Financial Results

CareFirst, Inc. and Affiliates
Consolidated Financial Statements and Other Financial Information
Years ended December 31, 2006 and 2005 with Report of Independent Auditors

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Report of Independent Auditors

Board of Directors of CareFirst, Inc.
Board of Directors of CareFirst of Maryland, Inc.
Board of Trustees of Group Hospitalization and Medical Services, Inc.

We have audited the accompanying consolidated balance sheets of CareFirst, Inc. and affiliates (collectively referred to as the Company) as of December 31, 2006 and 2005, and the related consolidated statements of operations, changes in reserves and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company at December 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

February 26, 2007

Ernst & Young LLP

CareFirst, Inc. and Affiliates
Consolidated Balance Sheets
(in thousands)

	December 31	
	2006	**2005**[1]
Assets		
Current assets:		
Cash and cash equivalents	**$ 187,099**	$ 231,236
Short-term investments	**59,522**	52,555
Advances to providers	**182,416**	176,986
Accounts receivable, less allowance for doubtful accounts of $16,619 and $12,389 as of December 31, 2006 and 2005, respectively	**451,863**	435,994
Interest income receivable	**13,453**	12,402
Current assets of discontinued operations	**–**	1,047
Other current assets	**655,908**	582,435
Deferred tax assets, net	**19,413**	20,446
Total current assets	**1,569,674**	1,513,101
Long-term investments	**1,647,646**	1,347,279
Property and equipment, net	**137,689**	136,749
Goodwill	**29,956**	29,956
Long-term assets of discontinued operations	**606**	1,940
Other assets	**78,461**	99,637
Total assets	**$ 3,464,032**	$ 3,128,662
Liabilities and reserves		
Current liabilities:		
Short-term borrowings	**$ 168,368**	$ 141,277
Medical claims payable	**519,779**	510,026
Accounts payable and accrued expenses	**323,530**	283,480
Unearned revenues	**766,981**	699,607
Group experience funds and advances	**197,552**	189,969
Note payable, current portion	**1,338**	1,206
Current liabilities of discontinued operations	**6,362**	10,010
Total current liabilities	**1,983,910**	1,835,575
Note payable, noncurrent	**1,613**	2,354
Deferred tax liabilities, net	**10,935**	19,044
Long-term employee benefit obligations	**76,138**	76,912
Long-term liabilities of discontinued operations	**5,065**	6,541
Other liabilities	**19,799**	5,879
Total liabilities	**2,097,460**	1,946,305
Minority interest	**–**	75
Reserves:		
Retained earnings	**1,318,410**	1,154,154
Accumulated other comprehensive income	**48,162**	28,128
Total reserves	**1,366,572**	1,182,282
Total liabilities and reserves	**$ 3,464,032**	$ 3,128,662

See accompanying notes.

[1] The 2005 balances reflected herein have been restated to exclude the accounts of BCBSD, Inc., which was removed from the consolidated reporting entity in 2006. See Notes 1 and 2 for discussion.

CareFirst, Inc. and Affiliates
Consolidated Statements of Operations
(in thousands)

	Year ended December 31	
	2006	**2005[1]**
Premiums earned	**$ 5,279,510**	$ 4,941,014
Amounts attributable to self-funded arrangements	**2,979,001**	2,740,356
Less amounts attributable to claims under self-funded arrangements	**(2,773,455)**	(2,538,216)
Other	**25,128**	25,788
Net revenue	**5,510,184**	5,168,942
Operating expenses:		
Cost of care	**4,515,832**	4,273,591
General and administrative	**862,071**	829,687
Total operating expenses	**5,377,903**	5,103,278
Income from operations	**132,281**	65,664
Investment income, net	**77,406**	79,659
Other than temporary impairment of investments	**(1,009)**	(4,024)
Minority interest	**74**	(74)
Other (loss) income, net	**(538)**	4,725
Income from continuing operations before provision for income taxes	**208,214**	145,950
Provision for income taxes	**43,738**	33,197
Income from continuing operations	**164,476**	112,753
Discontinued operations:		
(Loss) income from discontinued operations, net of applicable income tax (benefit) expense of $(226) and $1,980 for the years ended December 31, 2006 and 2005, respectively	**(220)**	5,750
Net income	**$ 164,256**	$ 118,503

See accompanying notes.

[1] The 2005 balances reflected herein have been restated to exclude the accounts of BCBSD, Inc., which was removed from the consolidated reporting entity in 2006. See Notes 1 and 2 for discussion.

CareFirst, Inc. and Affiliates
Consolidated Statements of Changes in Reserves
Years ended December 31, 2006 and 2005

(in thousands)

	Retained Earnings	Accumulated Other Comprehensive Income (Loss)		Total Reserves
		Unrealized Gains (Losses) on Securities, Net	Minimum Pension Liability	
Balance, as of December 31, 2004[1]	$ 1,035,651	$ 52,709	$ (1,976)	$ 1,086,384
Net income[1]	118,503	–	–	118,503
Other comprehensive income (loss), net of tax:[1]				
Change in net unrealized gains and losses on investments, net of reclassification adjustments	–	(22,522)	–	(22,522)
Minimum pension liability adjustment	–	–	(83)	(83)
Total comprehensive income				95,898
Balance, as of December 31, 2005[1]	1,154,154	30,187	(2,059)	1,182,282
Net income	**164,256**	**–**	**–**	**164,256**
Other comprehensive income (loss), net of tax:				
Change in net unrealized gains and losses on investments, net of reclassification adjustments	**–**	**22,243**	**–**	**22,243**
Minimum pension liability adjustment	**–**	**–**	**(2,209)**	**(2,209)**
Total comprehensive income				**184,290**
Balance, as of December 31, 2006	**$ 1,318,410**	**$ 52,430**	**$ (4,268)**	**$ 1,366,572**

See accompanying notes.

[1] The 2005 balances reflected herein have been restated to exclude the accounts of BCBSD, Inc., which was removed from the consolidated reporting entity in 2006. See Notes 1 and 2 for discussion.

CareFirst, Inc. and Affiliates
Consolidated Statements of Cash Flows
(in thousands)

	Year ended December 31	
	2006	**2005**[(1)]
Operating activities		
Net income	**$ 164,256**	$ 118,503
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**49,468**	49,040
Realized losses (gains) on investments, net	**2,986**	(19,891)
Gain on sale of real estate held for sale	**–**	(5,887)
Minority interest	**(74)**	74
Other than temporary impairment of investments	**1,009**	4,024
Benefit for deferred income taxes	**(7,911)**	(2,456)
Changes in operating assets and liabilities:		
Increase in advances to providers	**(5,430)**	(5,760)
Increase in accounts receivable, net	**(15,869)**	(49,348)
Increase in interest income receivable	**(1,051)**	(1,834)
Increase in other current assets	**(73,473)**	(5,950)
Decrease in other assets	**5,661**	2,459
Increase in medical claims payable	**9,753**	50,030
Increase in accounts payable and accrued expenses	**40,050**	9,330
Increase in unearned revenues	**67,374**	15,492
Increase in group experience funds and advances	**7,583**	9,362
Increase in other liabilities	**13,146**	14,302
Changes in net assets and liabilities of discontinued operations	**(2,743)**	4,285
Net cash provided by operating activities	**254,735**	185,775
Investing activities		
Purchases of investments	**(1,888,446)**	(2,582,195)
Proceeds from sales of investments	**1,597,500**	2,379,131
Purchases of property and equipment	**(50,408)**	(43,108)
Proceeds from sale of joint venture	**16,000**	–
Net cash used in investing activities	**(325,354)**	(246,172)
Financing activities		
Increase in short-term borrowings	**27,091**	23,364
Proceeds from issuance of stock to minority interest holder	**–**	1
Proceeds from long-term debt	**–**	4,109
Repayment on long-term debt	**(609)**	(549)
Net cash provided by financing activities	**26,482**	26,925
Net decrease in cash and cash equivalents	**(44,137)**	(33,472)
Cash and cash equivalents at beginning of year	**231,236**	264,708
Cash and cash equivalents at end of year	**$ 187,099**	$ 231,236
Supplemental disclosures		
Cash paid for income taxes	**$ 48,457**	$ 27,381

See accompanying notes.

[(1)] The 2005 balances reflected herein have been restated to exclude the accounts of BCBSD, Inc., which was removed from the consolidated reporting entity in 2006. See Notes 1 and 2 for discussion.

CareFirst, Inc. and Affiliates
Notes to Consolidated Financial Statements
December 31, 2006
(in thousands)

1. Organization

CareFirst, Inc. (CFI) and affiliates (collectively referred to as the Company) provide a comprehensive array of health insurance and managed care products and services primarily through indemnity health insurance, health maintenance organization (HMO) coverage and health benefits administration. Other products and services include preferred provider and point of service networks, fee-for-service arrangements, third-party administrator services and other managed care services. These products and services are provided to individuals, businesses and governmental agencies primarily in the State of Maryland and in the Washington, D.C. metropolitan area.

CFI was incorporated on January 16, 1998, to become the not-for-profit parent of CareFirst of Maryland, Inc. (CFMI) and Group Hospitalization and Medical Services, Inc. (GHMSI). These affiliates do business as CareFirst BlueCross BlueShield. CFMI and GHMSI also hold joint interests in a health maintenance organization subsidiary, CareFirst BlueChoice, Inc. (CFBC). On March 22, 2000, CFI also entered into a business affiliation with BCBSD, Inc. (BCBSD) whereby CFI maintained the sole membership interest in BCBSD. This business affiliation terminated on September 21, 2006 (see Note 2).

In 2004, in compliance with certain 2003 legislation in Maryland, CFI changed the structure and membership of the CFI Board of Directors. In response to the situation, which led to the governance changes of the CFI Board of Directors, the CFI and BCBSD Boards of Directors approved the restructuring of BCBSD's affiliation with CFI. Effective September 21, 2006, as a result of various legal and regulatory actions, CFI ceased to be the sole member of BCBSD, thus effecting the formal structural disaffiliation of BCBSD from CFI, GHMSI, CFMI and their related companies. Although a formal contractual relationship has not been established with BCBSD subsequent to the disaffiliation, such a relationship is being contemplated and administrative services continue to be provided to BCBSD on a fee-for-service basis.

In 2005, the CFI Board also approved certain proposed changes regarding the governance structure of CFI, CFMI and GHMSI. In 2006, all required regulatory and BlueCross BlueShield Association (BCBSA) approvals were obtained to permit the restructuring that creates parity between CFMI and GHMSI, as to their representation on CFI's Board. Management believes that these changes did not materially impact CFI's control over CFMI or GHMSI.

Certain business has been written by CFMI and GHMSI which represents contracts outside the historic CFMI and GHMSI service areas (cross-jurisdictional sales). In 2006, the Boards of CFI, CFMI and GHMSI approved redistribution of earnings between CFMI and GHMSI related to cross-jurisdictional sales. The underwriting gains and losses from this cross-jurisdictional business would be distributed from the company that earned them to the company in whose service area they were earned. Implementation of such earnings redistributions is pending regulatory approval.

Also in 2006, the Boards of CFI, CFMI and GHMSI approved earnings redistributions to evenly share changes in the statutory surplus which are a result of the net gain of CFBC effective January 1, 2005. Using this approach, cash transfers would be made between CFMI and GHMSI such that each company would record 50% of the CFBC surplus change. Implementation of such earnings redistribution is pending regulatory approval.

Effective January 1, 2005, a new subsidiary of GHMSI was created to operate the Federal Employee Program (FEP) Operations Center, which had previously been operated by GHMSI under a contract with BCBSA. The newly created subsidiary, Service Benefit Plan Administrative Services Corporation (SBP), is 90% owned by GHMSI and 10% owned by BCBSA (see Note 3).

2. Change in Reporting Entity

As stated in Note 1, CFI ceased to be the sole member of BCBSD on September 21, 2006. For accounting purposes, the disaffiliation of BCBSD from CFI and its affiliates has been treated as a change in reporting entity. Accordingly, all prior year amounts appearing in the accompanying consolidated balance sheets, statements of operations, changes in reserves and cash flows have been restated to exclude the accounts of BCBSD for all periods presented. No consideration was exchanged related to the disaffiliation of BCBSD.

The following tables present a summary of the impact of the change in reporting entity on amounts previously reported in CFI's consolidated financial statements:

	CFI & Affiliates, Including BCBSD[1]	BCBSD	CFI Excluding BCBSD
Total reserves at December 31, 2004	$ 1,236,241	$ 149,857	$ 1,086,384
Net income	132,780	14,277	118,503
Other comprehensive loss	(27,245)	(4,640)	(22,605)
Total reserves at December 31, 2005	$ 1,341,776	$ 159,494	$ 1,182,282

	Year ended December 31, 2005		
	CFI & Affiliates, Including BCBSD[1]	BCBSD	CFI Excluding BCBSD
Net revenues	$ 5,596,652	$ 427,710	$ 5,168,942
Income from continuing operations	127,030	14,277	112,753
Total assets[2]	3,421,067	292,405	3,128,662

[1] As previously reported.
[2] Amounts have been grossed-up for intercompany balances previously eliminated in consolidation.

3. Summary of Significant Accounting Policies

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of CFI and its affiliates: CFMI, GHMSI, and CFBC. All intercompany transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Reclassifications

Certain amounts from the prior year financial statements have been reclassified in order to conform to the current year presentation.

Fair Value of Financial Instruments

The carrying amounts of financial instruments, including cash and cash equivalents, advances to providers, accounts receivable, interest income receivable, other current assets, investments, short-term borrowings, medical claims payable, accounts payable and accrued expenses, unearned revenues, group experience funds and advances, and notes payable approximate fair value given the short-term nature of these financial instruments.

Cash and Cash Equivalents and Short-Term Borrowings

Cash and cash equivalents include amounts invested in accounts which are readily convertible to cash. Investments with contractual maturities of 90 days or less from the date of original purchase are classified as cash and cash equivalents. In accordance with the Company's cash management policy of maximizing the amount of funds invested in income-earning assets, the Company routinely anticipates the timing and amount of future cash flows. This policy frequently results in the existence of negative book cash balances, which are reflected as short-term borrowings in the accompanying consolidated financial statements.

Accounts Receivable

Accounts receivable primarily represent uncollected amounts earned from insured and self-funded groups. Provision is made for accounts considered uncollectible and/or potential adjustments, which arise as a result of review by management or a third party.

Advances to Providers

The Company has advances on deposit with certain regulated hospitals in the State of Maryland. These advances permit the Company to earn differentials of 2.25% and 2.00% of allowed inpatient and outpatient charges, respectively, by these hospitals.

Investments

Investment Securities

Investments consist primarily of U.S. Treasury and agency securities, corporate bonds, equity securities and mortgage-backed securities.

The Company has determined that its debt and equity securities are available-for-sale. Debt and equity securities are carried at estimated fair value based on quoted market prices for the same or similar instruments. The Company's policy is to classify all investments with contractual maturities within one year as current. Investment income is recognized when earned and reported net of investment expenses. Unrealized holding gains and losses are excluded from earnings and are reported as a separate component of accumulated other comprehensive income until realized, unless the losses are deemed to be other than temporary. Realized gains or losses, including any provision for other than temporary declines in value, are included in the consolidated statements of operations.

3. Summary of Significant Accounting Policies (continued)

Investments (continued)

The Company periodically evaluates whether any declines in the fair value of investments are other than temporary. This evaluation consists of a review of several factors, including but not limited to: length of time and extent that a security has been in an unrealized loss position; the existence of an event that would impair the issuer's future earnings potential; the near term prospects for recovery of the market value of a security; and the intent and ability of the Company to hold the security until the market value recovers. Declines in value below cost for debt securities where it is considered probable that all contractual terms of the security will be satisfied, the decline is due primarily to changes in interest rates (and not because of increased credit risk), and where the Company intends and has the ability to hold the investment for a period of time sufficient to allow a market recovery, are not assumed to be other than temporary.

Declines in fair value below cost that are deemed to be other than temporary are recorded as realized losses and are included in "other than temporary impairment of investments" in the accompanying consolidated statements of operations. Based on its evaluation, the Company has recorded an other than temporary impairment of investments of $1,009 and $4,024 for the years ended December 31, 2006 and 2005, respectively.

Securities Lending

The Company participates in securities lending transactions whereby the Company lends investments in exchange for collateral. Under the terms of its securities lending arrangements, the Company requires collateral, representing cash, government securities, or irrevocable bank letters of credit, of a value at least equal to 102% of the then fair value of the loaned investments and accrued interest, if any. The Company does not have the right to sell or repledge the collateral.

Property and Equipment

Property and equipment are recorded at cost and are depreciated using the straight-line method over useful lives ranging from three to five years for purchased computer equipment and software, three to five years for capitalized software, five to twelve years for furniture and equipment, and fifteen to forty years for buildings and building improvements. Leasehold improvements are amortized over the terms of the respective leases or over the estimated useful life of the improvements, if shorter than the lease term.

Certain costs related to the development or purchase of internal-use software are capitalized and amortized over the estimated useful life of the software. Computer software costs that are incurred in the preliminary project stage are expensed as incurred. Direct consulting costs, payroll and payroll-related costs for employees incurred during the development stage that are directly associated with each project are capitalized and amortized over the estimated useful life of the software once placed into operation.

Goodwill

Goodwill represents the excess of the cost of businesses acquired over the fair value of the net identifiable assets at the date of acquisition.

The Company follows Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*, and does not amortize goodwill. The Company has determined that it has five reporting units: third party administrative (TPA), HMO, indemnity risk, indemnity non-risk, and the FEP. All of the Company's goodwill has been allocated to the HMO reporting unit at December 31, 2006 and 2005. In accordance with SFAS No. 142, the Company completed its annual goodwill impairment evaluations at October 1, 2006 and 2005. These evaluations indicated that the estimated fair value of goodwill exceeded its carrying value and thus no impairment loss was recognized for the years ended December 31, 2006 or 2005. There were no changes in the carrying amount of goodwill of $29,956 during the years ended December 31, 2006 and 2005.

Other Assets

Other assets primarily include prepaid pension costs and cash surrender value of life insurance policies. In 2005, other assets included an investment in a real estate joint venture, which was accounted for under the equity method. This joint venture was sold in 2006.

3. Summary of Significant Accounting Policies (continued)

Note Payable

In connection with the creation of SBP on January 1, 2005, as discussed above, fixed assets previously owned by GHMSI and used by the FEP Operations Center were sold to SBP at their net book value as of January 1, 2005. The costs of these fixed assets, as well as future fixed assets purchased by SBP, are funded under a revolving credit agreement with BCBSA. The amount available under the line of credit is $15,000. The line of credit is due monthly and bears interest at variable rates. The balance outstanding under this line of credit was $2,951 and $3,560 as of December 31, 2006 and 2005, respectively.

Revenue Recognition

Premiums are recognized as earned on a monthly basis for the period the health care coverage is in effect. Unearned revenues represent prepayments of premiums for future health care coverage and FEP unearned premiums.

The Company provides coverage for certain groups whose contracts provide for payments based on group experience factors (experience rated contracts). Under these contracts, revenue is generally recorded on the basis of incurred claims, plus retention. In certain cases, maximum rates are established by contract, and losses can result if claims and retention exceed these maximum rates. Any such losses are recorded in the year incurred and may, in many cases, be recouped against subsequent years' gains.

The Company participates with other BlueCross and BlueShield plans in administering certain health care benefits of various accounts of the other plans. Administrative fees are generally recognized as earned and are recorded as a reduction of general and administrative expenses.

Certain claim payments, premium rates, administrative expense reimbursements and provider discounts are subject to review and potential retroactive adjustment by third parties. Reserves to reduce revenue are established for potential obligations arising from such reviews. Management believes that the resolution of these claims will not be materially different from amounts recorded in the accompanying consolidated financial statements.

Cost of Care and Medical Claims Payable

The Company negotiates contractual agreements with physicians and medical management groups to provide defined health care services to its members. All other physician and institutional services are provided by medical providers to whom the Company pays fees based upon fee schedules. Cost of care is recognized in the period in which members receive medical services. In addition to actual benefits paid, cost of care includes the impact of accruals for estimates of reported and unreported claims, which are unpaid as of the balance sheet date. The liability for medical claims payable, as discussed in more detail below, is computed in accordance with generally accepted actuarial practices and is based upon past claims payment experience, together with other current factors which, in management's judgment, require recognition in the calculation.

Each reporting period, the Company estimates its liability for medical care services that have been rendered on behalf of insured members but for which claims have either not been received or processed. The Company develops its estimates for medical care services incurred but not reported using an actuarial process that is consistently applied.

The actuarial models consider factors such as time from the dates of service to claims receipt, claims backlogs, seasonal variances in medical care consumption, provider rate changes, medical care utilization and other medical cost trends, membership volume and demographics and other factors. Depending on the health care provider and type of service, the typical billing lag for services can vary significantly. Substantially all claims related to medical care services are known and settled within nine to twelve months from the date of service.

The Company regularly re-examines its previously established medical claims payable estimates based on actual claim submissions and other changes in facts and circumstances. As the liability estimates recorded in prior periods become more exact, the Company increases or decreases the amounts of the estimates and includes the changes in estimates in cost of care in the period in which the changes are identified. If the revised estimate of prior period cost of care is less than the previous estimate, the Company decreases reported cost of care in the current period. Conversely, if the revised estimate of prior period cost of care is greater than the previous estimate, the Company increases reported cost of care in the current period. Due to the uncertainties inherent in the claims estimation process, it is at least reasonably possible that the actual claims paid could differ materially from the amounts accrued in the accompanying consolidated balance sheets.

3. Summary of Significant Accounting Policies (continued)

Income Taxes

The Company's provision for income taxes reflects the estimated current and future tax consequences of all events that have been recognized in the consolidated financial statements as measured by the provisions of currently enacted tax laws and rates applicable to future periods.

Comprehensive Income

Comprehensive income encompasses all changes in reserves and includes net income, net unrealized gains or losses on available-for-sale securities and minimum pension liability adjustments. Comprehensive income is net of reclassification adjustments to adjust for items currently included in net income, such as realized gains or losses on investment securities.

Federal Employee Program

The Company participates in the BlueCross and BlueShield FEP, which is one of the plans offered through the Federal Employee Health Benefits Program (FEHBP), administered by the Office of Personnel Management (OPM). Claims incurred on behalf of FEP are reimbursed by OPM and reported as revenues during the period in which the claims are incurred. The related administrative fees are recognized as revenues as they are earned during the contract period. BCBSA contracts directly with OPM to administer FEP and subcontracts with CFMI and GHMSI. BCBSA also provides information to the Company for inclusion in the accompanying consolidated financial statements. The BCBSA contract and the Company's subcontract are experience rated and could result in losses to the Company under certain circumstances. OPM conducts periodic audits to verify compliance with FEHBP requirements.

OPM holds certain reserves on behalf of the Company to provide funding, if necessary, for excess claims costs, subject to certain limitations. The Company records its allocable share of amounts held by OPM as an asset, with an equivalent amount recorded as unearned revenues. These amounts are $622,506 and $562,104 as of December 31, 2006 and 2005, respectively, and are included in other current assets and unearned revenues, respectively, in the accompanying consolidated balance sheets. Amounts incurred in excess of these reserves would not be reimbursed to the Company. The BCBSA contract renews automatically each year unless written notice of termination is given by either party.

FEP represented approximately 55% and 60% of accounts receivable as of December 31, 2006 and 2005, respectively. FEP represented approximately 37% of net revenue for the years ended December 31, 2006 and 2005.

FEP Operations Center

SBP performs certain administrative functions as the national operations center for FEP under its 10-year cost-reimbursement contract with BCBSA. The reimbursement of allocable costs under this contract is recorded as a reduction to general and administrative expenses. FEP reimbursed the Company for costs incurred in connection with this agreement totaling $72,505 and $68,309 for the years ended December 31, 2006 and 2005, respectively.

Effective January 1, 2005, a new subsidiary of GHMSI was created to operate the FEP Operations Center, which had previously been operated by GHMSI under a contract with BCBSA. The newly created subsidiary, SBP, is owned 90% by GHMSI and 10% by BCBSA. The arrangement contains automatic termination provisions upon the occurrence of certain triggering events. The creation of the new subsidiary did not have a significant impact on the accompanying consolidated financial statements.

Minority interest at December 31, 2006 and 2005 represents BCBSA's share of the equity of SBP. As of January 1, 2005, in connection with the formation of SBP, BCBSA contributed $1 for 10% of the common stock. The income (loss) attributable to the noncontrolling interest was $74 and $(74) for the years ended December 31, 2006 and 2005, respectively, and is included in minority interest in the accompanying consolidated statements of operations.

3. Summary of Significant Accounting Policies (continued)

Reimbursement of Medicare Claims Cost and Expenses

CFMI acted as a fiscal intermediary under contract with BCBSA for Part A of the Medicare program through September 30, 2005. On that date, CFMI terminated the contract. To date, the Federal Centers for Medicare and Medicaid Services (CMS) has reimbursed CFMI for most of the costs incurred by CFMI in connection with the termination. The Company expects CMS to reimburse most of the remaining costs. Any costs not expected to be reimbursed have been expensed in the accompanying consolidated statements of operations for the years ended December 31, 2006 and 2005.

Under this contract, CFMI processed claims of approximately $3,616,007 in the year ended December 31, 2005. Payment and reimbursement of Medicare claims are not included in the accompanying consolidated financial statements. No claims were processed during 2006, as the contract was terminated in 2005.

Administrative expense reimbursements related to the Medicare program were approximately $9,619 for the year ended December 31, 2005. No administrative expense reimbursements were recorded in 2006. Operating expenses in the accompanying consolidated statements of operations are recorded net of these reimbursements.

Medicare Part D Benefits

Effective January 1, 2006, FirstCare, Inc. (FirstCare), a wholly-owned subsidiary of CFS Health Group, Inc. (CFS), which in turn is a wholly-owned subsidiary of CFMI, began serving as a plan sponsor offering Medicare Part D prescription drug insurance coverage under a contract with CMS. Effective January 1, 2006, CFMI, GHMSI and BCBSD entered into a quota-share reinsurance contract with FirstCare. The agreement relates to all Medicare Part D insurance policies written by FirstCare for individuals living in CFMI's, GHMSI's and BCBSD's service areas. Under the terms of the agreement, CFMI, GHMSI and BCBSD assume all underwriting risk on the business written in their service areas. Therefore, all revenue and expenses related to the members covered by the quota-share reinsurance contract with respect to CFMI and GHMSI are included in the accompanying 2006 consolidated statement of operations.

Under the Medicare Part D program, there are six separate elements of payment received by FirstCare during the plan year. These payment elements are as follows:

- CMS Premium – CMS pays a fixed monthly premium per member to FirstCare for the entire plan year.
- Member Premium – Additionally, each member pays a fixed monthly premium to FirstCare for the entire plan year.
- Low-Income Premium Subsidy – For qualifying low-income members, CMS pays some portion or all of the member's monthly premiums to FirstCare on the member's behalf.
- Catastrophic Reinsurance Subsidy – CMS pays FirstCare a cost reimbursement estimate monthly to fund the CMS obligation to pay approximately 80% of the costs incurred by individual members in excess of the individual annual out-of-pocket maximum. A settlement is made based on actual cost experience subsequent to the end of the plan year.
- Low-Income Member Cost Sharing Subsidy – For qualifying low-income members, CMS pays on the member's behalf some portion or all of a member's cost sharing amounts, such as deductibles and coinsurance. The cost sharing subsidy is funded by CMS through monthly payments to FirstCare. FirstCare administers and pays the subsidized portion of the claims on behalf of CMS, and a settlement payment is made between CMS and FirstCare based on actual claims experience subsequent to the end of the plan year.
- CMS Risk Share – If the ultimate per member per month benefit costs of any Medicare Part D regional plan varies more than 2.5 percentage points above or below the level estimated in the original bid submitted by the plan and approved by CMS, there is a risk-share settlement with CMS that is settled subsequent to the end of the plan year. The risk-share adjustment, if any, is recorded as an adjustment to premiums earned and other receivables or liabilities.

3. Summary of Significant Accounting Policies (continued)

Medicare Part D Benefits (continued)

The CMS Premium, the Member Premium, and the Low-Income Premium Subsidy represent payments for FirstCare's insurance risk coverage under the Medicare Part D program and therefore are recorded as premiums earned in the accompanying consolidated financial statements. Premiums earned are recognized ratably over the period in which eligible individuals are entitled to receive prescription drug benefits. FirstCare records premium payments received in advance of the applicable service period as unearned revenues.

The Catastrophic Reinsurance Subsidy and the Low-Income Member Cost Sharing Subsidies represent cost reimbursements under the Medicare Part D program. The Company is fully reimbursed by CMS for costs incurred for these contract elements and, accordingly, there is no insurance risk to FirstCare. Amounts received for these subsidies are not reflected as premiums earned, but rather are accounted for as deposits, with the related liability recorded in the accompanying consolidated financial statements.

Additionally, at December 31, 2006, the Company estimates that no receivable or payable is due under the risk-sharing provisions with CMS.

Sale of Joint Venture Partnership/Leaseback of Building

Effective December 22, 2006, CFMI entered into a transaction in which CFMI sold its 50% share of a joint venture that owns the Company's Corporate Headquarters in Owings Mills, MD. In connection with the sale, the Company entered into a 12-year operating lease that is effective January 1, 2007. These transactions are accounted for as a sale-leaseback with no continuing involvement. The gain on the sale of the joint venture along with other deferred rent received of approximately $12,000 will be recognized ratably over the remaining lease term.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. SFAS No. 158 amends SFAS No. 87, SFAS No. 88, SFAS No. 106, and SFAS No. 132R and requires employers to recognize the funded status of defined benefit pension, retiree health, and other postretirement plans as an asset or a liability on the balance sheet. SFAS No. 158 is effective June 15, 2007 for not-for-profit companies and applies to those companies with fiscal years ending after June 15, 2007. Therefore, SFAS No. 158 will be effective for the Company for the fiscal year ending December 31, 2007. The adoption of SFAS No. 158 will result in a reduction of total reserves and other comprehensive income.

In June 2006, the FASB issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109* (FIN 48), which prescribes a minimum recognition threshold and measurement attribute methodology for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. FIN 48 is required to be adopted by the Company for the year ending December 31, 2007. The Company is still in the process of determining the impact of FIN 48 on its consolidated financial statements.

4. Discontinued Operations

Potomac Physicians, P.A.

During 2004, the Company determined that the Potomac Physicians, P.A. (PPPA) operations were no longer considered part of the Company's core business, and as a result, effective August 13, 2004, the Company terminated its affiliation with PPPA. The termination met the requirements for discontinued operations treatment under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, as PPPA meets the definition of a component of an entity.

The results of operations of PPPA, including the costs of discontinuance, included in discontinued operations, were $(226) and $2,616 at December 31, 2006 and 2005, respectively.

The 2005 results of operations for discontinued operations were positively impacted by gains recognized on investment real estate held for sale which was sold in July 2005. Benefit for income taxes in 2005 includes the impact of reversal of certain discontinued operations tax contingency reserves, based upon events occurring in 2005.

The major classes of assets and liabilities of discontinued operations related to PPPA as of December 31, 2006 and 2005, respectively, which are reflected in the accompanying consolidated balance sheets, are as follows:

	2006	2005
Other assets	**$ 606**	$ 1,119
Total assets	**606**	1,119
Reserves for discontinued operations	**(8,737)**	(10,532)
Net liabilities	**$ (8,131)**	$ (9,413)

Patuxent Medical Group

Effective November 1, 2004, the Company ceased operations of Patuxent Medical Group (PMG), a wholly-owned subsidiary. Similar to PPPA, PMG operations are no longer considered part of the Company's core business. This event met the requirements for discontinued operations treatment under SFAS No. 144, as PMG meets the definition of a component of an entity.

The results of operations of PMG, including the costs of discontinuance, included in discontinued operations, were $6 and $1,344 at December 31, 2006 and 2005, respectively.

The 2005 results of operations for discontinued operations were positively impacted by gains recognized on investment real estate held for sale which was sold in July 2005.

The major classes of assets and liabilities of discontinued operations related to PMG as of December 31, 2006 and 2005, which are reflected in the accompanying consolidated balance sheets are as follows:

	2006	2005
Cash and cash equivalents	$ –	$ 1,031
Other current assets	–	16
Other assets	–	821
Total assets	–	1,868
Reserves for discontinued operations	**(2,690)**	(6,019)
Net liabilities	**$ (2,690)**	$ (4,151)

5. Regulatory Matters

The Company is subject to regulation and supervision by regulatory authorities of the various jurisdictions in which CFI and its affiliates are licensed to conduct business. The authorities mandate, among other things, the maintenance of minimum statutory reserves and unassigned funds and prohibit certain transactions between the affiliates within the Company without prior regulatory approval. In addition, the Company must also comply with various conditions, restricting certain operations and financial transactions, that were contained in regulatory orders approving the affiliation of CFMI and GHMSI.

Financial statements filed by CFI and its affiliates with their respective state insurance regulators are prepared in accordance with statutory accounting practices prescribed or permitted by said regulators, which differ from GAAP. The most significant differences result from the exclusion of certain assets from statutory capital and surplus, recording subordinated notes payable as a component of reserves and unassigned funds for statutory accounting and as a liability for GAAP, differences in the carrying value of investments, valuation of investments in subsidiaries, treatment of subsidiary net income (loss) as an unrealized capital gain (loss), and the modification or exclusion of certain Statements of Financial Accounting Standards.

At December 31, 2006, the Company's regulated subsidiaries' statutory reserves and unassigned funds exceed the minimum statutory requirements as determined by each of the jurisdictions in which those subsidiaries conduct business.

6. Investments

The Company's investments consist of the following:

December 31, 2006	Amortized Cost Basis	Gross Unrealized Losses	Gross Unrealized Gains	Fair Value
Debt securities issued by the U.S. Treasury and other U.S. government agencies	**$ 366,899**	**$ 1,945**	**$ 732**	**$ 365,686**
Corporate debt securities	**422,309**	**3,032**	**13,349**	**432,626**
Equity securities	**230,686**	**856**	**66,765**	**296,595**
Mortgage-backed securities	**613,281**	**2,962**	**1,942**	**612,261**
Total investments	**$ 1,633,175**	**$ 8,795**	**$ 82,788**	**$ 1,707,168**

December 31, 2005	Amortized Cost Basis	Gross Unrealized Losses	Gross Unrealized Gains	Fair Value
Debt securities issued by the U.S. Treasury and other U.S. government agencies	$ 234,311	$ 2,201	$ 1,265	$ 233,375
Corporate debt securities	430,461	7,219	15,154	438,396
Equity securities	241,763	6,414	46,170	281,519
Mortgage-backed securities	451,755	7,019	1,808	446,544
Total investments	$ 1,358,290	$ 22,853	$ 64,397	$ 1,399,834

The amounts shown above as amortized cost basis include the effects of other than temporary impairments of investments previously recognized through net income.

The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other than temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2006 and December 31, 2005:

	Fair Value < 1 year	Unrealized Losses < 1 year	Fair Value > 1 year	Unrealized Losses > 1 year	Total Unrealized Losses
December 31, 2006					
Debt securities issued by the U.S. Treasury and other U.S. government agencies	**$ 250,678**	**$ 1,441**	**$ 38,273**	**$ 504**	**$ 1,945**
Corporate debt securities	**128,353**	**1,978**	**58,911**	**1,054**	**3,032**
Equity securities	**12,824**	**751**	**2,418**	**105**	**856**
Mortgage-backed securities	**363,879**	**1,956**	**78,703**	**1,006**	**2,962**
Total investments	**$ 755,734**	**$ 6,126**	**$ 178,305**	**$ 2,669**	**$ 8,795**
December 31, 2005					
Debt securities issued by the U.S. Treasury and other U.S. government agencies	$ 126,010	$ 950	$ 40,378	$ 1,251	$ 2,201
Corporate debt securities	198,861	5,432	23,867	1,787	7,219
Equity securities	50,250	5,134	8,484	1,280	6,414
Mortgage-backed securities	317,086	4,754	46,838	2,265	7,019
Total investments	$ 692,207	$ 16,270	$ 119,567	$ 6,583	$ 22,853

The unrealized losses on the Company's investments in debt securities issued by the U.S. Treasury and other U.S. government agencies, corporate debt securities and mortgage-backed securities were caused primarily by interest rate increases. Because the decline in market value is primarily attributable to changes in interest rates and not credit quality, and because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other than temporarily impaired at December 31, 2006 and 2005.

6. Investments (continued)

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

	Amortized Cost Basis	Fair Value
Within 1 year	$ 59,487	$ 59,530
After 1 year through 5 years	235,857	235,147
After 5 years through 10 years	227,019	227,522
After 10 years	266,845	276,113
Mortgage-backed securities	613,281	612,261
Total	$ 1,402,489	$ 1,410,573

Available-for-sale securities were sold as follows:

	Year ended December 31	
	2006	**2005**
Proceeds from sales	**$ 1,597,500**	$ 2,379,131
Gross realized gains	**26,632**	38,555
Gross realized losses	**29,618**	18,664

For purposes of computing realized gains and losses, the specific-identification method of determining cost was used.

7. Property and Equipment

Property and equipment are comprised of the following:

	December 31	
	2006	**2005**
Leasehold improvements	**$ 33,549**	$ 30,080
Purchased computer equipment and software	**63,407**	66,632
Capitalized software	**233,863**	213,541
Furniture and equipment	**54,350**	53,753
	385,169	364,006
Less accumulated depreciation and amortization	**247,480**	227,257
Property and equipment, net	**$ 137,689**	$ 136,749

Depreciation and amortization expense on property and equipment was $49,468 and $49,040 for the years ended December 31, 2006 and 2005, respectively, and is included as a component of general and administrative expenses in the accompanying consolidated statements of operations.

8. Medical Claims Payable

Activity in the liability accounts for medical claims is summarized as follows:

	2006	**2005**
Balance as of January 1	**$ 510,026**	$ 459,996
Incurred related to:		
Current year	**4,590,613**	4,327,688
Prior years	**(74,781)**	(54,097)
Total incurred	**4,515,832**	4,273,591
Paid related to:		
Current year	**4,078,224**	3,830,132
Prior years	**427,855**	393,429
Total paid	**4,506,079**	4,223,561
Balance at December 31	**$ 519,779**	$ 510,026

Changes in the estimates associated with medical claims payable are recorded prospectively as changes in claims payment patterns, membership and utilization trends are identified and quantified.

For the years ended December 31, 2006 and 2005, approximately $(28,743) and $(812), respectively, of the incurred amount related to prior years was a result of changes in estimates for FEP contracts. These changes were offset by similar changes in revenue and thus, no significant change in income from operations arose as a result of these changes.

The Company accrues estimated claims processing expenses relating to the liability for unpaid claims. These accruals totaled $18,431 and $18,335 as of December 31, 2006 and 2005, respectively, and are included in accounts payable and accrued expenses in the accompanying consolidated balance sheets.

9. Lease Commitments

The Company leases certain administrative and medical facilities, including its corporate offices, and equipment under operating leases. Some of these lease agreements contain escalation clauses for increases in real estate taxes and operating costs over base year amounts. These leases expire on various dates with renewal options available on many of the leases.

Future noncancelable minimum payments for leases are as follows:

2007	$ 32,477
2008	29,704
2009	27,631
2010	24,892
2011	20,682
Thereafter	82,211
	$ 217,597

Rent expense for the years ended December 31, 2006 and 2005 for all operating leases was $39,089 and $40,161, respectively, and has been included within general and administrative expenses in the accompanying consolidated statements of operations.

10. Pension Benefits

Prior to December 31, 2002, CFMI and GHMSI maintained qualified noncontributory defined benefit retirement plans covering substantially all full-time employees. Effective December 31, 2002, these plans merged to become the CareFirst, Inc. Retirement Plan. Although the Company merged the CFMI and GHMSI plans, it has committed to maintain separate recordkeeping of plan assets and benefit obligations so that it will comply with certain regulatory restrictions that apply to CFMI and GHMSI. Consistent with the standards for multiple-employer plan accounting, CFMI and GHMSI have accounted for their net pension obligation as if the plans had remained separate.

During 2005, in connection with the creation of SBP (see Note 1), a separate qualified noncontributory defined benefit retirement plan was established covering substantially all full-time SBP employees. The transfer of assets and liabilities between the plans for those employees previously in the GHMSI plan are reflected in the tables below as "transfer to SBP plan."

The annual contributions are not less than the minimum funding standards set forth in the Employee Retirement Income Security Act of 1974, as amended. The plans provide for eligible employees to receive benefits based principally on years of service with the Company and a percentage of certain compensation prior to normal retirement.

10. Pension Benefits (continued)

The following tables set forth the Company's plans' obligations, funded status, amounts recognized in the accompanying consolidated financial statements as of December 31:

	2006		
	CFMI	GHMSI	SBP
Accumulated benefit obligation	$ 185,510	$ 223,833	$ 31,160
Change in projected benefit obligation			
Benefit obligation at beginning of year	$ 199,806	$ 231,350	$ 30,542
Service cost	10,378	5,801	1,454
Interest cost	11,437	13,010	1,856
Actuarial gain	(19,094)	(15,136)	(1,209)
Benefits paid	(15,013)	(9,668)	(1,182)
Benefit obligation at end of year	$ 187,514	$ 225,357	$ 31,461

	2006		
	CFMI	GHMSI	SBP
Change in plan assets of the qualified pension plans			
Fair value of plan assets at beginning of year	$ 183,826	$ 228,933	$ 29,544
Actual return on plan assets	22,667	29,314	3,625
Employer contributions	500	1,510	–
Benefits paid	(15,013)	(9,668)	(1,182)
Fair value of plan assets at end of year	$ 191,980	$ 250,089	$ 31,987
Funded status	$ 4,466	$ 24,732	$ 526
Unrecognized actuarial loss	31,428	10,121	802
Unrecognized prior service asset	(6,001)	(8,434)	(1,280)
Prepaid pension asset (included as a component of other assets)	$ 29,893	$ 26,419	$ 48
Amounts recognized in the consolidated balance sheet consist of:			
Prepaid pension asset (included as a component of other assets)	$ 29,893	$ 26,419	$ 48
Components of net periodic benefit cost (credit) for the year ended December 31, are as follows			
Service cost	$ 10,378	$ 5,801	$ 1,454
Interest cost	11,437	13,010	1,856
Expected return on plan assets	(14,642)	(18,355)	(2,361)
Amortization of prior service asset	(1,497)	(1,608)	(244)
Net recognized actuarial loss	4,539	1,485	299
Net periodic benefit cost	$ 10,215	$ 333	$ 1,004
Weighted-average assumptions to determine benefit obligations:			
Discount rate – benefit obligation	5.75%	5.75%	5.75%
Discount rate – net benefit cost	5.75%	5.75%	5.75%
Expected return on plan assets	8.50%	8.50%	8.50%
Rate of compensation increase	4.50%	4.50%	4.50%

10. Pension Benefits (continued)

	2005		
	CFMI	GHMSI	SBP
Accumulated benefit obligation	$ 173,460	$ 219,347	$ 27,348
Change in projected benefit obligation			
Benefit obligation at beginning of year	$ 209,533	$ 254,352	$ –
Service cost	10,416	5,723	1,347
Interest cost	11,472	12,623	1,834
Actuarial (gain) loss	(6,243)	1,121	64
Plan settlement	(23,437)	–	(3,744)
Transfer to SBP plan	–	(31,343)	31,343
Benefits paid	(1,935)	(11,126)	(302)
Benefit obligation at end of year	$ 199,806	$ 231,350	$ 30,542
Change in plan assets of the qualified pension plans			
Fair value of plan assets at beginning of year	$ 189,424	$ 252,130	$ –
Actual return on plan assets	7,994	15,917	1,442
Employer contributions	11,780	2,140	2,020
Plan settlement	(23,437)	–	(3,744)
Transfer to SBP plan	–	(30,128)	30,128
Benefits paid	(1,935)	(11,126)	(302)
Fair value of plan assets at end of year	$ 183,826	$ 228,933	$ 29,544
Funded status	$ (15,980)	$ (2,417)	$ (998)
Unrecognized actuarial loss	63,086	37,700	3,572
Unrecognized prior service asset	(7,498)	(10,042)	(1,524)
Prepaid pension asset (included as a component of other assets)	$ 39,608	$ 25,241	$ 1,050
Amounts recognized in the consolidated balance sheet consist of:			
Prepaid pension asset (included as a component of other assets)	$ 39,608	$ 25,241	$ 1,050

	2005		
	CFMI	GHMSI	SBP
Components of net periodic benefit cost (credit) for the year ended December 31, are as follows			
Service cost	$ 10,416	$ 5,723	$ 1,347
Interest cost	11,472	12,623	1,834
Expected return on plan assets	(14,860)	(18,228)	(2,416)
Amortization of prior service asset	(1,521)	(1,608)	(244)
Net recognized actuarial loss	4,960	1,036	158
Plan settlement	7,400	–	438
Net periodic benefit cost (credit)	$ 17,867	$ (454)	$ 1,117
Weighted-average assumptions to determine benefit obligations:			
Discount rate – benefit obligation	5.75%	5.75%	5.75%
Discount rate – net benefit cost	5.75%	5.75%	5.75%
Expected return on plan assets	8.50%	8.50%	8.50%
Rate of compensation increase	4.50%	4.50%	4.50%

As a result of the discontinuance of PMG and PPPA operations as described above in Note 4, as well as the reduction in overall Company staff levels, CFMI's and SBP's lump-sum pension distributions during 2005 surpassed the settlement threshold equal to the sum of service cost and interest cost, requiring settlement recognition for all cash settlements in 2005. The Company recorded a $7,838 settlement charge in 2005 of which $1,883 is included in discontinued operations in the accompanying consolidated statement of operations.

10. Pension Benefits (continued)

The expected long-term rate of return for the plan's total assets is based on the expected return of each of the investment categories, weighted based on the median of the target allocation for each class. Equity securities are expected to return 8% to 12% over the long term, while cash and fixed income securities are expected to return between 4% and 6%. Based on historical experience, the CareFirst, Inc. Retirement Committee expects that the Plan's asset managers will provide a modest (0.5% – 1.0% per annum) premium to their respective market benchmark indices.

The Company's investment policy, as established by the CareFirst, Inc. Retirement Committee, is to provide for growth of capital with a moderate level of volatility by investing assets per the target allocations stated below. The assets are reallocated as needed to meet the target allocations. The investment policy is reviewed on a quarterly basis, under the advisement of a certified investment advisor, to determine if the policy should be changed. The pension plan weighted-average asset allocations by asset category are as follows:

	Target Allocation	CFMI	GHMSI	SBP
December 31, 2006				
Domestic equity securities	**46%-58%**	**52%**	**51%**	**52%**
International equity securities	**10%-16%**	**15**	**15**	**15**
Debt securities	**32%-38%**	**31**	**32**	**31**
Cash and cash equivalents	**Residual**	**2**	**2**	**2**
Total		**100%**	**100%**	**100%**
December 31, 2005				
Domestic equity securities	46%-58%	51%	54%	54%
International equity securities	10%-16%	15	15	15
Debt securities	32%-38%	30	30	28
Cash and cash equivalents	Residual	4	1	3
Total		100%	100%	100%

The Company expects to make contributions of $12,197 to the CFMI plan, $30 to the GHMSI plan, and $0 to the SBP plan during 2007.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid for the years ending December 31:

	CFMI	GHMSI	SBP
2007	$ 25,356	$ 13,938	$ 2,310
2008	14,192	15,301	3,149
2009	19,883	17,296	3,336
2010	20,004	17,618	3,318
2011	18,505	18,821	3,432
2012 through 2016	124,193	106,875	18,997
Total	$ 222,133	$ 189,849	$ 34,542

10. Pension Benefits (continued)

The Company also has nonqualified supplemental retirement benefit plans covering certain officers, which provide for eligible employees to receive additional benefits based principally on compensation and years of service. These plans provide for incremental benefit payments from the Company's funds so that total benefit payments equal amounts that would have been payable from the Company's principal retirement plan if it were not for limitations imposed by income tax regulations. As of December 31, 2006 and 2005, CFMI has accrued $33,303 and $26,052, respectively, GHMSI has accrued $3,483 and $2,766, respectively, and SBP has accrued $16 and $12, respectively for these benefits. Supplemental retirement benefit plan expense for the years ended December 31, 2006 and 2005 for CFMI was $5,696 and $3,953, respectively, for GHMSI was $494 and $417, respectively, and for SBP was $4 and $1, respectively.

For financial reporting purposes under SFAS No. 87, *Employers' Accounting for Pensions*, a pension plan is considered underfunded when the fair value of plan assets is less than the accumulated benefit obligation. When that is the case, an additional pension liability must be recognized for the difference between the accrued pension cost and the minimum liability which represents the amount of the unfunded accumulated benefit obligation. In recognizing such a liability, an intangible asset may also be recorded up to the amount of the prior service cost not yet recognized. When the liability is greater than the intangible asset limit, a charge is recorded to accumulated other comprehensive income for the excess amount, net of any tax effects.

As of December 31, 2006 and 2005, an additional minimum pension liability of $6,780 and $4,297, respectively, was recognized for CFMI's supplemental retirement plans. In accordance with SFAS No. 87, as of December 31, 2006 and 2005, an intangible asset of $1,446 and $1,723, respectively, was also recorded.

In addition, the Company sponsors 401(k) plans for the benefit of all eligible employees. The Company contributes to certain of these plans and recognized expenses for the years ended December 31, 2006 and 2005 of $4,926 and $5,259, respectively.

11. Postretirement Benefits

The Company provides certain health care benefits for retired employees. Substantially all employees become eligible for those benefits if they have at least ten years of service, are at least age 55, and have the Company's medical benefit coverage at the time of termination or retirement. The Company's postretirement benefit programs provide for a specific credit amount, which may be used to purchase health insurance upon retirement. The credit amount is based upon the retiree's age and years of service with the Company.

In accordance with SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* the Company records the expected cost of these benefits as expense during the years that employees render service.

During 2005, in connection with the creation of SBP (see Note 1), the Company established a Voluntary Employee Beneficiary Association (VEBA), a tax-exempt trust to fund certain healthcare benefits for eligible SBP employees. Contributions to the VEBA during 2006 and 2005 were $948 and $909, respectively.

With the exception of the VEBA described above, the Company funds postretirement benefits as benefits are paid. The following tables show the funded status of the postretirement plans and the amounts recognized in the accompanying consolidated financial statements as of December 31:

	2006		
	CFMI	**GHMSI**	**SBP**
Change in benefit obligation			
Benefit obligation at beginning of year	**$ 37,631**	**$ 23,676**	**$ 3,148**
Service cost	**1,438**	**768**	**143**
Interest cost	**2,397**	**1,443**	**191**
Actuarial loss	**5,748**	**2,168**	**190**
Benefits paid	**(3,065)**	**(1,289)**	**(45)**
Benefit obligation at end of year	**$ 44,149**	**$ 26,766**	**$ 3,627**
Change in plan assets			
Fair value of plan assets at beginning of year	**$ –**	**$ –**	**$ 909**
Actual return on plan assets	**–**	**–**	**89**
Employer contributions	**–**	**–**	**948**
Benefits paid	**–**	**–**	**–**
Fair value of plan assets at end of year	**$ –**	**$ –**	**$ 1,946**

11. Postretirement Benefits (continued)

	2006		
	CFMI	**GHMSI**	**SBP**
Funded status	**$ (44,149)**	**$ (26,766)**	**$ (1,681)**
Unrecognized transition liability	**–**	**3,312**	**222**
Unrecognized actuarial loss	**12,503**	**1,805**	**465**
Unrecognized prior service (asset) cost	**(81)**	**239**	**–**
Net amount recognized – accrued benefit cost	**$ (31,727)**	**$ (21,410)**	**$ (994)**
Components of net periodic benefit cost for the year ended December 31, are as follows			
Service cost	**$ 1,438**	**$ 768**	**$ 143**
Interest cost	**2,397**	**1,443**	**191**
Amortization of transition liability	**–**	**552**	**37**
Expected rate of return plan assets	**–**	**–**	**(40)**
Amortization of prior service (asset) cost	**(206)**	**40**	**–**
Recognized actuarial loss	**839**	**–**	**27**
Net periodic benefit cost	**$ 4,468**	**$ 2,803**	**$ 358**

	2005		
	CFMI	**GHMSI**	**SBP**
Change in benefit obligation			
Benefit obligation at beginning of year	$ 42,733	$ 25,586	$ –
Service cost	1,433	749	129
Interest cost	2,022	1,270	165
Actuarial (gain) loss	(6,047)	(384)	49
Benefits paid	(2,510)	(740)	–
Transfer to SBP	–	(2,805)	2,805
Benefit obligation at end of year	$ 37,631	$ 23,676	$ 3,148
Change in plan assets			
Fair value of plan assets at beginning of year	$ –	$ –	$ –
Actual return on plan assets	–	–	–
Employer contributions	–	–	909
Benefits paid	–	–	–
Fair value of plan assets at end of year	$ –	$ –	$ 909

	2005		
	CFMI	**GHMSI**	**SBP**
Funded status	$ (37,631)	$ (23,676)	$ (2,239)
Unrecognized transition liability	–	3,864	259
Unrecognized actuarial (gain) loss	7,593	(362)	395
Unrecognized prior service (asset) cost	(287)	278	–
Net amount recognized – accrued benefit cost	$ (30,325)	$ (19,896)	$ (1,585)
Components of net periodic benefit cost for the year ended December 31, are as follows			
Service cost	$ 1,433	$ 749	$ 129
Interest cost	2,022	1,270	165
Amortization of transition liability	–	552	37
Amortization of prior service (asset) cost	(207)	40	–
Recognized actuarial loss	360	–	15
Net periodic benefit cost	$ 3,608	$ 2,611	$ 346

For measurement purposes, a 5.75% discount rate was assumed for the years ended December 31, 2006 and 2005. A 6.0% annual rate of increase in the per capita cost of covered health care benefits was also assumed for the years ended December 31, 2006 and 2005.

11. Postretirement Benefits (continued)

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid for the years ending December 31:

	CFMI	GHMSI	SBP
2007	$ 2,842	$ 1,201	$ 80
2008	2,944	1,299	118
2009	3,029	1,449	162
2010	3,137	1,593	199
2011	3,257	1,751	231
2012 through 2016	18,152	11,116	1,650
Total	$ 33,361	$ 18,409	$ 2,440

12. Income and Other Taxes

The Company files a consolidated federal income tax return. For federal taxes, the Company benefits from a special deduction available to certain BlueCross plans under Internal Revenue Code Section 833(b) (the 833(b) deduction). Due to the 833(b) deduction, the Company has effectively incurred federal taxes at Alternative Minimum Tax (AMT) rates. The Company could lose the benefit of the 833(b) deduction in the future if CFMI and/or GHMSI cease to be not-for-profit, if CFMI's and/or GHMSI's reserves reach certain levels, or if certain other events occur. The statutory AMT rate was 20% during 2006 and 2005. If the Company would lose the benefit of the 833(b) deduction in the future, the Company would be subject to federal income taxes at the regular statutory rate of 35%. In such situation, the Company would have available certain regular net operating loss carryforwards and/or AMT credits.

CFMI is exempt from Maryland state income tax under Title 10, Subtitle 1, Section 10-104(2) of the Maryland Code and is governed by Title 14, Subtitle 1, Section 14-102 of the Maryland Insurance Code. GHMSI is exempt from all income taxes in the District of Columbia, Maryland and Virginia. Subsidiary operations are subject to the applicable state or District of Columbia income taxes.

In January 2005, the Maryland General Assembly passed new legislation which imposed a premium tax on managed care organizations at 2% of earned premiums. Effective January 1, 2005, this premium tax replaced the existing Maryland state income tax requirements for CFBC prior to the legislation. The Maryland state premium tax incurred by the Company under the new legislation during 2006 and 2005 was approximately $22,001 and $20,276, respectively, and is included as a component of general and administrative expenses in the accompanying consolidated statements of operations. CFBC continues to be subject to state income taxes in Virginia and Washington D.C. relative to the portion of its income which is apportioned to those jurisdictions.

Provision for income taxes includes deferred income taxes resulting primarily from temporary differences between the tax basis of assets and liabilities and their reported amounts in the consolidated financial statements. The principal sources of temporary differences include nondeductible accruals, accounts receivable, property and equipment and medical claims payable. As of December 31, 2006 and 2005, the Company had deferred tax assets of $42,358 and $33,833, respectively, and deferred tax liabilities of $33,880 and $32,431, respectively. Management has determined, based on the Company's long-term history of operating earnings and its expectations for the future, that income of the Company will more likely than not be sufficient to realize fully any net recorded deferred tax assets.

12. Income and Other Taxes (continued)

The provision for income taxes attributable to income from continuing operations consists of the following components:

	Year ended December 31	
	2006	**2005**
Current:		
Federal	**$ 48,491**	$ 35,340
State	**3,158**	313
	51,649	35,653
Deferred:		
Federal	**(7,841)**	(4,834)
State	**(70)**	2,378
	(7,911)	(2,456)
Provision for income taxes	**$ 43,738**	$ 33,197

13. Other Comprehensive Income

The components of other comprehensive income, including the reconciliation of net unrealized holding gains and losses to net unrealized holding gains and losses, net of reclassification adjustments and taxes, are as follows:

	Before-Tax Amount	Tax (Expense) Benefit	Net-of-Tax Amount
Year ended December 31, 2006			
Net unrealized gains and losses arising during the period	**$ 24,128**	**$ (5,045)**	**$ 19,083**
Less reclassification adjustments for net gains and losses realized or recognized in net income	**(3,994)**	**834**	**(3,160)**
Net unrealized gains and losses	**28,122**	**(5,879)**	**22,243**
Minimum pension liability adjustment	**(2,760)**	**551**	**(2,209)**
Total other comprehensive income (loss)	**$ 25,362**	**$ (5,328)**	**$ 20,034**

	Before-Tax Amount	Tax (Expense) Benefit	Net-of-Tax Amount
Year ended December 31, 2005			
Net unrealized gains and losses arising during the period	$(12,059)	$ 2,410	$ (9,649)
Less reclassification adjustments for net gains and losses realized or recognized in net income	16,274	(3,401)	12,873
Net unrealized gains and losses	(28,333)	5,811	(22,522)
Minimum pension liability adjustment	(104)	21	(83)
Total other comprehensive income (loss)	$(28,437)	$ 5,832	$ (22,605)

14. Commitments and Contingencies

The health care and health insurance industries are subject to numerous laws and regulations of federal, state and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government health care program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by health care insurers and providers. Violations of these laws and regulations could result in expulsion from government health care programs, together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Management believes that the Company is in compliance with fraud and abuse, as well as other applicable government laws and regulations. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time.

During 2003, a federal grand jury subpoena was served on CFI, its subsidiaries and affiliates, requesting information and documentation pertaining to the attempted conversion and sale of those companies to a third party. The subpoena covers the time period from January 1, 1998 to August 1, 2003. The companies have produced the documents specified in the subpoena and provided them to the U.S. Attorneys Office in Baltimore.

Beginning in 1999, a series of class action lawsuits were filed against virtually all major entities in the health benefits business, including BCBSA and the BCBSA licensees. The suits allege that over a course of years the defendants have conspired to use criteria and standards for adjudication of provider claims that result in underpayment of provider claims. They allege that the defendants have been involved in a conspiracy to make false representations to providers and to conceal material information from providers about the manner in which claims are adjudicated. The plaintiffs assert that the alleged misconduct violates the Racketeer Influenced and Corrupt Organizations Act (RICO). Plaintiffs seek treble damages and injunctive relief under RICO. The Company intends to vigorously defend these proceedings; however, it is possible that a settlement could be reached on this matter. Various other lawsuits, including class action lawsuits and other claims, occur in the normal course of business and are pending against the Company. The Company records accruals for such matters when a loss is deemed to be probable and estimable. Management, after consultation with legal counsel, is of the opinion that the lawsuits and other claims, when resolved, will not have a material adverse effect on the accompanying consolidated financial statements; however, there can be no assurance in this regard.

CFI and its affiliates have employment contracts and other benefit arrangements with certain executives which contain provisions that could trigger the acceleration of certain benefits and/or payment of additional compensation. Such acceleration occurs upon termination of employment without cause or for “good reason” as defined in the contract. Additional acceleration occurs if said termination occurs “in connection with a change of control.” Potential incremental payments related to sums owed for a termination in connection with a change of control have not been accrued as of December 31, 2006 or 2005, as management believes that the relevant triggering events have not occurred.

Effective November 2, 2006, the contract of the President and Chief Executive Officer of CFI, CFMI and GHMSI was terminated by mutual agreement with the Boards of those various entities. The amount to be paid in severance, pension and other payments resulting from his separation has been recognized in the accompanying consolidated financial statements. Payment of these obligations may be subject to review and approval by the Maryland Insurance Administration and District of Columbia Department of Insurance, Securities and Banking.

In the jurisdictions in which the Company is licensed to conduct business, associations have been created for the purpose, among others, of protecting insured parties under health insurance policies. The Company is contingently liable for assessments in any calendar year, in order to provide any required funds to carry out the power and duties of the associations.

The Company operates under licensing agreements with BCBSA, whereby the Company uses the service marks of BCBSA in the course of its business. The Company files periodic reports with BCBSA.

14. Commitments and Contingencies (continued)

CFMI and GHMSI entered into an intercompany agreement that requires CFMI or GHMSI, or their respective subsidiaries, to provide the financial resources necessary to satisfy the respective statutory or regulatory reserve requirement, subject to specific limitations, if either CFMI or GHMSI or their respective subsidiaries fail to meet or maintain their respective statutory or regulatory reserve requirement as required by law, or if such transfer of financial resources is needed to satisfy any other legally enforceable obligation.

The agreement also provides that certain functions may be performed by CFMI or GHMSI or their respective subsidiaries on behalf of another party to this agreement. Any costs incurred by one party in this agreement are reimbursed to the party performing those functions.

The Company's professional liability coverage is on a claims-made basis. Should the claims-made policy not be renewed or replaced with equivalent insurance, claims based on occurrences during its term, but reported subsequently, will be uninsured. The claims-made policy has been renewed through November 1, 2007. In connection with ceasing operations of PMG and PPPA (the medical groups) as discussed in Note 4, the Company purchased an extended reporting period (ERP) endorsement to ensure that claims made against physicians that were employed by the Company are insured. This ERP for the medical malpractice program covers the period November 2, 2004 through November 1, 2009. Reserves have been established to cover estimated exposure related to this program not covered by the ERP.

The Company has a commitment for a credit facility with a commercial bank under which certain of its affiliates may borrow up to a maximum amount of $60,000. There have been no draws made on this line of credit during 2006 or 2005.

Report of Independent Auditors on Other Financial Information

Board of Directors of CareFirst, Inc.
Board of Directors of CareFirst of Maryland, Inc.
Board of Trustees of Group Hospitalization and Medical Services, Inc.

Our audit was conducted for the purpose of forming an opinion on the December 31, 2006 consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis and is not a required part of the December 31, 2006 consolidated financial statements. Such information has been subjected to the auditing procedures applied in our audit of the December 31, 2006 consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the December 31, 2006 consolidated financial statements taken as a whole.

February 26, 2007

Ernst & Young LLP

CareFirst, Inc. and Affiliates
Consolidating Balance Sheet
December 31, 2006

(in thousands)

	CareFirst, Inc.	CareFirst of Maryland, Inc. and Subsidiaries	Group Hospitalization Hospitalization and Medical Services, Inc. and Subsidiaries	CareFirst BlueChoice, Inc. and Subsidiaries	Eliminations	Consolidated
Assets						
Current assets:						
Cash and cash equivalents	$ 401	$ 83,146	$ 68,501	$ 35,051	$ –	$ 187,099
Short-term investments	–	17,404	30,572	11,546	–	59,522
Advances to providers	–	124,198	24,924	33,294	–	182,416
Accounts receivable, net	–	155,718	258,559	38,730	(1,144)	451,863
Due from affiliates, net	–	7,495	–	2,897	(10,392)	–
Interest income receivable	3	4,085	6,031	3,334	–	13,453
Other current assets	–	162,962	492,145	801	–	655,908
Deferred tax assets, net	–	9,086	6,774	3,553	–	19,413
Total current assets	404	564,094	887,506	129,206	(11,536)	1,569,674
Long-term investments	124	498,990	759,572	388,960	–	1,647,646
Property and equipment, net	–	69,594	68,095	–	–	137,689
Investment in affiliates	–	205,630	137,087	–	(342,717)	–
Goodwill	–	12,710	–	17,246	–	29,956
Long-term assets of discontinued operations	–	606	–	–	–	606
Other assets	–	45,176	33,165	120	–	78,461
Deferred tax assets, net	–	4,285	–	–	(4,285)	–
Total assets	$ 528	$ 1,401,085	$ 1,885,425	$ 535,532	$ (358,538)	$ 3,464,032
Liabilities and reserves						
Current liabilities:						
Short-term borrowings	$ –	$ 96,355	$ 70,294	$1,719	$ –	$ 168,368
Medical claims payable	–	134,138	265,192	120,449	–	519,779
Due to affiliates, net	529	–	9,863	–	(10,392)	–
Accounts payable and accrued expenses	–	171,645	126,609	26,420	(1,144)	323,530
Unearned revenues	–	186,191	540,045	40,745	–	766,981
Group experience funds and advances	–	130,784	66,383	385	–	197,552
Note payable, current portion	–	–	1,338	–	–	1,338
Current liabilities of discontinued operations	–	6,362	–	–	–	6,362
Total current liabilities	529	725,475	1,079,724	189,718	(11,536)	1,983,910
Note payable, noncurrent	–	–	1,613	–	–	1,613
Deferred taxes liabilities, net	–	–	12,123	3,097	(4,285)	10,935
Long-term employee benefit obligations	–	51,540	24,598	–	–	76,138
Long-term liabilities of discontinued operations	–	5,065	–	–	–	5,065
Other liabilities	–	12,002	7,797	–	–	19,799
Total liabilities	529	794,082	1,125,855	192,815	(15,821)	2,097,460
Reserves:						
Retained earnings	–	588,012	730,398	332,911	(332,911)	1,318,410
Accumulated other comprehensive income (loss)	(1)	18,991	29,172	9,806	(9,806)	48,162
Total reserves	(1)	607,003	759,570	342,717	(342,717)	1,366,572
Total liabilities and reserves	$ 528	$ 1,401,085	$ 1,885,425	$ 535,532	$ (358,538)	$ 3,464,032

CareFirst, Inc. and Affiliates
Consolidating Statement of Operations
December 31, 2006

(in thousands)

	CareFirst, Inc.	CareFirst of Maryland, Inc. and Subsidiaries	Group Hospitalization Hospitalization and Medical Services, Inc. and Subsidiaries	CareFirst BlueChoice, Inc. and Subsidiaries	Eliminations	Consolidated
Premiums earned	$ –	$ 1,399,483	$ 2,460,228	$ 1,420,706	$ (907)	$ 5,279,510
Amounts attributable to self-funded arrangements	–	2,093,085	885,916	–	–	2,979,001
Less amounts attributable to claims under self-funded arrangements	–	(1,949,967)	(823,488)	–	–	(2,773,455)
Other	182	12,074	12,872	–	–	25,128
Net revenue	182	1,554,675	2,535,528	1,420,706	(907)	5,510,184
Operating expenses:						
Cost of care	–	1,208,459	2,176,566	1,131,714	(907)	4,515,832
General and administrative	173	331,303	309,917	220,678	–	862,071
Total operating expenses	173	1,539,762	2,486,483	1,352,392	(907)	5,377,903
Income from operations	9	14,913	49,045	68,314	–	132,281
Investment income, net	(9)	23,441	35,501	18,473	–	77,406
Other than temporary impairment of investments	–	(523)	(243)	(243)	–	(1,009)
Equity in gain of affiliate	–	39,807	26,538	–	(66,345)	–
Minority interest	–	–	74	–	–	74
Other (loss) income, net	–	566	(1,317)	213	–	(538)
Income from continuing operations before provision for income taxes	–	78,204	109,598	86,757	(66,345)	208,214
Provision for income taxes	–	5,930	17,396	20,412	–	43,738
Income from continuing operations	–	72,274	92,202	66,345	(66,345)	164,476
Discontinued operations:						
Loss from discontinued operations, net of applicable income tax benefit of $(226)	–	(220)	–	–	–	(220)
Net income	$ –	$ 72,054	$ 92,202	$ 66,345	$ (66,345)	$ 164,256