



HILL PHYSICIANS MEDICAL GROUP, INC. AND SUBSIDIARIES

Consolidated Financial Statements

December 31, 2020 and 2019

(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 financial statements of Hill Physicians Medical Group, Inc. and subsidiaries, which comprise the consolidated balance sheets as of December 31, 2020 and 2019, and the related consolidated statements of operations, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with U.S. generally accepted accounting principles; 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 audit 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 risks 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 Hill Physicians Medical Group, Inc. and subsidiaries as of December 31, 2020 and 2019, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

KPMG LLP

San Francisco, California
April 29, 2021

HILL PHYSICIANS MEDICAL GROUP, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

December 31, 2020 and 2019

(In thousands)

Assets	2020	2019
Current assets:		
Cash and cash equivalents	\$ 61,689	56,789
Marketable securities	63,186	45,185
Accounts receivable:		
Capitation and other receivables, net	19,326	11,573
Prepaid expenses and other	7,753	3,805
Total current assets	151,954	117,352
Property and equipment, net	64,842	77,190
Goodwill	1,549	1,971
Deferred taxes	1,747	2,088
Other assets	5,045	4,378
Total assets	\$ 225,137	202,979
Liabilities and Shareholders' Equity		
Current liabilities:		
Claims payable	\$ 33,882	29,904
Supplemental provider payments	17,368	10,892
Accounts payable and accrued liabilities	10,321	13,542
Accrued employee benefit liabilities	12,189	11,482
Health plan advance payable	5,000	—
Premium deficiency reserve	—	1,616
Short-term portion of capital lease obligation	1,145	1,107
Short-term portion of loans payable	268	61
Total current liabilities	80,173	68,604
Deferred rent	756	1,249
Deferred taxes	8,886	7,712
Other long-term liabilities	2,133	1,877
Capital lease obligation	587	1,732
Loans payable	5,827	5,919
Total liabilities	98,362	87,093
Shareholders' equity:		
Common stock	1	1
Additional paid-in capital	156	254
Retained earnings	121,252	110,390
Total shareholders' equity attributable to Hill	121,409	110,645
Noncontrolling interest	5,366	5,241
Total shareholders' equity	126,775	115,886
Total liabilities and shareholders' equity	\$ 225,137	202,979

See accompanying notes to consolidated financial statements.

HILL PHYSICIANS MEDICAL GROUP, INC. AND SUBSIDIARIES

Consolidated Statements of Operations

Years ended December 31, 2020 and 2019

(In thousands)

	<u>2020</u>	<u>2019</u>
Revenue:		
Health plan capitation revenue	\$ 464,963	479,998
Other revenue	84,233	65,641
Investment income, net	<u>5,141</u>	<u>6,401</u>
Total revenue	<u>554,337</u>	<u>552,040</u>
Expenses:		
Physician and other contracted services	402,406	405,358
Premium deficiency expense (gain)	<u>(1,616)</u>	<u>1,616</u>
Total physician and other contracted services	<u>400,790</u>	<u>406,974</u>
Gross margin	<u>153,547</u>	<u>145,066</u>
Administrative and other expenses:		
Salaries and benefits	85,397	79,043
Physician administrative services	1,838	1,920
Software maintenance and support	13,106	11,782
Other purchased services	13,450	20,300
Rent	5,046	4,322
Depreciation and amortization	17,923	17,218
Other	<u>2,311</u>	<u>3,818</u>
Total administrative and other expenses	<u>139,071</u>	<u>138,403</u>
Net income before provision for income taxes	14,476	6,663
Provision for income taxes	3,579	1,975
Net income attributable to noncontrolling interest	<u>125</u>	<u>314</u>
Net income	<u>\$ 10,772</u>	<u>4,374</u>

See accompanying notes to consolidated financial statements.

HILL PHYSICIANS MEDICAL GROUP, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders' Equity

Years ended December 31, 2020 and 2019

(In thousands of dollars)

	Common stock			Additional paid-in capital	Retained earnings	Noncontrolling interest	Total shareholders' equity
	Shares		Par amount				
	Authorized	Issued					
Balance at December 31, 2018	1,000	242	\$ 1	252	106,016	4,927	111,196
Comprehensive income:							
Net income	—	—	—	—	4,374	—	4,374
Change in noncontrolling interest	—	—	—	—	—	314	314
Issuance of common stock	—	24	—	24	—	—	24
Repurchase of common stock	—	(22)	—	(22)	—	—	(22)
Balance at December 31, 2019	1,000	244	1	254	110,390	5,241	115,886
Comprehensive income:							
Net income	—	—	—	—	10,772	—	10,772
Change in noncontrolling interest	—	—	—	—	—	125	125
Issuance of common stock	—	21	—	7	—	—	7
Repurchase of common stock	—	(22)	—	(15)	—	—	(15)
Other	—	—	—	(90)	90	—	—
Balance at December 31, 2020	1,000	243	\$ 1	156	121,252	5,366	126,775

See accompanying notes to consolidated financial statements.

HILL PHYSICIANS MEDICAL GROUP, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended December 31, 2020 and 2019

(In thousands)

	<u>2020</u>	<u>2019</u>
Cash flows from operating activities:		
Net income	\$ 10,772	4,374
Net change in noncontrolling interest	125	314
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	17,923	17,218
Gain on marketable securities	(3,855)	(4,630)
Deferred taxes	1,515	1,813
Deferred rent	(493)	(441)
Changes in assets and liabilities:		
Accounts receivable	(7,753)	5,493
Prepaid expenses and other	(3,948)	8,057
Other assets	(88)	(91)
Claims payable	3,978	1,368
Supplemental provider payments	6,476	87
Accounts payable and accrued liabilities	(3,530)	(8,099)
Accrued employee benefit liabilities, advance and other	2,084	(301)
Premium deficiency reserve	(1,616)	1,616
Net cash provided by operating activities	<u>21,590</u>	<u>26,778</u>
Cash flows from investing activities:		
Investment in healthcare venture	(579)	(803)
Proceeds from sales of marketable securities	18,264	17,358
Purchases of marketable securities	(32,410)	(18,659)
Purchases of property and equipment	(4,844)	(10,946)
Net cash used in investing activities	<u>(19,569)</u>	<u>(13,050)</u>
Cash flows from financing activities:		
Health plan advance	3,879	—
Paycheck Protection Program loan proceeds	175	—
Loan principal payments	(60)	(20)
Capital lease principal payments	(1,107)	(549)
Issuance of common stock	7	24
Repurchase of common stock	(15)	(22)
Net cash provided by (used in) financing activities	<u>2,879</u>	<u>(567)</u>
Net increase in cash and cash equivalents	4,900	13,161
Cash and cash equivalents – beginning of year	<u>56,789</u>	<u>43,628</u>
Cash and cash equivalents – end of year	\$ <u>61,689</u>	<u>56,789</u>
Supplemental cash flow information:		
Income taxes received (paid)	\$ (4,841)	8,539
Change in accrued purchases of property and equipment	309	(1,079)
Addition of equipment under capital leases	—	3,388

See accompanying notes to consolidated financial statements.

HILL PHYSICIANS MEDICAL GROUP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2020 and 2019

(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' 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 243 physicians and contracts with 5,005 member-physician providers.

Hill Physicians has a management services agreement with PriMed Management Consulting Services, Inc. (PriMed), which extends through 2033. 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 has an ownership interest in PriMed, which is considered a variable interest due to the management agreement terms. Hill Physicians has been determined to be the primary beneficiary of PriMed. Accordingly, the financial statements of PriMed are included in the accompanying consolidated financial statements.

Hill Physicians owns preferred stock in PriMed, which results in a 36% ownership interest. This ownership interest is eliminated in the accompanying consolidated financial statements. The noncontrolling interest represents 64% outside ownership interest in the common and preferred stocks of PriMed.

Hill Health, Inc. (Hill Health) is a California for-profit professional corporation, and its purpose is to employ physicians to provide medical services in Northern California.

Hill Physicians has provided loans totaling \$9,143,000 to Hill Health, which are considered a variable interest in Hill Health. Hill Physicians received \$6,000,000 of financing from health plans to fund loans for Hill Health. Hill Physicians has been determined to be the primary beneficiary of Hill Health. The financial statements of Hill Health are included in the accompanying consolidated financial statements.

Hill Physicians Care Solutions, Inc. (HPCS) was formed in September 2019 and operations began September 2020. HPCS applied and was granted a limited Knox-Keene license with the California Department of Managed Health Care (DMHC) to enter into contracts with full-service health care service plans to arrange for and manage the care of enrollees. Hill Physicians contributed \$2,500,000 to and has 100% ownership of HPCS. The financial statements of HPCS are included in the accompanying consolidated financial statements.

(2) Summary of Significant Accounting Policies

(a) Basis of Consolidation

The consolidated financial statements include PriMed, Hill Health and HPCS. Significant intercompany accounts and transactions among consolidated entities have been eliminated.

(b) Use of Estimates

The preparation of the consolidated financial statements in conformity with U.S. generally accepted accounting principles 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

HILL PHYSICIANS MEDICAL GROUP, INC. AND SUBSIDIARIES

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December 31, 2020 and 2019

of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

(c) Cash and Cash Equivalents

Cash comprises cash in bank checking and money market accounts. Cash equivalents include all highly liquid investments with maturity of three months or less when purchased. The Company holds the majority of its cash at a single bank. Consequently, the Company's bank balances may exceed federal deposit insurance limits.

(d) Marketable Securities

Marketable securities consist principally of domestic debt and equity securities. The Company accounts for its marketable securities under the fair value method of accounting. Under this method, unrealized gains and losses are recorded in investment income in the accompanying 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.

(e) Property and Equipment

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

(f) Goodwill

Goodwill represents the excess of the amount paid by Hill Physicians over the book value of the shares purchased for a portion of its ownership in PriMed. Goodwill is amortized on a straight-line basis over ten years.

(g) Claims Payable

The cost of professional and institutional 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. Because of the degree of estimation involved in determining the claims payable liability, the actual amount paid in subsequent periods is likely to differ from the recorded liability.

(h) Supplemental Provider Payments

Supplemental provider payments represent accruals for performance compensation awards to providers that are earned by the providers during a given year but paid in the succeeding year.

(i) Premium Deficiency Reserve

Hill Physicians performs premium deficiency reserve testing at the line of business level. Reserves and the related expenses are recognized when projected provider payments and allocated maintenance costs are expected to exceed anticipated revenues over the contract period. At December 31, 2020

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and 2019, premium deficiency reserves were \$0 and \$1,616,000, respectively, related to the managed MediCal line of business. Investment income was not included in the premium deficiency testing. Given the inherent variability of such estimates, the actual liability could differ significantly from the calculated amount.

(j) Health Plan Advance

Hill Physicians received an interest-free advance from a health plan to provide assistance for providers who have experienced hardship during the COVID-19 pandemic. The advance received totaled \$5,000,000 and is to be repaid in twelve equal installments in 2021.

(k) Revenue Recognition

The Company recognizes revenue based on the estimated transaction price expected to be collected as a result of satisfying performance obligations. Revenue primarily consists of capitation, fee-for-service arrangements, care management fees, grant programs, and quality and risk sharing incentive arrangements.

(i) Capitation

Hill Physicians and HPCS contracts with Health Maintenance Organizations (HMO) to provide physician and other defined medical services for their enrollees. Capitation revenue is recorded in the month in which enrollees are entitled to receive medical services. Five HMOs in 2020 and 2019 comprise 79% and 83% of capitation revenue, respectively, with each HMO accounting for between 11% and 28% of capitation revenue in 2020 and between 9% and 26% of capitation revenue in 2019.

(ii) Fee for Service

Hill Physicians contracts with Preferred Provider Organizations (PPO) to provide physician services through a clinically integrated network. Revenue is recorded on a fee-for-service basis as services are provided.

Many HMO contracts include provisions where certain injectable drugs and other medical services are reimbursed by health plans on a fee-for-service basis. Hill Physicians recognizes revenue based on the claims submitted to health plans with an estimate for claims incurred-but-not reported.

Hill Health is paid for a majority of its contracted services on a fee-for-service basis with several payers. Contractually adjusted revenue is recorded as services are provided.

(iii) Care Management Programs

Hill Physicians contracts with health plans and other partners to provide care management services to enrollees attributed to various programs. Care management revenue is recorded in the month in which attributed enrollees are entitled to receive care management services.

(iv) Grant Programs

Hill Physicians participates in grant programs with health plans to fund the costs of special programs and initiatives. Revenue is recognized as related costs are incurred.

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(v) *Quality and Shared Risk Incentive Arrangements*

Under quality and shared risk incentive arrangements, Hill Physicians can earn incentives based on quality and total cost performance. Reliable performance information is not normally available until several months after the program period. Hill Physicians recognizes revenue based on third-party final performance statements.

(l) **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 basis and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using 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. A valuation allowance is recorded if the realizability of deferred tax assets is uncertain.

The Company recognizes the benefit of uncertain tax positions only if those positions are more likely than not of being sustained. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs.

The Company, PriMed, and Hill Health file separate Federal and State of California income tax returns. HPCS files Federal and State of California income tax returns on a consolidated basis as a subsidiary of and inclusive with the Company.

(m) **Recently Issued Accounting Pronouncements**

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*, aimed at making leasing activities more transparent and comparable. The new standard requires substantially all leases, including operating leases, be recognized by lessees on their balance sheet as a right-of-use asset and corresponding lease liability. ASU No. 2016-02 is effective for the Company on January 1, 2022, and early adoption is permitted. The Company has reviewed its leases and in the process of assessing the impact of Topic 842. At the time of adoption, the Company will record a significant right of use asset and a corresponding lease liability

(3) **Risks and Uncertainty**

On January 30, 2020, the World Health Organization declared the outbreak of COVID-19 as a “public health emergency of international concern,” and on March 13, 2020, the President of the United States declared a state of national emergency. COVID-19 has precipitated both a health crisis and economic uncertainty and has impacted the markets in which the Company operates.

COVID-19’s overall impact on the Company will be driven primarily by the severity and duration of the pandemic; the pandemic’s impact on the United States economy and the timing, scope, and effectiveness of federal, state, and local governmental responses to the pandemic. Those primary drivers are uncertain and beyond management’s control and may adversely impact the Company’s membership levels, healthcare expenses, supply chain, values of investments, and workforce, among other aspects of the Company’s business.

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(4) Fair Value of Financial Instruments – Marketable Securities

The carrying amounts reported in the consolidated balance sheets for cash and cash equivalents, accounts receivable, claims payable, supplemental provider payments, accounts payable and accrued liabilities, and accrued employee benefit liabilities approximate fair value due to the short maturities of these financial instruments.

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.

The following table presents the fair value measurements of investments by level at December 31, 2020 and 2019 (in thousands):

	2020			2019		
	Level 1	Level 2	Total	Level 1	Level 2	Total
Fixed-income securities:						
Municipal securities	\$ —	35,270	35,270	—	21,640	21,640
Equity securities:						
U.S. common stock	16,113	—	16,113	13,333	—	13,333
Foreign common stock	3,252	—	3,252	3,122	—	3,122
Mutual funds	5,649	—	5,649	2,172	—	2,172
Exchange traded funds	2,883	—	2,883	4,918	—	4,918
Master limited partnership	19	—	19	—	—	—
Total	<u>\$ 27,916</u>	<u>35,270</u>	<u>63,186</u>	<u>23,545</u>	<u>21,640</u>	<u>45,185</u>

Transfers between fair value input levels, if any, are recorded at the end of the reporting period. During the years ended December 31, 2020 and 2019, there were no transfers between Level 1 and Level 2 investments.

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Maturities of fixed-income securities are as follows at December 31, 2020 and 2019 (in thousands):

	2020		2019	
	Adjusted cost	Fair value and carrying amount	Adjusted cost	Fair value and carrying amount
Fixed-income securities:				
0 to 5 years maturity	\$ 18,246	18,487	10,679	10,817
5 to 10 years maturity	7,924	8,336	5,386	5,694
Over 10 years maturity	8,317	8,447	5,071	5,129
Total	\$ <u>34,487</u>	<u>35,270</u>	<u>21,136</u>	<u>21,640</u>

Investment income comprises the following for the years ended December 31, 2020 and 2019 (in thousands):

	2020	2019
Interest and dividends	\$ 1,286	1,771
Realized gains	448	364
Unrealized gain	3,407	4,266
Total	\$ <u>5,141</u>	<u>6,401</u>

(5) Property and Equipment

Property and equipment consists of the following at December 31, 2020 and 2019 (in thousands):

	2020	2019
Leasehold improvements	\$ 900	862
Furniture and equipment	7,313	7,155
Application software	136,987	131,390
Technology projects in progress	397	1,037
Total	145,597	140,444
Less accumulated depreciation and amortization	<u>(80,755)</u>	<u>(63,254)</u>
Property and equipment – net	\$ <u>64,842</u>	<u>77,190</u>

(6) Loans Payable

As part of a coordinated plan to provide funding for and to support the formation and development of Hill Health, Hill Physicians entered into loan agreements with two health plans to borrow up to \$4,000,000 from each, for a total of \$8,000,000. The loans accrue interest at a rate of 3.25% per annum with respect to all

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amounts outstanding and unpaid. In 2019, amendments to the loan agreements were made to extend the repayment period from 10 years to 30 years. As of December 31, 2020 and 2019, the outstanding balance of the loans payable to the health plans is \$5,920,000 and \$5,980,000, respectively. Accrued interest payable as of December 31, 2020 and 2019 is \$444,000 and \$346,000, respectively.

Up to \$3,000,000 of the December 31, 2020 loan payable balance to the health plans is forgivable upon Hill Health's achievement of certain milestones and performance standards. Hill Physicians is only responsible for making payments on the loans payable to the health plans from payments received on the loan receivable from Hill Health.

In 2020, Hill Health received loan proceeds of \$175,000 under the Paycheck Protection Program ("PPP"). The PPP, established as part of the Coronavirus Aid, Relief and Economic Security Act ("CARES Act"), provides for loans to qualifying businesses for amounts up to 2.5 times of the average monthly payroll expenses of the qualifying business. The loan and accrued interest are forgivable if the loan proceeds are used for eligible purposes. The unforgiven portion of the PPP loan accrues interest at 1.00% and is payable over two years. The Company has accounted for the PPP loan as debt under Accounting Standards Codification (ASC) 470, *Debt*.

As of December 31, 2020, the outstanding balance of the PPP loan payable is \$175,000. Accrued interest payable as of December 31, 2020 is \$1,000.

Future scheduled principal payments on the loans payable as of December 31, 2020 are as follows (in thousands):

	Loans payable
2021	\$ 199
2022	154
2023	129
2024	133
2025	137
Thereafter	<u>5,343</u>
Total	<u>\$ 6,095</u>

(7) Employee Benefit Plan

PriMed and Hill Health both offer 401(k) tax deferred savings plans (the Plans) through The Principal Financial Group, under which eligible employees, subject to certain limitations, may elect to have up to 80% for PriMed and Hill Health, respectively, of their salary deferred and contributed to the Plans.

Employees become eligible to participate in the Plans in the month or quarter, for PriMed and Hill Health, respectively, following their hire date. The amount of salary deferred is not subject to federal income tax at the time of deferral. PriMed and Hill Health matches 100% of the employees' contributions up to 6.5% and 6.0%, respectively, of their salary. PriMed contributed \$3,517,000 and \$3,321,000 to the Plan in 2020 and

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2019, respectively. Hill Health contributed \$65,000 and \$63,000 to the Plans in 2020 and 2019, respectively.

(8) Income Taxes

The provision (benefit) for income taxes consists of the following for the years ended December 31, 2020 and 2019 (in thousands):

	2020	2019
Current federal taxes	\$ 1,546	(24)
Current state taxes	518	186
Deferred	1,515	1,813
Total	\$ 3,579	1,975

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities are presented below at December 31, 2020 and 2019 (in thousands):

	2020	2019
Deferred tax assets (liabilities):		
Vacation accrual	\$ 878	946
Depreciation	(15,806)	(17,796)
Deferred rent	226	373
Premium deficiency reserve	—	482
State taxes	530	106
Tax effect of unrealized gains on securities	(2,252)	(1,296)
Prepaid expenses	(1,293)	(906)
Nonqualified deferred compensation	454	428
Long-term incentive plan	703	679
Net operating loss	8,711	10,368
Research and development credit	3,167	3,402
Distribution payable	337	—
Alternative minimum tax	35	65
Other	70	37
Total gross deferred tax liability	(4,240)	(3,112)
Less valuation allowance	(2,899)	(2,512)
Net deferred tax liability	\$ (7,139)	(5,624)

As of December 31, 2020, PriMed has federal and California research and development tax credits of \$3,031,000 and \$1,270,000, respectively. The federal research and development credits have an expiration date of 20 years and will begin expiring in 2033. The California research and development credits have no expiration dates.

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In assessing the realizability of the deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. Based upon the projected future operating trends and the expected reversal of deferred tax liabilities, management believes it is more likely than not that PriMed and Hill Health will be unable to realize a portion of these deductible differences. Accordingly, a valuation allowance of \$2,899,000 and \$2,512,000 is recorded as of December 31, 2020 and 2019, respectively.

Income tax expense for 2020 differed from the amount computed by applying the U.S. federal tax rate of 21% primarily due to state taxes and a rate differential on a carryback. Income tax expense for 2019 differed from the amount computed by applying the U.S. federal tax rate of 21% primarily due to state taxes and goodwill amortization.

The Company files income tax returns in the U.S. Federal and in the State of California tax jurisdictions. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service for tax years 2017 and forward and under the statute of limitations by the State of California Franchise Tax Board for tax years 2016 and forward.

(9) Commitments and Contingencies

In 2019, the Company entered into a line of credit agreement with a bank in the amount of \$20,000,000, which expires August 27, 2021. Any unpaid balance accrues interest at LIBOR daily rate plus 1.25% and is payable monthly. Under the terms of the agreement, the Company is required to maintain a debt service coverage ratio and unrestricted cash and investments to senior committed debt ratio, as defined. There have been no borrowings against this line of credit.

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.

The Company is required to periodically file financial statements and other information with the DMHC and is in compliance with regulatory requirements.

(10) Operating Leases

The Company, PriMed, and Hill Health have entered into certain operating leases for office space, hardware and software. Expenses in connection with these leases are recognized on a straight-line basis over the life of the lease. Accrued but unpaid rent is \$756,000 and \$1,249,000 at December 31, 2020 and 2019, respectively.

HILL PHYSICIANS MEDICAL GROUP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2020 and 2019

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

2021	\$	5,730
2022		3,679
2023		4,737
2024		4,875
2025		5,016
Thereafter		<u>2,320</u>
Total	\$	<u><u>26,357</u></u>

(11) Capital Lease

In 2019, Hill Physicians and PriMed entered into a capital lease arrangement to lease software totaling \$3,389,000. The leased software is depreciated on a straight-line basis over three years. Total accumulated depreciation related to the leased software is \$1,657,000 as of December 31, 2020. The interest rate was calculated using LIBOR plus 1.25%, which approximates 3.37%.

Future capital lease commitments are as follows (in thousands):

Year ending December 31:		
2021	\$	1,186
2022		<u>592</u>
Total minimum lease payments		1,778
Less amount representing interest		<u>46</u>
Present value of minimum lease payments	\$	<u><u>1,732</u></u>

(12) Subsequent Events

The Company has evaluated the subsequent events from the consolidated balance sheet date through April 29, 2021, the date at which the consolidated financial statements were available to be issued, and determined there are no additional items to disclose.