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Hill Physicians Medical Group, Inc.

Consolidated Financial Statements for the Years Ended December 31, 2009 and 2008 with Independent Auditors' Report Thereon

KPMG LLP
55 Second Street
San Francisco, CA 94105

Independent Auditors' Report

The Board of Directors
Hill Physicians Medical Group, Inc.:

We have audited the accompanying consolidated balance sheets of Hill Physicians Medical Group, Inc. and subsidiary as of December 31, 2009 and 2008, and the related consolidated statements of operations, changes in shareholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Hill Physicians Medical Group, Inc. and subsidiary as of December 31, 2009 and 2008, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

KPMG LLP

May 5, 2010

Hill Physicians Medical Group, Inc.

Consolidated Balance Sheets
December 31, 2009 and 2008

(in thousands)

	2009	2008
Assets		
Current assets:		
Cash and cash equivalents	$ 31,110	$ 20,510
Marketable securities	35,012	28,950
Accounts receivable:		
Shared risk and pay for performance	7,349	7,848
Capitation and other receivables	5,207	6,049
Prepaid expenses and other	1,133	1,256
Deferred tax asset	754	731
Total current assets	80,565	65,344
Property and equipment, net	7,627	8,619
Other	334	469
Total assets	$ 88,526	$ 74,432
Liabilities and shareholders' equity		
Current liabilities:		
Claims payable	$ 24,518	$ 28,140
Supplemental provider payments	14,000	9,043
Accounts payable and accrued expenses	2,897	2,037
Accrued employee benefit liabilities	3,965	3,581
Total current liabilities	45,380	42,801
Deferred taxes and rent	3,952	1,556
Total liabilities	49,332	44,357
Minority interest	2,316	2,316
Shareholders' equity:		
Common stock	1	1
Additional paid-in capital	336	320
Net unrealized gain on marketable securities	4,629	203
Retained earnings	31,912	27,235
Total shareholders' equity	36,878	27,759
Total liabilities and shareholders' equity	$ 88,526	$ 74,432

See notes to consolidated financial statements

Hill Physicians Medical Group, Inc.

Consolidated Statements of Operations
Years Ended December 31, 2009 and 2008

(in thousands)

	2009	2008
Revenue:		
Health plan capitation revenue	$ 380,383	$ 383,995
Health plan and other revenue	37,062	44,033
Investment income (loss)	2,029	(7,458)
Total revenue	419,474	420,570
Expenses for physician and other contracted services	345,571	354,311
Gross margin	73,903	66,259
Administrative and other expenses:		
Salaries and benefits	39,015	38,072
Physician administrative services	2,177	2,071
Technology support	9,536	11,290
Other purchased services	5,314	7,414
Rent	4,892	2,378
Depreciation and amortization	3,222	3,225
Other	2,780	3,677
Total administrative and other expenses	66,936	68,127
Net income (loss) before provision for income taxes	6,967	(1,868)
Provision for income taxes	(2,290)	(2,532)
Net income (loss)	$ 4,677	$ (4,400)

See notes to consolidated financial statements

Hill Physicians Medical Group, Inc.

Consolidated Statements of Changes in Shareholders' Equity
For the Years Ended December 31, 2009 and 2008
(in thousands of dollars)

	Common Stock Shares Authorized	Common Stock Shares Issued	Common Stock Par Amount	Additional Paid-In Capital	Net Unrealized Gain on Marketable Securities	Retained Earnings	Total Shareholders' Equity
Balance at December 31, 2007	1,000	278	$ 1	$ 306	$ 1,024	$ 31,635	$ 32,966
Comprehensive income:							
Net loss						(4,400)	(4,400)
Change in net unrealized gain on marketable securities - net of tax					(821)		(821)
Total comprehensive income							(5,221)
Issuance of common stock		42		21			21
Repurchase of common stock		(10)		(7)			(7)
Balance at December 31, 2008	1,000	310	1	320	203	27,235	27,759
Comprehensive income:							
Net income						4,677	4,677
Change in net unrealized gain on marketable securities - net of tax					4,426		4,426
Total comprehensive income							9,103
Issuance of common stock		41		21			21
Repurchase of common stock		(4)		(5)			(5)
Balance at December 31, 2009	1,000	347	$ 1	$ 336	$ 4,629	$ 31,912	$36,878

See notes to consolidated financial statements

Hill Physicians Medical Group, Inc.

Consolidated Statements of Cash Flows
For the Years Ended December 31, 2009 and 2008

(in thousands)

	2009	2008
Cash flows from operating activities:		
Net income (loss)	$ 4,677	$ (4,400)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	3,222	3,225
Recognized loss (gain) on marketable securities	(759)	9,149
Deferred taxes	(352)	(248)
Changes in current assets and liabilities:		
Accounts receivable and other	1,341	2,222
Prepaid expenses and other	123	400
Claims payable	(3,622)	(3,431)
Supplemental provider payments	4,957	(6,155)
Accounts payable and accrued liabilities	2,859	281
Accrued employee benefit liabilities	384	355
Net cash provided by operating activities	12,830	1,398
Cash flows from investing activities:		
Proceeds from sales of marketable securities	21,607	14,996
Purchases of marketable securities	(21,758)	(23,157)
Loans to physicians	-	(150)
Repayments of loans to physicians	135	14
Purchases of property and equipment	(2,230)	(2,375)
Net cash used in investing activities	(2,246)	(10,672)
Cash flows from financing activity:		
Issuances of common stock - net of repurchases	16	14
Net cash provided by financing activity	16	14
Net decrease in cash and cash equivalents	10,600	(9,260)
Cash and cash equivalents - beginning of year	20,510	29,770
Cash and cash equivalents - end of year	$ 31,110	$ 20,510
<u>Supplemental cash flow information</u>		
Income taxes paid - net of refund	$ 1,498	$ 1,300

See notes to consolidated financial statements

1. Organization and Purpose

Hill Physicians Medical Group, Inc. (Hill Physicians or the Company) is an independent practice association delivering medical care to health plan enrollees. Hill Physicians' emphasis is to provide medical care to enrollees under capitated contracts with health maintenance organizations (HMOs). Hill Physicians' mission is to control medical cost while delivering quality medical care and a high level of service through effective management and efficient operations. Hill Physicians is owned by 347 physicians and contracts with approximately 2,200 member-physician providers.

Hill Physicians has a management agreement with PriMed Management Consulting Services, Inc. (PriMed), which extends through 2015. Under terms of the agreement, PriMed provides strategic direction, contract negotiation, claims processing, utilization review, quality assurance, physician credentialing, accounting, and marketing services. PriMed is compensated based on its cost plus incentives related to revenue growth, operating results and administrative efficiency.

Hill Physicians' ownership interest in PriMed is being treated as a variable interest due to the management agreement terms. PriMed has been determined to qualify as a variable interest entity of Hill Physicians as a result of Hill Physicians being the primary beneficiary of PriMed. Accordingly, the financial statements of PriMed are included in the accompanying consolidated financial statements of Hill Physicians.

Hill Physicians owns preferred stock in PriMed, which results in a 28% ownership interest. This ownership interest is eliminated in the accompanying consolidated financial statements. The minority interest represents 72% outside ownership interest of common and preferred stocks in PriMed as of December 31, 2009 and 2008.

2. Summary of Significant Accounting Policies

Basis of Consolidation—The consolidated financial statements include PriMed. Significant intercompany accounts and transactions among consolidated entities have been eliminated.

Use of Estimates—The preparation of financial statements in conformity with accounting principles generally accepted 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenue Recognition—Hill Physicians contracts with HMOs to provide physician and other defined medical services for their enrollees. Four HMOs comprise 88 and 90 percent of capitation revenue in 2009 and 2008 respectively, with each HMO accounting for between 12 percent and 30 percent of capitation revenue in 2009 and between 11 percent and 32 percent in 2008.

Hill Physicians is paid for the majority of its contracted services on a capitated basis. Capitation revenue is recognized corresponding to the periods in which services are rendered. Hill Physicians is paid for certain services on a fee for service basis. These payments are included in other health plan revenue, and are estimated and accrued in the year in which services are performed. Hill Physicians participates in hospital utilization, pharmacy utilization, and quality incentive programs. Revenue from these programs is recognized when it is estimable and deemed probable of receipt. They are subject to periodic settlements based upon information from the HMOs.

Cash and Cash Equivalents—Cash and cash equivalents comprise cash in bank checking and money market accounts.

Marketable Securities—Marketable securities consist principally of domestic debt and equity securities. All marketable securities are classified as available for sale and are available to support current operations or to take advantage of other investment opportunities. These securities are stated at estimated fair market value based upon market quotes. Unrealized gains and losses are computed on the basis of specific identification and are included in the accompanying consolidated statements of changes in shareholders' equity. Other than temporary declines in market value below original cost are charged to investment losses in the consolidated statements of operations and a new basis for the security is established. Realized gains and losses from sales of assets are recorded as investment income in the consolidated statements of operations. Purchases and sales of marketable securities are recorded on a trade-date basis. Interest income is recorded on the accrual basis. Dividends are recorded on the ex-dividend date.

Property and Equipment—Property and equipment are stated at cost, and the related depreciation is calculated using a methodology that approximates the straight-line method of depreciation using estimated useful lives ranging from three to ten years for furniture and equipment and the shorter of the life of the lease or the assets' useful life for leasehold improvements.

Claims Payable—The costs of professional medical services rendered to members through the end of the year, but not yet paid, are accrued as claims payable. A portion of the claims payable represents an estimate of claims incurred but not yet reported.

Supplemental Provider Payments—Supplemental provider payments represent accruals for performance compensation awards to providers that are earned by the providers during the current year but paid in the first quarter of the succeeding year.

Comprehensive Income— Unrealized gains and losses on the Company's marketable securities are included in other comprehensive income, which is reflected in the consolidated statements of changes in shareholders' equity.

Income Taxes—The asset and liability method is used to recognize future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation reserves are recorded if the realizability of deferred tax assets is uncertain.

The Company files income tax returns in the U.S. Federal and in the State of California jurisdictions. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service for tax years 2006 and forward and, under the statute of limitations, by the State of California Franchise Tax Board for tax years 2005 and forward. The Company is not currently under federal or state income tax examination.

Recent Accounting Pronouncements — In December 2009, the Company adopted standards that amend the Variable Interest Entity (VIE) requirements for consolidation. These standards revise the test for determining the primary quantitative risks and rewards calculation based on the VIE's expected losses and expected residual returns to a primarily qualitative analysis based on identifying the party or related-party group with (a) the power to direct the activities that most significantly impact the VIE's economic performance and (b) the obligation to absorb losses of, or the right to receive benefits from, the VIE that could potentially be significant to the VIE. This requirement is effective for periods beginning after December 15, 2009 and may not be early adopted. The Company has evaluated the revised standards and does not believe there will be an effect on its consolidated financial statements.

Reclassifications —The 2008 financial statements have been reclassified to conform to the 2009 presentation.

3. Marketable Securities

The composition of marketable securities, based on quoted market prices, is as follows at December 31 (in thousands):

	2009		2008	
	Adjusted Cost	Fair Value and Carrying Amount	Adjusted Cost	Fair Value and Carrying Amount
Marketable equity securities	$ 14,450	$ 19,615	$ 11,559	$ 11,796
Marketable debt securities :				
0 to 5 years maturity	7,846	7,831	8,181	8,048
5 to 10 years maturity	3,574	3,782	5,911	6,059
Over 10 years maturity	3,649	3,784	2,955	3,047
Total	$ 29,519	$ 35,012	$ 28,606	$ 28,950

Marketable debt securities consist of municipal bonds and other government agency securities. Equity securities consist of domestic and international corporate equities.

The Company adopted revised standards for fair value measurements of financial assets and financial liabilities on January 1, 2008. The revised standards established a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The three levels of fair value hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the company has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs are unobservable inputs for the asset or liability.

The level in the fair value hierarchy within which a fair measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

The following table presents investments by level at December 31, 2009 (in thousands):

	2009	2008
Level 1	$ 15,384	$ 9,510
Level 2	19,628	19,440
Level 3	-	-
Total available for sale securities	$ 35,012	$ 28,950

All marketable debt securities are included in Level 2.

Investment income comprises the following for the years ended December 31, 2009 and 2008 (in thousands):

	2009	2008
Dividends	$ 198	$ 323
Capital gain distributions on mutual funds	-	34
Interest	692	668
Earnings on money market accounts and other	380	666
Recognized gain (loss) on sale of investments and other than temporary impairment	759	(9,149)
Total	$ 2,029	$ (7,458)

Upon determination that the market value of securities is other than temporarily impaired, adjustments are made to revalue the securities at current market value and recognize the unrealized loss. Hill Physicians incurred impairment charges of $103,000 and $8,416,000 in 2009 and 2008, respectively, to recognize unrealized losses deemed other than temporary.

4. Property and Equipment

Property and equipment at December 31, 2009 and 2008 consists of the following (in thousands):

	2009	2008
Leasehold improvements	$ 438	$ 1,799
Furniture and equipment	12,299	11,304
Application software	18,401	18,131
Construction in progress	588	886
Total	31,726	32,120
Less accumulated depreciation and amortization	(24,099)	(23,501)
Property and equipment - net	$ 7,627	$ 8,619

Depreciation and amortization expense was $3,222,000 and $3,225,000 for the years ended December 31, 2009 and 2008, respectively.

5. Employee Benefit Plan

PriMed offers a 401(k) tax deferred saving plan (the Plan) through The Principal Financial Group under which eligible employees, subject to certain limitations, may elect to have up to 20% of their salary deferred and contributed to the Plan. Employees become eligible to participate in the Plan in the quarter following their hire date. The amount of salary deferred is not subject to federal income tax at the time of deferral. PriMed matches 100% of the employees' contributions up to 6.5% of their salary. PriMed contributed $1,774,000 and $1,699,000 to the Plan in 2009 and 2008, respectively.

6. Income Taxes

The provision for income taxes consists of the following at December 31 (in thousands):

	2009	2008
Current federal taxes	$ 1,910	$ 1,359
Current state taxes	732	605
Deferred taxes	(352)	568
Total	$ 2,290	$ 2,532

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets are presented below at December 31 (in thousands):

	2009	2008
Deferred tax assets (liabilities):		
Vacation accrual	$ 756	$ 687
Depreciation	(1,748)	(1,342)
Deferred rent	976	0
State taxes	(46)	(59)
Tax effect of unrealized gains on securities	(865)	(140)
Other than temporary write-down of securities	2,329	3,163
Capital loss carryovers	1,276	1,012
Other	(250)	(233)
Total gross deferred tax assets	2,428	3,088
Less valuation allowances	(3,349)	(3,636)
Net deferred tax liabilities	$ (921)	$ (548)

Net deferred tax liabilities increased between 2009 and 2008 by $373,000 primarily due to an increase in deferred tax liabilities for temporary differences associated with depreciation expense and the tax effect of unrealized gains on securities. The realization of the deferred tax assets related to the other than temporary write down of marketable securities and capital loss carryovers is dependent on the generation of future taxable capital gains. Management does not believe the generation of such gains is likely within a reasonable number of years, and therefore, a valuation allowance equal to 100% of the deferred tax asset, less capital gain carryforward has been recorded for 2009.

The Company's marketable securities affected the Company's effective tax rate in 2009 and 2008. Income tax expense for 2009 and 2008 differed from the amount computed by applying the U. S. federal income tax rate of 34% primarily due to the valuation allowance applied to the unrealized loss on investments. Other differences arose in 2009 and 2008 due to state income taxes and tax exempt interest on the Company's marketable securities.

7. Related Party Transactions

Hill Physicians periodically makes investments to strengthen its provider network and to encourage physicians to expand their practices by making grants or loans to physicians. No such grants or loans were made to directors or officers of the company in 2009 or 2008.

8. Commitments and Contingencies

From time to time, the company may at times be a defendant in various actions arising from its healthcare services. No such actions that may have a material adverse effect on the company's financial position are currently pending.

Hill Physicians is a party to operating leases for office space that is occupied and paid for by PriMed and Hill Physicians. A new lease for office space was signed during 2008, which includes free rent periods. Hill Physicians and PriMed now occupy the new offices, and vacated their prior offices in 2009. The lease associated with the prior offices expires in February 2010. The schedule below reflects those periods where no rent will be paid; however, rent charged to operating expense will be the average rent paid per month over the life of the lease.

Future rental commitments, including office leases, are as follows (in thousands):

2010	$ 2,367
2011	2,930
2012	2,882
2013	2,631
2014	2,631
2015	2,631
2016	2,631
Total	$ 18,703

Rental expense incurred for 2009 and 2008 was $4,892,000 and $2,378,000, respectively. The 2009 expense included a one-time moving expense.

9. Subsequent Events

As a result of recently enacted and pending federal health care reform legislation, substantial changes are anticipated in the United States health care system. Such legislation includes numerous provisions affecting the delivery of health care services, the financing of health care costs, reimbursement of health care providers and the legal obligations of health insurers, providers and employers. These provisions are currently slated to take effect at specified times over approximately the next decade. This federal health care reform legislation does not affect the 2009 consolidated financial statements.

The Company has evaluated the subsequent events from the balance sheet date through May 5, 2010, the date at which the consolidated financial statements were available to be issued, and determined there are no other items to disclose.

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