2005 financial results

CAREFIRST, INC. AND AFFILIATES

Consolidated Financial Statements and Other Financial Information
Years ended December 31, 2005 and 2004 with Report of Independent Auditors

CONTENTS

CareFirst BlueCross BlueShield

www.carefirst.com

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.
Board of Directors of BCBSD, Inc.

We have audited the accompanying consolidated balance sheets of CareFirst, Inc. and affiliates (collectively referred to as the Company) as of December 31, 2005 and 2004, 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, 2005 and 2004, and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

February 22, 2006

Ernst + Young LLP

CAREFIRST, INC. AND AFFILIATES
Consolidated Balance Sheets
(in thousands)

	December 31 2005	December 31 2004
Assets		
Current assets:		
Cash and cash equivalents	**$ 252,813**	$293,662
Short-term investments	**60,517**	52,798
Advances to providers	**185,479**	180,044
Accounts receivable, less allowance for doubtful accounts of $12,933 and $10,562 as of December 31, 2005 and 2004, respectively	**465,139**	406,156
Interest income receivable	**14,069**	12,137
Current assets of discontinued operations	**1,047**	1,054
Other current assets	**590,922**	584,828
Deferred tax assets, net	**22,566**	25,123
Total current assets	**1,592,552**	1,555,802
Long-term investments	**1,528,156**	1,332,578
Property and equipment, net	**144,808**	144,118
Goodwill	**29,956**	29,956
Long-term assets of discontinued operations	**1,940**	19,621
Other assets	**121,610**	116,478
Total assets	**$3,419,022**	$3,198,553
Liabilities and reserves		
Current liabilities:		
Short-term borrowings	**$ 153,978**	$130,172
Medical claims payable	**550,378**	495,566
Accounts payable and accrued expenses	**328,529**	309,901
Unearned revenues	**710,030**	694,475
Group experience funds and advances	**190,106**	180,744
Note payable, current portion	**1,206**	–
Current liabilities of discontinued operations	**10,010**	19,776
Total current liabilities	**1,944,237**	1,830,634
Note payable, noncurrent	**2,354**	–
Deferred tax liabilities, net	**21,984**	34,340
Long-term employee benefit obligations	**96,176**	78,485
Long-term liabilities of discontinued operations	**6,541**	10,178
Other liabilities	**5,879**	8,675
Total liabilities	**2,077,171**	1,962,312
Minority interest	**75**	–
Reserves:		
Retained earnings	**1,311,002**	1,178,222
Accumulated other comprehensive income	**30,774**	58,019
Total reserves	**1,341,776**	1,236,241
Total liabilities and reserves	**$3,419,022**	$3,198,553

See accompanying notes.

CAREFIRST, INC. AND AFFILIATES
Consolidated Statements of Operations
(in thousands)

	Year ended December 31	
	2005	**2004**
Premiums earned	**$5,318,817**	$4,719,612
Amounts attributable to self-funded arrangements	**3,385,312**	3,166,750
Less amounts attributable to claims under self-funded arrangements	**(3,140,049)**	(2,932,973)
Other	**32,572**	29,756
Net revenue	**5,596,652**	4,983,145
Operating expenses:		
Cost of care	**4,599,188**	4,006,864
General and administrative	**926,005**	834,624
Total operating expenses	**5,525,193**	4,841,488
Income from operations	**71,459**	141,657
Investment income, net	**90,572**	94,107
Other than temporary impairment of investments	**(4,668)**	–
Minority interest	**(74)**	–
Other income, net	**4,725**	379
Income from continuing operations before provision for income taxes	**162,014**	236,143
Provision for income taxes	**34,984**	50,267
Income from continuing operations	**127,030**	185,876
Discontinued operations:		
Income (loss) from discontinued operations, net of applicable income tax benefit of $1,980 and $9,315 for the years ended December 31, 2005 and 2004, respectively	**5,750**	(45,393)
Net income	**$132,780**	$140,483

See accompanying notes.

CareFirst, Inc. and Affiliates
Consolidated Statements of Changes in Reserves
Years ended December 31, 2005 and 2004

(in thousands)

	Retained Earnings	Accumulated Other Comprehensive Income (Loss): Unrealized Gains (Losses) on Securities Net	Accumulated Other Comprehensive Income (Loss): Minimum Pension	Total Reserves
Balance, as of December 31, 2003	$1,037,739	$62,995	$(37,124)	$1,063,610
Net income	140,483	–	–	140,483
Other comprehensive income (loss), net of tax:				
Change in net unrealized gains and losses on investments, net of reclassification adjustments	–	(3,002)	–	(3,002)
Minimum pension liability adjustment	–	–	35,150	35,150
Total comprehensive income				172,631
Balance, as of December 31, 2004	1,178,222	59,993	(1,974)	1,236,241
Net income	132,780		–	132,780
Other comprehensive income (loss), net of tax:				
Change in net unrealized gains and losses on investments, net of reclassification adjustments	–	(26,974)	–	(26,974)
Minimum pension liability adjustment	–	–	(271)	(271)
Total comprehensive income				105,535
Balance, as of December 31, 2005	$1,311,002	$33,019	$ (2,245)	$1,341,776

See accompanying notes.

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

	Year ended December 31	
	2005	2004
Operating activities		
Net income	**$ 132,780**	$ 140,483
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**51,699**	50,085
Realized gains on investments, net	**(22,473)**	(33,558)
Building impairment loss	**–**	1,300
Gain on sale of real estate held for sale	**(5,952)**	–
Minority interest	**74**	–
Other than temporary impairment of investments	**4,668**	–
(Benefit) provision for deferred income taxes	**(1,790)**	13,382
Changes in operating assets and liabilities:		
Increase in advances to providers	**(5,435)**	(18,147)
(Increase) decrease in accounts receivable, net	**(58,983)**	18,067
(Increase) decrease in interest income receivable	**(1,932)**	1,761
(Increase) decrease in other current assets	**(522)**	8,701
Increase in other assets	**(2,484)**	(74,428)
Increase (decrease) in medical claims payable	**54,812**	(54,054)
Increase in accounts payable and accrued expenses	**18,628**	38,321
Increase in unearned revenues	**9,983**	6,906
Increase (decrease) in group experience funds and advances	**9,362**	(4,336)
Increase (decrease) in other liabilities	**14,895**	(51,664)
Changes in net assets and liabilities of discontinued operations	**4,285**	21,508
Net cash provided by operating activities	**201,615**	64,327
Investing activities		
Purchases of investments	**(2,701,774)**	(1,284,847)
Proceeds from sales of investments	**2,481,028**	1,381,506
Acquisition of subsidiary, less cash acquired	**–**	(4,404)
Acquisition of health plan membership	**(3,311)**	–
Purchases of property and equipment	**(45,774)**	(47,403)
Net cash (used in) provided by investing activities	**(269,831)**	44,852
Financing activities		
Increase in short-term borrowings	**$ 23,806**	$ 5,470
Proceeds from issuance of stock to minority interest holder	**1**	–
Payments on obligation under capital lease	**–**	(1,358)
Proceeds from long-term debt	**4,109**	–
Repayment on long-term debt	**(549)**	–
Net cash provided by financing activities	**27,367**	4,112
Net (decrease) increase in cash and cash equivalents	**(40,849)**	113,291
Cash and cash equivalents at beginning of year	**293,662**	180,371
Cash and cash equivalents at end of year	**$ 252,813**	$ 293,662
Supplemental disclosures		
Cash paid for income taxes	**$ 30,381**	$ 35,715
Cash paid for interest	**$ –**	$ 73

See accompanying notes.

CareFirst, Inc. and Affiliates
Notes to Consolidated Financial Statements
December 31, 2005
(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 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 states of Maryland and Delaware 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), CFI has also entered into a business affiliation with BCBSD, Inc. (BCBSD), whereby CFI maintains the sole membership interest in BCBSD.

In 2004, in compliance with certain 2003 legislation in Maryland, CFI changed the structure and membership of the CFI Board of Directors. In response to the situation which led to the governance changes of the CFI Board of Directors, the CFI and BCBSD Boards of Directors approved the restructuring of BCBSD's affiliation with CFI. On June 30, 2004, the Delaware Department of Insurance issued a ruling ordering termination of the affiliation agreement between CFI and BCBSD, but also providing that CFI could continue its affiliation with BCBSD on a contractual basis only if CFI transferred its corporate membership, BlueCross BlueShield Association (BCBSA) license and service mark back to the control of the BCBSD Board. That order was appealed by CFI and ultimately affirmed by the Delaware Supreme Court. The Maryland Insurance Commissioner rejected the proposed amendments to the BCBSD structural relationship and stated that CFI could appeal his decision, submit a new plan of affiliation, continue to operate under the existing agreement, or apply for permission to end the affiliation.

CFI subsequently filed a motion requesting that the Federal District Court in Baltimore, Maryland assume jurisdiction over this matter. Beginning January 6, 2005, all parties had agreed to several time periods during which all pending actions would be stayed to allow further discussions among the parties. In September 2005, the CFI Board agreed for BCBSD to regain its independence by allowing it to no longer be structurally affiliated with CFI, but to enter into a contractual relationship, with the ability to return to a structural affiliation at a later time if agreeable to all of the parties. The change in affiliation would involve, among other things, the transfer of BCBSD's corporate membership, BCBSA license, and service markback to the control of the BCBSD Board. The proposed change in affiliation between CFI and BCBSD is subject to approvals of the insurance commissioner in Maryland, Delaware and the District of Columbia, as well as approval by BCBSA, which approvals have not yet been received. Management believes that the proposed changes to the BCBSD affiliation, if approved by the regulatory authorities and BCBSA in their current form, would result in deconsolidation of BCBSD from CFI's consolidated financial statements on a prospective basis.

In 2005, the CFI Board approved certain proposed changes regarding the governance structure for CFI, CFMI and GHMSI. Revisions to those changes have subsequently been proposed which are now subject to approval by the CFI, CFMI and GHMSI Boards. Management believes the proposed changes would not impact CFI's control over CFMI or GHMSI. All proposed changes in governance structure are also subject to regulatory and BCBSA approval. In connection with these proposed changes, the CFMI and GHMSI Boards have agreed in principle to change the allocation of CFBC net income or loss from 60% CFMI and 40% GHMSI to an equal 50% interest by each owner, retroactive to January 1, 2005. This agreement is subject to final Board, regulatory and BCBSA approval. If this agreement were approved, it would have no net impact to the Company as of December 31, 2005.

There is no certainty at this time regarding the conclusion of these various matters. As of December 31, 2005, CFI maintains its full membership interest in BCBSD and control over the operations of BCBSD, CFMI, GHMSI and CFBC. The future impact, if any, of the above actions on the accompanying consolidated financial statements cannot be determined.

On November 1, 2004, the Company completed its acquisition of The Dental Network, Inc. and TDN Administrative Services, LLC (collectively, TDN) which market and administer managed dental benefits. The purchase price and related acquisition costs of approximately $5,000 exceeded the estimated fair value of identifiable net assets acquired by $4,551. Under the purchase method of accounting, the Company assigned this amount to goodwill. In addition, the terms of the transaction include a provision for additional contingent payments of up to $1,500 based on TDN achieving certain performance targets during 2005 and 2006. The final amount of goodwill may increase as a result of these contingent payments. As the 2005 performance targets were not achieved, no additional goodwill was recognized during 2005. The operating results for TDN are included in the accompanying consolidated statements of operations for the period during 2004 following the completion of the acquisition and for the year ended December 31, 2005.

Effective January 1, 2005, a new subsidiary of GHMSI was created to operate the Federal Employee Program (FEP) operations center, which had previously been operated by GHMSI under a contract with BCBSA. The newly created subsidiary, Service Benefit Plan Administrative Services Corporation (SBP), is 90% owned by GHMSI and 10% owned by BCBSA (see Note 2).

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Use of Estimates

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

Reclassifications

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

Fair Value of Financial Instruments

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

Cash and Cash Equivalents and Short-Term Borrowings

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

Accounts Receivable

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

Advances to Providers

The Company has advances on deposit with certain regulated hospitals in the state of Maryland and a large health system in Delaware. Advances on deposit with regulated Maryland hospitals permit the Company to earn differentials of 2.25% and 2.00% of allowed inpatient and outpatient charges, respectively, by these hospitals.

Investments

Investment Securities

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

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

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

Declines in fair value below cost that are deemed to be other than temporary are recorded as realized losses and are included in "other than temporary impairment of investments" in the accompanying consolidated statements of operations. Based on its evaluation, the Company has recorded an other than temporary impairment of investments of $4,668 for the year ended December 31, 2005. There were no other than temporary impairments of investments for the year ended December 31, 2004.

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.

Investment Real Estate Held for Sale

During 2004, in connection with discontinuance of physician group operations discussed in Note 3, certain owned buildings of the Company were reclassified as investment real estate held for sale in accordance with Statement of Financial Accounting Standards (SFAS) No. 60, *Accounting and Reporting by Insurance Enterprises*. Investment real estate held for sale is carried within long-term assets of discontinued operations at the lower of carrying value or fair value less estimated selling costs. Fair value is generally estimated using comparable sales information. At the time of sale, the difference between the sales price and carrying value is recorded as a realized capital gain or loss. Upon revaluing the real estate held for sale under SFAS No. 60, an impairment loss of $1,300 (pre-tax) was recognized during the year ended December 31, 2004. This loss is included as a component of discontinued operations in the accompanying 2004 consolidated statement of operations. During 2005, these buildings were sold for amounts above the 2004 estimates, resulting in a pre-tax gain of approximately $5,952. This gain is included as a component of discontinued operations in the accompanying 2005 consolidated statement of operations.

Property and Equipment

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

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

Goodwill

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

The Company follows SFAS No. 142, *Goodwill and Other Intangible Assets*, and does not amortize goodwill. The Company has determined that it has five reporting units: third party administrative (TPA), HMO, indemnity risk, indemnity non-risk, and FEP. All of the Company's goodwill has been allocated to the HMO reporting unit at December 31, 2005 and 2004. In accordance with SFAS No. 142, the Company completed its annual goodwill impairment evaluations at October 1, 2005 and 2004. 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, 2005 or 2004.

There were no changes in the carrying amount of goodwill during the year ended December 31, 2005. The change in the carrying amount of goodwill for the year ended December 31, 2004 is as follows:

Balance as of January 1, 2004	$25,405
Acquisition of TDN (see Note 1)	4,551
Balance as of December 31, 2004	$29,956

Other Assets

Other assets primarily include prepaid pension costs, an investment in a real estate joint venture, which is accounted for under the equity method, an intangible asset associated with the acquisition of certain health plan membership, and cash surrender value of life insurance policies. During the year ended December 31, 2005, an intangible asset of $3,311 was recorded at the time of acquisition of certain health plan membership and is being amortized over a useful life of 3 years. According to the purchase agreement, certain additional payments to the seller may be required based on levels of membership retention and the achievement of certain financial ratios.

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 cost of these fixed assets, as well as future fixed assets to be 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 $3,560 as of December 31, 2005.

Revenue Recognition

Premiums earned 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 FEP unearned premiums.

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

The Company participates with other BlueCross and BlueShield plans in administering the health care benefits of various accounts of the other plans. Administrative fees are generally recognized as earned for the period the participating agreement is in effect 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. While claims for such adjustments 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 and Medical Claims Payable

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

Each reporting period, the Company estimates its liability for medical care services that have been rendered on behalf of insured members but for which claims have either not been received or processed. The Company develops its estimates for medical care

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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

Comprehensive Income

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

Federal Employee Program

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

OPM holds certain reserves on behalf of the Company to provide funding, if necessary, for excess claims costs, subject to certain limitations. The Company records its allocable share of amounts held by OPM as an asset, with an equivalent amount recorded as unearned revenues. These amounts are $566,959 and $561,387 as of December 31, 2005 and 2004, respectively, and are included in other current assets and unearned revenues, respectively, in the accompanying consolidated balance sheets. Amounts incurred in excess of these reserves would not be reimbursed to the Company. The BCBSA contract renews automatically each year unless written notice of termination is given by either party.

FEP represented approximately 58% and 65% of accounts receivable as of December 31, 2005 and 2004, respectively. FEP represented approximately 35% and 36% of net revenue for the years ended December 31, 2005 and 2004, respectively.

Reimbursement of FEP Operations Center Expenses

One of the Company's affiliates performs certain administrative functions as the national operations center for FEP under a 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 $68,102 and $55,803 for the years ended December 31, 2005 and 2004, respectively.

During 2004, the Company was notified by BCBSA that this cost-reimbursement contract, which expired December 31, 2004, would not be renewed under its then-present structure. Effective January 1, 2005, a new subsidiary of GHMSI was created to operate the FEP operations center under a 10-year contract with BCBSA. The newly created subsidiary, SBP, is owned 90% by GHMSI and 10% by BCBSA. The arrangement contains automatic termination provisions upon the occurrence of certain triggering events. The creation of the new subsidiary did not have a significant impact on the accompanying consolidated financial statements.

Minority interest at December 31, 2005 represents BCBSA's share of the equity of SBP. As of January 1, 2005, in connection with the formation of SBP, BCBSA contributed $1 for 10% of the common stock. The income attributable to the non-controlling interest in 2005 was $74, and is included in minority interest in the accompanying 2005 consolidated statement of operations.

Reimbursement of Medicare Claims Cost and Expenses

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

Under this contract, CFMI processed claims of approximately $3,616,007 and $4,406,094 in each of the years ended December 31, 2005 and 2004, respectively. Payment and reimbursement of Medicare claims are not included in the accompanying consolidated financial statements.

Administrative expense reimbursements related to the Medicare program were approximately $9,619 and $10,769 for the years ended December 31, 2005 and 2004, respectively. Operating expenses in the accompanying consolidated statements of operations are recorded net of these reimbursements. During 2004, CFMI entered into a Corporate Integrity Agreement with CMS related to certain compliance issues which occurred in its Medicare fiscal intermediary operations (see Note 13).

3. DISCONTINUED OPERATIONS

Potomac Physicians, P.A. (PPPA)

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

In connection with the discontinuance of PPPA, the Company recorded expenses of $7,530 during 2004, which included estimated severance costs, lease terminations, a write-down of real estate held for sale and certain other direct and incremental costs.

The results of operations of PPPA, including the costs of discontinuance, included in discontinued operations are as follows:

	December 31	
	2005	**2004**
Revenues	**$ –**	$ 8,801
Operating expenses:		
Cost of care	**1,042**	12,218
General and administrative	–	12,199
Total operating expenses	**1,042**	24,417
Loss from discontinued operations before other income and benefit for income taxes	**(1,042)**	(15,616)
Other income, net	**1,051**	–
Benefit for income taxes	**(2,926)**	(1,534)
Income (loss) from discontinued operations	**$2,935**	$(14,082)

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

The major classes of assets and liabilities of discontinued operations related to PPPA as of December 31, 2005 and 2004, respectively, which are reflected in the accompanying consolidated balance sheets are as follows:

	2005	**2004**
Investment real estate held for sale	**$ –**	$ 5,363
Other assets	**1,119**	1,264
Total assets	**1,119**	6,627
Self-insurance reserves and other accruals	**(7,145)**	(10,272)
Reserves for discontinued operations	**(3,387)**	(4,511)
Net liabilities	**$(9,413)**	$(8,156)

A rollforward of reserves related to the discontinuance of PPPA for the year ended December 31, 2005 is as follows:

	December 31 2004	**Payments**	**December 31 2005**
Lease obligations	$4,450	$(1,063)	**$3,387**
Employee severance and termination	61	(61)	–
	$4,511	$(1,124)	**$3,387**

Patuxent Medical Group

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

In connection with the discontinuance of PMG in 2004, the Company recorded expenses of $20,400 during 2004, which included estimated contract terminations, severance and certain other direct and incremental costs.

3. DISCONTINUED OPERATIONS (CONTINUED)

The results of operations of PMG, including the costs of discontinuance, included in discontinued operations are as follows:

	December 31	
	2005	**2004**
Revenues	**$ –**	$ 8,043
Operating expenses:		
Cost of care	**1,382**	47,665
Loss from discontinued operations before investment and other income (loss) and provision (benefit) for income taxes	**(1,382)**	(39,622)
Investment and other income (loss), net	**5,143**	(13)
Provision (benefit) for income taxes	**946**	(7,926)
Income (loss) from discontinued operations	**$2,815**	$(31,709)

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

The major classes of assets and liabilities of discontinued operations related to PMG as of December 31, 2005 and 2004, respectively, which are reflected in the accompanying consolidated balance sheets are as follows:

	2005	**2004**
Cash and cash equivalents	**$ 1,031**	$ 975
Accounts receivable, net	**–**	62
Other current assets	**16**	17
Property and equipment	**–**	798
Investment real estate held for sale	**–**	9,848
Other assets	**821**	2,348
Total assets	**1,868**	14,048
Medical claims payable	**–**	(569)
Accounts payable and accrued expenses	**(3,392)**	(4,165)
Reserves for discontinued operations	**(2,627)**	(10,437)
Net liabilities	**$(4,151)**	$(1,123)

A rollforward of reserves related to the discontinuance of PMG for the year ended December 31, 2005 is as follows:

	December 31 2004	Payments	December 31 2005
Physician severance and contract termination	$8,865	$(6,312)	**$2,553**
Other employee severance and termination	1,572	(1,498)	**74**
	$10,437	$(7,810)	**$2,627**

4. 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 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 CFI and BCBSD.

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, 2005, 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.

5. INVESTMENTS

The Company's investments consist of the following:

	Amortized Cost Basis	Gross Unrealized Losses	Gross Unrealized Gains	Fair Value
December 31, 2005				
Debt securities issued by the U.S. Treasury and other U.S. government agencies	**$ 261,934**	**$ 2,348**	**$ 1,442**	**$ 261,028**
Foreign government debt securities	**564**	**–**	**47**	**611**
Corporate debt securities	**483,252**	**8,290**	**15,981**	**490,943**
Equity securities	**272,756**	**7,219**	**51,826**	**317,363**
Mortgage-backed securities	**525,003**	**8,315**	**2,040**	**518,728**
Total investments	**$1,543,509**	**$26,172**	**$71,336**	**$1,588,673**
December 31, 2004				
Debt securities issued by the U.S. Treasury and other U.S. government agencies	$ 262,333	$1,834	$ 4,673	$ 265,172
Foreign government debt securities	782	–	99	881
Corporate debt securities	480,738	2,569	26,337	504,506
Equity securities	152,179	3,297	55,461	204,343
Mortgage-backed securities	408,817	2,168	3,825	410,474
Total investments	$1,304,849	$9,868	$90,395	$1,385,376

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, 2005:

	Fair Value < 1 year	Unrealized Losses < 1 year	Fair Value > 1 year	Unrealized Losses > 1 year	Total Unrealized Losses
December 31, 2005					
Debt securities issued by the U.S. Treasury and other U.S. government agencies	$126,061	$ 951	$ 59,520	$1,397	$ 2,348
Corporate debt securities	206,790	6,025	45,657	2,265	8,290
Equity securities	50,250	5,134	14,437	2,085	7,219
Mortgage-backed securities	333,110	5,185	85,427	3,130	8,315
Total investments	$716,211	$17,295	$205,041	$8,877	$26,172

The unrealized losses on the Company's investments in debt securities issued by the U.S. Treasury and other U.S. government agencies, corporate debt securities and mortgage-backed securities were caused primarily by interest rate increases. Because the decline in market value is primarily attributable to changes in interest rates and not credit quality, and because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2005. Unrealized losses on securities greater than one year were not significant at December 31, 2004.

5. INVESTMENTS (CONTINUED)

The amortized cost and estimated fair value of debt securities at December 31, 2005, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities of mortgage-backed securities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost Basis	**Fair Value**
Within 1 year	$ 60,122	$ 59,817
After 1 year through 5 years	266,074	265,507
After 5 years through 10 years	177,813	177,372
After 10 years	241,705	249,886
Mortgage-backed securities	525,039	518,728
Total	$1,270,753	$1,271,310

Available-for-sale securities were sold as follows:

	Year ended December 31	
	2005	**2004**
Proceeds from sales	**$2,481,028**	$1,381,506
Gross realized gains	**43,133**	46,686
Gross realized losses	**20,660**	13,128

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

6. PROPERTY AND EQUIPMENT

Property and equipment are comprised of the following:

	December 31	
	2005	**2004**
Land	**$ 315**	$ 315
Buildings and building improvements	**10,139**	9,863
Leasehold improvements	**31,050**	27,112
Purchased computer equipment and software	**84,934**	77,650
Capitalized software	**213,541**	187,884
Furniture and equipment	**63,862**	69,071
	403,841	371,895
Less accumulated depreciation and amortization	**259,033**	227,777
Property and equipment, net	**$144,808**	$144,118

Depreciation and amortization expense on property and equipment was $51,036 and $50,085 for the years ended December 31, 2005 and 2004, respectively, and is included as a component of cost of care and general and administrative expenses, as applicable, in the accompanying consolidated statements of operations.

7. MEDICAL CLAIMS PAYABLE

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

	2005	2004
Balance as of January 1	**$ 495,566**	$ 549,488
Acquisition of TDN (see Note 1)	**–**	132
Incurred related to:		
Current year	**4,656,203**	4,073,669
Prior years	**(57,015)**	(66,805)
Total incurred	**4,599,188**	4,006,864
Paid related to:		
Current year	**4,121,991**	3,591,487
Prior years	**422,385**	469,431
Total paid	**4,544,376**	4,060,918
Balance at December 31	**$ 550,378**	$ 495,566

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, 2005 and 2004, approximately $(625) and $(20,465) of the incurred amount related to prior years was a result of changes in estimates for FEP contracts. These changes were offset by similar changes in revenue and thus, no significant change in income from operations arose as a result of these changes.

The Company accrues estimated claims processing expenses relating to the liability for unpaid claims. These accruals totaled $22,660 and $19,277 as of December 31, 2005 and 2004, respectively, and are included in accounts payable and accrued expenses in the accompanying consolidated balance sheets.

8. LEASE COMMITMENTS

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 the leases.

Future noncancelable minimum payments for leases are as follows:

2006	$ 43,693
2007	40,393
2008	35,143
2009	25,533
2010	22,808
Thereafter	59,008
	$226,578

Rent expense for the years ended December 31, 2005 and 2004 for all operating leases was $43,391 and $42,968, respectively, and has been included within general and administrative expenses in the accompanying consolidated statements of operations.

9. PENSION BENEFITS

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

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

9. PENSION BENEFITS (CONTINUED)

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.

For financial reporting purposes under SFAS No. 87, *Employers' Accounting for Pensions*, a pension plan is considered underfunded when the fair value of plan assets is less than the accumulated benefit obligation. When that is the case, an additional pension liability must be recognized for the difference between the accrued pension cost and the minimum liability which represents the amount of the unfunded accumulated benefit obligation. In recognizing such a liability, an intangible asset may also be recorded up to the amount of the prior service cost not yet recognized. When the liability is greater than the intangible asset limit, a charge is recorded to accumulated other comprehensive income for the excess amount, net of any tax effects. As of December 31, 2003, the Company had recorded charges to other comprehensive income as the result of certain unfunded pension liabilities of its qualified plans. During 2004, these charges were reversed since minimum pension liabilities were not required for the qualified plans as of December 31, 2004 and 2005.

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

	2005			
	CFMI	**GHMSI**	**SBP**	**BCBSD**
Accumulated benefit obligation	**$173,460**	**$219,347**	**$27,348**	**$75,105**
Change in projected benefit obligation:				
Benefit obligation at beginning of year	$209,533	$254,352	$ –	$80,694
Service cost	10,416	5,723	1,347	2,342
Interest cost	11,472	12,623	1,834	4,756
Actuarial (gain) loss	(6,243)	1,121	64	4,231
Plan settlement	(23,437)	–	(3,744)	–
Transfer to SBP Plan	–	(31,343)	31,343	–
Benefits paid	(1,935)	(11,126)	(302)	(5,647)
Benefit obligation at end of year	$199,806	$231,350	$30,542	$86,376
Change in plan assets of the qualified pension plans:				
Fair value of plan assets at beginning of year	$189,424	$252,130	$ –	$73,796
Actual return on plan assets	7,994	15,917	1,442	3,393
Employer contributions	11,780	2,140	2,020	7,750
Plan settlement	(23,437)	–	(3,744)	–
Transfer to SBP Plan	–	(30,128)	30,128	–
Benefits paid	(1,935)	(11,126)	(302)	(5,647)
Fair value of plan assets at end of year	$183,826	$228,933	$29,544	$79,292
Funded status	$(15,980)	$ (2,417)	$ (998)	$(7,084)
Unrecognized actuarial loss	63,086	37,700	3,572	26,506
Unrecognized prior service asset	(7,498)	(10,042)	(1,524)	(97)
Prepaid pension asset (included as a component of other assets)	$ 39,608	$ 25,241	$ 1,050	$19,325
Amounts recognized in the consolidated balance sheet consist of: Prepaid pension asset (included as a component of other assets)	$ 39,608	$ 25,241	$ 1,050	$19,325
Components of net periodic benefit cost (credit) for the year ended December 31, are as follows:				
Service cost	$ 10,416	$ 5,723	$ 1,347	$ 2,342
Interest cost	11,472	12,623	1,834	4,756
Expected return on plan assets	(14,860)	(18,228)	(2,416)	(5,506)
Amortization of prior service asset	(1,521)	(1,608)	(244)	(59)
Net recognized actuarial loss	4,960	1,036	158	2,347
Plan Settlement	7,400	–	438	–
Net periodic benefit cost (credit)	$ 17,867	$ (454)	$ 1,117	$ 3,880

9. PENSION BENEFITS (CONTINUED)

Weighted-average assumptions to determine benefit obligations:				
Discount rate – benefit obligation	**5.75%**	**5.75%**	**5.75%**	**5.75%**
Discount rate – net benefit cost	**5.75%**	**5.75%**	**5.75%**	**5.75%**
Expected return on plan assets	**8.50%**	**8.50%**	**8.50%**	**8.50%**
Rate of compensation increase	**4.50%**	**4.50%**	**4.50%**	**4.50%**

	2004		
	CFMI	**GHMSI**	**BCBSD**
Accumulated benefit obligation	$184,164	$240,187	$ 70,218
Change in projected benefit obligation:			
Benefit obligation at beginning of year	$185,966	$236,063	$ 71,754
Service cost	10,341	6,601	2,401
Interest cost	11,636	14,245	4,555
Actuarial loss	18,704	5,841	4,317
Plan curtailment	(2,480)	–	–
Benefits paid	(14,634)	(8,398)	(2,333)
Benefit obligation at end of year	$209,533	$254,352	$ 80,694
Change in plan assets of the qualified pension plans:			
Fair value of plan assets at beginning of year	$110,289	$240,794	$ 39,513
Actual return on plan assets	16,039	18,834	6,484
Employer contributions	77,730	900	30,132
Benefits paid	(14,634)	(8,398)	(2,333)
Fair value of plan assets at end of year	$189,424	$252,130	$ 73,796
Funded status	$ (20,109)	$ (2,222)	$ (6,898)
Unrecognized actuarial loss	74,824	38,435	22,509
Unrecognized prior service asset	(9,020)	(13,419)	(156)
Prepaid pension asset (included as a component of other assets)	$ 45,695	$ 22,794	$ 15,455
Amounts recognized in the consolidated balance sheet consist of:			
Prepaid pension asset (included as a component of other assets)	$ 45,695	$ 22,794	$ 15,455
Additional information:			
Decrease in minimum liability included in other comprehensive income (pre-tax)	$ (31,284)		$(13,938)

Components of net periodic benefit cost (credit) for the year ended December 31, are as follows:			
Service cost	$ 10,341	$ 6,601	$ 2,401
Interest cost	11,636	14,245	4,555
Expected return on plan assets	(11,612)	(20,267)	(3,971)
Amortization of prior service asset	(1,688)	(1,905)	(59)
Plan curtailment	(1,107)	–	–
Net recognized actuarial loss	3,995	–	1,971
Net periodic benefit cost (credit)	$ 11,565	$ (1,326)	$ 4,897
Weighted-average assumptions to determine benefit obligations:			
Discount rate – benefit obligation	5.75%	5.75%	5.75%
Discount rate – net benefit cost	6.25%	6.25%	6.25%
Rate of compensation increase	4.50%	4.50%	4.50%
Expected return on plan assets	8.50%	8.50%	8.50%

As a result of the discontinuance of PMG and PPPA operations as described above in Note 3 as well as the reduction in overall Company staff levels, CFMI's and SBP's lump-sum pension distributions during 2005 surpassed the settlement threshold equal to the sum of service cost and interest cost, requiring settlement recognition for all cash settlements in 2005. The Company recorded a $7,838 settlement charge in 2005 of which $1,883 is included in discontinued operations in the accompanying 2005 consolidated statement of operations.

9. PENSION BENEFITS (CONTINUED)

During the year ended December 31, 2004, the Company recorded a $1,107 curtailment gain as a result of the discontinuance of PPPA and PMG, as discussed in Note 3. The curtailment gain is included within the 2004 loss from discontinued operations in the accompanying 2004 consolidated statement of operations.

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

The Company's investment policy, as established by the CareFirst, Inc. Retirement Committee, is to provide for growth of capital with a moderate level of volatility by investing assets per the target allocations stated below. The assets are reallocated as needed to meet the above target allocations. The investment policy is reviewed on a quarterly basis, under the advisement of a certified investment advisor, to determine if the policy should be changed. The pension plan weighted-average asset allocations by asset category are as follows as of December 31:

	2005				
	Target Allocation	**CFMI**	**GHMSI**	**SBP**	**BCBSD**
Domestic equity securities	**46%-58%**	**51%**	**54%**	**54%**	**50%**
International equity securities	**10%-16%**	**15**	**15**	**15**	**14**
Debt securities	**32%-38%**	**30**	**30**	**28**	**29**
Cash and cash equivalents	**Residual**	**4**	**1**	**3**	**7**
Total		**100%**	**100%**	**100%**	**100%**

	2004			
	Target Allocation	**CFMI**	**GHMSI**	**BCBSD**
Domestic equity securities	46%-58%	53%	51%	53%
International equity securities	10%-16%	13	16	13
Debt securities	32%-38%	29	30	29
Cash and cash equivalents	Residual	5	3	5
Total		100%	100%	100%

The Company expects to make contributions during 2006 of $1,612 to the CFMI plan, $30 to the GHMSI plan, $0 to the SBP plan and $0 to the BCBSD plan. The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid for the years ending December 31:

	CFMI	**GHMSI**	**SBP**	**BCBSD**
2006	$ 14,391	$ 13,293	$ 2,243	$ 7,094
2007	13,576	14,299	2,575	7,231
2008	15,238	15,512	3,293	7,809
2009	21,099	17,386	3,466	8,257
2010	20,794	18,096	3,641	8,174
2011 through 2015	141,610	109,342	19,531	42,609
Total	$226,708	$187,928	$34,749	$81,174

The Company also has nonqualified supplemental retirement benefit plans covering certain officers, which provide for eligible employees to receive additional benefits based principally on compensation and years of service. These plans provide for incremental benefit payments from the Company's funds so that total benefit payments equal amounts that would have been payable from the Company's principal retirement plan if it were not for limitations imposed by income tax regulations. As of December 31, 2005 and 2004, CFMI has accrued $21,755 and $17,801, respectively, GHMSI has accrued $2,635 and $2,032, respectively, and BCBSD has accrued $2,856 and $2,796, respectively, for these benefits. SBP has accrued $12 as of December 31, 2005. Supplemental retirement benefit plan expense for the years ended December 31, 2005 and 2004, for CFMI was $3,953 and $3,261, respectively, for GHMSI was $417 and $264, respectively, and for BCBSD was $60 and $10, respectively. Supplemental retirement benefit plan expense for SBP was $1 for the year ended December 31, 2005.

As of December 31, 2005 and 2004, an additional minimum pension liability of $4,297 and $3,903, respectively, was recognized for CFMI's supplemental retirement plans. BCBSD had also recognized a minimum pension liability of $186, net of tax benefit as of December 31, 2005. In accordance with SFAS No. 87, as of December 31, 2005 and 2004, respectively, an intangible asset of $1,723 and $943 was also recorded.

In addition, the Company sponsors 401(k) plans for the benefit of all eligible employees. The Company contributes to certain of these plans and recognized expenses for the years ended December 31, 2005 and 2004, of $6,113 and $5,941, respectively.

10. POSTRETIREMENT BENEFITS

The Company provides certain healthcare benefits for retired employees. Substantially all employees become eligible for these 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 a specific credit amount, which may be used to purchase health insurance upon retirement. The credit amount is based primarily on the retiree's age and years of service with the Company.

In accordance with SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* the Company records the expected cost of these benefits as expense during the years that employees render service. During 2005, in connection with the creation of SBP (see Note 2), the Company established a Voluntary Employee Beneficiary Association (VEBA), a tax-exempt trust to fund certain healthcare benefits for eligible SBP employees. Contributions to the VEBA during 2005 were $909.

On December 8, 2003 the Medicare Prescription Drug Improvement and Modernization Act of 2003 (the Act) was enacted. The Act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. The Company believes its benefits are actuarially equivalent to Medicare Part D and therefore, it will qualify for federal subsidy. As permitted by FASB Staff Position (FSP) 106-1, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, the Company deferred the recognition of the impact of the new Medicare provisions at December 31, 2003 and 2004. During 2004, FSP 106-2 was issued and included final guidance on accounting for the provisions of this legislation which was required during 2005. The impact of adopting FSP 106-2 on the 2005 net periodic benefit cost was a reduction of $1,162 for CFMI, $206 for GHMSI, $33 for SBP and $759 for the BCBSD. The reduction in the benefit obligation as of January 1, 2005 was $8,533 for CFMI, $2,942 for GHMSI, $154 for SBP and $6,166 for BCBSD. These reductions incorporate the expectation that the Company will be eligible for federal subsidies as a result of providing these benefits. Although management believes the Company will be eligible for such subsidies, there can be no assurance in this regard.

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

	2005			
	CFMI	**GHMSI**	**SBP**	**BCBSD**
Change in benefit obligation:				
Benefit obligation at beginning of year	$ 42,733	$ 25,586	$ –	$ 19,408
Service cost	1,433	749	129	571
Interest cost	2,022	1,270	165	1,080
Actuarial loss	1,324	2,352	170	6,171
Benefits paid	(2,510)	(740)	–	(1,698)
Transfer to SBP	–	(2,805)	2,805	–
Impact of estimated Medicare Part D subsidy	(7,371)	(2,736)	(121)	(5,407)
Benefit obligation at end of year	$ 37,631	$ 23,676	$3,148	$ 20,125
Change in plan assets:				
Fair value of plan assets at beginning of year	$ –	$ –	$ –	$ –
Actual return on plan assets	–	–	–	–
Employer contributions	–	–	909	–
Benefits paid	–	–	–	–
Fair value of plan assets at end of year	$ –	$ –	$909	$ –
Funded status	$(37,631)	$(23,676)	$(2,239)	$(20,125)
Unrecognized transition liability	–	3,864	259	3,154
Unrecognized actuarial (gain) loss	7,593	(362)	395	796
Unrecognized prior service (asset) cost	(287)	278	–	–
Net amount recognized – accrued benefit cost	$(30,325)	$(19,896)	$(1,585)	$(16,175)
Components of net periodic benefit cost for the year ended December 31, are as follows:				
Service cost	$ 1,433	$749	$129	$ 571
Interest cost	2,022	1,270	165	1,080
Amortization of transition liability	–	552	37	347
Amortization of prior service (asset) cost	(207)	40	–	–
Recognized actuarial loss	360	–	15	–
Net periodic benefit cost	$ 3,608	$ 2,611	$346	$ 1,998

10. POSTRETIREMENT BENEFITS (CONTINUED)

	2004		
	CFMI	GHMSI	BCBSD
Change in benefit obligation:			
Benefit obligation at beginning of year	$ 38,303	$ 22,111	$ 17,537
Service cost	1,644	861	592
Interest cost	2,336	1,390	1,066
Actuarial loss	1,664	1,815	1,554
Benefits paid	(1,214)	(591)	(1,341)
Benefit obligation at end of year	$ 42,733	$ 25,586	$ 19,408
Funded status	$(42,733)	$(25,586)	$(19,408)
Unrecognized transition liability	–	4,712	3,502
Unrecognized actuarial loss	14,001	385	31
Unrecognized prior service (asset) cost	(494)	318	–
Net amount recognized – accrued benefit cost	$(29,226)	$(20,171)	$(15,875)
Components of net periodic benefit cost for the year ended December 31, are as follows:			
Service cost	$ 1,644	$ 861	$ 592
Interest cost	2,336	1,390	1,066
Amortization of transition liability	–	588	348
Amortization of prior service (asset) cost	(207)	40	–
Recognized actuarial loss	892	–	–
Net periodic benefit cost	$ 4,665	$ 2,879	$ 2,006

For measurement purposes, a 5.75% and 6.25% discount rate was assumed for the years ended December 31, 2005 and 2004. A 6.0% annual rate of increase in the per capita cost of covered health care benefits was also assumed for the years ended December 31, 2005 and 2004. The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid for the years ending December 31:

	CFMI	GHMSI	SBP	BCBSD
2006	$ 2,142	$ 905	$ 125	$ 657
2007	2,279	1,028	149	720
2008	2,420	1,147	186	795
2009	2,569	1,284	230	886
2010	2,739	1,436	262	982
2011 through 2015	15,823	9,504	1,778	6,286
Total	$ 27,972	$15,304	$2,730	$10,326

11. INCOME TAXES

The Company files a consolidated federal income tax return. For federal taxes, the Company benefits from a special deduction available to certain Blue Cross plans under Internal Revenue Code Section 833(b) (the 833(b) deduction). Due to the 833(b) deduction, the Company has effectively incurred federal taxes at Alternative Minimum Tax (AMT) rates. The Company could lose the benefit of the 833(b) deduction in the future if CFMI, GHMSI and/or BCBSD ceases to be not-for-profit, if CFMI's, GHMSI's and/or BCBSD's reserves reach certain levels, or if certain other events occur. The statutory AMT rate was 20% during 2005 and 2004. If the Company would lose the benefit of the 833(b) deduction in the future, the Company would be subject to Federal income taxes at the regular statutory rate of 35%. In such situation, the Company would have available certain regular net operating loss carryforwards and/or AMT credits.

CFMI is exempt from Maryland state income tax under Title 10, Subtitle 1, Section 10104(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. BCBSD is exempt from Delaware State income taxes. Subsidiary operations are subject to the applicable state or District of Columbia income taxes.

In January 2005, the Maryland General Assembly passed new legislation which imposed a premium tax on managed care organizations at 2 percent of earned premiums. Effective January 1, 2005, this premium tax replaced the existing Maryland state income tax requirements for CFBC prior to the legislation. The 2005 Maryland state premium tax incurred by the Company under the new legislation was approximately $18,781 and is included as a component of general and administrative expenses in the accompanying consolidated statement of operations for the year ended December 31, 2005. CFBC continues to be subject to state income taxes in Virginia and Washington D.C. relative to the portion of its income which is apportioned to those jurisdictions.

11. INCOME TAXES (CONTINUED)

Provision for income taxes includes deferred income taxes resulting primarily from temporary differences between the tax basis of assets and liabilities and their reported amounts in the consolidated financial statements. The principal sources of temporary differences include nondeductible accruals, accounts receivable, property and equipment and medical claims payable. As of December 31, 2005 and 2004, the Company had deferred tax assets of $26,917 and $30,330, respectively, and deferred tax liabilities of $26,335 and $39,547, respectively. Management has determined, based on the Company's long-term history of operating earnings and its expectations for the future, that income of the Company will more likely than not be sufficient to fully realize any net recorded deferred tax assets.

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

	Year ended December 31 2005	2004
Current:		
Federal	**$36,461**	$29,880
State	**313**	7,005
	36,774	36,885
Deferred:		
Federal	**(4,168)**	13,025
State	**2,378**	357
	(1,790)	13,382
Provision for income taxes	**$34,984**	$50,267

12. OTHER COMPREHENSIVE INCOME

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

Year ended December 31, 2005	Before-Tax Amount	Tax Amount	Net-of-Tax Amount
Net unrealized gains and losses arising during the period	**$(15,366)**	**$ 3,071**	**$(12,295)**
Less reclassification adjustments for net gains and losses realized or recognized in net income	**18,532**	**(3,853)**	**14,679**
Net unrealized gains and losses	**(33,898)**	**6,924**	**(26,974)**
Minimum pension liability adjustment	**(336)**	**65**	**(271)**
Total other comprehensive income (loss)	**$(34,234)**	**$ 6,989**	**$(27,245)**
Year ended December 31, 2004			
Net unrealized gains and losses arising during the period	$ 31,489	$(6,791)	$ 24,698
Less reclassification adjustments for net gains and losses realized or recognized in net income	33,558	(5,858)	27,700
Net unrealized gains and losses	(2,069)	(933)	(3,002)
Minimum pension liability adjustment	43,936	(8,786)	35,150
Total other comprehensive income (loss)	$ 41,867	$(9,719)	$ 32,148

13. COMMITMENTS AND CONTINGENCIES

The health care and health insurance industries are subject to numerous laws and regulations of federal, state and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government health care program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by health care insurers and providers. Violations of these laws and regulations could result in expulsion from government health care programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Management believes that the Company is in compliance with fraud and abuse, as well as other applicable government laws and regulations. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time. During 2004, CFMI settled an investigation by CMS related to CFMI's Medicare Part A fiscal intermediary operations.

13. COMMITMENTS AND CONTINGENCIES (CONTINUED)

The investigation involved certain adjudication activities which the Company performed with respect to the reimbursement of a specific provider. In connection with this settlement, CFMI has entered into a Corporate Integrity Agreement with CMS, which imposes certain compliance and monitoring requirements on CFMI. CFMI is monitoring its compliance with the Corporate Integrity Agreement, which has a term of three years. The Company believes the outcome of this matter will not have a significant impact on the accompanying consolidated financial statements.

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

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

CFI and its affiliates have employment contracts and other benefit arrangements with certain executives which contain provisions that could trigger the acceleration of certain benefits and/or payment of additional compensation. Such acceleration occurs upon termination of employment without cause or for "good reason" as defined in the contract. Additional acceleration occurs if said termination occurs "in connection with a change of control" contract. Potential incremental payments have not been accrued as of December 31, 2005 or 2004, as management believes all the appropriate triggering events have not occurred.

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.

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 April 30, 2006. In connection with ceasing operations of PMG and PPPA (the medical groups) as discussed in Note 3, the Company purchased an extended reporting period (ERP) endorsement to ensure that claims made against physicians that were employed by the Company are insured. This ERP for the medical malpractice program covers the period November 2, 2004 through November 1, 2009. Reserves have been established to cover estimated exposure related to this program not covered by the ERP.

The Company has a commitment for a credit facility with a commercial bank under which certain of its affiliates may borrow up to a maximum amount of $60,000. There have been no draws made on this line of credit during 2005 or 2004.

14. SUBSEQUENT EVENT

In February 2006, the Company was notified that the Federal government has agreed to reimburse costs previously incurred in relation to obtaining reduced hospital rates for FEP subscribers through participation in the Maryland Substantial, Available and Affordable Coverage (SAAC) program from 2001 through 2003. Reimbursement of these costs totaling approximately $8,454 is expected to be recognized as income in 2006.

OTHER FINANCIAL INFORMATION

Report of Independent Auditors on Other Financial Information

Board of Directors of CareFirst, Inc.
Board of Directors of CareFirst of Maryland, Inc.
Board of Trustees of Group Hospitalization and Medical Services, Inc.
Board of Directors of BCBSD, Inc.
Our audit was conducted for the purpose of forming an opinion on the December 31, 2005 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, 2005 consolidated financial statements. Such information has been subjected to the auditing procedures applied in our audit of the December 31, 2005 consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the December 31, 2005 consolidated financial statements taken as a whole.

February 22, 2006

CAREFIRST, INC. AND AFFILIATES
Consolidating Balance Sheet
December 31, 2005
(in thousands)

	CareFirst, Inc.	Carefirst of Maryland, Inc. and Subsidiaries	Group Hospitalization and Medical Services, Inc. and Subsidiaries	BCBSD, Inc. and Subsidiaries	Carefirst Blue Choice Inc. and Subsidiaries	Eliminations	Consolidated
Assets							
Current assets:							
Cash and cash equivalents	$381	$ 77,716	$ 106,534	$21,577	$ 46,605	$ –	$252,813
Short-term investments	–	10,978	27,185	7,962	14,392	–	60,517
Advances to providers	–	122,019	22,445	8,493	32,522	–	185,479
Accounts receivable, net	–	139,663	256,362	31,190	37,924	–	465,139
Due from affiliates, net	–	11,946	540	–	8,077	(20,563)	–
Interest income receivable	3	3,853	5,533	1,667	3,013	–	14,069
Current assets of discontinued operations	–	1,047	–	–	–	–	1,047
Other current assets	–	114,695	466,970	8,487	770	–	590,922
Deferred tax assets, net	–	10,317	6,665	2,120	3,464	–	22,566
Total current assets	384	492,234	892,234	81,496	146,767	(20,563)	1,592,552
Long-term investments	123	423,269	612,582	180,877	311,305	–	1,528,156
Property and equipment, net	–	70,829	65,823	8,059	97	–	144,808
Investment in affiliates	–	163,056	108,704	–	–	(271,760)	–
Goodwill	–	12,710	–	–	17,246	–	29,956
Long-term assets of discontinued operations	–	1,940	–	–	–	–	1,940
Other assets	–	67,179	32,292	21,973	166	–	121,610
Total assets	$507	$1,231,217	$1,711,635	$292,405	$475,581	$(292,323)	$3,419,022

See accompanying notes.

	CareFirst, Inc.	Carefirst of Maryland, Inc. and Subsidiaries	Group Hospitalization and Medical Services, Inc. and Subsidiaries	BCBSD, Inc. and Subsidiaries	Carefirst Blue Choice Inc. and Subsidiaries	Eliminations	Consolidated
Liabilities and reserves							
Current liabilities:							
Short-term borrowings	$ –	$ 74,614	$ 65,598	$ 12,701	$ 1,065	$ –	$ 153,97
Medical claims payable	–	139,102	250,450	40,352	120,474	–	550,378
Due to affiliates, net	509	128	16,150	2,045	1,731	(20,563)	–
Accounts payable and accrued expenses	–	141,664	109,006	45,049	32,810	–	328,529
Unearned revenues	–	143,359	511,697	10,423	44,551	–	710,030
Group experience funds and advances	–	129,541	60,115	137	313	–	190,106
Note payable, current portion	–	–	1,206	–	–	–	1,206
Current liabilities of discontinued operations	–	10,010	–	–	–	–	10,010
Total current liabilities	509	638,418	1,014,222	110,707	200,944	(20,563)	1,944,237
Note payable, noncurrent	–	–	2,354	–	–	–	2,354
Deferred taxes liabilities, net	–	5,192	10,975	2,940	2,877	–	21,984
Long-term employee benefit obligations	–	53,707	23,205	19,264	–	–	96,176
Long-term liabilities of discontinued operations	–	6,541	–	–	–	–	6,541
Other liabilities	–	360	5,519	–	–	–	5,879
Total liabilities	509	704,218	1,056,275	132,911	203,821	(20,563)	2,077,171
Minority interest	–	–	75	–	–	–	75
Reserves:							
Retained earnings	–	515,958	638,196	156,848	266,566	(266,566)	1,311,002
Accumulated other comprehensive income (loss)	(2)	11,041	17,089	2,646	5,194	(5,194)	30,774
Total reserves	(2)	526,999	655,285	159,494	271,760	(271,760)	1,341,776
Total liabilities and reserves	$507	$1,231,217	$1,711,635	$292,405	$475,581	$(292,323)	$3,419,022

See accompanying notes.

CAREFIRST, INC. AND AFFILIATES
Consolidating Statement of Operations
Year ended December 31, 2005
(in thousands)

	CareFirst, Inc.	Carefirst of Maryland, Inc. and Subsidiaries	Group Hospitalization and Medical Services, Inc. and Subsidiaries	BCBSD, Inc. and Subsidiaries	Carefirst Blue Choice Inc. and Subsidiaries	Eliminations	Consolidated
Premiums earned	$ –	$1,380,032	$2,259,380	$377,803	$1,301,602	$ –	$5,318,817
Amounts attributable to self-funded arrangements	–	1,873,917	861,025	644,956	5,414	–	3,385,312
Less amounts attributable to claims under self-funded arrangements	–	(1,736,925)	(795,608)	(601,833)	(5,683)	–	(3,140,049)
Other	176	11,656	13,956	6,784	–	–	32,572
Net revenue	176	1,528,680	2,338,753	427,710	1,301,333	–	5,596,652
Operating expenses:							
Cost of care	–	1,196,201	2,015,012	325,597	1,062,378	–	4,599,188
General and administrative	159	323,782	286,299	96,318	219,447	–	926,005
Total operating expenses	159	1,519,983	2,301,311	421,915	1,281,825	–	5,525,193
Income from operations	17	8,697	37,442	5,795	19,508	–	71,459
Investment income, net	–	28,178	33,418	10,913	23,950	(5,887)	90,572
Other than temporary impairment of investments	–	(1,861)	(1,412)	(644)	(751)	–	(4,668)
Equity in gain of affiliate	–	15,991	12,450	–	–	(28,441)	–
Minority interest	–	–	(74)	–	–	–	(74)
Other (loss) income, net	(17)	541	4,097	–	104	–	4,725
Income from continuing operations before provision for income taxes	–	51,546	85,921	16,064	42,811	(34,328)	162,014
Provision for income taxes	–	7,699	15,225	1,787	11,686	(1,413)	34,984
Income from continuing operations	–	43,847	70,696	14,277	31,125	(32,915)	127,030
Discontinued operations:							
Income from discontinued operations, net of applicable income tax benefit of $1,980	–	3,960	–	–	–	1,790	5,750
Net income	$ –	$ 47,807	$ 70,696	$ 14,277	$ 31,125	(31,125)	$ 132,780

See accompanying notes.