

CONSOLIDATED FINANCIAL STATEMENTS AND OTHER  
FINANCIAL INFORMATION

CareFirst, Inc. and Affiliates  
Years Ended December 31, 2007 and 2006  
With Report of Independent Auditors

CareFirst, Inc. and Affiliates

Consolidated Financial Statements  
and Other Financial Information

Years Ended December 31, 2007 and 2006

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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, 2007 and 2006, 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, 2007 and 2006, 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.

As discussed in Note 2 to the financial statements, in 2007 the Company adopted Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*.



February 27, 2008

CareFirst, Inc. and Affiliates  
Consolidated Balance Sheets

*(in thousands)*

	<b>December 31</b>	
	<b>2007</b>	<b>2006</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 197,849	\$ 185,081
Short-term investments	38,840	59,522
Advances to providers	195,740	182,416
Accounts receivable, less allowance for doubtful accounts of \$15,470 and \$16,619 as of December 31, 2007 and 2006, respectively	505,730	463,424
Interest income receivable	14,508	13,453
Other current assets	537,511	675,623
Deferred tax assets, net	20,444	19,413
Total current assets	1,510,622	1,598,932
Long-term investments	1,734,424	1,647,646
Property and equipment, net	170,576	137,689
Goodwill	29,956	29,956
Other assets	37,197	70,762
Total assets	\$ 3,482,775	\$ 3,484,985
<b>Liabilities and reserves</b>		
Current liabilities:		
Short-term borrowings	\$ 168,198	\$ 164,981
Medical claims payable	543,236	521,419
Accounts payable and accrued expenses	284,566	326,627
Unearned revenues	156,218	133,011
CMS program advances	5,375	9,824
Group experience funds and advances	683,352	845,003
Note payable, current portion	787	1,338
Total current liabilities	1,841,732	2,002,203
Note payable, noncurrent	834	1,613
Deferred tax liabilities, net	3,851	10,329
Long-term employee benefit obligations	98,844	74,586
Other liabilities	32,670	29,681
Total liabilities	1,977,931	2,118,412
Reserves:		
Retained earnings	1,498,867	1,318,410
Accumulated other comprehensive income	5,977	48,163
Total reserves	1,504,844	1,366,573
Total liabilities and reserves	\$ 3,482,775	\$ 3,484,985

*See accompanying notes*

CareFirst, Inc. and Affiliates

Consolidated Statements of Operations

(in thousands)

	<b>Year Ended December 31</b>	
	<b>2007</b>	<b>2006</b>
Premiums earned	<b>\$ 5,861,269</b>	\$ 5,281,150
Amounts attributable to self-funded arrangements	<b>3,110,533</b>	2,979,001
Less amounts attributable to claims under self-funded arrangements	<b>(2,898,554)</b>	(2,773,455)
Other	<b>25,383</b>	25,206
Net revenue	<b>6,098,631</b>	5,511,902
Operating expenses:		
Cost of care	<b>5,022,133</b>	4,499,868
General and administrative	<b>936,394</b>	879,675
Total operating expenses	<b>5,958,527</b>	5,379,543
Income from operations	<b>140,104</b>	132,359
Investment income, net	<b>101,709</b>	77,449
Other than temporary impairment of investments	<b>(10,604)</b>	(1,009)
Other income (loss), net	<b>1,375</b>	(579)
Income before provision for income taxes	<b>232,584</b>	208,220
Provision for income taxes	<b>52,127</b>	43,964
Net income	<b>\$ 180,457</b>	\$ 164,256

See accompanying notes.

CareFirst, Inc. and Affiliates

Consolidated Statements of Changes in Reserves

Years Ended December 31, 2007 and 2006  
(in thousands)

	<b>Accumulated Other Comprehensive Income (Loss)</b>				<b>Total Reserves</b>
	<b>Retained Earnings</b>	<b>Unrealized Gains on Securities, Net</b>	<b>Minimum Pension Liability</b>	<b>Adjustment to Recognize the Funded Status of Pension and OPEB Plans</b>	
Balance, as of January 1, 2006	\$ 1,154,154	\$ 30,189	\$ (2,059)	\$ —	\$ 1,182,284
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	—	22,242	—	—	22,242
Minimum pension liability adjustment	—	—	(2,209)	—	(2,209)
Total comprehensive income					<u>184,289</u>
Balance, as of December 31, 2006	1,318,410	52,431	(4,268)	—	1,366,573
Net income	<b>180,457</b>	—	—	—	<b>180,457</b>
Other comprehensive income (loss), net of tax:					
Change in net unrealized gains and losses on investments, net of reclassification adjustments	—	<b>1,289</b>	—	—	<b>1,289</b>
Minimum pension liability adjustment	—	—	<b>734</b>	—	<b>734</b>
Total comprehensive income					<u>182,480</u>
Adjustment to recognize the adoption of SFAS 158, net of tax	—	—	<b>3,534</b>	<b>(47,743)</b>	<b>(44,209)</b>
Balance, as of December 31, 2007	<b>\$ 1,498,867</b>	<b>\$ 53,720</b>	<b>\$ —</b>	<b>\$ (47,743)</b>	<b>\$ 1,504,844</b>

See accompanying notes.

# CareFirst, Inc. and Affiliates

## Consolidated Statements of Cash Flows

(in thousands)

	<b>Year Ended December 31</b>	
	<b>2007</b>	<b>2006</b>
<b>Operating activities</b>		
Net income	\$ 180,457	\$ 164,256
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	43,746	49,468
Realized (gains) losses on investments, net	(14,602)	2,986
Other than temporary impairment of investments	10,604	1,009
Provision (benefit) for deferred income taxes	3,738	(6,538)
Changes in operating assets and liabilities:		
Increase in advances to providers	(13,324)	(5,430)
Increase in accounts receivable, net	(54,289)	(13,490)
Increase in interest income receivable	(1,055)	(1,051)
Decrease (increase) in other current assets	138,112	(75,704)
(Increase) decrease in other assets	(5,660)	6,995
Increase in medical claims payable	21,817	11,393
(Decrease) increase in accounts payable and accrued expenses	(42,061)	33,137
Increase (decrease) in unearned revenues	23,207	(13,306)
(Decrease) increase in group experience funds and advances	(166,100)	87,844
Increase in other liabilities	11,140	14,861
Net cash provided by operating activities	<u>135,730</u>	<u>256,430</u>
<b>Investing activities</b>		
Purchases of investments	(2,530,734)	(1,888,772)
Proceeds from sales and maturities of investments	2,470,535	1,597,500
Purchases of property and equipment, net	(76,633)	(50,408)
Proceeds from sale of joint venture	11,983	16,000
Net cash used in investing activities	<u>(124,849)</u>	<u>(325,680)</u>
<b>Financing activities</b>		
Increase in short-term borrowings	3,217	23,704
Repayment on long-term debt	(1,330)	(609)
Net cash provided by financing activities	<u>1,887</u>	<u>23,095</u>
Net increase (decrease) in cash and cash equivalents	12,768	(46,155)
Cash and cash equivalents at beginning of year	185,081	231,236
Cash and cash equivalents at end of year	<u>\$ 197,849</u>	<u>\$ 185,081</u>
<b>Supplemental disclosures</b>		
Cash paid for income taxes	<u>\$ 60,927</u>	<u>\$ 48,457</u>

See accompanying notes.

# CareFirst, Inc. and Affiliates

## Notes to Consolidated Financial Statements

December 31, 2007

*(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. For accounting purposes, the disaffiliation of BCBSD from CFI and its affiliates was treated as 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 do not include the accounts of BCBSD for all periods presented. No consideration was exchanged related to the disaffiliation of BCBSD.

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. A formal contractual relationship was established with BCBSD subsequent to the disaffiliation, whereby 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.

# CareFirst, Inc. and Affiliates

## Notes to Consolidated Financial Statements (continued)

*(in thousands)*

### **1. Organization (continued)**

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 redistribution 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 of CFBC effective January 1, 2005. The Company is currently considering several options to obtain this result. Implementation of such earnings redistribution would require 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 the BCBSA. The newly created subsidiary, Service Benefit Plan Administrative Services Corporation (SBP), is 90% owned by GHMSI and 10% owned by BCBSA (see Note 2).

On November 1, 2004, CFBC completed its acquisition of The Dental Network, Inc. and TDN Administrative Services, LLC (collectively, TDN) which market and administer managed dental benefits. The purchase price and related acquisition costs of \$5,000 exceeded the estimated fair value of identifiable net assets by \$4,551. Under the purchase method of accounting, CFBC assigned this amount to goodwill. Effective June 20, 2007, The Dental Network, Inc. merged into CFBC. Effective September 20, 2007, CFBC formed a new subsidiary called The Dental Network, Inc. to meet the regulatory requirements of selling free standing dental products in the state of Maryland. As of December 31, 2007, The Dental Network, Inc. is still in the process of obtaining a license to sell insurance products in the state of Maryland from the Maryland Insurance Administration.

### **2. 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.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### **2. Summary of Significant Accounting Policies (continued)**

##### **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, accounts payable and accrued expenses, unearned revenues, CMS program advances, 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 discounts of 2.25% and 2.00% of allowed inpatient and outpatient charges, respectively, by these hospitals.

# CareFirst, Inc. and Affiliates

## Notes to Consolidated Financial Statements (continued)

*(in thousands)*

### **2. Summary of Significant Accounting Policies (continued)**

#### **Investments**

##### *Investment Securities*

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

The fair value of the foreign common stocks is translated at the end-of-period exchange rates. Realized gains and losses are translated at the exchange rate on the trade date of each transaction. Dividend income is recognized and translated at the exchange rates on the ex-dividend dates. Unrealized holding gains and losses from the change in foreign exchange rates are aggregated with the market gains and losses and are included in the change in net unrealized gains and losses on investments, a component of accumulated other comprehensive income in the accompanying consolidated statements of changes in reserves.

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.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### **2. Summary of Significant Accounting Policies (continued)**

##### **Investments (continued)**

###### *Investment Securities (continued)*

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 \$10,604 and \$1,009 for the years ended December 31, 2007 and 2006, 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; therefore, the collateral is not recorded in the consolidated balance sheets. The amount of securities on loan under the securities lending program was \$265,037 and \$237,320 at December 31, 2007 and 2006, respectively.

##### **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, and five to twelve years for furniture and equipment. Leasehold improvements are amortized over the terms of the respective leases or over the estimated useful lives 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.

# CareFirst, Inc. and Affiliates

## Notes to Consolidated Financial Statements (continued)

(in thousands)

### 2. Summary of Significant Accounting Policies (continued)

#### 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 nonrisk, and the FEP. All of the Company's goodwill has been allocated to the HMO reporting unit at December 31, 2007 and 2006. In accordance with SFAS No. 142, the Company completed its annual goodwill impairment evaluations at October 1, 2007 and 2006. 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, 2007 or 2006. There were no changes in the carrying amount of goodwill of \$29,956 during the years ended December 31, 2007 and 2006.

#### Other Assets

Other assets primarily consist of prepaid expenses, including prepaid pension assets, the cash surrender value of life insurance policies, and amounts due from the Office of Personnel Management (OPM) under the FEP contracts. See *Federal Employee Program* and *Federal Employee Program – HMO* sections of Note 2.

#### 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 \$1,621 and \$2,951 as of December 31, 2007 and 2006, 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.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### **2. Summary of Significant Accounting Policies (continued)**

##### **Revenue Recognition (continued)**

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 dates. 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.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### **2. Summary of Significant Accounting Policies (continued)**

##### **Cost of Care and Medical Claims Payable (continued)**

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. 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.

##### **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 CFMI and GHMSI participate in the Federal Employee Health Benefits Program (FEHBP) with other BlueCross BlueShield plans. This program includes an experience-rated contract between the Office of Personnel Management (OPM) and the BCBSA, which acts as an agent for the participating BlueCross BlueShield plans. In addition, each participating plan, including CFMI and GHMSI, executes a contract with BCBSA which obligates each participating plan to underwrite FEP benefits in its service area. Premium rates are developed by BCBSA and approved by OPM annually. These rates determine the funds that will be available to the

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### **2. Summary of Significant Accounting Policies (continued)**

##### **Federal Employee Program (continued)**

participating BlueCross BlueShield plans to provide insurance to Federal employees that enroll with the BlueCross BlueShield FEHBP Plan. The excess of gross premiums for the life of the program over the charges for the life of the program on an accrual basis is considered the special reserve under the contract between OPM and BCBSA. Each year, OPM also allocates additional funds to a contingency reserve which may be utilized by the participating plans in the event that funds set aside from annual premiums are insufficient or fall below certain prescribed levels by OPM. Funds available to each participating BlueCross BlueShield plan, including the special reserve and the contingency reserve, are held at the U.S. Treasury, including amounts unused from prior periods. Any funds which remain unused upon termination of the BCBSA contract, after the claims run-out and reimbursement of allowable administrative expenses, would be returned to OPM for the benefit of the FEHBP. The BCBSA contract renews automatically each year unless written notice of termination is given by either party.

In accordance with the contract, OPM holds the unused funds on behalf of CFMI and GHMSI to provide funding for claims, administrative expenses, and other charges to the contract. CFMI and GHMSI, along with other BlueCross BlueShield plans who participate in the FEHBP contract, have an unrestricted right to draw funds being held in the special reserve for any valid claim or expense. The unaudited amounts being held in the special reserve are \$2,244,911 and \$3,725,834, as of December 31, 2007 and 2006, respectively. The unaudited amounts being held in the contingency reserve are \$6,013,846 as of September 30, 2007 and \$5,454,869 as of December 31, 2006. If the balance of the special reserve is exhausted or falls below certain prescribed levels, OPM will transfer funds from the contingency reserve to the special reserve. Amounts incurred in excess of the total reserves held at the U.S. Treasury for the FEHBP would not be reimbursed to CFMI or GHMSI.

Based upon formulas developed by BCBSA, CFMI and GHMSI have recorded their allocable share of the special reserve being held by OPM as an asset, with an equivalent amount recorded as a rate stabilization reserve. These amounts are \$474,118 and \$622,506 as of December 31, 2007 and 2006, respectively, and are included in other current assets and group experience funds and advances, respectively, in the accompanying consolidated balance sheets.

FEP represented approximately 57% and 58% of consolidated accounts receivable as of December 31, 2007 and 2006. FEP represented approximately 37% of consolidated net revenue for the years ended December 31, 2007 and 2006, respectively.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### **2. Summary of Significant Accounting Policies (continued)**

##### **Federal Employee Program – HMO**

CFBC has an experience-rated HMO contract with the OPM to provide managed health care services under the Federal Employee Health Benefits Program (FEHBP). OPM conducts periodic audits to verify compliance with FEHBP requirements.

The excess of gross premiums for the life of the program over the charges for the life of the program on an accrual basis is considered the special reserve under the contract between OPM and CFBC. Each year, OPM also allocates additional funds to a contingency reserve, which may be utilized by CFBC in the event that funds set aside from annual premiums are insufficient or fall below certain prescribed levels. OPM funds available to CFBC are held at the U.S. Treasury, including amounts unused from prior periods. Any funds which remain unused upon termination of the contract, after the claims run-out and reimbursement of allowable administrative expenses, would be returned to OPM for the benefit of the FEHBP. The OPM contract renews automatically each year unless written notice of termination is given by either party.

In accordance with the OPM contract, OPM holds the unused funds on behalf of CFBC and other participating BlueCross BlueShield plans to provide funding for claims, administrative expenses, and other charges to the contract. CFBC has an unrestricted right to draw funds being held in the special reserve for any valid claim or expense. The amounts being held in the special reserve and the contingency reserve are \$15,623 and \$19,182, as of December 31, 2007, respectively, and \$12,015 and \$13,641 as of December 31, 2006, respectively. If the balance of the special reserve is exhausted or falls below certain prescribed levels, OPM will transfer funds from the contingency reserve to the special reserve. Amounts incurred in excess of the total reserves held at the U.S. Treasury for the FEBHP would not be reimbursed to CFBC. The OPM contract renews automatically each year unless written notice of termination is given by either party.

CFBC has recorded the amount of the special reserve being held by OPM as an asset, with an equivalent amount recorded as a rate stabilization reserve. These amounts are included in other current assets and group experience funds and advances, respectively, in the accompanying consolidated balance sheets.

FEHBP represented less than 1% of consolidated accounts receivable as of December 31, 2007 and 2006. FEHBP represented less than 1% of consolidated net revenue for the years ended December 31, 2007 and 2006.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### **2. Summary of Significant Accounting Policies (continued)**

##### **FEP Operations Center**

SBP, a subsidiary of GHMSI operates the FEP Operations Center under a contract with BCBSA. SBP is owned 90% by GHMSI and 10% by BCBSA. The arrangement contains automatic termination provisions upon the occurrence of certain triggering events.

SBP performs certain administrative functions as the national operations center for FEP under its ten-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 \$81,207 and \$72,505 for the years ended December 31, 2007 and 2006, respectively.

##### **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 the Federal Centers for Medicare and Medicaid Services (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 consolidated statements of operations for the years ended December 31, 2007 and 2006.

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.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### **2. Summary of Significant Accounting Policies (continued)**

##### **Medicare Part D Benefits (continued)**

- 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.

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 as CMS program advances in the accompanying consolidated financial statements.

As of December 31, 2007 and 2006, the Company estimated a receivable of \$3,403 and \$0, respectively, is due under the risk-sharing provisions with CMS.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

(in thousands)

#### 2. Summary of Significant Accounting Policies (continued)

##### **CMS Program Advances**

CMS program advances represent estimated premiums to cover reinsurance claims. Excess premiums will be reimbursed to 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 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 \$12,693 is being recognized ratably over the remaining lease term. The balance of the deferred income as of December 31, 2007 is \$11,635 of which the current portion of \$1,058 is classified as accounts payable and accrued expenses and the noncurrent portion of \$10,577 is classified as other liabilities.

##### **Recent Accounting Pronouncements**

Effective December 31, 2007, the Company adopted SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (SFAS 158). SFAS 158 amends SFAS No. 87, SFAS No. 88, SFAS 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. Pursuant to SFAS 158, the difference between each plan's funded status and its existing balance sheet position is recognized, net of tax, as a component of accumulated other comprehensive income. In order to reflect the funded status of the Company's retirement plans on the consolidated balance sheet at December 31, 2007 in accordance with SFAS 158, the prepaid pension asset and intangible assets were reduced by \$36,685 and \$2,540, respectively, and the accrued liabilities were increased by \$16,107. These adjustments resulted in an after tax charge to accumulated other comprehensive income of \$44,209, net of the elimination of the minimum pension liability of \$3,534, and a deferred tax asset of \$11,123. These non-cash transactions did not impact net income, and therefore are not reflected in the consolidated statements of cash flows. SFAS 158 also requires the measurement of the funded status of pension and OPEB plans at the year-end balance sheet date. This provision of SFAS 158 is effective at December 31, 2008. The company currently utilizes the year-end balance sheet date as the measurement date.

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

2. Summary of Significant Accounting Policies (continued)

Recent Accounting Pronouncements (continued)

Recent Accounting Pronouncements (continued)The following table outlines the impact of the adoption of SFAS 158 on the Company's financial statements as of December 31, 2007:

	Prior to Adopting SFAS 158	(Decrease) Increase Due to Adoption of SFAS 158		
		Total Pension Plans	Post Retirement Plan	Total Impact
Prepaid pension assets	55,629	(36,685)	–	(36,685)
Intangible asset	2,540	(2,540)	–	(2,540)
Accrued liability	97,913	2,589	13,518	16,107
Deferred income taxes	4,931	8,391	2,732	11,123
Accumulated other comprehensive income, net of tax	(3,534)	(33,423)	(10,786)	(44,209)

In June 2006, the Financial Accounting Standards Board (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. On February 1, 2008, the FASB issued FASB Staff Position (FSP) No. FIN 48-2 to formally defer the effective date of FIN 48 to fiscal years beginning after December 15, 2007, for nonpublic enterprises that have not yet issued financial statements prepared in accordance with GAAP. Therefore, the Company will be required to adopt FIN 48 for the year ending December 31, 2008. The Company is in the process of determining the impact of FIN 48 on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and therefore, is effective for the Company beginning January 1, 2008. The Company does not expect the adoption of SFAS 157 to have a material effect on the Company's consolidated financial statements.

# CareFirst, Inc. and Affiliates

## Notes to Consolidated Financial Statements (continued)

(in thousands)

### 2. Summary of Significant Accounting Policies (continued)

#### Recent Accounting Pronouncements (continued)

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 permits companies to choose to measure many financial instruments and certain other items at fair value. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007, but adoption is not required. The Company is not planning on adopting the provisions of SFAS 159 for the year ended December 31, 2008.

### 3. 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, 2007, 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.

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**4. Investments**

The Company's short-term and long-term investments consist of the following:

	<b>Amortized Cost Basis</b>		<b>Gross Unrealized Losses</b>		<b>Gross Unrealized Gains</b>		<b>Fair Value</b>
<b>December 31, 2007</b>							
Debt securities issued by the U.S. Treasury and other U.S. government agencies	\$ 370,351	\$	80	\$	11,154	\$	381,425
Corporate debt securities	516,393		5,220		18,387		529,560
Equity securities	179,067		3,272		48,684		224,479
Mortgage-backed securities	633,039		2,685		7,446		637,800
Total investments	<u>\$ 1,698,850</u>	<u>\$</u>	<u>11,257</u>	<u>\$</u>	<u>85,671</u>	<u>\$</u>	<u>1,773,264</u>

	<b>Amortized Cost Basis</b>		<b>Gross Unrealized Losses</b>		<b>Gross Unrealized Gains</b>		<b>Fair Value</b>
<b>December 31, 2006</b>							
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	<u>\$ 1,633,175</u>	<u>\$</u>	<u>8,795</u>	<u>\$</u>	<u>82,788</u>	<u>\$</u>	<u>1,707,168</u>

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

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**4. Investments (continued)**

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, 2007 and December 31, 2006:

	Fair Value < 1 year	Unrealized Losses < 1 year	Fair Value > 1 year	Unrealized Losses > 1 year	Total Unrealized Losses
<b>December 31, 2007</b>					
Debt securities issued by the U.S. Treasury and other U.S. government agencies	\$ 2,487	\$ 22	\$ 3,812	\$ 58	\$ 80
Corporate debt securities	95,299	2,837	88,974	2,383	5,220
Equity securities	32,513	3,064	1,465	208	3,272
Mortgage-backed securities	118,600	1,905	55,540	780	2,685
Total investments	\$ 248,899	\$ 7,828	\$ 149,791	\$ 3,429	\$ 11,257

	Fair Value < 1 year	Unrealized Losses < 1 year	Fair Value > 1 year	Unrealized Losses > 1 year	Total Unrealized Losses
<b>December 31, 2006</b>					
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

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**4. Investments (continued)**

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, 2007 and 2006.

The amortized cost and estimated fair value of debt securities at December 31, 2007, 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.

	<b>Amortized Cost Basis</b>	<b>Fair Value</b>
Within 1 year	\$ 38,821	\$ 38,840
After 1 year through 5 years	257,501	262,738
After 5 years through 10 years	294,442	300,690
After 10 years	295,980	308,717
Mortgage-backed securities	633,039	637,800
Total	<u>\$ 1,519,783</u>	<u>\$ 1,548,785</u>

Available-for-sale securities matured or sold were as follows:

	<b>Year Ended December 31</b>	
	<b>2007</b>	<b>2006</b>
Proceeds from sales and maturities	<b>\$ 2,470,535</b>	\$ 1,597,500
Gross realized gains	<b>57,794</b>	26,632
Gross realized losses	<b>43,192</b>	29,618

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

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**5. Property and Equipment**

Property and equipment are comprised of the following:

	<b>December 31</b>	
	<b>2007</b>	<b>2006</b>
Leasehold improvements	<b>\$ 43,065</b>	\$ 33,549
Purchased computer equipment and software	<b>84,638</b>	63,407
Capitalized software	<b>271,990</b>	233,863
Furniture and equipment	<b>54,242</b>	54,350
	<b>453,935</b>	385,169
Less accumulated depreciation and amortization	<b>283,359</b>	247,480
Property and equipment, net	<b>\$ 170,576</b>	\$ 137,689

Depreciation and amortization expense on property and equipment was \$43,746, and \$49,468 for the years ended December 31, 2007 and 2006, respectively, and is included as a component of general and administrative expenses in the accompanying consolidated statements of operations.

**6. Medical Claims Payable**

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

	<b>2007</b>	<b>2006</b>
Balance as of January 1	<b>\$ 521,419</b>	\$ 510,026
Incurred related to:		
Current year	<b>5,072,666</b>	4,574,649
Prior years	<b>(50,533)</b>	(74,781)
Total incurred	<b>5,022,133</b>	4,499,868
Paid related to:		
Current year	<b>4,537,810</b>	4,060,620
Prior years	<b>462,506</b>	427,855
Total paid	<b>5,000,316</b>	4,488,475
Balance at December 31	<b>\$ 543,236</b>	\$ 521,419

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.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

(in thousands)

#### 6. Medical Claims Payable (continued)

For the years ended December 31, 2007 and 2006, approximately \$(7,269) and \$(28,743), 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 negative amounts noted as “prior year” medical costs are favorable adjustments for claim estimates being settled for amounts less than originally anticipated. As noted above, these favorable changes from original estimates occur due to changes in medical utilization, mix of provider rates and other components of medical cost trends.

The Company accrues estimated claims processing expenses relating to the liability for unpaid claims. These accruals totaled \$18,520 and \$18,431 as of December 31, 2007 and 2006, respectively, and are included in accounts payable and accrued expenses in the accompanying consolidated balance sheets.

#### 7. 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:

2008	\$ 33,794
2009	31,209
2010	28,494
2011	24,515
2012	22,653
Thereafter	82,233
	<u>\$ 222,898</u>

Rent expense for the years ended December 31, 2007 and 2006 for all operating leases was \$38,734 and \$39,089, respectively, and has been included within general and administrative expenses in the accompanying consolidated statements of operations.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### **8. 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 annual contributions exceeded 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.

Effective December 31, 2007, the Company adopted SFAS 158 (*refer to Note 2, Summary of Significant Accounting Policies – Recent Accounting Pronouncements, for additional information*). In order to reflect the funded status of the Company's qualified pension benefit and nonqualified supplemental retirement plan on the consolidated balance sheet at December 31, 2007 in accordance with SFAS 158, the Company reduced the prepaid pension asset and intangible assets by \$36,685 and \$2,540, respectively, and increased the accrued liabilities by \$2,589. These adjustments resulted in an after tax charge to accumulated other comprehensive income of \$33,423, net of the elimination of the minimum pension liability of \$3,534, and a deferred tax asset of \$8,391.

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**8. Pension Benefits (continued)**

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

	2007		
	CFMI	GHMSI	SBP
<b>Accumulated benefit obligation</b>	<b>\$ 194,115</b>	<b>\$ 232,362</b>	<b>\$ 33,555</b>
<b>Change in projected benefit obligation</b>			
Benefit obligation at beginning of year	\$ 187,514	\$ 225,357	\$ 31,461
Service cost	11,275	6,181	1,665
Interest cost	10,723	13,126	1,813
Actuarial (gain)/loss	(1,918)	(632)	290
Benefits paid	(10,739)	(9,619)	(1,315)
Benefit obligation at end of year	<b>\$ 196,855</b>	<b>\$ 234,413</b>	<b>\$ 33,914</b>
<b>Change in plan assets of the qualified pension plans</b>			
Fair value of plan assets at beginning of year	\$ 191,980	\$ 250,089	\$ 31,987
Actual return on plan assets	7,995	11,163	1,327
Employer contributions	5,400	1,725	-
Benefits paid	(10,739)	(9,619)	(1,315)
Fair value of plan assets at end of year	<b>\$ 194,636</b>	<b>\$ 253,358</b>	<b>\$ 31,999</b>
Funded status	\$ (2,219)	\$ 18,945	\$ (1,915)
Unrecognized actuarial loss	-	-	-
Unrecognized prior service asset	-	-	-
(Accrued) benefit cost or prepaid pension asset (included as a component of long-term employee benefit obligations or other assets)	<b>\$ (2,219)</b>	<b>\$ 18,945</b>	<b>\$ (1,915)</b>

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

8. Pension Benefits (continued)

	<b>2007</b>		
	<b>CFMI</b>	<b>GHMSI</b>	<b>SBP</b>
<b>Components of net periodic benefit cost (benefit) for the year ended December 31, are as follows</b>			
Service cost	\$ 11,275	\$ 6,181	\$ 1,665
Interest cost	10,723	13,126	1,813
Expected return on plan assets	(14,567)	(19,148)	(2,426)
Amortization of prior service asset	(1,350)	(1,607)	(244)
Net recognized actuarial loss	2,538	636	9
Net periodic cost (benefit)	<u>\$ 8,619</u>	<u>\$ (812)</u>	<u>\$ 817</u>

For the year ended December 31, 2007, net unrecognized actuarial losses of \$52,561 and unrecognized prior service assets of \$12,513 have not been recognized in the Company's net periodic benefit cost. These amounts have been recorded within accumulated other comprehensive income.

Weighted-average assumptions to determine benefit obligations:

Discount rate – benefit obligation	6.25%	6.25%	6.25%
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%

	<b>2006</b>		
	<b>CFMI</b>	<b>GHMSI</b>	<b>SBP</b>
<b>Accumulated benefit obligation</b>	<u>\$185,510</u>	<u>\$223,833</u>	<u>\$31,160</u>
<b>Change in projected benefit obligation</b>			
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	<u>\$187,514</u>	<u>\$225,357</u>	<u>\$31,461</u>

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**8. Pension Benefits (continued)**

	<b>CFMI</b>	<b>2006 GHMSI</b>	<b>SBP</b>
<b>Change in plan assets of the qualified pension plans</b>			
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	<u>\$191,980</u>	<u>\$250,089</u>	<u>\$31,987</u>
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)	<u>\$ 29,893</u>	<u>\$ 26,419</u>	<u>\$ 48</u>
<b>Components of net periodic benefit cost for the year ended December 31, are as follows</b>			
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	<u>\$ 10,215</u>	<u>\$ 333</u>	<u>\$ 1,004</u>
<b>Weighted-average assumptions to determine benefit obligations:</b>			
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%

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

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### 8. Pension Benefits (continued)

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 active 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:

	<b>Target Allocation</b>	<b>CFMI</b>	<b>GHMSI</b>	<b>SBP</b>
<b>December 31, 2007</b>				
Domestic equity securities	<b>30-50%</b>	<b>34%</b>	<b>35%</b>	<b>36%</b>
International equity securities	<b>15-25%</b>	<b>21</b>	<b>21</b>	<b>22</b>
Emerging markets	<b>0-10%</b>	<b>4</b>	<b>4</b>	<b>4</b>
Real estate	<b>0-10%</b>	<b>5</b>	<b>5</b>	<b>5</b>
Debt securities	<b>25-35%</b>	<b>32</b>	<b>33</b>	<b>32</b>
Cash and cash equivalents	<b>Residual</b>	<b>4</b>	<b>2</b>	<b>1</b>
Total		<b>100%</b>	<b>100%</b>	<b>100%</b>
<b>December 31, 2006</b>				
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%

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, 2007 and 2006, CFMI has accrued \$35,194 and \$33,303, respectively, GHMSI has accrued \$3,489 and \$2,968, respectively, and SBP has accrued \$6 and \$16, respectively for these benefits. Supplemental retirement benefit plan expense for the years ended December 31, 2007 and 2006 for CFMI was \$4,078 and \$5,696, respectively, for GHMSI was \$561 and \$494, respectively, and for SBP was \$(1) and \$4, respectively.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### 8. Pension Benefits (continued)

The Company does not expect to make contributions to the qualified pension plans for CFMI, GHMSI and SBP during 2008. The Company expects to make contributions of \$10,391, \$572 and \$0 to the nonqualified supplemental retirement benefit plans for CFMI, GHMSI and SBP, respectively, during 2008.

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

	CFMI	GHMSI	SBP
2008	\$ 25,049	\$ 16,539	\$ 3,686
2009	21,992	17,706	3,722
2010	19,431	18,005	3,561
2011	18,464	18,552	3,608
2012	18,611	19,582	3,600
2013 through 2017	135,493	111,614	19,915
Total	\$ 239,040	\$ 201,998	\$ 38,092

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, 2007 and 2006 of \$2,824 and \$2,873, respectively, for CFMI, \$1,589 and \$1,622, respectively, for GHMSI and \$514 and \$431, respectively, for SBP.

#### 9. 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.

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**9. Postretirement Benefits (continued)**

Effective December 31, 2007, the Company adopted SFAS 158 (refer to Note 2, Summary of Significant Accounting Policies – Recent Accounting Pronouncements, for additional information). In order to reflect the funded status of the Company’s postretirement benefits plans on the consolidated balance sheet at December 31, 2007 in accordance with SFAS 158, the Company increased the accrued liabilities by \$13,518. These adjustments resulted in an after tax charge to accumulated other comprehensive income of approximately \$10,786 and a deferred tax asset of approximately \$2,732.

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 2007 and 2006 were \$766 and \$948, 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.

	<b>CFMI</b>	<b>2007 GHMSI</b>	<b>SBP</b>
<b>Change in benefit obligation</b>			
Benefit obligation at beginning of year	\$ 44,149	\$ 26,766	\$ 3,627
Service cost	1,499	817	153
Interest cost	2,463	1,538	210
Actuarial loss	(2,286)	(1,025)	(190)
Benefits paid	(2,425)	(1,202)	(43)
Benefit obligation at end of year	<u>\$ 43,400</u>	<u>\$ 26,894</u>	<u>\$ 3,757</u>
<b>Change in plan assets</b>			
Fair value of plan assets at beginning of year	\$ –	\$ –	\$ 1,946
Employer contributions	–	–	766
Actual return on plan assets	–	–	168
Benefits paid	–	–	(30)
Fair value of plan assets at end of year	<u>\$ –</u>	<u>\$ –</u>	<u>\$ 2,850</u>

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**9. Postretirement Benefits (continued)**

	<b>CFMI</b>	<b>2007 GHMSI</b>	<b>SBP</b>
Funded status	\$(43,400)	\$(26,894)	\$ (907)
Unrecognized transition liability	-	-	-
Unrecognized actuarial loss	-	-	-
Unrecognized prior service cost	-	-	-
Net amount recognized – accrued benefit cost	<u>\$(43,400)</u>	<u>\$(26,894)</u>	<u>\$ (907)</u>

**Components of net periodic benefit cost for the year ended**

**December 31, are as follows**

Service cost	\$ 1,499	\$ 817	\$ 153
Interest cost	2,463	1,538	210
Amortization of transition liability	-	552	37
Expected return on plan assets	-	-	(86)
Amortization of prior service (asset) cost	(80)	40	-
Recognized actuarial loss	798	-	16
Net periodic benefit cost	<u>\$ 4,680</u>	<u>\$ 2,947</u>	<u>\$ 330</u>

For the year ended December 31, 2007, unrecognized transition liabilities of \$2,945, net unrecognized actuarial losses of \$10,375 and unrecognized prior service assets of \$2,945 have not been recognized in the Company's net periodic postretirement benefit cost. These amounts have been recorded within accumulated other comprehensive income.

	<b>CFMI</b>	<b>2006 GHMSI</b>	<b>SBP</b>
<b>Change in benefit obligation</b>			
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	<u>\$ 44,149</u>	<u>\$ 26,766</u>	<u>\$ 3,627</u>

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

9. Postretirement Benefits (continued)

	CFMI	2006 GHMSI	SBP
<b>Change in plan assets</b>			
Fair value of plan assets at beginning of year	\$ –	\$ –	\$ 909
Employer contributions	–	–	948
Actual return on plan assets	–	–	89
Benefits paid	–	–	–
Fair value of plan assets at end of year	<u>\$ –</u>	<u>\$ –</u>	<u>\$ 1,946</u>
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	<u>\$(31,727)</u>	<u>\$(21,410)</u>	<u>\$ (994)</u>
<b>Components of net periodic benefit cost for the year ended December 31, are as follows</b>			
Service cost	\$ 1,438	\$ 768	\$ 143
Interest cost	2,397	1,443	191
Amortization of transition liability	–	552	37
Expected return on plan assets	–	–	(40)
Amortization of prior service (asset) cost	(206)	40	–
Recognized actuarial loss	839	–	27
Net periodic benefit cost	<u>\$ 4,468</u>	<u>\$ 2,803</u>	<u>\$ 358</u>

For measurement purposes, a 6.25% and 5.75% discount rate was assumed for the years ended December 31, 2007 and 2006, respectively. A 6.00% annual rate of increase in the per capita cost of covered health care benefits was also assumed for the years ended December 31, 2007 and 2006.

The Company expects to make contributions of \$2,936, \$1,281 and \$962 to the postretirement benefits plans of CFMI, GHMSI and SBP, respectively, during 2008.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### 9. 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:

	<b>CFMI</b>	<b>GHMSI</b>	<b>SBP</b>
2008	\$ 2,936	\$ 1,281	\$ 98
2009	3,026	1,444	147
2010	3,134	1,595	187
2011	3,229	1,756	221
2012	3,273	1,901	258
2013 through 2017	18,347	11,929	1,826
Total	\$ 33,945	\$ 19,906	\$ 2,737

#### 10. Income 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 2007 and 2006. 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.

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**10. Income Taxes (continued)**

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, 2007 and 2006, the Company had deferred tax assets of \$57,094 and \$42,964, respectively, and deferred tax liabilities of \$40,501 and \$33,880, 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.

The provision for income taxes consists of the following components:

	<b>Year Ended December 31</b>	
	<b>2007</b>	<b>2006</b>
Current:		
Federal	\$ 43,604	\$ 47,344
State	4,785	3,158
	<u>48,389</u>	<u>50,502</u>
Deferred:		
Federal	3,750	(6,468)
State	(12)	(70)
	<u>3,738</u>	<u>(6,538)</u>
Provision for income taxes	<u>\$ 52,127</u>	<u>\$ 43,964</u>

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**11. 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:

	<b>Before-Tax Amount</b>	<b>Tax (Expense) Benefit</b>	<b>Net-of-Tax Amount</b>
<b>Year Ended December 31, 2007</b>			
Net unrealized gains and losses arising during the period	\$ 5,538	\$ (1,044)	\$ 4,494
Less reclassification adjustments for net gains and losses realized or recognized in net income	3,997	(792)	3,205
Net unrealized gains and losses	1,541	(252)	1,289
Minimum pension liability adjustment	838	(104)	734
Total other comprehensive income (loss)	<u>\$ 2,379</u>	<u>\$ (356)</u>	<u>\$ 2,023</u>
<b>Year Ended December 31, 2006</b>			
Net unrealized gains and losses arising during the period	\$ 24,128	\$ (5,046)	\$ 19,082
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	(5,880)	22,242
Minimum pension liability adjustment	(2,760)	551	(2,209)
Total other comprehensive income (loss)	<u>\$ 25,362</u>	<u>\$ (5,329)</u>	<u>\$ 20,033</u>

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### **12. 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. Attorney's Office in Baltimore. Management, after consultation with legal counsel, is of the opinion that the subpoena will not have a material adverse effect on the accompanying consolidated financial statements; however, there can be no assurance in this regard.

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 continues to maintain that the assertions made in this action are completely without foundation but, for entirely practical purposes, has reached an agreement in principle with the Plaintiffs that will likely settle this matter for all parties. The terms of settlement are now in the hands of the Court for review and approval. 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

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### **12. Commitments and Contingencies (continued)**

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, 2007 or 2006, 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 is subject to review and approval by the Maryland Insurance Administration and may be subject to review and approval by the 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.

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

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

*(in thousands)*

**12. Commitments and Contingencies (continued)**

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, 2008.

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 2007 or 2006.

# Other Financial Information

## 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, 2007 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, 2007 consolidated financial statements. Such information has been subjected to the auditing procedures applied in our audit of the December 31, 2007 consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the December 31, 2007 consolidated financial statements taken as a whole.

*Ernst + Young LLP*

February 27, 2008

CareFirst, Inc. and Affiliates

Consolidating Balance Sheet

December 31, 2007

(in thousands)

	<b>CareFirst, Inc.</b>	<b>CareFirst of Maryland, Inc. and Subsidiaries</b>	<b>Group Hospitalization and Medical Services, Inc. and Subsidiaries</b>	<b>CareFirst BlueChoice, Inc. and Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
<b>Assets</b>						
Current assets:						
Cash and cash equivalents	\$ 394	\$ 49,680	\$ 92,603	\$ 55,172	\$ –	\$ 197,849
Short-term investments	–	9,390	15,336	14,114	–	38,840
Advances to providers	–	132,337	27,927	35,476	–	195,740
Accounts receivable, net	–	159,143	300,150	47,766	(1,329)	505,730
Due from affiliates, net	–	6,504	–	11,094	(17,598)	–
Interest income receivable	2	4,055	6,436	4,015	–	14,508
Other current assets	–	122,693	398,352	16,466	–	537,511
Deferred tax assets, net	–	9,359	7,176	3,909	–	20,444
<b>Total current assets</b>	<b>396</b>	<b>493,161</b>	<b>847,980</b>	<b>188,012</b>	<b>(18,927)</b>	<b>1,510,622</b>
Long-term investments	131	488,935	795,885	449,473	–	1,734,424
Property and equipment, net	–	100,145	70,431	–	–	170,576
Investment in affiliates	–	255,176	170,117	–	(425,293)	–
Goodwill	–	12,710	–	17,246	–	29,956
Other assets	–	12,538	24,446	213	–	37,197
Deferred tax assets, net	–	10,048	–	–	(10,048)	–
<b>Total assets</b>	<b>\$ 527</b>	<b>\$ 1,372,713</b>	<b>\$ 1,908,859</b>	<b>\$ 654,944</b>	<b>\$ (454,268)</b>	<b>\$ 3,482,775</b>

CareFirst, Inc. and Affiliates

Consolidating Balance Sheet (continued)

December 31, 2007

(in thousands)

	CareFirst, Inc.	CareFirst of Maryland, Inc. and Subsidiaries	Group Hospitalization and Medical Services, Inc. and Subsidiaries	CareFirst BlueChoice, Inc. and Subsidiaries	Eliminations	Consolidated
<b>Liabilities and reserves</b>						
Current liabilities:						
Short-term borrowings	\$ 4	\$ 82,317	\$ 84,264	\$ 1,613	\$ –	\$ 168,198
Medical claims payable	–	121,433	298,236	123,567	–	543,236
Due to affiliates, net	523	–	17,075	–	(17,598)	–
Accounts payable and accrued expenses	–	153,348	95,520	37,027	(1,329)	284,566
Unearned revenues	–	42,842	65,248	48,128	–	156,218
CMS program advances	–	5,375	–	–	–	5,375
Group experience funds and advances	–	225,757	441,649	15,946	–	683,352
Note payable, current portion	–	–	787	–	–	787
Total current liabilities	527	631,072	1,002,779	226,281	(18,927)	1,841,732
Note payable, noncurrent	–	–	834	–	–	834
Deferred taxes liabilities, net	–	–	10,529	3,370	(10,048)	3,851
Long-term employee benefit obligations	–	67,488	31,356	–	–	98,844
Other liabilities	–	20,012	12,658	–	–	32,670
Total liabilities	527	718,572	1,058,156	229,651	(28,975)	1,977,931
Reserves:						
Retained earnings	–	667,371	831,496	413,535	(413,535)	1,498,867
Accumulated other comprehensive (loss) income	–	(13,230)	19,207	11,758	(11,758)	5,977
Total reserves	–	654,141	850,703	425,293	(425,293)	1,504,844
Total liabilities and reserves	\$ 527	\$ 1,372,713	\$ 1,908,859	\$ 654,944	\$ (454,268)	\$ 3,482,775

CareFirst, Inc. and Affiliates

Consolidating Statement of Operations

Year Ended December 31, 2007

(in thousands)

	CareFirst, Inc.	CareFirst of Maryland, Inc. and Subsidiaries	Group Hospitalization and Medical Services, Inc. and Subsidiaries	CareFirst BlueChoice, Inc. and Subsidiaries	Eliminations	Consolidated
Premiums earned	\$ -	\$ 1,443,202	\$ 2,827,657	\$1,591,360	\$ (950)	\$ 5,861,269
Amounts attributable to self-funded arrangements	-	2,164,777	945,756	-	-	3,110,533
Less amounts attributable to claims under self-funded arrangements	-	(2,020,476)	(878,078)	-	-	(2,898,554)
Other	210	13,524	11,582	67	-	25,383
Net revenue	210	1,601,027	2,906,917	1,591,427	(950)	6,098,631
Operating expenses:						
Cost of care	-	1,253,605	2,507,343	1,262,135	(950)	5,022,133
General and administrative	205	334,257	356,397	245,535	-	936,394
Total operating expenses	205	1,587,862	2,863,740	1,507,670	(950)	5,958,527
Income from operations	5	13,165	43,177	83,757	-	140,104
Investment income, net	(5)	30,076	46,875	24,763	-	101,709
Other than temporary impairment of investments	-	(3,139)	(4,836)	(2,629)	-	(10,604)
Equity in gain of affiliate	-	48,374	32,250	-	(80,624)	-
Other income, net	-	363	883	129	-	1,375
Income before provision for income taxes	-	88,839	118,349	106,020	(80,624)	232,584
Provision for income taxes	-	9,480	17,251	25,396	-	52,127
Net income	\$ -	\$ 79,359	\$ 101,098	\$ 80,624	\$ (80,624)	\$ 180,457

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