



**CENTRAL OREGON INDEPENDENT
HEALTH SERVICES, INC.**

Consolidated Financial Statements
Years Ended December 31, 2006 and 2005
With Independent Auditors' Report

CENTRAL OREGON INDEPENDENT HEALTH SERVICES, INC.
YEARS ENDED DECEMBER 31, 2006 AND 2005
CONTENTS

	<u>Page</u>
INDEPENDENT AUDITORS' REPORT	1
FINANCIAL STATEMENTS:	
Consolidated Balance Sheets	2-3
Consolidated Statements of Income	4
Consolidated Statements of Changes in Stockholders' Equity	5
Consolidated Statements of Cash Flows	6
Notes to Consolidated Financial Statements	7-21



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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Central Oregon Independent Health Services, Inc.

We have audited the accompanying consolidated balance sheet of Central Oregon Independent Health Services, Inc. (the Company) as of December 31, 2006, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The consolidated financial statements of the Company as of and for the year ended December 31, 2005 were audited by other auditors whose report dated April 14, 2006, expressed an unqualified opinion on those statements.

We conducted our audit 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 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 consolidated 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 audit provides a reasonable basis for our opinion.

In our opinion, the 2006 consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Central Oregon Independent Health Services, Inc. as of December 31, 2006, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Perkins & Company, P.C.

May 4, 2007

CENTRAL OREGON INDEPENDENT HEALTH SERVICES, INC.
CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2006 AND 2005

	<u>2006</u>	<u>2005</u>
<u>ASSETS</u>		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 17,814,268	\$ 17,069,771
Available for sale investments	4,948,877	10,185,267
Accounts and other receivables	9,998,445	4,011,793
Income taxes receivable	3,058,866	1,361,068
Deferred income tax assets	<u>293,611</u>	<u>413,505</u>
Total current assets	36,114,067	33,041,404
 AVAILABLE FOR SALE INVESTMENTS	 43,693,225	 37,387,055
 PROPERTY AND EQUIPMENT, NET	 2,164,797	 1,716,471
 PROPERTY HELD FOR FUTURE DEVELOPMENT	 836,225	 836,225
 RESTRICTED ASSETS	 6,288,420	 3,363,911
 DEPOSITS AND OTHER ASSETS	 <u>131,755</u>	 <u>156,626</u>
	<u>\$ 89,228,489</u>	<u>\$ 76,501,692</u>

See notes to consolidated financial statements.

CENTRAL OREGON INDEPENDENT HEALTH SERVICES, INC.
CONSOLIDATED BALANCE SHEETS (continued)
DECEMBER 31, 2006 AND 2005

	2006	2005
<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>		
CURRENT LIABILITIES:		
Claims payable	\$ 19,454,012	\$ 14,402,994
Unpaid claims adjudication expense	1,226,000	1,023,000
Accrued medical incentive pool	14,637,124	16,570,396
Premiums received in advance	412,430	521,607
Accounts payable and accrued liabilities	3,577,827	3,521,107
Total current liabilities	39,307,393	36,039,104
DEFERRED INCOME TAX LIABILITIES		
Total liabilities	1,111,566	284,938
	40,418,959	36,324,042
STOCKHOLDERS' EQUITY:		
Class 1 common stock, no par value; 5,000,000 shares authorized, 1,814,689 shares issued and outstanding (1,786,660 in 2005)	11,369,353	10,720,887
Accumulated other comprehensive income	2,618,637	1,177,111
Retained earnings	34,821,540	28,279,652
Total stockholders' equity	48,809,530	40,177,650
	\$ 89,228,489	\$ 76,501,692

See notes to consolidated financial statements.

CENTRAL OREGON INDEPENDENT HEALTH SERVICES, INC.
CONSOLIDATED STATEMENTS OF INCOME
YEARS ENDED DECEMBER 31, 2006 AND 2005

	<u>2006</u>	<u>2005</u>
REVENUES:		
Medicare premiums	\$ 101,767,771	\$ 79,047,018
Medicaid premiums	48,050,576	55,051,979
Commercial premiums	17,178,327	10,462,825
Other revenues	<u>685,033</u>	<u>654,179</u>
Total revenues	167,681,707	145,216,001
EXPENSES:		
Claims incurred	144,616,097	118,597,806
Operating expenses	14,531,508	10,809,921
Impairment charge	<u>2,395,710</u>	<u>-</u>
Total expenses	<u>161,543,315</u>	<u>129,407,727</u>
INCOME FROM OPERATIONS	6,138,392	15,808,274
INVESTMENT INCOME	<u>4,444,928</u>	<u>2,341,378</u>
INCOME BEFORE INCOME TAX EXPENSE	10,583,320	18,149,652
INCOME TAX EXPENSE	<u>4,041,432</u>	<u>6,712,660</u>
NET INCOME	<u><u>\$ 6,541,888</u></u>	<u><u>\$ 11,436,992</u></u>

See notes to consolidated financial statements.

CENTRAL OREGON INDEPENDENT HEALTH SERVICES, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
YEAR ENDED DECEMBER 31, 2006

	Common Stock		Accumulated Other Comprehensive Income	Retained Earnings	Total Stockholders' Equity
	Shares	Amount			
BALANCES AT JANUARY 1, 2005	1,629,714	\$ 4,191,446	\$ 642,953	\$ 25,083,765	\$ 29,918,164
Comprehensive income:					
Net income	-	-	-	11,436,992	11,436,992
Unrealized gains on available for sale investments, net of income taxes	-	-	861,738	-	861,738
Reclassification adjustment for net gains on sales of available for sale investments included in net income, net of income taxes	-	-	(327,580)	-	<u>(327,580)</u>
Comprehensive income	-	-	-	-	11,971,150
Issuance of common stock, net of offering costs of approximately \$718,000	250,000	6,782,027	-	-	6,782,027
Repurchases of common stock	(349,125)	(766,320)	-	(8,241,105)	(9,007,425)
Stock options exercised	37,935	143,080	-	-	143,080
Tax benefit from non-qualified stock options exercised	-	370,654	-	-	370,654
Exchange of common stock (Note 6)	<u>218,136</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
BALANCES AT DECEMBER 31, 2005	1,786,660	10,720,887	1,177,111	28,279,652	40,177,650
Comprehensive income:					
Net income	-	-	-	6,541,888	6,541,888
Unrealized gains on available for sale investments, net of income taxes	-	-	1,845,402	-	1,845,402
Reclassification adjustment for net gains on sales of available for sale investments included in net income, net of income taxes	-	-	(403,876)	-	<u>(403,876)</u>
Comprehensive income	-	-	-	-	7,983,414
Stock option expense	-	185,011	-	-	185,011
Stock options exercised	28,029	201,826	-	-	201,826
Tax benefit from non-qualified stock options exercised	<u>-</u>	<u>261,629</u>	<u>-</u>	<u>-</u>	<u>261,629</u>
BALANCES AT DECEMBER 31, 2006	<u>1,814,689</u>	<u>\$ 11,369,353</u>	<u>\$ 2,618,637</u>	<u>\$ 34,821,540</u>	<u>\$ 48,809,530</u>

See notes to consolidated financial statements.

CENTRAL OREGON INDEPENDENT HEALTH SERVICES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2006 AND 2005

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 6,541,888	\$ 11,436,992
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	356,834	198,807
Provision for deferred income taxes	92,601	176,854
Net gains on sales of available for sale investments	(661,008)	(558,058)
Impairment charge on software project	2,395,710	-
Loss on disposal of fixed assets	55,896	-
Stock option expense	185,011	-
Changes in operating assets and liabilities		
Accounts and other receivables	(5,986,652)	(1,791,150)
Income taxes receivable	(1,697,798)	(1,361,068)
Deposits and other assets	24,871	(5,180)
Claims payable	5,051,018	811,515
Unpaid claims adjudication expense	203,000	223,000
Accrued medical incentive pool	(1,933,272)	6,894,297
Premiums received in advance	(109,177)	(5,531,212)
Accounts payable and accrued liabilities	(98,962)	1,083,914
Income taxes payable	-	(1,045,021)
Net cash provided by operating activities	4,419,960	10,533,690
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of available for sale investments	(36,303,959)	(43,549,486)
Proceeds from sales and maturities of available for sale investments	38,237,852	24,263,655
Purchases of property and equipment	(3,148,302)	(1,572,577)
Increase in restricted assets	(2,924,509)	(52,515)
Net cash used in investing activities	(4,138,918)	(20,910,923)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuance of common stock	-	6,782,027
Repurchases of common stock	-	(9,007,425)
Stock options exercised	201,826	143,080
Tax benefit from non-qualified stock options exercised	261,629	370,654
Net cash provided by (used in) investing activities	463,455	(1,711,664)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	744,497	(12,088,897)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	17,069,771	29,158,668
CASH AND CASH EQUIVALENTS, END OF YEAR	\$ 17,814,268	\$ 17,069,771

See notes to consolidated financial statements.

CENTRAL OREGON INDEPENDENT HEALTH SERVICES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2006 AND 2005

NOTE 1 - ORGANIZATION

Organization and Basis of Presentation - The accompanying consolidated financial statements include the accounts of Central Oregon Independent Health Services, Inc. (COIHS), and its wholly-owned subsidiaries, Clear Choice Health Plans, Inc. (an insurance company authorized to conduct insurance business in Oregon and Montana), and Central Oregon Individual Health Solutions, Inc. (COIHS II) (collectively, "the Company").

On March 15, 2007 the Company merged COIHS into Clear Choice Health Plans, Inc. which will continue on as the surviving company. The merger of the two entities was designed to be a tax-free reorganization and has been approved by the State of Oregon Department of Consumer and Business Services, Insurance Division ("Oregon Insurance Division"). On March 15, 2007 COIHS II became a wholly-owned subsidiary of Clear Choice Health Plans, Inc.

All significant intercompany accounts and transactions have been eliminated in consolidation.

Description of Business - The Company provides prepaid health services, commercial and Medicare insurance coverage and certain third-party administrative services for employers with self-funded insurance plans. Health services are provided in central and eastern Oregon. The Company's premium revenues are primarily generated from capitated managed care contracts, whereby the Company provides certain healthcare services for a fixed monthly fee per member.

The Company is currently under contract with the Oregon Department of Human Services, Division of Medical Assistance Programs (DMAP) to provide prepaid health services, as a fully capitated health plan. COIHS II manages the Company's business related to DMAP. The Company contracts annually with DMAP and its present service contract expires on December 31, 2007.

The Company also provides commercial and Medicare insurance coverage. The Company is licensed to write commercial insurance as a Healthcare Service Contractor under Oregon Revised Statutes Chapter 750. The Company's commercial insurance plans are offered to certain employers or groups. The Company is certified by the Centers for Medicare and Medicaid Services (CMS) to provide Medicare insurance coverage. The Company's Medicare insurance plans are offered to individuals in the State of Oregon.

During 2006 and 2005, the Company transacted business with certain physicians and hospitals that are stockholders of the Company. Accordingly, the Company's financial condition and results of operations can be affected by the terms of transactions with such related parties.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting - The accompanying consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) using the accrual method of accounting which recognizes revenues and income when earned and expenses and losses when incurred.

Cash and Cash Equivalents - The Company considers all cash on hand, amounts deposited with banks, money market accounts, and short-term, highly liquid investments with remaining maturities of three months or less at the time of purchase by the Company, to be cash and cash equivalents.

Concentrations of Credit Risk - The Company's financial instruments that are exposed to concentrations of credit risk consist primarily of cash equivalents, available for sale investments and accounts and other receivables. Due to the Company's normal operating cash flow requirements, the Company typically has cash and cash equivalents that exceed the Federal Deposit Insurance Corporation (FDIC) coverage of \$100,000 or may not be insured at all. Management believes that its credit risk with respect to cash and cash equivalents is minimal due to the relative financial strength of the financial institutions which maintain the Company's bank balances and the short-term nature of its other cash equivalents. Credit risk related to available for sale investments varies depending on the nature of the investments. Management believes that its credit risk related to debt securities is limited due to the financial strength of the U.S. Government and supporting corporations securing such investments. Credit risk related to equity securities can vary depending on a variety of economic factors affecting the companies issuing such securities. Management believes that its credit risk related to equity securities is limited due to the diversity of such investments. Due to changes in economic conditions, interest rates, and common stock prices, the fair value of the Company's debt and equity securities can be volatile. Consequently, the fair value of such investments can significantly change in the near term as a result of such volatility. Credit risk relative to accounts and other receivables is limited due to the nature of significant receivables. Premiums receivable from DMAP represented 20% and 44% of accounts and other receivables at December 31, 2006 and 2005, respectively.

During 2006, the Company generated 61% and 29% of its total revenues from Medicare and DMAP government contracts, respectively. During 2005, the Company generated 54% and 38% of its total revenues from Medicare and DMAP government contracts, respectively. If these contracts are not renewed, the Company's future results of operations and financial position could be materially affected.

Available for Sale Investments - Available for sale investments are reported at fair value, with unrealized gains and losses excluded from earnings and reported as other comprehensive income or loss, net of income taxes. The fair value of debt securities are based on quoted market prices, where available. For debt securities not actively traded, fair values are estimated using values obtained from independent pricing services or are estimated based on expected future cash flows using a current market rate applicable to the yield, credit quality, and maturity of the investments. The fair values of equity securities are based on quoted market prices. The fair value of certificates of deposit approximates cost.

Gains and losses on the sales of available for sale investments are determined using the specific-identification method. Premiums and discounts on available for sale investments are recognized in interest income using the effective interest method generally over the period to maturity.

Declines in the fair value of individual available for sale investments below their cost that are other than temporary would result in write-downs of the individual investments to their fair value. In estimating other than temporary impairment losses, management considers, among other things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near term prospects of the issuer, and (iii) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery of fair value. The related write-downs would be included in earnings as realized losses.

Accounts and Other Receivables - Receivables consist of uncollateralized amounts due from DMAP, companies and individuals for services provided or premiums billed. Premiums are due upon the start of the coverage period. Interest is not charged on delinquent balances. Management individually reviews all delinquent balances and works with the customer to collect amounts owing. Receivable balances delinquent more than 90 days were not material to the consolidated financial statements as of December 31, 2006 or 2005. The Company did not provide an allowance for doubtful accounts as all accounts are considered collectible.

Property and Equipment - Property and equipment acquisitions are recorded at cost. Improvements and replacements of property and equipment are capitalized. Routine maintenance and repairs are charged to expense as incurred. Depreciation and amortization is provided over the shorter of the estimated useful lives of the assets or terms of leases and is computed using the straight-line method.

Restricted Assets - The Company's restricted investment requirements are governed by the Oregon Insurance Division, the Montana State Auditor's Office - Insurance Division and DMAP. In addition, the Company is required by the State of Oregon to maintain a statutory deposit because it is a health care service contractor. To meet these requirements, the Company has pledged U.S. Treasury Notes totaling approximately \$770,000 and money market accounts totaling approximately \$5,518,000.

Claims Payable - Claims incurred represent capitation and noncapitation payments due to physicians, hospitals, and other healthcare providers for healthcare services rendered.

The liability for claims payable includes payments to be made on claims reported as of the balance sheet date and a provision for estimated incurred but not reported (IBNR) claims. IBNR claims represent the estimated liability for members who have been referred to healthcare providers but for which the invoices for services rendered have not yet been received as of the balance sheet date. IBNR claims are actuarially determined based on historical claims payment experience and other statistics related to the Company's current business nature and volume.

Establishment of a liability for estimated IBNR claims is an inherently uncertain process, and there can be no assurance that currently established reserves will prove adequate to cover actual ultimate expenses. The Company believes that its claims payable is adequate to satisfy its ultimate claims liabilities; however, the IBNR claims liability included in the accompanying consolidated balance sheets may vary significantly from actual claims amounts, and as such adjustments are deemed necessary, they are included in current operations.

Accrued Medical Incentive Pool - The Company contracts directly with physicians and hospitals to provide healthcare services to plan members. Under the terms of the current provider contracts, the Company retains a percentage of fees in a risk pool reserve, to be remitted to the providers following the end of the Company's fiscal year. Payments from the risk pool reserve may be limited by payment of healthcare costs to providers and hospitals in excess of the agreed-upon medical target loss ratios, as stipulated in the provider contracts.

Reinsurance - The Company seeks to limit its loss on any single insured risk and to recover a portion of benefits paid by ceding reinsurance to its reinsurer, ING Group ("the reinsurer"), under excess coverage agreements. The Company cedes reinsurance premiums to the reinsurer on a per-member per-month basis. In return, the reinsurer generally assumes 90% of the risk in excess of \$125,000 per-member per-year (\$75,000 for commercial business) for hospital and physician services. The reinsurer assumed no risk on claims in excess of \$1,000,000 per-member per-year (\$2,000,000 for commercial claims) during 2006 and 2005. Reinsurance agreements do not relieve the Company from its primary obligation to policyholders.

Amounts recoverable under reinsurance agreements are estimated in a manner consistent with the claim liability associated with the reinsurance policy. Reinsurance premiums are netted against written premium, and reinsurance recoveries are offset against claims incurred. Reinsurance premiums ceded were approximately \$1,212,000 and \$1,096,000 for the years ended December 31, 2006 and 2005, respectively, and estimated recoveries were approximately \$1,770,000 and \$1,071,000 for the years ended December 31, 2006 and 2005, respectively. Amounts receivable under reinsurance policies, included in accounts and other receivables were approximately \$1,388,000 and \$1,022,000 at December 31, 2006 and 2005, respectively.

Loss Contracts - The Company monitors its provider contracts for the provision of medical care and recognizes losses on any applicable contracts when it is probable that expected future healthcare and maintenance costs will exceed anticipated future premiums. The estimation of future healthcare medical costs includes all costs related to the provision of healthcare to members covered by contracts. As of December 31, 2006, management does not anticipate that future costs will exceed premiums related to provider contracts.

Income Taxes - Income taxes are provided for the tax effects of transactions reported in the financial statements and consist of taxes currently due plus deferred taxes. Deferred income taxes are determined based on the estimated future tax effects of differences between the financial statement and tax basis of assets and liabilities given the provisions of enacted tax laws and tax rates applicable to the periods in which the differences are expected to reverse. Valuation allowances are established, when necessary, to reduce deferred income tax assets to the amount expected to be realized.

Revenue Recognition - Revenues from Medicare and commercial premiums are recognized during the period in which the Company is obligated to provide healthcare services to its members. Premiums from DMAP for maternity services are recognized as revenue during the period that such services are provided, whereas all other premiums from DMAP are recognized as revenue during the period in which the Company is obligated to provide healthcare services to its members.

Information from DMAP and CMS is presently not available to substantiate all capitation payments received and there is at least a reasonable possibility that amounts will have to be refunded back to DMAP and CMS or additional amounts will be paid to the Company from DMAP and CMS related to services rendered in prior years. If this occurs, such amounts will be recorded in the period the Company is notified by DMAP and CMS of such amounts. In addition, the Company has filed a complaint alleging that DMAP has underpaid the Company during 1997 through 2002 (see Note 12).

Impairment of Long-Lived Assets - In accordance with the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* ("SFAS 144"), management reviews long-lived assets for impairment when circumstances indicate the carrying amount of an asset may not be recoverable based on the undiscounted future cash flows of the asset. If the carrying amount of an asset may not be recoverable, a write-down to fair value is recorded. Fair values are determined based on the discounted cash flows, quoted market values, or external appraisals, as applicable. Long-lived assets are reviewed for impairment at the individual asset or the asset group level for which the lowest level of independent cash flows can be identified.

Stock-Based Compensation Plans - Prior to January 1, 2006, the Company accounted for stock-based employee compensation arrangements in accordance with the intrinsic value provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25) and related interpretations. Under the intrinsic value method of APB 25, when the exercise price of an employee stock award equals the market price of the underlying stock on the date of grant, no compensation expense was recognized in the statement of operations. Compensation expense under APB 25 was recognized as a result of the issuance of restricted stock, and if stock options were granted with an exercise price below fair market value on the date of grant. Additionally, the Company provided the pro forma disclosures required by Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation* (SFAS 123), as amended by SFAS No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*.

Effective January 1, 2006, the Company adopted SFAS 123(R), which establishes accounting for equity instruments exchanged for employee services. SFAS 123(R) supersedes APB 25, and amends Financial Accounting Standards No. 95, *Statement of Cash Flows*. SFAS 123(R) requires all share-based payments to employees, including grants of employee and director stock options, to be recognized as compensation cost in the consolidated financial statements based on their fair values.

The Company has used the modified prospective method of transition. Accordingly, the financial statement amounts for periods prior to January 1, 2006 have not been restated to reflect the fair value method of expensing share-based compensation. Compensation cost recognized in periods subsequent to January 1, 2006 includes all share-based payments granted prior to, but not yet vested as of that date, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and compensation cost for all share-based payments granted subsequent to that date, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R).

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

Recently Issued Accounting Standards - In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Tax—an Interpretation of FASB Statement No. 109*. FIN 48 changes how uncertain income tax positions are recognized, measured, and disclosed in financial statements. FIN 48 requires that companies evaluate all material income tax positions for periods that remain open under applicable statutes of limitation, as well as positions expected to be taken in future returns. Additionally, recognition of income tax benefits will be allowed if the tax position has a “more likely than not” chance of being sustained on its technical merits. This interpretation is effective for fiscal years beginning after December 15, 2006. Management is evaluating the impact of adopting this statement.

Reclassifications - Certain reclassifications have been made to the 2005 financial statements in order to conform to the 2006 presentation.

NOTE 3 - AVAILABLE FOR SALE INVESTMENTS

Available for sale investments at December 31 consisted of the following:

<u>2006</u>	<u>Amortized cost</u>	<u>Gross unrealized gains</u>	<u>Gross unrealized losses</u>	<u>Estimated fair value</u>
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 10,772,338	\$ 40,780	\$ (41,808)	\$ 10,771,310
Corporate debt securities	<u>7,745,533</u>	<u>51,666</u>	<u>(63,937)</u>	<u>7,733,262</u>
Total debt securities	18,517,871	92,446	(105,745)	18,504,572
Common stocks	<u>25,877,474</u>	<u>4,273,669</u>	<u>(13,613)</u>	<u>30,137,530</u>
	<u>\$ 44,395,345</u>	<u>\$ 4,366,115</u>	<u>\$ (119,358)</u>	<u>48,642,102</u>
Less portion reported as current				<u>(4,948,877)</u>
				<u>\$ 43,693,225</u>
<u>2005</u>	<u>Amortized cost</u>	<u>Gross unrealized gains</u>	<u>Gross unrealized losses</u>	<u>Estimated fair value</u>
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 14,610,562	\$ 14,459	\$ (160,852)	\$ 14,464,169
Corporate debt securities	<u>7,079,066</u>	<u>79,527</u>	<u>(69,735)</u>	<u>7,088,858</u>
Total debt securities	21,689,628	93,986	(230,587)	21,553,027
Common stocks	<u>23,929,729</u>	<u>2,126,802</u>	<u>(37,236)</u>	<u>26,019,295</u>
	<u>\$ 45,619,357</u>	<u>\$ 2,220,788</u>	<u>\$ (267,823)</u>	<u>47,572,322</u>
Less portion reported as current				<u>(10,185,267)</u>
				<u>\$ 37,387,055</u>

The following tables present the estimated fair value and the gross unrealized losses of the Company's available for sale investments, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31:

	<u>Less than 12 months</u>		<u>12 months or more</u>		<u>Total</u>	
	<u>Estimated fair value</u>	<u>Unrealized losses</u>	<u>Estimated fair value</u>	<u>Unrealized losses</u>	<u>Estimated fair value</u>	<u>Unrealized losses</u>
<u>2006</u>						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 2,787,823	\$ 21,740	\$ 1,753,119	\$ 20,068	\$ 4,540,942	\$ 41,808
Corporate debt securities	<u>1,661,789</u>	<u>10,150</u>	<u>2,106,222</u>	<u>53,787</u>	<u>3,768,011</u>	<u>63,937</u>
Total debt securities	4,449,612	31,890	3,859,341	73,855	8,308,953	105,745
Common stocks	<u>266,336</u>	<u>9,480</u>	<u>133,020</u>	<u>4,133</u>	<u>399,356</u>	<u>13,613</u>
Total temporarily impaired investment securities	<u>\$ 4,715,948</u>	<u>\$ 41,370</u>	<u>\$ 3,992,361</u>	<u>\$ 77,988</u>	<u>\$ 8,708,309</u>	<u>\$ 119,358</u>

2005	Less than 12 months		12 months or more		Total	
	Estimated fair value	Unrealized losses	Estimated fair value	Unrealized losses	Estimated fair value	Unrealized losses
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 10,032,075	\$ 127,413	\$ 1,911,951	\$ 33,439	\$ 11,944,026	\$ 160,852
Corporate debt securities	4,051,469	51,234	461,500	18,501	4,512,969	69,735
Total debt securities	14,083,544	178,647	2,373,451	51,940	16,456,995	230,587
Common stocks	1,422,423	37,236	-	-	1,422,423	37,236
Total temporarily impaired investment securities	<u>\$ 15,505,967</u>	<u>\$ 215,883</u>	<u>\$ 2,373,451</u>	<u>\$ 51,940</u>	<u>\$ 17,879,418</u>	<u>\$ 267,823</u>

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

At December 31, 2006, the 44 debt securities with unrealized losses have depreciated 1% from the Company's cost basis. These securities are either guaranteed by the U.S. Government or are securities of large established corporations. These unrealized losses relate principally to current interest rates for similar types of securities. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition. As management has the ability to hold debt securities until maturity, or for the foreseeable future if classified as available-for-sale, no declines are deemed to be other-than-temporary.

The amortized cost and fair value of debt securities at December 31, 2006, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties:

	Amortized cost	Estimated fair value
Due in one year or less	\$ 4,948,051	\$ 4,948,876
Due after one year through five years	8,984,251	8,979,546
Due after five years through ten years	2,594,923	2,567,151
Due after ten years	1,990,646	2,008,999
	<u>\$ 18,517,871</u>	<u>\$ 18,504,572</u>

Realized gains and losses on sales of available for sale investments during the years ended December 31 were as follows:

	Gross realized gains	Gross realized losses	Realized gains, net
2006	\$ 804,343	\$ (143,335)	\$ 661,008
2005	\$ 1,850,008	\$ (1,291,950)	\$ 558,058

Investment income for the years ended December 31 consisted of the following:

	<u>2006</u>	<u>2005</u>
Interest and dividends	\$ 3,783,920	\$ 1,783,320
Realized gains, net	661,008	558,058
Investment income	<u>\$ 4,444,928</u>	<u>\$ 2,341,378</u>

NOTE 4 - PROPERTY AND EQUIPMENT

Property and equipment at December 31 consisted of the following:

	<u>2006</u>	<u>2005</u>
Telephone and data processing equipment	\$ 1,316,234	\$ 1,108,387
Furniture	287,784	264,823
Computer software	625,174	178,387
Leasehold improvements	182,777	167,764
Transportation equipment	37,944	37,944
	<u>2,449,913</u>	<u>1,757,305</u>
Less accumulated depreciation and amortization	1,589,493	1,185,441
	860,420	571,864
Construction in progress	1,304,377	1,144,607
Property and equipment, net	<u>\$ 2,164,797</u>	<u>\$ 1,716,471</u>

Construction in progress as of December 31, 2006 primarily consists of costs incurred in connection with the building of the Company's new facility. The Company expects to complete the construction of the facility in 2008. As of December 31, 2006, management estimates that the aggregate cost to complete this project is approximately \$19,000,000. The Company has entered into various contracts to construct the building. The total cost of the contracts is approximately \$14,800,000 of which approximately \$425,000 has been incurred as of December 31, 2006.

Construction in progress as of December 31, 2005 primarily consisted of a project to replace the Company's claims processing system. On January 19, 2007, the Company's Board of Directors approved the discontinuance of this project. As a result of the decision to discontinue the claims processing system replacement project, management performed an impairment analysis on the assets of the project in accordance with the provisions of SFAS 144 and determined that the assets held in construction in progress had no remaining value as of December 31, 2006. Accordingly, the Company has recorded an impairment charge of \$2,395,710 as of December 31, 2006.

NOTE 5 - CLAIMS PAYABLE, UNPAID CLAIMS ADJUDICATION EXPENSE, AND ACCRUED MEDICAL INCENTIVE POOL

Activity related to claims payable, unpaid claims adjudication expenses, and accrued medical incentive pool liabilities for the years ended December 31 was as follows:

	<u>2006</u>	<u>2005</u>
Balance at beginning of year	\$ 31,996,390	\$ 24,067,578
Claims incurred related to:		
Current year	146,616,897	118,667,660
Prior year	<u>(2,000,800)</u>	<u>(69,854)</u>
Total incurred	144,616,097	118,597,806
Claims paid related to:		
Current year	114,076,623	91,904,908
Prior year	<u>27,218,728</u>	<u>18,764,086</u>
Total paid	141,295,351	110,668,994
Balance at end of year	<u>\$ 35,317,136</u>	<u>\$ 31,996,390</u>

Amounts incurred related to prior years vary from previously estimated liabilities as the claims are ultimately settled.

	<u>2006</u>	<u>2005</u>
Reported on consolidated balance sheets as:		
Claims payable	\$ 19,454,012	\$ 14,402,994
Unpaid claims adjudication expense	1,226,000	1,023,000
Accrued medical incentive pool	<u>14,637,124</u>	<u>16,570,396</u>
	<u>\$ 35,317,136</u>	<u>\$ 31,996,390</u>

NOTE 6 - STOCKHOLDERS' EQUITY

Restructuring: In December 2004, the Company's stockholders approved a restructuring plan (the Restructuring) which, in addition to other items, amended the Company's articles of incorporation, modified the Company's existing capital stock structure, and modified certain rights and agreements related to the Company's capital stock. In conjunction with the Restructuring, the Company authorized two additional classes of stock: 5,000,000 shares of Class 1 common stock (less any outstanding shares of Class A common stock or Class D common stock) and 1,000,000 shares of preferred stock. Upon approval of the Restructuring by each of the Company's individual stockholders, the stockholders' existing shares of Class A common stock, Class C common stock, or Class D common stock were exchanged for 150 shares of Class 1 common stock. As of December 31, 2005, all of the Company's Class A, C, and D common stock had been exchanged for Class 1 common stock in connection with the Restructuring, and such classes of stock are no longer authorized.

Class 1 Common Stock: Class 1 common stock has no ownership or voting limitations or restrictions, except with respect to voting on the valuation of the previous Class A or Class D common stock.

Class A Common Stock: Class A common stock could only be held by participating providers who were in “good standing” with the Central Oregon Independent Practice Association. Class A common stockholders had no voting limitations or restrictions.

Class C Common Stock: Class C common stock could be sold to such persons or entities as the Board designated and could be offered in one or more series.

Class D Common Stock: Class D common stock could only be sold to key employees, officers, and directors of the Company as prescribed in the Company’s Equity Incentive Plan (see Note 10) or to such persons designated by the Board. In addition, Class D common stock was exchanged for Class A common stock when stockholders no longer met the requirements to be a Class A stockholder. Class D stockholders did not have voting privileges, except those required by law.

The restructuring of the Company’s capital structure during 2005 occurred as follows:

	Class 1 Common Stock		Class A Common Stock		Class D Common Stock		Total Common Stock	
	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount
Balances at								
January 1, 2005	1,628,250	\$ 3,723,306	1,249	\$ 411,888	215	\$ 56,252	1,629,714	\$ 4,191,446
Exchange of common stock	219,600	468,140	(1,249)	(411,888)	(215)	(56,252)	218,136	-
Balances at								
December 31, 2005	<u>1,847,850</u>	<u>\$ 4,191,446</u>	<u>-</u>	<u>\$ -</u>	<u>-</u>	<u>\$ -</u>	<u>1,847,850</u>	<u>\$ 4,191,446</u>

Preferred Stock: Preferred stock may be sold to such persons or entities as the Board designates and may be offered in one or more series. The Board may designate the rights and preferences of any series of preferred stock issued. There are 1,000,000 shares of no par value preferred stock authorized and no preferred stock issued or outstanding at December 31, 2006 or 2005.

Repurchases: Repurchases of common stock are charged to the related common stock accounts only to the extent of the original cost of the specific shares repurchased. Any amounts paid to repurchase common stock in excess of the original cost of specific shares repurchased are charged to retained earnings.

Stock Offering: In October 2005, the Company completed a stock offering of 250,000 shares of Class 1 common stock at a price of \$30 per share. In connection with the stock offering, the Company issued a stock warrant to purchase an aggregate of 7,500 shares of the Company’s Class 1 common stock at \$30 per share. The warrant is exercisable over a three year period. If the warrant is exercised, the amount of the exercise price will be recorded as an increase to stockholders’ equity.

NOTE 7 - INCOME TAXES

The provision for income taxes for the years ended December 31 was as follows:

	2006	2005
Current:		
Federal	\$ 3,291,946	\$ 5,805,236
State	656,885	730,570
	<u>3,948,831</u>	<u>6,535,806</u>
Deferred	92,601	176,854
	<u>\$ 4,041,432</u>	<u>\$ 6,712,660</u>

The provision for income taxes results in effective tax rates which are different than the federal income tax statutory rate. The nature of the differences for the years ended December 31, 2006 and 2005 were as follows:

	<u>2006</u>	<u>2005</u>
Expected federal income tax provision at statutory rates	\$ 3,598,328	\$ 6,352,378
State income taxes, net of federal effect	461,009	474,871
Change in valuation allowance	(39,000)	(76,000)
Other, net	21,095	(38,589)
	<u>\$ 4,041,432</u>	<u>\$ 6,712,660</u>

The components of the net deferred income tax assets at December 31 were as follows:

	<u>2006</u>	<u>2005</u>
Deferred income tax assets:		
Accrued compensation	\$ 42,433	\$ 299,434
Deferred compensation	366,623	276,727
Claims payable and unpaid claims adjudication expense, net	271,359	-
Capital loss carryforwards on sales of investments	-	250,725
Accrued vacation	88,883	60,931
Premiums received in advance	32,409	40,988
Stock option expense	41,540	-
Other	40,202	44,753
Total deferred income tax assets	<u>883,449</u>	<u>973,558</u>
Deferred income tax liabilities:		
Claims payable and unpaid claims adjudication expense, net	-	(7,909)
Unrealized gains on available for sale investments	(1,669,020)	(775,854)
Property and equipment	(32,384)	(22,228)
Total deferred income tax liabilities	<u>(1,701,404)</u>	<u>(805,991)</u>
	(817,955)	167,567
Valuation allowance	-	(39,000)
Net deferred income tax assets (liabilities)	<u>\$ (817,955)</u>	<u>\$ 128,567</u>

At December 31, 2005, the valuation allowance was based on management's estimate of the likelihood that the Company would generate sufficient future capital gains to offset historical capital losses. Management believes that the net deferred income tax assets will be recognized in the normal course of operations and, accordingly, has not recognized a valuation allowance at December 31, 2006.

NOTE 8 - LEASE COMMITMENTS

The Company leases its office facilities and equipment under noncancelable operating lease agreements which expires in 2010. The main office lease agreement provides for annual rental increases of 2% per year and has two 5-year renewal options. Total rental expense was approximately \$492,000 and \$452,000 for the years ended December 31, 2006 and 2005, respectively. As of December 31, 2006, the future minimum lease commitments under the Company's operating lease agreements were approximately as follows for the years ending December 31:

2007	\$ 501,000
2008	284,000
2009	13,000
2010	2,000
	<u>\$ 800,000</u>

NOTE 9 - REGULATION

The Company is subject to various regulatory requirements as administered by the Insurance Division. Failure to meet minimum premium-to-surplus requirements as prescribed by the Insurance Division can initiate certain mandatory and possibly additional discretionary actions that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. As of December 31, 2006, management believes that the Company was in compliance with the Insurance Division's requirements.

The Company is required to file statutory basis financial statements with DMAP within five months of each calendar year-end. These statutory basis financial statements are prepared in conformity with accounting practices prescribed or permitted by the Insurance Division. Prescribed statutory accounting practices are those practices mandated by the National Association of Insurance Commissioners (NAIC), as well as state laws, regulations, and general administrative rules. In contrast, permitted statutory accounting practices are those practices for which a company has applied for and received specific permission from their state of domicile. The Company's statutory surplus was approximately \$611,000 and \$1,595,000 less than total stockholders' equity at December 31, 2006 and 2005, respectively. This difference is primarily due to designating intangible assets and certain equipment as nonadmitted assets and differences in investment and deferred income tax accounting.

The NAIC requires insurance companies to calculate risk-based capital (RBC) ratios, which serve as a benchmark for the regulation of insurance companies' solvency by state insurance regulators. The formulas for determining the amount of RBC specify various weighting factors that are applied to financial balances or various levels of activity based on a perceived degree of risk. Regulatory compliance is determined by a ratio of the enterprise's regulatory total adjusted capital to its authorized control level RBC. Enterprises below specific trigger points or ratios are classified within certain levels, each of which require specified corrective action or may cause state regulators to take certain actions. As of December 31, 2006 and 2005, management believes that the Company's RBC ratios exceeded all regulatory requirements.

NOTE 10 - BENEFIT PLANS

401(k) Plan - The Company has a 401(k) employee benefit plan (the 401(k) Plan) which covers all full-time employees who have completed at least 90 days of service. Eligible employees may contribute a percentage of their compensation to the 401(k) Plan, not to exceed 15%, subject to certain limitations. The Company may make matching contributions and profit-sharing contributions to the 401(k) Plan at the discretion of the Board. The Company made matching contributions of approximately \$111,000 and \$98,000 to the 401(k) Plan for the years ended December 31, 2006 and 2005, respectively. There were no Company discretionary profit-sharing contributions to the 401(k) Plan in 2006 and 2005.

Deferred Compensation - The Company has a voluntary deferral plan for Board members which allows them to defer the payment of their Board fees to future periods.

Salary Continuation Plan - The Company maintains a salary continuation plan for certain key executives that provides defined benefits to the participants upon termination of employment on or after attainment of normal retirement age as defined in the individual agreements. The defined benefits are for a period of ten years. The benefits are subject to certain vesting requirements, and vested amounts are generally payable upon termination in either a lump-sum or monthly installments. The salary continuation plan also includes death benefit provisions related to the participants. Expense related to the salary continuation plan is not significant.

Equity Incentive Plan - The Company has two Equity Incentive Plans (the Plans), whereby it can issue Incentive Stock Options (ISOs) and Non-qualified Stock Options (NSOs) related to the Company's Class 1 common stock (Class D common stock prior to the Restructuring). The Plans also provide for the issuance of various other forms of equity-based compensation. ISOs can be granted to key employees and officers. NSOs can be granted to members of the Board. ISOs are to be granted at not less than fair market value as determined by the stock price at the date of grant. NSOs are to be granted at any amount as determined by the Board. Stock options have vesting periods that range between zero and three years and expire between five and ten years from the date of grant. All share and per-share amounts below have been retroactively adjusted to reflect the 150-for-one share exchange ratio provided for in the Restructuring. At December 31, 2006, 324,150 shares reserved under the Plans were available for future grant.

The fair value of each stock option award is estimated on the date of the grant using the Black-Scholes Merton option pricing model which was previously used for the Company's proforma disclosures under SFAS 123. The Company's determination of fair value of equity based payment awards on the date of grant using an option-pricing model is affected by the fair value of the Company's stock as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, expected volatility in the fair value of the Company's stock over the term of the awards, and the actual and the projected employee stock option exercise behaviors. The risk-free rate is based on the U.S Treasury rates in effect during the corresponding period of grant. The projected employee stock options exercise behaviors are determined by management based on estimated employee turnover. The expected volatility is determined by reference to the actual volatility the Company's common stock. Because changes in the subjective assumptions can materially affect the estimated value, in management's opinion, the existing valuation models may not provide an accurate measure of the fair value of the Company's employee stock options. Although the fair value of employee stock options is determined in accordance with SFAS 123R using an option-pricing model, that value may not be

indicative of the fair value observed in a willing buyer/willing seller market transaction. For SFAS 123R purposes, the fair value of each option grant has been estimated as of the date of grant using the following weighted average assumptions:

	<u>2006</u>	<u>2005</u>
Risk-free rate	4.90%	3.98%
Expected dividends	-	-
Expected term	4 years	5 years
Expected volatility	41.45%	-
Grant date fair value of options granted	\$13.99	\$9.60

A summary of option activity under the Plan as of December 31, 2006 and changes during the year then ended is presented below:

	<u>Options</u>	<u>Weighted average exercise price</u>	<u>Weighted average remaining contractual life (in years)</u>
Outstanding at January 1, 2006	121,215	\$ 8.06	
Granted	24,000	\$ 36.00	
Exercised	(28,029)	\$ 7.18	
Forfeited	<u>(3,968)</u>	\$ 24.31	
Outstanding December 31, 2006	<u>113,218</u>	\$ 13.63	3.0
Exercisable at December 31, 2006	91,214	\$ 9.32	2.7

The total fair value of shares vested in 2006 and 2005 was \$321,747 and \$217,098, respectively.

A summary of the status of the Company's non-vested options as of December 31, 2006 and changes during the year then ended is presented below:

	<u>Options</u>	<u>Weighted average grant date fair value</u>
Non-vested at January 1, 2006	18,790	\$ 8.66
Granted	24,000	\$ 13.99
Vested	(18,787)	\$ 10.56
Forfeited	<u>(1,999)</u>	\$ 11.02
Non-vested at December 31, 2006	<u>22,004</u>	\$ 12.64

At December 31, 2006, there was \$334,880 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over a weighted average period of 1.7 years. Compensation cost recognized on options granted in 2006 was \$185,011.

NOTE 11 - SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

During the years ended December 31, 2006 and 2005, noncash investing and financing transactions resulted from unrealized gains (losses) on available for sale investments, net of income taxes; reclassifications of Class A common stock to Class D common stock; and exchanges of Classes A, C, and D common stock to Class I common stock, all as disclosed in the accompanying consolidated statements of changes in stockholders' equity, and from purchases of equipment on credit of \$155,682 in 2006.

Cash paid for income taxes totaled approximately \$5,385,000 and \$8,586,000 during the years ended December 31, 2006 and 2005, respectively.

NOTE 12 - CONTINGENCIES

Litigation - In December 2002, following a period of extensive discussions with DMAP, the Company filed a complaint against the Department of Human Services and DMAP in Marion County, Oregon for breach of contract in its capitation rate-setting process for the years 1997 through 2002. The Company claims that DMAP underpaid the Company for each year during this period. In September 2003, the Department of Human Services filed counterclaims against the Company for breach of contract and other related matters.

In January 2005, a summary judgment was issued in favor of the Department of Human Services and DMAP, effectively dismissing the case. Management subsequently appealed the judgment in March 2005. In April 2007, the summary judgment was overturned by the appellate court. The Department of Human Services and DMAP have now petitioned to have the case heard by the Oregon Supreme Court. At this time, the final outcome of the proceedings cannot be determined, and no estimate can be made as to when the litigation will be concluded or the amount, if any, which either of the parties will receive or pay.

Coverage Claims - In the normal course of business, the Company is party to various legal proceedings, many of which involve claims related to healthcare coverage. The Company, like health maintenance organizations and other health insurers, generally excludes the coverage of certain healthcare services under its contracts. The Company, in its ordinary course of business, is subject to the claims of its enrollees arising out of decisions to restrict treatment or reimbursement for certain services. The loss of even one such claim, if it results in a significant punitive damage award, could have a material adverse effect on the Company. In addition, the risk of potential liability under punitive damage theories may significantly increase the difficulty of obtaining reasonable settlements of coverage claims. However, the financial and operating impact that such evolving theories of recovery will have on the managed care industry and the Company is presently unknown.

Legal proceedings against the Company are, or may be, covered under insurance policies or indemnification agreements. Based upon the information presently available, management believes that the final outcome of all such proceedings will not have a material adverse effect on the Company's future financial condition or results of operations.

Other - The Company has entered into employment contracts with certain executive officers which provide for payments contingent upon a change in control of the Company.