

**STATE OF WASHINGTON
OFFICE OF THE INSURANCE
COMMISSIONER**



FINANCIAL EXAMINATION

of

**KPS Health Plans
Bremerton, Washington**

**NAIC CODE 53872
DECEMBER 31, 2006**

SALUTATION

Seattle, Washington
August 11, 2008

The Honorable Mike Kreidler, Commissioner
Washington State Office of the Insurance Commissioner (OIC)
Insurance Building – Capitol Campus
302 Sid Snyder Avenue SW, Suite 200
Olympia, WA 98504

Dear Commissioner Kreidler:

In accordance with your instructions, and in compliance with the statutory requirements of RCW 48.44.145 and RCW 48.03.010, an examination was made of the corporate affairs and financial records of

KPS Health Plans

of

Bremerton, Washington

hereinafter referred to as “KPS” or the “Company,” at the location of its home office, 400 Warren Avenue, Bremerton, Washington 98337. This report is respectfully submitted showing the condition of the Company as of December 31, 2006.

CHIEF EXAMINER'S AFFIDAVIT

I hereby certify I have read the attached Report of the Financial Examination of KPS Health Plans of Bremerton, Washington. This report shows the financial condition and related corporate matters as of December 31, 2006.



Patrick H. McNaughton
Chief Examiner

8-11-08

Date

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SCOPE OF THE EXAMINATION

This examination covers the period January 1, 2003 through December 31, 2006 and comprises a comprehensive review of the books and records of the Company. The examination followed the statutory requirements contained in the Washington Administrative Code (WAC), the Revised Code of Washington (RCW), and the guidelines recommended by the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook. The examination included identification and disposition of material transactions and events occurring subsequent to the date of examination that were noted during the examination.

Corporate records, external reference materials, and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. In addition, the Company's certified public accountant's (CPA's) work papers were reviewed and utilized, where possible, to facilitate efficiency in the examination.

INSTRUCTIONS

The examiners reviewed the Company's filed 2006 NAIC Annual Statement as part of the statutory examination. This review was performed to determine if the Company completed the NAIC Annual Statement in accordance with the NAIC Annual Statement Instructions and to determine if the Company's accounts and records were prepared and maintained in accordance with Title 48 RCW, Title 284 WAC, and the NAIC Statements of Statutory Accounting Principles (SSAP) as contained in the NAIC Accounting Practices and Procedures Manual (AP&P).

1. NAIC Annual Statement Errors and Misclassifications

The results of the examination disclosed several instances in which the Company's filing of the 2006 NAIC Annual Statement did not conform to the NAIC Accounting Practices and Procedures Manual and the NAIC Annual Statement Instructions.

a. Special Deposits Schedule

The Company did not include interest earnings in the 2005 and 2006 NAIC Annual Statement, Schedule E - Part 3 for Special Deposits. No examination report adjustment was needed because interest earnings were properly reflected in the NAIC Annual Statements for Assets, Liabilities, Capital and Surplus for 2005 and 2006.

b. Security Rating for Long-Term Bonds

The 2006 NAIC Annual Statement, Schedule D -- Part 1, incorrectly listed two securities with a NAIC designation 1 instead of 1FE. The NAIC designation "FE" indicates KPS determined the rating of the securities based on information from a nationally recognized statistical rating organization.

c. Reclassification of Claim Expenses to Claim Adjustment Expenses

The Company misclassified \$93,686 for vendor fees paid in 2006 as claim expenses. The fees were for services to identify, validate and recover claim overpayment. SSAP No. 85, paragraph 4.a, states that expenses resulting in reduced costs of health care services should be classified as cost containment expenses which are a subdivision of claim adjustment expense. (See examination adjustment No. 1., debiting, "Claim adjustment expenses" and crediting, "Hospital/medical benefits", in the amount of \$ 93,686.)

d. Amounts Receivable Relating to Administrative Services Only (ASO) Plans

The Company recorded receivables for unpaid claims in the amount of \$181,042 for three Administrative Services Only (ASO) Plans in the 2006 NAIC Annual Statement. The Company processed claims for the ASO Plans prior to December 31, 2006, but the claim checks were held until the cash was received from the ASO Plans in January 2007. The Company is not in compliance with SSAP No. 47, paragraph 8, which states that a receivable shall not be recorded for unpaid claims. (See examination adjustment No. 2., debiting, "Cash, cash equivalents and short-term investments", and crediting, "Amounts receivable relating to uninsured plans", in the amount of \$ 181,042.)

e. Health Care Receivable Reporting

The health care receivable amount as shown in the account title of the 2006 NAIC Annual Statement, page 2, line 22, is incorrect. The account title description shows a balance of zero, while Exhibit 3- Health Care Receivables, shows the Company has \$253,006 in admitted health care receivables.

The Company is instructed to file an accurate statement of its financial condition, transactions, and affairs in compliance with RCW 48.43.097, which requires the filing of its financial statements in accordance with the NAIC AP&P Manual, and with WAC 284-07-050(2) which requires adherence to the NAIC Annual Statement Instructions.

2. Claims Unpaid

The OIC actuarial staff determined that the Company's estimate of claims unpaid for comprehensive and Medicare supplement coverage was not within a reasonable range which required an increase of \$1,861,165 to Claims unpaid in 2006. SSAP No. 55, paragraph 8, requires claim reserves to be based upon the estimated ultimate cost of settling the claims. The OIC actuarial staff developed an estimate based on KPS' historical claim data from 2004 through November 2007. Using more current data to estimate the December 31, 2006 values enables a more accurate calculation to be made of liabilities and avoids the need for margins to be incorporated. (See examination adjustment No. 3., debiting "Hospital/medical benefits", and crediting "Claims unpaid", in the amount of \$1,861,165.)

The Company is instructed to file an accurate statement of its financial condition, transactions, and affairs in compliance with RCW 48.43.097, which requires the filing of its financial statements in accordance with the NAIC AP&P Manual, and with WAC 284-07-050(2) which requires adherence to the NAIC Annual Statement Instructions.

3. Unpaid Claims Adjustment Expenses

The OIC actuarial staff determined that the Company's estimate of unpaid claims adjustment expenses was not within a reasonable range. The Company had not considered cost containment expenses in developing the estimated unpaid claims adjustment expenses which required an increase of \$508,923 to the unpaid claims adjustment expenses in 2006.

SSAP No. 55, paragraph 5, states claim adjustment expenses are classified into two broad categories; defense and cost containment, and adjusting and other. (See examination adjustment No. 4., debiting "Claims adjustment expenses", and crediting "Unpaid claim adjustment expenses", in the amount of \$508,923.)

The Company is instructed to file an accurate statement of its financial condition, transactions, and affairs in compliance with RCW 48.43.097, which requires the filing of its financial statements in accordance with the NAIC AP&P Manual, and with WAC 284-07-050(2) which requires adherence to the NAIC Annual Statement Instructions.

4. Paid Claims Reconciliation

KPS was not able to reconcile paid claims as reported in the 2006 NAIC Annual Statement to the paid claims triangle data reported to the examination team and to the Company's opining actuary. The 2006 NAIC Annual Statement, Underwriting and Investment Exhibit, Part 2B – Analysis of Claims Unpaid, Column 2, Line 1, reported \$1,034,616 more than what was reported on the corresponding paid claims triangle data.

The Company is instructed to keep and maintain sufficient detail records in accordance with RCW 48.03.030(1) and RCW 48.44.145(2).

5. Custodial Agreement

In the 2006 NAIC Annual Statement, General Interrogatories, No. 24, KPS indicated that its securities were held with a custodian in accordance with Part 1 – General, Section IV. J – Custodial or Safekeeping agreements of the NAIC Financial Condition Examiners Handbook. Our review of the Company's custodial agreement with US Bank indicates the following needs to be added in order to be consistent with the NAIC Financial Condition Examiners Handbook standards.

- Securities/Assets shall expressly be subject to the instructions of KPS Health Plans and withdrawn upon demand.
- Securities/Assets held indirectly by US Bank or in a clearing corporation must be separately identified on the custodian's official records as being owned by KPS Health Plans.
- The custodial agreement must allow for securities to be registered in the name of the customer or customer's nominee.

The Company is instructed to file an accurate statement of its financial condition, transactions, and affairs in compliance with RCW 48.43.097, which requires the filing of its

financial statements in accordance with the NAIC AP&P and pursuant to WAC 284-07-050(2) which requires adherence to the NAIC Annual Statement Instructions. It is also recommended that the Company amend its custodial agreement with US Bank in accordance with the NAIC Financial Condition Examiners Handbook, Part 1 – General, Section IV.J – Custodial or Safekeeping agreements.

6. Administrative Services Agreement

KPS' parent, Group Health Cooperative (GHC), charged KPS for administrative services in 2006 without a contract filed with OIC. An administrative services agreement between GHC and KPS was not executed until January 1, 2007. A Form D was filed for the administrative services agreement on January 15, 2008.

RCW 48.31C.050(2)(d) states that management agreements, service contracts, and cost-sharing arrangements may not be entered into unless a health carrier has notified the commissioner in writing of its intention to enter into the transaction.

The Company is instructed to comply with RCW 48.31C.050(2)(d) which requires prior notification of all administrative service agreements before execution.

7. Holding Company – Form B Disclosure

In the 2005 and 2006 Form B filings, KPS failed to disclose its inter-company tax sharing agreement and inter-company services and cost allocation agreement. Both agreements are with Northwest Credentials Verification Services, LLC. Both agreements have been in effect since 2004.

RCW 48.31C.040(2)(e)(v) requires the disclosure of all management agreements, service contracts, and cost-sharing arrangements. RCW 48.31C.040(2)(c)(viii) requires the disclosure of consolidated tax allocation agreements. WAC 284-18A-370 requires the disclosure on the Annual Registration of Health Carriers, Form B.

The Company is instructed to comply with RCW 48.31C.040 and WAC 284-18A-370 to properly disclose inter-company agreements annually or by reporting all material changes within fifteen (15) days after the end of the month when the material change occurred.

COMMENTS AND RECOMMENDATIONS

I. Business Continuity Plan

KPS has a formal, written business continuity plan (BCP) that addresses the continuation of all significant business activities, including financial functions, telecommunication services and data processing services, in the event of a disruption of normal business activities, as recommended by NAIC guidelines. However, the BCP has not been updated for two years and it has been three years since the last formal test of the BCP.

It is recommended that the Company review the business continuity plan on a regular basis, as necessary. Testing of the BCP should be performed annually, as recommended by NAIC guidelines.

2. Conflict of Interest Policy

KPS did not follow its Conflict of Interest Policy procedures in 2006. Our review indicates the following deficiencies:

- KPS provided only five completed Declaration of Conflict of Interest (DCI) forms for 2006, one from an officer, and four from key personnel. KPS' policy requires annual completion of this form by officers, directors and key employees. The Jurat page of the 2006 NAIC Annual Statement shows thirteen officers and board members.
- If an employee indicates a potential conflict exists on a DCI form, the employee must complete a Conflict of Interest Disclosure (CID) form. There was not adequate documentation to show that the KPS compliance officer had reviewed the completed CID forms. The compliance officer did sign and date the CID forms but failed to identify whether the potential conflict was approved or disapproved by a check mark provided on the form. Also, a comment section is on the form for providing a written explanation for approval or disapproval that was never utilized.

It is recommended that KPS follow its conflict of interest policy requiring officers, directors of the board, and employees to complete annual conflict of interest forms going forward. It is also recommended that the compliance officer document his/her review when a potential conflict is declared on a CID form.

COMPANY PROFILE

Company History

The Company was formed by the Kitsap County Medical-Dental Business Bureau. The Company was incorporated on June 8, 1948 as a Washington non-profit corporation under the name of Kitsap County Medical Service Bureau. It received a certificate of registration from the OIC as a Health Care Service Contractor in the same year. On May 13, 1960, the Articles of Incorporation were amended to change its name to Kitsap Physicians Service. The Company merged with several companies and changed its name to KPS Health Plans (KPS) in April of 1999.

- On May 19, 1965, KPS merged with Mason County Medical Service Corporation.
- On December 24, 1975, KPS merged with Jefferson County Medical Service Corporation.
- In May 1984, KPS purchased all of the outstanding stock of Kitsap Administrative Services, Inc., a data processing service corporation.

- In March 1994, Harrison Memorial Hospital and KPS formed Westsound Community Health Network (WCHN), a non-profit physician hospital organization. KPS had a 50% ownership of the subsidiary company. In 1998, KPS relinquished all ownership in WCHN.
- In April 1999, the Company changed its name to KPS Health Plans.

On August 2, 1999, pursuant to RCW 48.31 and RCW 48.99, KPS was placed into receivership for the purpose of rehabilitation by Order of the Thurston County Superior Court.

On October 1, 2005, KPS emerged from receivership. Group Health Cooperative contributed \$19 million and became the sole voting member of KPS.

Capitalization

Minimum capital requirements pursuant to RCW 48.44.037 are met with an examination adjusted \$18.5 million in net worth (capital and surplus) as of December 31, 2006.

Territory and Plan of Operation

The Company is registered as a health care service contractor in the state of Washington only. It is engaged in the following lines of business: Comprehensive (hospital and medical), Federal Employee Health Benefit Plan, and Medicare Supplement. In 2006, approximately 58% of the business came from the Comprehensive line, 39% from the Federal Employee Health Benefit Plan (FEHBP), and 3% from Medicare Supplement.

Growth of the Company

The following reflects the growth of the Company based on its filed NAIC Annual Statements for the years ending December 31:

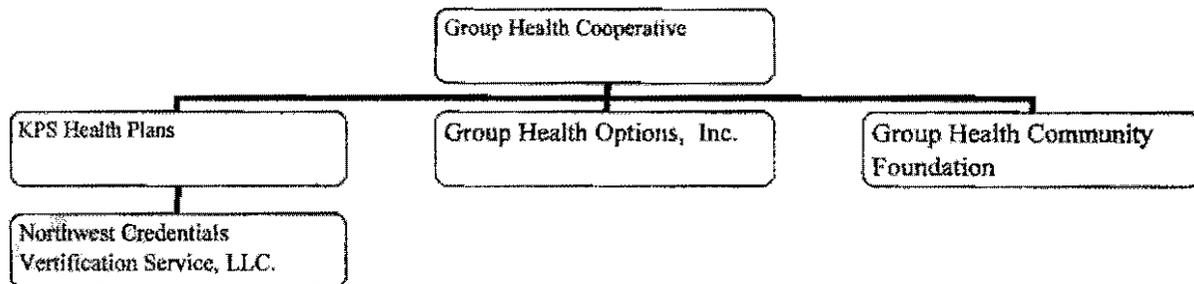
<u>Year</u>	<u>Admitted Assets</u>	<u>Liabilities</u>	<u>Capital & Surplus</u>	
2006	\$42,893,821	\$22,006,359	\$20,887,462	
2005	43,218,712	19,912,862	23,305,850	
2004	19,791,314	20,220,590	(429,276)	
2003	21,203,366	19,894,345	1,309,021	

<u>Year</u>	<u>Premium Earned</u>	<u>Net Underwriting Gain(Loss)</u>	<u>Net Investment Gain(Loss)</u>	<u>Net Income</u>
2006	\$ 137,973,060	\$ 4,008,950	\$ 2,709,276	\$ 4,714,625
2005	143,272,317	7,195,939	449,892	6,624,925
2004	151,994,679	(2,057,714)	742,369	(1,531,600)
2003	123,742,615	(245,971)	1,004,593	484,498

AFFILIATED COMPANIES

Organizational Chart

KPS is a wholly-owned subsidiary of Group Health Cooperative (GHC), a Washington domiciled not for profit company registered as a health maintenance organization. KPS owns 100% of Northwest Credentials, LLC., a non insurance affiliate that provides credentialing information on health providers. GHC owns 100% of the issued and outstanding stock of Group Health Options, Inc., a Washington domiciled for-profit health care service contractor. Group Health Community Foundation is registered in the state of Washington as a charitable gift annuity organization that carries out the purposes of GHC by securing, investing, and allocating charitable gifts that support the purposes of GHC.



Inter-company Agreements

Transfer Agreement

A transfer agreement was entered on July 15, 2005 between the OIC as Receiver of KPS Health Plans, in Rehabilitation and GHC. GHC agreed to contribute nineteen million dollars to KPS and became the sole voting member. The transfer was finalized on October 1, 2005.

Administrative Services Agreement

An administrative services agreement was entered between KPS and GHC, effective January 1, 2007. GHC is to provide administrative services to KPS in the area of legal services, risk management and insurance services, internal audit services, governance services, and financial services. The agreement shall remain in effect until written notice of termination. (See Instruction No. 6.)

Inter-company Services and Cost Allocation Agreement

A service and cost allocation agreement was entered between KPS and Northwest Credentials Verification Service, LLC (NCVS) effective January 18, 2004. KPS is to provide general administrative service to NCVS on cost basis. The agreement shall remain in effect until written notice of termination. (See Instruction No. 7.)

Inter-company Tax Sharing Agreement

Effective 2004, Northwest Credentials Verification Services, LLC agreed to join KPS Health Plans to file consolidated tax returns. The tax liabilities are computed on a separate tax return basis, and the agreement is in effect until written notice of termination. (See Instruction No. 7.)

MANAGEMENT AND CONTROLS

Ownership

GHC is the sole voting member of the Company since October 1, 2005.

Board of Directors (BOD)

The management of the Company is vested in a board of nine directors as provided for by its Bylaws. A majority of the directors constitutes a quorum for the transaction of business. The BOD delegates its management function to the following committees: Executive Committee, Audit Committee, Investment Committee, and Retirement Committee.

The following nine individuals were directors as of December 31, 2006:

Janet Ann Liang
Rick Dale Woods
Carl Douglas Cramer
Scott Elliott Armstrong
Jerry Franklin Campbell
Gordon Nicholas Cromwell Jr.
Maureen Patricia McLaughlin
Russell Barnes Voegtlen Jr.
David Owen Miller

Officers

The Company's Bylaws require that officers be appointed or elected by the BOD. Officers as of December 31, 2006 were:

Janet Ann Liang	Chair, Board of Directors, Vice President
Rick Dale Woods	Vice Chair, Board of Directors
Elizabeth Anne Gilje	President and Chief Executive Officer
Willis James Page Jr.	Treasurer
Judith Cristina Krisologo-Elliott	Secretary
David Michael Hennes	Medical Director

Conflict of Interest

KPS enforces its conflict of interest policy annually by a two step process. First, all officers, the BOD, and selected key employees are required to file Declaration of Conflict of Interest forms at the beginning of each year. If a person indicates they have engaged, or will engage in activities which might cause a conflict of interest either in fact or in appearance, the person is required to proceed to step two, completing a Conflict of Interest Disclosure form for each potential conflict

item. Those completed forms are to be returned to the KPS compliance officer for review and determination of conflict. (See Comments and Recommendation No. 2.)

Effective December 2007, the Company eliminated the two step process and adopted a comprehensive approach to enforce its conflict of interest policy. The new policy requires the BOD, officers and associates of KPS to file comprehensive disclosure statements annually.

Fidelity Bond and Other Insurance

The Company is a named insured under a fidelity crime coverage plan purchased by its parent, GHC. The coverage plan has a limit of \$10 million each line and retention of \$100,000 as of December 31, 2006. The coverage limit amount exceeds the NAIC recommended minimum coverage range of \$800,000 to \$900,000.

The Company is also protected under various other insurance policies. They are:

- Property and Business Interruption Policy
- Directors and Officers Liability Policy
- Fiduciary Liability Policy
- Kidnap, Ransom and Detention Policy
- Errors and Omissions Liability Policy

A review of the Company's insurance policies indicate insurance coverage has been purchased and is in force covering hazards to which the Company is exposed as of the examination date.

Officers', Employees', and Agents' Welfare and Pension Plans

Retirement Pension Plan

KPS offers a qualified defined benefit pension plan to employees who are at least 21 years of age and work a minimum of 1,000 hours per year. A consulting actuary evaluates the retirement plan annually. For 2006, the actuary expressed an opinion that the valuation reflects the true and correct assessment of the liabilities, funded status and cost requirements of the plan.

401(k) Savings Plan

KPS offers a 401(k) Savings Plan to eligible employees. Employees are eligible to participate in the savings plan after three months of employment and at least 21 years of age. Employees may voluntarily defer from 1% to 100% of their pre-tax salary to this plan, up to the published IRS annual maximum. KPS will match the employee's elective deferral at its discretion and the matching is vested immediately. In 2006, the Company incurred \$297,072 in expenses associated with the plan.

Executive Deferred Compensation Plan

KPS offers an unfunded deferred plan to provide supplemental retirement benefits for a select group of management or highly compensated employees within the meaning of Sections 201, 301 and 401 of the Employee Retirement Income Security Act of 1974 (ERISA). The participants may elect to defer 0% to 80% of their salary, and the Company may make discretionary contributions. In 2006, only one employee had elected to participate in the plan.

Physicians Deferred Compensation Plan – Fund A

Fund A was created on May 1, 1956 in order to establish a tax-deferred investment vehicle for participating physician providers. Contributions to Fund A were discontinued in 1968. As of December 31, 2006, the fund had a liability of \$7,403.

CORPORATE RECORDS

The Articles of Incorporation, Bylaws, Certificate of Registration, and minutes of the BOD and Committees were reviewed for the period under examination. All BOD meetings were conducted with a quorum present.

ACTUARIAL REVIEW

The OIC health actuary reviewed the Company's actuarial report, claims unpaid, and other claim liabilities as of December 31, 2006. The review included examining the Company's reserving philosophy and methodologies to determine the reasonableness of the claim liabilities, verifying that claim liabilities include provisions for all components noted in SSAP No. 55, paragraphs 7 and 8, reviewing historical paid claims and loss ratios, and checking the consistency of the incurred-paid data from the Company's system with the figures reported in the 2006 NAIC Annual Statement. The unpaid claims and claim adjustment expenses were determined to be insufficient as of December 31, 2006. (See Instruction Nos. 2 and 3.)

REINSURANCE

KPS participated in an excess risk reinsurance agreement with ReliaStar Life Insurance Company for losses incurred from July 1, 2006 through June 30, 2007 which were paid and reported by December 31, 2007 and submitted by January 31, 2008. The reinsurance agreement was found to be in compliance with Washington State reinsurance statutes. The reinsurer is authorized to do business in Washington State and is properly classified in Schedule F of the 2006 NAIC Annual Statement. In 2006, the Company did not have any losses exceeding the retention amount.

SPECIAL DEPOSITS

The OIC requires the filing of the Underwriting of Indemnity Calculation of Funded Reserve form pursuant to WAC 284-07-050(8). The calculation as of December 31, 2006, pursuant to WAC 284-44-330 and WAC 284-44-340, requires a minimum deposit of \$898,843.

To satisfy the funded reserve required, the Company has various securities with a total fair market value of \$1.4 million held in a special deposit account by its custodian, US Bank, pursuant to RCW 48.44.030. The deposits were confirmed to be held by the Company for the protection of its policyholders.

ACCOUNTING RECORDS AND INFORMATION SYSTEM

The Company maintains its accounting records on a Generally Accepted Accounting Principles (GAAP) basis and adjusts it to Statutory Accounting Practice (SAP) basis for NAIC Annual Statement reporting. The Company was audited by Ernst and Young, LLP for 2003 and 2004 and Deloitte and Touche, LLP for 2005 and 2006. The Company received unqualified opinions for all years under review. In the 2006 statutory report issued by Deloitte, and Touche, LLP, the prior year amount for the Special Reserve Fund liability was increased by \$1.431 million. This was a restatement of the ending balance for year 2005 to adjust for loss adjustment expenses and subrogation amounts for the FEHBP.

The management of KPS is sufficiently knowledgeable of the information system process. System development, acquisition, and maintenance controls were evaluated to gain assurance that appropriate internal controls are in place. Operations and application controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; back up and recovery facilities employed; and the internal controls exercised to maintain data security. We concluded that sufficient internal controls were in place and monitored by the Company, with the exception of the business continuity plan. (See Comments and Recommendations No. 1.)

SUBSEQUENT EVENTS

Effective July 13, 2007, Elizabeth Anne Gilje was replaced by Richard Topkins Marks as the President and Chief Executive Officer of the Company. Effective February 7, 2007, Janet Ann Liang was replaced by Rick Dale Woods as the Chair of the Board of Directors.

An Apportionment Plan was entered on June 26, 2007 between GHC and its subsidiaries including KPS, to allocate tax benefits in accordance with IRC 1561 and Treas. Reg. 1.1561-3T. The Plan will remain in effect with respect to all taxable years for which the Company remains a member of Group Health Cooperative.

In 2007, upon the OIC's approval, the Company paid surplus notes in the amount of \$1,065,770 to its member providers. The majority of the surplus notes were issued in 2000 to provide for additional net worth to the Company in order for the Company to maintain compliance with minimum net worth and risk-based capital requirements.

In 2007, the Company converted \$4.8 million non-admitted investment assets to admitted assets. The Company non-admitted \$4.8 million of investments in one institution over the 4% limit during 2006 in accordance with RCW 48.13.030 and 48.13.270(3).

FINANCIAL STATEMENTS

The following examination financial statements show the financial condition of the Company as of December 31, 2006:

Assets, Liabilities, Capital and Surplus

Statement of Revenue and Expenses

Four-Year Reconciliation of Surplus

Analysis of Changes in Financial Statements Resulting from the Examination

KPS Health Plans
Assets, Liabilities, Capital and Surplus
As of December 31, 2006

	<u>BALANCE</u> <u>PER COMPANY</u>	ref.	<u>EXAMINATION</u> <u>ADJUSTMENTS</u>	<u>BALANCE PER</u> <u>EXAMINATION</u>
Assets				
Bonds	\$11,284,966			\$11,284,966
Common stocks	4,027,070			4,027,070
Real estate:				
Properties occupied by the company	3,377,508			3,377,508
Cash and short-term investments	15,996,073	2	\$181,042	16,177,115
Other invested assets	496,410			496,410
Investment income due and accrued	345,971			345,971
Premiums and considerations:				
Uncollected premiums and agents' balances	5,234,765			5,234,765
Amounts receivable relating to uninsured plans	186,003	2	(181,042)	4,961
Current federal and foreign income tax recoverable	446,871			446,871
Net deferred tax asset	980,141			980,141
Electronic data processing equipment and software	174,314			174,314
Health care and other amounts receivable	253,006			253,006
Aggregate write-ins for other than invested assets:	90,723			90,723
Total Assets	\$42,893,821		\$0	\$42,893,821
Liabilities, Capital, and Surplus				
Claims unpaid	\$17,527,538	3	\$1,861,165	\$19,388,703
Unpaid claims adjustment expenses	248,103	4	508,923	757,026
Premiums received in advance	2,303,391			2,303,391
General expenses due or accrued	862,837			862,837
Amounts withheld or retained for the account of others	451,179			451,179
Amounts due to parent, subsidiaries and affiliates	431,370			431,370
Aggregate write-ins for other liabilities:	181,941			181,941
Total Liabilities	22,006,359		2,370,088	24,376,447
Gross paid in and contributed surplus	19,000,000			19,000,000
Surplus notes	1,081,384			1,081,384
Unassigned funds (surplus)	806,078	3,4	(2,370,088)	(1,564,010)
Total Capital and Surplus	20,887,462		(2,370,088)	18,517,374
Total Liabilities, Capital, and Surplus	\$42,893,821		\$0	\$42,893,821

KPS Health Plans
Statement of Revenue and Expenses
For the Year Ended December 31, 2006

	<u>BALANCE PER COMPANY</u>	<u>ref.</u>	<u>EXAMINATION ADJUSTMENTS</u>	<u>BALANCE PER EXAMINATION</u>
Member months	513,248			513,248
Net premium income	\$137,973,060			\$137,973,060
Total revenues	137,973,060		\$0	137,973,060
<u>Hospital and Medical:</u>				
Hospital/medical benefits	73,883,103	1,3	1,767,479	75,650,582
Other professional services	12,057,566			12,057,566
Outside referrals	4,353,276			4,353,276
Emergency room and out-of-area	5,225,740			5,225,740
Prescription drugs	18,415,914			18,415,914
Subtotal	113,935,599		1,767,479	115,703,078
Total hospital and medical	113,935,599	1,3	1,767,479	115,703,078
Claims adjustment expenses	6,213,406	1,4	602,609	6,816,015
General administrative expenses	13,815,105			13,815,105
Total underwriting deductions	133,964,110		2,370,088	136,334,198
Net underwriting gain or (loss)	4,008,950		(2,370,088)	1,638,862
Net investment income earned	2,133,126			2,133,126
Net realized capital gains or (losses)	576,150			576,150
Net investment gains or (losses)	2,709,276			2,709,276
Aggregate write-ins for other income or expenses	(357,553)			(357,553)
Net income or (loss) before FIT	6,360,673			3,990,585
Federal and foreign income taxes incurred	1,646,048			1,646,048
Net Income (Loss)	\$4,714,625		(\$2,370,088)	\$2,344,537
<u>CAPITAL AND SURPLUS ACCOUNT</u>				
Capital and surplus prior reporting period	\$23,305,850			\$23,305,850
Net Income (Loss) from above	4,714,625		(\$2,370,088)	2,344,537
Change in net unrealized capital gains and losses	49,052			49,052
Change in net deferred income tax	3,228			3,228
Change in nonadmitted assets	(3,170,779)			(3,170,779)
Change in surplus notes	(2,583,249)			(2,583,249)
Aggregate write-ins for gains or (losses) in surplus	(1,431,265)			(1,431,265)
Net change in capital and surplus	(2,418,388)		(2,370,088)	(4,788,476)
Capital and surplus end of reporting period	\$20,887,462		(\$2,370,088)	\$18,517,374

**KPS Health Plans
Four Year Reconciliation of Surplus
For the Years Ended December**

	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Capital and surplus, prior reporting year	<u>\$23,305,850</u>	<u>(\$429,276)</u>	<u>\$1,309,021</u>	<u>\$1,079,384</u>
Net income or (loss)	4,714,625	6,624,925	(1,531,600)	484,498
Change in valuation basis of aggregate policy and claim reserves				
Change in net unrealized capital gains and losses	49,052	704,745	71,202	(7,376)
Change in net unrealized foreign exchange capital gain or (loss)				
Change in net deferred income tax	3,228	(2,724,566)	607,229	187,980
Change in nonadmitted assets	(3,170,779)	2,659,298	(907,104)	(447,190)
Change in unauthorized reinsurance				
Change in treasury stock				
Change in surplus notes	(2,583,249)	(2,529,276)	21,976	11,725
Cumulative effect of changes in accounting principles				
Capital changes:				
Paid in		19,000,000		
Surplus adjustments:				
Paid in				
Dividends to stockholders				
Aggregate write-ins for gains or (losses) in surplus	(1,431,265)			
Examination adjustments	(2,370,088)			
Net change in capital and surplus	<u>(4,788,476)</u>	<u>23,735,126</u>	<u>(1,738,297)</u>	<u>229,637</u>
Capital and surplus, end of reporting period	<u>\$18,517,374</u>	<u>\$23,305,850</u>	<u>(\$429,276)</u>	<u>\$1,309,021</u>

KPS Health Plans
Analysis of Changes in Financial Statements Resulting from the Examination
For the Year Ended December 31, 2006

	<u>BALANCE PER</u> <u>COMPANY</u>	<u>BALANCE PER</u> <u>EXAMINATION</u>	<u>ref.</u>	<u>INCREASE</u> <u>(DECREASE)</u> <u>IN SURPLUS</u>	<u>TOTAL</u>
Capital and Surplus, December 31, 2006 Per Annual Statement					\$20,887,462
<u>ASSETS</u>					
Cash and short-term investments	\$15,996,073	\$16,177,115	2	\$181,042	
Amounts receivable relating to uninsured plans	\$186,003	\$4,961	2	(181,042)	
<u>LIABILITIES</u>					
Claims unpaid	17,527,538	19,388,703	3	1,861,165	
Unpaid claims adjustment expenses	248,103	757,026	4	508,923	
<u>CAPITAL AND SURPLUS</u>					
Unassigned funds (surplus)	806,078	(1,564,010)	3,4	(2,370,088)	
<u>STATEMENT OF REVENUE AND EXPENSES</u>					
Hospital/medical benefits	73,883,103	75,650,582	1,3	1,767,479	
Claims adjustment expenses	6,213,406	6,816,015	1,4	<u>602,609</u>	
Change in surplus					<u>(2,370,088)</u>
Capital and Surplus, December 31, 2006 Per Examination					<u><u>\$18,517,374</u></u>

NOTES TO THE FINANCIAL STATEMENTS

Special Consent Investment No. 87 was issued to KPS Health Plans on September 25, 1998, and will expire on December 31, 2008. The Company was granted the ability to acquire and hold its real estate investments in excess of ten percent of its admitted assets.

There were four examination report adjustments.

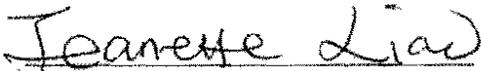
1. KPS misclassified fees paid to an outside vendor for claim recovery services as claim expenses, instead of claim adjustment expenses. An examination adjustment of \$93,686, debiting "Claims adjustment expenses", and crediting "Hospital/medical benefits", is reflected in the preceding financial statements. (See Instruction No. 1c.)
2. KPS erroneously recorded a receivable for unpaid claims related to an administrative service only (ASO) plan. An examination adjustment of \$181,042, debiting "Cash, cash equivalents, and short-term investments", and crediting "Amounts receivable relating to uninsured plans", is reflected in the preceding financial statements (See Instruction No. 1d.)
3. The OIC actuarial staff determined that KPS' estimate of claims unpaid was not within a reasonable range. An examination adjustment of \$1,861,165, debiting "Hospital/medical benefits", and crediting "Claims unpaid", is reflected in the preceding financial statements. (See Instruction No. 2.)
4. The OIC actuarial staff determined that KPS' estimate of unpaid claim adjustment expenses was not within a reasonable range. An examination adjustment of \$508,923, debiting "Claims adjustment expenses", and crediting "Unpaid claim adjustment expenses", is reflected in the preceding financial statements. (See Instruction No. 3.)

ACKNOWLEDGMENT

Acknowledgment is hereby made of the cooperation extended to the examiners by the officers and staff of KPS Health Plans during the course of this examination.

In addition to the undersigned, Michael V. Jordan, CPA, CFE, MHP, Assistant Chief Examiner; Carl M. Baker, CPA, CFE, CISA, Supervising Examiner; John R. Jacobson, AFE, CISA, AES, Automated Examination Specialist; Shiraz Jetha, FSA, FCIA, MAAA, Health Actuary; Lichiou Lee, ASA, MAAA, Health Actuary; Susan Campbell, CPA, CFE, Reinsurance Specialist; Timothy F. Hays, CPA, JD, Investment Specialist; Kathy Hicks, CPA, Financial Examiner; Tony Quach, Financial Examiner; Friday Enoye, Financial Examiner; all from the Washington State Office of the Insurance Commissioner, participated in the examination and the preparation of this report.

Respectfully submitted,



Jeanette Jiangtao Liao, CPA, CFE
Examiner-in-Charge
State of Washington

AFFIDAVIT

STATE OF WASHINGTON }
 } ss
COUNTY OF KING }

Jeanette Jiangtao Liao, being duly sworn, deposes and says that the foregoing report subscribed is true to the best of her knowledge and belief.

She attests that the examination of KPS Health Plans was performed in a manner consistent with the standards and procedures required or prescribed by the Washington State Office of the Insurance Commissioner and the National Association of Insurance Commissioners (NAIC).

Jeanette Liao
Jeanette Jiangtao Liao, CPA, CFE
Examiner-in-Charge
State of Washington

Subscribed and sworn to before me on this 11th day of August, 2008.

Colleen Jansen
Notary Public in and for the
State of Washington.

