

SCAN Long Term Care

Financial Statements as of and for the Years
Ended December 31, 2008 and 2007, and
Independent Auditors' Report

SCAN LONG TERM CARE

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
SCAN Long Term Care:

We have audited the accompanying statements of financial position of SCAN Long Term Care (the "Company") as of December 31, 2008 and 2007, and the related statements of activities and changes in net assets and of 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. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2008 and 2007, and the results of its operations, changes in net assets, and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

April 20, 2009

SCAN LONG TERM CARE

STATEMENTS OF FINANCIAL POSITION AS OF DECEMBER 31, 2008 AND 2007

	2008	2007
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$25,108,326	\$ 16,373,680
Premiums and other receivables — net	2,485,353	873,997
Prepaid expenses and other current assets	<u> </u>	<u>84,403</u>
Total current assets	27,593,679	17,332,080
PROPERTY AND EQUIPMENT — Net	<u>179,288</u>	<u>418,334</u>
TOTAL	<u>\$27,772,967</u>	<u>\$17,750,414</u>
 LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	\$ 108,768	\$ 136,980
Accrued payroll and related benefits	409,899	442,623
Medical claims payable	12,793,222	9,029,576
Due to parent and affiliates	1,466,622	
Other current liabilities	<u>1,129,166</u>	<u> </u>
Total liabilities	15,907,677	9,609,179
COMMITMENTS AND CONTINGENCIES (Note 7)		
NET ASSETS	<u>11,865,290</u>	<u>8,141,235</u>
TOTAL	<u>\$27,772,967</u>	<u>\$17,750,414</u>

See notes to financial statements.

SCAN LONG TERM CARE

STATEMENTS OF ACTIVITIES AND CHANGES IN NET ASSETS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

	2008	2007
NET REVENUES:		
Premiums and reinsurance recoveries	\$87,188,335	\$43,010,001
Supplemental premiums	62,346	3,242,139
Interest income	<u>365,422</u>	<u>611,229</u>
Total net revenues	<u>87,616,103</u>	<u>46,863,369</u>
OPERATING EXPENSES:		
Hospital, physicians, and other services	72,866,544	36,913,451
Medical administration expenses	3,080,899	1,660,794
Marketing, general, and administrative expenses	7,705,559	7,029,593
Depreciation and amortization	<u>239,046</u>	<u>239,048</u>
Total operating expenses	<u>83,892,048</u>	<u>45,842,886</u>
INCREASE IN NET ASSETS	3,724,055	1,020,483
NET ASSETS — Beginning of year	<u>8,141,235</u>	<u>7,120,752</u>
NET ASSETS — End of year	<u>\$ 11,865,290</u>	<u>\$ 8,141,235</u>

See notes to financial statements.

SCAN LONG TERM CARE

STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Increase in net assets	\$ 3,724,055	\$ 1,020,483
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	239,046	239,048
Loss on disposal of property and equipment		366,969
Changes in operating assets and liabilities:		
Premiums and other receivables — net	(1,611,356)	(788,496)
Prepaid expenses and other current assets	84,403	(84,403)
Accounts payable and accrued expenses	(28,212)	(797,166)
Accrued payroll and related benefits	(32,724)	353,619
Medical claims payable	3,763,646	6,930,255
Due to parent and affiliates	1,466,622	
Other current liabilities	1,129,166	
	<u>8,734,646</u>	<u>7,240,309</u>
Net cash provided by operating activities		
	<u>8,734,646</u>	<u>7,240,309</u>
INCREASE IN CASH AND CASH EQUIVALENTS		
	8,734,646	7,240,309
CASH AND CASH EQUIVALENTS — Beginning of year	<u>16,373,680</u>	<u>9,133,371</u>
CASH AND CASH EQUIVALENTS — End of year	<u>\$25,108,326</u>	<u>\$ 16,373,680</u>

See notes to financial statements.

SCAN LONG TERM CARE

NOTES TO FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

1. ORGANIZATION

SCAN Long Term Care (the “Company”) is an Arizona nonprofit corporation that filed, in March 2007, for recognition by the Internal Revenue Service (“IRS”) as exempt from federal income taxes in accordance with Internal Revenue Code (“IRC”) Section 501(c)(4), and was approved April 24, 2008. SCAN Health Plan Arizona is the sole corporate member of the Company; the Company is located in Phoenix, AZ. SCAN Group has been the sole corporate member of SCAN Health Plan Arizona since SCAN Health Plan Arizona’s conversion to a Arizona nonprofit corporation on April 6, 2006. SCAN Health Plan Arizona is licensed with the Arizona Department of Insurance and commenced operations in January 2007. SCAN Health Plan Arizona’s application to the IRS for recognition as a tax-exempt organization described in IRC Section 501(c)(4) was also approved April 24, 2008.

Pursuant to the Amended and Restated Articles of Incorporation of SCAN Health Plan, filed with the California Secretary of State on September 4, 2007, and the Amended and Restated Articles of Incorporation of SCAN Group (formally known as Senior Care Action Network Foundation), filed on August 24, 2007, SCAN Group became the sole corporate member of SCAN Health Plan. Prior to such filings, SCAN Health Plan was the sole corporate member of SCAN Group.

On May 1, 2006, the Arizona Health Care Cost Containment System Administration (“AHCCCSA”) entered into a contractual agreement with the Company to participate in the Arizona Long Term Care System (“ALTCS”) program. ALTCS is the state of Arizona Medicaid program that administers acute care, long-term care, behavioral health, and case management services to frail seniors and the physically disabled. The enrollment of participants in the Company’s managed care plan initially began on October 1, 2006; the contract was renewed for the new contract year which began October 1, 2008, and is limited to residents of Maricopa County in the state of Arizona.

2. REGULATORY REQUIREMENTS AND OPERATIONS

The Company is subject to regulatory oversight by AHCCCSA and is required to periodically file financial statements with AHCCCSA in accordance with various statutory accounting and reporting practices. At December 31, 2008, the Company’s minimum capitalization requirement is \$4,500,000 as compared to actual capitalization of \$11,865,290.

In addition to the minimum capitalization requirements, the Company is required to establish and maintain a performance bond of standard commercial scope issued by a surety company doing business in the state of Arizona, an irrevocable letter of credit, or a cash deposit to AHCCCSA for as long as the Company has AHCCCSA-related liabilities of \$50,000 or more outstanding, or 15 months following the termination date of the contract with AHCCCSA, whichever is later, to guarantee (1) payment of the Company’s obligations to providers and (2) performance by the Company of its obligations under the contract. As of December 31, 2008 and 2007, SCAN Group maintained a letter of credit with U.S. Bank in the amount of \$5,220,761 and \$2,747,294, respectively, on behalf of the Company. No amounts were withdrawn on the letter of credit in 2008 and 2007.

As of December 31, 2008 and 2007, the Company is in compliance with the financial viability standards and performance guidelines as required by the AHCCCSA contract except for the requirement regarding total administrative cost percentage. For the contract years ended September 30, 2008 and 2007, the administrative cost percentage was 8% and 22%, respectively, as compared to the performance guideline of not more than 8%. The 22% administrative cost ratio for the contract year ended September 30, 2007, was primarily due to additional start-up costs and lower membership. The Company received \$3,304,485 of administrative reimbursements from AHCCCSA for contract year 2007 based on membership level. The Company does not expect administrative reimbursement from AHCCCSA for contract year 2008 since the Company's membership has exceeded the requirement to qualify for AHCCCSA administrative reimbursement.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation — The accompanying financial statements include the accounts of the Company and have been prepared in accordance with accounting principles generally accepted in the United States of America (“generally accepted accounting principles”), including Financial Accounting Standards Board (“FASB”) Statement No. 117, *Financial Statements of Not-for-Profit Organizations*. FASB Statement No. 117 establishes standardized external financial reporting by not-for-profit organizations.

Generally accepted accounting principles require not-for-profit organizations to report information regarding their financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets, based on the existence or absence of donor-imposed restrictions. As of December 31, 2008 and 2007, the Company had no temporarily or permanently restricted net assets or contributions.

Use of Estimates — Management uses estimates and assumptions in preparing the financial statements in accordance with generally accepted accounting principles. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported revenues and expenses. Actual results could vary from the estimates that were assumed in preparing the accompanying financial statements.

Cash and Cash Equivalents — Cash and cash equivalents primarily include highly liquid debt instruments purchased with a maturity of three months or less, as well as cash on hand and on-demand bank deposits.

Premiums and Other Receivables — Premium receivables include the capitation and reinsurance receivable due from AHCCCSA. Other receivables include amounts due from members, claims receivable or due from providers, and pharmacy rebates receivable. The Company establishes an allowance for those accounts that are estimated to have credit risk. Management does not believe that there are significant credit risks associated with the outstanding receivable from AHCCCSA. See Note 7 for the associated concentration risk with AHCCCSA.

Property and Equipment — Costs associated with the development of internal-use software especially for the ALTCS program are capitalized in accordance with Statement of Position No. 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Amortization is provided on the straight-line method over three years.

Impairment of Long-Lived Assets — Management reviews long-lived assets to be held and used in the Company's operations for impairment at least annually, or more frequently if circumstances indicate that the carrying amount of an asset may not be recoverable. Long-lived assets are deemed to be impaired if estimated undiscounted future cash flows are less than the carrying amount of the assets. Estimates of

expected future cash flows are based on management's best estimates of anticipated operating results over the remaining useful lives of the assets. The Company measures the impairment as the amount by which the carrying amount of the asset exceeds the fair value of the asset. Management does not believe any impairment of its long-lived assets existed at December 31, 2008 and 2007.

Revenue Recognition — Under the contracts with AHCCCSA, revenue is recognized based on the number of eligible members per month multiplied by the contracted monthly rate. Revenue is recorded in the month in which eligible members are entitled to health care services.

The Company is also paid monthly for all prior period coverage ("PPC") member months, including partial member months by AHCCCSA. PPC revenue is recorded as premiums revenue in the statements of activities and changes in net assets in the month in which eligible members are entitled to health care services.

In the monthly capitation payments from AHCCCS, there is an assumed deduction for the share of cost ("SOC") which members contribute to the cost of care. After the end of the contract year, AHCCCS compares actual SOC assignment to the assumed SOC in the calculation of the capitation rate, and the difference, if any, will be a receivable or a payable to AHCCCS. The Company fully reconciles assumed SOC to actual SOC assignment on a quarterly basis, and estimates its liability to be \$1,129,166 and \$0 as of December 31, 2008 and 2007, respectively, which is included in other current liabilities in the statements of financial position.

Certain estimates are required to record revenues and accounts receivable at net realizable value due to the nature of the membership contracts, specifically eligibility changes in the membership base. These estimates are based on actual historical adjustments to monthly capitation premiums. Inherent in these estimates is the risk that they will have to be adjusted as additional information becomes available. Such adjustments are typically identified and recorded at the point of cash application or account review.

Reinsurance — Reinsurance is a stop-loss program provided by AHCCCSA for the partial reimbursement of covered medical services incurred for a member beyond an annual deductible; the deductible is the responsibility of the Company. Reinsurance recoveries of \$2,683,689 and \$1,151,055 for the years ended December 31, 2008 and 2007, respectively, are included in premiums and reinsurance recoveries in the statements of activities and changes in net assets.

Supplemental Premiums — In accordance with the AHCCCSA contract, the Company received \$3,304,485 of administrative reimbursements from AHCCCSA for the contract year 2007 based on membership level. In 2008 and 2007, \$62,346 and \$3,242,139 was received, respectively, and recorded as supplemental premiums in the financial statements.

Hospital, Physicians, and Other Services — Health care costs are recorded in the period when members are entitled to services. Most physician and hospital services are provided under fee for service contracts. The accrued hospital costs for the fee for service contracts are recorded monthly based upon historical experience and expected trends in claim frequency and severity using accepted actuarial methods. These accruals represent claims reported, as well as estimates for claims incurred but not reported, and are included in medical claims payable in the statements of financial position. While the ultimate amount of claims and expenses is dependent on future developments, management believes the liability for medical claims payable and the medical expenses included in the financial statements are reasonable estimates.

Medical Administration Expenses — Medical administration expenses include salaries, benefits, travel, and training expenses for the case managers and case management supervisors.

Marketing, General, and Administrative Expenses — Administrative expenses include salaries, benefits, premium tax, marketing, other general administrative expenses, and allocations from SCAN Health Plan and SCAN Health Plan Arizona.

Income Taxes — The Company is an Arizona nonprofit corporation that filed for recognition by the IRS as exempt from federal income taxes in accordance with IRC Section 501(c)(4), and was approved in April 2008. Management believes the Company is in compliance with the provisions of IRC Section 501(c)(4) and is exempt from federal tax under IRC Section 501(a).

Fair Value of Financial Instruments — The carrying amounts of cash and cash equivalents; premiums and other receivables; and accounts payable and accrued expenses, and medical claims payable at December 31, 2008 and 2007, approximate fair value because of the relatively short period of time between origination of the instruments and their expected liquidation.

Recent Accounting Pronouncements — In 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*. FASB Statement No. 157 provides guidance for using fair value to measure assets and liabilities. The standard expands required disclosures about the extent to which entities measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. FASB Statement No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. FASB Statement No. 157 does not expand the use of fair value in any new circumstances. FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. Subsequently, in February 2008, the FASB issued two staff positions on FASB Statement No. 157 (FASB Staff Position (“FSP”) FAS 157-1 and 157-2), one of which excludes the lease classification measurements under FASB Statement No. 13, *Accounting for Leases*, from FASB Statement No. 157 and the other of which delays the effective date of FASB Statement No. 157 for all nonrecurring fair value measurements of nonfinancial assets and nonfinancial liabilities until fiscal years beginning after November 15, 2008. The Company has adopted FASB Statement No. 157 as of January 1, 2008. The adoption of FASB Statement No. 157 did not have a material impact on its financial position or results of operations.

In February 2007, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities — including an amendment of FASB Statement No. 115*. This standard permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This standard is expected to expand the use of fair value measurement, which is consistent with the FASB’s long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 is effective as of the beginning of an entity’s first fiscal year that begins after November 15, 2007. Requirements of FASB Statement No. 159 are adopted concurrently with the adoption of FASB Statement No. 157. The Company has adopted FASB Statement No. 159 as of January 1, 2008. The adoption of FASB Statement No. 159 did not have a material impact on its financial position or results of operations.

In June 2006, the FASB issued FASB Interpretation (“FIN”) No. 48, *Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109*. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized under FASB Statement No. 109, *Accounting for Income Taxes*. FIN No. 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on various related matters, such as derecognition, interest and penalties, and disclosure. The FASB issued FSP FIN 48-3, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, to defer FIN No. 48 for all nonpublic entities until fiscal years beginning after

December 15, 2008. The Company is currently evaluating the effect that adoption of this interpretation will have on its financial position and results of operations.

4. PREMIUMS AND OTHER RECEIVABLES — NET

Receivables as of December 31, 2008 and 2007, consist of the following:

	2008	2007
Premiums receivable from AHCCCSA	\$ 27,342	\$ 14,022
Reinsurance receivable from AHCCCSA	2,411,156	828,397
Supplemental premium receivable	<u>36,623</u>	<u>3,831</u>
	2,475,121	846,250
Less allowance for doubtful accounts	<u>(16,488)</u>	<u>(383)</u>
Premiums receivable — net	<u>2,458,633</u>	<u>845,867</u>
Pharmacy rebates	18,000	7,674
Overpayment to providers and other	<u>8,720</u>	<u>20,456</u>
Other receivables — net	<u>26,720</u>	<u>28,130</u>
Total	<u>\$2,485,353</u>	<u>\$ 873,997</u>

5. PROPERTY AND EQUIPMENT

Property and equipment as of December 31, 2008 and 2007, consist of the following:

	2008	2007
Computer software	\$ 717,141	\$ 717,141
Less accumulated depreciation	<u>(537,853)</u>	<u>(298,807)</u>
Total	<u>\$ 179,288</u>	<u>\$ 418,334</u>

6. MEDICAL CLAIMS PAYABLE

Activity in medical claims payable as of December 31, 2008 and 2007, is as follows:

	2008	2007
Beginning balance	\$ 9,029,576	\$ 2,099,322
Incurred related to:		
Current period	74,351,033	37,630,328
Prior periods	<u>(547,411)</u>	<u>(649,221)</u>
	<u>73,803,622</u>	<u>36,981,107</u>
Paid related to:		
Current period	(61,691,562)	(28,611,734)
Prior periods	<u>(8,348,414)</u>	<u>(1,439,119)</u>
	<u>(70,039,976)</u>	<u>(30,050,853)</u>
Total	<u>\$ 12,793,222</u>	<u>\$ 9,029,576</u>

As a result of payments made in the current year related to prior years' estimated claims, the provision for medical claims payable and claim adjustment expense decreased by \$547,411 and \$649,221 for the years ended December 31, 2008 and 2007, respectively, due to a lower-than-anticipated settlement of claims.

Liabilities for unpaid claims and claim expenses are estimates of payments to be made under health coverage for reported but unpaid claims and for incurred but not yet reported claims. Management develops these estimates using actuarial methods based upon historical data for payment patterns, cost trends, product mix, seasonality, utilization of health care services, and other relevant factors.

7. COMMITMENTS AND CONTINGENCIES

Credit Concentration — The majority of operating revenues for the years ended December 31, 2008 and 2007, results from contracts with AHCCCSA. AHCCCSA's cancellation of its contract with the Company or nonpayment of amounts due to the Company would have a material adverse effect on the Company's financial position and results of operations.

Medical Claims Risk — The Company is exposed to certain medical claims risk due to the nature of its operations. The major portion of medical services provided for the Company's members is performed under contract. However, the Company regularly incurs costs for noncontracted services from providers. In addition, in the event of default or financial difficulties with certain providers, the Company could be liable for outstanding claims, which, if substantial, could have a material adverse effect on the Company's financial position and results of operations.

Cost Containment Measures — Both government and private pay sources have instituted cost containment measures designed to limit payments made to providers of health care services, and there can be no assurance that future measures designed to limit payments made to providers will not adversely affect the Company's financial position.

Professional Liability Insurance — The Company carries professional liability insurance with coverage of \$5,000,000 per occurrence and in aggregate in any one year. In the ordinary course of business, the Company is subject to the claims of its members arising out of decisions to restrict treatment or to restrict reimbursement for certain services.

Litigation — The Company is involved in various legal actions arising in the normal course of business. After taking into consideration legal counsel's evaluation of such legal actions, management believes the outcome of these matters will not have a material adverse effect on the Company's financial position or changes in net assets.

8. TRANSACTIONS WITH SCAN HEALTH PLAN AND SCAN HEALTH PLAN ARIZONA

SCAN Health Plan provides administrative services in support of the operations of the Company and SCAN Health Plan Arizona. The Company and SCAN Health Plan Arizona have agreed to reimburse SCAN Health Plan for providing and arranging legal, accounting and financial, information technology, and other services. The amount of the expenses to be reimbursed to SCAN Health Plan is allocated to the Company based on a time allocation by each department of SCAN Health Plan. The charges for these services to the Company totaled \$1,879,366 in both 2008 and 2007, and are included in administrative expenses in the statements of activities and changes in net assets.

As of December 31, 2008, the Company recorded payables due to SCAN Health Plan and SCAN Health Plan Arizona of \$11,133 and \$1,455,489, respectively, which are included in due to parent and affiliates in the statements of financial position. As of December 31, 2007, the Company recorded receivables due from SCAN Health Plan and SCAN Health Plan Arizona of \$13,363 and \$31,540, respectively, which are included in prepaid expenses and other current assets in the statements of financial position. These amounts represent balances due or prepayments in 2008 and 2007, respectively, for costs incurred in the ordinary course of business by or on behalf of the Company. The amounts were settled through intercompany settlement within 30 days of year-end.

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