

# Evercare of Arizona, Inc.

Financial Statements as of and for the  
Years Ended December 31, 2010 and 2009,  
Supplemental Schedules as of and  
for the Year Ended December 31, 2010,  
Independent Auditors' Report, and  
Internal Control Letter

# EVERCARE OF ARIZONA, INC.

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## INDEPENDENT AUDITORS' REPORT

To the Board of Directors of  
Evercare of Arizona, Inc.  
Phoenix, Arizona

We have audited the accompanying balance sheets of Evercare of Arizona, Inc. (the "Company") as of December 31, 2010 and 2009, and the related statements of operations, changes in stockholders' equity and accumulated other comprehensive income (loss), 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audits included 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, such financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2010 and 2009, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules in Exhibit I required by the Arizona Health Care Cost Containment System reporting guidelines are presented for the purpose of additional analysis and are not a required part of the basic financial statements. These schedules are the responsibility of the Company's management. Such schedules have not been subject to the auditing procedures applied in our audits of the basic financial statements and, accordingly, we express no opinion on them.

*Deloitte & Touche LLP*

March 31, 2011

# EVERCARE OF ARIZONA, INC.

## BALANCE SHEETS

AS OF DECEMBER 31, 2010 AND 2009

(In thousands, except share data)

	2010	2009
<b>ASSETS</b>		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 10,670	\$ 20,228
Short-term investments	2,718	1,590
Receivables — net of allowance of \$0 and \$368 in 2010 and 2009, respectively	5,073	3,318
Deferred income taxes	89	294
Current federal income taxes receivable	323	
Current state income taxes receivable		24
Other	9	
Total current assets	18,882	25,454
LONG-TERM INVESTMENTS	25,556	25,611
<b>TOTAL</b>	<b>\$44,438</b>	<b>\$51,065</b>
<b>LIABILITIES AND STOCKHOLDER'S EQUITY</b>		
CURRENT LIABILITIES:		
Medical services payable	\$ 13,411	\$ 16,831
Payable to AHCCCS	1,082	902
Related-party payable — net	1,601	97
Current federal income taxes payable		2,111
Other	1,156	1,648
Total current liabilities	17,250	21,589
LONG-TERM DEFERRED INCOME TAXES	392	384
Total liabilities	17,642	21,973
CONTINGENCIES (Note 8)		
STOCKHOLDER'S EQUITY:		
Common stock, \$1 par value — authorized, 2,000,000 shares; 1 share issued and outstanding		
Additional paid-in capital	10,999	10,999
Retained earnings	15,174	17,491
Accumulated other comprehensive income	623	602
Total stockholder's equity	26,796	29,092
<b>TOTAL</b>	<b>\$44,438</b>	<b>\$51,065</b>

See notes to financial statements.

## EVERCARE OF ARIZONA, INC.

### STATEMENTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009 (In thousands)

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	2010	2009
CAPITATION REVENUE	\$ 126,083	\$ 144,898
NET INTEREST AND OTHER INVESTMENT INCOME	<u>1,436</u>	<u>1,087</u>
Total revenues	<u>127,519</u>	<u>145,985</u>
MEDICAL SERVICES EXPENSES:		
Institutional care	57,416	69,222
Home- and community-based services	30,948	41,087
Acute care	18,156	21,995
Recoveries from AHCCCS	<u>(9,243)</u>	<u>(9,151)</u>
Total medical services expenses	<u>97,277</u>	<u>123,153</u>
MANAGEMENT FEES	<u>14,500</u>	<u>16,663</u>
OPERATING EXPENSES	<u>3,258</u>	<u>3,803</u>
INCOME BEFORE INCOME TAXES	12,484	2,366
FEDERAL AND STATE INCOME TAX PROVISION	<u>4,801</u>	<u>807</u>
NET INCOME	<u>\$ 7,683</u>	<u>\$ 1,559</u>

See notes to financial statements.

## EVERCARE OF ARIZONA, INC.

### STATEMENTS OF CHANGES IN SHAREHOLDER'S EQUITY AND ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009 (In thousands, except share data)

	<u>Common Stock</u>		<u>Additional</u>	<u>Retained</u>	<u>Accumulated</u>	
	<u>Shares</u>	<u>Amount</u>	<u>Paid-In</u>	<u>Earnings</u>	<u>Other</u>	<u>Total</u>
			<u>Capital</u>		<u>Income (Loss)</u>	
BALANCE — January 1, 2009	1	\$ 1	\$ 10,999	\$ 15,932	\$ (163)	\$ 26,769
Comprehensive income:						
Net income				1,559		1,559
Change in net unrealized gain on investments available-for-sale — net of tax effects and reclassification adjustments					824	824
Reclassification adjustments for net realized losses included in net income — net of tax effects					(59)	(59)
Total comprehensive income						<u>2,324</u>
BALANCE — December 31, 2009	1	1	10,999	17,491	602	29,092
Comprehensive income:						
Net income				7,683		7,683
Change in net unrealized loss on investments available-for-sale — net of tax effects and reclassification adjustments					(181)	(181)
Reclassification adjustments for net realized gains included in net income — net of tax effects					202	<u>202</u>
Total comprehensive income						<u>7,704</u>
Dividends paid				(10,000)		<u>(10,000)</u>
BALANCE — December 31, 2010	<u>1</u>	<u>\$ 1</u>	<u>\$ 10,999</u>	<u>\$ 15,174</u>	<u>\$ 623</u>	<u>\$ 26,796</u>

See notes to financial statements.

# EVERCARE OF ARIZONA, INC.

## STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009 (In thousands)

	2010	2009
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 7,683	\$ 1,559
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of investment premium — net	99	123
Loss on long-term investments	(334)	97
Deferred income taxes	212	1,515
Tax impact of unrealized gains and losses	(14)	(499)
Changes in operating assets and liabilities:		
Receivables	(1,755)	(934)
Other current assets	(9)	22
Other current liabilities	295	(141)
Federal and state income taxes	(2,410)	2,651
Medical services payable	(3,420)	(3,685)
Payable to AHCCCS	180	420
Related-party payable — net	<u>1,504</u>	<u>(1,811)</u>
Net cash provided by (used in) operating activities	<u>2,031</u>	<u>(683)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of investments available-for-sale	(8,851)	(5,131)
Proceeds from maturities/sales of investments available-for-sale	<u>8,049</u>	<u>4,558</u>
Net cash used in investing activities	<u>(802)</u>	<u>(573)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Dividends paid	(10,000)	
Outstanding checks	<u>(787)</u>	<u>(228)</u>
Net cash used in financing activities	<u>(10,787)</u>	<u>(228)</u>
NET CHANGE IN CASH AND CASH EQUIVALENTS	(9,558)	(1,484)
CASH AND CASH EQUIVALENTS — Beginning of year	<u>20,228</u>	<u>21,712</u>
CASH AND CASH EQUIVALENTS — End of year	<u>\$ 10,670</u>	<u>\$ 20,228</u>
<b>SUPPLEMENTAL CASH FLOW DISCLOSURES:</b>		
Cash paid (received) for income taxes	<u>\$ 7,013</u>	<u>\$ (2,860)</u>

See notes to financial statements.

# EVERCARE OF ARIZONA, INC.

## NOTES TO FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009 In thousands

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### 1. ORGANIZATIONAL STRUCTURE

**Organization** — Evercare of Arizona, Inc. (the “Company”) is a prepaid health plan that derives substantially all of its revenue through a contract with the Arizona Health Care Cost Containment System (AHCCCS) to provide specified long-term health care services to qualified members. The Company contracts for fixed monthly premiums, based on negotiated per-capita enrollee rates. The Company subcontracts with hospitals, physicians, and other medical providers within Arizona and surrounding states to care for AHCCCS members in various counties.

The Company is a wholly owned subsidiary of Ovations, Inc. which is a wholly owned subsidiary of UnitedHealthCare Services, Inc. (UHS), which is a wholly owned subsidiary of UnitedHealth Group Incorporated (UHG). The headquarters of the Company is located in Phoenix, Arizona.

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Basis of Presentation** — The Company has prepared the financial statements according to U.S. Generally Accepted Accounting Principles (GAAP).

**Use of Estimates** — These financial statements include certain amounts based on the Company’s estimates and judgments. These estimates require the Company to apply complex assumptions and judgments, often because the Company must make estimates about the effects of matters that are inherently uncertain and will change in subsequent periods. The most significant estimates relate to medical services expense and medical services payable. The Company adjusts these estimates as more current information becomes available, and any adjustment could have a significant impact on operating results. The impact of any changes in estimates is included in the determination of net income in the period in which the change in estimate is adjusted.

**Cash, Cash Equivalents, and Investments** — Cash and cash equivalents are highly liquid investments that have an original maturity of three months or less. The fair value of cash and cash equivalents approximates their carrying value because of the short maturity of the instruments.

The Company had checks outstanding of \$521 and \$1,308 at December 31, 2010 and 2009, respectively, which were classified as other in current liabilities in the balance sheets and have been reflected as outstanding checks within financing activities in the statements of cash flows.

Investments with maturities of less than one year are classified as short-term. All other investments are classified as available-for-sale and reported at fair value based on quoted market prices, where available.

The Company excludes unrealized gains and losses on investments in available-for-sale securities from earnings and reports them, net of income tax effects, as a separate component of shareholder’s equity. The Company evaluates investments for impairment by considering 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 the Company’s intent to sell the security or the likelihood that it will be required to sell the security before

recovery of the entire amortized cost. For debt securities, if the Company intends to either sell or determines that it will more likely than not be required to sell a security before recovery of the entire amortized cost basis or maturity of the security, the Company recognizes the entire impairment in earnings. If the Company does not intend to sell the debt security and it determines that it more likely will not be required to sell the security but it does not expect to recover the entire amortized cost basis, the impairment is bifurcated into the amount attributed to the credit loss, which is recognized in earnings, and all other causes, which are recognized in accumulated other comprehensive income. The Company manages its investment portfolio to limit its exposure to any one issuer or market sector, and largely limits its investments to U.S. government and agency obligations; state and municipal obligations; U.S. and non-U.S. agency mortgage-backed securities; and corporate obligations, substantially all of investment-grade quality. Securities downgraded below policy minimums after purchase will be disposed of in accordance with the investment policy. To calculate realized gains and losses on the sale of investments, the Company uses the specific cost or amortized cost of each investment sold.

**Minimum Net Worth** — Under the laws of the State of Arizona, AHCCCS requires the Company to maintain a minimum net worth of \$2 per member. As of December 31, 2010, the Company had \$9 of equity per member, meeting this requirement.

**Revenues** — Long-term care capitation premiums and prior period coverage (PPC) capitation premiums are both recognized as revenue in the month that the Company receives notification from AHCCCS that members are entitled to long-term health care services. Prior period capitation premiums pertain to service dates prior to notification. AHCCCS reconciles PPC capitation and refunds the Company all costs in excess of 110% of the premium. AHCCCS may also recoup from the Company any PPC profit amounts in excess of 10%.

**Medical Services Expense and Medical Services Payable** — Medical services expense and medical services payable include estimates of the Company's obligations for medical care services that have been rendered on behalf of insured consumers but for which the Company has either not yet received or processed claims, and for liabilities for physician, hospital and other medical services expense disputes. The Company develops estimates for medical services expense 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 professional contract rate changes, medical care consumption and other medical services expense trends. The Company estimates liabilities for physician, hospital and other medical services payable disputes based upon an analysis of potential outcomes, assuming a combination of litigation and settlement strategies. Each period, the Company re-examines previously established medical services payable estimates based on actual claim submissions and other changes in facts and circumstances. As the liability estimates recorded in prior periods become more exact, the Company adjusts the amount of the estimates, and includes the changes in estimates in medical services expense in the period in which the change is identified. In every reporting period, the Company's operating results include the effects of more completely developed medical services payable estimates associated with previously reported periods.

The Company contracts for nursing home services at negotiated per diem rates. Hospital services are generally contracted at per-diem rates or adjusted total charges, as defined by AHCCCS, less any applicable discounts. Home- and community-based services, physicians' services, and other medical services are contracted on a capitates or fee-for-service basis.

**Recoveries from AHCCCS** — In the normal course of business, the Company seeks to limit its exposure to loss on any single insured and to recover a portion of benefits paid through stop loss recoveries from AHCCCS, as provided by program contract. The Company received recoveries from

AHCCCS related to these retrospectively rated adjustments of \$9,243 and \$9,151 during 2010 and 2009, respectively, which are included as a reduction to medical services expenses in the accompanying statements of operations. Recoveries from AHCCCS are stated at actual and estimated amounts due to the Company pursuant to the AHCCCS contract. These recoveries are recognized as a percentage of eligible expenses in which medical costs exceed the stated deductible per member for the contract year.

**Income Taxes** — The Company's operations are included in the consolidated U.S. federal income tax return of UHG. Federal and state income taxes are paid to or refunded by UHG pursuant to the terms of a tax-sharing agreement (TSA) under which taxes approximate the amount that would have been computed on a separate company basis. Deferred income tax assets and liabilities are recognized for the differences between the financial and income tax reporting bases of assets and liabilities based on enacted tax rates and laws. The deferred income tax provision or benefit generally reflects the net change in deferred income tax assets and liabilities during the year, excluding any deferred income tax assets and liabilities of acquired businesses, net unrealized gains or losses on investments and share-based compensation cancellations. The current income tax provision reflects the tax consequences of revenues and expenses currently taxable or deductible on various income tax returns for the year reported.

**Concentration of Business and Credit Risks** — The Company's only source of revenue is its contract with AHCCCS, which provides the Company the right to offer services in Apache, Coconino, Mohave, and Navajo counties. The Company's contract with AHCCCS serving members in all contracted counties is up for renewal in September 2011.

The Company's contract in Maricopa County was not renewed after September 2006. Through an agreement with AHCCCS, the Company was allowed to retain its membership in Maricopa County, but is unable to enroll or market to new members in that county. Although the Company's operations have negative impact from the loss of the contract in Maricopa County, this decision by AHCCCS has allowed management time to develop strategies to evaluate and minimize disruptions to ongoing operations.

For the years ended December 31, 2010 and 2009, Maricopa County capitation revenue of \$72,047 and \$92,372 accounted for 57% and 64% of the total capitation revenue, respectively.

Concentration of credit risk with respect to receivables is limited due to the fact that AHCCCS, the Company's sole customer, is a governmental agency. As of December 31, 2010 and 2009, the Company had cash and cash equivalents on deposit with a major financial institution that were in excess of Federal Deposit Insurance Corporation insured limits.

**Recently Adopted Accounting Standards** — In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2010-06, *Improving Disclosures about Fair Value Measurements* (ASU 2010-06). This update amends the fair value guidance of the FASB Accounting Standards Codification (ASC) to require additional disclosures regarding (i) transfers in and out of Level 1 and Level 2 fair value measurements and (ii) activity in Level 3 fair value measurements. ASU 2010-06 also clarifies existing disclosure requirements regarding (i) the level of asset and liability disaggregation and (ii) fair value measurement inputs and valuation techniques. The new disclosures and clarifications of existing disclosures are effective for the Company's fiscal year 2010, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in Level 3 fair value measurements, which will be effective for the Company's fiscal year 2011. The Company's fair value disclosures, including the new disclosures effective in 2010, have been included in Note 10 of Notes to the financial statements.

The Company has determined that all other recently issued accounting standards will not have a material impact on its financial statements, or do not apply to its operations.

**3. OTHER AMOUNTS**

There are no material amounts included in other as a component of current assets or current liabilities not addressed in Note 2 included in the balance sheets or included as other in the statements of operations for the years ended December 31, 2010 or 2009.

**4. PLEDGES/ASSIGNMENTS AND GUARANTEES**

The Company has no pledges, assignments, collateralized assets, or guaranteed liabilities not disclosed on the balance sheet as of December 31, 2010.

**5. PERFORMANCE BOND**

Pursuant to the contracts with the State of Arizona, the Company is required to provide either a performance bond or a designated substitute security to guarantee performance of the Company's obligations under the contracts. To satisfy this requirement, the Company maintained a surety bond in 2010 and 2009 in the amount of approximately \$17,500. The bond is unsecured and requires no Company assets to secure this obligation.

**6. MATERIAL ADJUSTMENTS**

There were no material adjustments related to claims incurred but not reported, see Note 7 for further discussion.

## 7. MEDICAL SERVICES PAYABLE ANALYSIS

Changes in estimates related to prior years' incurred claims are included in medical services expenses in the current year in the accompanying statements of operations. The following tables disclose paid claims, incurred claims, and the balance in the unpaid claim reserve for the years ended December 31, 2010 and 2009:

	<b>2010</b>		
	<b>Current Year's Incurred Claims</b>	<b>Prior Years' Incurred Claims</b>	<b>Total</b>
Beginning-of-year claim reserve	\$ -	\$ (16,831)	\$ (16,831)
Paid claims	91,884	10,549	102,433
End-of-year claim reserve	<u>13,489</u>	<u>(78)</u>	<u>13,411</u>
Incurred claims before stop loss recoveries receivable	105,373	(6,360)	99,013
Beginning-of-year stop loss recoveries receivable		1,678	1,678
End-of-year stop loss recoveries receivable	<u>(3,372)</u>	<u>(42)</u>	<u>(3,414)</u>
Incurred claims	<u>\$ 102,001</u>	<u>\$ (4,724)</u>	<u>\$ 97,277</u>
	<b>2009</b>		
	<b>Current Year's Incurred Claims</b>	<b>Prior Years' Incurred Claims</b>	<b>Total</b>
Beginning-of-year claim reserve	\$ -	\$ (20,517)	\$ (20,517)
Paid claims	109,599	17,349	126,948
End-of-year claim reserve	<u>16,684</u>	<u>147</u>	<u>16,832</u>
Incurred claims before stop loss recoveries receivable	126,284	(3,021)	123,263
Beginning-of-year stop loss recoveries receivable		1,568	1,568
End-of-year stop loss recoveries receivable	<u>(1,145)</u>	<u>(534)</u>	<u>(1,678)</u>
Incurred claims	<u>\$ 125,139</u>	<u>\$ (1,987)</u>	<u>\$ 123,153</u>

The Company recognized recoveries from AHCCCS, net of allowance, of \$9,243 in 2010 and \$9,151 in 2009 that are included in the table above. These recoveries represent those claims costs the Company was reimbursed for by AHCCCS and are presented as a reduction to medical services expense in the accompanying statements of operations. For 2009, certain amounts were adjusted to conform to the 2010 presentation.

The liability for medical services payable at December 31, 2009 and 2008, exceeded the actual claims incurred in 2010 and 2009, respectively, related to prior years by approximately \$4,724 and \$1,986, respectively. For 2010, the primary drivers consist of favorable development as a result of ongoing analysis of loss development trends related to the release and establishment of \$1,500 in known environmental claims and \$2,000 for higher than expected recoveries.

## 8. CONTINGENT LIABILITIES AND GOVERNMENT REGULATIONS

**Legal Matters** — Because of the nature of its businesses, the Company is frequently made party to a variety of legal actions and regulatory inquiries related to, among other things, the design and management of its service offerings. The Company records liabilities for its estimates of probable costs resulting from these matters where appropriate. These matters include, but are not limited to, claims relating to health care benefits coverage, medical malpractice actions, contract disputes and claims related to certain business practices. Litigation and any potential regulatory proceeding or action may be time consuming, expensive and distracting from the conduct of the Company's business. The adverse resolution of any specific lawsuit or any potential regulatory proceeding or action could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company records liabilities for its estimates of probable costs resulting from these matters where appropriate. Estimates of probable costs resulting from legal and regulatory matters involving the Company are inherently difficult to predict, particularly where the matters: involve indeterminate claims for monetary damages or may involve fines, penalties or punitive damages; present novel legal theories or represent a shift in regulatory policy; involve a large number of claimants or regulatory bodies; are in the early stages of the proceedings; or could result in a change in business practices. Accordingly, except as otherwise noted below, the Company is unable to estimate the losses or range of losses for those matters where there is a reasonable possibility or it is probable that a loss may be incurred.

**Government Regulations** — The Company's business is regulated at federal, state and local levels, and the Company must obtain and maintain regulatory approvals to market and sell many of its products. The laws and rules governing the Company's business and interpretations of those laws and rules are subject to frequent change. Broad latitude is given to the agencies administering those regulations. Further, the Company must obtain and maintain regulatory approvals to market and sell many of its products. State legislatures and Congress continue to focus on health care issues.

During the first quarter of 2010, the Patient Protection and Affordable Care Act and a reconciliation measure, the Health Care and Education Reconciliation Act of 2010 (collectively known as Health Reform Legislation), were signed into law. The Health Reform Legislation expands access to coverage and modifies aspects of the commercial insurance market, as well as the Medicaid and Medicare programs, Children's Health Insurance Program and other aspects of the health care system. Certain provisions of the Health Reform Legislation have already taken effect, and other provisions become effective at various dates over the next several years. The Department of Health and Human Services, the Department of Labor and the Treasury Department have issued regulations (or proposed regulations) on a number of aspects of Health Reform Legislation, but the Company awaits final rules and interim guidance on other key aspects of the legislation. Certain aspects of the Health Reform Legislation are also being challenged in federal court, with the proponents of such challenges seeking to limit the scope of or have all or portions of the Health Reform Legislation declared unconstitutional. Congress may also withhold the funding necessary to implement the Health Reform Legislation, or may attempt to replace the legislation with amended provisions or repeal it altogether.

The Health Reform Legislation and the related federal and state regulations will impact how the Company does business and could restrict revenue and enrollment growth in certain products and market segments, restrict premium growth rates for certain products and market segments, increase the Company's medical and administrative costs, expose the Company to an increased risk of liability (including increasing our liability in federal and state courts for coverage determinations and contract interpretation) or put the Company at risk for loss of business. In addition, the Company's results of operations, financial condition, and cash flows could be materially adversely affected by such changes. The Health Reform Legislation may create new or expand existing opportunities for business growth,

but due to its complexity, the impact of the Health Reform Legislation remains difficult to predict and is not yet fully known.

## 9. INVESTMENTS

A summary of short-term and long-term investments is as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>December 31, 2010</b>				
Debt securities — available-for-sale:				
U.S. government and agency obligations	\$ 5,798	\$ 162	\$ (15)	\$ 5,945
State and municipal obligations	11,927	355	(75)	12,207
Corporate obligations	6,529	392	(1)	6,920
U.S. agency mortgage-backed securities	1,505	105		1,610
Non-U.S. agency mortgage-backed securities	<u>1,486</u>	<u>106</u>		<u>1,592</u>
Total debt securities — available-for-sale	<u>27,245</u>	<u>1,120</u>	<u>(91)</u>	<u>28,274</u>
Total investments	<u>\$ 27,245</u>	<u>\$ 1,120</u>	<u>\$ (91)</u>	<u>\$ 28,274</u>
<b>December 31, 2009</b>				
Debt securities — available-for-sale:				
U.S. government and agency obligations	\$ 2,054	\$ 2	\$ -	\$ 2,056
State and municipal obligations	12,859	538	(26)	13,371
Corporate obligations	6,691	345	(1)	7,035
U.S. agency mortgage-backed securities	2,880	157		3,037
Non-U.S. agency mortgage-backed securities	<u>1,723</u>	<u>4</u>	<u>(25)</u>	<u>1,702</u>
Total debt securities — available-for-sale	<u>26,207</u>	<u>1,046</u>	<u>(52)</u>	<u>27,201</u>
Total investments	<u>\$ 26,207</u>	<u>\$ 1,046</u>	<u>\$ (52)</u>	<u>\$ 27,201</u>

For 2009, certain classifications within available-for-sale securities were adjusted to conform to the 2010 presentation.

The amortized cost and fair value of available-for-sale debt securities as of December 31, 2010, by contractual maturity, were as follows:

	Amortized Cost	Fair Value
Due in one year or less	\$ 2,680	\$ 2,718
Due after one year through five years	10,063	10,624
Due after five years through ten years	8,544	8,791
Due after ten years	2,967	2,939
U.S. agency mortgage-backed securities	1,505	1,610
Non-U.S. agency mortgage-backed securities	<u>1,486</u>	<u>1,592</u>
Total debt securities — available-for-sale	<u>\$27,245</u>	<u>\$28,274</u>

The fair value of available-for-sale investments with gross unrealized losses by investment type and length of time that individual securities have been in a continuous unrealized loss position were as follows:

	<u>Less Than 12 Months</u>		<u>12 Months or Greater</u>		<u>Total</u>	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
<b>December 31, 2010</b>						
Debt securities — available-for-sale:						
U.S. government and agency obligations	\$ 284	\$ (16)	\$ -	\$ -	\$ 284	\$ (16)
State and municipal obligations	3,861	(75)	20		3,881	(75)
Corporate obligations	<u>353</u>	<u>(1)</u>			<u>353</u>	<u>(1)</u>
Total debt securities — available-for-sale	<u>\$4,498</u>	<u>\$ (92)</u>	<u>\$ 20</u>	<u>\$ -</u>	<u>\$4,518</u>	<u>\$ (92)</u>
<b>December 31, 2009</b>						
Debt securities — available-for-sale:						
State and municipal obligations	\$ 862	\$ (20)	\$ 100	\$ (5)	\$ 962	\$ (25)
Corporate obligations	139	(1)			139	(1)
Non-U.S. agency mortgage-backed securities	<u>952</u>	<u>(13)</u>	<u>407</u>	<u>(12)</u>	<u>1,359</u>	<u>(25)</u>
Total debt securities — available-for-sale	<u>\$1,953</u>	<u>\$ (34)</u>	<u>\$507</u>	<u>\$ (17)</u>	<u>\$2,460</u>	<u>\$ (51)</u>

The unrealized losses from all securities as of December 31, 2010, were generated from approximately 22 positions out of a total of approximately 126 positions. The Company believes that it will collect all principal and interest due on its investments that have an amortized cost in excess of fair value. The unrealized losses on investments in state and municipal obligations, and corporate obligations as of December 31, 2010, were primarily caused by interest rate increases and not by unfavorable changes in the credit ratings 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 amortized cost. The Company evaluated the underlying credit quality of the issuers and the credit ratings of the state and municipal obligations and the corporate obligations, noting neither a significant deterioration since purchase nor other factors leading to an other-than-temporary impairment (OTTI). As of December 31, 2010, the Company did not have the intent to sell any of the securities in an unrealized loss position.

Net realized gains (losses), before taxes, were from the following sources:

	<u>Year Ended December 31,</u>	
	<u>2010</u>	<u>2009</u>
Total OTTI	\$ -	\$ (104)
Portion of loss recognized in other comprehensive income	<u>          </u>	<u>          </u>
Net OTTI recognized in earnings	-	(104)
Gross realized losses from sales		
Gross realized gains from sales	<u>334</u>	<u>7</u>
Net realized gains (losses)	<u>\$ 334</u>	<u>\$ (97)</u>

For the year ended December 31, 2009, all of the recorded OTTI charges resulted from the Company's intent to sell certain impaired securities.

#### 10. FAIR VALUE

Fair values of available-for-sale debt are based on quoted market prices, where available. The Company obtains one price for each security primarily from a third-party pricing service ("pricing service"), which generally uses quoted or other observable inputs for the determination of fair value. The pricing service normally derives the security prices through recently reported trades for identical or similar securities, making adjustments through the reporting date based upon available observable market information. For securities not actively traded, the pricing service may use quoted market prices of comparable instruments or discounted cash flow analyses, incorporating inputs that are currently observable in the markets for similar securities. Inputs that are often used in the valuation methodologies include, but are not limited to, non-binding broker quotes, benchmark yields, credit spreads, default rates, and prepayment speeds. As the Company is responsible for the determination of fair value, it performs quarterly analyses on the prices received from the pricing service to determine whether the prices are reasonable estimates of fair value. Specifically, the Company compares the prices received from the pricing service to prices reported by its custodian, its investment consultant and third-party investment advisors. Additionally, the Company compares changes in the reported market values and returns to relevant market indices to test the reasonableness of the reported prices. Based on the Company's internal price verification procedures and review of fair value methodology documentation provided by independent pricing services, the Company has not historically adjusted the prices obtained from the pricing service.

In instances in which the inputs used to measure fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset.

The fair value hierarchy is as follows:

*Level 1* — Quoted (unadjusted) prices for identical assets in active markets.

Level 2 — Other observable inputs, either directly or indirectly, including:

- Quoted prices for similar assets in active markets;
- Quoted prices for identical or similar assets in non-active markets (e.g., few transactions, limited information, non-current prices, high variability over time, etc.);
- Inputs other than quoted prices that are observable for the asset/liability (e.g., interest rates, yield curves, volatilities, default rates); and
- Inputs that are derived principally from or corroborated by other observable market data.

Level 3 — Unobservable inputs that cannot be corroborated by observable market data.

The following table presents information about the Company's financial assets which are measured at fair value on a recurring basis, according to the valuation techniques the Company used to determine their fair values.

	Quoted Prices In Active Markets (Level 1)	Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total Fair Value
<b>December 31, 2010</b>				
Cash and cash equivalents	\$ 10,670	\$ -	\$ -	\$ 10,670
Debt securities — available-for-sale:				
U.S. government and agency obligations	5,390	555		5,945
State and municipal obligations		12,207		12,207
Corporate obligations		6,920		6,920
U.S. agency mortgage-backed securities		1,610		1,610
Non-U.S. agency mortgage-backed securities		1,592		1,592
Total debt securities — available-for-sale	<u>5,390</u>	<u>22,884</u>	<u>-</u>	<u>28,274</u>
Total cash, cash equivalents and investments at fair value	<u>\$ 16,060</u>	<u>\$ 22,884</u>	<u>\$ -</u>	<u>\$ 38,944</u>
Percentage of total financial assets at fair value	<u>41 %</u>	<u>59 %</u>	<u>- %</u>	<u>100 %</u>
<b>December 31, 2009</b>				
Cash and cash equivalents	\$ 20,228	\$ -	\$ -	\$ 20,228
Debt securities — available-for-sale:				
U.S. government and agency obligations	1,501	555		2,056
State and municipal obligations		13,371		13,371
Corporate obligations		7,035		7,035
U.S. agency mortgage-backed securities		3,037		3,037
Non-U.S. agency mortgage-backed securities		1,702		1,702
Total debt securities — available-for-sale	<u>1,501</u>	<u>25,700</u>	<u>-</u>	<u>27,201</u>
Total cash, cash equivalents and investments at fair value	<u>\$ 21,729</u>	<u>\$ 25,700</u>	<u>\$ -</u>	<u>\$ 47,429</u>
Percentage of total financial assets at fair value	<u>46 %</u>	<u>54 %</u>	<u>- %</u>	<u>100 %</u>

There were no transfers between Levels 1 and 2 during the year ended December 31, 2010.

The following methods and assumptions were used to estimate the fair value of each class of financial instrument:

**Cash and Cash Equivalents** — The carrying value of cash and cash equivalents approximates fair value as maturities are less than three months. Fair values of cash equivalent instruments that do not trade on a regular basis in active markets are classified as Level 2.

**Debt Securities** — The estimated fair values of debt securities held as available-for-sale are based on quoted market prices and/or other market data for the same or comparable instruments and transactions in establishing the prices. Fair values of debt securities that do not trade on a regular basis in active markets are classified as Level 2.

There were no fair value adjustments recorded during the years ended December 31, 2010 and 2009 for non-financial assets and liabilities or financial assets and liabilities that are measured at fair value on a nonrecurring basis. These assets and liabilities are subject to fair value adjustments only in certain circumstances, such as when the Company records impairments.

The table below includes fair values for certain financial instruments for which it is practicable to estimate fair value. The carrying values and fair values of these financial instruments were as follows:

	December 31, 2010		December 31, 2009	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets:				
Debt securities — available-for-sale	<u>\$28,274</u>	<u>\$28,274</u>	<u>\$27,201</u>	<u>\$27,201</u>

The carrying amounts reported in the balance sheets for cash and cash equivalents, accounts and other current receivables, unearned revenues and accounts payable and accrued liabilities approximate fair value because of their short-term nature. These assets and liabilities are not listed in the table above.

## 11. RELATED-PARTY TRANSACTIONS

Balances with related parties as of and for the years ended December 31, 2010 and 2009, are as follows:

The Company has a management agreement with UHS to perform substantially all of the administration of the Company. UHS is responsible for all equipment, furniture, and computer hardware and software expenses associated with the administration of the Company. The Company is responsible for its own audit fees; fees for consultants (marketing) not authorized by UHS in connection with its management of the Company; premiums for insurance coverage for professional liability, life, and directors and officers; board of directors fees; and any other expenses such as banking or investment fees that are clearly related to the business of the Company as an independent corporate entity. Operations of the Company may not be indicative of those that would have occurred if it had operated as an independent company. Fees paid to UHS are based on a percentage of capitation revenue. Management fees under this arrangement totaled approximately \$14,500 and \$16,663 in 2010 and 2009, respectively.

The Company has entered into a TSA with UHG (see Note 18).

The Company entered into an agreement with Dental Benefit Providers, Inc. (DBP) effective February 28, 2008. DBP provides dental care assistance. The Company expensed in medical services expenses \$43 and \$50 in capitation fees to DBP.

The Company entered into an agreement, effective January 1, 2009, with RxSolutions to provide administrative services related to pharmacy management and pharmacy claims processing for its enrollees. Fees related to these agreements, which are calculated on a per-claim basis, of approximately \$64 and \$31 in 2010 and 2009, respectively, are included in operating expenses in the accompanying statements of operations. Additionally, RxSolutions collects rebates on certain pharmaceutical products based on member utilization. Rebates related to these agreements of approximately \$172 and \$213 in 2010 and 2009, respectively, are included as a reduction of medical services expense in the accompanying statements of operations. Rebate receivables of approximately \$66 and \$63 as of December 31, 2010 and 2009, respectively, are included as an offset to related-party payable — net on the balance sheets.

## **12. STOCKHOLDER'S EQUITY**

As a result of the change in net unrealized gains and losses on investments available-for-sale, the Company had accumulated other comprehensive income of \$21 and \$765 for the years ended December 31, 2010 and 2009, respectively.

The Company paid a dividend of \$10,000 on December 28, 2010 to Ovations which was approved by AHCCCS and recorded as a reduction to retained earnings. There was no dividend distribution or capital contributions for the year ended December 31, 2009.

## **13. COMPLIANCE WITH FINANCIAL VIABILITY STANDARDS AND PERFORMANCE GUIDELINES**

As of December 31, 2010, the Company was in compliance with the Financial Viability Standards and Performance Guidelines.

## **14. PRIOR PERIOD ADJUSTMENTS**

As of and for the year ended December 31, 2010 and 2009, there were no adjustments made to previously submitted or the current financial statements except for: Federal and state income taxes, outstanding checks, and net interest and other investment income were reclassified for the 2009 financial statements (see Note 21).

## **15. DRUG REBATES/DISCOUNTS**

The Company received \$172 and \$213 in pharmacy rebates for AHCCCS in 2010 and 2009, respectively. The pharmacy rebates are included in medical services expense in the statements of operations.

## **16. NON-COVERED SERVICES**

The Company does not have any non-covered services.

## 17. RECEIVABLES

Receivables from third parties at December 31, 2010 and 2009, consist of the following:

	2010	2009
AHCCCS receivables:		
Capitation	\$ 1,381	\$ 1,370
Stop loss recoveries receivable — net of allowance of \$0 and \$368 at December 31, 2010 and 2009, respectively	<u>3,414</u>	<u>1,678</u>
Total AHCCCS receivables	4,795	3,048
Due from providers		5
Interest	<u>278</u>	<u>265</u>
Total	<u>\$ 5,073</u>	<u>\$ 3,318</u>

## 18. INCOME TAXES

The components of the provision for income taxes for the years ended December 31, 2010 and 2009, are as follows:

	2010	2009
Current portion:		
Federal	\$ 3,775	\$ (220)
State	<u>828</u>	<u>11</u>
Total current portion	<u>4,603</u>	<u>(209)</u>
Deferred portion:		
Federal	163	861
State	<u>35</u>	<u>155</u>
Total deferred portion	<u>198</u>	<u>1,016</u>
Total income tax provision	<u>\$ 4,801</u>	<u>\$ 807</u>

The reconciliation of the tax provision at the U.S. federal statutory rate of 35% to the provision for income taxes for the years ended December 31, 2010 and 2009, is as follows:

	2010	2009
Tax provision at the U.S. federal statutory rate	\$ 4,370	\$ 828
State income taxes, net of federal benefit	561	108
Tax-exempt investment income	(130)	(145)
Other, net	<u>16</u>	<u>16</u>
Total income tax provision	<u>\$ 4,801</u>	<u>\$ 807</u>

As of December 31, 2010 and 2009, the components of deferred income tax assets and liabilities are as follows:

	2010	2009
Deferred income tax assets:		
Bad debt reserve	\$ -	\$ 146
Investments	20	42
Medical services payable and loss adjustment expense	<u>100</u>	<u>133</u>
Total deferred tax assets	<u>120</u>	<u>321</u>
Deferred income tax liabilities:		
Investments	(16)	(19)
Unrealized gain/loss	<u>(407)</u>	<u>(392)</u>
Total deferred tax liabilities	<u>(423)</u>	<u>(411)</u>
Net deferred income tax liabilities	<u>\$ (303)</u>	<u>\$ (90)</u>

Valuation allowances are provided when it is considered more likely than not that deferred tax assets will not be realized. The Company had no valuation allowances as of December 31, 2010 or 2009.

The Company's operations are included in the consolidated federal income tax return of UHG. Federal income taxes are paid to or refunded by UHG pursuant to the terms of the TSA, approved by the Board of Directors, under which taxes approximate the amount that would have been computed on a separate company basis. Income taxes incurred in the current and prior years will be available for recoupment by the Company only in the event of future net losses of consolidated UHG. The Company receives a benefit at the federal rate in the current year for net losses incurred in that year to the extent losses can be utilized in the consolidated federal income tax return of UHG. UHG currently files income tax returns in the United States federal jurisdiction, various states, and foreign jurisdictions. The U.S. Internal Revenue Service (IRS) has completed exams on UHG's consolidated income tax returns for fiscal years 2009 and prior. UHG's 2010 tax return is under advance review by the IRS under its Compliance Assurance Program. With the exception of a few states, UHG is no longer subject to income tax examinations prior to 2004 in major state and foreign jurisdictions. The Company does not believe any adjustments that may result from these examinations will be material to the Company.

The Company has not included a reconciliation of the beginning and ending amount of unrecognized tax benefits, as it does not have any uncertain tax positions as of December 31, 2010.

Federal income taxes receivable of \$323 and federal income taxes payable of \$2,111 as of December 31, 2010 and 2009, respectively, are included in the current federal income taxes receivable and current federal income taxes payable accounts, respectively. State income taxes receivable of \$0 and \$24 as of December 31, 2010 and 2009, respectively, are included in the current state income taxes receivable account.

Federal and state income taxes paid net of refunds in 2010 was \$7,013 and federal and state income taxes received, net of refunds, in 2009 was \$2,860.

**19. RETIREMENT PLANS, DEFERRED COMPENSATION, POSTEMPLOYMENT BENEFITS AND COMPENSATED ABSENCES, AND OTHER POSTRETIREMENT BENEFIT PLANS**

The Company has no retirement plan, deferred compensation, and other benefit plans, since all personnel are employees of UHS, which provides services to the Company under the terms of a management agreement (see Note 11).

**20. SUBSEQUENT EVENTS**

The Company has evaluated subsequent events through March 31, 2011, which is the date these financial statements were available for issuance.

**21. RECLASSIFICATION OF FINANCIAL STATEMENTS**

Certain 2009 amounts in the accompanying financial statements have been reclassified to conform to the 2010 presentation. Specifically, the 2009 current federal and state income tax balances are now reported as separate line items in the accompanying financial statements as opposed to being included as a component of intercompany receivable. In addition, outstanding checks are now being reported in other liabilities. Also, net interest and other investment income is now being reported in revenue. These reclassifications had no effect on net income or total retained earnings as previously reported.

**BALANCE SHEET**  
**AS OF DECEMBER 31, 2009**  
(In thousands, except share data)

	2009 As Previously Reported	Reclassifications	2009 As Reclassified
<b>ASSETS</b>			
<b>CURRENT ASSETS:</b>			
Cash and cash equivalents	\$ 20,228	\$ -	\$ 20,228
Short-term investments	1,590		1,590
Receivables — net of allowance of \$368	3,318		3,318
Deferred income taxes	294		294
Current state income taxes receivable		24	24
Other			
Total current assets	25,430	24	25,454
<b>LONG-TERM INVESTMENTS</b>	25,611		25,611
<b>TOTAL</b>	\$ 51,041	\$ 24	\$ 51,065
<b>LIABILITIES AND STOCKHOLDER'S EQUITY</b>			
<b>CURRENT LIABILITIES:</b>			
Medical services payable	\$ 18,139	\$ (1,308)	\$ 16,831
Payable to AHCCCs	902		902
Related-party payable — net	2,184	(2,087)	97
Current federal income taxes payable		2,111	2,111
Other	340	1,308	1,648
Total current liabilities	21,565	24	21,589
Long-term investments	384		384
Total liabilities	21,949	24	21,973
<b>CONTINGENCIES (Note 8)</b>			
<b>STOCKHOLDER'S EQUITY:</b>			
Common stock, \$1 par value — authorized, 2,000,000 shares; 1 share issued and outstanding			
Additional paid-in capital	10,999		10,999
Retained earnings	17,491		17,491
Accumulated other comprehensive income (loss)	602		602
Total stockholder's equity	29,092	-	29,092
<b>TOTAL</b>	\$ 51,041	\$ 24	\$ 51,065

**STATEMENT OF OPERATIONS**  
**FOR THE YEAR ENDED DECEMBER 31, 2009**  
(In thousands)

	2009 As Previously Reported	Reclassifications	2009 As Reclassified
CAPITATION REVENUE	\$ 144,898	\$ -	\$ 144,898
NET INTEREST AND OTHER INVESTMENT INCOME	<u>                    </u>	<u>1,087</u>	<u>1,087</u>
Total revenues	<u>144,898</u>	<u>1,087</u>	<u>145,985</u>
MEDICAL SERVICES EXPENSES:			
Institutional care	69,222		69,222
Home- and community-based services	41,087		41,087
Acute care	21,995		21,995
Recoveries from AHCCCS	<u>(9,151)</u>	<u>                    </u>	<u>(9,151)</u>
Total medical services expenses	<u>123,153</u>	<u>-</u>	<u>123,153</u>
INCOME BEFORE MANAGEMENT FEES AND OPERATING EXPENSES	21,745	1,087	22,832
MANAGEMENT FEES	16,663		16,663
OPERATING EXPENSES	<u>3,803</u>	<u>                    </u>	<u>3,803</u>
INCOME (LOSS) BEFORE NET INTEREST INCOME	1,279	1,087	2,366
NET INTEREST INCOME	<u>1,087</u>	<u>(1,087)</u>	<u>                    </u>
INCOME (LOSS) BEFORE INCOME TAXES	2,366	-	2,366
FEDERAL AND STATE INCOME TAX PROVISION	<u>807</u>	<u>                    </u>	<u>807</u>
NET INCOME	<u>\$ 1,559</u>	<u>\$ -</u>	<u>\$ 1,559</u>

**STATEMENT OF CASH FLOWS**  
**FOR THE YEAR ENDED DECEMBER 31, 2009**  
(In thousands)

	2009 As Previously Reported	Reclassifications	2009 As Reclassified
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$ 1,559	\$ -	\$ 1,559
Adjustments to reconcile net income to net cash used in operating activities:			
Amortization of investment premium — net	123		123
Loss on long-term investments	97		97
Deferred income taxes	1,515		1,515
Tax impact of unrealized gains and losses	(499)		(499)
Change in operating assets and liabilities:			
Receivables	(934)		(934)
Other current assets	22		22
Other current liabilities	(141)		(141)
Federal and state income taxes		2,651	2,651
Medical services payable	(3,913)	228	(3,685)
Payable to AHCCCS	420		420
Related party payables — net	<u>840</u>	<u>(2,651)</u>	<u>(1,811)</u>
Net cash provided by (used in) operating activities	<u>(911)</u>	<u>228</u>	<u>(683)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchases of investments available-for-sale	(5,131)		(5,131)
Proceeds from maturities/sales of investments available-for-sale	<u>4,558</u>		<u>4,558</u>
Net cash used in investing activities	<u>(573)</u>	<u>-</u>	<u>(573)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Outstanding checks		(228)	(228)
Net cash used in financing activities	<u>-</u>	<u>(228)</u>	<u>(228)</u>
<b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>	(1,484)	-	(1,484)
<b>CASH AND CASH EQUIVALENTS — Beginning of year</b>	<u>21,712</u>		<u>21,712</u>
<b>CASH AND CASH EQUIVALENTS — End of year</b>	<u>\$ 20,228</u>	<u>\$ -</u>	<u>\$ 20,228</u>
<b>SUPPLEMENTAL CASH FLOW DISCLOSURES:</b>			
Cash paid (received) for income taxes	<u>\$ (2,860)</u>	<u>\$ -</u>	<u>\$ (2,860)</u>

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