PACIFICSOURCE HEALTH PLANS
AND SUBSIDIARIES

INDEPENDENT AUDITORS' REPORT

and

CONSOLIDATED FINANCIAL STATEMENTS
AND SUPPLEMENTAL INFORMATION

YEARS ENDED DECEMBER 31, 2011 AND 2010

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES

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KERNUTTSTOKES

INDEPENDENT AUDITORS' REPORT

Board of Trustees
PacificSource Health Plans and Subsidiaries:

We have audited the accompanying consolidated balance sheets of PacificSource Health Plans and Subsidiaries (the Company) as of December 31, 2011 and 2010, and the related consolidated statements of income, comprehensive income, fund balance 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 audits to obtain reasonable assurance about whether the consolidated 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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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 the Company as of December 31, 2011 and 2010, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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 relates 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 9, 2012

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES

Consolidated Balance Sheets

	December 31 2011	December 31 2010
ASSETS		
Investments	$ 157,773,378	$ 125,678,610
Cash and cash equivalents	25,849,704	42,529,263
Trust funds	4,549,629	7,234,012
Accounts receivable	21,755,372	18,245,327
Prepaid expenses and deposits	4,094,227	4,814,221
Prepaid income taxes	1,014,700	3,425,859
Prepaid pension costs	-	885,062
Property, net	50,015,825	54,940,724
Goodwill	12,611,772	13,611,772
Intangible assets, net	8,989,732	10,297,789
Group life insurance and purchased annuities	1,950,895	1,992,959
Total	$ 288,605,234	$ 283,655,598
LIABILITIES AND FUND BALANCE		
LIABILITIES:		
Unpaid claims and claims adjustment expenses	$ 76,902,301	$ 75,534,434
Book overdraft	4,664,460	849,966
Line of credit	2,420,660	-
Accounts payable	6,126,305	8,881,661
Accrued expenses	6,483,726	6,816,610
Accrued pension liability	4,714,111	-
Unearned premiums	7,508,388	6,636,517
Payable for securities	-	180,374
Incentive compensation payable under managed care plans	2,706,986	1,434,872
Accrued retro settlements	1,290,224	1,126,571
Collections for others	4,549,629	7,234,012
Deferred compensation payable to member physicians	1,950,895	1,992,959
Deferred tax liabilities	2,612,177	4,230,309
Notes payable	11,073,231	14,771,999
Total	133,003,093	129,690,284
FUND BALANCE:		
Fund balance, unrestricted	162,151,267	154,496,481
Accumulated other comprehensive loss	(6,923,261)	(854,574)
Noncontrolling interests	374,135	323,407
Total	155,602,141	153,965,314
Total	$ 288,605,234	$ 283,655,598

See accompanying notes.

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES

Consolidated Statements of Income

	Year Ended December 31 2011	2010
PREMIUMS:		
Commercial premiums	$ 652,038,430	$ 600,854,513
Medicare premiums	118,468,331	69,590,212
Medicaid premiums	126,604,314	55,950,516
Total	897,111,075	726,395,241
CLAIMS EXPENSE:		
Commercial	576,116,555	524,513,614
Medicare	87,179,015	44,569,021
Medicaid	121,352,244	46,005,070
Commissions on premiums	18,281,981	18,586,464
Total	802,929,795	633,674,169
EXCESS OF PREMIUMS OVER CLAIMS EXPENSE	94,181,280	92,721,072
ADMINISTRATIVE SERVICE CONTRACTS:		
Payments received from self-insured employers	2,128,379	1,203,079
Claims paid on behalf of self-insured employers	(525,309)	(229,384)
Service fees earned	1,603,070	973,695
EXCESS OF PREMIUMS AND FEES OVER COSTS	95,784,350	93,694,767
ADMINISTRATIVE REVENUES	12,116,141	11,471,676
GENERAL AND ADMINISTRATIVE EXPENSES	100,104,083	88,201,183
UNDERWRITING GAIN	7,796,408	16,965,260
OTHER INCOME (EXPENSE):		
Investment income	6,722,674	7,696,837
Interest expense	(1,134,168)	(771,605)
Charitable contributions	(1,135,634)	(2,011,364)
Miscellaneous expense	(86,962)	(192,260)
Total	4,365,910	4,721,608
INCOME BEFORE INCOME TAXES	12,162,318	21,686,868
INCOME TAX EXPENSE	4,442,526	8,047,389
TOTAL INCOME	7,719,792	13,639,479
LESS INCOME ATTRIBUTABLE TO NONCONTROLLING INTERESTS	65,006	56,995
NET INCOME	$ 7,654,786	$ 13,582,484

See accompanying notes.

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES
Consolidated Statements of Comprehensive Income

	Year Ended December 31	
	2011	**2010**
NET INCOME	$ 7,654,786	$ 13,582,484
OTHER COMPREHENSIVE (LOSS) INCOME, NET OF TAXES:		
Unrealized appreciation and depreciation of investments available-for-sale	(2,760,395)	1,306,343
Reclassification adjustment for gains and losses realized in net income	151,920	1,119,952
Net unrealized appreciation and depreciation	(2,608,475)	2,426,295
Deferred income taxes	822,000	(982,000)
Unrealized appreciation and depreciation of investments available-for-sale, net of deferred taxes	(1,786,475)	1,444,295
Defined benefit pension plan net loss and prior service credit	(7,062,212)	(886,545)
Deferred income taxes	2,780,000	350,000
Defined benefit pension plan adjustments, net of deferred taxes	(4,282,212)	(536,545)
Total other comprehensive (loss) income	(6,068,687)	907,750
COMPREHENSIVE INCOME	$ 1,586,099	$ 14,490,234

See accompanying notes.

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES
Consolidated Statements of Fund Balance

	Fund Balance	Accumulated Other Comprehensive Income (Loss)	Noncontrolling Interests	Total
BALANCE, January 1, 2010	$ 140,913,997	$ (1,762,324)	$ 281,781	$ 139,433,454
Net income	13,582,484	-	56,995	13,639,479
Redemption of IPN common stock	-	-	(15,369)	(15,369)
Unrealized appreciation of investments available-for-sale (net of reclassification adjustment), net of deferred taxes of $982,000	-	1,444,295	-	1,444,295
Defined benefit pension plan net loss and prior service credit, net of deferred taxes of $350,000	-	(536,545)	-	(536,545)
BALANCE, December 31, 2010	154,496,481	(854,574)	323,407	153,965,314
Net income	7,654,786	-	65,006	7,719,792
Redemption of IPN common stock	-	-	(14,278)	(14,278)
Unrealized depreciation of investments available-for-sale (net of reclassification adjustment), net of deferred taxes of $822,000	-	(1,786,475)	-	(1,786,475)
Defined benefit pension plan net loss and prior service credit, net of deferred taxes of $2,780,000	-	(4,282,212)	-	(4,282,212)
BALANCE, December 31, 2011	$ 162,151,267	$ (6,923,261)	$ 374,135	$ 155,602,141

See accompanying notes.

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Change in Cash and Cash Equivalents

	Year Ended December 31 2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Premiums collected	$ 896,103,503	$ 732,180,413
Claims paid	(800,126,161)	(637,810,758)
General and administrative expenses paid	(90,183,102)	(93,436,945)
Investment income received	5,296,200	3,807,981
Other revenue received	12,116,141	9,164,589
Interest paid	(1,135,067)	(772,443)
Income taxes paid	(47,499)	(223,726)
Net cash provided by operating activities	22,024,015	12,909,111
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from sale of investments	112,073,582	241,494,954
Investments purchased	(145,015,481)	(205,495,498)
Payment for purchase of PacificSource Community Health Plans Inc. (Formerly Clear One Health Plans, Inc.), net of cash acquired	-	(33,598,919)
Proceeds from sale of Trusteed Plans Service Corporation (TPSC), net of cash disposed	608,523	-
Proceeds from sale of property	15,810	8,750
Property purchased	(5,093,622)	(3,903,678)
Net cash used in investing activities	(37,411,188)	(1,494,391)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net proceeds from line of credit	2,420,660	-
Payments on notes payable	(3,698,768)	(278,763)
Redemption of common stock	(14,278)	(15,369)
Net cash used in financing activities	(1,292,386)	(294,132)
CHANGE IN CASH AND CASH EQUIVALENTS	(16,679,559)	11,120,588
CASH AND CASH EQUIVALENTS, beginning of year	42,529,263	31,408,675
CASH AND CASH EQUIVALENTS, end of year	$ 25,849,704	$ 42,529,263

(Continued)

See accompanying notes.

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES
Consolidated Statements of Cash Flows (Continued)

Reconciliation of Net Income to Net Cash Provided by Operating Activities

	Year Ended December 31 2011	2010
NET INCOME	$ 7,654,786	$ 13,582,484
ADJUSTMENTS TO RECONCILE NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Income attributable to noncontrolling interest	65,006	56,995
Depreciation and amortization	10,237,547	8,213,476
Deferred tax expense	1,983,868	7,241,827
Gain on sale of investments	(1,162,082)	(4,343,503)
Loss on disposal of property	845,225	107,820
Adjustments resulting from changes in:		
Accounts receivable	(3,482,513)	7,394,822
Accrued investment income	(264,392)	73,483
Prepaid income taxes	2,411,159	578,617
Prepaid (accrued) pension costs	(1,463,039)	(1,706,474)
Prepaid expenses and deposits	663,424	(963,553)
Unpaid claims and claims adjustment expenses	1,367,867	(6,296,043)
Book overdraft	3,814,494	849,966
Accounts payable	(2,676,631)	(5,982,342)
Unearned premiums	871,871	(4,700,174)
Incentive compensation payable	1,272,114	(78,565)
Accrued retro settlements	163,653	1,350,817
Accrued expenses	(278,342)	(2,470,542)
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 22,024,015	$ 12,909,111

(Continued)

See accompanying notes.

Schedule of Noncash Investing Activities

The following is a summary of transactions in the deferred compensation plan with respect to member physicians for 2011 and 2010:

	Group Life Insurance Contract	Annuity Contracts	Total
Balance at December 31, 2009	$ 1,575,786	$ 478,517	$ 2,054,303
Earnings on contracts, net	62,736	23,189	85,925
Purchase of annuity	(4,909)	4,909	-
Payments to annuitants	-	(147,269)	(147,269)
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

Other Non-Cash Investing and Financing Activities

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.

The Company has a payable of $0 and $180,374 at December 31, 2011 and 2010, respectively, for securities that were purchased but had not settled by year-end.

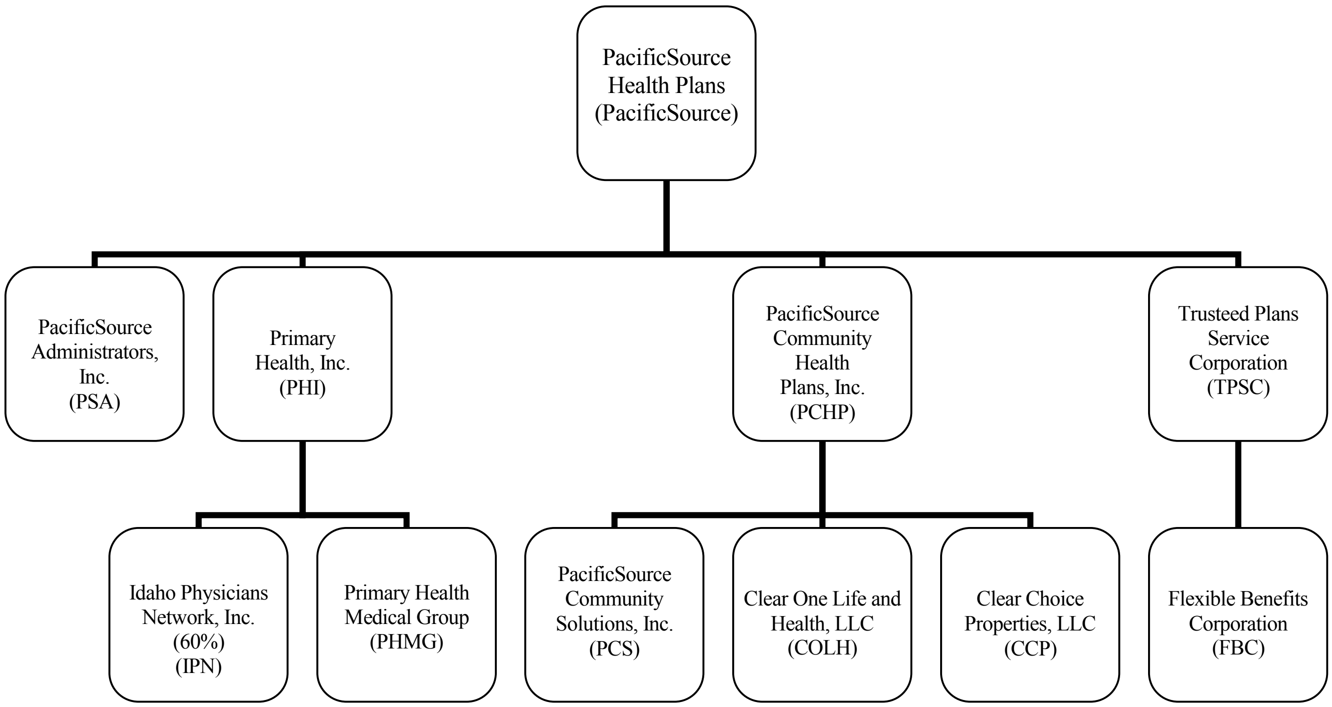
At December 31, 2011, there was unrealized appreciation and depreciation of investments, net of reclassification adjustments of $2,608,475 with deferred taxes of $822,000. At December 31, 2010, there was unrealized appreciation and depreciation of investments, net of reclassification adjustments of $2,426,295 with deferred taxes of $982,000.

At December 31, 2011, there were defined benefit pension plan adjustments of $7,062,212 with deferred taxes of $2,780,000. At December 31, 2010, there were defined benefit pension plan adjustments of $886,545 with deferred taxes of $350,000.

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 are as follows:

	2011		2010	
PacificSource	$ 646,938,875	71.2%	$ 585,171,853	79.3%
PCHP and subsidiaries	250,297,460	27.5%	141,266,588	19.1%
PSA	4,715,315	0.5%	5,998,278	0.8%
TPSC and subsidiary	4,885,949	0.5%	3,315,371	0.5%
PHI and subsidiaries	2,389,617	0.3%	2,114,827	0.3%
Gross revenue	$ 909,227,216	100.0%	$ 737,866,917	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 (formerly Clear One Health Plans, Inc.) and TPSC. All significant intercompany balances and transactions have been eliminated in the consolidation.

(Continued)

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

PacificSource purchased a 100% interest in PCHP, an Oregon domiciled stock insurance company, and its wholly owned subsidiaries PCS (formerly Central Oregon Individual Health Solutions, Inc.), CCP, COLH and TPSC on May 21, 2010 for $45,497,600. (See Note 2.) Subsequent to the acquisition, PCHP distributed TPSC to PacificSource. TPSC is the 100% owner of FBC, a Washington based for-profit non-insurance entity. TPSC was sold effective November 30, 2011.

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 supplement products and, through their subsidiary, Medicaid plans.

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.

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. 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 practices (SAP) used by regulatory authorities.

Operations. Services include commercial medical and dental insurance plans, Medicare and Medicaid policies. The Company had written policies at December 31 follows:

	2011	**2010**
Commercial	192,892	179,856
Medicare	10,691	9,430
Medicaid	41,662	34,529
Total	245,245	223,815

(Continued)

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

Codification. The National Association of Insurance Commissioners (NAIC) completed a process to codify statutory accounting practices for certain insurance enterprises (codification). Codification became effective on January 1, 2001. The insurance laws and regulations of the State of Oregon require insurance companies domiciled in the state to comply with the guidance provided in the NAIC Accounting Practices and Procedures Manual except as prescribed or permitted by state law.

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. The 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, 2011, 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 and $2,611,472 as of December 31, 2011 and 2010, respectively.

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.

(Continued)

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

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, 2011 and 2010, management determined that an allowance of approximately $0 and $195,000, respectively, was necessary.

As of December 31, 2011 and 2010, pharmacy rebates were approximately $6.1 million and $4.8 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 the realizability of goodwill 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, 2011 and 2010, 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.

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.

(Continued)

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 $373,943 and $317,472 at December 31, 2011 and 2010, respectively, and are recorded in prepaid expenses and deposits on the consolidated balance sheets. The Company contributed $27,906 and $21,196 to the plan for 2011 and 2010, 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 state and local income tax examinations by tax authorities for years prior to 2008 in jurisdictions where tax returns have been filed, as the statute of limitations has expired on those years. The Company recently completed an IRS examination for federal tax years 2005 through 2008 and there was no adjustment to federal tax liability based on the examination.

Statutory Capital Reserves. PacificSource and PCHP are required by Oregon law to maintain minimum capital reserves of 50% of their average monthly claims incurred during the last 12 months, to a minimum of $2,500,000; this amount is included in the fund balance.

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.

(Continued)

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 $2,579,446 and $2,634,580 for 2011 and 2010, 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 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 income.

(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 2011 annual impairment tests of goodwill, the Company adopted new guidance issued by the Financial Accounting Standards Board. The new guidance provides an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity determines that this is the case, it is required to perform the currently prescribed two-step goodwill impairment test. If an entity determines that the fair value of a reporting unit is greater than its carrying amount, the two-step goodwill impairment test is not required. 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 9, 2012, which is the date the consolidated financial statements were available to be issued.

Reclassifications. Certain 2010 amounts have been reclassified to conform with 2011 presentation. The reclassifications had no effect on previously reported net income.

2. Business Combinations

On May 21, 2010, the Company acquired 100% of the outstanding common shares of PCHP. PCHP is an Oregon based company that had four wholly owned subsidiaries, which included PCS, COLH, CCP and TPSC and TPSC's wholly owned subsidiary, FBC. PCS manages the business related to its contract with the Oregon Department of Human Services, Division of Medical Assistance Programs. COLH sells life, disability, dental, vision and voluntary benefit programs in Oregon and Montana. CCP manages the building where the PCHP entities operate. TPSC provides administration and account management services. FBC is licensed in the State of Washington as an insurance broker as a means to negotiate insurance rates and benefits for excess loss insurance coverage for self-funded benefit plans. Subsequent to the acquisition, PCHP distributed TPSC and FBC to PacificSource.

(Continued)

2. Business Combinations (Continued)

PacificSource acquired the outstanding common stock of PCHP for $45,497,600. The allocation of the purchase price for identifiable assets acquired and liabilities assumed, as of the date of the acquisition, was as follows:

Cash and investments	$ 45,844,600
Other current assets	4,916,611
Property	2,314,249
Investment in subsidiary - PCS	24,140,496
Investment in subsidiary - COLH	29,754
Investment in subsidiary - CCP	5,405,559
Investment in subsidiary - TPSC	1,870,295
Deferred tax assets	6,733,223
Total assets	91,254,787
Liabilities	(45,757,187)
Total net assets	$ 45,497,600

The fair value of the interest in PCS was determined based upon the assets acquired and liabilities assumed at the date of acquisition. The investment in subsidiary - PCS was allocated as follows:

Cash and investments	$ 15,842,430
Other current assets	6,897,894
Intangible asset - goodwill	9,087,214
Other assets	8,349,429
Total assets	40,176,967
Liabilities	(16,036,471)
Total net assets - investment in subsidiary - PCS	$ 24,140,496

(Continued)

2. Business Combinations (Continued)

The fair value of the interest in COLH was determined based upon the assets acquired and liabilities assumed at the date of acquisition. The investment in subsidiary - COLH was allocated as follows:

Cash	$	39,251
Liabilities		(9,497)
Total net assets - investment in subsidiary - COLH	$	29,754

The fair value of the interest in CCP was determined based upon the assets acquired and liabilities assumed at the date of acquisition. The investment in subsidiary - CCP was allocated as follows:

Cash and investments	$	2,162,510
Other current assets		18,937
Property		16,519,689
Other assets		27,069
Total assets		18,728,205
Liabilities		(13,322,646)
Total net assets - investment in subsidiary - CCP	$	5,405,559

The fair value of the interest in TPSC was determined based upon the assets acquired and liabilities assumed at the date of acquisition. At the time of the acquisition, TPSC became a wholly owned subsidiary of PacificSource. The investment in subsidiary - TPSC was allocated as follows:

Cash	$	1,289,300
Other current assets		306,676
Property		253,381
Intangible asset - goodwill		1,000,000
Total assets		2,849,357
Liabilities		(979,062)
Total net assets - investment in subsidiary - TPSC	$	1,870,295

3. Investments

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

	2011	2010
Debt securities	$ 116,922,980	$ 79,726,340
Equity securities and mutual funds	30,968,056	34,903,805
Certificates of deposit	2,611,738	2,611,472
Other invested assets	6,381,674	7,812,454
Accrued investment income	888,930	624,539
Total	$ 157,773,378	$ 125,678,610

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, 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.

(Continued)

3. Investments (Continued)

The cost and fair value of the investments at December 31, 2010 are as follows:

	Cost	Fair Value	Unrealized Appreciation (Depreciation)	Tax Effect	Net Unrealized Appreciation (Depreciation)
U.S. Government debt securities	$ 14,678,768	$ 14,827,534	$ 148,766	$ (52,000)	$ 96,766
Mortgage/asset backed securities	25,146,820	26,324,946	1,178,126	(411,000)	767,126
Corporate debt securities	37,280,752	38,573,860	1,293,108	(451,000)	842,108
Debt securities	77,106,340	79,726,340	2,620,000	(914,000)	1,706,000
Equity securities and mutual funds	32,889,991	34,903,805	2,013,814	(702,000)	1,311,814
Total	$ 109,996,331	$ 114,630,145	$ 4,633,814	$ (1,616,000)	$ 3,017,814

The unrealized appreciation of debt securities of $2,620,000 for 2010 consisted of unrealized gains of $3,105,562 and unrealized losses of $485,562. The unrealized appreciation of equity securities and mutual funds of $2,013,814 for 2010 consisted of unrealized gains of $2,390,177 and unrealized losses of $376,363. Approximately $9 million of gross realized gains and $4 million of gross realized losses were included in investment income on the consolidated statements of income for 2010.

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)

3. Investments (Continued)

The aggregate fair values of securities, by category, that had gross unrealized losses at December 31, 2011, and the securities that were in a loss position at December 31, 2010 that were still in a loss position at December 31, 2011, 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	$ 23,316,490	$ (1,094,857)	$ 1,713,191	$ (122,986)	$ 25,029,681	$ (1,217,843)
Equity securities/ mutual funds	18,467,653	(1,971,509)	1,023,318	(452,854)	19,490,971	(2,424,363)
	$ 41,784,143	$ (3,066,366)	$ 2,736,509	$ (575,840)	$ 44,520,652	$ (3,642,206)

As of December 31, 2011, the Company had 156 securities in an unrealized loss position. All of these securities had a percentage decline of less than 19%. At December 31, 2011 and 2010, the Company did not hold any less-than-investment grade corporate debt securities.

At December 31, 2011, debt securities were scheduled to mature as follows:

	Cost	**Fair Value**	**Unrealized Appreciation**
Due in one year or less	$ 547,301	$ 559,019	$ 11,718
Due in one to five years	30,017,720	30,218,491	200,771
Due in five to ten years	36,489,313	38,034,530	1,545,217
Due after ten years	46,861,924	48,110,940	1,249,016
Total	$ 113,916,258	$ 116,922,980	$ 3,006,722

See Note 8 regarding investment securities pledged to secure the line of credit at December 31, 2011.

(Continued)

3. Investments (Continued)

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

	Cost	Fair Value	Unrealized Appreciation (Depreciation)	Tax Effect	Net Unrealized Appreciation (Depreciation)
December 31, 2011	$ 145,865,697	$ 147,891,036	$ 2,025,339	$ (794,000)	$ 1,231,339
Less December 31, 2010	109,996,331	114,630,145	4,633,814	(1,616,000)	3,017,814
Change in unrealized appreciation (depreciation)			$ (2,608,475)	$ 822,000	$ (1,786,475)

Investment expenses were approximately $301,000 and $383,000 for the years ended December 31, 2011 and 2010, 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. On an annual basis, the LLC makes distributions of the annual income. The Company's pro rata share of gain was $23,000 and $27,283 in 2011 and 2010, respectively; cumulative loss prior to 2010 was $147,400.

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 and $1,279,124 was sold during 2011. PacificSource's pro rata share of the limited partnership loss was $174,656 and $307,571 in 2011 and 2010, respectively; cumulative loss prior to 2010 was $1,835,031.

4. Property

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

	2011	2010
Land	$ 3,172,078	$ 3,172,078
Buildings	20,358,271	20,318,082
Furniture and fixtures	8,335,109	8,178,983
Electronic data processing equipment	8,316,071	7,737,316
Software	47,531,150	45,753,857
Automobiles	240,185	136,361
Leasehold improvements	2,018,215	1,867,651
Work in process	316,335	-
	90,287,414	87,164,328
Less accumulated depreciation	13,537,920	11,311,891
Less accumulated amortization - software	26,733,669	20,911,713
Total	$ 50,015,825	$ 54,940,724

5. Intangible Assets

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

	2011	2010
Customer relationships	$ 4,868,630	$ 4,868,630
Contractual arrangements	4,858,055	4,858,055
Trade names and trademarks	600,000	600,000
Other intangible assets	130,163	282,061
Loan fees	97,904	97,904
	10,554,752	10,706,650
Less accumulated amortization	1,565,020	408,861
Total	$ 8,989,732	$ 10,297,789

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: 2012, $722,299; 2013, $717,393; 2014, $702,718; 2015, $702,718; 2016, $702,718; and $5,441,886 thereafter.

6. 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, 2011 and 2010, the single-premium group life insurance contract consisted of aggregate paid-up life insurance of $2,921,891 and a cash value of $1,673,491 and $1,633,613, 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 $277,404 and $359,346 at December 31, 2011 and 2010, 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, 2009	$ 1,575,786	$ 478,517	$ 2,054,303
Earnings on contracts, net	62,736	23,189	85,925
Purchase of annuity	(4,909)	4,909	-
Payments to annuitants	-	(147,269)	(147,269)
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

7. 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:

	2011	2010
Unpaid claims and claims adjustment expenses, January 1	$ 75,534,434	$ 45,299,900
Less reinsurance receivable	(1,104,602)	(394,763)
Net balance	74,429,832	44,905,137
Incurred related to:		
Current year	799,677,007	669,013,628
Prior years	2,199,365	(1,459,469)
Total incurred	801,876,372	667,554,159
Paid related to:		
Current year	(722,392,362)	(594,189,033)
Prior years	(77,733,799)	(43,840,431)
Total paid	(800,126,161)	(638,029,464)
Net balance	76,180,043	74,429,832
Plus reinsurance receivable	722,258	1,104,602
Unpaid claims and claims adjustment expenses, December 31	$ 76,902,301	$ 75,534,434

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 $722,258) increased by $2,199,365 in 2011. The liability for unpaid claims and claims adjustment expenses (net of reinsurance recoveries of $1,104,602) decreased by $1,459,469 in 2010. The Company records a liability for unpaid claims and claims adjustment expenses that includes an allowance for potential shock claims.

8. 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 $2,420,660 and $0 at December 31, 2011 and 2010. The line of credit bears interest at the Daily One Month LIBOR Rate plus 1.00% (an effective rate of 1.30% at December 31, 2011) and matures in February 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 $4,841,320 at December 31, 2011. The line of credit is subject to certain covenants, which the Company was in compliance with at December 31, 2011.

9. Notes Payable

Notes payable consisted of the following at December 31:

	2011	2010
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.	$ 9,823,368	$ 13,368,055
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, 2011), collateralized by business assets, matures March 2018.	1,249,863	1,403,944
Total	$ 11,073,231	$ 14,771,999

The note payable to the bank is subject to certain covenants, which the Company was in compliance with at December 31, 2011.

(Continued)

9. Notes Payable (Continued)

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

2012	$	443,660
2013		474,266
2014		505,210
2015		538,188
2016		8,817,062
Thereafter		294,845
	$	11,073,231

10. 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.

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

	2011	2010
Projected benefit obligation for service rendered to date	$ (30,317,898)	$ (20,565,252)
Plan assets at fair value	25,603,787	21,450,314
Funded status	$ (4,714,111)	$ 885,062
Change in projected benefit obligation:		
Projected benefit obligation, beginning of year	$ 20,565,252	$ 16,091,870
Service cost	2,691,623	1,664,237
Interest cost	1,254,709	1,160,259
Benefits paid and administrative expenses	(355,759)	(346,222)
Actuarial loss	6,162,073	1,995,108
Projected benefit obligation, end of year	$ 30,317,898	$ 20,565,252

(Continued)

10. Retirement Plans (Continued)

	2011	2010
Change in fair value of plan assets:		
Fair value of plan assets, beginning of year	$ 21,450,314	$ 16,157,003
Actual return on plan assets	9,232	1,639,533
Employer contributions	4,500,000	4,000,000
Benefits paid	(308,539)	(308,018)
Administrative expenses	(47,220)	(38,204)
Fair value of plan assets, end of year	$ 25,603,787	$ 21,450,314
Net periodic benefit cost:		
Service cost	$ 2,691,623	$ 1,664,237
Interest cost	1,254,709	1,160,259
Expected return on plan assets	(1,612,260)	(1,059,884)
Amortization of loss	868,361	694,386
Amortization of prior service credits	(165,472)	(165,472)
Total net periodic benefit cost	$ 3,036,961	$ 2,293,526
Amounts recognized in accumulated other comprehensive income:		
Net loss	$ 14,134,946	$ 7,238,206
Prior service credit	(1,138,447)	(1,303,919)
Total accumulated other comprehensive income	$ 12,996,499	$ 5,934,287
Changes in other comprehensive income:		
Net loss	$ 7,765,101	$ 1,415,459
Amortization of net loss	(868,361)	(694,386)
Amortization of prior service credit	165,472	165,472
Total recognized in other comprehensive income	$ 7,062,212	$ 886,545
Accumulated benefit obligation, end of year	$ 24,282,983	$ 16,764,478

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 2012 to be $1,235,056, $(165,472) and $0, respectively.

(Continued)

10. Retirement Plans (Continued)

The Company expects to contribute $4,000,000 to its pension plan in 2012. Future anticipated benefit payments from the defined benefit pension plan are as follows: 2012, $1,627,742; 2013, $984,452; 2014, $934,044; 2015, $2,115,874; 2016, $598,679; and from 2017 to 2021, $15,419,969.

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

	2011	2010
Assumptions used for net periodic benefit costs:		
Discount rate used in determining present values	5.5%	6.5%
Annual increase in future compensation levels	3.5	4.0
Expected long-term rate of return on assets	7.25	6.0
Assumptions used to determine benefit obligation:		
Discount rate used in determining present values	4.7%	5.5%
Annual increase in future compensation levels	3.5	3.5
Measurement date	December 31	December 31

The plan assets are invested in the following asset classes:

Debt investments	45%	68%
Equity investments	35	32
Cash equivalents	13	-
Other	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.

(Continued)

10. Retirement Plans (Continued)

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 $750,345 and $571,553 in 2011 and 2010, respectively.

11. 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:

	2011	2010
Current income tax expense:		
Federal	$ 2,539,176	$ 468,359
State	285,218	447,264
Total current income tax expense	2,824,394	915,623
Deferred tax expense	1,618,132	7,131,766
Total income tax expense	$ 4,442,526	$ 8,047,389

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

	2011	2010
Tax expense computed at statutory rate	$ 4,135,000	$ 7,373,000
State tax expense, net of federal income tax benefit	530,000	954,000
Permanent and other differences	39,526	(199,611)
Dividend received deduction	(262,000)	(80,000)
Total income tax expense	$ 4,442,526	$ 8,047,389

(Continued)

11. Income Taxes (Continued)

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

	2011	2010
Deferred tax assets:		
Federal and state net operating loss carryforwards	$ 3,450,631	$ 4,341,763
Alternative minimum tax credit carryforwards	1,560,000	2,476,000
Unrealized losses	1,430,000	151,000
Accruals	1,368,000	633,000
Contribution carryforwards	1,178,000	889,000
Defined benefit pension plan	1,045,000	-
Partnership difference	663,000	515,000
Deferred compensation	575,000	446,845
Discount of claims provision	516,000	465,560
Capital loss carryforward	258,000	-
Goodwill	17,000	19,035
Operating lease impairment	14,000	-
Bad debt reserve	-	66,242
Premium deficiency reserve	-	4,857
Total deferred tax assets	12,074,631	10,008,302
Deferred tax liabilities:		
Property	(11,128,808)	(10,225,481)
Unrealized gains	(2,225,000)	(1,683,602)
Prepaids	(1,291,000)	(1,260,000)
Subsidiary equity income	(42,000)	(290,000)
Goodwill	-	(779,528)
Defined benefit pension plan	-	(290,000)
Total deferred tax liabilities	(14,686,808)	(14,238,611)
Net deferred tax liabilities	$ (2,612,177)	$ (4,230,309)

As of December 31, 2011, the Company recognized a deferred tax asset of $3,450,631, for the anticipated utilization of federal and state net operating loss carryforwards. Federal net operating loss carryforwards of $5,786,707 will expire on December 31, 2028, if not used before then. State net operating loss carryforwards of $30,160,374 will expire on various dates through 2029. Contribution carryforwards of $3,003,820 will expire on various dates through 2015. Alternative minimum tax credit carryforwards of $2,607,034 have no expiration date.

(Continued)

11. 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.

12. 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, 2011 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

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, 2011:

Medicare and Medicaid	Retention	Deductible	Aggregate Limit
Layer 1	10%	$ 350,000	Unlimited

Premiums ceded under the terms of the reinsurance policies were $5,027,828 and $4,407,871 in 2011 and 2010, respectively. The reinsurance contracts do not relieve the Company from its primary obligation to policyholders.

13. Leases

Effective November 1997, PHI entered into a lease for real property in Mountain Home, Idaho. It is a fifteen-year lease expiring November 2012. The lease has three renewal terms of five years each. The Company is responsible for substantially all executory costs. Minimum payments under the lease are subject to annual adjustment of 3%. Future minimum lease payments are as follows: $90,475 for 2012.

(Continued)

13. Leases (Continued)

Effective June 2004, the Company entered into a real property lease for the Medford, Oregon sales office under a five-year operating agreement expiring August 2009 and extended through August 2012. The Company is responsible for substantially all executory costs. Future minimum lease payments are $23,104 for 2012.

Effective August 2007, the Company entered into a real property lease for the Tigard, Oregon sales office under a seven-year operating agreement expiring October 31, 2014. The Company is responsible for substantially all executory costs. Minimum payments under the lease, which are subject to annual adjustment, are $20,443 per month. Future minimum lease payments are as follows: 2012, $253,427; 2013, $261,554; 2014, $223,359.

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 $2,350 per month. The Company is responsible for substantially all executory costs. Future minimum lease payments are as follows: 2012, $29,204; 2013, $17,281.

Effective October 2010, the Company entered into a real property lease for the Boise, Idaho office under a five-year operating agreement expiring September 2015. 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 $25,485 per month. Future minimum lease payments are as follows: 2012, $310,426; 2013, $316,635; 2014, $323,771; 2015, $248,251.

Effective February 2011, the Company entered into a real property lease for the Helena, Montana sales office under a one year operating agreement, with the option to renew the lease for an additional one year term. The Company is responsible for substantially all executory costs. Future minimum lease payments are $650 for 2012.

Effective July 2011, the Company entered into a real property lease for an additional Springfield, Oregon office under a three-year operating agreement expiring June 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: 2012, $194,447; 2013, $203,154; 2014, $104,479.

Effective June 2007, the Company entered into a real property lease for the Boise, Idaho sales office under a five-year operating agreement expiring May 2012. This lease was terminated in April 2011.

As part of the sale of TPSC, the Company transferred the real property lease for the Tacoma, Washington office effective November 30, 2011.

Amounts charged to rent expense for the various leases were $1,229,140 and $1,089,634 for 2011 and 2010, respectively.

14. 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.

15. 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, 2011, 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.

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, 2011, 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 a 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 evaluating the impact of the exchanges on future business operations.

In February 2011, Oregon Legislature enacted Senate Bill 1580 that allows for the establishment of Coordinated Care Organizations (CCOs). The Company is reviewing the opportunity to apply for various CCOs.

16. 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, its insurance company will pay up to $2,000,000 with the balance of the possible settlement covered by the escrow fund. The lawsuit was settled during 2011 and the Company, PHI's former shareholders and the reinsurer are discussing payments from the escrow account.

17. 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, 2011 and 2010, total assets (unaudited), consisting primarily of cash equivalents and marketable securities, were approximately $5,950,000 and $6,900,000, 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 2011 and 2010, the Company made a contribution of $0 and $1,000,000 to the Foundation, respectively.

18. 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, 2011. 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.

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

Investments in debt and 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.

Certificates of deposit are traded in active markets and are valued at quoted market prices. These investments are generally categorized in Level One of the fair value hierarchy.

(Continued)

18. Fair Value of Financial Instruments (Continued)

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.

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

	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	-	-
Certificates of deposit	2,611,738	2,611,738	-	-
Other invested assets	6,381,674	-	6,381,674	-

(Continued)

18. Fair Value of Financial Instruments (Continued)

	Fair Value Measurement at December 31, 2010			
	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	$ 14,827,534	$ 14,827,534	$ -	$ -
Mortgage/asset backed debt securities	26,324,946	26,324,946	-	-
Corporate debt securities	38,573,860	38,573,860	-	-
Total debt securities	79,726,340	79,726,340	-	-
Available-for-sale equity securities:				
Mutual funds				
Value	11,822,685	11,822,685	-	-
Fixed income	8,396,289	8,396,289	-	-
Growth	7,987,367	7,987,367	-	-
Balanced	6,697,464	6,697,464	-	-
Total equity securities	34,903,805	34,903,805	-	-
Certificates of deposit	2,611,472	2,611,472	-	-
Other invested assets	7,812,454	-	7,812,454	-

(Continued)

18. 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, 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	$ -	$ -

	Fair Value Measurement at December 31, 2010			
Description	**Total**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Pooled separate accounts:				
Fixed income funds	$ 6,093,590	$ -	$ 6,093,590	$ -
Balanced funds	3,162,668	-	3,162,668	-
Growth funds	1,486,468	-	1,486,468	-
Value funds	1,467,134	-	1,467,134	-
Real estate funds	637,265	-	637,265	-
Total pooled separate accounts	12,847,125	-	12,847,125	-
Registered investment companies:				
Fixed income funds	3,346,850	3,346,850	-	-
Guaranteed interest fund	5,256,339	-	-	5,256,339
Total	$ 21,450,314	$ 3,346,850	$ 12,847,125	$ 5,256,339

(Continued)

18. 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.

The fair value of pooled separate accounts equals the number of shares owned in the underlying separate account multiplied by the closing net asset value per unit as quoted by the contract issuer. They are generally categorized in Level Two of the fair value hierarchy.

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, January 1, 2010	$ 3,205,944
Interest	148,184
Purchases, issuances and settlements	2,000,000
Distributions and fees	(97,789)
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	$ -

19. Subsequent Events

On February 29, 2012, the Company purchased certain commercial health business from New West Health Services located in Helena, Montana, including large employer, association and individual policies through a bulk reinsurance transfer for up to $1.25 million.

20. 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.

In addition, the commissioner of the Insurance Division has the right to permit other practices that may deviate from prescribed practices. Prescribed SAP are those practices that are incorporated directly or by reference in state laws, regulations and general administrative rules applicable to all insurance enterprises domiciled in Oregon. Permitted SAP encompasses all accounting practices that are not prescribed; such practices differ from state to state, may differ from company to company within a state and may change in the future. PacificSource and PCHP follow the NAIC's SAP and do not have permitted practices that deviate from NAIC SAP. Therefore, PacificSource and PCHP's statutory capital and surplus are in accordance with NAIC SAP requirements.

SUPPLEMENTAL INFORMATION

PACIFICSOURCE HEALTH PLANS AND SUBSIDIARIES

Consolidated Schedules of General and Administrative Expenses

	Year Ended December 31	
	2011	**2010**
Salaries	$ 37,965,545	$ 32,197,206
Payroll taxes	3,376,709	2,923,368
Employee benefits	7,822,784	7,034,901
Retirement plans	3,831,429	2,900,184
Contract labor	349,498	289,142
Administrative expense, net	1,224,165	937,971
Advertising	2,579,446	2,634,580
Automobile expense	289,958	246,745
Banking charges	191,054	132,083
Board expenses	390,589	358,177
Building rent	1,229,140	1,089,634
Computer and software	244,188	301,664
Consultant fees	7,688,502	8,246,194
Depreciation and amortization	10,237,547	8,213,476
Dues and subscriptions	643,483	424,757
Insurance	801,900	632,861
Imaging expense	363,270	340,979
Legal fees	220,909	338,847
Professional accounting, state audit and actuarial services	485,722	466,161
Office and data processing supplies	678,718	434,108
OMIP assessments	6,839,689	6,411,252
Outside service fees	1,008,742	923,638
Postage	2,256,027	1,811,316
Printing expense	1,055,836	828,822
Repairs and maintenance	1,193,247	1,087,885
Taxes and licenses	5,099,168	3,733,115
Telephone	685,282	692,073
Travel and education	910,868	750,736
Utilities	226,220	195,893
Other	214,448	586,091
Merger and acquisition fees	-	1,037,324
Total	$ 100,104,083	$ 88,201,183