PACIFICSOURCE AND SUBSIDIARIES

Independent Auditors' Report
Consolidated Financial Statements and Supplemental Information
Years Ended December 31, 2013 and 2012

PACIFICSOURCE AND SUBSIDIARIES

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KERNUTTSTOKES

INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying consolidated financial statements of PacificSource Health Plans and Subsidiaries (the Company), which comprise the consolidated balance sheets as of December 31, 2013 and 2012, and the related consolidated statements of operations, comprehensive income (loss), fund balance and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the 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 PacificSource Health Plans and Subsidiaries as of December 31, 2013 and 2012, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Supplementary Information

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

Kernutt Stokes LLP

Eugene, Oregon
May 30, 2014

PACIFICSOURCE AND SUBSIDIARIES

Consolidated Balance Sheets

	December 31 2013	December 31 2012
ASSETS		
Investments	$ 142,493,436	$ 164,025,128
Cash and cash equivalents	75,710,800	20,986,414
Trust funds	4,296,284	4,973,929
Accounts receivable	30,617,791	38,337,136
Prepaid expenses and deposits	5,311,166	4,051,375
Prepaid income taxes	3,554,196	3,039,313
Prepaid pension costs	3,699,390	-
Property, net	38,807,540	43,162,333
Goodwill	12,611,772	12,611,772
Intangible assets, net	8,905,921	9,354,136
Deferred tax assets	1,827,000	4,523,000
Total	$ 327,835,296	$ 305,064,536
LIABILITIES AND FUND BALANCE		
LIABILITIES:		
Unpaid claims and claims adjustment expenses	$ 102,490,850	$ 94,908,633
Book overdraft	5,745,948	15,225,651
Line of credit	-	8,087,428
Accounts payable	8,794,072	9,612,371
Accrued expenses	10,260,457	6,121,527
Accrued pension liability	-	2,645,133
Unearned premiums	4,761,085	7,652,996
Incentive compensation payable under managed care plans	1,519,687	388,733
Accrued retro settlements	3,892,260	2,730,751
Collections for others	4,296,284	4,973,929
Notes payable	36,907,479	10,632,735
Total	178,668,122	162,979,887
FUND BALANCE:		
Fund balance, unrestricted	149,465,961	143,186,664
Accumulated other comprehensive loss	(788,402)	(1,511,596)
Noncontrolling interests	489,615	409,581
Total	149,167,174	142,084,649
Total	$ 327,835,296	$ 305,064,536

See accompanying notes.

PACIFICSOURCE AND SUBSIDIARIES
Consolidated Statements of Operations

	Year Ended December 31 2013	2012
PREMIUMS:		
Commercial	$ 724,619,511	$ 725,325,309
Medicare	301,439,367	166,134,084
Medicaid	138,185,134	131,038,229
Total	1,164,244,012	1,022,497,622
CLAIMS EXPENSE:		
Commercial	631,817,620	656,547,340
Medicare	289,301,330	161,832,436
Medicaid	123,333,698	121,554,768
Commissions on premiums	26,356,558	22,925,105
Premium taxes and OMIP assessments	16,950,646	18,390,890
Total	1,087,759,852	981,250,539
EXCESS OF PREMIUMS OVER CLAIMS EXPENSE	76,484,160	41,247,083
ADMINISTRATIVE REVENUES	11,489,055	9,736,304
GENERAL AND ADMINISTRATIVE EXPENSES	91,783,082	89,286,951
UNDERWRITING LOSS	(3,809,867)	(38,303,564)
OTHER INCOME (EXPENSE):		
Investment income	15,540,853	9,652,612
Interest expense	(678,326)	(675,816)
Charitable contributions	(952,925)	(1,750,776)
Miscellaneous income (expense)	835,916	(360,276)
Total	14,745,518	6,865,744
INCOME (LOSS) BEFORE INCOME TAXES	10,935,651	(31,437,820)
INCOME TAX EXPENSE (BENEFIT)	4,556,320	(12,538,276)
TOTAL INCOME (LOSS)	6,379,331	(18,899,544)
LESS INCOME ATTRIBUTABLE TO NONCONTROLLING INTERESTS	100,034	65,059
NET INCOME (LOSS)	$ 6,279,297	$ (18,964,603)

See accompanying notes.

PACIFICSOURCE AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Loss)

	Year Ended December 31	
	2013	**2012**
NET INCOME (LOSS)	$ 6,279,297	$ (18,964,603)
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAXES:		
Unrealized appreciation and depreciation of investments:		
Unrealized depreciation and appreciation arising during year (net of tax of $964,000 in 2013 and $2,340,000 in 2012)	(1,494,605)	3,629,543
Reclassification adjustment for gains and losses realized in net income (loss) (net of tax of $1,169,000 in 2013 and $68,000 in 2012)	(1,814,439)	105,094
Unrealized depreciation and appreciation of investments, net	(3,309,044)	3,734,637
Defined benefit pension plan:		
Net gain arising during year (net of tax of $2,590,000 in 2013 and $1,564,000 in 2012)	4,032,238	2,361,475
Prior service cost due to curtailment (net of tax of $388,000 in 2012)	-	(584,975)
Amortization of prior service cost (net of tax of $66,000 in 2012)	-	(99,472)
Defined benefit pension plan, net	4,032,238	1,677,028
Total other comprehensive income	723,194	5,411,665
COMPREHENSIVE INCOME (LOSS)	$ 7,002,491	$ (13,552,938)

See accompanying notes.

PACIFICSOURCE AND SUBSIDIARIES
Consolidated Statements of Fund Balance

	Fund Balance	Accumulated Other Comprehensive Income (Loss): Unrealized Appreciation and Depreciation on Investments	Accumulated Other Comprehensive Income (Loss): Defined Benefit Pension Plan	Noncontrolling Interests	Total
BALANCE, January 1, 2012	$ 162,151,267	$ 963,238	$ (7,886,499)	$ 374,135	$ 155,602,141
Net (loss) income	(18,964,603)	-	-	65,059	(18,899,544)
Other comprehensive income	-	3,734,637	1,677,028	-	5,411,665
Redemption of IPN common stock	-	-	-	(29,613)	(29,613)
BALANCE, December 31, 2012	143,186,664	4,697,875	(6,209,471)	409,581	142,084,649
Net income	6,279,297	-	-	100,034	6,379,331
Other comprehensive (loss) income	-	(3,309,044)	4,032,238	-	723,194
Distributions	-	-	-	(20,000)	(20,000)
BALANCE, December 31, 2013	$ 149,465,961	$ 1,388,831	$ (2,177,233)	$ 489,615	$ 149,167,174

See accompanying notes.

PACIFICSOURCE AND SUBSIDIARIES
Consolidated Statements of Cash Flows

Change in Cash and Cash Equivalents

	Year Ended December 31 2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Premiums collected	$ 1,169,071,446	$ 1,006,060,466
Claims paid	(1,077,885,172)	(954,139,831)
General and administrative expenses paid	(88,405,968)	(76,257,490)
Investment income received	5,167,634	5,079,916
Other revenue received	11,489,055	9,434,993
Interest paid	(679,359)	(676,780)
Income taxes paid	(2,832,203)	(139,514)
Net cash provided by (used in) operating activities	15,925,433	(10,638,240)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from sale of investments	155,221,892	218,591,383
Investments purchased	(128,759,025)	(214,127,800)
Proceeds from sale of property	-	9,400
Purchase of intangible assets	(425,933)	(1,215,000)
Property purchased	(5,405,297)	(2,679,692)
Net cash provided by investing activities	20,631,637	578,291
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net (payments on) proceeds from line of credit	(8,087,428)	5,666,768
Proceeds from notes payable	29,223,419	-
Payments on notes payable	(2,948,675)	(440,496)
Redemption of common stock	-	(29,613)
Distributions	(20,000)	-
Net cash provided by financing activities	18,167,316	5,196,659
CHANGE IN CASH AND CASH EQUIVALENTS	54,724,386	(4,863,290)
CASH AND CASH EQUIVALENTS, beginning of year	20,986,414	25,849,704
CASH AND CASH EQUIVALENTS, end of year	$ 75,710,800	$ 20,986,414

(Continued)

See accompanying notes.

PACIFICSOURCE AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Continued)

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

	Year Ended December 31 2013	2012
NET INCOME (LOSS)	$ 6,279,297	$ (18,964,603)
ADJUSTMENTS TO RECONCILE NET INCOME (LOSS) TO NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES:		
Income attributable to noncontrolling interest	100,034	65,059
Depreciation and amortization	10,012,823	10,333,890
Deferred tax expense (benefit)	2,239,000	(10,653,177)
Gain on sale of investments	(10,391,245)	(4,690,880)
Loss on disposal of property	621,415	40,490
Adjustments resulting from changes in:		
Accounts receivable	7,719,345	(16,581,764)
Accrued investment income	18,026	118,184
Prepaid expenses and deposits	(1,259,791)	42,852
Prepaid income taxes	(514,883)	(2,024,613)
Prepaid pension costs	2,922,848	-
Unpaid claims and claims adjustment expenses	7,582,217	18,006,332
Book overdraft	(9,479,703)	10,561,191
Accounts payable	(818,299)	3,486,066
Accrued pension liability	(2,645,133)	718,050
Unearned premiums	(2,891,911)	144,608
Incentive compensation payable	1,130,954	(2,318,253)
Accrued retro settlements	1,161,509	1,440,527
Accrued expenses	4,138,930	(362,199)
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	$ 15,925,433	$ (10,638,240)

Supplemental Schedule of Noncash Investing and Financing Activities

On December 31, 2013, the Company repaid an existing note payable with the Bank of the Cascades with the proceeds from a new note payable in the amount of $6,776,581.

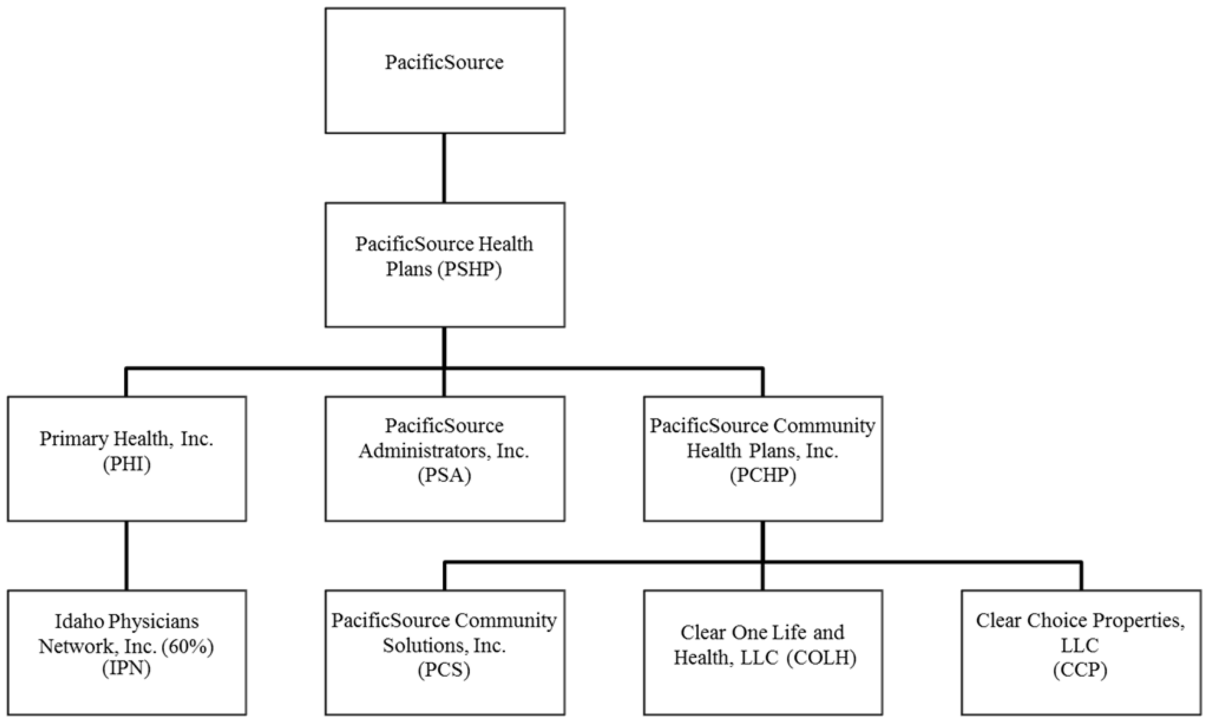
At December 31, 2013, there was a decrease from December 31, 2012 in unrealized appreciation of investments, net of reclassification adjustments, of $(5,442,044) with deferred taxes of $2,133,000. At December 31, 2012, there was an increase from December 31, 2011 in unrealized appreciation of investments, net of reclassification adjustments, of $6,142,637 with deferred taxes of $(2,408,000).

At December 31, 2013, there were defined benefit pension plan adjustments of $6,622,238 with deferred taxes of $(2,590,000). At December 31, 2012, there were defined benefit pension plan adjustments of $2,787,028 with deferred taxes of $(1,110,000).

See accompanying notes.

1. Organization and Summary of Significant Accounting Policies

PacificSource and its subsidiaries are organized as follows:



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

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. IPN is a physician contracting network.

PCHP is a health insurance company licensed in the states of Oregon, Idaho and Montana. They offer Medicare Advantage and, through their subsidiary PCS, Medicaid plans. COLH was dissolved in 2012. They sold life, disability, dental, vision and voluntary benefit programs in Oregon, Idaho, Montana and Washington. CCP owned the building located in Bend, Oregon, that was transferred to PacificSource on December 31, 2013.

(Continued)

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

During 2013, the Company's board of directors facilitated the reorganization of the PacificSource group of companies. They created a new entity, PacificSource, and effective December 31, 2013, PSHP became the sole member of PacificSource. Additionally on December 31, 2013, PSHP, PCHP and CCP:

- Sold their office buildings, furniture and equipment to PacificSource;
- Sold other assets and transferred liabilities including certain prepaid assets, intangible assets and deferred compensation plans; and
- Transferred their employees to PacificSource where they will be available to provide services to the Company under administrative services agreements. As part of the transfer of the employees, the payroll and related liabilities and retirement plans were also transferred to PacificSource.

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

	2013		2012	
PSHP	$ 728,081,539	61.9%	$ 728,061,474	70.5%
PCHP and subsidiaries	439,992,450	37.4%	297,484,459	28.9%
PSA	4,114,431	0.4%	4,226,449	0.4%
PHI and subsidiaries	3,544,647	0.3%	2,461,544	0.2%
Gross revenue	$ 1,175,733,067	100.0%	$1,032,233,926	100.0%

Principles of Consolidation. The accompanying financial statements of PacificSource are consolidated with PSHP and its subsidiaries (collectively the Company). PSHP has three wholly-owned subsidiaries. These entities are: PSA, PHI and PCHP. All significant intercompany balances and transactions have been eliminated in the consolidation.

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

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

(Continued)

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

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. PSHP and PCHP maintain statutory deposits as required by regulatory authorities. At December 31, 2013, the deposits were in the form of certificates of deposit maturing at various dates through April 2014 and were included in investments on the consolidated balance sheets. The fair value of the statutory deposits was $2,611,738 at December 31, 2013 and 2012.

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 for self-insurance and third-party administrator services, the Company is required to maintain separate cash trust accounts for benefit administration services received for various employers.

Accounts Receivable. Uncollected premiums represent amounts receivable from policyholders. Amounts receivable relating to uninsured health plans are amounts collectible from groups under administrative service contracts. Pharmacy rebates are receivable based upon pharmacy claims expenses of the Company. Other receivables are claims refunds collectible from providers, insureds and third parties based upon coordination of benefits under healthcare plans. All receivables of the Company are unsecured. Management determines and evaluates past due balances on an account-by-account basis, and if amounts become uncollectible, they will be charged to operations when that determination is made. As of December 31, 2013 and 2012, management considered receivables to be fully collectible; accordingly, no allowance for doubtful accounts was considered necessary.

As of December 31, 2013 and 2012, pharmacy rebates were approximately $3.3 million and $2.8 million, respectively, the majority of 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.

(Continued)

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

Goodwill. The Company assesses goodwill for impairment annually and whenever events or changes in circumstances indicate it may be impaired. When an impairment is indicated, any excess of carrying value over fair value of goodwill is recorded as an operating loss. The Company completed annual tests for impairment at December 31, 2013 and 2012, and determined that the fair value of goodwill exceeded the carrying value, thus goodwill is not considered impaired.

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

The Company assesses the recoverability of intangibles whenever events or changes in circumstances indicate they may be impaired. When an impairment is indicated, any excess of carrying value over fair value of intangibles is recorded as an operating loss. The Company completed tests for impairment at December 31, 2013 and 2012, and determined that the fair value of intangibles exceeded the carrying value, thus intangibles are not considered impaired.

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

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 \$694,861 and \$525,591 at December 31, 2013 and 2012, respectively, and are recorded in prepaid expenses and deposits on the consolidated balance sheets. The Company contributed \$15,449 and \$30,463 to the plan for 2013 and 2012, respectively.

(Continued)

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

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

The Company files income tax returns in the U.S. federal jurisdiction and multiple state and local jurisdictions. The Company is not subject to federal, state or local income tax examinations by tax authorities for years prior to 2010 in jurisdictions where tax returns have been filed, as the statute of limitations has expired on those years.

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

Reinsurance. The Company seeks to limit its loss on any single insured risk and to recover a portion of benefits paid by ceding reinsurance to its reinsurer under excess coverage agreements. Reinsurance agreements do not relieve the Company from its primary obligation to the policyholders, but provide the Company with insurance for large claims. Reinsurance premiums and reinsurance recoveries are offset against claims incurred. Amounts recoverable under reinsurance agreements include such amounts due from the reinsurer for the reimbursement of amounts paid on claims in excess of the insurance risk transferred to the reinsurer.

Assessments. 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 $2,621,910 and $3,505,496 for 2013 and 2012, respectively.

(Continued)

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

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

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

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

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

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

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

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

Concentrations of Credit Risk. The Company's financial instruments that are exposed to concentrations of credit risk consist primarily of debt securities, cash and cash equivalents and accounts receivable. Credit risk related to investments varies depending on the nature of the investments. Management believes that its credit risk related to debt securities is limited due to the financial strength of the U.S. Government and supporting corporations securing such investments. Due to the Company's normal operating cash flow requirements, the Company typically has cash and cash equivalents that exceed the Federal Deposit Insurance Corporation (FDIC) coverage or may not be insured at all. Management believes that its credit risk with respect to cash and cash equivalents is minimal due to the relative financial strength of the financial institutions which maintain the Company's bank balances and the short-term nature of its investments. Credit risk relative to accounts receivable is minimal due to the nature of the receivables and due to the large number of policyholders.

(Continued)

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

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

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.

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 May 30, 2014, which is the date the consolidated financial statements were available to be issued.

Reclassifications. Certain 2012 amounts have been reclassified to conform with 2013 presentation. The reclassifications had no effect on previously reported net loss.

2. Investments

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

	2013	2012
Debt securities	$ 123,992,221	$ 118,539,871
Equity securities and mutual funds	13,852,580	36,324,238
Certificates of deposit	2,611,738	2,611,738
Other invested assets	1,248,124	5,778,535
Accrued investment income	788,773	770,746
Total	$ 142,493,436	$ 164,025,128

(Continued)

2. Investments (Continued)

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, 2013 are as follows:

	Cost	Gross Unrealized Appreciation	Gross Unrealized Depreciation	Fair Value
U.S. Government debt securities	$ 15,214,367	$ 234,506	$ (185,355)	$ 15,263,518
Mortgage/asset backed securities	39,559,435	878,281	(524,971)	39,912,745
Corporate debt securities	68,448,979	1,118,755	(751,776)	68,815,958
Total debt securities	123,222,781	2,231,542	(1,462,102)	123,992,221
Equity securities and mutual funds	11,896,088	2,057,315	(100,823)	13,852,580
Total	$ 135,118,869	$ 4,288,857	$ (1,562,925)	$ 137,844,801

Approximately $12.0 million of gross realized gains and $1.7 million of gross realized losses were included in investment income on the consolidated statements of operations for 2013.

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

	Cost	Gross Unrealized Appreciation	Gross Unrealized Depreciation	Fair Value
U.S. Government debt securities	$ 12,647,188	$ 506,682	$ (7,137)	$ 13,146,733
Mortgage/asset backed securities	39,591,373	2,001,118	(79,209)	41,513,282
Corporate debt securities	61,256,516	2,652,136	(28,796)	63,879,856
Total debt securities	113,495,077	5,159,936	(115,142)	118,539,871
Equity securities and mutual funds	33,201,056	3,224,818	(101,636)	36,324,238
Total	$ 146,696,133	$ 8,384,754	$ (216,778)	$ 154,864,109

Approximately $4.7 million of gross realized gains and $18,000 of gross realized losses were included in investment income on the consolidated statements of income for 2012.

(Continued)

2. Investments (Continued)

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.

The aggregate fair values of securities, by category, that had gross unrealized losses at December 31, 2013, and the securities that were in a loss position at December 31, 2012 that were still in a loss position at December 31, 2013, are as follows:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Depreciation	Fair Value	Gross Unrealized Depreciation	Fair Value	Gross Unrealized Depreciation
Debt securities	$ 48,104,187	$ (1,250,246)	$ 5,203,345	$ (211,856)	$ 53,307,532	$ (1,462,102)
Equity securities	878,258	(61,920)	473,632	(38,903)	1,351,890	(100,823)
	$ 48,982,445	$ (1,312,166)	$ 5,676,977	$ (250,759)	$ 54,659,422	$ (1,562,925)

As of December 31, 2013, the Company had 133 securities in an unrealized loss position. All of these securities had a percentage decline of less than 14%. At December 31, 2013 and 2012, the Company did not hold any less-than-investment grade corporate debt securities.

At December 31, 2013, debt securities were scheduled to mature as follows:

	Cost	Fair Value
Due in one year or less	$ 12,314,970	$ 12,389,349
Due in one to five years	67,227,045	68,437,866
Due in five to ten years	43,321,573	42,795,033
Due after ten years	359,193	369,973
Total	$ 123,222,781	$ 123,992,221

(Continued)

2. Investments (Continued)

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

	Cost	Fair Value	Unrealized Appreciation	Tax Effect	Net Unrealized Appreciation
December 31, 2013	$ 135,118,869	$ 137,844,801	$ 2,725,932	$ (1,069,000)	$ 1,656,932
Less December 31, 2012	146,696,133	154,864,109	8,167,976	(3,202,000)	4,965,976
Change in unrealized appreciation			$ (5,442,044)	$ 2,133,000	$ (3,309,044)

Investment expense was approximately $399,000 and $343,000 for the years ended December 31, 2013 and 2012, 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.

3. Property

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

	2013	2012
Land	$ 3,172,078	$ 3,172,078
Buildings	18,700,814	20,368,750
Furniture and fixtures	3,087,083	8,681,700
Electronic data processing equipment	116,456	8,944,911
Office equipment	1,316,428	-
Software	11,533,475	48,881,833
Automobiles	73,505	240,185
Leasehold improvements	1,536,952	2,099,413
Work-in-process	-	459,366
	39,536,791	92,848,236
Less accumulated depreciation	486,102	16,359,784
Less accumulated amortization - software	243,149	33,326,119
Total	$ 38,807,540	$ 43,162,333

Generally, the decrease in the gross cost basis and accumulated depreciation and amortization of certain asset groups is due to the transfer of assets to PacificSource on December 31, 2013.

4. Intangible Assets

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

	2013	2012
Customer relationships	$ 6,083,630	$ 6,083,630
Contractual arrangements	3,785,235	4,858,055
Trade names and trademarks	600,000	600,000
Other intangible assets	125,000	126,273
Loan fees	425,933	97,904
	11,019,798	11,765,862
Less accumulated amortization	2,113,877	2,411,726
Total	$ 8,905,921	$ 9,354,136

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

Generally, the decrease in the gross cost basis and accumulated amortization of certain asset categories is due to the transfer of assets in the reorganization on December 31, 2013.

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: 2014, $943,902; 2015, $943,902; 2016, $943,902; 2017, $943,902; 2018, $936,960; and $4,193,353 thereafter.

5. 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.

(Continued)

5. Liability for Unpaid Claims and Claims Adjustment Expenses (Continued)

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

	2013	2012
Unpaid claims and claims adjustment expenses, January 1	$ 94,908,633	$ 76,902,301
Less reinsurance receivable	(5,790,055)	(722,258)
Net balance	89,118,578	76,180,043
Incurred related to:		
Current year	1,103,522,041	959,660,557
Prior years	(17,709,663)	7,417,809
Total incurred	1,085,812,378	967,078,366
Paid related to:		
Current year	(1,000,686,202)	(869,819,721)
Prior years	(77,198,970)	(84,320,110)
Total paid	(1,077,885,172)	(954,139,831)
Net balance	97,045,784	89,118,578
Plus reinsurance receivable	5,445,066	5,790,055
Unpaid claims and claims adjustment expenses, December 31	$ 102,490,850	$ 94,908,633

As a result of changes in estimates of insured events in prior years, the liability for unpaid claims and claims adjustment expenses (net of reinsurance recoveries of $5,445,066) decreased by $17,709,663 in 2013. The liability for unpaid claims and claims adjustment expenses (net of reinsurance recoveries of $5,790,055) increased by $7,417,809 in 2012. The Company records a liability for unpaid claims and claims adjustment expenses that includes an allowance for potential shock claims.

6. Line of Credit

The Company had a line of credit from a bank, which provided for maximum borrowings of $40,000,000. The balance on the line of credit was $0 and $8,087,428 at December 31, 2013 and 2012, respectively. The line of credit was paid off and closed in December 2013.

7. Notes Payable

Notes payable consisted of the following at December 31:

	2013	2012
Note payable to bank, due in monthly installments of $89,655, plus interest at LIBOR plus 2.5% per annum (effective rate of 2.67% at December 31, 2013), collateralized by real property, due in full at maturity December 2018.	$ 21,500,000	$ -
Note payable to bank, due in monthly installments of $241,715, plus interest at LIBOR plus 3% per annum (effective rate of 3.17% at December 31, 2013), collateralized by administrative service agreements, due in full at maturity December 2018.	14,500,000	-
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, 2013), collateralized by business assets, matures March 2018.	907,479	1,084,642
Note payable to bank, paid in full December 2013.	-	9,548,093
Total	$ 36,907,479	$ 10,632,735

The note payable to the bank is subject to certain financial and non-financial covenants. The Company was not in compliance with the non-financial covenant requiring audited financial statements be delivered to the bank within 120 days of December 31, 2013. The bank has waived its right with respect to this covenant.

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

2014	$ 4,166,516
2015	4,180,257
2016	4,194,991
2017	4,210,790
2018	20,154,925
	$ 36,907,479

8. 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. Effective December 31, 2012, the benefits associated with the plan were frozen.

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

	2013	2012
Projected benefit obligation for service rendered to date	$ (28,877,813)	$ (32,291,157)
Plan assets at fair value	32,577,203	29,646,024
Funded status	$ 3,699,390	$ (2,645,133)
Change in projected benefit obligation:		
Projected benefit obligation, beginning of year	$ 32,291,157	$ 30,317,898
Service cost	-	3,140,174
Interest cost	1,338,076	1,387,128
Curtailment gain	-	(8,090,897)
Benefits paid and administrative expenses	(899,608)	(1,001,370)
Actuarial (gain) loss	(3,851,812)	6,538,224
Projected benefit obligation, end of year	$ 28,877,813	$ 32,291,157

(Continued)

8. Retirement Plans (Continued)

	2013	2012
Change in fair value of plan assets:		
Fair value of plan assets, beginning of year	$ 29,646,024	$ 25,603,787
Actual return on plan assets	3,830,787	3,043,607
Employer contributions	-	2,000,000
Benefits paid	(899,608)	(1,001,370)
Fair value of plan assets, end of year	$ 32,577,203	$ 29,646,024
Net periodic benefit cost:		
Service cost	$ -	$ 3,140,174
Interest cost	1,338,076	1,387,128
Expected return on plan assets	(1,843,531)	(1,905,861)
Amortization of loss	790,527	1,235,056
Amortization of prior service credits	-	(165,472)
Curtailment gain	-	(972,975)
Total net periodic benefit cost	$ 285,072	$ 2,718,050
Amounts recognized in accumulated other comprehensive income:		
Net loss	$ 3,587,233	$ 10,209,471
Total accumulated other comprehensive income	$ 3,587,233	$ 10,209,471
Changes in other comprehensive income:		
Net (gain) loss	$ (6,622,238)	$ (3,925,475)
Prior service cost as a result of curtailment	-	972,975
Amortization of prior service credit	-	165,472
Total recognized in other comprehensive income	$ (6,622,238)	$ (2,787,028)
Accumulated benefit obligation, end of year	$ 28,877,813	$ 32,291,157

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 2014 to be $37,573, $0 and $0, respectively.

(Continued)

8. Retirement Plans (Continued)

As a result of the pension plan being frozen, the Company does not expect to make any contribution to its pension plan in 2014. Future anticipated benefit payments from the defined benefit pension plan are as follows: 2014, $1,987,067; 2015, $1,193,805; 2016, $623,466; 2017, $945,788; 2018, $937,236; and from 2019 to 2023, $10,488,993.

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

	2013	2012
Assumptions used for net periodic benefit costs:		
Discount rate used in determining present values	4.2%	4.7%
Annual increase in future compensation levels	N/A	3.5
Expected long-term rate of return on assets	6.31	7.25
Assumptions used to determine benefit obligation:		
Discount rate used in determining present values	5.1%	4.2%
Measurement date	December 31	December 31

The plan assets are invested in the following asset classes:

Debt investments	62%	49%
Equity investments	27	38
Cash equivalents	5	3
Other	6	10
Total	100%	100%

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

The 401(k) plan 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. For 2013, in addition to the annual matching contributions, the Company made a 3% contribution for all eligible employees. Company contributions under the plan were $2,183,475 and $809,602 in 2013 and 2012, respectively.

9. Income Taxes

PacificSource 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 PSHP 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:

	2013	2012
Current income tax expense (benefit):		
Federal	$ 1,857,537	$ (1,926,065)
State	459,783	40,966
Total current income tax expense (benefit)	2,317,320	(1,885,099)
Deferred tax expense (benefit)	2,239,000	(10,653,177)
Total income tax expense (benefit)	$ 4,556,320	$ (12,538,276)

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

	2013	2012
Tax expense (benefit) computed at statutory rate	$ 3,718,000	$ (10,689,000)
State tax expense (benefit), net of federal income tax benefit	542,000	(1,369,000)
Permanent and other differences	465,320	(203,276)
Dividend received deduction	(169,000)	(277,000)
Total income tax expense (benefit)	$ 4,556,320	$ (12,538,276)

(Continued)

9. Income Taxes (Continued)

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

	2013	2012
Deferred tax assets:		
Alternative minimum tax credit carryforwards	$ 4,281,000	$ 4,872,000
Federal and state net operating loss carryforwards	3,747,000	7,286,000
Contribution carryforwards	1,027,000	1,261,000
Accruals	946,000	1,315,000
Partnership difference	762,000	574,000
Unrealized losses	613,000	90,000
Deferred compensation	543,000	561,000
Discount of claims provision	437,000	534,000
Bad debt reserve	304,000	-
Goodwill	8,000	13,000
Defined benefit pension plan	-	1,038,000
Total deferred tax assets	12,668,000	17,544,000
Deferred tax liabilities:		
Property	(6,396,000)	(8,742,000)
Unrealized gains	(1,682,000)	(3,292,000)
Defined benefit pension plan	(1,447,000)	-
Prepaids	(1,260,000)	(940,000)
Subsidiary equity income	(56,000)	(47,000)
Total deferred tax liabilities	(10,841,000)	(13,021,000)
Net deferred tax assets	$ 1,827,000	$ 4,523,000

As of December 31, 2013, the Company recognized a deferred tax asset of $3,747,000, for the anticipated utilization of federal and state net operating loss carryforwards. Federal net operating loss carryforwards of $4,327,238 will expire in 2028, if not used before then. State net operating loss carryforwards of $29,574,296 will expire on various dates through 2032. Contribution carryforwards of $2,617,901 will expire on various dates through 2017. Alternative minimum tax credit carryforwards of $4,281,429 have no expiration date.

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 allowance has been recorded because it appears more likely than not that the full tax benefit of deferred tax assets will be realized.

10. Reinsurance

The Company 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, 2013 in order of their application:

Commercial	Retention	Deductible	Aggregate Limit
Layer 1	10% up to $135,000	$ 650,000	$1,350,000 per member
Layer 2	10% up to $300,000	$ 2,000,000	$3,000,000 per member
Layer 3	$ -	$ 5,000,000	$5,000,000 per member
Layer 4	$ -	$ 10,000,000	$10,000,000 per member
Layer 5	$ -	$ 20,000,000	Unlimited
Medicare	**Retention**	**Deductible**	**Aggregate Limit**
Layer 1	10%	$ 300,000	Unlimited
Medicaid	**Retention**	**Deductible**	**Aggregate Limit**
Layer 1	10%	$ 400,000	Unlimited

Premiums ceded under the terms of the reinsurance policies were $7,174,295 and $5,912,194 in 2013 and 2012, respectively. Reinsurance recoveries were $7,989,450 and $9,771,551 in 2013 and 2012, respectively. The reinsurance contracts do not relieve the Company from its primary obligation to policyholders.

11. Leases

Effective January 2008, the Company entered into a real property lease for the Tigard, Oregon sales office under an operating lease agreement expiring December 31, 2014. In 2013, the lease was renewed through June 30, 2017. The Company is responsible for substantially all executory costs. Minimum payments under the lease, which are subject to annual adjustment, are $16,910 per month. Future minimum lease payments are as follows: 2014, $208,345; 2015, $208,464; 2016, $215,268; 2017, $110,874.

Effective July 2013, the Company entered into a real property lease for the Idaho Falls, Idaho office under an operating lease agreement expiring October 31, 2016. Minimum payments under the lease, are $2,530 per month. The Company is responsible for substantially all executory costs. Future minimum lease payments are as follows: 2014, $30,360; 2015, $30,360; 2016, $25,300.

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

Effective August 2011, the Company entered into a real property lease for an additional Springfield, Oregon office under a three-year operating agreement expiring July 2014. In 2014, the lease was renewed through June 30, 2016. The Company is responsible for substantially all executory costs. Minimum payments under the lease, which are subject to annual adjustment, are $17,413 per month. Future minimum lease payments are as follows: 2014, $208,956; 2015, $214,763; 2016, $110,284.

Effective September 2012, the Company entered into a real property lease for the Medford, Oregon office under a five-year operating agreement expiring August 2017. The Company is responsible for substantially all executory costs. Minimum payments under the lease, which are subject to annual adjustment, are $4,080 per month. Future minimum lease payments are as follows: 2014, $49,960; 2015, $50,940; 2016, $51,960; 2017, $34,640.

(Continued)

11. Leases (Continued)

Effective October 2012, the Company entered into a real property lease for the Helena, Montana office under a seven-year operating agreement expiring September 2019. The lease contains an option to renew the lease for an additional five-year term. The Company is responsible for substantially all executory costs. Minimum payments under the lease, which are subject to annual adjustment, are $7,720 per month. Future minimum lease payments are as follows: 2014, $92,640; 2015, $94,520; 2016, $98,280; 2017, $99,560; 2018, $102,120; thereafter, $68,080.

Amounts charged to rent expense for the various leases were $1,196,950 and $1,011,144 for 2013 and 2012, respectively.

12. 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 from the Company, and the Company pays such excess claims on the same basis as its other indemnity contracts.

13. Commitments

In March 2010, the President of the United States signed into law the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010. This legislation includes a number of provisions that impact the health insurance industry, including provisions on increasing the number of insured members, new rules on guaranteed issue contracts, elimination of lifetime annual maximum caps on policy payments, coverage of dependent children on the parents' policy until age 26 and many others. The Company has calculated expected costs as a result of the reform and has adjusted premium rates accordingly. In addition, this legislation created health insurance exchanges. In 2014, the Company began offering individual and small group products on the exchanges in Oregon, Idaho and Montana.

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

(Continued)

13. Commitments (Continued)

On January 1, 2014, the Company will be subject to an annual fee under section 9010 of the Affordable Care Act (ACA). This annual fee will be allocated to individual health insurers based on the ratio of the amount of the entity's net premiums written during the preceding calendar year to the amount of health insurance for any U.S. health risk that is written during the preceding calendar year. A health insurance entity's portion of the annual fee becomes payable once the entity provides health insurance for any U.S. health risk for each calendar year beginning on or after January 1, 2014. As of December 31, 2013, the Company has written health insurance subject to the ACA assessment, expects to conduct health insurance business in 2014 and estimates their portion of the annual health insurance industry fee to be payable on September 30, 2014 to be approximately $18 million.

14. Litigation and Contingent Liabilities

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

During 2009, as part of the acquisition of PHI, an escrow account was established for $2,000,000. The escrow account was established to cover a contingent liability of PHI due to litigation. Upon settlement of the lawsuit by PHI, Hudson, its malpractice insurance company, was to pay up to $2,000,000 with the balance of the possible settlement covered by the escrow fund. In 2012, PHI and Hudson entered into litigation regarding the payment of the excess malpractice verdict. The litigation went to trial in March 2013 with a resulting favorable award to PHI of $2,400,000 in bad faith claims and $7,200,000 in punitive damages. PHI's receipts, net of legal expenses, were approximately $1.2 million.

15. 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, 2013 and 2012, total assets (unaudited), consisting primarily of cash equivalents and marketable securities, were approximately $5,060,000 and $5,675,000, 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 2013 and 2012, the Company made contributions of $0 and $600,000 to the Foundation, respectively.

16. 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, 2013. Valuation techniques utilized to determine fair value are consistently applied.

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

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

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

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

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

(Continued)

16. Fair Value of Financial Instruments (Continued)

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

	Total	Fair Value Measurement: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2013				
Available-for-sale debt securities:				
U.S. Government debt securities	$ 15,263,518	$ -	$ 15,263,518	$ -
Mortgage/asset backed debt securities	39,912,745	-	39,912,745	-
Corporate debt securities	68,815,958	-	68,815,958	-
Total debt securities	123,992,221	-	123,992,221	-
Available-for-sale equity securities:				
Mutual funds	13,852,580	13,852,580	-	-
Other invested assets	1,248,124	-	1,248,124	-
December 31, 2012				
Available-for-sale debt securities:				
U.S. Government debt securities	$ 13,146,733	$ -	$ 13,146,733	$ -
Mortgage/asset backed debt securities	41,513,282	-	41,513,282	-
Corporate debt securities	63,879,856	-	63,879,856	-
Total debt securities	118,539,871	-	118,539,871	-
Available-for-sale equity securities:				
Mutual funds	36,324,238	36,324,238	-	-
Other invested assets	5,778,535	-	5,778,535	-

(Continued)

16. 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		
Description	**Total**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
December 31, 2013				
Registered investment companies:				
Fixed income funds	$ 8,872,080	$ 8,872,080	$ -	$ -
Balanced funds	10,998,917	10,998,917	-	-
Growth funds	6,600,524	6,600,524	-	-
Value funds	4,041,469	4,041,469	-	-
Money market funds	526,873	526,873	-	-
Real estate funds	1,537,340	1,537,340	-	-
Total	$ 32,577,203	$ 32,577,203	$ -	$ -
December 31, 2012				
Registered investment companies:				
Fixed income funds	$ 11,174,692	$ 11,174,692	$ -	$ -
Balanced funds	6,919,907	6,919,907	-	-
Growth funds	5,339,468	5,339,468	-	-
Value funds	3,794,339	3,794,339	-	-
Money market funds	848,995	848,995	-	-
Real estate funds	1,568,623	1,568,623	-	-
Total	$ 29,646,024	$ 29,646,024	$ -	$ -

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

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

17. Statutory Financial Information

PSHP 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.

PSHP and PCHP follow the NAIC's SAP and do not have permitted practices that deviate from NAIC SAP. PSHP and PCHP's statutory capital and surplus were sufficient to satisfy regulatory requirements at December 31, 2013.

SUPPLEMENTAL INFORMATION

PACIFICSOURCE AND SUBSIDIARIES
Consolidated Schedules of General and Administrative Expenses

	Year Ended December 31 2013	2012
Salaries	$ 36,255,931	$ 32,996,955
Payroll taxes	3,351,181	3,116,496
Employee benefits	7,549,314	8,004,893
Retirement plans	2,133,812	3,440,344
Contract labor	651,066	461,879
Administrative expense, net	886,194	2,047,158
Advertising	2,621,910	3,505,496
Automobile expense	292,672	295,972
Banking charges	427,179	290,533
Board expenses	395,587	402,214
Building maintenance	400,513	358,079
Consultant fees	1,964,440	5,950,344
Depreciation and amortization	10,012,823	10,333,890
Education and training	240,832	271,538
Imaging expense	385,393	430,675
Insurance	710,626	696,996
Legal fees	635,143	305,875
Meals and entertainment	459,357	460,868
Office expenses and supplies	959,794	908,478
Postage	2,538,715	1,909,030
Printing expense	1,910,800	1,445,810
Professional accounting, state audit and actuarial services	525,258	498,067
Professional dues	253,964	230,796
Purchased services	5,425,660	1,476,138
Recruiting	131,717	208,814
Rent - equipment	125,383	217,153
Rent - regional offices	1,228,825	1,011,144
Repairs and maintenance	663,360	830,860
Software licenses	6,378,325	5,050,759
Subscriptions	67,621	81,605
Surveys and studies	4,382	3,070
Taxes and licenses	581,288	464,334
Telephone	703,484	684,643
Travel	643,177	665,345
Utilities	267,356	230,700
Total	$ 91,783,082	$ 89,286,951

PACIFICSOURCE AND SUBSIDIARIES
Consolidating Balance Sheet
December 31, 2013

	PS	PSHP	PCHP	PCS	COLH	CCP	PHI	IPN	PSA	Eliminations	Consolidated Total
ASSETS											
Investments	$ 155,358,879	$ 171,745,936	$ 54,008,415	$ 7,826,328	$ -	$ -	$ 734,424	$ -	$ -	$ (247,180,546)	$ 142,493,436
Cash and cash equivalents	163,279	43,877,209	9,155,482	18,503,570	88,955	45,656	1,704,965	1,741,552	430,132	-	75,710,800
Trust funds	-	-	-	-	-	-	-	-	4,296,284	-	4,296,284
Accounts receivable	(7,031)	16,795,688	7,840,240	4,688,104	-	657,843	286	277,938	364,723	-	30,617,791
Prepaid expenses and deposits	4,707,086	499,252	-	-	-	11,018	93,810	-	-	-	5,311,166
Prepaid income taxes	(221,058)	3,775,254	-	-	-	-	-	-	-	-	3,554,196
Prepaid pension costs	3,699,390	-	-	-	-	-	-	-	-	-	3,699,390
Property, net	38,739,773	-	-	-	-	-	11,283	-	56,484	-	38,807,540
Goodwill	-	-	-	9,087,214	-	-	497,917	-	3,026,641	-	12,611,772
Intangible assets, net	425,933	4,660,031	-	-	-	-	3,785,235	-	34,722	-	8,905,921
Deferred tax assets (liabilities)	3,945,000	(4,961,000)	706,000	34,000	-	(840,000)	3,103,000	-	(160,000)	-	1,827,000
Intercompany receivables	-	1,957,864	4,783,991	6,689,799	-	2,807,079	562,170	-	-	(16,800,903)	-
Total	$ 206,811,251	$ 238,350,234	$ 76,494,128	$ 46,829,015	$ 88,955	$ 2,681,596	$ 10,493,090	$ 2,019,490	$ 8,048,986	$ (263,981,449)	$ 327,835,296
LIABILITIES AND FUND BALANCE											
LIABILITIES:											
Unpaid claims and claims adjustment expenses	$ -	$ 63,300,000	$ 29,853,434	$ 9,337,416	$ -	$ -	$ -	$ -	$ -	$ -	$ 102,490,850
Book overdraft	-	5,745,948	-	-	-	-	-	-	-	-	5,745,948
Accounts payable	-	4,436,098	2,967,844	1,304,164	-	78,939	1,747	7,000	(1,720)	-	8,794,072
Accrued expenses	6,312,447	189,568	759,351	2,963,563	-	2,550	-	27,684	5,294	-	10,260,457
Unearned premiums	-	4,521,043	225,822	-	-	-	-	-	14,220	-	4,761,085
Incentive compensation payable under managed care plans	-	906,435	613,252	-	-	-	-	-	-	-	1,519,687
Accrued retro settlements	-	3,892,260	-	-	-	-	-	-	-	-	3,892,260
Collections for others	-	-	-	-	-	-	-	-	4,296,284	-	4,296,284
Notes payable	36,000,000	-	-	-	-	-	-	-	907,479	-	36,907,479
Intercompany payables	15,821,245	-	-	-	27,000	-	-	760,767	191,891	(16,800,903)	-
Total	58,133,692	82,991,352	34,419,703	13,605,143	27,000	81,489	1,747	795,451	5,413,448	(16,800,903)	178,668,122
FUND BALANCE:											
Fund balance, unrestricted	149,465,961	153,970,051	42,062,816	33,216,346	61,955	2,600,107	10,491,343	734,424	2,635,538	(245,772,580)	149,465,961
Accumulated other comprehensive (income) loss	(788,402)	1,388,831	11,609	7,526	-	-	-	-	-	(1,407,966)	(788,402)
Noncontrolling interests	-	-	-	-	-	-	-	489,615	-	-	489,615
Total	148,677,559	155,358,882	42,074,425	33,223,872	61,955	2,600,107	10,491,343	1,224,039	2,635,538	(247,180,546)	149,167,174
Total	$ 206,811,251	$ 238,350,234	$ 76,494,128	$ 46,829,015	$ 88,955	$ 2,681,596	$ 10,493,090	$ 2,019,490	$ 8,048,986	$ (263,981,449)	$ 327,835,296

PACIFICSOURCE AND SUBSIDIARIES
Consolidating Statement of Operations
Year Ended December 31, 2013

	PS	PSHP	PCHP	PCS	COLH	CCP	PHI	IPN	PSA	Eliminations	Consolidated Total
PREMIUMS:											
Commercial	$ -	$ 724,559,297	$ 60,214	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 724,619,511
Medicare	-	-	301,439,367	-	-	-	-	-	-	-	301,439,367
Medicaid	-	-	-	138,185,134	-	-	-	-	-	-	138,185,134
Total	-	724,559,297	301,499,581	138,185,134	-	-	-	-	-	-	1,164,244,012
CLAIMS EXPENSE:											
Commercial	-	632,197,916	(49,399)	-	-	-	-	-	-	(330,897)	631,817,620
Medicare	-	-	289,301,330	-	-	-	-	-	-	-	289,301,330
Medicaid	-	-	-	123,333,698	-	-	-	-	-	-	123,333,698
Commissions on premiums	-	20,951,603	5,404,955	-	-	-	-	-	-	-	26,356,558
Premium taxes and OMIP assessments	-	15,903,658	2,402	1,044,586	-	-	-	-	-	-	16,950,646
Total	-	669,053,177	294,659,288	124,378,284	-	-	-	-	-	(330,897)	1,087,759,852
EXCESS OF PREMIUMS OVER CLAIMS EXPENSE	-	55,506,120	6,840,293	13,806,850	-	-	-	-	-	330,897	76,484,160
ADMINISTRATIVE REVENUES	-	3,522,242	-	-	5,966	1,515,991	-	3,875,544	4,138,695	(1,569,383)	11,489,055
GENERAL AND ADMINISTRATIVE EXPENSES	-	60,497,917	15,068,966	8,222,361	127	1,627,796	75,023	3,588,281	3,941,097	(1,238,486)	91,783,082
UNDERWRITING (LOSS) INCOME	-	(1,469,555)	(8,228,673)	5,584,489	5,839	(111,805)	(75,023)	287,263	197,598	-	(3,809,867)
OTHER INCOME (EXPENSE):											
Investment income	-	13,747,875	1,600,634	214,142	-	(21,924)	-	-	126	-	15,540,853
Interest expense	-	(12,477)	(174,794)	-	-	(766,579)	-	-	(69,279)	344,803	(678,326)
Charitable contributions	-	(932,725)	(5,200)	(15,000)	-	-	-	-	-	-	(952,925)
Miscellaneous (expense) income	-	(417,920)	(93,029)	354,251	-	-	1,255,574	70,001	11,842	(344,803)	835,916
Income from subsidiaries	-	1,571,430	3,448,414	-	-	-	150,051	-	-	(5,169,895)	-
Total	-	13,956,183	4,776,025	553,393	-	(788,503)	1,405,625	70,001	(57,311)	(5,169,895)	14,745,518
INCOME (LOSS) BEFORE INCOME TAXES	-	12,486,628	(3,452,648)	6,137,882	5,839	(900,308)	1,330,602	357,264	140,287	(5,169,895)	10,935,651
INCOME TAX EXPENSE (BENEFIT)	-	6,207,331	(2,366,642)	2,079,000	2,000	(286,000)	(1,391,406)	107,179	204,858	-	4,556,320
TOTAL INCOME (LOSS)	-	6,279,297	(1,086,006)	4,058,882	3,839	(614,308)	2,722,008	250,085	(64,571)	(5,169,895)	6,379,331
LESS INCOME ATTRIBUTABLE TO NONCONTROLLING INTERESTS	-	-	-	-	-	-	-	100,034	-	-	100,034
NET INCOME (LOSS)	$ -	$ 6,279,297	$ (1,086,006)	$ 4,058,882	$ 3,839	$ (614,308)	$ 2,722,008	$ 150,051	$ (64,571)	$ (5,169,895)	$ 6,279,297