PacificSource

Independent Auditors' Report

Consolidated Financial Statements and Supplemental Information

Years Ended December 31, 2014 and 2013

KERNUTTSTOKES

PACIFICSOURCE AND SUBSIDIARIES

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
PacificSource and Subsidiaries:

We have audited the accompanying consolidated financial statements of PacificSource and Subsidiaries (the Company), which comprise the consolidated balance sheets as of December 31, 2014 and 2013, and the related consolidated statements of operations, comprehensive (loss) income, 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 and Subsidiaries as of December 31, 2014 and 2013, 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 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 29, 2015

PACIFICSOURCE AND SUBSIDIARIES
Consolidated Balance Sheets

	December 31 2014	December 31 2013
ASSETS		
Investments	$ 138,222,058	$ 142,493,436
Cash and cash equivalents	68,137,400	75,710,800
Trust funds	4,616,759	4,296,284
Accounts receivable	69,012,321	30,617,791
Prepaid expenses and deposits	7,576,410	7,136,123
Prepaid income taxes	9,465,147	3,554,196
Prepaid pension costs	-	3,699,390
Property, net	32,129,037	38,807,540
Goodwill	12,611,772	12,611,772
Intangible assets, net	7,621,785	8,905,921
Deferred tax assets	2,079,700	1,827,000
Total	$ 351,472,389	$ 329,660,253
LIABILITIES AND FUND BALANCE		
LIABILITIES:		
Unpaid claims and claims adjustment expenses	$ 96,185,220	$ 102,490,850
Premium deficiency reserve	4,960,000	-
Book overdraft	-	5,745,948
Accounts payable	5,460,156	8,794,072
Accrued expenses	50,235,010	12,085,414
Accrued pension liability	2,434,177	-
Unearned premiums	7,996,378	4,761,085
Provider incentive compensation and withholds payable	34,489,082	1,519,687
Accrued retro settlements	4,978,572	3,892,260
Collections for others	4,616,759	4,296,284
Notes payable	717,508	36,907,479
Total	212,072,862	180,493,079
FUND BALANCE:		
Fund balance, unrestricted	141,234,966	149,465,961
Accumulated other comprehensive loss	(2,405,907)	(788,402)
Noncontrolling interests	570,468	489,615
Total	139,399,527	149,167,174
Total	$ 351,472,389	$ 329,660,253

See accompanying notes.

PACIFICSOURCE AND SUBSIDIARIES
Consolidated Statements of Operations

	Year Ended December 31 2014	2013
PREMIUMS:		
Commercial	$ 612,313,200	$ 724,619,511
Medicare	328,645,614	301,439,367
Medicaid	274,106,015	138,185,134
Total	1,215,064,829	1,164,244,012
CLAIMS EXPENSE:		
Commercial	541,044,015	631,817,620
Medicare	305,936,452	289,301,330
Medicaid	236,524,570	123,333,698
Commissions on premiums	21,616,772	26,356,558
Premium taxes and assessments	14,196,099	16,950,646
Change in premium deficiency reserve	4,960,000	-
Total	1,124,277,908	1,087,759,852
EXCESS OF PREMIUMS OVER CLAIMS EXPENSE	90,786,921	76,484,160
ADMINISTRATIVE REVENUES	13,229,330	11,489,055
GENERAL AND ADMINISTRATIVE EXPENSES	111,776,217	91,783,082
UNDERWRITING LOSS	(7,759,966)	(3,809,867)
OTHER INCOME (EXPENSE):		
Investment income	6,658,788	15,540,853
Interest expense	(570,119)	(678,326)
Charitable contributions	(954,088)	(952,925)
Miscellaneous (expense) income	(757,235)	835,916
Total	4,377,346	14,745,518
(LOSS) INCOME BEFORE INCOME TAXES	(3,382,620)	10,935,651
INCOME TAX EXPENSE	4,764,054	4,556,320
TOTAL (LOSS) INCOME	(8,146,674)	6,379,331
LESS INCOME ATTRIBUTABLE TO NONCONTROLLING INTERESTS	84,321	100,034
NET (LOSS) INCOME	$ (8,230,995)	$ 6,279,297

See accompanying notes.

PACIFICSOURCE AND SUBSIDIARIES
Consolidated Statements of Comprehensive (Loss) Income

	Year Ended December 31 2014	2013
NET (LOSS) INCOME	$ (8,230,995)	$ 6,279,297
OTHER COMPREHENSIVE (LOSS) INCOME, NET OF TAXES:		
Unrealized appreciation and depreciation of investments:		
Unrealized appreciation and depreciation arising during year (net of tax of $1,546,000 in 2014 and $(964,000) in 2013)	2,644,379	(1,494,605)
Reclassification adjustment for gains and losses realized in net (loss) income (net of tax of $(374,000) in 2014 and $(1,169,000) in 2013), included in investment income	(639,468)	(1,814,439)
Unrealized appreciation and depreciation of investments, net	2,004,911	(3,309,044)
Defined benefit pension plan:		
Net (loss) gain arising during year (net of tax of $(2,690,000) in 2014 and $2,281,000 in 2013), included in general and administrative expenses	(4,043,075)	3,550,711
Amortization of net loss (net of tax of $280,000 in 2014 and $309,000 in 2013), included in general and administrative expenses	420,659	481,527
Defined benefit pension plan, net	(3,622,416)	4,032,238
Total other comprehensive (loss) income	(1,617,505)	723,194
COMPREHENSIVE (LOSS) INCOME	$ (9,848,500)	$ 7,002,491

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, 2013	$ 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
Net (loss) income	(8,230,995)	-	-	84,321	(8,146,674)
Other comprehensive income (loss)	-	2,004,911	(3,622,416)	-	(1,617,505)
Redemption of IPN common stock	-	-	-	(3,468)	(3,468)
BALANCE, December 31, 2014	$ 141,234,966	$ 3,393,742	$ (5,799,649)	$ 570,468	$ 139,399,527

See accompanying notes.

PACIFICSOURCE AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Change in Cash and Cash Equivalents

	Year Ended December 31 2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES:		
Premiums collected	$ 1,179,905,592	$ 1,169,071,446
Claims paid	(1,091,567,831)	(1,077,885,172)
General and administrative expenses paid	(74,602,268)	(88,405,968)
Investment income received	4,985,424	5,167,634
Other revenue received	13,229,330	11,489,055
Interest paid	(571,228)	(679,359)
Income taxes paid	(9,689,705)	(2,832,203)
Net cash provided by operating activities	21,689,314	15,925,433
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from sale of investments	130,785,088	155,221,892
Investments purchased	(121,663,435)	(128,759,025)
Purchase of intangible assets	-	(425,933)
Property purchased	(2,190,928)	(5,405,297)
Net cash provided by investing activities	6,930,725	20,631,637
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net payments on line of credit	-	(8,087,428)
Proceeds from notes payable	-	29,223,419
Payments on notes payable	(36,189,971)	(2,948,675)
Redemption of common stock	(3,468)	-
Distributions	-	(20,000)
Net cash (used in) provided by financing activities	(36,193,439)	18,167,316
CHANGE IN CASH AND CASH EQUIVALENTS	(7,573,400)	54,724,386
CASH AND CASH EQUIVALENTS, beginning of year	75,710,800	20,986,414
CASH AND CASH EQUIVALENTS, end of year	$ 68,137,400	$ 75,710,800

(Continued)

See accompanying notes.

PACIFICSOURCE AND SUBSIDIARIES
Consolidated Statements of Cash Flows (Continued)

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

	Year Ended December 31 2014	2013
NET (LOSS) INCOME	$ (8,230,995)	$ 6,279,297
ADJUSTMENTS TO RECONCILE NET (LOSS) INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Income attributable to noncontrolling interest	84,321	100,034
Depreciation and amortization	9,770,484	10,012,823
Deferred tax expense	985,300	2,239,000
Gain on sale of investments	(1,777,423)	(10,391,245)
Loss on disposal of property and intangible assets	383,083	621,415
Change in premium deficiency reserve	4,960,000	-
Adjustments resulting from changes in:		
Accounts receivable	(38,394,530)	7,719,345
Accrued investment income	104,059	18,026
Prepaid expenses and deposits	(440,287)	(1,259,791)
Prepaid income taxes	(5,910,951)	(514,883)
Prepaid pension costs	3,699,390	2,922,848
Unpaid claims and claims adjustment expenses	(6,305,630)	7,582,217
Book overdraft	(5,745,948)	(9,479,703)
Accounts payable	(3,333,916)	(818,299)
Accrued pension liability	(3,598,239)	(2,645,133)
Unearned premiums	3,235,293	(2,891,911)
Incentive compensation payable	32,969,395	1,130,954
Accrued retro settlements	1,086,312	1,161,509
Accrued expenses	38,149,596	4,138,930
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 21,689,314	$ 15,925,433

Supplemental Schedule of Noncash Investing and Financing Activities

At December 31, 2014, there was an increase from December 31, 2013 in unrealized appreciation of investments, net of reclassification adjustments, of $3,176,911 with deferred taxes of $(1,172,000). 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.

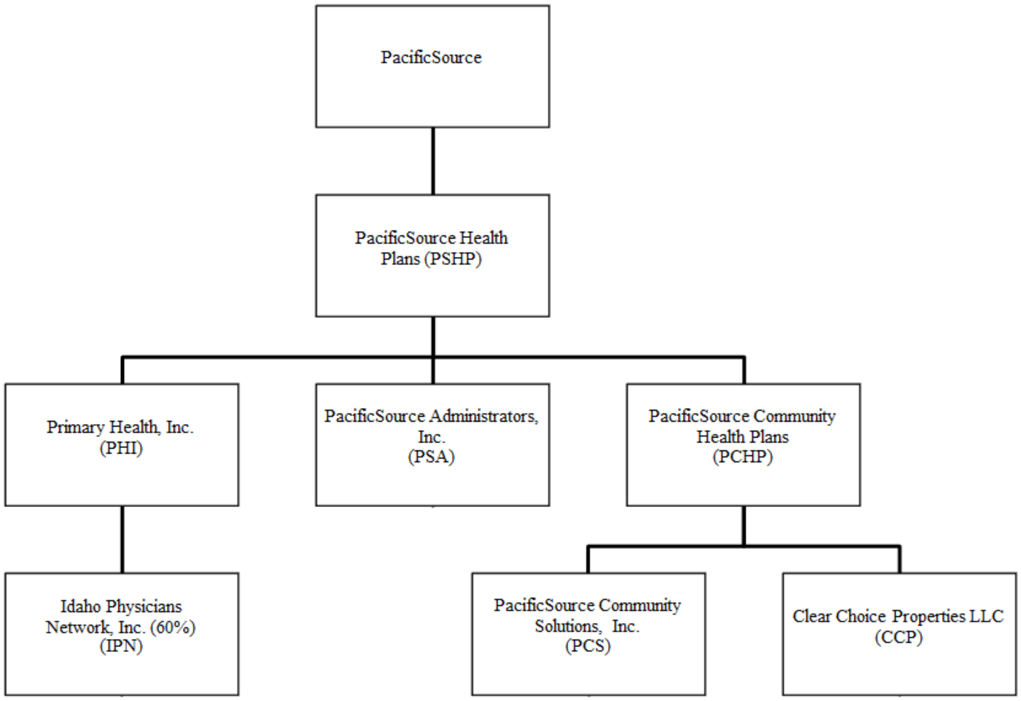
At December 31, 2014, there were defined benefit pension plan adjustments of $(6,032,416) with deferred taxes of $2,410,000. At December 31, 2013, there were defined benefit pension plan adjustments of $6,622,238 with deferred taxes of $(2,590,000).

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

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. CCP owned the building located in Bend, Oregon, that was transferred to PacificSource on December 31, 2013.

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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, PacificSource became the sole member of PSHP. 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 to PacificSource; 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, payroll and related liabilities and retirement plans were also transferred to PacificSource.

On December 31, 2014, PacificSource Community Health Plans, Inc. merged into a newly formed not-for-profit health care contractor company, PacificSource Community Health Plans.

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

	2014		2013	
PacificSource	$ 425,888	0.0%	$ -	0.0%
PSHP	617,712,845	50.3%	728,081,539	61.9%
PCHP and subsidiaries	602,740,588	49.0%	439,992,450	37.4%
PSA	4,172,523	0.4%	4,114,431	0.4%
PHI and subsidiaries	3,242,315	0.3%	3,544,647	0.3%
Gross revenue	$ 1,228,294,159	100.0%	$ 1,175,733,067	100.0%

Principles of Consolidation. The accompanying financial statements of PacificSource are consolidated with PSHP and its subsidiaries (collectively the Company). 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.

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

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.

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.

Restricted Deposits. PSHP, PCHP and PCS maintain deposits as required by regulatory authorities. PSHP and PCHP had restricted deposits in the form of certificates of deposit maturing at various dates through April 2015 of $2,611,738 and $2,611,738 that were included at fair value in investments on the consolidated balance sheets at December 31, 2014 and 2013, respectively. PCS had restricted deposits in a money market account of $6,394,906 and $6,387,237 included in cash and cash equivalents on the consolidated balance sheets at December 31, 2014 and 2013, 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 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. Accounts receivable consist primarily of uncollected premiums from policyholders, amounts due from groups under administrative service contracts for uninsured health plans, pharmacy rebates, claims refunds collectible from providers, insureds and third parties, amounts due under the Patient Protection and Affordable Care Act (ACA) reinsurance and risk adjustment programs and amounts due for contractual adjustments from the Centers for Medicare and Medicaid Services (CMS).

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, 2014 and 2013, management considered receivables to be fully collectible; accordingly, no allowance for doubtful accounts was considered necessary.

(Continued)

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

Health Care Reform. The ACA enacted significant reforms to various aspects of the U.S. health insurance industry. Certain of these reforms became effective January 1, 2014, including an annual premium-based health insurance provider fee and the establishment of federally-facilitated or state-based exchanges. The U.S. Department of Health and Human Services (HHS) pays a portion of the premium and a portion of the claim costs for low-income individual public exchange members. In addition, HHS administers three premium stabilization programs, as described more fully below.

ACA Reinsurance. The ACA established a temporary three-year reinsurance program, under which all issuers of major medical commercial insurance products and self-insured plan sponsors are required to contribute funding in amounts set by HHS. Funds collected will be utilized to reimburse issuer's high claims costs incurred for qualified individual members. The expense related to this required funding is reflected in claims expense - premium taxes and assessments, for all of the Company's insurance products with the exception of products associated with qualified individual members. At December 31, 2014, the Company recorded an accrued expense for funding contribution fees under the temporary three-year reinsurance program. When annual claim costs incurred by the Company's qualified individual members exceed a specified attachment point, the Company is entitled to certain reimbursements from this program. The Company recorded a receivable and offset claims expense to reflect its estimate of these recoveries.

Risk Adjustment. The ACA established a permanent risk adjustment program to transfer funds from qualified individual and small group insurance plans with below average risk scores to plans with above average risk scores. Based on the risk of the Company's qualified plan members relative to the average risk of members of other qualified plans in comparable markets, the Company estimates its ultimate 2014 risk adjustment receivable and reflects the impact as an adjustment to premium revenue.

Risk Corridor. The ACA established a temporary three-year risk sharing program for qualified individual and small group insurance plans. Under this program the Company makes (or receives) a payment to (or from) HHS based on the ratio of allowable costs to target costs. The Company records a risk corridor receivable or payable as an adjustment to premium revenue on a pro-rata year-to-date basis based on its estimate of the ultimate 2014 risk sharing amount. At December 31, 2014, the Company believes it is in a receivable position; however it did not record a risk corridor receivable because the collectability of payments from HHS under this program are deemed uncertain.

The Company will perform a final reconciliation and settlement with HHS of the 2014 claims expense, ACA reinsurance, risk adjustment and risk corridor during 2015.

(Continued)

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

Medicare Part D. The Company covers prescription drug benefits in accordance with Medicare Part D under multiple contracts with CMS. The payments received monthly from CMS and members, which are determined from an annual bid, represent amounts for providing prescription drug insurance coverage. The Company recognizes premium revenue for providing insurance coverage ratably over the term of its annual contract. CMS payments are subject to risk sharing through the Medicare Part D risk corridor provisions. In addition, the Company is not at risk for amounts due for reinsurance, low-income cost subsidies and certain discounts on brand name prescription drugs in the coverage gap. The Company expenses the cost of covered prescription drugs as incurred. Costs associated with low-income Medicare beneficiaries and the catastrophic drug costs paid in advance by CMS are recorded as a liability and offset claims expense when incurred.

The risk corridor provisions compare costs targeted in the Company's bids to actual prescription drug costs, limited to actual costs that would have been incurred under the standard coverage as defined by CMS. Variances exceeding certain thresholds may result in CMS making additional payments to the Company or require refunds to CMS for a portion of the premiums received. The Company records a receivable or payable at the contract level as an adjustment to premium revenue based on the timing of expected settlement. The Company performs a reconciliation of the final risk-sharing, low-income subsidy and catastrophic amounts after the end of each contract year.

Medicare Risk-Score Adjustment. CMS utilizes a risk-score adjustment model which apportions premiums paid to Medicare plans according to health severity. The risk-score adjustment model pays more for enrollees with predictably higher costs, allowing health plans to be paid appropriately based upon members' overall health. Under the risk-score adjustment methodology, new members are assigned a risk score upon enrollment based upon a variety of factors, including demographics and health history. The risk score is then used in an actuarial model to calculate the rates paid to a health plan. The Company estimates risk-score adjustment revenues based on retrospective chart reviews of its members performed by a third party.

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 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, 2014 and 2013, and determined that the fair value of goodwill exceeded the carrying value, thus goodwill is not considered impaired.

(Continued)

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

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, 2014 and 2013, 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.

Premium Deficiency Reserve. The Company reassesses the profitability of its contracts for providing insurance coverage to its members when current operating results or actuarial forecasts indicate probable future losses. The Company establishes a premium deficiency liability in current operations to the extent that the sum of expected future costs, claim adjustment expenses and maintenance costs exceed related future premiums under contracts without consideration of investment income. For purposes of premium deficiency losses, contracts are grouped in a manner consistent with the Company's method of acquiring, servicing and measuring the profitability of such contracts and represents the Company's best estimate in a range of potential outcomes. Losses recognized as a premium deficiency result in a beneficial effect in subsequent periods as operating losses under these contracts are charged to the liability previously established. The Company recognized a premium deficiency liability of $4,960,000 and corresponding loss during the year ended December 31, 2014. No premium deficiency liability was considered necessary in 2013.

(Continued)

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

Coordinated Care Organization Risk Sharing. The Company was awarded the Coordinated Care Organization (CCO) contracts with the state which cover the Central Oregon and Gorge regions. Under the terms of the CCO contracts, the Company is subject to various risk sharing targets. Based on an annual review of performance and utilization, the Company is either required to remit amounts to contract participants following the end of the Company's fiscal year or may be entitled to collect amounts from contract participants. Amounts due under these contract provisions are recorded as accrued expenses on the accompanying consolidated balance sheets.

Provider Incentive Compensation and Withholds Payable. The Company contracts with certain medical provider groups to provide healthcare services to plan members that involve risk sharing arrangements. Contracts are renegotated annually and based on revised contract terms, the recorded balance may fluctuate. Under the terms of the contracts with participating providers, a percentage of their fees are retained by the Company in an incentive pool reserve. Based on an annual review of performance and utilization, pool surpluses are generally paid to providers and pool deficits are generally retained by the Company.

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.

Revenue Recognition. Premiums are recognized on a monthly basis over the policy term. Administrative revenues are recognized over the period the service is provided and include the operations of the non-insurance subsidiaries and administrative service contract fees which are received in exchange for performing certain claims processing and member services.

(Continued)

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

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 $3,633,219 and $2,621,910 for 2014 and 2013, 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 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.

(Continued)

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

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, reinsurance receivables and other 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.

The Company evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from geographic regions, activities, or economic characteristics of its reinsurers. At December 31, 2014, the Company's reinsurance recoverables consisted primarily of amounts due from the U.S. Government and are therefore considered to have a low credit risk. The remainder of the Company's reinsurance recoverables are due from third parties that are rated consistent with companies that are considered to have the ability to meet their obligations. Credit risk relative to accounts receivable is minimal due to the nature of the receivables and due to the large number of policyholders.

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 29, 2015, which is the date the consolidated financial statements were available to be issued.

Reclassifications. Certain 2013 amounts have been reclassified to conform with 2014 presentation. The reclassifications had no effect on previously reported net income.

2. Investments

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

	2014	2013
Debt securities	$ 101,024,624	$ 123,992,221
Equity securities and mutual funds	33,023,559	13,852,580
Certificates of deposit	2,611,738	2,611,738
Other invested assets	877,423	1,248,124
Accrued investment income	684,714	788,773
Total	$ 138,222,058	$ 142,493,436

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, 2014 are as follows:

	Amortized Cost/ Cost	Gross Unrealized Appreciation	Gross Unrealized Depreciation	Fair Value
U.S. Government debt securities	$ 14,032,024	$ 297,918	$ (24,002)	$ 14,305,940
Mortgage/asset backed securities	28,800,237	672,679	(84,272)	29,388,644
Corporate debt securities	56,365,000	1,209,503	(244,463)	57,330,040
Total debt securities	99,197,261	2,180,100	(352,737)	101,024,624
Equity securities and mutual funds	28,948,079	4,306,139	(230,659)	33,023,559
Total	$ 128,145,340	$ 6,486,239	$ (583,396)	$ 134,048,183

Approximately $1.8 million of gross realized gains and $72 thousand of gross realized losses were included in investment income on the consolidated statements of operations for 2014.

(Continued)

2. Investments (Continued)

The cost and fair value of the investments at December 31, 2013 are as follows:

	Amortized Cost/ 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 income for 2013.

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, 2014, and the securities that were in a loss position at December 31, 2013 that were still in a loss position at December 31, 2014, 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	$ 14,127,154	$ (207,261)	$ 11,371,957	$ (145,476)	$ 25,499,111	$ (352,737)
Equity securities	3,897,670	(222,705)	87,224	(7,954)	3,984,894	(230,659)
	$ 18,024,824	$ (429,966)	$ 11,459,181	$ (153,430)	$ 29,484,005	$ (583,396)

As of December 31, 2014, the Company had 115 securities in an unrealized loss position. All of these securities had a percentage decline of less than 10%. At December 31, 2014 and 2013, the Company did not hold any less-than-investment grade corporate debt securities.

(Continued)

2. Investments (Continued)

At December 31, 2014, debt securities were scheduled to mature as follows:

	Amortized Cost	Fair Value
Due in one year or less	$ 6,195,961	$ 6,229,406
Due in one to five years	51,497,621	52,472,020
Due in five to ten years	37,290,297	38,030,250
Due after ten years	4,213,382	4,292,948
Total	$ 99,197,261	$ 101,024,624

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

	Amortized Cost/ Cost	Fair Value	Unrealized Appreciation	Tax Effect	Net Unrealized Appreciation
December 31, 2014	$ 128,145,340	$ 134,048,183	$ 5,902,843	$ (2,241,000)	$ 3,661,843
Less December 31, 2013	135,118,869	137,844,801	2,725,932	(1,069,000)	1,656,932
Change in unrealized appreciation			$ 3,176,911	$ (1,172,000)	$ 2,004,911

Investment expense was approximately $350,000 and $399,000 for the years ended December 31, 2014 and 2013, 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. Accounts Receivable

Accounts receivable at December 31 consisted of the following:

	2014	2013
ACA reinsurance	$ 19,207,012	$ -
Medicare risk score	13,132,000	6,334,000
Uncollected premiums from policyholders	8,530,969	9,677,574
Reinsurance recoverables	7,562,571	5,445,066
Medicare Part D	7,027,590	-
Pharmacy rebates	3,544,823	3,316,463
Amounts due from groups under administrative service contracts	3,135,575	2,278,556
ACA risk adjustment	2,293,491	-
Other	4,578,290	3,566,132
Total	$ 69,012,321	$ 30,617,791

4. Property

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

	2014	2013
Land	$ 3,172,078	$ 3,172,078
Buildings	18,771,989	18,700,814
Furniture and fixtures	2,955,894	3,087,083
Electronic data processing equipment	-	116,456
Office equipment	2,141,028	1,316,428
Software	12,264,352	11,533,475
Automobiles	73,505	73,505
Leasehold improvements	1,483,286	1,536,952
Work-in-process	136,339	-
	40,998,471	39,536,791
Less accumulated depreciation and amortization	8,869,434	729,251
Total	$ 32,129,037	$ 38,807,540

5. Intangible Assets

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

	2014	2013
Customer relationships	$ 6,083,630	$ 6,083,630
Contractual arrangements	3,785,235	3,785,235
Trade names and trademarks	600,000	600,000
Other intangible assets	125,000	125,000
Loan fees	-	425,933
	10,593,865	11,019,798
Less accumulated amortization	2,972,080	2,113,877
Total	$ 7,621,785	$ 8,905,921

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: 2015, $858,203; 2016, $858,203; 2017, $858,203; 2018, $851,261; 2019, $687,476; and $3,508,439 thereafter.

6. 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:

	2014	2013
Unpaid claims and claims adjustment expenses, January 1	$ 102,490,850	$ 94,908,633
Less reinsurance receivable	(5,445,066)	(5,790,055)
Net balance	97,045,784	89,118,578
Incurred related to:		
Current year	1,074,161,162	1,103,522,041
Prior years	(10,223,478)	(17,709,663)
Total incurred	1,063,937,684	1,085,812,378
Paid related to:		
Current year	(999,300,459)	(1,000,686,202)
Prior years	(92,267,372)	(77,198,970)
Total paid	(1,091,567,831)	(1,077,885,172)
Net balance	69,415,637	97,045,784
Plus reinsurance receivable	26,769,583	5,445,066
Unpaid claims and claims adjustment expenses, December 31	$ 96,185,220	$ 102,490,850

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 $26,769,583) decreased by $10,223,478 in 2014. 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 Company records a liability for unpaid claims and claims adjustment expenses that includes an allowance for potential shock claims.

7. Accrued Expenses

Accrued expenses at December 31 consisted of the following:

	2014	2013
CCO risk sharing	$ 25,800,170	$ 2,480,706
ACA reinsurance	12,754,984	-
Accrued payroll and taxes	4,874,929	5,340,746
Deferred compensation	2,883,076	2,794,772
Other	3,921,851	1,469,190
Total	$ 50,235,010	$ 12,085,414

8. Line of Credit

The Company had a line of credit from a bank, which provided for maximum borrowings of $40,000,000. The line of credit was paid off and closed in December 2013.

9. Notes Payable

Notes payable consisted of the following at December 31:

	2014	2013
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, 2014), collateralized by business assets, matures March 2018.	$ 717,508	$ 907,479
Note payable to bank, repaid in full during 2014.	-	21,500,000
Note payable to bank, repaid in full during 2014.	-	14,500,000
Total	$ 717,508	$ 36,907,479

(Continued)

9. Notes Payable (Continued)

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

2015	$ 203,817
2016	218,551
2017	234,350
2018	60,790
	$ 717,508

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. 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:

	2014	2013
Projected benefit obligation for service rendered to date	$ (33,786,562)	$ (28,877,813)
Plan assets at fair value	31,352,385	32,577,203
Funded status	$ (2,434,177)	$ 3,699,390
Change in projected benefit obligation:		
Projected benefit obligation, beginning of year	$ 28,877,813	$ 32,291,157
Settlement gain	(227,667)	-
Interest cost	1,418,637	1,338,076
Settlement payments	(2,328,922)	-
Benefits paid and administrative expenses	(263,271)	(899,608)
Actuarial loss (gain)	6,309,972	(3,851,812)
Projected benefit obligation, end of year	$ 33,786,562	$ 28,877,813

(Continued)

10. Retirement Plans (Continued)

	2014	2013
Change in fair value of plan assets:		
Fair value of plan assets, beginning of year	$ 32,577,203	$ 29,646,024
Actual return on plan assets	1,367,375	3,830,787
Settlement payments	(2,328,922)	-
Benefits paid	(263,271)	(899,608)
Fair value of plan assets, end of year	$ 31,352,385	$ 32,577,203
Net periodic benefit cost:		
Interest cost	$ 1,418,637	$ 1,338,076
Expected return on plan assets	(2,025,502)	(1,843,531)
Amortization of loss	37,573	790,527
Settlement loss	663,086	-
Total net periodic benefit cost	$ 93,794	$ 285,072
Amounts recognized in accumulated other comprehensive income:		
Net loss	$ 9,619,649	$ 3,587,233
Total accumulated other comprehensive income	$ 9,619,649	$ 3,587,233
Changes in other comprehensive income:		
Net loss (gain)	$ 6,733,075	$ (5,831,711)
Amortization of net loss	(700,659)	(790,527)
Total recognized in other comprehensive income	$ 6,032,416	$ (6,622,238)
Accumulated benefit obligation, end of year	$ 33,786,562	$ 28,877,813

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 2015 to be $706,794, $0 and $0, respectively.

(Continued)

10. Retirement Plans (Continued)

The Company does not expect to make any contribution to its pension plan in 2015. Future anticipated benefit payments from the defined benefit pension plan are as follows: 2015, $2,091,931; 2016, $469,908; 2017, $925,490; 2018, $895,066; 2019, $1,644,599; and from 2020 to 2024, $10,117,986.

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

	2014	2013
Assumptions used for net periodic benefit costs:		
Discount rate used in determining present values	5.1%	4.2%
Annual increase in future compensation levels	N/A	N/A
Expected long-term rate of return on assets	6.4	6.3
Assumptions used to determine benefit obligation:		
Discount rate used in determining present values	4.1%	5.1%
Measurement date	December 31	December 31

The plan assets are invested in the following asset classes:

Equity investments	61%	62%
Debt investments	28	27
Real Estate	6	5
Other	5	6
Total	100%	100%

During 2014, the Society of Actuaries released new mortality tables for pension plans. The Company's plan incorporated the new tables during 2014 when determining the pension benefit obligation at December 31, 2014. In general, the new mortality tables increased the life expectancy of most plan participants, which in turn increased their expected future benefits under the plan.

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. In both 2014 and 2013, in addition to the annual matching contributions, the Company made a 3% contribution for all eligible employees. Company contributions under the plan were $2,273,467 and $2,183,475 in 2014 and 2013, respectively.

11. 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:

	2014	2013
Current income tax expense:		
Federal	$ 2,198,431	$ 1,857,537
State	1,580,323	459,783
Total current income tax expense	3,778,754	2,317,320
Deferred tax expense	985,300	2,239,000
Total income tax expense	$ 4,764,054	$ 4,556,320

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

	2014	2013
Tax (benefit) expense computed at statutory rate	$ (1,150,000)	$ 3,718,000
State tax (benefit) expense, net of federal income tax benefit	(147,000)	542,000
Health insurance provider fee	6,420,000	-
Dividend received deduction	(161,000)	(169,000)
Permanent and other differences	(197,946)	465,320
Total income tax expense	$ 4,764,054	$ 4,556,320

(Continued)

11. Income Taxes (Continued)

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

	2014	2013
Deferred tax assets:		
Alternative minimum tax credit carryforwards	$ 2,001,700	$ 4,281,000
Federal and state net operating loss carryforwards	3,503,000	3,747,000
Contribution carryforwards	787,000	1,027,000
Accruals	1,120,000	946,000
Partnership difference	815,000	762,000
Deferred compensation	542,000	543,000
Discount of claims provision	433,000	437,000
Bad debt reserve	350,000	304,000
Goodwill	4,000	8,000
Defined benefit pension plan	969,000	-
Total deferred tax assets	10,524,700	12,055,000
Deferred tax liabilities:		
Property	(4,068,000)	(6,396,000)
Unrealized gains	(2,252,000)	(1,069,000)
Defined benefit pension plan	-	(1,447,000)
Prepaids	(2,068,000)	(1,260,000)
Subsidiary equity income	(67,000)	(56,000)
Total deferred tax liabilities	(8,445,000)	(10,228,000)
Net deferred tax assets	$ 2,079,700	$ 1,827,000

As of December 31, 2014, the Company recognized a deferred tax asset of $3,503,000 for the anticipated utilization of federal and state net operating loss carryforwards. Federal net operating loss carryforwards of $4,505,444 will expire in 2031, if not used before then. State net operating loss carryforwards of $39,179,177 will expire on various dates through 2034. Contribution carryforwards of $1,978,869 will expire on various dates through 2017. Alternative minimum tax credit carryforwards of $2,001,700 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.

12. 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, 2014 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%	$ 400,000	Unlimited
Medicaid	**Retention**	**Deductible**	**Aggregate Limit**
Layer 1	10%	$ 400,000	Unlimited

Premiums ceded under the terms of the reinsurance policies were $9,743,444 and $7,174,295 in 2014 and 2013, respectively. Reinsurance recoveries were $32,038,536 and $7,989,450 in 2014 and 2013, respectively. The reinsurance contracts do not relieve the Company from its primary obligation to policyholders.

13. 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 $17,414 per month. Future minimum lease payments are as follows: 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: 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 $43,176 per month. Future minimum lease payments are as follows: 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: 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 $4,162 per month. Future minimum lease payments are as follows: 2015, $50,940; 2016, $51,960; 2017, $34,640.

(Continued)

13. 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: 2015, $94,520; 2016, $98,280; 2017, $99,560; 2018, $102,120; 2019, $68,080.

Effective August 2014, the Company entered into a real property lease for the Billings, Montana office under a six-month operating agreement expiring January 2015. In February 2015, the lease was renewed for an additional one-year term expiring January 2016, reverting to a month-to-month agreement at that time. The Company is responsible for substantially all executory costs. Minimum payments under the lease are $918 per month. Future minimum lease payments are as follows: 2015, $11,016; 2016, $918.

Amounts charged to rent expense for the various leases were $1,249,995 and $1,228,825 for 2014 and 2013, respectively.

14. 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.

(Continued)

14. Commitments (Continued)

The Company is subject to an annual fee under the ACA which is not deductible for tax purposes. 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. During 2014, the Company paid $16,735,185 related to 2013 net premiums written. As of December 31, 2014, the Company has written health insurance subject to the ACA assessment, expects to conduct health insurance business in 2015 and estimates their portion of the annual health insurance industry fee to be payable on September 30, 2015 to be approximately $15.9 million.

15. 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.

16. 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, 2014 and 2013, total assets (unaudited), consisting primarily of cash equivalents and marketable securities, were approximately $4,450,000 and $5,060,000, 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 2014 and 2013, the Company made no contributions to the Foundation.

17. 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, 2014. 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)

17. Fair Value of Financial Instruments (Continued)

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

		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, 2014				
Available-for-sale debt securities:				
U.S. Government debt securities	$ 14,305,940	$ -	$ 14,305,940	$ -
Mortgage/asset backed debt securities	29,388,645	-	29,388,645	-
Corporate debt securities	57,330,040	-	57,330,040	-
Total debt securities	101,024,624	-	101,024,624	-
Available-for-sale equity securities:				
Mutual funds	33,023,559	33,023,559	-	-
Other invested assets	877,423	-	877,423	-
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	-

(Continued)

17. 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, 2014				
Registered investment companies:				
Fixed income funds	$ 8,964,714	$ 8,964,714	$ -	$ -
Balanced funds	10,394,681	10,394,681	-	-
Growth funds	6,290,238	6,290,238	-	-
Value funds	3,891,716	3,891,716	-	-
Money market funds	84,604	84,604	-	-
Real estate funds	1,726,432	1,726,432	-	-
Total	$ 31,352,385	$ 31,352,385	$ -	$ -
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	$ -	$ -

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.

18. 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, 2014.

SUPPLEMENTAL INFORMATION

PACIFICSOURCE AND SUBSIDIARIES
Consolidated Schedules of General and Administrative Expenses

	Year Ended December 31 2014	2013
Salaries	$ 35,872,846	$ 36,255,931
Payroll taxes	3,274,937	3,351,181
Employee benefits	7,631,659	7,549,314
Retirement plans	1,994,650	2,133,812
Administrative expense, net	1,169,861	885,674
Advertising	3,633,219	2,621,910
Auditing and tax services	482,391	525,258
Automobile expense	315,599	292,672
Banking charges	468,260	427,179
Board expenses	427,787	395,587
Building maintenance	379,957	400,513
Consultant fees	1,769,632	1,964,440
Contract labor	971,941	651,066
Depreciation and amortization	9,770,484	10,012,823
Education and training	218,730	240,832
Health insurance provider fee	16,735,185	-
Imaging expense	322,988	385,393
Insurance	714,868	710,626
Legal fees	407,014	635,143
Meals and entertainment	524,460	459,357
Office expenses and supplies	918,612	959,794
Postage	2,703,113	2,538,715
Printing expense	1,620,111	1,910,800
Professional dues	299,921	253,964
Purchased services	9,587,247	5,425,660
Recruiting	294,559	131,717
Rent - equipment	92,390	125,383
Rent - regional offices	1,249,995	1,228,825
Repairs and maintenance	841,266	663,360
Software licenses	4,284,161	5,918,230
Subscriptions	75,243	67,621
Surveys and studies	4,725	4,382
Taxes and licenses	987,711	1,041,903
Telephone	736,842	703,484
Travel	711,002	643,177
Utilities	282,851	267,356
Total	$ 111,776,217	$ 91,783,082