

Report of independent public accountants

To the Board of Directors of CareFirst, Inc.,
the Board of Directors of CareFirst of Maryland, Inc.,
the Board of Trustees of Group Hospitalization and Medical Services, Inc.
and the Board of Directors of BCBSD, Inc.:



We have audited the accompanying consolidated balance sheets of CareFirst, Inc. (a Maryland corporation) and affiliates (collectively referred to as the Company) as of December 31, 2001 and 2000, and the related consolidated statements of operations, changes in reserves and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as 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 financial position of the Company as of December 31, 2001 and 2000, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

Arthur Andersen LLP

Baltimore, Maryland
January 26, 2002

Consolidated balance sheets

As of December 31, 2001 and 2000 (in thousands)

	2001	2000
Assets		
Current Assets:		
Cash and cash equivalents	\$ 162,390	\$ 230,870
Investments	18,073	19,725
Advances to providers	139,841	121,250
Accounts receivable, net	699,380	601,057
Interest income receivable	10,875	9,783
Other current assets	317,421	250,960
Deferred tax assets, net	15,835	13,060
Total current assets	1,363,815	1,246,705
Long-term investments	955,911	822,517
Property and equipment, net	170,487	143,260
Intangible and other assets, net	53,432	48,955
Deferred tax assets, net	22,046	18,962
Net long-term assets of discontinued operations	—	1,766
Total assets	<u>\$ 2,565,691</u>	<u>\$ 2,282,165</u>
Liabilities and Reserves		
Current Liabilities:		
Short-term borrowings	\$ 94,908	\$ 96,549
Medical claims payable	775,771	725,134
Accounts payable and accrued expenses	299,617	260,809
Unearned revenues	391,663	301,208
Group experience funds and advances	146,849	121,845
Current portion of note payable	8,937	8,937
Net current liabilities of discontinued operations	411	1,640
Total current liabilities	1,718,156	1,516,122
Note payable	162	9,347
Obligations under capital lease	2,563	2,997
Other liabilities	60,126	61,916
Total liabilities	<u>1,781,007</u>	<u>1,590,382</u>
Commitments and Contingencies		
Reserves:		
Retained earnings	781,479	682,783
Accumulated other comprehensive income	3,205	9,000
Total reserves	<u>784,684</u>	<u>691,783</u>
Total liabilities and reserves	<u>\$ 2,565,691</u>	<u>\$ 2,282,165</u>

The accompanying notes are an integral part of these consolidated balance sheets.

Consolidated statements of operations

For the years ended December 31, 2001 and 2000 (in thousands)

	2001	2000
Revenues	\$ 5,954,771	\$ 4,984,656
Operating Expenses:		
Cost of care	5,371,288	4,473,951
General and administrative	547,648	455,273
Affiliation costs	—	11,934
Total operating expenses	<u>5,918,936</u>	<u>4,941,158</u>
Income from operations	35,835	43,498
Investment income, net	67,476	55,710
Other income, net	<u>9,480</u>	<u>6,880</u>
Income from continuing operations before provision for income taxes	112,791	106,088
Provision for income taxes	<u>20,383</u>	<u>19,977</u>
Income from continuing operations	92,408	86,111
Discontinued operations:		
Income (loss) from discontinued, operations net of applicable income tax provision (benefit) \$2,755 and \$(5,768)	7,448	(18,181)
Loss on disposal of discontinued operations, net of applicable income tax benefit of \$(290) and \$(1,231)	<u>(1,160)</u>	<u>(4,126)</u>
Net income	<u><u>\$ 98,696</u></u>	<u><u>\$ 63,804</u></u>

Consolidated statements of changes in reserves

For the years ended December 31, 2001 and 2000 (in thousands)

	Retained earnings	Accumulated other comprehensive income (loss)	Total reserves
Balance, as of December 31, 1999	\$ 618,979	\$ (20,760)	\$ 598,219
Net income	63,804	—	63,804
Other comprehensive income (loss), net of tax:			
Change in net unrealized gains and losses on investments, net of reclassification adjustments	—	30,316	30,316
Minimum pension liability adjustment	—	(507)	(507)
Foreign currency translation adjustment	—	(49)	<u>(49)</u>
Total comprehensive income	<u>63,804</u>	<u>29,809</u>	<u>93,613</u>
Balance, as of December 31, 2000	682,783	9,000	691,783
Net income	98,696	—	98,696
Other comprehensive income (loss), net of tax:			
Change in net unrealized gains and losses on investments, net of reclassification adjustments	—	2,578	2,578
Minimum pension liability adjustment	—	(8,460)	(8,460)
Foreign currency translation adjustment	—	87	<u>87</u>
Total comprehensive income	<u>98,696</u>	<u>(5,882)</u>	<u>92,814</u>
Balance, as of December 31, 2001	<u><u>\$ 781,479</u></u>	<u><u>\$ 3,205</u></u>	<u><u>\$ 784,684</u></u>

The accompanying notes are an integral part of these consolidated statements.

Consolidated statements of cash flows

For the years ended December 31, 2001 and 2000 (in thousands)

	2001	2000		2001	2000
Cash Flows From Operating Activities:			Cash Flows From Investing Activities:		
Net income	\$ 98,696	\$ 63,804	Net purchases of investments	\$ (128,549)	\$ (14,708)
Adjustments to reconcile net income to net cash flows from operating activities:			Net purchases of property and equipment	(63,295)	(63,200)
Depreciation and amortization	39,201	37,579	Cash received in PHN acquisition	—	4,922
Loss on disposal of property and equipment	77	179	(Increase) decrease in intangible and other assets, net	(480)	178
Benefit for deferred income taxes	(6,387)	(1,560)	Net cash flows from investing activities	<u>(192,324)</u>	<u>(72,808)</u>
Gain on sale of assets	(1,644)	—			
Changes in operating assets and liabilities:			Cash Flows From Financing Activities:		
Increase in accounts receivable, net	(90,077)	(6,376)	(Decrease) increase in short-term borrowings	(1,641)	9,167
Increase in interest income receivable	(1,092)	(300)	Payments on obligation under capital lease	(434)	(472)
Increase in other current assets	(1,877)	(9,130)	Repayment on note payable	(8,995)	(9,017)
Increase in other assets	(10,030)	(8,244)	(Increase) decrease in advances to providers	(18,591)	2,926
Increase in medical claims payable	50,637	92,364	Net cash flows from financing activities	<u>(29,661)</u>	<u>2,604</u>
Increase in accounts payable and accrued expenses	21,933	26,003	Net (decrease) increase in cash and cash equivalents	(68,480)	117,516
Increase in unearned revenues	30,317	5,779	Cash and cash equivalents, beginning of year	<u>230,870</u>	<u>113,354</u>
Increase in group experience funds and advances	25,004	15,736	Cash and cash equivalents, end of year	<u>\$ 162,390</u>	<u>\$ 230,870</u>
Decrease in other liabilities	(1,790)	(5,168)			
Changes in net assets and liabilities of discontinued operations	537	(22,946)	Supplemental Disclosures:		
Net cash flows from operating activities	<u>153,505</u>	<u>187,720</u>	Cash paid for income taxes	<u>\$ 11,128</u>	<u>\$ 11,830</u>
			Cash paid for interest	<u>\$ 1,864</u>	<u>\$ 2,382</u>

The accompanying notes are an integral part of these consolidated statements.

Notes to consolidated financial statements

December 31, 2001 and 2000 (in thousands)

1. Organization and principles of consolidation:

CareFirst, Inc. (a Maryland corporation) and affiliates (collectively, the Company) provide a comprehensive array of health insurance and managed care products and services primarily through indemnity health insurance, health benefits administration and health maintenance organizations (HMOs). These products and services are provided to individuals, businesses and governmental agencies primarily in the States of Maryland and Delaware and the Washington, D.C., metropolitan area.

CareFirst, Inc. incorporated 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.

On March 22, 2000, CareFirst, Inc., also entered into a business affiliation with BCBSD, Inc. (BCBSD). In connection with this affiliation, the Company incurred affiliation costs of \$11,934 for the year ended December 31, 2000. These affiliation costs consist primarily of personnel related expenses, legal fees and consulting fees. This affiliation qualified as a tax-free exchange and was accounted for using the "pooling of interest" method of accounting for business combinations under Accounting Principles Board Opinion No. 16. Accordingly, the consolidated financial statements have been presented to include the combined financial position, results of operations, and cash flows as though the affiliation occurred on the first day of the earliest period presented.

The accompanying consolidated financial statements include the accounts of CareFirst, Inc. and its affiliates. All significant intercompany transactions have been eliminated in consolidation.

On November 8, 2000, the Company, through one of its subsidiaries, acquired the remaining outstanding stock of Preferred Health Network of Maryland, Inc. (PHN). Prior to November 8, 2000, the Company maintained a cost-based investment in PHN. PHN and its subsidiaries provide managed care products for clients located in Maryland.

On November 20, 2001, WellPoint Health Networks, Inc. (WellPoint) and CareFirst, Inc. signed a definitive agreement to merge. Under the agreement, WellPoint has agreed to acquire CareFirst, Inc. for \$1.3 billion following CareFirst, Inc.'s conversion to for-profit status and pending

approval from various regulatory agencies. The purchase price would be provided to benefit residents in CareFirst, Inc.'s three principal areas – Maryland, Delaware and the District of Columbia.

2. Summary of significant accounting policies:

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 reported amounts of assets, liabilities, revenues and expenses in the financial statements and in the disclosures of contingent assets and liabilities. While actual results could differ from those estimates, management believes that actual results will not be materially different from amounts provided in the accompanying consolidated financial statements.

Fair value of financial instruments

The fair value of the Company's investments are based primarily on quoted market prices. The carrying amounts of other financial instruments, including cash and cash equivalents, advances to providers, accounts receivable, other current assets, short-term borrowings, medical claims payable, accounts payable and accrued expenses, unearned revenues, and group experience funds and advances, 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 ninety days or less from the date of original purchase are classified as cash and cash equivalents. In accordance with the Company's cash management policy of maximizing the amount of funds invested in income-earning assets, the Company routinely anticipates the timing and amount of future cash flows. This policy frequently results in the existence of negative book cash balances, which represent short-term borrowings.

Advances to providers

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

Revenue recognition

Revenues are recognized and earned on a monthly basis for the period the health care coverage is in effect. Unearned revenues represent prepayments of premiums for future health care coverage and Federal Employee Program unearned premiums.

The Company has administrative service contracts with certain customers, under which the Company earns fees for processing medical claims, and is reimbursed for the cost of such claims. Claims incurred and fees earned under these contracts are reported as revenues. The Company also provides coverage for certain groups whose contracts provide for payments based on group experience factors. 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 be recouped against subsequent years' gains.

The Company participates with other Blue Cross and Blue Shield plans in administering the health care benefit plans of various national accounts. Administrative fees are generally recognized and earned on a monthly basis for the period the participating agreement is in effect.

Accounts receivable primarily represent unpaid amounts earned from employer groups and individuals for health benefits and amounts offsetting the estimate of self-funded medical claims payable and accrued claims processing expenses. Provision is made for accounts considered uncollectible and/or potential adjustments which arise as a result of management or third party review. Accounts receivable are shown net of allowance for doubtful accounts of \$14,549 and \$13,159 as of December 31, 2001 and 2000, respectively.

Certain claim payments, premium rates, administrative expense reimbursements and provider discounts are subject to review and potential retroactive adjustment by third parties. Reserves are established for potential obligations arising from such reviews. While claims have been asserted against the Company, 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

Cost of care is recognized in the period in which members receive medical services. Amounts recorded represent contractual payments to providers and estimates of medical claims payable.

Federal employee program

The Company participates in the Blue Cross and Blue Shield Federal Employee Program (FEP) through the Office of Personnel Management (OPM). Claims incurred on behalf of FEP are reported as revenues during the period in which the claims are incurred. The related administrative fees are recognized as revenues as they are earned during the contract period. The Blue Cross and Blue Shield Association (BCBSA) contracts directly with OPM to administer this portion of the FEP Program and subcontracts with CFMI and GHMSI. BCBSA also provides information to the Company for inclusion in the accompanying consolidated financial statements.

The Company records its allocable share of amounts held by the OPM as an asset, with an equivalent amount recorded as unearned revenues. These amounts are \$291,445 and \$230,341 as of December 31, 2001 and 2000, respectively, and are included in other current assets and unearned revenues, respectively, in the accompanying consolidated balance sheets. The activity related to these amounts is considered noncash operating activity and has been excluded from the accompanying consolidated statements of cash flows. The current contract expires December 31, 2002.

FEP represented approximately 23 percent of accounts receivable as of December 31, 2001 and 2000. FEP represented approximately 23 and 25 percent of revenues for the years ended December 31, 2001 and 2000, respectively.

Reimbursement of FEP operations center expenses

GHMSI performs certain administrative functions as the national operations center for the FEP under a cost reimbursement contract with the BCBSA. The reimbursement of allocable costs under this contract is recorded as a reduction of general and administrative expenses. The FEP reimbursed GHMSI for costs incurred in connection with this agreement totaling \$48,382 and \$45,862 for the years ended December 31, 2001 and 2000, respectively.

Reimbursement of Medicare claims cost and expenses

CFMI acted as a fiscal intermediary under contract with BCBSA for Part A of the Medicare program in 2001 and 2000. Under this contract, CFMI processed claims of approximately \$3.5 billion and \$3.1 billion in 2001 and 2000, respectively. Payment and reimbursement of Medicare claims are not included in the accompanying consolidated financial statements.

Administrative expense reimbursements received from the Medicare program were approximately \$11,633 and \$10,463 for the years ended December 31, 2001 and 2000, respectively. Operating expenses in the accompanying consolidated statements of operations are recorded net of these reimbursements.

Intangible and other assets

Intangible and other assets primarily include employer group contracts, goodwill, and cash surrender value of life insurance policies. The intangible assets are being amortized over their useful lives which range from 10 to 30 years. Amortization expense of \$3,210 and \$2,548 has been recorded in the accompanying consolidated statements of operations for the years ended December 31, 2001 and 2000, respectively. Accumulated amortization was \$26,364 and \$23,154 as of December 31, 2001 and 2000, respectively.

Recent accounting pronouncements

In June 1998, Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities", was issued. SFAS No. 133 establishes accounting and reporting standards for derivative instruments and derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities. It requires that an entity

recognize all derivatives as either assets or liabilities in the balance sheet and measure those instruments at fair value. SFAS 137, "Accounting for Derivative Instruments and Hedging Activities – Deferral of the Effective Date of FASB Statement No. 133" was issued in June 1999 and deferred the effective date of SFAS No. 133 to fiscal years beginning after June 15, 2000. SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities," was issued in June 2000 and also amends SFAS No. 133. SFAS No. 138 addresses a limited number of issues causing implementation difficulties. The Company adopted these pronouncements effective January 1, 2001, and the impact of adoption was not material to the Company's consolidated financial statements.

In June 2001, the Financial Accounting Standards Board finalized SFAS No. 142, "Goodwill and Other Intangible Assets." With the adoption of SFAS No. 142, goodwill is no longer subject to amortization over its estimated useful life. Rather, goodwill will be subject to at least an annual assessment for impairment by applying a fair-value-based test. Similarly, goodwill associated with equity-method investments is no longer amortized. Equity-method goodwill is not, however, subject to the new impairment rules; the impairment guidance in existing rules for equity-method investments continues to apply. Under the new rules, an acquired intangible asset should be separately recognized (and amortized over its useful life) if the benefit of the intangible asset is obtained through contractual or other legal rights, or if the intangible asset can be sold, transferred, licensed, rented, or exchanged, regardless of the acquirer's intent to do so. The new rules are effective for fiscal years beginning after December 15, 2001, although early adoption is permitted in certain circumstances. The Company plans to implement this standard in 2002. The Company is in the process of evaluating the impact of SFAS No. 142 on its consolidated financial statements.

Reclassifications

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

3. Discontinued operations:

Public HMO Sector – FSHP

In July 2000, management and the Board of Directors of the Company adopted a formal plan for one of the Company's HMO's, Free State Health Plan, Inc. (FSHP), to fully exit its Medicare HMO segment effective December 31, 2000. In December 2000, management and the Board of Directors also adopted a formal plan for FSHP to fully exit its Medicaid HMO segment effective March 31, 2001. These segments included all of the operations surrounding FSHP's Medicare and Medicaid risk products. As of December 31, 2001, the Company has completed its exit from these businesses.

The Company has accounted for the disposal of the segments under Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations – Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions" (APB 30). APB 30 requires that the results of the continuing operations be reported separately from those of discontinued operations for all periods presented and that any gain or loss from disposal of a segment of business be reported in conjunction with the related results of discontinued operations. Accordingly, the Company has restated its results of operations for all prior periods. The Company recorded an after-tax loss on disposal of its public sector businesses of approximately \$2,126 during the year ended December 31, 2000, representing the writeoff of certain assets and estimated severance costs.

The summarized results of the operations for the discontinued segments are as follows:

	2001	2000
Revenues	\$ 34,331	\$ 460,224
Operating expenses:		
Cost of care	(22,803)	(458,438)
General and administrative	(1,325)	(24,040)
Total operating expenses	(24,128)	(482,478)
Income (loss) from discontinued operations before benefit for income taxes	10,203	(22,254)
Provision (benefit) for income taxes	2,755	(5,697)
Income (loss) from discontinued operations	\$ 7,448	\$ (16,557)

The 2001 results of operations for discontinued segments were positively impacted by changes in estimates of \$7,611 related to reserves on certain provider settlement receivables and medical claims payable.

The following is a summary of the current assets and (liabilities) of the discontinued public sector HMO segments as of December 31, 2001 and 2000, respectively, which are reflected in the accompanying consolidated balance sheets.

	2001	2000
Advances to providers	\$ 8,165	\$ 43,970
Accounts receivable	—	25,861
Medical claims payable	(4,145)	(67,864)
Unearned revenues	—	(101)
Other	(3,089)	370
Net current assets of discontinued operations	\$ 931	\$ 2,236

As of December 31, 1999, FSHP carried a \$2,189 investment in CarePartners, LLC (CarePartners). CarePartners served as a preferred provider network for the FSHP's State of Maryland Medicaid enrollees and coordinated the delivery of health care services to those State of Maryland Medicaid enrollees who selected a primary care physician in certain designated geographic areas. FSHP also served as a claims processor for CarePartners. In December 2000, FSHP recorded a pre-tax impairment charge of \$2,189 against the CarePartners investment. This charge has been included within the loss on disposal of discontinued operations for the year ended December 31, 2000.

International operations – BCBSD

During 2000, BCBSD entered into two transactions, which effectively resulted in a discontinuance of its international operations.

On June 30, 2000, BCBSD sold its interest in Allnation Uruguay S.A. (BCBSU) and Allnation Argentina S.A. (BCBSAR) to a third party. A gain of \$824 was recorded on the sale and has been

included within the loss on disposal of discontinued operations within the consolidated statement of operations. The loss from discontinued operations includes the operating results of BCBSU and BCBSAR prior to the sale.

In October 2000, the Company determined that it would discontinue its remaining international operations, which consisted of Allnation Insurance Company (Allnation). This decision resulted in a measurement date for discontinued operations. Accordingly, the disposal of the international business has been accounted for under APB 30, as described above and results of operations for prior periods have been restated.

In January 2001, the Company entered into an agreement to sell Allnation to another insurance company. As of December 31, 2000, initial estimates were made for losses expected to be sustained during the disposal period, as well as severance costs, legal fees, and reserves for uncollectible reinsurance receivables. These costs were accumulated and shown separately in the consolidated statement of operations for 2000 as discontinued operations. Total estimated loss on disposal (net of tax), including the gain noted above, was \$2,000.

In November 2001, the Company finalized the sale of Allnation. Allnation's business included prepaid health insurance contracts sold under license of the Blue Cross Blue Shield Association (branded) and essentially similar products sold without reference to the Blue Cross Blue Shield Association (unbranded). Also included within Allnation were the assets, liabilities, and results of operations of the Taiwan branch, which had obtained a license to sell health insurance products in Taiwan. Additional charges were recorded in 2001 against discontinued operations to reflect the finalization of this sale.

The assets and liabilities related to BCBSU's international operations have been combined and shown separately at their net realizable value as net assets or net liabilities of discontinued operations in the accompanying balance sheets. These assets and (liabilities) at December 2001 and 2000, are as follows

	2001	2000
Current:		
Cash and cash equivalents	\$ —	\$ 1,400
Other current assets	62	1,564
	62	2,964
Medical claims payable	(1,404)	(2,100)
Unearned revenues	—	(3,147)
Accounts payable and accrued expenses	—	(1,593)
	(1,404)	(6,840)
Net current liabilities of discontinued operations	\$ (1,342)	\$ (3,876)
Long-term:		
Long-term investments	\$ —	\$ 1,766
Net long-term assets of discontinued operations	\$ —	\$ 1,766

4. PHN acquisition:

In November 2000, one of CFMI's subsidiaries acquired the stock of PHN for consideration, including previous investments and forgiveness of certain receivables, of \$4,539. This transaction was accounted for as a purchase; thus, the consideration was allocated to the acquired assets and liabilities based on their estimated fair values at the time of acquisition. The estimated fair value of the assets acquired and (liabilities) assumed were as follows:

Cash	\$ 1,634
Accounts receivable, net	15,269
Other current assets	304
Property and equipment, net	11
Investments	3,288
Medical claims payable	(24,950)
Other	(4,497)
Net liabilities assumed	\$ (8,941)

Goodwill of \$13,482 related to the PHN acquisition are being amortized over 20 years.

5. Regulatory matters:

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

Financial statements filed by certain of the regulated companies with the regulatory authorities are prepared in accordance with statutory accounting practices prescribed or permitted by said authorities, which differ from GAAP. The most significant differences result from the exclusion of certain assets from statutory reserves, recording the note 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 (losses) as an unrealized capital gain, and the modification or exclusion of certain Statements of Financial Accounting Standards.

In 2001, the Company, CFMI, GHMSI, and BCBSD (collectively referred to as the Group) adopted the National Association of Insurance Commissioners' Codification of Statutory Accounting Principles, which altered the treatment of certain assets and liabilities for statutory purposes. At December 31, 2001 and 2000, the Group's statutory reserves and unassigned funds exceed the minimum statutory requirements as determined by each of the jurisdictions in which the Group conducts business.

6. Investments:

Under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," the Company's investments are classified as available-for-sale. Available-for-sale securities are carried at fair value, which is determined based on quoted market prices. Investment income is recognized when earned and reported net of investment expenses. These investments consist of the following:

	Amortized cost basis	Gross unrealized losses	Gross unrealized gains	Gross Aggregate fair gains
December 31, 2001:				
Debt securities issued by the U.S. Treasury and other U.S. Government agencies	\$379,501	\$ 996	\$ 7,844	\$386,349
Foreign government debt securities	2,304	6	126	2,424
Corporate debt securities	425,099	7,290	14,282	432,091
Equity securities	121,983	11,339	11,705	122,349
Mortgage backed securities	30,368	186	589	30,771
Total investments	\$959,255	\$ 19,817	\$34,546	\$973,984
December 31, 2000:				
Debt securities issued by the U.S. Treasury and other U.S. government agencies	\$398,885	\$ 2,366	\$ 3,971	\$400,490
Foreign government debt securities	2,277	3	72	2,346
Corporate debt securities	323,898	7,133	7,254	324,019
Equity securities	90,317	5,118	14,421	99,620
Mortgage backed securities	15,432	10	345	15,767
Total investments	\$830,809	\$ 14,630	\$26,063	\$842,242

The Company's policy is to classify all investments with contractual maturities within one year as current. 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. The contractual maturities of the Company's available-for-sale securities, excluding equity securities which have no contractual maturity as of December 31, 2001, are as follows:

	Amortized cost basis	Amortized fair value
Within 1 year	\$ 17,776	\$ 18,073
After 1 year through 5 years	242,502	249,376
After 5 years through 10 years	263,530	270,691
After 10 years	313,464	313,495
Total	\$ 837,272	\$ 851,635

Available-for-sale securities were sold as follows for the years ended December 31:

	2001	2000
Proceeds from sales	\$ 335,764	\$ 276,051
Gross realized gains	18,339	13,508
Gross realized losses	5,152	10,374

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

7. Property and equipment:

Property and equipment are recorded at cost and are depreciated on the straight-line method over useful lives ranging from eighteen months to five years for purchased computer equipment and software, five years for capitalized software, three to fifteen years for furniture and equipment and twenty to forty years for buildings and building improvements. Leasehold improvements are amortized over the terms of the respective leases. Property and equipment are comprised of the following as of December 31:

	2001	2000
Land	\$ 8,114	\$ 8,114
Buildings and building improvements	33,976	32,602
Leasehold improvements	21,310	17,892
Purchased computer equipment and software	85,642	106,846
Capitalized software	132,813	110,654
Furniture and equipment	64,890	64,837
	346,745	340,945
Less— accumulated depreciation and amortization	176,258	197,685
Property and equipment, net	\$ 170,487	\$ 143,260

Depreciation and amortization expense on property and equipment was \$35,991 and \$34,862 for the years ended December 31, 2001 and 2000, respectively, and are included as components of cost of care and general and administrative expenses in the accompanying consolidated statements of operations.

8. Sale/leaseback of GHMSI headquarters building:

On December 3, 1998, GHMSI sold its headquarters building in Washington, D.C. The sale resulted in a realized gain, based on depreciated cost, of \$41,079. In connection with the sale, GHMSI entered into a five-year leaseback for all of the net rentable space in the building. The purchaser has the right to recapture a portion of the space upon notice to GHMSI at various points in time during the leaseback period. Due to the leaseback arrangement, approximately \$25,019 of the realized gain from the sale of the building was originally recorded as a deferred liability in the accompanying consolidated balance sheets and is being amortized over the life of the leaseback period in proportion to the lease payments.

In 2001 and 2000, \$3,624 and \$5,032, respectively, was amortized against rent expense. The originally recorded deferred gain was equal to the net present value of the future lease payments, using a discount rate of 6.5 percent. The deferred gain is to be adjusted

downward through other income in periods in which the purchaser exercises its recapture rights. As of December 31, 2001 and 2000, the deferred gain liability was \$5,671 and \$14,597, respectively, and is included in other liabilities in the accompanying consolidated balance sheets.

On August 25, 2000, pursuant to the lease recapture provision, the purchaser gave notice that certain space in the building would be recaptured. Under the lease recapture provision, the space was recaptured on May 31, 2001. Resulting from this notice, \$555 of the deferred gain was recognized through other income, net in the 2000 accompanying consolidated statement of operations. On January 3, 2001, pursuant to the lease recapture provision, the purchaser gave notice additional space would be recaptured on May 31, 2001. Resulting from this notice, \$5,302 of the deferred gain was recognized as other income in 2001, reflecting the period in which the lease modification was received. Accordingly, future lease payments related to both recapture events have been excluded from minimum future lease payments listed below.

Minimum future lease payments at December 31, 2001 (reflecting the above recapture of space by the purchaser) are as follows:

2002	\$ 3,088
2003	3,134
Total minimum payments	\$ 6,222

9. Medical claims payable:

The liability for medical claims payable is computed in accordance with generally accepted actuarial practices and is based upon authorized health care services and past claims payment experience, together with current factors which, in management's judgment, require recognition in the calculation. These estimates are periodically reviewed and any adjustments are reflected in current operations.

On January 1, 2001, a related professional association transferred its medical claims payable to FSHP primarily in exchange for forgiveness of an obligation to the related professional association. Activity in the liability account for medical claims is summarized as follows:

	2001	2000
Balance at January 1	\$ 725,134	\$ 607,820
Liability transferred from a related professional association as of January 1, 2001	19,412	—
Liability acquired in connection with PHN acquisition	—	24,950
Adjusted balance	744,546	632,770
Incurred related to:		
Current year	5,361,069	4,472,972
Prior years	10,219	979
Total incurred	5,371,288	4,473,951
Paid related to:		
Current year	4,631,679	3,816,269
Prior years	708,384	565,318
Total paid	5,340,063	4,381,587
Balance at December 31	\$ 775,771	\$ 725,134

The methodology used in calculating the liability for medical claims has been consistently applied between years. A significant portion of the adjustment to prior year incurred claims relates to self-insured groups and FEP and is offset by revenue adjustments in an equivalent amount.

The Company accrues estimated claims processing expenses relating to the liability for unpaid claims. These accruals totaled \$24,729 and \$27,064 as of December 31, 2001 and 2000, respectively, and are included in accounts payable and accrued expenses in the accompanying consolidated balance sheets.

10. Note payable:

GHMSI has a note payable held by BCS Plan Investors Corporation (BPIC), an affiliate of BCBSA. The outstanding balance of the note was \$8,937 and \$17,874 as of December 31, 2001 and 2000, respectively. The note is unsecured and bears interest at 6 percent per annum. The note is guaranteed by CFMI and CareFirst, Inc. Interest is payable out of 50 percent of the previous calendar year's statutory earnings and profits generated by GHMSI and CFMI (as determined by reference to GHMSI's and CFMI's audited statutory financial statements ended on December 31 of such calendar year) and is due April 30. In addition, GHMSI agreed to repay the balance in equal annual installments, beginning April 30, 1998, through April 30, 2002. Both interest and principal payments require the prior approval of the District of Columbia Department of Insurance and Securities Regulation.

GHMSI incurred interest expense of \$715 and \$1,251, respectively, on the note for the years ended December 31, 2001 and 2000.

11. Lease commitments:**Operating lease obligations**

The Company leases certain administrative and medical facilities 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 these leases.

Future noncancelable minimum payments for leases, excluding GHMSI's building lease discussed previously, are as follows:

2002	\$ 31,332
2003	28,647
2004	21,789
2005	18,850
2006	18,002
2007 and thereafter	64,616
Total minimum payments	\$ 183,236

Rent expense for the years ended December 31, 2001 and 2000, for all operating leases was \$31,982 and \$26,966, respectively.

Capital lease obligations

BCBSD leases a building under a capital lease and the property has a cost of \$7,700 and accumulated depreciation of \$6,019. Minimum future lease payments for this lease are as follows:

2002	\$ 1,167
2003	1,167
2004	1,167
2005	1,167
2006	582
	5,250
Less— amounts representing interest and executory costs	2,201
	\$ 3,049

12. Pension benefits:

CFMI, GHMSI and BCBSD have noncontributory defined benefit retirement plans covering substantially all full-time employees. The annual contributions are not less than the minimum funding standards set forth in the Employee Retirement Income Security Act of 1974, as amended. The plans provide for eligible employees to receive benefits based principally on years of service with the Company and a percentage of certain compensation prior to normal retirement.

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

	2001		
	CFMI	GHMSI	BCBSD
Actuarial present value of benefit obligations:			
Accumulated benefit obligation	\$ (131,592)	\$ (171,715)	\$ (43,569)
Projected benefit obligation for service rendered to date	\$ (163,637)	\$ (189,457)	\$ (53,686)
Plan assets at fair value	103,200	222,981	41,009
Projected benefit obligation (greater) less than plan assets	(60,437)	33,524	(12,677)
Unrecognized net transition asset	(207)	—	(109)
Unrecognized prior service (asset) cost	(16,301)	(20,156)	17
Unrecognized net loss (gain)	56,518	(1,386)	7,670
(Accrued) prepaid pension cost before additional pension liability	(20,427)	11,982	(5,099)
Additional pension liability	(7,965)	—	—
(Accrued) prepaid pension cost included in the accompanying consolidated balance sheets	\$ (28,392)	\$ 11,982	\$ (5,099)
Net periodic pension cost includes the following components:			
Normal service cost-benefits earned during the period	\$ 8,047	\$ 5,634	\$ 1,548
Interest cost on projected benefit obligation	9,795	12,743	3,653
Actual return on plan assets	2,214	2,806	2,939
Net amortization and deferral	(13,516)	(26,725)	(7,214)
Net periodic pension cost	\$ 6,540	\$ (5,542)	\$ 926
2000			
	CFMI	GHMSI	BCBSD
Actuarial present value of benefit obligations:			
Accumulated benefit obligation	\$ (107,784)	\$ (166,180)	\$ (39,560)
Projected benefit obligation for service rendered to date	\$ (135,380)	\$ (179,198)	\$ (48,910)
Plan assets at fair value	108,688	232,341	45,253
Projected benefit obligation (greater) less than plan assets	(26,692)	53,143	(3,657)
Unrecognized net transition asset	(578)	—	(193)
Unrecognized prior service (asset) cost	(18,396)	(22,397)	22
Unrecognized net loss (gain)	25,473	(24,306)	(1,462)
(Accrued) prepaid pension cost included in the accompanying consolidated balance sheets	\$ (20,193)	\$ 6,440	\$ (5,290)
Net periodic pension cost includes the following components:			
Normal service cost-benefits earned during the period	\$ 7,561	\$ 4,986	\$ 1,504
Interest cost on projected benefit obligation	9,273	12,326	3,417
Actual return on plan assets	2,303	(6,470)	2,287
Net amortization and deferral	(13,091)	(16,652)	(6,304)
Net periodic pension cost	\$ 6,046	\$ (5,810)	\$ 904

The following tables set forth employer contributions to the plans, benefits paid from the plans and certain actuarial assumptions for the years ended December 31:

	2001		
	CFMI	GHMSI	BCBSD
Employer contributions	\$ 6,308	\$ —	\$ 1,118
Benefits paid	9,582	6,554	2,422
Weighted average discount rate	7.25%	7.25%	7.25%
Increase in future compensation levels	5.00%	5.00%	4.75%
Expected long-term rate of return	9.00%	9.00%	9.00%

	2000		
	CFMI	GHMSI	BCBSD
Employer contributions	\$ 400	\$ —	\$ 1,152
Benefits paid	8,071	6,562	2,213
Weighted average discount rate	7.50%	7.50%	7.50%
Increase in future compensation levels	5.00%	5.00%	4.75%
Expected long-term rate of return	9.00%	9.00%	9.00%

For financial reporting purposes under SFAS 87 "Employers' Accounting for Pensions," a pension plan is considered unfunded when the fair value of plan assets is less than the accumulated benefit obligation. When that is the case, an additional pension liability is recognized for the difference between the accrued pension cost and the minimum liability which represents the amount of the unfunded accumulated benefit obligation. In recognizing such a liability, an intangible asset is also recorded up to the amount of the prior service cost not yet recognized. When the additional liability is greater than the intangible asset limit, a charge is recorded to accumulated other comprehensive income for the excess, net of any tax effects.

At December 31, 2001 and 2000, an additional pension liability of \$7,965 and \$0, respectively, was recognized for CFMI's qualified retirement plan and \$5,722 and \$3,282, respectively, for CFMI's supplemental retirement plan (see below). In accordance with SFAS 87, as of December 31, 2001 and 2000, respectively, an intangible asset of \$1,960 and \$2,130 was recorded for the supplemental retirement plan. In addition, other comprehensive income in 2001 and 2000 includes charges of \$8,460 and \$507, net of tax, respectively, pursuant to these provisions.

CFMI also has a nonqualified supplemental retirement benefit plan covering certain officers, which provides for eligible employees to receive additional benefits based principally on compensation and years of service. This plan provides for incremental benefit payments from CFMI's funds so that total benefit payments equal amounts that would have been payable from the CFMI's principal retirement plans if it were not for limitations imposed by income tax regulations. As of December 31, 2001 and 2000, respectively, CFMI has accrued \$8,629 and \$6,302 for these benefits. Supplemental retirement benefit plan expense for the years ended December 31, 2001 and 2000, was \$2,327 and \$1,845, respectively.

GHMSI 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 GHMSI's funds so that total benefit payments equal amounts that would have been payable from GHMSI's principal retirement plans if it were not for limitations imposed by income tax regulations. As of December 31, 2001 and 2000, respectively, GHMSI has accrued \$5,102 and \$5,591 for these benefits. Supplemental retirement benefit plan expense for the years ended December 31, 2001 and 2000, was \$240 and \$418, respectively.

BCBSD also provides for retirement benefits through nonqualified retirement plans covering certain employees. These plans provide for incremental pension payments from BCBSD's funds so that total pension payments equal amounts that would have been payable from BCBSD's principal pension plans if it were not for limitations imposed by income tax regulations. Under these plans, the annual

lifetime benefit is based upon a percentage of compensation during the final ten years of service, offset by several other sources of retirement income including benefits payable under the qualified retirement plan. The estimated amounts to be paid under these plans are accrued over the period of active employment of covered employees. As of December 31, 2001 and 2000, respectively, BCBSD has \$4,368 and \$14,460 for these benefits. Supplemental retirement benefit plan expense for the years ended December 31, 2001 and 2000, was \$1,019 and \$8,481, respectively.

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 expense of \$4,387 and \$3,792 for the years ended December 31, 2001 and 2000, respectively.

13. Postretirement benefits:

CFMI and GHMSI provide certain healthcare and life insurance benefits for retired employees. Substantially all employees become eligible for those benefits if they reach early retirement age while working for the Company and meet certain eligibility requirements.

The Company's postretirement benefit programs provide for specific benefits based primarily on the retiree's age and years of service with the Company.

BCBSD sponsors two defined postretirement benefit plans that provide health benefits and a life insurance plan to retirees and their dependents who meet plan eligibility requirements. Qualified retirees are eligible to continue health and life insurance benefits upon meeting certain age and service requirements. These benefits provide for a percentage of cost sharing between the retiree and BCBSD. The health care coverage is available provided that such retiree had BCBSD's health insurance coverage in effect during the last five years of employment.

In accordance with SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," the Company records the expected cost of these benefits as expense during the years that employees render service. The following tables set forth the postretirement benefit amounts recognized in the accompanying consolidated financial statements as of December 31:

	2001		
	CFMI	GHMSI	BCBSD
Accumulated post retirement benefit obligation	\$ (30,001)	\$ (16,071)	\$ (17,350)
Unrecognized net transition liability	—	6,478	4,911
Unrecognized prior service (asset) cost	(1,114)	438	123
Unrecognized net loss (gain)	9,590	(5,148)	(307)
Accrued postretirement benefit cost included in the accompanying consolidated balance sheets	\$ (21,525)	\$ (14,303)	\$ (12,623)
Net periodic postretirement benefit cost includes the following components:			
Normal service cost-benefits earned during the period	\$ 977	\$ 453	\$ 837
Interest cost on post retirement benefit obligation	2,051	1,080	1,136
Net amortization and deferral	308	284	370
Net periodic postretirement benefit cost	\$ 3,336	\$ 1,817	\$ 2,343

	2000		
	CFMI	GHMSI	BCBSD
Accumulated postretirement benefit obligation	\$ (23,059)	\$ (14,546)	\$ (16,404)
Unrecognized net transition liability	—	7,067	5,286
Unrecognized prior service (asset) cost	(1,321)	478	127
Unrecognized net loss (gain)	4,241	(6,100)	5
Accrued postretirement benefit cost included in the accompanying consolidated balance sheets	\$ (20,139)	\$ (13,101)	\$ (10,986)
Net periodic postretirement benefit cost includes the following components:			
Normal service cost-benefits during the period	\$ 711	\$ 324	\$ 779
Interest cost on postretirement benefit obligation	1,620	1,020	1,098
Net amortization and deferral	(83)	212	368
Net periodic postretirement benefit cost	\$ 2,248	\$ 1,556	\$ 2,245

The following table sets forth employer benefits paid from the plans and certain actuarial assumptions for the years ended December 31:

	2001		
	CFMI	GHMSI	BCBSD
Benefits paid	\$ 1,950	\$ 615	\$ 706
Weighted average discount rate	7.25%	7.25%	7.50%
Annual rate of next year increases in per capita cost of covered health care benefits	5.00%	6.00%	6.00%
Assumed rate of change in future costs	5.00%	5.50%	6.00%

	2000		
	CFMI	GHMSI	BCBSD
Benefits paid	\$ 1,493	\$ 726	\$ 562
Weighted average discount rate	7.50%	7.50%	7.75%
Annual rate of next year increases in per capita cost of covered health care benefits	5.00%	6.00%	6.00%
Assumed rate of change in future costs	5.00%	5.50%	6.00%

14. Income taxes:

The Company files a consolidated federal income tax return and reflects federal tax expense at Alternative Minimum Tax (AMT) rates. The Company has regular tax loss carryforwards of approximately \$125,477 at December 31, 2001, which expire between 2002 and 2020, and accumulated AMT credits of approximately \$101,667 as of December 31, 2001. Both the carryforwards and the credits can be used, in certain circumstances, to offset future regular taxable income and tax, respectively. As a result of the CFMI and GHMSI business affiliation, certain net operating loss carryforwards will be limited under Section 382 of the Internal Revenue Code.

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

Provision for income taxes includes deferred income taxes resulting primarily from temporary differences between the tax basis of assets and liabilities and their reported amounts in the consolidated financial statements. The principal sources of temporary differences

between the tax basis of assets and liabilities include nondeductible accruals, accounts receivable, property and equipment, and medical claims payable.

The provision for income taxes for the years ended December 31, 2001 and 2000, consists of the following components:

	2001	2000
Current:		
Federal	\$ 25,553	\$ 19,977
State	1,217	1,560
	26,770	21,537
Deferred:		
Federal	(4,261)	808
State	(2,126)	(2,368)
	(6,387)	(1,560)
Provision for income taxes	\$ 20,383	\$ 19,977

As of December 31, 2001 and 2000, the Company had deferred tax assets of \$177,253 and \$194,896, respectively, and deferred tax liabilities of \$9,567 and \$14,200, respectively. Valuation reserves of \$129,805 and \$148,674, primarily against the regular tax loss carryforwards and AMT credits, have been recorded against the net deferred tax assets in the accompanying consolidated balance sheets as of December 31, 2001 and 2000, respectively. Management does not believe the Company will be subject to regular tax prior to the expiration of these carryforwards. Management has determined, based on the Company's long-term history of operating earnings and its expectations for the future, that operating income of the Company will more likely than not be sufficient to fully realize the net recorded deferred tax assets.

15. Other comprehensive income:

In accordance with SFAS No. 130, "Reporting Comprehensive Income" (SFAS 130), comprehensive income (loss) includes net income plus certain items designated as "other comprehensive income." For the Company, other comprehensive income is comprised of unrealized gains and losses on certain investments in debt and equity securities, foreign currency translation adjustments and minimum pension liability adjustments. SFAS 130 requires the

Company to classify items of other comprehensive income (loss) by their nature in the financial statements and to display the accumulated balance of other comprehensive income (loss), net of taxes, separately from retained earnings in the consolidated balance sheets. The Company has chosen to present other comprehensive income (loss) items in the accompanying consolidated statements of changes in reserves and display the accumulated balances as accumulated other comprehensive income (loss) in the accompanying consolidated balance sheets.

Under SFAS 130, reclassification adjustments are made to avoid double counting in comprehensive income (loss) items that are displayed as part of net income for a period that also have been displayed as part of other comprehensive income in that period or earlier periods. The reconciliation of net unrealized holding gains and losses to net unrealized holding gains and losses net of reclassification adjustments and taxes, foreign currency translation adjustments and minimum pension liability adjustments is as follows for the years ended December 31:

	2001		
	Before-tax amount	Tax (expense) benefit	Net-of-tax amount
Net unrealized gains and losses arising during the period	\$ 13,479	\$ (2,612)	\$ 10,867
Less: reclassification adjustments for net gains and losses realized in net income	10,292	(2,003)	8,289
Net unrealized gains and losses	3,187	(609)	2,578
Minimum pension liability adjustment	(10,575)	2,115	(8,460)
Foreign currency translation adjustment	109	(22)	87
Total other comprehensive income (loss)	\$ (7,279)	\$ 1,484	\$ (5,795)

	2000		
	Before-tax amount	Tax (expense) benefit	Net-of-tax amount
Net unrealized gains and losses arising during the period	\$ 37,993	\$ (6,725)	\$ 31,268
Less: reclassification adjustments for net gains and losses realized in net income	1,133	(181)	952
Net unrealized gains and losses	36,860	(6,544)	30,316
Minimum pension liability adjustment	(631)	124	(507)
Foreign currency translation adjustment	(61)	12	(49)
Total other comprehensive income (loss)	\$ 36,168	\$ (6,408)	\$ 29,760

16. Related party transactions:

A related professional association of physicians provides medical care to certain of CFMI's members on a capitated basis. Capitation expense related to these services totaled \$12,357 and \$103,008 for the years ended December 31, 2001 and 2000, respectively, and is included in cost of care in the accompanying consolidated statements of operations. CFMI maintains a commitment to support the operations and liquidity of this related professional association. As of December 31, 2001, the accumulated deficit for this related party was \$1,238.

17. Commitments and contingencies:

The healthcare 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 healthcare 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 statues and regulations by healthcare insurers and providers. Violations of these laws and regulations could result in expulsion from government healthcare programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Management believes that the Company is in compliance with fraud and abuse as well as other applicable government laws and regulations. While no material regulatory inquiries have been made, 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.

The Health Insurance Portability and Accountability Act (HIPAA) was enacted August 21, 1996, to assure health insurance portability, reduce healthcare fraud and abuse, guarantee security and privacy of health information and enforce standards for health information. Organizations are required to be in compliance with certain transaction standard provisions beginning October 2002, although a one-year extension may be obtained upon the submittal of a formal compliance plan. Organizations receiving this extension must still meet privacy regulations by April 2003. Management intends to pursue this extension. Provisions not yet finalized are required to be implemented two years after the effective date of the regulation. Organizations are subject to significant fines and penalties if found not to be compliant with the provisions outlined in the regulations. Management is in the process of modifying and updating current procedures and systems to comply with the legislation.

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.

One of CFMI's subsidiaries entered into employment agreements with certain physicians with terms through 2006. Early termination of the contracts by the subsidiary is allowable with two years written notice. Upon such termination, the employer would pay to each physician two years salary and benefits, along with other defined compensation. Approximate compensation due under the contracts is \$12,000 annually through March 2006, subject to allowable consumer price index or market rate changes. Additionally, certain compensation is guaranteed to these physicians during the remaining term of their contracts. Total wages paid under these agreements in 2001 and 2000 were approximately \$11,137 and \$10,197, respectively. CFMI and one of CFMI's subsidiaries are jointly and severally liable for payments under these agreements.

The Company has employment contracts with certain executives which contain provisions that could result in the acceleration of non-vested retirement benefits upon a "change in control" of the Company. In addition, these contracts also obligate the Company to fulfill the remaining amounts due under the

specific employment contracts for certain actions that could result from such a "change in control."

Various lawsuits, including class action lawsuits, and other claims occur in the normal course of business and are pending against the Company. Management, after consultation with legal counsel, is of the opinion that the lawsuits and other claims, when resolved, will not have a material effect on the accompanying consolidated financial statements.

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 May 1, 2002. The Company also purchases extended reporting period endorsements to ensure that claims made against physicians no longer employed by the Company are insured.

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 2001 or 2000.