**2011**
Salaries	$ 38,799,881	$ 37,965,545
Payroll taxes	3,666,650	3,376,709
Employee benefits	9,371,562	7,822,784
Retirement plans	3,564,712	3,831,429
Contract labor	460,641	349,498
Administrative expense, net	2,551,763	1,224,165
Advertising	3,511,368	2,579,446
Automobile expense	316,527	289,958
Banking charges	290,533	191,054
Board expenses	405,014	390,589
Building rent	1,011,144	1,229,140
Computer and software	671,839	244,188
Consultant fees	6,989,628	7,688,502
Depreciation and amortization	10,333,890	10,237,547
Dues and subscriptions	470,611	643,483
Insurance	696,996	801,900
Imaging expense	430,675	363,270
Legal fees	305,875	220,909
Professional accounting, state audit and actuarial services	498,067	485,722
Office and data processing supplies	811,664	678,718
Outside service fees	1,479,208	1,008,742
Postage	1,914,144	2,256,027
Printing expense	1,479,550	1,055,836
Repairs and maintenance	1,188,939	1,193,247
Taxes and licenses	5,310,827	5,047,752
Telephone	684,643	685,282
Travel and education	1,045,329	910,868
Utilities	230,700	226,220
Other	475,362	214,448
Total	$ 98,967,742	$ 93,212,978