Blue Shield of California (California Physicians' Service) and Subsidiaries

Consolidated Financial Statements as of and for the Years Ended December 31, 2013 and 2012, and Independent Auditors' Report

BLUE SHIELD OF CALIFORNIA
(CALIFORNIA PHYSICIANS' SERVICE)
AND SUBSIDIARIES

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INDEPENDENT AUDITORS' REPORT

Blue Shield of California
(California Physicians' Service)
and Subsidiaries:

We have audited the accompanying consolidated financial statements of Blue Shield of California (California Physicians' Service) and its subsidiaries (the "Company"), which comprise the consolidated balance sheets as of December 31, 2013 and 2012, and the related consolidated statements of operations, comprehensive income, changes in stabilization fund, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with 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 audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's 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 Company'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 Company'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 the Company as of December 31, 2013 and 2012, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

March 7, 2014

BLUE SHIELD OF CALIFORNIA
(CALIFORNIA PHYSICIANS' SERVICE)
AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 2013 AND 2012
(Dollars in thousands)

	2013	2012
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 233,685	$ 121,129
Investments	1,379,314	1,276,976
Receivables — net	673,063	670,624
Prepaid expenses and other assets	183,282	151,258
Deferred taxes — current	-	2,682
Total current assets	2,469,344	2,222,669
INVESTMENTS — Long-term	3,222,616	3,141,711
FIXED ASSETS — Net	497,136	425,848
DEFERRED TAXES — Long-term	43,454	63,104
GOODWILL AND INTANGIBLE ASSETS	134,924	134,936
OTHER ASSETS	57,634	63,488
TOTAL	$ 6,425,108	$ 6,051,756
LIABILITIES AND STABILIZATION FUND		
CURRENT LIABILITIES:		
Claims payable	$ 1,059,754	$ 950,578
Reserve for experience rating arrangements	244,772	273,010
Accounts payable and accrued expenses	599,857	615,862
Unearned premiums	180,694	195,294
Deferred tax liability	79,437	-
Total current liabilities	2,164,514	2,034,744
PENSION LIABILITIES, POSTRETIREMENT BENEFITS, AND OTHER	117,307	159,381
Total liabilities	2,281,821	2,194,125
STABILIZATION FUND:		
Unrestricted	3,887,733	3,717,098
Accumulated other comprehensive income — net of tax	255,554	140,533
Total stabilization fund	4,143,287	3,857,631
TOTAL	$ 6,425,108	$ 6,051,756

See notes to consolidated financial statements.

BLUE SHIELD OF CALIFORNIA
(CALIFORNIA PHYSICIANS' SERVICE)
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012
(Dollars in thousands)

	2013	2012
REVENUE:		
Earned premium and other revenue	$ 10,731,225	$ 10,154,789
Self-funded arrangements	3,124,683	2,869,949
Less health care services for self-funded arrangements	(3,031,625)	(2,784,608)
Net investment and other income	208,710	251,519
Other-than-temporary impairment losses on investments	(11,154)	(27,436)
Total revenue	11,021,839	10,464,213
OPERATING EXPENSES:		
Health benefits	9,194,330	8,642,778
Marketing and selling	542,845	515,162
General and administrative	1,035,805	1,006,921
Total operating expenses	10,772,980	10,164,861
OPERATING INCOME	248,859	299,352
INCOME TAX EXPENSE	78,224	95,161
NET INCOME	$ 170,635	$ 204,191

See notes to consolidated financial statements.

BLUE SHIELD OF CALIFORNIA
(CALIFORNIA PHYSICIANS' SERVICE)
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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012
(Dollars in thousands)

	2013	2012
NET INCOME	$ 170,635	$ 204,191
OTHER COMPREHENSIVE INCOME:		
Unrealized gains (losses) on investments available-for-sale:		
Unrealized holding gains on investments arising during the period — net of income tax expense of $71,207 and $81,196 in 2013 and 2012, respectively	132,241	150,792
Non-credit component of other-than-temporary impairment losses on investments — net of income tax benefit of $1,464 and $345 in 2013 and 2012, respectively	(2,718)	(642)
Less reclassification adjustments for gains included in earnings — net of income tax benefit of $34,983 and $33,546 in 2013 and 2012, respectively	(64,969)	(62,301)
Unrealized gains on investments available-for-sale — net	64,554	87,849
Defined benefit plans:		
Net gain (loss) arising during the period — net of income tax loss of $21,865 and benefit $10,549 in 2013 and 2012, respectively	40,607	(19,591)
Less amortization of prior service cost and net loss included in net periodic pension cost — net of income tax expense of $5,309 and $3,007 in 2013 and 2012, respectively	9,860	5,585
Defined benefit plans — net	50,467	(14,006)
Other comprehensive income — net of tax	115,021	73,843
COMPREHENSIVE INCOME	$ 285,656	$ 278,034

See notes to consolidated financial statements.

BLUE SHIELD OF CALIFORNIA
(CALIFORNIA PHYSICIANS' SERVICE)
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CONSOLIDATED STATEMENTS OF CHANGES IN STABILIZATION FUND
FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012
(Dollars in thousands)

	Unrestricted Stabilization Fund	Accumulated Other Comprehensive Income	Total Stabilization Fund
BALANCE — January 1, 2012	$3,512,907	$ 66,690	$3,579,597
Net income	204,191	-	204,191
Other comprehensive income	-	73,843	73,843
BALANCE — December 31, 2012	3,717,098	140,533	3,857,631
Net income	170,635	-	170,635
Other comprehensive income	-	115,021	115,021
BALANCE — December 31, 2013	$3,887,733	$255,554	$4,143,287

See notes to consolidated financial statements.

BLUE SHIELD OF CALIFORNIA
(CALIFORNIA PHYSICIANS' SERVICE)
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012
(Dollars in thousands)

	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 170,635	$ 204,191
Adjustments to reconcile net income to net cash provided by operating activities:		
Net gain on investments	(92,199)	(105,606)
Net loss on disposal of fixed assets	176	7,806
Depreciation and amortization	74,303	69,589
Amortization of bond premium — net	23,558	15,543
Deferred income tax expense	39,835	50,166
Changes in operating assets and liabilities:		
Receivables	(2,439)	(200,907)
Prepaid expenses and other current assets	(42,765)	15,520
Other non-current assets	9,255	26,941
Claims payable	109,176	5,476
Reserve for experience rating arrangements	(28,238)	(5,103)
Accounts payable and accrued expenses	(43,901)	57,066
Unearned premiums	(14,600)	5,324
Pension liabilities, postretirement benefits, and other	35,568	(948)
Net cash provided by operating activities	238,364	145,058
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(5,302,831)	(5,833,134)
Sales and maturity of available-for-sale investments	5,319,072	5,677,045
Purchases of fixed assets	(142,049)	(85,717)
Proceeds from sales of fixed assets	-	47
Net cash used in investing activities	(125,808)	(241,759)
INCREASE (DECREASE) IN CASH AND EQUIVALENTS	112,556	(96,701)
CASH AND CASH EQUIVALENTS:		
Beginning of year	121,129	217,830
End of year	$ 233,685	$ 121,129
SUPPLEMENTAL DISCLOSURES:		
Income taxes paid	$ 66,231	$ 23,790
Non-cash additions to fixed assets	$ 26,889	$ 35,327

See notes to consolidated financial statements.

1. DESCRIPTION OF OPERATIONS

California Physicians' Service and subsidiaries, dba Blue Shield of California ("Blue Shield of California" or the "Company"), is incorporated as a not-for-profit health care service plan in the state of California. The Company is subject to regulation by the California Department of Managed Health Care and the California Department of Insurance. The Company provides a continuum of managed health care products, including Preferred Provider Organization (PPO), Point of Service (POS), and Health Maintenance Organization (HMO) plans. These services are marketed to individuals and businesses by both the Company and independent agents. The Company also processes claims and provides special utilization control and review programs for employer groups. Prepaid medical care and other health benefits are provided to subscribers through health care providers. The Company's subscribers are primarily domiciled in the state of California.

The Blue Cross and Blue Shield Association licenses Blue Shield of California to offer certain products and services under the BlueShield® brand name. Blue Shield of California is an independent organization governed by its own Board of Directors and is solely responsible for its own debts and other obligations. Neither the Blue Cross and Blue Shield Association nor any other organization using the BlueShield® brand name acts as a guarantor of Blue Shield of California.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Consolidation Principles — The consolidated financial statements include the accounts of California Physicians' Service and its wholly owned subsidiaries, principally Blue Shield of California Life & Health Insurance Company and CareAmerica Life Insurance Company. All intercompany transactions have been eliminated in consolidation.

Use of Estimates — The preparation of consolidated 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 consolidated 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 — Cash equivalents of $141,362 and $68,346 at December 31, 2013 and 2012, respectively, are included with cash and generally consist of short-term, highly liquid investments with original maturities of three months or less.

Investments — The Company's investments are classified as available-for-sale and are reported at fair value, with unrealized gains and losses excluded from income and reported, net of tax effect, as a separate component of the stabilization fund until realized. Realized gains or losses are included in net investment and other income in the accompanying consolidated statements of operations. The cost of investments sold is determined using the first-in, first-out method except in certain cases where the specific identification method is used.

Equities and debt securities with maturities of one year or less are classified as current and debt securities with maturities in excess of one year are classified as long-term.

The Company periodically evaluates available-for-sale investments to determine whether declines in fair market value below amortized cost are other-than-temporary. New information and the passage of time can change these judgments. If any of the Company's equity securities experience a decline in value that is determined to be other-than-temporary, based on analysis of relevant factors, the Company records a realized loss in other-than-temporary impairment losses on investments. If a debt security is in an unrealized loss position and the Company has the intent to sell the debt security, or it is more likely than not that the Company will sell the debt security before recovery of its amortized cost basis, the decline in value is deemed to be other-than-temporary and is recorded to other-than-temporary impairment losses on investments in the consolidated statements of operations. For impaired debt securities that the Company does not intend to sell or it is more likely than not that the Company will not have to sell such securities, but expects that the Company will not fully recover the amortized cost basis, the credit component of the other-than-temporary impairment is recognized in other-than-temporary impairment losses on investments in the consolidated statements of operations and the non-credit component of the other-than-temporary impairment is recognized in other comprehensive income. Unrealized losses entirely caused by non-credit related factors related to debt securities for which the Company expects to fully recover the amortized cost basis continue to be recognized in accumulated other comprehensive income. Other-than-temporary impairment losses on investments were $11,154 and $27,436 for the years ended December 31, 2013 and 2012, respectively.

The Company uses the equity method of accounting for its 9.5% investment in TriWest Healthcare Alliance ("TriWest"). TriWest is set up as a corporate joint venture that allows the Company to provide sufficient influence to allow for the use of the equity method of accounting. The investment in TriWest is $39,718 and $47,315 at December 31, 2013 and 2012, respectively, and is included in other assets in the accompanying consolidated balance sheets. The Company's proportionate share of equity in net income of TriWest was $3,401 and $9,759 for the years ended December 31, 2013 and 2012, respectively, which is included in net investment and other income in the accompanying consolidated statements of operations. The Company also received $3,009 and $10,969 (included in earned premium and other revenue) in network service fees from TriWest for the years ended December 31, 2013 and 2012, respectively.

In March 2012, TriWest announced that it was not awarded the contract to continue to manage its sole customer, the 21-state TRICARE West region for the United States Department of Defense. This contract provides access to health care for the United States' active and retired uniformed service members and their families under the TRICARE program. On September 9, 2013, The Department of Veterans Affairs announced that one of two 5-year contracts would be awarded to TriWest, estimated to be $4.3 billion of revenue over five years.

As a result of this award, TriWest does not expect to experience material changes in its mission and operations. To support the smaller scale operations, TriWest has decreased its workforce, operations, and capital base. Based on these developments, the Company does not believe the carrying value of TriWest is impaired as of December 31, 2013.

Receivables — Receivables includes the uncollected amounts from insured groups, and is reported net of an allowance for doubtful accounts and retroactivity. The allowance of $12,428 and $15,164 as of December 31, 2013 and 2012, respectively, is based on historical collection trends and the Company's judgment regarding the ability to collect specific accounts and estimated retroactivity.

Fixed Assets — Furniture, equipment, buildings, and leasehold improvements are carried at cost, less accumulated depreciation and amortization. The Company records depreciation and amortization using the straight-line method over the useful life of the asset or the lease term, whichever is shorter. The useful lives of the assets range from 3 to 40 years.

Direct costs incurred to develop internally used software are capitalized after technological feasibility has been assured. Once the software is placed in operation, the software costs are amortized over periods ranging from three to nine years. The Company periodically evaluates the recoverability of capitalized costs and writes down such capitalized costs when events and circumstances indicate that the costs may not be recoverable.

Goodwill and Intangible Assets — Goodwill and intangible assets with indefinite lives are not amortized, but are tested annually for impairment. The Company completes an annual impairment test of existing goodwill and other intangible assets with indefinite lives using a measurement date of September 30. This test involves the use of estimates related to the fair value of the business with which the goodwill and other intangible assets with indefinite lives is allocated. This test requires a significant degree of management judgment and the use of subjective assumptions. The fair values are estimated using income and market valuation methods, incorporating internal estimates for inputs, including, but not limited to, revenue projections, income projections, cash flows and discount rates. Fair values calculated using income and market valuation methods are evaluated and weighted. No impairment losses were identified as a result of this test in 2013 and 2012. Goodwill and intangible assets with indefinite lives was $134,855 at December 31, 2013 and 2012, respectively.

The Company amortizes other identifiable intangible assets with finite useful lives. The net carrying amount of intangibles subject to amortization was $69 and $81 at December 31, 2013 and 2012, respectively.

Claims Payable — The reserves established for claims and claim adjustment expenses represent the Company's estimate of future payments for services rendered. Claims payable includes estimates of the Company's obligations for medical care services that have been rendered on behalf of insured members, but for which claims have not yet been received or processed. The Company develops estimates for medical costs incurred but not reported using an actuarial process that is consistently applied, centrally controlled and automated. The actuarial models consider factors such as time from date of service to claim receipt, claim backlogs, care provider contract rate changes, medical care consumption and other medical cost trends. Each period, the Company re-examines previously established claims payable estimates based on actual claim submissions and other changes in facts and circumstances. As the claims payable estimates recorded in prior periods develop, the Company adjusts the amount of the estimates and includes the changes in estimates in medical costs in the period in which the change is identified. Claim adjustment expenses include costs incurred in the claim settlement process such as costs to record, process, and adjust claims.

Experience Rating Arrangements — In accordance with the Company's experience rating formulas, groups with favorable experience may build up credits that may, depending upon the plan, be refunded in cash, applied against future dues payments, or applied against future adverse experience. In certain cases, the Company reserves the right to amend the formulas to meet changing conditions.

Included with the experience rating arrangements were $231,298 and $239,728 of premium reserves for the Federal Employees Program as of December 31, 2013 and 2012, respectively. The United States Office of Personnel Management ("OPM") has contracted with the Company to provide healthcare benefits to California federal employees. These premium reserves represent cumulative premiums collected by OPM on behalf of the Company for the program in excess of program expenses and are fully offset by premium receivables.

Premiums and Other Revenue — Premiums are billed in advance and recognized in the month members are entitled to services. The unearned portion of premiums represents cash received in advance and is reflected as unearned premiums in the accompanying consolidated balance sheets.

The Company periodically evaluates the adequacy of its premium rates to cover health care costs and other costs over the terms of its contracts. Accordingly, losses (premium deficiency) on health care contracts are accrued when it is probable that expected future health care costs and maintenance costs under an existing group of contracts will exceed anticipated future premiums and recoveries on those contracts. No premium deficiency reserve was recorded as of December 31, 2013 or 2012.

In 2011, the Company's Board of Directors (the "Board") approved a new initiative to limit net income to 2% of premium revenue, whereby any amount above the 2% would be returned to the Company's customers in the form of a credit and to the community (collectively referred to as "give-backs"). The 2% net income limit will remain in place, as long as the Board determines that the Company is financially solvent, with sufficient funds to make the investments needed for the Company to be competitive.

The Company recorded a reduction to earned premium and other revenue of $0 and $53 million in 2013 and 2012, respectively. As of December 31, 2013 and 2012, $36 million and $37 million, respectively, is included in accounts payable and accrued expenses in the accompanying balance sheets.

The Company serves as a plan sponsor offering Medicare Advantage and Medicare Part D prescription drug insurance coverage under contracts with Centers for Medicare and Medicaid Services (CMS). CMS deploys a risk adjustment model that apportions premiums paid to all health plans according to health severity and certain demographic factors. The CMS risk adjustment model pays more for members whose medical history indicates they have certain medical conditions. Under this risk adjustment methodology, CMS calculates the risk adjusted premium payment using diagnosis data from hospital inpatient, hospital outpatient and physician treatment settings. The Company and health care providers collect, capture, and submit the necessary and available diagnosis data to CMS within prescribed deadlines. The Company estimates risk adjustment revenues based upon the diagnosis data submitted to CMS.

Self-Funded Arrangements — The Company has contracts with self-funded groups under which the group is at risk for all or a portion of its claims experience. The Company charges self-funded groups a fee for services rendered. Benefits paid by the Company on behalf of the self-funded groups are reimbursed by such groups and are included in health care services for self-funded arrangements as a reduction of the associated reimbursement. Reimbursements from self-funded groups, as well as the associated fees, are included as revenue from self-funded arrangements in the accompanying consolidated statements of operations. The administrative fees earned by the Company were $93,058 and $85,341 for the years ended December 31, 2013 and 2012, respectively.

Health Benefits — The Company has contracts with a statewide network of hospitals, physicians, and other providers for its HMO and PPO products. Incentives are established for PPO members to use these providers and HMO members are required to use the contracting provider network, with limited exceptions. The Company pays the contracting provider either through a fee-for-service arrangement in which the provider is paid negotiated rates for specific services provided or a capitated payment, a fixed monthly fee for each member regardless of medical services provided to the member. The Company is at risk in varying degrees on benefit payments for its standard business.

Advertising Costs — The Company uses print, broadcast and other advertising to promote its products. Advertising costs are expensed as incurred and included in marketing and selling expenses in the accompanying consolidated statements of operations. Advertising costs were $19,069 and $24,702 for the years ended December 31, 2013 and 2012, respectively.

Income Taxes — The Company's income taxes are accounted for using the asset and liability method. Under this method, a deferred tax asset or liability is determined based on the enacted tax rates in effect when the differences between the financial statement carrying amounts and tax bases of existing assets and liabilities are expected to be reported in the Company's income tax returns. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date.

Tax benefits from uncertain tax positions are recognized when it is more likely than not that the position will be sustained upon examination, including resolution of any related appeals, based on technical merits. The amount recognized is measured as the largest amount of tax benefit that is greater than 50% likely to be realized upon effective settlement.

Concentration of Credit Risk — One customer accounted for 22% of premium revenue for the years ended December 31, 2013 and 2012. This customer also accounted for 16% and 26% of premium receivable at December 31, 2013 and 2012, respectively. No other customer exceeded 10% of premium revenue or receivable. Concentration of credit risk is limited due to the large number of payers that comprise the customer base.

Fair Value of Financial Instruments — The estimated fair value amounts of cash equivalents and investments have been determined by the Company using available market information and appropriate valuation methodologies. The carrying amounts of cash equivalents approximate fair value due to the short maturity of those instruments. Fair values for debt and equity investments are generally based upon broker quotes and quoted market prices, respectively. Where quoted market prices were not readily available, fair values were estimated using valuation methodologies based on available and observable market information. Such valuation methodologies include using discounted cash flow analysis, which incorporates current market inputs for similar financial instruments with comparable terms and matrix pricing. These valuation techniques involve some level of estimation and judgment. The carrying value of receivables, accounts payable, and certain other accrued liabilities approximate the fair value of such instruments.

Non-financial instruments such as real estate, property and equipment, other current assets, deferred income taxes, and intangible assets are excluded from the fair value disclosures. Therefore, the fair value amounts cannot be aggregated to determine the underlying economic value of the Company.

Impairment of Long-Lived Assets — The Company periodically evaluates its property, equipment, and intangible assets as well as their useful lives to determine whether current events or circumstances warrant adjustments to the carrying value and/or revised estimates of useful lives. No impairment indicators were present during 2013 or 2012.

Comprehensive Income — The Company reports comprehensive income, by major components and as a single total, in the consolidated financial statements. Comprehensive income includes all changes in net assets during the period from other sources. Comprehensive income for the Company includes net income and other comprehensive income. The Company's sources of other comprehensive income include unrealized gains or losses on securities available-for-sale, and deferred pension costs.

Accumulated other comprehensive income (loss) for the years ended December 31, 2013 and 2012, is as follows:

	Unrealized Gains (Losses) on Investments Available-for-Sale	Defined Benefit Plans	Accumulated Other Comprehensive Income
Balance — January 1, 2012	$ 140,044	$ (73,354)	$ 66,690
Other comprehensive income (loss) for the year ended December 31, 2012	87,849	(14,006)	73,843
Balance — December 31, 2012	227,893	(87,360)	140,533
Other comprehensive income for the year ended December 31, 2013	64,554	50,467	115,021
Balance — December 31, 2013	$ 292,447	$ (36,893)	$ 255,554

New Accounting Pronouncements — In February 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2013-02, *Comprehensive Income (Topic 220), Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income* (AOCI). ASU 2013-02 is intended to help entities improve the transparency of changes in other comprehensive income (OCI) and items reclassed out of AOCI in their financial statements. ASU 2013-02 requires entities to disclose additional information about reclassification adjustments, including (1) changes in AOCI balances by component and (2) significant items reclassified out of AOCI. ASU 2013-02 is effective with the Company's fiscal year beginning January 1, 2014. The adoption of the reporting guidance is not expected to have a material impact on the Consolidated Financial Statements.

In February 2013, the FASB issued ASU 2013-03, *Financial Instruments (Topic 825): Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities*, which exempts nonpublic entities from the requirements in ASC 825 (amended by ASU 2011-04) to disclose the fair value hierarchy level (i.e. level 1, 2, or 3) for fair value measurement of financial assets and financial liabilities that are disclosed in the footnotes to the financial statements but not reported at fair value in the statement of financial position. The ASU does not change any other fair value disclosure requirements in ASC 820 or 825. The amendments in ASU 2013-03 are effective upon issuance. This guidance did not have a material impact on the Consolidated Financial Statements.

In 2013, the FASB issued a private company decision-making framework that it and the Private Company Council will use to identify differences in the information needs of users of private company and public company financial statements. In December 2013, the FASB issued ASU 2013-12 *Definition of a Public Business Entity,* to include the definition of public business entity to be used in specifying the scope of future financial accounting and reporting guidance, such as determining which entities can use private company accounting alternatives provided by FASB. With the issuance of ASU 2014-02 *Intangibles-Goodwill and Other (Topic 350)*, an entity that is not a public business entity may elect to amortize goodwill on a straight-line basis over a period not-to-exceed 10 years and to discontinue performing the annual goodwill impairment test. ASU 2014-02 is effective for eligible companies for fiscal years beginning after December 15, 2014. Early adoption is permitted. The Company is evaluating the impact adoption of this pronouncement may have on its consolidated financial statements.

3. INVESTMENTS

Fair value of debt securities is based on broker quotes, where available, at the valuation date. Fair value of equity securities is generally based on quoted market prices at valuation date. Amortized cost, gross unrealized gains and losses, and fair value of available-for-sale investments, by type, as of December 31, 2013 and 2012, follows:

	2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities:				
U.S. government and its agencies	$ 542,361	$ 2,023	$ (6,125)	$ 538,259
Foreign governments	55,593	439	(550)	55,482
Corporate securities	1,345,268	22,194	(13,206)	1,354,256
Mortgage-backed securities	874,950	9,006	(19,990)	863,966
Collateralized mortgage obligation and asset-backed securities	432,662	2,829	(2,160)	433,331
Other debt securities	4,328	46	(93)	4,281
Total debt securities	3,255,162	36,537	(42,124)	3,249,575
Equity securities	896,851	461,677	(6,173)	1,352,355
Total investments	$ 4,152,013	$ 498,214	$ (48,297)	4,601,930
Less short-term investments				(1,379,314)
Long-term investments				$ 3,222,616

	2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities:				
U.S. government and its agencies	$ 496,429	$ 23,351	$ (297)	$ 519,483
Foreign governments	35,337	1,042	-	36,379
Corporate securities	1,427,515	58,151	(1,419)	1,484,247
Mortgage-backed securities	813,477	23,074	(591)	835,960
Collateralized mortgage obligation and asset-backed securities	313,980	6,018	(42)	319,956
Other debt securities	5,800	270	(54)	6,016
Total debt securities	3,092,538	111,906	(2,403)	3,202,041
Equity securities	975,700	252,368	(11,422)	1,216,646
Total investments	$4,068,238	$364,274	$(13,825)	4,418,687
Less short-term investments				(1,276,976)
Long-term investments				$ 3,141,711

The amortized cost and fair value of available-for-sale debt securities at December 31, 2013, are based on expected maturities as shown below. The maturities for asset-backed investments reflect the weighted-average life to maturity based on historical prepayment patterns. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The maturities of all other debt securities are based on contractual maturities.

	Available-for-Sale	
	Amortized Cost	Fair Value
Due in 1 year or less	$ 49,012	$ 49,282
Due after 1 year through 5 years	1,188,732	1,201,621
Due after 5 years through 10 years	885,863	878,200
Due after 10 years	1,131,555	1,120,472
Total debt securities	$3,255,162	$3,249,575

Net realized gains, before taxes, consisted of the following:

	2013	2012
Gross realized gains from sales	$ 109,394	$ 138,337
Gross realized losses from sales	(9,442)	(15,085)
Net realized gains	$ 99,952	$ 123,252

The Company's net investment management fees totaled $6,282 and $5,985 for the years ended December 31, 2013 and 2012, respectively.

The gross unrealized losses and fair value of investments with unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, as of December 31, 2013 and 2012, were as follows:

	2013					
	Less than 12 Months		12 Months or More		Total	
Description of Securities	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
Debt securities:						
U.S. government and its agencies	$ 293,056	$ (6,125)	$ -	$ -	$ 293,056	$ (6,125)
Foreign government	21,539	(550)	-	-	21,539	(550)
Corporate securities	541,383	(12,811)	9,553	(395)	550,936	(13,206)
Mortgage-backed securities	504,581	(17,646)	45,133	(2,344)	549,714	(19,990)
Collateralized mortgage obligation and asset-backed securities	260,499	(2,160)	-	-	260,499	(2,160)
Other debt securities	3,192	(93)	-	-	3,192	(93)
Subtotal	1,624,250	(39,385)	54,686	(2,739)	1,678,936	(42,124)
Equity securities	48,130	(4,204)	12,145	(1,969)	60,275	(6,173)
Total	$ 1,672,380	$ (43,589)	$ 66,831	$ (4,708)	$ 1,739,211	$ (48,297)

	2012					
	Less than 12 Months		12 Months or More		Total	
Description of Securities	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
Debt securities:						
U.S. government and its agencies	$ 65,816	$ (297)	$ -	$ -	$ 65,816	$ (297)
Foreign government	-	-	-	-	-	-
Corporate securities	120,656	(835)	9,324	(584)	129,980	(1,419)
Mortgage-backed securities	139,351	(591)	-	-	139,351	(591)
Collateralized mortgage obligation and asset-backed securities	29,780	(32)	959	(10)	30,739	(42)
Other debt securities	712	(54)	-	-	712	(54)
Subtotal	356,315	(1,809)	10,283	(594)	366,598	(2,403)
Equity securities	101,129	(9,242)	24,045	(2,180)	125,174	(11,422)
Total	$457,444	$ (11,051)	$ 34,328	$ (2,774)	$491,772	$ (13,825)

The unrealized losses as of December 31, 2013 and 2012, were generated from 1,475 and 795 positions out of a total of 4,949 and 4,931 positions, respectively.

The unrealized losses on investments in corporate debt securities were primarily caused by interest rate movements and changes in credit spreads and not by unfavorable changes in the credit quality associated with these securities. The Company evaluates impairment at each reporting period for securities where the fair value of the investment is less than its cost. For debt securities, the Company considers a variety of factors such as scheduled interest and principal payments, payment guarantees, type of underlying collateral if any, ratings and changes in ratings by rating agencies, discounted cash flows, prepayment speeds, vintage, default rates, severity and duration of the impairment, recoveries and changes in value to determine whether the unrealized losses are attributable to changes in interest rates as opposed to credit quality. The Company also evaluated the underlying credit quality of the issuers, noting no factors leading to an other-than-temporary impairment.

Most of the Company’s investments in equity securities consist of investments held in various public companies. Market conditions that affect the value of these equities will impact the value of the Company’s equity portfolio. The equity securities were evaluated for severity and duration of unrealized loss, overall market volatility and other market factors. The Company analyzes relevant factors individually and in combination including the length of time and extent to which market value has been less than cost, the financial condition and near-term prospects of the issuer as well as specific events or circumstances that may influence the operations of the issuer, and its intent and ability to hold the investment for a sufficient time to recover the Company’s cost. The Company revises impairment judgments when new information becomes known or when it does not anticipate holding the investment until recovery.

If any of the Company’s investments experiences a decline in fair value that is determined to be other-than-temporary, based on analysis of relevant factors, the Company records a realized loss in the consolidated statements of operations. The Company does not consider the unrealized losses on each of the investments described above to be other-than-temporarily impaired at December 31, 2013. The fair value of the securities could decline in the future if the overall general economy deteriorates. As a result, it is reasonably possible that other-than-temporary impairments may occur in the future.

4. FAIR VALUE MEASUREMENTS

Assets recorded at fair value in the consolidated balance sheets are categorized based upon the level of judgment associated with the inputs used to measure their fair value. Investments measured and reported at fair value are classified in one of the following categories:

Level I — Quoted prices for identical assets in active markets at the measurement date.

Level II — Inputs based on quoted prices for similar instruments in active markets, quoted prices for identical instruments in markets that are not active, and model based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the asset.

Level III — Unobservable inputs that reflect management’s best estimate of what market participants would use in pricing the asset at the measurement date that cannot be corroborated by other observable market data.

Transfers between levels, if any, are recorded at the end of the reporting period. For the years ended December 31, 2013 and 2012, there were no material transfers between levels.

The following tables summarize fair value measurements by level at December 31, 2013 and 2012, for investments measured at fair value on a recurring basis:

	2013			
	Level I	Level II	Level III	Total
Debt securities:				
U.S. government and its agencies	$ -	$ 538,259	$ -	$ 538,259
Foreign government	-	55,482	-	55,482
Corporate securities	-	1,354,256	-	1,354,256
Mortgage-backed securities	-	863,966	-	863,966
Collateralized mortgage obligation and asset-backed securities	-	433,331	-	433,331
Other debt securities	-	4,281	-	4,281
Equity securities	1,352,272	83	-	1,352,355
Total	$ 1,352,272	$ 3,249,658	$ -	$ 4,601,930

	2012			
	Level I	Level II	Level III	Total
Debt securities:				
U.S. government and its agencies	$ -	$ 519,483	$ -	$ 519,483
Foreign government	-	36,379	-	36,379
Corporate securities	-	1,484,247	-	1,484,247
Mortgage-backed securities	-	835,960	-	835,960
Collateralized mortgage obligation and asset-backed securities		319,956	-	319,956
Other debt securities		6,016	-	6,016
Equity securities	1,216,594	51	1	1,216,646
Total	$ 1,216,594	$ 3,202,092	$ 1	$ 4,418,687

There was no significant activity related to Level III investments for the years ended December 31, 2013 and 2012.

5. FIXED ASSETS

Fixed assets as of December 31, 2013 and 2012, were as follows:

	2013	2012
Leasehold improvements	$ 53,088	$ 53,484
Land and building	97,272	96,516
Furniture and equipment	223,289	188,324
Capitalized software	696,622	588,992
Total	1,070,271	927,316
Accumulated depreciation and amortization	(573,135)	(501,468)
Fixed assets — net	$ 497,136	$ 425,848

Depreciation expense was $74,291 and $69,577 for the years ended December 31, 2013 and 2012, respectively.

6. CLAIMS PAYABLE

The components of the change in claims payable and claim adjustment expenses for the years ended December 31, 2013 and 2012, were as follows:

	2013	2012
Claims payable — beginning of period	$ 950,578	$ 945,102
Reported medical costs:		
Current year	9,197,181	8,714,140
Prior years	(2,851)	(71,362)
Total reported medical costs	9,194,330	8,642,778
Claim payments:		
Payments for current year	(8,146,729)	(7,771,058)
Payments for prior year	(938,425)	(866,244)
Total claim payments	(9,085,154)	(8,637,302)
Claims payable — end of period	$ 1,059,754	$ 950,578

As a result of changes in estimates of insured events in prior years, the provision for claims payable and claim adjustment expenses decreased by $2,851 and $71,362 in 2013 and 2012, respectively.

The favorability observed in incurred claims related to prior years is due to actual claims experience being more favorable than the claims payable originally established. The primary driver consists of lower utilization of health care services across the industry and for the Company.

7. INCOME TAXES

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts for income tax purposes. The net deferred tax assets as of December 31, 2013 and 2012, consists of the following:

	2013	2012
Deferred tax assets	$ 307,338	$ 352,483
Deferred tax liabilities	(343,321)	(286,697)
Net deferred tax (liabilities) assets	$ (35,983)	$ 65,786

Significant temporary differences that give rise to deferred tax assets and liabilities include unrealized gains and other-than-temporary impairment losses on investments and the financial statement accrual of certain expenses related to employee benefits, deferred compensation, unpaid benefits and benefit processing expenses for tax purposes, depreciation and amortization, the excess of charitable contributions made during the tax year over the amount of the charitable contribution limitation amount and the value of alternative minimum tax (AMT) credit carryforwards.

The Company utilized AMT credit carryforwards of $27,335 and $29,694 in the years ended December 31, 2013 and 2012, respectively. $64,129 and $91,464 AMT credit carryforwards that have no expiration date were available at December 31, 2013 and 2012, respectively, and are included in deferred tax assets. The Company and its wholly owned subsidiaries file a consolidated federal income tax return.

The Company's provision for income tax for the years ended December 31, 2013 and 2012, consists of the following:

	2013	2012
Current	$ 38,389	$ 44,995
Deferred	39,835	50,166
Income tax expense	$ 78,224	$ 95,161

The Company's effective tax rate on pretax income differs from the statutory tax rate as a result of permanent differences between taxable income for financial reporting purposes and the amounts for income tax purposes for dividends received, charitable contributions of appreciated investments, compensation in excess of the deduction limitation for certain issuers of health insurance and interest associated with uncertain tax positions.

The Company does not have any tax positions for which it is reasonably possible the total amount of gross unrecognized tax benefits will increase or decrease within 12 months of December 31, 2013 or 2012. The unrecognized tax benefits may increase or change during the next year for items that arise in the ordinary course of business. The Company classifies net interest expense and any applicable penalties related to uncertain tax positions as a component of income tax expense. The Company had $1,281 and $1,339 of accrued interest at December 31, 2013 and 2012, respectively. The Company's tax return years 2009 through 2012 remain subject to examination by federal tax authorities.

8. PENSION AND POSTRETIREMENT HEALTH CARE BENEFITS

The Company sponsors a noncontributory defined benefit pension plan for its eligible employees, a defined postretirement health care plan for its eligible employees, other pension plans for its executives, and a defined contribution plan for its eligible employees. The Company uses a December 31 measurement date for its plans. The following table summarizes the benefit obligations, the fair value of plan assets, and the funded status of the defined benefit plans as of December 31, 2013 and 2012:

	Pension Benefits		Other Benefits	
	2013	2012	2013	2012
Benefit obligation at December 31	$ (397,318)	$ (409,655)	$ (50,318)	$ (49,237)
Fair value of plan assets — December 31	367,773	320,645	-	-
Funded status	$ (29,545)	$ (89,010)	$ (50,318)	$ (49,237)
Liability recognized in the consolidated balance sheets	$ (29,545)	$ (89,010)	$ (50,318)	$ (49,237)
Accumulated benefit obligation	$ (376,083)	$ (388,257)	$ -	$ -

The following table summarizes the amounts recognized in the consolidated balance sheets for the years ended December 31, 2013 and 2012:

	Pension Benefits		Other Benefits	
	2013	2012	2013	2012
Current liabilities	$ (3,224)	$ (14,945)	$ (1,280)	$ (1,333)
Noncurrent liabilities	(26,321)	(74,065)	(49,038)	(47,904)
	$ (29,545)	$ (89,010)	$ (50,318)	$ (49,237)

The amounts recognized in net periodic benefit cost and other comprehensive income (OCI) included the following:

	Pension Benefits		Other Benefits	
	2013	2012	2013	2012
Components of net periodic benefit cost:				
Service cost	$ 33,983	$ 30,042	$ 2,790	$ 2,296
Interest cost	15,420	17,036	2,321	2,297
Expected return on assets	(23,940)	(22,407)	-	-
Amortization of prior service cost (credit)	496	492	(1,721)	(1,721)
Amortization of actuarial loss	9,259	8,634	595	239
Settlements	6,541	947	-	-
Net periodic benefit cost	$ 41,759	$ 34,744	$ 3,985	$ 3,111
Other changes in plan assets and benefit obligations recognized in OCI:				
Net actuarial (gain) loss	$ (59,795)	$ 28,936	$ (2,677)	$ 1,205
Amortization of prior service (cost) credit	(496)	(492)	1,721	1,721
Amortization of actuarial loss	(15,799)	(9,581)	(595)	(240)
Net amount recognized in OCI	$ (76,090)	$ 18,863	$ (1,551)	$ 2,686

The amounts included in accumulated OCI that have not been recognized as components of net periodic benefit costs (credit) are shown in the following table:

	Pension Benefits		Other Benefits	
	2013	2012	2013	2012
Unrecognized prior service cost (credit)	$ 1,007	$ 1,502	$ (3,597)	$ (5,318)
Net actuarial loss	54,186	129,781	5,164	8,436
	$ 55,193	$ 131,283	$ 1,567	$ 3,118

The assumptions used in the measurement of the Company's benefit obligations and net benefit cost is shown in the following table:

	Pension Benefits		Other Benefits	
	2013	2012	2013	2012
Weighted-average assumptions — benefit obligations:				
Discount rate	4.45%–4.80%	3.5%–4.00%	5.35 %	4.50 %
Expected return on plan assets	7.75	7.75	-	-
Rate of compensation increase	4.00–9.00	4.00–9.00	-	-
Weighted-average assumptions — net benefit cost:				
Discount rate	3.50%–4.00%	4.50%–5.00%	4.50 %	5.25 %
Expected return on plan assets	7.75	8.00	-	-
Rate of compensation increase	4.00–9.00	4.00–9.00	-	-

For measurement purposes, an annual rate of increase in the per capita cost of covered health care benefits of 7.75% (for pre-65 participants) and 6.75% (for post-65 participants) was assumed for 2013. For measurement purposes, an annual rate of increase in the per capita cost of covered health care benefits of 8.00% (for pre-65 participants) and 7.25% (for post-65 participants) was assumed for 2012. The rate was assumed to decrease gradually to 5.0% for 2022 and remain at that level thereafter.

The net periodic benefit cost, employer contributions and benefits paid are as follows:

	Pension Benefits		Other Benefits	
	2013	2012	2013	2012
Net periodic benefit cost	$ 41,759	$ 34,744	$ 3,985	$ 3,111
Employer contributions	25,132	32,286	653	1,449
Benefits paid	43,651	36,557	2,006	1,449

The Company expects to contribute $15,000 to the defined benefit pension plan in 2014 and to fund 2014 benefits for the executive pension and defined postretirement health care plans as they become due.

The benefits expected to be paid in each of the next five years, and in the aggregate for the five years thereafter are as follows:

	Pension Benefits	Other Benefits
2014	$ 33,695	$ 1,280
2015	29,430	1,400
2016	32,667	1,510
2017	35,883	1,640
2018	37,674	1,800
2019–2023	231,272	11,670

The amounts included in accumulated other comprehensive income expected to be recognized during the next fiscal year are shown in the following table:

	Pension Benefits	Other Benefits
Prior service cost (credit)	$ 498	$ (1,721)
Actuarial loss	1,491	14
Amount to be recognized	$ 1,989	$ (1,707)

The asset allocation percentages for the pension plan assets are as follows:

	2013	2012
Equity securities	77 %	74 %
Debt securities	18	22
Other	5	4
Total	100 %	100 %

The investment policy of the defined benefit pension plan trust is to allocate plan assets in a prudent and diversified manner among various asset classes to achieve an acceptable long-term total rate of return at an acceptable level of risk. Target allocations are 70% to 80% for equity securities and 20% to 30% for debt securities.

The expected long-term rate of return is the result of the expected returns of the various asset classes at the target asset allocation noted above. The expected returns of the asset classes are based on historical experience with a margin for future expectations.

The fair values of the Company's pension plan assets at December 31, 2013 and 2012, by asset category are as follows (see Note 2 and Note 4 for description of fair value measurements and Level classifications, respectively):

	2013			
	Level I	Level II	Level III	Total
Cash and cash equivalents	$ 16,940	$ 3,000	$ -	$ 19,940
Debt securities:				
US government and its agencies	-	22,938	-	22,938
Corporate securities	-	18,018	5	18,023
Mortgage-backed securities	-	15,455	-	15,455
Collateralized mortgage obligation and asset-backed securities	-	9,453	-	9,453
Other debt securities	-	-	-	
Equity securities	281,964	-	-	281,964
Total	$ 298,904	$ 68,864	$ 5	$ 367,773

	2012			
	Level I	**Level II**	**Level III**	**Total**
Cash and cash equivalents	$ 9,890	$ 3,200	$ -	$ 13,090
Debt securities:				
US government and its agencies	-	28,334	-	28,334
Corporate securities	-	15,369	-	15,369
Mortgage-backed securities	-	20,550	-	20,550
Collateralized mortgage obligation and asset-backed securities	-	6,666	-	6,666
Other debt securities	-	5	-	5
Equity securities	236,325	306	-	236,631
Total	$ 246,215	$ 74,430	$ -	$ 320,645

There was no significant activity related to Level III investments for the years ended December 31, 2013 and 2012.

There were no material transfers between Levels I, II, and III during the years ended December 31, 2013 and 2012.

The Company sponsors a defined contribution 401(k) plan, whereby qualified participants may contribute up to 50% of their annual compensation as defined by the plan, on a tax-deferred basis, up to a maximum amount allowed by the Internal Revenue Code. These contributions are matched by the Company subject to certain limitations. Matching contributions made by the Company totaled $14,261 and $13,735 for the years ended December 31, 2013 and 2012, respectively.

9. CREDIT FACILITY

The Company maintains a $4,000 revolving credit facility available through March 31, 2015. The facility allows the Company to borrow uncollateralized at (i) the higher of the (a) the bank's prime rate and (b) the federal funds floating rate plus 75 basis points or (ii) LIBOR plus 75 basis points. The Company may also issue standby letters of credit at a fee of 75 basis points. At December 31, 2013 and 2012, the Company had no borrowings outstanding under the facility and had outstanding standby letters of credit totaling $2,550, primarily in support of workers' compensation benefits provided by the Company to its employees.

10. COMMITMENTS

The Company has entered into various operating and capital leases for its office space and certain equipment under long-term leases. These operating leases contain rent adjustment provisions for increases in property taxes and operating expenses.

At December 31, 2013, future minimum lease commitment for these non-cancelable operating and capital leases are as follows:

	Operating Leases	Capital Lease
2014	$ 20,646	$ 252
2015	17,044	252
2016	15,764	167
2017	14,853	-
2018	14,792	-
Thereafter	14,949	-
Total future minimum lease payments	$ 98,048	671
Less: interest		(16)
Total capital lease obligations		$ 655

These minimum operating lease payments have not been reduced by minimum sublease rentals of $230 due in the future under noncancelable subleases. Total sublease rental revenue was approximately $221 and $212 for the years ended December 31, 2013 and 2012, respectively.

Total rental expense for all operating leases was approximately $20,573 and $22,307 for the years ended December 31, 2013 and 2012, respectively.

11. REGULATORY REQUIREMENTS

The Company is regulated by the Department of Managed Health Care ("DMHC"). Pursuant to the California Code of Regulations, the Company is required to meet a minimum tangible net equity standard. The Company exceeds the minimum tangible net equity requirement as of December 31, 2013 and 2012.

The Company's subsidiaries are subject to Risk-Based Capital requirements of the National Association of Insurance Commissioners and the California Department of Insurance, which require the subsidiaries to maintain a minimum capital and surplus. The Company's subsidiaries exceed the minimum capital and surplus requirements as of December 31, 2013 and 2012.

Licensees are required to maintain minimum investment amounts for the restricted use of the regulators in certain limited circumstances. Within the scope of state requirements established by the regulators, management has discretion as to whether such funds shall be invested in cash and cash equivalents or other investments. Such restricted investments totaled $8,767 and $8,775 as of December 31, 2013 and 2012, respectively.

12. CONTINGENCIES

Risk Adjustment Data Validation (RADV) Audits — The Centers for Medicare and Medicaid Services (CMS) regularly audits the Company's and other companies' Medicare Plans' performance to determine compliance with CMS's regulations, contracts with CMS and the quality of services provided to Medicare members. CMS uses various payment mechanisms to allocate and adjust premium payments to the various Health Plans by considering the applicable health status of Medicare members as supported by information maintained and provided by health care providers. The Company collects claim and encounter data from providers and generally relies on providers to appropriately code their submissions and document their medical records. Medicare Advantage plans and prescription drug plans (PDPs) receive increased premiums for members who have certain medical conditions identified with specific health condition codes. Federal regulators review and audit the providers' medical records and related health condition codes that determine the members' health status and the resulting premium payments to the Health Plans.

In February 2012, CMS published its final payment error calculation methodology for RADV audits and announced it will begin applying this methodology for audits beginning with the 2011 payment year. The methodology includes a fee-for-service adjuster, which would limit liability to an error rate in excess of CMS's own fee-for service error rate. Any premium refunds or adjustments resulting from regulatory audits, whether as a result of RADV or other audits by CMS could be material and could adversely affect the Company's consolidated financial condition, results of operations or cash flows. In November 2013, the Company was informed that its Medicare Advantage contract was selected by CMS for review.

Guaranty Funds Assessment — Under state guaranty assessment laws, certain insurance companies issuing health, life and accident insurance policies, including Blue Shield of California Life & Health Insurance Company can be assessed (up to prescribed limits) for certain obligations to the policyholders and claimants of insolvent insurance companies that write the same line or lines of business. Assessments are generally based on premiums in the state compared to the premiums of other insurers, and could be spread out over a period of years. Some states permit member insurers to recover assessments paid through full or partial premium tax offsets.

The Pennsylvania Insurance Commissioner has placed long-term care insurer Penn Treaty Network America Insurance Company and one of its subsidiaries (collectively, "Penn Treaty") in rehabilitation, an intermediate action before insolvency, and has petitioned a state court for liquidation. On March 4, 2014, the Court granted Penn Treaty's motion for extension and continuation of stay until September 2, 2014. The Company cannot predict when a decision will be made, although the Company believes it is likely that the state court will rule within the next twelve months. If Penn Treaty is declared insolvent and placed in liquidation, insurers, including one of the Company's subsidiaries, likely would be assessed over a period of years by guaranty associations for the payments the guaranty associations are required to make to Penn Treaty policyholders. The Company is currently unable to predict the ultimate outcome of, or reasonably estimate the loss or range of losses resulting from, this potential insolvency because the Company cannot predict when the state court will render a decision, the amount of insolvency, if any, or the amount and timing of associated guaranty association assessments. It is reasonably possible that in future reporting periods, the Company may record a liability and expense relating to Penn Treaty which could have a material adverse effect on its consolidated financial condition, results of operations or cash flows.

Litigation and Regulatory Proceedings — Because of the nature of the Company's businesses, it is routinely party to a variety of legal actions, governmental investigations, audits, reviews, and administrative proceedings related to the design, management, and offerings of its services. These matters include, but are not limited to, claims relating to decisions to restrict or deny reimbursement for uncovered services, contract disputes, and claims related to disclosure of certain business practices. The Company believes it has meritorious defenses to all of these matters and intends to defend them vigorously.

In December 2008, a demand for arbitration was filed by Cedars-Sinai Medical Center, one of the Company's contracted hospitals. At present, the hospital asserts claims for approximately $20.4 million for breach of contract, breach of the implied covenant of good faith and fair dealing, quantum meruit, unjust enrichment, violation of California's Unfair Competition Law, and Relief from Forfeiture. The hospital alleges that the Company underpaid claims for hospital services from 2004 to the present. The Company believes it has meritorious defenses to the case and intends to defend it vigorously.

In October 2012, a demand for arbitration was filed by Sutter Health, one of the Company's contracted health systems. At present, the hospital asserts claims for approximately $13.6 million plus interest for breach of contract. The health system alleges that the Company underpaid claims for hospital services from 2008 through 2011. The Company believes it has meritorious defenses to the case and intends to defend it vigorously.

Although the results of pending litigation are always uncertain, management does not believe the results of any such actions currently threatened or pending, including those described above, will have a material effect on the Company's consolidated financial position or results of operations.

13. RELATED PARTY TRANSACTION

Blue Shield of California Foundation (the "Foundation"), a California public benefit corporation was founded in 1981. The Foundation's mission is to improve the lives of Californians by making health care effective, safe, and accessible for all Californians, particularly underserved populations, and by ending domestic violence. The Foundation is not a subsidiary of the Company and the financial results of the Foundation are not consolidated with the Company's consolidated financial statements. Certain officers and directors of the Company serve as trustees of the Foundation.

The Company donated to the Foundation equity securities totaling $35,000 and $40,000 in 2013 and 2012, respectively and cash of $2,500 in 2013. The Company also provided the Foundation with administrative support services and personnel totaling $2,643 and $2,498 in 2013 and 2012, respectively, for which the Company received no compensation.

14. HEALTH CARE REFORM

In March 2010, the federal Patient Protection and Affordable Care Act and Health Care and Education Reconciliation Act of 2010 were signed into law, and in September 2010 a package of California state laws were enacted implementing various provisions of the federal laws (collectively, "Health Care Reform"). Health Care Reform makes broad-based changes to the U.S. and California health care systems and is intended to expand access to health insurance coverage over time. This legislation includes a requirement that most individuals maintain a minimum level of health insurance coverage beginning in 2014 and also a requirement that most large employers offer coverage to their employees or they will be required to pay a financial penalty.

The legislation also imposes new requirements on the health insurance sector, including, but not limited to, guaranteed coverage requirements, prohibitions on some annual and all lifetime limits on amounts paid on behalf of or to the Company's members for essential health benefits, increased restrictions on rescinding coverage, a requirement to cover preventive services on a first dollar basis, minimum essential health benefit packages and greater limitations on the pricing of certain products. The legislation also reduces the reimbursement levels for health plans participating in the Medicare Advantage program over time.

Beginning in 2011, fully insured comprehensive health plans with medical loss ratios that fall below certain minimum thresholds are required to return portions of their premiums. The medical loss ratio is the percentage of premium that an insurance company spends on providing health care and improving the quality of care. Separate calculations are performed by each licensed entity for the individual, small group and large group market segments. This Health Care Reform requirement serves to limit the margin that can be attained. The Company paid rebates in the amounts of $38,205 and $10,818 for the 2012 and 2011 medical loss ratio reporting years, respectively. As of December 31, 2013, the Company does not anticipate paying rebates for the 2013 medical loss ratio reporting year.

Health Care Reform also requires the establishment of marketplaces, or "exchanges," for individuals and small employers to buy health insurance. The Company is participating in Covered California, the state-based marketplace created to offer health insurance coverage that will begin in January 2014. Residents who do not have health insurance from their employer or another government program, or for whom that insurance is not affordable, may qualify for financial assistance with premiums for coverage purchased through the Covered California exchange.

Expansion of health care coverage as contemplated by Health Care Reform will be funded in part by material additional fees and taxes on health insurers, health plans and other market participants and individuals beginning in 2014. The most significant of these is the annual health insurance assessment fee (the "Fee").

In July 2011, the FASB issued ASU 2011-06, *Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers*. This update addresses the recognition and classification of an entity's share of the Fee mandated by Health Care Reform. The Fee will be levied on health insurers for each calendar year beginning on or after January 1, 2014 and is not deductible for income tax purposes. The Fee will be allocated to health insurers based on the ratio of an entity's net health premiums written during the preceding calendar year to the total health insurance for all U.S. health risk that is written during the preceding calendar year. In accordance with ASU 2011-06, the liability for the Fee will be estimated and recorded in full once the Company provides qualifying health insurance in the applicable calendar year in which the Fee is payable (first applicable in 2014) with a corresponding deferred cost that will be amortized to expense using a straight-line method of allocation unless another method better allocates the Fee over the calendar year that is payable. The Company estimates its share of the 2014 Fee to be $148,000. Because the fee is non-deductible, this amount will have a significant negative impact to the Company's effective tax rate when it is recorded and paid in 2014.

Health Care Reform will significantly impact the Company's business operations. Components of the legislation will be phased in over the next several years. The full impact of this legislation may not be known for several years. Management is closely monitoring how Health Care Reform will impact the Company.

15. SUBSEQUENT EVENTS

On February 28, 2014, the Company acquired GEMCare Health Plan ("GEMCare") for approximately $31 million. GEMCare is based in Bakersfield, California and is active in the commercial and Medicare markets. The acquisition enables the Company to broaden its presence in the Bakersfield and Central Coast regions.

The Company has evaluated subsequent events from the balance sheet date through March 7, 2014, the date that the consolidated financial statements were available to be issued and concluded there were no other events or transactions during this period, other than those described in these notes, that required recognition or disclosure in these consolidated financial statements.

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