

MILLS-PENINSULA MEDICAL GROUP, INC.

FINANCIAL STATEMENTS

FOR THE YEARS ENDED
DECEMBER 31, 2008 AND 2007

Armanino McKenna ^{LLP}

Certified Public Accountants & Consultants



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INDEPENDENT AUDITORS' REPORT

To the Board of Directors
Mills-Peninsula Medical Group, Inc.
Burlingame, California

We have audited the accompanying balance sheets of Mills-Peninsula Medical Group, Inc. as of December 31, 2008 and 2007 and the related statements of operations, stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these 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 financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Mills-Peninsula Medical Group, Inc. as of December 31, 2008 and 2007, and the results of their operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Armanino McKenna LLP

ARMANINO MCKENNA LLP

April 17, 2009



MILLS-PENINSULA MEDICAL GROUP, INC.

Balance Sheets

December 31, 2008 and 2007

	<u>ASSETS</u>	
	<u>2008</u>	<u>2007</u>
Current assets		
Cash and cash equivalents	\$10,894,394	\$13,751,812
Investments - certificates of deposit	4,833,635	-
Shared-risk receivables	220,516	290,626
Recoveries receivable from HMOs	1,429,134	1,680,935
Patient accounts receivable, net of allowance for doubtful accounts of \$41,444 in 2008 and \$28,495 in 2007	172,108	131,910
Prepaid income taxes	328,500	-
Other prepaid expenses	259,342	204,710
Deferred income taxes, net	458,990	396,720
Total current assets	<u>18,596,619</u>	<u>16,456,713</u>
Furniture, fixtures, and equipment, net	969,342	1,278,649
Goodwill	<u>344,245</u>	<u>344,245</u>
Total assets	<u>\$19,910,206</u>	<u>\$18,079,607</u>
	<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>	
Current liabilities		
Accounts payable and accrued liabilities	\$ 5,025,908	\$ 4,326,875
Income taxes payable	-	230,473
Accrued payroll and related liabilities	1,260,900	1,131,270
Accrued liability for unpaid claims	2,962,311	3,500,545
Physician incentive payable	7,256,419	5,135,017
Other current liabilities	-	345,529
Total current liabilities	<u>16,505,538</u>	<u>14,669,709</u>
Stockholders' equity		
Common stock, no par value, 1,000,000 shares authorized and 291,450 and 297,150 issued and outstanding as of December 31, 2008 and 2007	534,714	537,714
Retained earnings	<u>2,869,954</u>	<u>2,872,184</u>
Total stockholders' equity	<u>3,404,668</u>	<u>3,409,898</u>
Total liabilities and stockholders' equity	<u>\$19,910,206</u>	<u>\$18,079,607</u>

The accompanying notes are an integral part of these financial statements.

MILLS-PENINSULA MEDICAL GROUP, INC.
 Statements of Operations
 For the Years Ended December 31, 2008 and 2007

	2008	2007
Revenue		
HMO capitation revenue	\$85,407,065	\$82,738,857
Quality incentives	1,407,068	1,229,723
HMO recoveries and other healthcare revenues	<u>10,438,655</u>	<u>8,045,832</u>
	97,252,788	92,014,412
Expense		
Healthcare expense		
Physician and other provider expense	<u>81,997,909</u>	<u>77,012,091</u>
Gross margin	<u>15,254,879</u>	<u>15,002,321</u>
Administrative and other operating expenses		
Salaries and benefits	10,020,337	9,629,690
Professional fees	1,718,550	1,136,539
Supplies	307,419	265,784
Depreciation	876,589	1,086,882
Other operating expenses	<u>2,731,655</u>	<u>2,481,297</u>
Total administrative and other operating expenses	<u>15,654,550</u>	<u>14,600,192</u>
Operating income (loss)	<u>(399,671)</u>	<u>402,129</u>
Other income (expense)		
Interest income	403,521	615,696
Interest expense	(3,850)	(3,716)
Other	-	(10,187)
Other income (expense), net	<u>399,671</u>	<u>601,793</u>
Net income before tax provision	-	1,003,922
Income tax provision	<u>(2,230)</u>	<u>(569,680)</u>
Net income (loss)	<u>\$ (2,230)</u>	<u>\$ 434,242</u>

The accompanying notes are an integral part of these financial statements.

MILLS-PENINSULA MEDICAL GROUP, INC.
 Statements of Stockholders' Equity
 For the Years Ended December 31, 2008 and 2007

	Common Stock Shares	Dollars	Retained Earnings	Total
Balance, December 31, 2006	310,500	\$534,514	\$ 2,437,942	\$2,972,456
Stock issued	3,150	10,500	-	10,500
Redemption of stock	(16,500)	(7,300)	-	(7,300)
Net income	<u>-</u>	<u>-</u>	<u>434,242</u>	<u>434,242</u>
Balance, December 31, 2007	297,150	537,714	2,872,184	3,409,898
Stock issued	300	1,000	-	1,000
Redemption of stock	(6,000)	(4,000)	-	(4,000)
Net loss	<u>-</u>	<u>-</u>	<u>(2,230)</u>	<u>(2,230)</u>
Balance, December 31, 2008	<u>291,450</u>	<u>\$534,714</u>	<u>\$ 2,869,954</u>	<u>\$3,404,668</u>

The accompanying notes are an integral part of these financial statements.

MILLS-PENINSULA MEDICAL GROUP, INC.
Statements of Cash Flows
For the Years Ended December 31, 2008 and 2007

	2008	2007
Cash flows from operating activities		
Net income (loss)	\$ (2,230)	\$ 434,242
Adjustments to reconcile net income (loss) to net cash provided by operating activities		
Depreciation	876,589	1,086,882
Loss on disposal of assets	-	14,328
Deferred income taxes, net	(62,270)	288,560
Changes in operating assets and liabilities		
Shared-risk receivables	70,110	111,483
Recoveries receivable from HMOs	211,603	(239,864)
Income taxes receivable	-	123,191
Prepaid income taxes	(328,500)	20,000
Other prepaid expenses	(54,632)	32,800
Accounts payable and accrued liabilities	699,033	673,561
Income taxes payable	(230,473)	229,523
Accrued payroll and related liabilities	129,630	142,567
Accrued liability for unpaid claims	(538,234)	(180,620)
Physician incentive payable	2,121,402	300,319
Other current liabilities	(345,529)	(71,984)
Other noncurrent liabilities	-	(112,149)
Net cash provided by operating activities	2,546,499	2,852,839
Cash flows from investing activities		
Purchase of investments	(4,833,635)	-
Purchase of equipment	(567,282)	(302,995)
Net cash used in investing activities	(5,400,917)	(302,995)
Cash flows from financing activities		
Proceeds from sale of common stock	1,000	10,500
Redemption of common stock	(4,000)	(7,300)
Net cash (used in) provided by financing activities	(3,000)	3,200
Net increase (decrease) in cash	(2,857,418)	2,553,044
Cash and cash equivalents at beginning of year	13,751,812	11,198,768
Cash and cash equivalents at end of year	\$10,894,394	\$13,751,812
<u>Supplemental cash flow information</u>		
Interest paid	\$ 3,850	\$ 3,716
Income taxes paid	\$ 618,240	\$ 53,000

The accompanying notes are an integral part of these financial statements.

MILLS-PENINSULA MEDICAL GROUP, INC.
Notes to Financial Statements
December 31, 2008 and 2007

1. Description of Organization

Mills-Peninsula Medical Group, Inc. ("MPMG"), a California professional medical corporation, is an independent practice association that delivers medical care to health plan enrollees under capitated contracts. MPMG enters into contracts with health plans, arranges for the provision of healthcare services to health plan members through its members' providers and other contractors, and pays claims associated with these services. MPMG is affiliated with Mills-Peninsula Health Services ("MPHS") and has ongoing service agreements to provide on call physicians and third party administrative services (see Note 8).

In 2005, MPMG created the Division of Physician Support Services, which offers practice management and electronic medical record services to the physician community.

MPMG operates a clinic division, MPMG Medical Clinics ("clinics"), which operates primary care offices as well as extended hours clinics in San Mateo and Burlingame, California. The clinics provide primary care services to both managed care and non-managed care patients in their community. The clinics employ several primary care physicians.

There are 215 and 217 shareholders as of December 31, 2008 and 2007, respectively.

2. Summary of Significant Accounting Policies

Use of estimates

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

Cash and cash equivalents

All highly liquid instruments with an original maturity of three months or less are considered to be cash equivalents. Periodically, such instruments may be in excess of federally insured limits. MPMG is required to maintain a minimum deposit balance of \$2,500,000 with a commercial bank under their line of credit agreement.

Investments

Investments represent two certificates of deposit that have an original maturity of greater than three months. These investments are carried at their cost basis, plus accrued interest, which approximates fair value at December 31, 2008. Fair value has been estimated by discounting the future cash flows to be received upon maturity using the current interest rate for this type of investment.

MILLS-PENINSULA MEDICAL GROUP, INC.
Notes to Financial Statements
December 31, 2008 and 2007

2. Summary of Significant Accounting Policies (continued)

Furniture, fixtures, and equipment

Furniture, fixtures, and equipment consist primarily of office furniture and equipment, integrated practice management and electronic medical record hardware and software, and leasehold improvements, which are recorded at cost. The related depreciation and amortization is calculated using the straight-line method over estimated useful lives of three to five years or lease term if shorter.

Long-lived assets

MPMG reviews the carrying value of property and equipment and intangible assets for impairment whenever events and circumstances indicate that the carrying value of an asset may not be recoverable from the estimated future cash flows expected to result from its use and eventual disposition. In cases where the expected future cash flows are less than the carrying value, an impairment loss is recognized equal to an amount by which the carrying value exceeds the fair value of the assets.

Goodwill

Goodwill represents the excess of costs over fair value of assets of businesses acquired. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but are tested for impairment at least annually.

Healthcare expense recognition

MPMG has agreements with contracting physicians who perform the health care services to be provided to subscribing participants. Under some of these agreements, MPMG makes monthly capitation payments based on the number of subscribing participants, regardless of the specific services actually performed by the physicians. MPMG also makes fee for service payments to certain physicians for non-capitated services based on contracted fee schedules.

The cost of physician and other provider services is recognized in the period in which the services are provided to a member, based in part on estimates, including an accrual for fee for service activities provided but not reported to MPMG (see Note 4).

Revenue recognition

MPMG contracts with numerous health maintenance organizations (HMOs) to provide physician and other defined medical services for their enrollees. In 2008, five HMOs each comprised greater than 10% of capitation revenue, individually comprising 13%, 14%, 18%, 21%, and 26%, respectively. In 2007, five HMOs each comprised greater than 10% of capitation revenue, individually comprising 12%, 15%, 16%, 19%, and 29%, respectively.

MILLS-PENINSULA MEDICAL GROUP, INC.
Notes to Financial Statements
December 31, 2008 and 2007

2. Summary of Significant Accounting Policies (continued)

Revenue recognition (continued)

MPMG is paid for most contracted services on a capitated basis. In addition to capitation, MPMG participates in incentive programs and in reinsurance for the cost of specific services and the cost of individual members that exceeds negotiated thresholds. These incentive and reinsurance payments are subject to periodic settlements based upon information maintained by the HMOs and MPHS. Settlements typically occur after the completion of the contract year. Incentive and reinsurance revenue is recognized on the accrual basis to the extent that it is estimable.

MPMG also receives recoveries revenue from HMOs for certain services performed for HMO enrollees outside of the capitation arrangements. Such revenues are recorded when estimable and receipt is probable.

Accounts receivable

MPMG records amounts due from HMOs, and from MPHS, related to incentives, stoploss and other HMO reimbursement agreements. These receivables are recorded when they are estimable and receipt is probable. The receivables are recorded at their estimated net realizable amounts and are considered to be fully collectible by management.

MPMG also records receivables for clinic services provided to patients that are reimbursable by third-party payors under contractual agreements. Allowances for contractual adjustments and for doubtful accounts are established based upon management's estimates considering contractual arrangements, current aging statistics and historical collection trends.

Income taxes

MPMG provides for income taxes under the liability method. Deferred taxes are recorded for differences in the timing of the recognition of revenues and expenses for financial reporting and income tax purposes. Deferred taxes result primarily from differences in the recognition of certain accrued liabilities for tax and financial statement purposes. A deferred tax asset is recognized for all deductible temporary differences and operating loss carryforwards. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal for deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods during which the deferred tax assets are deductible, management believes it is more likely than not that MPMG will realize the benefits of these deductible differences. Accordingly, no valuation allowance is recorded as of December 31, 2008 and 2007.

MILLS-PENINSULA MEDICAL GROUP, INC.
Notes to Financial Statements
December 31, 2008 and 2007

2. Summary of Significant Accounting Policies (continued)

Income taxes (continued)

In December 2008, the Financial Accounting Standards Board issued FASB Staff Position (FSP) FIN 48-3, "Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises." FSP FIN 48-3 permits an entity within its scope to defer the effective date of FASB Interpretation 48 (Interpretation 48), *Accounting for Uncertainty in Income Taxes*, to its annual financial statements for fiscal years beginning after December 15, 2008. The Company has elected to defer the application of Interpretation 48 for the year ending December 31, 2008. The Company evaluates its uncertain tax positions using the provisions of FASB Statement 5, *Accounting for Contingencies*. Accordingly, a loss contingency is recognized when it is probable that a liability has been incurred as of the date of the financial statements and the amount of the loss can be reasonably estimated. The amount recognized is subject to estimate and management judgment with respect to the likely outcome of each uncertain tax position. The amount that is ultimately sustained for an individual uncertain tax position or for all uncertain tax positions in the aggregate could differ from the amount recognized.

3. Furniture, Fixtures, and Equipment

Furniture, fixtures, and equipment consist of the following at December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Leasehold improvement	\$ 215,451	\$ 211,530
Computer equipment	4,463,091	4,032,201
Furniture and fixtures	1,097,801	994,794
Office equipment	200,596	205,127
Less accumulated depreciation	<u>(5,007,597)</u>	<u>(4,165,003)</u>
	<u>\$ 969,342</u>	<u>\$1,278,649</u>

Depreciation expense was \$876,589 and \$1,086,882 in 2008 and 2007, respectively.

4. Accrued Liability for Unpaid Claims

The IBNR (incurred but not reported claims) accrual is adjusted monthly based on estimations made by MPMG. This estimate is based upon claims payment experience, historical claims payment trends, membership trends, and subsequent cash disbursements for claims. Because of the inherent uncertainties in estimating claims liabilities, it is at least reasonably possible that management's estimates may be subject to material change in future periods.

MILLS-PENINSULA MEDICAL GROUP, INC.

Notes to Financial Statements

December 31, 2008 and 2007

5. Line of Credit

MPMG maintains a line of credit with a commercial bank that allows them to borrow up to \$2,000,000 through May 2, 2010, bearing interest at the prime rate as published in the Wall Street Journal which was 3.25% at December 31, 2008. The outstanding principal balance was zero as of December 31, 2008 and 2007.

The line of credit agreement contains restrictions on additional indebtedness, including capital leases, payment of dividends, and certain other transactions. In addition, the agreement restricts liens on assets and the acquisition or sale of assets. MPMG is also required to maintain a minimum deposit balance of \$2,500,000 with this commercial bank under this line of credit agreement.

6. Mills-Peninsula Medical Group, Inc. 401(k) Profit Sharing Plan

MPMG offers a 401(k) plan that allows all full-time employees who complete one year of service with the Company to contribute a percentage of their annual salary up to predefined limits. The plan allows the employer to make a discretionary contribution, which is determined by the board of directors subsequent to the fiscal year end. MPMG's discretionary contributions to the plan totaled \$442,086 and \$352,439 in 2008 and 2007, respectively, which are included in salaries and benefits expense in the accompanying statements of operations.

7. Income Taxes

The components of deferred taxes are as follows at December 31:

	<u>2008</u>	<u>2007</u>
Recognition of accrued liabilities	\$346,150	\$287,530
Provision for bad debts	11,350	11,350
Depreciation and amortization	(143,040)	(133,600)
NOL and charitable carryforwards	<u>244,530</u>	<u>231,440</u>
	<u>\$458,990</u>	<u>\$396,720</u>

The components of the provision for income taxes for the years ended December 31, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
Federal		
Current	\$63,690	\$276,340
Deferred	(62,570)	63,520
State		
Current	810	4,770
Deferred	<u>300</u>	<u>225,050</u>
	<u>\$ 2,230</u>	<u>\$569,680</u>

MILLS-PENINSULA MEDICAL GROUP, INC.

Notes to Financial Statements

December 31, 2008 and 2007

7. Income Taxes (continued)

The effective income tax rate for the years ended December 31, 2008 and 2007 was 0% and 57%. This rate differs from the federal statutory rate of 34% in 2008 as there was no pre tax income and in 2007 primarily because of the effects of state taxes, graduated tax rates and state loss carrybacks. As of December 31, 2008 MPMG has state loss carryforwards of \$3.7 million expiring in 2015.

8. Related Party Transactions

MPMG has a two year agreement with MPHS to provide on-call physicians for certain specialties to the MPHS Emergency Department. MPMG is paid a fee equal to the fair value of the specialty services provided. MPMG has an agreement with MPHS to provide third-party administration services related to MPHS capitated claims for medical services provided. MPMG also has an ongoing Care Management Services Agreement with MPHS to provide services related to coordinating and managing the utilization of hospital services and in achieving certain quality care standards.

Revenues associated with these related party agreements have been reported as HMO recoveries and other healthcare revenues and as quality incentives revenues in the accompanying statements of operations.

9. Commitments and Contingencies

Lease commitments

MPMG leases its office and clinical space under noncancelable operating lease agreements, which expire during the years 2010 and 2012. MPMG's rental expense totaled \$969,385 and \$922,199 for the years ended December 31, 2008 and 2007, respectively, which is included in other expenses in the statements of operations. The following is a schedule of the estimated future minimum lease payments under all leases as of December 31, 2008:

2009	\$ 904,000
2010	886,000
2011	742,000
2012	<u>603,000</u>
	<u>\$3,135,000</u>

MILLS-PENINSULA MEDICAL GROUP, INC.
Notes to Financial Statements
December 31, 2008 and 2007

9. Commitments and contingencies (continued)

Risk of litigation

From time to time, MPMG is subject to litigation and regulatory investigations arising in the course of business. In the opinion of management, as of December 31, 2008 and 2007, there are no such matters with a reasonable possibility of having a material adverse effect on the financial statements or MPMG's future financial position or results from operations.

Risks and uncertainties

The Company operates in Northern California. Northern California and the entire United States has been experiencing and is expected to continue to experience severe instability in the economy. The National Bureau of Economic Research officially declared that the United States entered into a recession in December 2007 and has remained there since. The length of the recession and whether the situation worsens even further is yet to be determined. The U.S. government has taken unprecedented actions attempting to prevent worsening economic conditions, including the passage of the Economic Stabilization Act of 2008. The results of many of these actions have not been fully realized to date. Given these events and circumstances, banks and investors have become increasingly cautious regarding financing decisions given the uncertainty around what the future holds for themselves, the counterparty of the transaction and the overall economy. These circumstances have resulted in the U.S. economy entering a period of significant uncertainty. Should the economic situation worsen significantly, the Company may be adversely affected.

10. Letter of intent - Palo Alto Medical Foundation

On February 28, 2008, MPMG executed a Letter of Intent with Palo Alto Medical Foundation (PAMF), a Sutter Health charitable, not for profit 502(c)(3) corporation organized as a healthcare provider under the California Health & Safety 1206(l) statute, to evaluate the potential for affiliation. Discussions were ongoing throughout 2008 and continue in 2009. Whether these discussions will lead to affiliation is unknown and uncertain at this time.

11. State of California Solvency Standards

The California Department of Managed Health Care ("DMHC") has established certain financial and reporting requirements to which risk-bearing organizations ("RBOs"), such as MPMG, must adhere. These regulations require MPMG to report quarterly to the DMHC a financial survey report, as well as statements as to whether or not MPMG has maintained positive tangible net equity and working capital during the quarter. Additionally, the regulations require MPMG to report quarterly to the DMHC whether or not MPMG has met certain standards for claim payment timeliness and IBNR estimation during the quarter. Currently, MPMG meets all of the requirements of the regulations.

The regulations require that RBOs maintain at all times a minimum "cash-to-claims" ratio of .75. MPMG was in compliance with this required ratio during 2008 and 2007.