

CONSOLIDATED FINANCIAL STATEMENTS  
AND OTHER FINANCIAL INFORMATION

CareFirst, Inc. and Affiliates  
Years Ended December 31, 2008 and 2007  
With Report of Independent Auditors

CareFirst, Inc. and Affiliates

Consolidated Financial Statements  
and Other Financial Information

Years Ended December 31, 2008 and 2007

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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, 2008 and 2007, 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, 2008 and 2007, 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 consolidated financial statements, in 2007 the Company adopted Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*.

*Ernst & Young LLP*

February 27, 2009

CareFirst, Inc. and Affiliates  
Consolidated Balance Sheets

*(in thousands)*

	<b>December 31</b>	
	<b>2008</b>	<b>2007</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 272,014	\$ 197,849
Short-term investments	39,423	38,840
Advances to providers	220,908	195,740
Accounts receivable, less allowance for doubtful accounts of \$19,316 and \$15,470 as of December 31, 2008 and 2007, respectively	549,645	502,943
Interest income receivable	10,880	14,508
Other current assets	643,242	555,348
Deferred tax assets, net	20,441	20,444
Total current assets	1,756,553	1,525,672
Long-term investments	1,425,058	1,734,424
Other invested assets	1,143	213
Property, equipment and capitalized software, net	215,298	170,576
Goodwill	29,956	29,956
Other assets	22,660	36,984
Deferred tax assets, net	35,375	-
Total assets	\$ 3,486,043	\$ 3,497,825
<b>Liabilities and reserves</b>		
Current liabilities:		
Short-term borrowings	\$ 168,050	\$ 168,198
Medical claims payable	594,787	543,236
Accounts payable and accrued expenses	284,952	302,403
Unearned revenues	162,333	156,218
CMS program advances	-	2,588
Group experience funds and advances	797,719	683,352
Note payable, current portion	281	787
Total current liabilities	2,008,122	1,856,782
Note payable, noncurrent	561	834
Deferred tax liabilities, net	-	3,851
Long-term employee benefit obligations	153,197	98,844
Other liabilities	27,644	32,670
Total liabilities	2,189,524	1,992,981
Reserves:		
Retained earnings	1,508,214	1,498,867
Accumulated other comprehensive (loss) income	(211,695)	5,977
Total reserves	1,296,519	1,504,844
Total liabilities and reserves	\$ 3,486,043	\$ 3,497,825

*See accompanying notes*

CareFirst, Inc. and Affiliates

Consolidated Statements of Operations

(in thousands)

	<b>Year Ended December 31</b>	
	<b>2008</b>	<b>2007</b>
Premiums earned	<b>\$ 6,320,242</b>	\$ 5,841,735
Amounts attributable to self-funded arrangements	<b>3,584,373</b>	3,110,533
Less amounts attributable to claims under self-funded arrangements	<b>(3,365,585)</b>	(2,898,554)
Other	<b>45,127</b>	44,917
Net revenue	<b>6,584,157</b>	6,098,631
Operating expenses:		
Cost of care	<b>5,572,973</b>	5,022,133
General and administrative	<b>1,023,454</b>	936,394
Total operating expenses	<b>6,596,427</b>	5,958,527
(Loss) income from operations	<b>(12,270)</b>	140,104
Investment income, net	<b>112,617</b>	101,709
Other than temporary impairment of investments	<b>(91,195)</b>	(10,604)
Other (loss) income, net	<b>(178)</b>	1,375
Income before (benefit) provision for income taxes	<b>8,974</b>	232,584
(Benefit) provision for income taxes	<b>(373)</b>	52,127
Net income	<b>\$ 9,347</b>	\$ 180,457

See accompanying notes.

CareFirst, Inc. and Affiliates

Consolidated Statements of Changes in Reserves

Years Ended December 31, 2008 and 2007  
(in thousands)

	Retained Earnings	Accumulated Other Comprehensive Income (Loss)		Total Reserves
		Unrealized Gains (Losses) on Securities, Net	Defined Benefit Plans Adjustment	
Balance, as of January 1, 2007	\$ 1,318,410	\$ 52,431	\$ (4,268)	\$ 1,366,573
Net income	180,457	–	–	180,457
Other comprehensive income, net of tax:				
Change in net unrealized gains and losses on investments, net of reclassification adjustments	–	1,289	–	1,289
Minimum pension liability adjustment	–	–	734	734
Other comprehensive income				2,023
Total comprehensive income				182,480
Adjustment to recognize the adoption of SFAS 158, net of tax	–	–	(44,209)	(44,209)
Balance, as of December 31, 2007	\$ 1,498,867	\$ 53,720	\$ (47,743)	\$ 1,504,844
Net income	9,347	–	–	9,347
Other comprehensive loss, net of tax:				
Change in net unrealized gains and losses on investments, net of reclassification adjustments	–	(95,777)	–	(95,777)
Defined benefit plans adjustments	–	–	(121,895)	(121,895)
Other comprehensive loss				(217,672)
Total comprehensive loss				(208,325)
Balance, as of December 31, 2008	\$ 1,508,214	\$ (42,057)	\$ (169,638)	\$ 1,296,519

See accompanying notes.

CareFirst, Inc. and Affiliates

Consolidated Statements of Cash Flows

(in thousands)

	Year Ended December 31	
	2008	2007
<b>Operating activities</b>		
Net income	\$ 9,347	\$ 180,457
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	50,239	43,746
Realized gains on investments, net	(40,375)	(14,602)
Other than temporary impairment of investments	91,195	10,604
Realized losses on embedded derivatives	16,933	934
Provision for deferred income taxes	16,257	3,738
Gain on equity method investment	(468)	(443)
Changes in operating assets and liabilities:		
Increase in advances to providers	(25,168)	(13,324)
Increase in accounts receivable, net	(46,702)	(51,502)
Decrease (increase) in interest income receivable	3,628	(1,055)
(Increase) decrease in other current assets	(87,894)	124,593
Increase in other assets	(53,860)	(5,567)
Increase in medical claims payable	51,551	21,817
Decrease in accounts payable and accrued expenses	(17,451)	(28,542)
Increase in unearned revenues	6,115	23,207
Increase (decrease) in group experience funds and advances	111,779	(168,887)
(Decrease) increase in other liabilities	(34,706)	11,140
Net cash provided by operating activities	<u>50,420</u>	<u>136,314</u>
<b>Investing activities</b>		
Purchases of investments	(3,516,033)	(2,531,668)
Proceeds from sales and maturities of investments	3,636,128	2,470,535
Purchases of other invested assets	(1,012)	-
Sales or distributions of other invested assets	550	12,333
Purchases of property, equipment and capitalized software, net	(94,961)	(76,633)
Net cash provided by (used in) investing activities	<u>24,672</u>	<u>(125,433)</u>
<b>Financing activities</b>		
(Decrease) increase in short-term borrowings	(148)	3,217
Repayment on long-term debt	(779)	(1,330)
Net cash (used in) provided by financing activities	<u>(927)</u>	<u>1,887</u>
Net increase in cash and cash equivalents	74,165	12,768
Cash and cash equivalents at beginning of year	197,849	185,081
Cash and cash equivalents at end of year	<u>\$ 272,014</u>	<u>\$ 197,849</u>
<b>Supplemental disclosures</b>		
Cash paid for income taxes	<u>\$ 15,954</u>	<u>\$ 60,927</u>

See accompanying notes.

# CareFirst, Inc. and Affiliates

## Notes to Consolidated Financial Statements

December 31, 2008

*(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).

In 2005, the CFI Board 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 income or loss from operations from this cross-jurisdictional business would be transferred via a quota-share reinsurance contract from the company that earned them to the company in whose service area they were earned. The Company received regulatory approval for these earnings redistributions, effective January 1, 2008, and the amounts were recorded in 2008. This agreement has no impact on the consolidated statements of CFI.

Also in 2006, the Boards of CFI, CFMI, and GHMSI approved earnings redistributions to evenly share changes in the statutory surplus of CFBC. In 2008, the Boards approved in principle the creation of a new holding company, CareFirst Holdings, LLC. (CHC), which would be owned 50%/50% by CFMI and GHMSI. Following regulatory approval, the establishment of CHC would satisfy the earning redistributions of CFBC.

# CareFirst, Inc. and Affiliates

## Notes to Consolidated Financial Statements (continued)

*(in thousands)*

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

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. Service Benefit Plan Administrative Services Corporation (SBP), is 90% owned by GHMSI and 10% owned by BCBSA (see Note 2).

### **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.

#### **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, investments, short-term borrowings, accounts payable and accrued expenses, unearned revenues, CMS program advances, and notes payable, current portion 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

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

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

##### **Cash and Cash Equivalents and Short-Term Borrowings (continued)**

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.

##### **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 (loss) 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

# CareFirst, Inc. and Affiliates

## Notes to Consolidated Financial Statements (continued)

(in thousands)

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

#### Investments (continued)

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

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 (loss) income in the accompanying consolidated statements of changes in reserves. As of December 31, 2008, the Company has sold all of its foreign common stocks.

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 assumed to be temporary.

The current economic environment and recent volatility of securities markets increase the difficulty of assessing investment impairment and the same influences tend to increase the risk of potential impairment of these assets. Declines in fair value below cost that are deemed to be other than temporary are recorded as realized losses and are included as "other than temporary impairment of investments" in the accompanying consolidated statements of operations. Other than temporary impairments recognized for the years ended December 31, 2008 and 2007 included charges for fixed maturity securities and equity securities for which, due to credit downgrades and/or the extent and duration of their decline in fair value in light of the current market conditions, management determined that the impairment was other than temporary.

Based on its evaluation, the Company has recorded an other than temporary impairment of investments as follows:

	<b>Year Ended December 31</b>	
	<b>2008</b>	<b>2007</b>
Equity securities	\$ 65,351	\$ 8,604
Debt securities	25,844	2,000
Total	<u>\$ 91,195</u>	<u>\$ 10,604</u>

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

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

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

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

Management believes that it has adequately reviewed its investment securities for other than temporary impairment and that its investment securities are carried at fair value. However, over time, the economic and market environment may provide additional insight regarding the fair value of certain securities, which could change management's judgment regarding other than temporary impairment. This could result in realized losses relating to other than temporary declines being charged against future income. Given the current market conditions and the judgments involved, there is a continuing risk that further declines in fair value may occur and additional material other than temporary impairments may be recorded in future periods.

###### *Derivative Financial Instruments*

A derivative is typically defined as an instrument whose value is "derived" from an underlying instrument, index or rate, has a notional amount, requires little or no initial investment and can be net settled. In accordance with Statement of Financial Accounting Standard (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133), all investments in derivatives are recorded at fair value. Included within the Company's long-term investments are certain financial instruments which contain embedded derivatives (such as options embedded in convertible fixed maturity securities). Derivatives embedded within non-derivative instruments are bifurcated from the host instrument when the embedded derivative is not clearly and closely related to the host instrument. These instruments have no hedge designation and as such, changes in the fair value are recorded as realized gains and losses. The Company recognized realized losses of \$16,933 and \$934, related to the embedded derivatives, in investment income, net for the years ended December 31, 2008 and 2007, 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 accompanying consolidated balance sheets. The amount of securities on loan under the securities lending program was \$0 and \$265,037 at December 31, 2008 and 2007, respectively. During the fourth quarter of 2008, the Company suspended its security lending program due to concerns with market volatility and uncertainty. The Company intends to re-establish its security lending program at some point in the future.

# CareFirst, Inc. and Affiliates

## Notes to Consolidated Financial Statements (continued)

(in thousands)

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

#### Other Invested Assets

Other invested assets consist of direct investments in limited partnerships, which are accounted for under the equity method.

#### Property, Equipment and Capitalized Software

Property, equipment and capitalized software 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 eight 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. The Company periodically assesses the carrying value of these fixed assets for purposes of determining any asset impairment.

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 SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), 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 (CFBC) at December 31, 2008 and 2007. In accordance with SFAS 142, the Company tests goodwill for impairment on an annual basis, or more frequently if circumstances indicate that a possible impairment has occurred. The Company uses discounted cash flow techniques based on the price that could be received in a current transaction to sell the asset assuming the asset or asset group (in-use premise) would be at highest and best use. The Company completed its annual goodwill impairment evaluations at October 1, 2008 and 2007. 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, 2008 and 2007. There were no changes in the carrying amount of goodwill of \$29,956 during the years ended December 31, 2008 and 2007.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

(in thousands)

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

##### Other Assets

Other assets primarily consist of prepaid expenses, including prepaid pension assets (2007 only), the cash surrender value of life insurance policies, federal and state income tax recoverable 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.

##### Retirement Benefit Plans

The Company sponsors various plans that provide defined benefit pension and other postretirement benefits covering eligible employees.

Pension benefits are recorded in accordance with SFAS No. 87, *Employers' Accounting for Pensions* (SFAS 87). Other postretirement benefits are recorded in accordance with SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. Effective December 31, 2007, the Company adopted SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Benefit Plans – an amendment of SFAS No. 87, 88, 106, and 132(R)* (SFAS 158). Effective with the adoption of SFAS 158, the Company recognizes the funded status of the benefit obligations for each of its plans as a current and noncurrent asset or liability on the consolidated balance sheets. The actuarial gains or losses, prior years costs and credits, and remaining net transition asset or liability that had not been included in net periodic costs are recognized, net of tax, as a component of accumulated other comprehensive income. Additionally, these changes eliminated the additional minimum pension liability provisions of SFAS 87. The adoption of SFAS 158 decreased accumulated other comprehensive income, net of tax, by \$44,209 at December 31, 2007. These non-cash transactions related to the adoption of SFAS 158 did not impact net income, and therefore are not reflected in the consolidated statements of cash flows. Prepaid pension benefits represent prepaid costs related to defined benefit pension plans and are included in other assets in the accompanying consolidated balance sheets. Other postretirement benefits represent outstanding obligations for retiree health benefits. Liabilities for pension and other postretirement benefits are recorded based on the amount by which the actuarial present value of benefits exceeds the fair value of plan assets. The current portion of the liabilities is the value of payments over the next twelve months that is greater than the plan assets. The current portion is classified as accounts payable and accrued expenses and the non-current portion is classified as long-term employee benefit obligations, respectively, in the accompanying consolidated balance sheets. The Company uses the year-end balance sheet date as the measurement date for all defined benefit pension and other postretirement benefit plans.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### **2. 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 \$842 and \$1,621 as of December 31, 2008 and 2007, 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.

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

## 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)**

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.

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.

##### **Income Taxes**

The Company's (benefit) 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.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

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

##### **Comprehensive (Loss) Income**

Comprehensive (loss) income encompasses all changes in reserves and includes net income, net unrealized gains or losses on available-for-sale securities and defined benefit plans adjustments. Comprehensive (loss) 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**

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 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 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 \$2,374,400 and \$2,240,167, as of December 31, 2008 and 2007, respectively. The unaudited amounts being held in the contingency reserve are \$5,284,003 as of September 30, 2008 and \$5,048,031 as of December 31, 2007. 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.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

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

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

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 \$553,397 and \$474,118 as of December 31, 2008 and 2007, 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% of consolidated accounts receivable as of December 31, 2008 and 2007. FEP represented approximately 36% and 37% of consolidated net revenue for the years ended December 31, 2008 and 2007, respectively.

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

CFBC has an experience-rated HMO contract with the OPM to provide managed health care services under the 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 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 are \$12,624 and \$15,623 as of December 31, 2008 and 2007, respectively. The amounts being held in the contingency reserve are \$26,067 and \$19,182 as of December 31, 2008 and 2007, 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.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

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

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

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, 2008 and 2007. FEHBP represented approximately 1% of consolidated net revenue for the years ended December 31, 2008 and 2007.

##### **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 \$87,636 and \$81,207 for the years ended December 31, 2008 and 2007, 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, which renews annually unless terminated prior to renewal, 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, 2008 and 2007.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

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

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

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 5.0 (2.5 in 2007) 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 accounts receivable, net or other 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.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

(in thousands)

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

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

The Catastrophic Reinsurance Subsidy and the Low-Income Member Cost Sharing Subsidies represent cost reimbursements under the Medicare Part D program. FirstCare 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, 2008 and 2007, the Company estimated a receivable of \$5,014 and \$3,403, respectively, is due under the risk-sharing provisions with CMS.

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

CMS program advances represent estimated premiums to cover reinsurance claims. Excess premiums will be reimbursed to CMS during settlement in the subsequent year.

##### **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, Maryland. 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, 2008 and 2007 is \$10,577 and \$11,635, respectively. At December 31, 2008, the current portion of \$1,058 is classified as accounts payable and accrued expenses and the non-current portion of \$9,519 is classified as other liabilities in the accompanying consolidated financial statements.

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

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). FIN 48 creates a model to address uncertainty in tax positions and clarifies the accounting for income taxes by prescribing a minimum recognition threshold, which all income tax positions must achieve before being recognized in the financial statements. In addition, FIN 48 requires expanded annual disclosures, including a roll-forward of the beginning and ending aggregate unrecognized tax benefits as well as specific detail related to tax

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

(in thousands)

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

##### Recent Accounting Pronouncements (continued)

uncertainties for which it is reasonably possible the amount of the unrecognized tax benefit will significantly increase or decrease within twelve months. On February 1, 2008, the FASB issued FASB Staff Position (FSP) No. FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, to formally defer the effective date of FIN 48 for certain nonpublic enterprises until annual financial statements for fiscal years beginning after December 15, 2007. On December 30, 2008, the FASB issued FASB FSP No. FIN 48-3, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, to further delay the effective date of FIN 48 for certain nonpublic enterprises until annual financial statements for fiscal years beginning after December 15, 2008. Therefore, the Company will be required to adopt FIN 48 for the year ending December 31, 2009. 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). SFAS 157 provides enhanced guidance for using fair value to measure assets and liabilities. SFAS 157 does not require any new fair value measurements, but does require expanded disclosures to provide information about the extent to which fair value is used to measure assets and liabilities, the methods and assumptions used to measure fair value, and the effect of fair value measures on earnings. SFAS 157 is effective for financial assets and liabilities recognized or disclosed in the accompanying consolidated financial statements.

On February 12, 2008, the FASB issued FASB Staff Position SFAS 157-2, *Effective Date of FASB Statement No. 157* (FSP 157). FSP 157 delayed, for one year, the effective date of SFAS 157 for all nonfinancial assets and liabilities, except those that are recognized or disclosed in the financial statements on at least an annual basis. The Company adopted SFAS 157 as of January 1, 2008, except for those provisions deferred under FSP 157 (refer to Note 8 *Fair Value Measurements for additional information*). The deferred provisions of SFAS 157 will be effective in 2009. The Company does not expect the adoption of the deferred portions of SFAS 157 to have a material effect on its consolidated financial statements.

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 did not adopt the provisions of SFAS 159 for the year ended December 31, 2008.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

(in thousands)

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

##### Recent Accounting Pronouncements (continued)

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations* (SFAS 141R), which replaces SFAS No. 141, *Business Combinations*. SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS 141R also establishes disclosure requirements that will enable users to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for fiscal years beginning after December 15, 2008, and therefore, is effective for the Company beginning January 1, 2009. Early adoption of this standard is not permitted. The Company does not expect the adoption of SFAS 141R to have a material effect on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements – An Amendment of ARB No. 51* (SFAS 160). SFAS 160 requires that accounting and reporting for minority interests be recharacterized as noncontrolling interests and classified as a component of equity. SFAS 160 is effective for fiscal years beginning after December 15, 2008, and therefore, is effective for the Company beginning January 1, 2009 and must be applied prospectively. The Company does not expect the adoption of SFAS 160 to have a material effect on its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133* (SFAS 161). SFAS 161 amends and expands the disclosure requirements of SFAS 133 to require qualitative disclosure about objectives and strategies for using derivatives; quantitative disclosures about fair value amounts and gain and losses on derivative instruments; and disclosures about credit-risk-related contingent features in derivative agreements. This statement is intended to improve financial reporting about derivative instruments and hedging activities through the enhanced disclosures in order to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. SFAS 161 is effective for fiscal years beginning after November 15, 2008, and therefore, is effective for the Company beginning January 1, 2009. The Company does not expect the adoption of SFAS 161 to have a material effect on its consolidated financial statements.

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**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, 2008, 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.

**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, 2008</b>				
Debt securities issued by the U.S. Treasury and other U.S. government agencies	\$ 106,550	\$ 149	\$ 3,016	\$ 109,417
Corporate debt securities	508,531	33,055	8,016	483,492
Options embedded in convertible debt securities	10,254	-	-	10,254
Equity securities	220,843	6,258	4,794	219,379
Mortgage-backed securities	670,142	38,326	10,123	641,939
Total investments	<u>\$ 1,516,320</u>	<u>\$ 77,788</u>	<u>\$ 25,949</u>	<u>\$ 1,464,481</u>

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**4. Investments (continued)**

	<b>Amortized Cost Basis</b>	<b>Gross Unrealized Losses</b>	<b>Gross Unrealized Gains</b>	<b>Fair Value</b>
December 31, 2007				
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>\$ 11,257</u>	<u>\$ 85,671</u>	<u>\$ 1,773,264</u>

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, 2008 and 2007:

	<b>Fair Value &lt; 1 year</b>	<b>Unrealized Losses &lt; 1 year</b>	<b>Fair Value &gt; 1 year</b>	<b>Unrealized Losses &gt; 1 year</b>	<b>Total Unrealized Losses</b>
<b>December 31, 2008</b>					
Debt securities issued by the					
U.S. Treasury and other					
U.S. government agencies	\$ 26,258	\$ 124	\$ 2,007	\$ 25	\$ 149
Corporate debt securities	218,751	17,384	98,839	15,672	33,056
Equity securities	123,925	5,967	851	290	6,257
Mortgage-backed securities	154,770	28,039	47,905	10,287	38,326
Total investments	<u>\$ 523,704</u>	<u>\$ 51,514</u>	<u>\$ 149,602</u>	<u>\$ 26,274</u>	<u>\$ 77,788</u>

**December 31, 2007**

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	<u>\$ 248,899</u>	<u>\$ 7,828</u>	<u>\$ 149,791</u>	<u>\$ 3,429</u>	<u>\$ 11,257</u>

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**4. Investments (continued)**

The Company's fixed maturity investment portfolio is sensitive to interest rate fluctuations, which impact the fair value of individual securities. 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 primarily caused by the effect of the interest rate environment and the widening of credit spreads on certain securities. The Company has the ability and intent to hold these investments until their full cost can be recovered. Therefore, the Company does not consider these investments to be other than temporarily impaired at December 31, 2008 and 2007.

The amortized cost and estimated fair value of debt securities at December 31, 2008, 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	\$ 39,283	\$ 39,423
After 1 year through 5 years	\$152,060	\$144,851
After 5 years through 10 years	\$183,941	\$172,478
After 10 years	\$250,051	\$246,411
Mortgage-backed securities	\$670,142	\$641,939
Total	<u>\$ 1,295,477</u>	<u>\$ 1,245,102</u>

A primary objective in the management of the fixed maturity and equity portfolios is to maximize total return relative to underlying liabilities and respective liquidity needs. In achieving this goal, assets may be sold to take advantage of market conditions or other investment opportunities, as well as tax considerations. Sales will generally produce realized gains and losses. In the ordinary course of business, the Company may sell securities for a number of reasons, including, but not limited to: (i) changes to the investment environment; (ii) expectation that the fair value could deteriorate further; (iii) desire to reduce exposure to an issuer or an industry; (iv) changes in credit quality; and (v) changes in expected cash flow.

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**4. Investments (continued)**

Available-for-sale securities sold were as follows:

	<b>Year Ended December 31</b>	
	<b>2008</b>	<b>2007</b>
Proceeds from sales	<b>\$ 2,804,949</b>	\$ 1,842,451
Gross realized gains	<b>71,082</b>	57,794
Gross realized losses	<b>30,707</b>	43,192

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

**5. Property, Equipment and Capitalized Software**

Property, equipment and capitalized software are comprised of the following:

	<b>December 31</b>	
	<b>2008</b>	<b>2007</b>
Leasehold improvements	<b>\$ 53,246</b>	\$ 43,065
Purchased computer equipment and software	<b>103,349</b>	84,638
Capitalized software	<b>324,302</b>	271,990
Furniture and equipment	<b>63,755</b>	54,242
	<b>544,652</b>	453,935
Less accumulated depreciation and amortization	<b>329,354</b>	283,359
Property, equipment and capitalized software, net	<b>\$ 215,298</b>	\$ 170,576

Depreciation and amortization expense on property, equipment and capitalized software was \$50,239, and \$43,746 for the years ended December 31, 2008 and 2007, respectively, and is included as a component of general and administrative expenses in the accompanying consolidated statements of operations. During the year ended December 31, 2008, the Company recognized an impairment loss of \$4,198 as a result of the annual evaluation of property, equipment and capitalized software, in accordance with the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**6. Medical Claims Payable**

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

	<u>2008</u>	<u>2007</u>
Balance as of January 1	\$ 543,236	\$ 521,419
Incurred related to:		
Current year	5,594,571	5,072,666
Prior years	(21,598)	(50,533)
Total incurred	<u>5,572,973</u>	<u>5,022,133</u>
Paid related to:		
Current year	5,020,127	4,537,810
Prior years	501,295	462,506
Total paid	<u>5,521,422</u>	<u>5,000,316</u>
Balance at December 31	<u>\$ 594,787</u>	<u>\$ 543,236</u>

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, 2008 and 2007, approximately \$(18,627) and \$(7,269), 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 \$20,649 and \$18,520 as of December 31, 2008 and 2007, respectively, and are included in accounts payable and accrued expenses in the accompanying consolidated balance sheets.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

(in thousands)

#### 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:

2009	\$ 33,840
2010	31,270
2011	26,125
2012	24,212
2013	20,812
Thereafter	70,037
Total minimum payments	<u>\$ 206,296</u>

Rent expense for the years ended December 31, 2008 and 2007 for all operating leases was \$41,607 and \$38,734, respectively, and has been included within general and administrative expenses in the accompanying consolidated statements of operations.

#### 8. Fair Value Measurements

The Company adopted SFAS 157, subject to the deferral provisions of FSP 157-2, as discussed in Note 2, as of January 1, 2008. This standard defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The fair value hierarchy is as follows:

*Level 1* – Quoted (unadjusted) prices for identical assets or liabilities in active markets.

*Level 2* – Other observable inputs, either directly or indirectly, including:

- Quoted prices for similar assets/liabilities in active markets;
- Quoted prices for identical or similar assets in non-active markets (few transactions, limited information, non-current prices, high variability over time);
- Inputs other than quoted prices that are observable for the asset/liability (e.g., interest rates, yield curves, volatilities, or default prices); and
- Inputs that are derived principally from or corroborated by other observable market data.

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**8. Fair Value Measurements (continued)**

*Level 3* – Unobservable inputs that cannot be corroborated by observable market data.

In instances in which the inputs used to measure fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company’s assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset. Management is responsible for the determination of fair value, and performs monthly analysis on the prices received from third parties to determine whether the prices appear to be reasonable estimates of fair value.

The following table presents information about the fair value of the Company’s financial assets.

	<b>Quoted Prices in Active Markets (Level 1)</b>	<b>Other Observable Inputs (Level 2)</b>	<b>Unobservable Inputs (Level 3)</b>	<b>Total Fair Value as of December 31, 2008</b>
<b>Assets</b>				
Cash and cash equivalents	\$ 272,014	\$ –	\$ –	\$ 272,014
Debt securities – available for sale:				
U.S. Treasury and other U.S. government agencies	71,527	37,890	–	109,417
Corporate debt securities	–	493,746	–	493,746
Mortgage-backed securities	–	594,757	47,182	641,939
Total debt securities – available for sale	71,527	1,126,393	47,182	1,245,102
Equity securities	–	211,197	8,182	219,379
Total assets at fair value	<u>\$ 343,541</u>	<u>\$ 1,337,590</u>	<u>\$ 55,364</u>	<u>\$ 1,736,495</u>

The following methods and assumptions were used to estimate the fair value of each class of financial instrument:

**Cash and cash equivalents.** The carrying value of cash and cash equivalents approximates fair value as maturities are less than three months.

**Debt securities.** Debt securities consist of U.S. Treasury and other U.S. government agencies securities, state and municipal bonds, corporate debt securities and mortgage-backed securities, which are all held as available-for-sale investments. The fair value of U.S. Treasury securities is determined by an active price for an identical security in an observable market and is therefore classified as Level 1. Other U.S. government agencies securities, state and municipal bonds, corporate debt securities and mortgage-backed securities that are priced by independent pricing services using observable inputs are classified as Level 2. Certain mortgage-backed securities where the fair value is obtained from non-binding broker quotes are classified as Level 3.

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**8. Fair Value Measurements (continued)**

**Equity securities.** Equity securities consist of publicly traded index funds, which are held as available-for-sale investments, and privately held equity securities. Fair value of publicly traded index funds where market quotes are available but are not considered actively traded are classified as Level 2. Fair values of privately held equity securities, where there has been limited trading activity or where less price transparency exists around the inputs to the valuation, are classified as Level 3.

A reconciliation of the beginning and ending balances of assets measured at fair value on a recurring basis using Level 3 inputs is as follow:

	<b>Debt Securities</b>	<b>Equity Securities</b>	<b>Total</b>
Beginning balance at January 1, 2008	\$ –	\$ 7,012	\$ 7,012
Total gains and losses:			
Realized in net income	(2,520)	–	(2,520)
Unrealized in accumulated other comprehensive loss	(5,624)	1,170	(4,454)
Purchases, sales, issuances and settlements	43,333	–	43,333
Transfers into Level 3	11,993	–	11,993
Ending balance at December 31, 2008	<u>\$ 47,182</u>	<u>\$ 8,182</u>	<u>\$ 55,364</u>
Change in unrealized losses included in net income related to assets still held	<u>\$ 2,367</u>	<u>\$ –</u>	<u>\$ 2,367</u>

**9. Retirement Plans and Other Postretirement Benefit Plans**

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. In November 2007, the Company approved a freeze to the Plan, effective January 1, 2009, whereby employees hired on or after January 1, 2009, will no longer be eligible to participate in the Plan. These employees will participate in an enhanced 401(k) program.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### **9. Retirement Plans and Other Postretirement Benefit Plans (continued)**

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 (ERISA). 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.

The Company also has nonqualified supplemental retirement benefit plans covering certain officers, which provide for eligible employees (and former 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 plans if it were not for limitations imposed by income tax regulations.

In addition, the Company provides certain health care benefits for retired employees. Substantially all CFMI and GHMSI 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 program provides 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. The Company funds postretirement benefits as benefits are paid.

During 2005, in connection with the creation of SBP (see Note 1), a Voluntary Employee Beneficiary Association (VEBA), a tax-exempt trust was established to fund certain healthcare benefits for eligible SBP employees. Contributions to the VEBA during 2008 and 2007 were \$675 and \$766, respectively.

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**9. Retirement Plans and Other Postretirement Benefit Plans (continued)**

The following table set forth the obligations, funded status, and amount recognized for the pension benefits, which include the qualified and nonqualified pension plans described above, and other postretirement benefits described above, in the accompanying consolidated financial statements as of December 31:

	Pension Benefits		Other Postretirement Benefits	
	2008	2007	2008	2007
<b>Accumulated benefit obligations</b>	<b>\$ 525,173</b>	\$ 497,616	<b>\$ 71,287</b>	\$ 74,051
<b>Change in projected benefit obligations</b>				
Benefit obligations at beginning of year	\$ 503,871	\$ 481,716	\$ 74,051	\$ 74,541
Service cost	23,432	21,001	2,177	2,470
Interest cost	30,640	27,517	4,263	4,211
Benefits paid	(28,225)	(23,390)	(3,833)	(3,671)
Plan amendments	1,044	1,153	(3,422)	–
Actuarial loss (gain)	1,076	(4,126)	(1,949)	(3,500)
Benefit obligations at end of year	<b>\$ 531,838</b>	\$ 503,871	<b>\$ 71,287</b>	\$ 74,051
<b>Change in plan assets</b>				
Fair value of plan assets at beginning of year	\$ 479,993	\$ 474,055	\$ 2,851	\$ 1,945
Actual return on plan assets	(115,739)	20,486	(859)	170
Employer contributions	88,978	8,842	4,416	4,393
Benefits paid	(28,225)	(23,390)	(3,874)	(3,657)
Fair value of plan assets at end of year	<b>\$ 425,007</b>	\$ 479,993	<b>\$ 2,534</b>	\$ 2,851
Funded status	<b>\$ (106,831)</b>	\$ (23,878)	<b>\$ (68,753)</b>	\$ (71,200)
<b>Net amount included in the consolidated balance sheets</b>				
Noncurrent assets	\$ –	\$ 18,945	\$ –	\$ –
Current liabilities	(18,129)	(10,964)	(4,258)	(4,217)
Noncurrent liabilities	(88,702)	(31,859)	(64,495)	(66,983)
Net amount at December 31	<b>\$ (106,831)</b>	\$ (23,878)	<b>\$ (68,753)</b>	\$ (71,200)

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

9. Retirement Plans and Other Postretirement Benefit Plans (continued)

	Pension Benefits		Other Postretirement Benefits	
	2008	2007	2008	2007
<b>Net amount included in accumulated other comprehensive (loss) income that have not been recognized in net periodic benefit cost</b>				
Net actuarial loss	\$ 210,008	\$ 56,262	\$ 8,933	\$ 10,375
Prior service (asset) cost	(6,554)	(9,953)	(1,698)	199
Transition liability	—	—	1,359	2,945
Net amount at December 31	<u>\$ 203,454</u>	<u>\$ 46,309</u>	<u>\$ 8,594</u>	<u>\$ 13,519</u>

The estimated net actuarial loss and prior service asset for the defined benefit pension plans that will be amortized from accumulated other comprehensive loss into net periodic benefit costs over the next fiscal year are \$2,108 and \$(2,302), respectively. The estimated net actuarial loss, prior service asset and transition liability for other postretirement benefit plans that will be amortized from accumulated other comprehensive loss into net periodic benefit costs over the next fiscal year are \$428, \$(277) and \$340, respectively.

	Pension Benefits		Other Postretirement Benefits	
	2008	2007	2008	2007
<b>Components of net periodic benefit cost</b>				
Service cost	\$ 23,432	\$ 21,001	\$ 2,177	\$ 2,470
Interest cost	30,640	27,517	4,263	4,211
Expected return on plan assets	(38,563)	(36,142)	(126)	(86)
Amortization of transition liability	—	—	340	589
Amortization of prior service asset	(2,354)	(2,612)	(277)	(41)
Net recognized actuarial loss	1,633	3,498	477	814
Net periodic benefit cost for the year ended December 31	<u>\$ 14,788</u>	<u>\$ 13,262</u>	<u>\$ 6,854</u>	<u>\$ 7,957</u>

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**9. Retirement Plans and Other Postretirement Benefit Plans (continued)**

The weighted-average assumptions used in calculating the benefit obligations for all plans are as follows:

	Pension Benefits		Other Postretirement Benefits	
	2008	2007	2008	2007
Discount rate – benefit obligation	<b>6.50%</b>	6.25%	<b>6.50%</b>	6.25%
Discount rate – net benefit cost	<b>6.25%</b>	5.75%	<b>6.25%</b>	5.75%
Expected return on plan assets	<b>8.50% / N/A*</b>	8.50% / N/A*	<b>N/A</b>	N/A
Rate of compensation increase	<b>4.50%</b>	4.50%	<b>N/A</b>	N/A
Annual rate of increase in the per capita cost of covered health care benefits	<b>N/A</b>	N/A	<b>6.00%</b>	6.00%

\* As of December 31, 2008 and 2007, the expected return on plan assets is 8.50% for qualified pension benefits and N/A for nonqualified pension benefits. The Company contributes to the nonqualified pension plans as benefits are paid.

The discount rates used to determine the Company's pension and other postretirement plan obligations were based on a hypothetical Aa yield curve represented by a series of annualized individual discount rates. Each bond issue underlying the yield curve is required to be non-callable and have a rating of Aa or better by Moody's Investor Service, Inc. or a rating of AA or better by Standard & Poor's. The yields are used to discount future pension and postretirement benefit plan cash flows at an interest rate specifically applicable to the timing of each respective cash flow. The sum of these discounted cash flows are totaled into a single present value and an equivalent weighted-average discount rate is calculated by imputing the singular interest rate that equates the total present value of the stream of future cash flows. This resulting interest rate, rounded, is used by the Company as its discount rate.

The expected long-term rate of return for the qualified pension plans' 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 qualified pension plans' active asset managers will provide a modest (0.5% to 1.0% per annum) premium to their respective market benchmark indices.

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**9. Retirement Plans and Other Postretirement Benefit Plans (continued)**

The Company's pension 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 weighted-average asset allocations by asset category for the qualified pension plans are as follows:

	<b>Target Allocation</b>	<b>Actual Allocation</b>
<b>December 31, 2008</b>		
Domestic equity securities	<b>30% – 50%</b>	<b>30%</b>
International equity securities	<b>15% – 25%</b>	<b>16</b>
Emerging markets	<b>0% – 10%</b>	<b>2</b>
Real estate	<b>0% – 10%</b>	<b>6</b>
Debt securities	<b>25% – 35%</b>	<b>24</b>
Cash and cash equivalents	<b>Residual</b>	<b>22</b>
Total		<b>100%</b>
<b>December 31, 2007</b>		
Domestic equity securities	30% – 50%	35%
International equity securities	15% – 25%	21
Emerging markets	0% – 10%	4
Real estate	0% – 10%	5
Debt securities	25% – 35%	32
Cash and cash equivalents	Residual	3
Total		100%

As shown above, the Company's actual weighted-average asset allocations were not within the target allocations for certain asset categories at December 31, 2008. The Company funded the qualified pension plan in December 2008, but did not invest the cash and cash equivalents prior to December 31, 2008. The assets were reallocated to meet the target asset allocations in the first week of 2009.

The investment policy related to the VEBA (i.e., plans holding less than \$10 million in assets) provides that the assets in the trust be invested in a "balanced" type of fund that provides diversification reasonably similar to an asset allocation of 60% domestic equity securities and 40% debt securities.

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**9. Retirement Plans and Other Postretirement Benefit Plans (continued)**

The Company expects to make contributions of \$28,481 and \$4,981, respectively, to the pension benefit plans and other postretirement benefit plans during 2009.

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

	<b>Pension Benefits</b>	<b>Other Postretirement Benefits</b>
2009	\$ 59,762	\$ 4,380
2010	45,709	4,644
2011	43,707	4,880
2012	44,294	5,057
2013	54,436	5,207
2014 through 2018	272,974	31,798
	<u>\$ 520,882</u>	<u>\$ 55,966</u>

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 of \$5,806 and \$4,927 for the years ended December 31, 2008 and 2007, respectively.

**10. Income Taxes**

The Company files a consolidated federal income tax return. The federal statutory income tax rate for the Company is 35 percent. For federal income tax purposes, the Company benefits from a special deduction available to certain BlueCross and BlueShield organizations under Internal Revenue Code Section 833(b) (the 833(b) deduction). The 833(b) deduction results in the Company incurring federal income taxes at the Tentative Minimum Tax (TMT) rates of 20 percent. As a result, the Company's income tax provision is reduced from the statutory rate of 35 percent to account for the benefit of the 833(b) deduction. The Company could lose the benefit of the 833(b) deduction in the future if there is a change in the tax law, 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. If the Company can no longer use the 833(b), the Company will incur federal income taxes at the statutory rate of 35 percent net of available Alternative Minimum Tax (AMT) credits.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### **10. Income Taxes (continued)**

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.

(Benefit) 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. In addition, generally, the Company's TMT liability results in AMT credits for future use. AMT credits do not expire under current law. The Company records its deferred tax assets and liabilities at the federal statutory rate of 35 percent. Because the Company anticipates continued benefits of the 833(b) deduction, its net deferred tax assets have been reduced by valuation allowances to the amounts realizable at the TMT rates. Generally, changes to the Company's valuation allowances are accounted for in the Company's income tax (benefit) provision. If the Company were to incur federal income taxes at the statutory rate of 35 percent primarily due to the loss of the 833(b) deduction, at such time, the Company will also evaluate the continued need for any existing valuation allowances on its net deferred tax assets.

The principal sources of temporary differences include nondeductible accruals, accounts receivable, property and equipment, capitalized software costs, pension and postretirement benefits, medical claims payable, unrealized gains and losses, and AMT credits. The Company experienced significant decline in the value of its investment portfolio. As a result, the Company recognized losses in its consolidated statement of operations as well as through other comprehensive loss. These losses are not recognized for income tax purposes until the investments are disposed and result in deferred tax assets. The Company performed additional analysis of its deferred tax assets related to unrealized losses from its investments. The realization of these deferred tax assets is limited by the Company's ability to generate capital gains through sales of securities in an unrealized gain position, holding debt securities to maturity, or the carry-back of prior year capital gains. Because of these limitations, the Company recorded a valuation allowance of \$12,097 against deferred tax assets arising from other than temporary impairments of investments. This valuation allowance was recorded through the Company's tax (benefit) provision. The Company also recorded a valuation allowance of \$1,132 related to other deferred tax assets for unrealized losses included in other comprehensive loss at December 31, 2008.

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**10. Income Taxes (continued)**

As of December 31, 2008 and 2007, the Company had deferred tax assets of \$424,532 and \$322,450, (net of valuation allowance of \$277,456 and \$235,605) respectively, and deferred tax liabilities of \$91,260 and \$70,249, respectively. These amounts include the deferred tax assets and related valuation allowances from investment losses discussed above. A substantial amount of the valuation allowance is related to the difference between the 35% statutory rate and the 20% TMT rate. 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 (benefit) provision for income taxes consists of the following components:

	<b>Year Ended December 31</b>	
	<b>2008</b>	<b>2007</b>
Current:		
Federal	<b>\$ (16,001)</b>	\$ 43,604
State	<b>(629)</b>	4,785
	<b>(16,630)</b>	48,389
Deferred:		
Federal	<b>16,350</b>	3,750
State	<b>(93)</b>	(12)
	<b>16,257</b>	3,738
(Benefit) provision for income taxes	<b>\$ (373)</b>	\$ 52,127

The (benefit) provision for income taxes for 2008 and 2007 differs from the statutory rate of 35 percent principally as a result of the 833(b) deduction, changes in tax contingency reserves and valuation allowance.

CareFirst, Inc. and Affiliates

Notes to Consolidated Financial Statements (continued)

(in thousands)

**11. Other Comprehensive (Loss) Income**

The components of other comprehensive (loss) income, including the reconciliation of net unrealized holding gains and losses to net unrealized holding gains and losses, net of reclassification adjustments and taxes and the impact of recording the SFAS 158 defined benefit adjustment, are as follows:

	<b>Before-Tax Amount</b>	<b>Tax Benefit (Expense)</b>	<b>Net-of-Tax Amount</b>
<b>Year Ended December 31, 2008</b>			
Net unrealized gains and losses arising during the period	\$(170,423)	\$ 34,525	\$(135,898)
Less reclassification adjustments for net gains and losses realized or recognized in net income	(50,819)	10,698	(40,121)
Net unrealized gains and losses	(119,604)	23,827	(95,777)
Defined benefit plans adjustment	(152,220)	30,325	(121,895)
Total other comprehensive loss	<u>\$(271,824)</u>	<u>\$ 54,152</u>	<u>\$(217,672)</u>
<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	<u>\$ 2,379</u>	<u>\$ (356)</u>	<u>\$ 2,023</u>

**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

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

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

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 laws and regulations, 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.

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). The 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. The court order related to this lawsuit was signed on April 19, 2008. The court order did not include a specific settlement date as an appeal was submitted by several physicians.

Effective November 2, 2006, the contract of the President and Chief Executive Officer (CEO) 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 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. Pursuant to a hearing, the Insurance Commissioner for the State of Maryland allowed a portion of the proposed payment to the former President and CEO and disallowed the remainder. The former President and CEO has appealed the Insurance Commissioner's decision to the Circuit Court of Maryland and initiated an independent action under ERISA in Federal Court to compel full payment. The former President and CEO is also maintaining an action against CFI to compel full payment under his contract. In 2008, the Company paid the amount authorized by the Maryland Insurance Commissioner.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

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

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, 2008 or 2007, as management believes that the relevant triggering events have not occurred.

In June 2008, the District of Columbia Attorney General office filed suit against CFI and GHMSI alleging the breach of GHMSI’s federal charter as a “charitable and benevolent” institution. Also, the District of Columbia’s City Council Committee on Public Services and Consumer Affairs (D.C. City Council) launched an investigation of and issued a subpoena to GHMSI and CFI regarding various items including the accumulation of statutory surplus, rate setting, executive compensation, and community benefits. CFI has responded to these parties and has provided the information requested. In addition, the D.C. City Council has introduced legislation giving the Insurance Commissioner authority to cap those GHMSI statutory reserves attributable to the District of Columbia and compel the offering of an expanded open enrollment product in the District of Columbia. The legislation was passed by the D.C. City Council in December 2008. The Company is of the opinion that it is in a good position to effectively defend against the Attorney General's action.

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.

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.

## CareFirst, Inc. and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(in thousands)*

#### **12. 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 requirements, subject to specific limitations, if either CFMI or GHMSI or their respective subsidiaries fail to meet or maintain their respective statutory or regulatory reserve requirements as required by law, or if such transfer of financial resources is needed to satisfy any other legally enforceable obligation.

During 2008, the Company, through its affiliates (CFMI and GHMSI) made a commitment to fund \$15,000 into the Blue Venture Fund Limited Partnership. The amount of the unfunded commitment was \$13,988 at December 31, 2008. The Company anticipates that the additional amount will be invested in the limited partnership over the next five years.

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, 2009. The Company also 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 2008 or 2007.

#### **13. Subsequent Events**

Effective January 1, 2009, BCBSD opted out of the reinsurance contract with FirstCare. The business that FirstCare writes in BCBSD's service area will be ceded to the Company effective January 1, 2009. CFMI and GHMSI have renewed the contract with FirstCare for 2009.

# 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, 2008 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, 2008 consolidated financial statements. Such information has been subjected to the auditing procedures applied in our audit of the December 31, 2008 consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the December 31, 2008 consolidated financial statements taken as a whole.

*Ernst & Young LLP*

February 27, 2009

CareFirst, Inc. and Affiliates

Consolidating Balance Sheet

December 31, 2008

(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	\$ 363	\$ 70,299	\$ 116,205	\$ 85,147	\$ –	\$ 272,014
Short-term investments	–	15,784	14,967	8,672	–	39,423
Advances to providers	–	146,896	33,374	40,638	–	220,908
Accounts receivable, net	–	199,210	302,073	49,660	(1,298)	549,645
Due from affiliates, net	–	2,961	–	12,012	(14,973)	–
Interest income receivable	4	2,468	5,205	3,203	–	10,880
Other current assets	–	152,836	473,612	16,794	–	643,242
Deferred tax assets, net	–	9,094	5,926	5,421	–	20,441
Total current assets	367	599,548	951,362	221,547	(16,271)	1,756,553
Long-term investments	140	319,880	688,583	416,455	–	1,425,058
Other invested assets	–	506	506	131	–	1,143
Property, equipment and capitalized software, net	–	131,370	83,928	–	–	215,298
Investment in affiliates	–	250,743	167,162	–	(417,905)	–
Goodwill	–	12,710	–	17,246	–	29,956
Other assets	–	11,546	11,114	–	–	22,660
Deferred tax assets, net	–	20,201	10,368	4,806	–	35,375
Total assets	\$ 507	\$ 1,346,504	\$ 1,913,023	\$ 660,185	\$ (434,176)	\$ 3,486,043

CareFirst, Inc. and Affiliates

Consolidating Balance Sheet (continued)

December 31, 2008

(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>Liabilities and reserves</b>						
Current liabilities:						
Short-term borrowings	\$ —	\$ 81,970	\$ 83,664	\$ 2,416	\$ —	\$ 168,050
Medical claims payable	—	149,972	295,218	149,597	—	594,787
Due to affiliates, net	495	—	14,478	—	(14,973)	—
Accounts payable and accrued expenses	—	162,857	93,007	30,386	(1,298)	284,952
Unearned revenues	—	39,539	75,753	47,041	—	162,333
Group experience funds and advances	—	250,961	533,918	12,840	—	797,719
Note payable, current portion	—	—	281	—	—	281
Total current liabilities	495	685,299	1,096,319	242,280	(16,271)	2,008,122
Note payable, noncurrent	—	—	561	—	—	561
Long-term employee benefit obligations	—	84,469	68,728	—	—	153,197
Other liabilities	—	17,540	10,104	—	—	27,644
Total liabilities	495	787,308	1,175,712	242,280	(16,271)	2,189,524
Reserves:						
Retained earnings	—	659,688	848,526	430,016	(430,016)	1,508,214
Accumulated other comprehensive income (loss)	12	(100,492)	(111,215)	(12,111)	12,111	(211,695)
Total reserves	12	559,196	737,311	417,905	(417,905)	1,296,519
Total liabilities and reserves	\$ 507	\$ 1,346,504	\$ 1,913,023	\$ 660,185	\$ (434,176)	\$ 3,486,043

CareFirst, Inc. and Affiliates

Consolidating Statement of Operations

Year Ended December 31, 2008

(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	\$ —	\$ 1,828,617	\$ 2,743,995	\$ 1,747,822	\$ (192)	\$ 6,320,242
Amounts attributable to self-funded arrangements	—	2,493,805	1,090,568	—	—	3,584,373
Less amounts attributable to claims under self-funded arrangements	—	(2,350,368)	(1,015,217)	—	—	(3,365,585)
Other	400	21,548	23,117	62	—	45,127
Net revenue	400	1,993,602	2,842,463	1,747,884	(192)	6,584,157
Operating expenses:						
Cost of care	—	1,629,625	2,478,528	1,465,012	(192)	5,572,973
General and administrative	387	392,360	352,395	278,312	—	1,023,454
Total operating expenses	387	2,021,985	2,830,923	1,743,324	(192)	6,596,427
Income (loss) from operations	13	(28,383)	11,540	4,560	—	(12,270)
Investment income, net	(15)	29,537	53,915	29,180	—	112,617
Other than temporary impairment of investments	—	(24,375)	(41,699)	(25,121)	—	(91,195)
Equity in gain of affiliate	—	9,889	6,592	—	(16,481)	—
Other income (loss), net	2	529	218	(927)	—	(178)
(Loss) income before (benefit) provision for income taxes	—	(12,803)	30,566	7,692	(16,481)	8,974
(Benefit) provision for income taxes	—	(5,120)	13,536	(8,789)	—	(373)
Net (loss) income	\$ —	\$ (7,683)	\$ 17,030	\$ 16,481	\$ (16,481)	\$ 9,347