



*Hill Physicians
Medical Group, Inc.*

**Consolidated Financial Statements for the
Years Ended December 31, 2010 and 2009
with Independent Auditors' Report Thereon**



KPMG LLP
Suite 1400
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, 2010 and 2009, 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 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 audit procedures that are appropriate in the circumstances, but not for the purpose of 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 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 of December 31, 2010 and 2009, 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 6, 2011

Hill Physicians Medical Group, Inc.

Consolidated Balance Sheets December 31, 2010 and 2009

(in thousands)

| | 2010 | 2009 |
|--|-------------------|------------------|
| <u>Assets</u> | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 47,448 | \$ 31,110 |
| Marketable securities | 37,798 | 35,012 |
| Accounts receivable: | | |
| Shared risk and pay for performance | 5,234 | 7,349 |
| Capitation and other receivables | 6,361 | 5,207 |
| Prepaid expenses and other | 1,712 | 1,133 |
| Deferred tax asset | 1,116 | 754 |
| Total current assets | 99,669 | 80,565 |
| Property and equipment, net | 7,313 | 7,627 |
| Other | 159 | 334 |
| Total assets | \$ 107,141 | \$ 88,526 |
| <u>Liabilities and shareholders' equity</u> | | |
| Current liabilities: | | |
| Claims payable | \$ 30,676 | \$ 24,518 |
| Supplemental provider payments | 16,708 | 14,000 |
| Accounts payable and accrued expenses | 5,577 | 2,897 |
| Accrued employee benefit liabilities | 4,440 | 3,965 |
| Total current liabilities | 57,401 | 45,380 |
| Deferred taxes and rent | 4,192 | 3,952 |
| Total liabilities | 61,593 | 49,332 |
| Shareholders' equity: | | |
| Common stock | 1 | 1 |
| Additional paid-in capital | 328 | 336 |
| Net unrealized gain on marketable securities | 5,561 | 4,629 |
| Retained earnings | 37,342 | 31,912 |
| Total shareholders' equity attributable to Hill | 43,232 | 36,878 |
| Noncontrolling interest | 2,316 | 2,316 |
| Total shareholders' equity | 45,548 | 39,194 |
| Total liabilities and shareholders' equity | \$ 107,141 | \$ 88,526 |

See accompanying notes to consolidated financial statements

Hill Physicians Medical Group, Inc.

Consolidated Statements of Operations Years Ended December 31, 2010 and 2009

(in thousands)

| | 2010 | 2009 |
|---|------------|------------|
| Revenue: | | |
| Health plan capitation revenue | \$ 419,005 | \$ 380,383 |
| Health plan and other revenue | 34,266 | 37,062 |
| Investment income | 1,854 | 2,029 |
| Total revenue | 455,125 | 419,474 |
| Expenses for physician and other contracted services | 377,010 | 345,571 |
| Gross margin | 78,115 | 73,903 |
| Administrative and other expenses: | | |
| Salaries and benefits | 42,193 | 39,015 |
| Physician administrative services | 2,142 | 2,177 |
| Technology support | 9,988 | 9,536 |
| Other purchased services | 6,760 | 5,314 |
| Rent | 2,798 | 4,892 |
| Depreciation and amortization | 2,759 | 3,222 |
| Other | 3,221 | 2,780 |
| Total administrative and other expenses | 69,861 | 66,936 |
| Net income before provision for income taxes | 8,254 | 6,967 |
| Provision for income taxes | (2,824) | (2,290) |
| Net income | \$ 5,430 | \$ 4,677 |

See accompanying notes to consolidated financial statements

Hill Physicians Medical Group, Inc.

Consolidated Statements of Changes in Shareholders' Equity For the Years Ended December 31, 2010 and 2009 (in thousands of dollars)

| | Common Stock | | Additional Paid-In Capital | Net Unrealized Gain on Marketable Securities | Retained Earnings | Non- Controlling Interest | Total Shareholders' Equity | |
|---|--------------|---------------|----------------------------------|--|----------------------|---------------------------------|----------------------------------|-----------------|
| | Shares | Par Amount | | | | | | |
| | Authorized | Issued | | | | | | |
| Balance at December 31, 2008 | 1,000 | 310 | \$ 1 | \$ 320 | \$ 203 | \$ 27,235 | \$ 2,316 | \$ 30,075 |
| 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 | 2,316 | 39,194 |
| Comprehensive income: | | | | | | | | |
| Net income | | | | | | 5,430 | | 5,430 |
| Change in net unrealized gain on marketable securities - net of tax | | | | | 932 | | | 932 |
| Total comprehensive income | | | | | | | | 6,362 |
| Issuance of common stock | | 3 | | 1 | | | | 1 |
| Repurchase of common stock | | (15) | | (9) | | | | (9) |
| Balance at December 31, 2010 | <u>1,000</u> | <u>335</u> | <u>\$ 1</u> | <u>\$ 328</u> | <u>\$ 5,561</u> | <u>\$ 37,342</u> | <u>\$ 2,316</u> | <u>\$45,548</u> |

See accompanying notes to consolidated financial statements

Hill Physicians Medical Group, Inc.

Consolidated Statements of Cash Flows

For the Years Ended December 31, 2010 and 2009

(in thousands)

| | <u>2010</u> | <u>2009</u> |
|---|------------------|------------------|
| Cash flows from operating activities: | | |
| Net income | \$ 5,430 | \$ 4,677 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 2,759 | 3,222 |
| Recognized gain on marketable securities | (562) | (759) |
| Deferred taxes | (331) | (352) |
| Changes in current assets and liabilities: | | |
| Accounts receivable and other | 961 | 1,341 |
| Prepaid expenses and other | (579) | 123 |
| Claims payable | 6,158 | (3,622) |
| Supplemental provider payments | 2,708 | 4,957 |
| Accounts payable and accrued liabilities | 2,570 | 2,859 |
| Accrued employee benefit liabilities | 475 | 384 |
| Net cash provided by operating activities | <u>19,589</u> | <u>12,830</u> |
| Cash flows from investing activities: | | |
| Proceeds from sales of marketable securities | 12,763 | 21,607 |
| Purchases of marketable securities | (13,736) | (21,758) |
| Repayments of loans to physicians | 175 | 135 |
| Purchases of property and equipment | (2,445) | (2,230) |
| Net cash used in investing activities | <u>(3,243)</u> | <u>(2,246)</u> |
| Cash flows from financing activity: | | |
| Issuances of common stock - net of repurchases | <u>(8)</u> | <u>16</u> |
| Net cash provided by (used in) financing activity | <u>(8)</u> | <u>16</u> |
| Net increase in cash and cash equivalents | 16,338 | 10,600 |
| Cash and cash equivalents - beginning of year | <u>31,110</u> | <u>20,510</u> |
| Cash and cash equivalents - end of year | <u>\$ 47,448</u> | <u>\$ 31,110</u> |
| <u>Supplemental cash flow information</u> | | |
| Income taxes paid - net of refund | <u>\$ 3,570</u> | <u>\$ 1,498</u> |

See accompanying notes to consolidated financial statements

Hill Physicians Medical Group, Inc.

Notes to the Consolidated Financial Statement December 31, 2010 and 2009

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 335 physicians and contracts with approximately 3,100 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 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 noncontrolling interest represents 72% outside ownership interest of common and preferred stocks in PriMed as of December 31, 2010 and 2009.

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 87 and 88 percent of capitation revenue in 2010 and 2009, respectively, with each HMO accounting for between 11 percent and 32 percent of capitation revenue in 2010 and between 12 percent and 30 percent in 2009.

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. It is 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 now 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. Management has elected to carry investments in trusts under the fair value option. 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 and the consolidated statements of operations. Purchase 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 cost of professional medical services rendered to members through the end of the year, but not yet paid, is 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 represents accruals for performance compensation awards to providers that are earned by the providers during a given 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 2007 and forward and, under the statute of limitations by the State of California Franchise Tax Board for tax years 2006 and forward. The Company is not currently under federal or state income tax examination.

Recent Accounting Pronouncements – In 2010, 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 the 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. The adoption of the revised standards did not have material impact on the Company’s financial position, results of operations, or cash flows.

In 2010, the company adopted standards that improve disclosures about fair value measurement. These standards revised the level of disaggregation of each class of assets and liabilities and require disclosures about the valuation techniques and inputs used to measure fair value for both recurring and non-recurring fair value measurements. Those disclosures are required for fair value measurements that fall in either Level 2 or Level 3. The adoption of the revised standards did not have material effect on the Company’s financial position, results of operations, or cash flows.

Reclassifications – Certain amounts in the 2009 financial statements have been reclassified to conform to the 2010 presentation.

3. Fair Value of Financial Instruments

The carrying amounts reported in the consolidated balance sheets for cash and cash equivalents, accounts receivables, claims payable, supplemental provider payments, accounts payable and accrued expenses, and accrued employee benefit liabilities approximate fair value.

Marketable securities are reported at fair value. The fair values of marketable securities are based on quoted market prices, if available, or are estimated using quoted market prices for similar investments.

The Company utilizes a three-level 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 of the fair value hierarchy for an asset class is based on the lowest level input that is significant to the fair value measurement of the asset class.

4. Marketable Securities

The following table presents the fair value measurements of investments by level at December 31 (in thousands):

| Asset Class | 2010 | | | 2009 | | |
|-------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|
| | Level 1 | Level 2 | Total | Level 1 | Level 2 | Total |
| Equity Securities: | | | | | | |
| Large-cap value | \$ 4,846 | | \$ 4,846 | \$ 4,343 | | \$ 4,343 |
| Large-cap growth | 4,069 | | 4,069 | 3,834 | | 3,834 |
| Mid-cap value | 1,648 | | 1,648 | 1,299 | | 1,299 |
| Mid-cap growth | 1,396 | | 1,396 | 1,002 | | 1,002 |
| International large-cap value | 4,356 | | 4,356 | 4,160 | | 4,160 |
| Emerging markets growth | 863 | | 863 | 746 | | 746 |
| Fixed Income Securities: | | | | | | |
| US Government agency bonds | | \$ 2,339 | 2,339 | | \$ 1,421 | 1,421 |
| Corporate notes | | 891 | 891 | | 411 | 411 |
| Mortgage-backed securities | | 120 | 120 | | 1,002 | 1,002 |
| Municipal securities | | 12,733 | 12,733 | | 12,563 | 12,563 |
| Other Investments: | | | | | | |
| Tax managed investment trust | | 4,537 | 4,537 | | 4,231 | 4,231 |
| Total: | \$ 17,178 | \$ 20,620 | \$ 37,798 | \$ 15,384 | \$ 19,628 | \$ 35,012 |

Management has elected to carry investments in trusts at fair value under the fair value option. The fair value of trusts has been determined using net asset value as a practical

expedient. The investment objective of the Company's trust investment is to achieve long-term capital growth on a total return basis through investments in equity and equity related securities of companies in a tax efficient manner. The Company's trust investment is redeemable weekly, and the Company has no unfunded commitments related to such investment.

Unrealized gains on securities are \$6,700,000 and \$5,500,000 at December 31, 2010 and 2009 respectively.

Maturities of marketable debt securities are as follows at December 31 (in thousands):

| | 2010 | | 2009 | |
|-----------------------------|------------------|--------------------------------------|------------------|--------------------------------------|
| | Adjusted Cost | Fair Value and Carrying Amount | Adjusted Cost | Fair Value and Carrying Amount |
| Marketable Debt Securities: | | | | |
| 0 to 5 years maturity | \$ 7,723 | \$ 7,640 | \$ 7,846 | \$ 7,831 |
| 5 to 10 years maturity | 3,812 | 4,025 | 3,574 | 3,782 |
| Over 10 years maturity | <u>4,384</u> | <u>4,418</u> | <u>3,649</u> | <u>3,784</u> |
| Total: | <u>\$ 15,919</u> | <u>\$ 16,083</u> | <u>\$ 15,069</u> | <u>\$ 15,397</u> |

Investment income comprises the following for the years ended December 31, 2010 and 2009 (in thousands):

| | 2010 | 2009 |
|---|-----------------|-----------------|
| Dividends | \$ 233 | \$ 198 |
| Interest | 630 | 692 |
| Earnings on money market accounts and other | 429 | 380 |
| Recognized gain on sale of investments and other than temporary impairment | <u>562</u> | <u>759</u> |
| Total: | <u>\$ 1,854</u> | <u>\$ 2,029</u> |

Gross realized gains from the sale of investment securities included in investment income were \$1,431,000 and \$2,376,000 in 2010 and 2009 respectively. Gross realized losses from the sale of investment securities included in investment income were \$651,000 and \$1,514,000 in 2010 and 2009, respectively.

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. As of December 31, 2010 and 2009 all decreases in the fair value of securities below original cost were determined to be other-than-temporary. Hill Physicians incurred impairment charges of \$218,000 and \$103,000 in 2010 and 2009, respectively, to recognize unrealized losses deemed other than temporary.

5. Property and Equipment

Property and equipment at December 31, 2010 and 2009 consists of the following (in thousands):

| | 2010 | 2009 |
|--|-----------------|-----------------|
| Leasehold improvements | \$ 442 | \$ 438 |
| Furniture and equipment | 9,238 | 7,802 |
| Application software | 12,810 | 11,917 |
| Construction in progress | 705 | 587 |
| Total: | \$ 23,195 | \$ 20,744 |
| Less accumulated depreciation and amortization | (15,882) | (13,117) |
| Property and equipment – net | <u>\$ 7,313</u> | <u>\$ 7,627</u> |

Depreciation and amortization expense was \$2,759,000 and \$3,222,000 for the years ended December 31, 2010 and 2009, respectively.

6. Employee Benefit Plan

PriMed offers a 401(k) tax deferred savings 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, subject to certain limitations, 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 \$1,788,000 and \$1,774,000 to the Plan in 2010 and 2009, respectively.

7. Income Taxes

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

| | 2010 | 2009 |
|-----------------------|-----------------|-----------------|
| Current federal taxes | \$ 2,383 | \$ 1,910 |
| Current state taxes | 772 | 732 |
| Deferred | (331) | (352) |
| Total: | <u>\$ 2,824</u> | <u>\$ 2,290</u> |

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):

| | <u>2010</u> | <u>2009</u> |
|---|-----------------|-----------------|
| Deferred tax assets (liabilities): | | |
| Vacation accrual | \$ 860 | \$ 756 |
| Depreciation | (1,899) | (1,748) |
| Deferred rent | 1,113 | 976 |
| State taxes | 207 | (46) |
| Tax effect of unrealized gains on securities | (1,185) | (865) |
| Other than temporary write-down of securities | 596 | 2,329 |
| Capital loss carryovers | 1,029 | 1,276 |
| Other | <u>(6)</u> | <u>(250)</u> |
| Total gross deferred tax assets | 715 | 2,428 |
| Less valuation allowances | <u>(1,625)</u> | <u>(3,349)</u> |
| Net deferred tax liabilities | <u>\$ (910)</u> | <u>\$ (921)</u> |

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 has not established a tax planning strategy to generate such gains. Therefore, a valuation allowance equal to 100% of these deferred tax assets has been recorded for 2010 and 2009.

The Company's marketable securities affected the Company's effective tax rate in 2010 and 2009. Income tax expense for 2010 and 2009 differed from the amount computed by applying the U.S. federal tax rate of 34% primarily due to the valuation allowance applied to the unrealized loss on investments. Other differences arose in 2010 and 2009 due to state income taxes and tax exempt interest on marketable securities.

8. 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. In 2010 and 2009, no such grants or loans were made to directors or officers of the company, or to an entity in which a director or officer has a direct or indirect material interest.

9. Commitments and Contingencies

From time to time, the Company may 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.

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

| | |
|--------|------------------|
| 2011 | \$ 2,913 |
| 2012 | 2,983 |
| 2013 | 2,752 |
| 2014 | 2,752 |
| 2015 | 2,752 |
| 2016 | <u>2,752</u> |
| Total: | <u>\$ 16,904</u> |

Rental expense incurred for 2010 and 2009 was \$2,798,000 and \$4,892,000, respectively. The 2009 expense includes one-time moving expenses.

10. Subsequent Events

The Company has evaluated the subsequent events from the balance sheet date through May 6, 2011 the date at which the consolidated financial statements were available to be issued, and determined there are no other items to disclose.