REPORT OF MANAGEMENT ON BLUE CROSS AND BLUE SHIELD OF MASSACHUSETTS, INC.'S INTERNAL CONTROL OVER FINANCIAL REPORTING

February 11, 2005

We, as members of management of Blue Cross and Blue Shield of Massachusetts, Inc., (the Company) are responsible for establishing and maintaining effective internal control over financial reporting. Internal control is designed to provide reasonable assurance to the Company's management and board of directors regarding the preparation of reliable published financial statements in conformity with accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance. Internal control over financial reporting includes self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

Because of inherent limitations in any internal control, no matter how well-designed, misstatements due to error or fraud may occur and not be detected, including the possibility of the circumvention or overriding of controls. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, internal control effectiveness may vary over time.

Management assessed the Company's internal control as of December 31, 2004 based on criteria for effective internal control over financial reporting described in "Internal Control—Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, we assert that the Company maintained effective internal control over financial reporting as of December 31, 2004 based on the COSO criteria.

Ernst & Young LLP audited the Company's financial statements and has issued an attestation report on management's assessment of the Company's internal control over financial reporting which is included in our annual report.

Blue Cross Blue Shield of Massachusetts, Inc.

by William C. Van Faasen

William C. Van Faasen, Chief Executive Officer

by

Cleve Killingsworth, Jr., President and Chief Operating Officer

by Allen Maltz

Allen Maltz, Executive Vice President and Chief Financial Officer

by William T. Cushing Jr.

William T. Cushing, Jr., Senior Vice President and Chief Audit Executive

AUDITORS OPINION ON MANAGEMENT'S ASSESSMENT AND THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

Board of Directors

Blue Cross and Blue Shield of Massachusetts, Inc.

We have audited management's assessment, included in the accompanying Report of Management's Internal Control Over Financial Reporting, that Blue Cross and Blue Shield of Massachusetts, Inc. (the Company) maintained effective internal control over financial reporting as of December 31, 2004 based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in conformity with accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in conformity with accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisitions, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the COSO criteria. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on the COSO criteria.

We also have audited, in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States), the statutory-basis balance sheet of Blue Cross and Blue Shield of Massachusetts, Inc. at December 31, 2004 and 2003, and the related statutory-basis statements of income, change in surplus and cash flows for the years then ended and our report dated February 11, 2005 expressed an unqualified opinion thereon.

Ernst & Young LLP

February 11, 2005
Boston, Massachusetts

Competitive Compensation Assessment

Watson Wyatt & Company conducted a review of Blue Cross and Blue Shield of Massachusetts' broad-based compensation programs for the Human Resources Committee (the "Committee").

Watson Wyatt is a global consulting firm focused on human capital and financial management, specializing in employee benefits, human capital strategies, technology solutions, and insurance and financial services. The Committee engaged Watson Wyatt directly, and the Committee annually commissions a competitive assessment of Blue Cross and Blue Shield of Massachusetts (BCBSMA) compensation programs.

The 2004 review was designed to determine if current BCBSMA programs continue to be appropriate given BCBSMA's business direction and current market practice. The review focused on:

- Current compensation philosophy;
- Base salary structure and administrative guidelines;
- Incentive pay provided through the Associate Performance Plan, Leadership Performance Plan and Long-Term Incentive Plan (short-term and long-term incentive programs).

Overall, the current philosophy and programs serve the organization well and are consistent with competitive market practices. BCBSMA programs are effectively designed to provide sufficient flexibility to respond to market trends over time. Continued consideration should be given to the short- and long-term incentive performance measures to ensure the programs continue to support BCBSMA's business needs and are aligned with current strategic objectives. The Committee will continue to evaluate programs on an ongoing basis relative to market trends and business needs.

Compensation Philosophy and Programs

The current BCBSMA compensation philosophy was most recently reviewed and approved by the Committee in November 2003. This review indicates the philosophy continues to effectively support business needs and reflect leading market practice. Key elements of the philosophy are:

- Provide competitive compensation opportunities (salary and incentives) sufficient to attract and retain high quality associates and to motivate them to achieve superior performance.
- Place a significant portion of compensation at reasonable risk through incentive plans for associates in leadership positions.
- Provide all associates the opportunity to supplement competitive base salaries through an incentive plan.
- Support business plans and strategies with effective compensation arrangements.
- Ensure compensation results that are responsible and consistent with sound business practices found in other large, multi-product billion dollar organizations.

How Current Programs Support the Philosophy

BCBSMA's current programs effectively support the compensation philosophy as follows.

BCBSMA Philosophy	Program
Provide competitive compensation opportunities sufficient to attract and retain high quality associates.	The base pay program targets median compensation levels based on industry and/or local market benchmarks.
Place a significant portion of compensation at reasonable risk through incentive plans for associates in leadership positions.	The Leadership Performance Plan provides leaders with an incentive opportunity targeted at 10% to 60% of base salary. In combination with the Long-Term Incentive Plan, with its incentive opportunity targeted at 10% to 100%, the programs encourage a balance between short-term business goals and long-term organization objectives.
Provide all associates the opportunity to supplement base salaries through an incentive plan. (Also supports motivation to achieve superior performance.)	The Associate Performance Plan provides all associates in non-leadership positions with an incentive opportunity targeted at 4% of base salary. BCBSMA also provides a wide range of additional incentive programs ("recognition programs") targeted at specific business groups and recognizing key accomplishments within those groups.
Support business plans and strategies with effective compensation arrangements.	The incentive plans provide a platform for communicating the Company's goals and rewarding their achievement. The plans are designed to focus associates on desired behaviors and link overall compensation with demonstrated results.
Ensure compensation results that are responsible and consistent with sound business practices.	BCBSMA uses flexible compensation policies and procedures that permit the organization to compete effectively for essential talent. The elements employed in the current compensation program are consistent with prevalent industry practice.

Base Salary Structure

BCBSMA targets base salary at median market levels, which is consistent with market practice. The base pay structure and administrative practices generally align well with other organizations.

Annual Incentive Plans

As part of fulfilling its compensation philosophy, BCBSMA provides annual incentive opportunities to all associates, through a combination of the Leadership Performance Plan and the Associate Performance Plan. Awards for 2004 are currently based on GAAP Net Income, Member Satisfaction and Member Loyalty measures, all key indicators of BCBSMA's success. Having achieved the goals of stabilizing finances, developing improved products, and delivering a high level of service, BCBSMA is refocusing the organization on:

- Health care affordability;
- Maintaining core business objectives and company values; and,
- Continuing to meet financial goals and maintain world-class member satisfaction.

BCBSMA extends annual incentives further down in the organization than many other firms do.

Long-Term Incentive Plan

In addition to the short-term incentive plans, the Long-Term Incentive Plan (for selected senior leaders) bases awards on company performance and provides a key element in the attraction and retention of talented executives. The performance measure for the 2003 through 2005 performance cycle is membership growth combined with a minimum level of GAAP reserves.

By encouraging the delivery of cost-effective health care products as a means to increase membership, the Long-Term Incentive Plan focuses senior leaders on the health care affordability initiative. As with the short-term incentive plans, the organization is considering alternative designs that would further support its current strategic direction.

Recognition Programs

In addition to annual and long-term incentives, BCBSMA sponsors a wide range of recognition programs that can effectively motivate and reward individual or team accomplishments and ideas. All associates are eligible for at least one form of recognition award, with the nature of awards varying based on individual department success criteria.

CEO and Senior Associate Compensation Competitive Assessment

BCBSMA conducts regular annual reviews of senior associate competitive compensation levels. This year's analysis and report were prepared by Watson Wyatt & Company. To the greatest extent possible, the methodology for the review has remained unchanged year-to-year, focusing on similar data sources as in prior years, and presented in a similar format.

The comparator organizations used in the analysis continue to reflect a mix of large Blue Cross Blue Shield plans, managed care organizations, and broader industry life/health insurers. The Committee believes this mix of comparators (which includes a mix of stock and non-stock organizations) continues to be appropriate given the nature of BCBSMA's competition for senior associate talent. BCBSMA's greatest competition for talent is found within other Blue Cross Blue Shield and managed care companies.

Key findings of the 2004 analysis suggest that current senior associate compensation levels are generally consistent with median market practice, as summarized below.

Compensation Element	Findings
Base Salaries	Overall, base salaries are within a competitive range (+/-10%) of median industry market practice, including the CEO position.
Total Cash Compensation (TCC—base salary plus bonus)	Total cash compensation is competitive with median market practice for the CEO and EVPs.
Total Direct Compensation (TDC—base salary plus bonus and long-term incentives)	BCBSMA target total direct compensation levels (base salary plus bonus and long-term incentives) for the CEO and EVPs are at 90% of market median, within a competitive range. BCBSMA total direct pay levels are more conservative (lower) when compared to public peer organizations of similar size due to the prevalent use of equity compensation among those organizations. The Committee finds that this is not inconsistent with the practices among non-stock organizations like BCBSMA.

AUDITED STATUTORY-BASIS FINANCIAL STATEMENTS

Blue Cross and Blue Shield of Massachusetts, Inc.

Years Ended December 31, 2004 and 2003

CONTENTS

Board of Directors

Blue Cross and Blue Shield of Massachusetts, Inc.

We have audited the accompanying statutory-basis balance sheets of Blue Cross and Blue Shield of Massachusetts, Inc. (the Company) as of December 31, 2004 and 2003, and the related statutory-basis statements of income, changes in surplus, and cash flow 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 the auditing standards of the Public Company Accounting Oversight Board (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.

As described in Note 2 to the financial statements, the Company presents its financial statements in conformity with accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance, which practices differ from accounting principles generally accepted in the United States. The variances between such practices and accounting principles generally accepted in the United States, and the effects on the accompanying financial statements, are described in Note 2.

In our opinion, because of the effects of the matter described in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States, the financial position of Blue Cross and Blue Shield of Massachusetts, Inc. at December 31, 2004 and 2003, or the results of its operations or its cash flow for the years then ended.

However, in our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Blue Cross and Blue Shield of Massachusetts, Inc. at December 31, 2004 and 2003, and the results of its operations and its cash flow for the years then ended, in conformity with accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance.

We also have audited, in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated February 11, 2005 expressed an unqualified opinion thereon.

February 11, 2005
Boston, Massachusetts

Ernst & Young LLP

(IN THOUSANDS)

	December 31 2004	December 31 2003
Admitted assets		
Bonds	**$ 769,063**	$ 925,830
Common stock	**985,530**	880,861
Cash, cash equivalents and short-term investments	**269,836**	99,064
Real estate, less accumulated depreciation	**59,328**	31,250
Receivable for securities	**1,326**	16,060
Other invested assets	**10,000**	10,000
Total cash and invested assets	**2,095,083**	1,963,065
Receivable related to uninsured plans	**369,770**	273,695
Due from Federal Employees Program	**31,884**	30,576
Health care receivables	**34,459**	28,002
Current income tax recoverable	**4,772**	—
Deferred tax asset	**1,436**	12,227
Data processing equipment	**9,853**	10,889
Accrued investment income	**7,264**	8,625
Premiums receivable	**2,472**	520
Receivables from affiliates	**291**	100
Other assets	**36,673**	34,339
Total admitted assets	**$2,593,957**	$2,362,038
Liabilities and surplus		
Health care claim reserves	**$ 419,072**	$ 531,720
Uninsured group advance deposits	**369,081**	302,883
Accounts payable and accrued liabilities	**358,595**	269,112
Premiums received in advance	**165,814**	139,469
Federal income taxes payable	**42,369**	97,930
Liability for postretirement benefits	**48,385**	40,344
Aggregate policy reserves	**44,166**	37,903
Accrued medical incentive pool and bonus payments	**39,723**	34,593
Payable to affiliates	**13,934**	4,676
Payable for securities	**1,833**	15,763
Total liabilities	**1,502,972**	1,474,393
Surplus	**1,090,985**	887,645
Total liabilities and surplus	**$2,593,957**	$2,362,038

See accompanying notes.

STATUTORY-BASIS STATEMENTS OF INCOME

(IN THOUSANDS)

	Years Ended December 31	
	2004	2003
Premiums earned	**$ 4,927,604**	$ 4,298,194
Health care benefits	**4,246,880**	3,615,104
General and claim adjustment expenses	**479,592**	467,253
Total expenses	**4,726,472**	4,082,357
Underwriting gain	**201,132**	215,837
Net investment income	**82,140**	72,520
Net realized investment gains	**18,105**	13,868
Net income before federal income tax expense	**301,377**	302,225
Federal income tax expense	**58,615**	69,916
Net income	**$ 242,762**	$ 232,309

See accompanying notes.

STATUTORY-BASIS STATEMENTS OF CHANGES IN SURPLUS

(IN THOUSANDS)

	Years Ended December 31	
	2004	2003
Balance at January 1	**$ 887,645**	$ 616,063
Net income	**242,762**	232,309
Change in net unrealized gains, net of taxes	**34,500**	79,610
Increase in nonadmitted assets	**(85,854)**	(57,557)
Change in net deferred income taxes	**11,401**	17,534
Pension liability adjustment, net of taxes	**531**	(314)
Balance at December 31	**$ 1,090,985**	$ 887,645

See accompanying notes.

(IN THOUSANDS)

	Years Ended December 31	
	2004	2003
Operating activities		
Premiums received	**$ 4,964,523**	$ 4,328,715
Health care benefits paid	**(4,362,164)**	(3,607,542)
General and claim adjustment expenses paid	**(492,183)**	(437,305)
Net investment income received	**83,501**	73,205
Federal income taxes paid	**(118,947)**	(55,246)
Net cash provided by operating activities	**74,730**	301,827
Investing activities		
Sales, maturities and redemptions of investments	**1,646,910**	847,123
Proceeds from sale of real estate	**—**	1,905
Cost of investments acquired	**(1,537,724)**	(1,123,414)
Acquisition of real estate	**(28,448)**	(31,488)
Other invested assets	**(3,309)**	(17,100)
Net cash provided by (used in) investing activities	**77,429**	(322,974)
Financing or miscellaneous activities		
Other sources, net	**18,613**	7,433
Net cash provided by financing or miscellaneous activities	**18,613**	7,433
Net increase (decrease) in cash, cash equivalents and short-term investments	**170,772**	(13,714)
Cash, cash equivalents and short-term investments:		
Beginning of year	**99,064**	112,778
End of year	**$ 269,836**	$ 99,064

See accompanying notes.

1. Nature of Business and Reorganization

Blue Cross and Blue Shield of Massachusetts, Inc. (the Company) is a nonprofit hospital and medical service corporation in the Commonwealth of Massachusetts, subject to regulation by the Commonwealth of Massachusetts Division of Insurance (DOI). The Company is organized for the purpose of establishing, maintaining and operating a nonprofit hospital and medical service company to provide hospital and medical care and reimbursement for other health services to its members. Hospitalization, medical and other health benefits are provided to members through contracts with hospitals, participating physicians, skilled nursing facilities, nursing homes and other health care organizations, including health maintenance organizations. The Company participates in a national arrangement to process claims for other Blue Cross and Blue Shield companies throughout the country. The Company offers a variety of group indemnity plans, health maintenance organizations, preferred provider networks, nongroup plans, Medicare extension, dental and other supplementary programs for the benefit of its members.

On December 1, 2004, the DOI issued a Health Maintenance Organization license to Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. (HMO Blue), pursuant to Chapter 176G of the Massachusetts General Laws (M.G.L. c.176G). HMO Blue, formerly known as XYZ Managed Care Corporation, was formed on February 7, 1997 as a not-for-profit corporation pursuant to Chapter 180 of Massachusetts General Laws. HMO Blue has been a shell entity since its formation. Subsequent to January 1, 2005, HMO Blue will provide hospitalization, medical and other health benefits as a health maintenance organization. HMO Blue will operate as a nonprofit charitable organization and qualifies as a tax-exempt social welfare organization under Section 501(c)(4) of the Internal Revenue Code. HMO Blue will be a wholly controlled subsidiary of the Company in accordance with terms set forth in the Master Reorganization Agreement (MRA) effective January 1, 2005. In connection with the MRA, the Company transferred its health maintenance organization line of business (except for the BlueCare 65 Medicare product, which the Company expects to transfer upon receipt of necessary approvals), including related assets and liabilities to HMO Blue, on January 1, 2005. The estimated impact from this transfer to the Company's January 1, 2005 statutory surplus is a reduction of approximately $632,400.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying financial statements have been prepared in accordance with the National Association of Insurance Commissioners (NAIC) *Statements of Statutory Accounting Principles* (SSAP), and in conformity with accounting practices prescribed or permitted by the DOI, which practices differ from accounting principles generally accepted in the United States (GAAP).

The more significant variances from GAAP are as follows:

Investments: Investments in bonds are reported at amortized cost or market value based on their NAIC rating; for GAAP, such fixed maturity investments would be designated at purchase as available-for-sale. For GAAP, available-for-sale investments would be reported at fair value with unrealized holding gains and losses reported in a separate component of surplus.

All single class and multi-class mortgage-backed/asset-backed securities are adjusted for the effects of changes in prepayment assumptions on the related accretion of discount or amortization of premium of such securities using the retrospective method. If it is determined that a decline in fair value is other-than-temporary, the cost basis of the security is written down to the undiscounted estimated future cash flows.

For GAAP purposes, all securities, purchased or retained, that represent beneficial interests in securitized assets, other than high credit quality securities, are adjusted using the prospective method when there is a change in estimated future cash flows. If it is determined that a decline in fair value is other-than-temporary, the cash basis of the security is written down to the discounted fair value. If high credit quality securities are adjusted, the retrospective method is used.

Fair value of certain investments in bonds and stocks are based on values specified by the NAIC rather than on actual or estimated market values, and therefore, are not stated in accordance with GAAP.

Investments in real estate are reported net of related obligations rather than on a gross basis. Real estate owned and occupied by the Company is included in investments rather than reported as an operating asset under GAAP, and investment income and operating expenses include rent for the Company's occupancy of those properties.

Nonadmitted Assets: Certain assets designated as "nonadmitted," including deferred federal income taxes in excess of certain statutory limits, furniture, fixtures and equipment, leasehold improvements, nonoperating system software, prepaid expenses, certain premium receivable balances and other assets not specifically identified as an admitted asset within the SSAP are excluded from the accompanying balance sheets and are charged directly to surplus. Under GAAP, such assets are included in the balance sheets.

(DOLLARS IN THOUSANDS)

2. Summary of Significant Accounting Policies (continued)

Deferred Income Taxes: Deferred tax assets are limited to (1) the amount of federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year, plus (2) the lesser of the remaining gross deferred tax assets expected to be realized within one year of the balance sheet date or 10% of surplus excluding any net deferred tax assets, EDP equipment and operating software, plus (3) the amount of remaining gross deferred tax assets that can be offset against existing gross deferred tax liabilities. The remaining deferred tax assets are nonadmitted. Under GAAP, a deferred tax asset is recorded for the amount of gross deferred tax assets expected to be realized in future years, and a valuation allowance is established for deferred tax assets not realizable.

Employee Benefits: For purposes of calculating the Company's pension and postretirement benefit obligations, only vested participants and current retirees are included in the valuation. Under GAAP, active participants not currently eligible also would be included.

Statement of Cash Flows: Cash, cash equivalents and short-term investments in the statements of cash flow represent cash balances and investments with initial maturities of one year or less. Under GAAP, the corresponding caption of cash and cash equivalents includes cash balances and investments with initial maturities of three months or less.

A reconciliation of net income and surplus of the Company, as determined in accordance with statutory accounting practices to amounts determined in accordance with GAAP, is as follows:

	Year Ended December 31, 2004		Year Ended December 31, 2003	
	Net Income	**Surplus**	**Net Income**	**Surplus**
Statutory-basis amounts	**$ 242,762**	**$ 1,090,985**	$ 232,309	$ 887,645
Investments	**—**	**14,833**	—	25,873
Federal income taxes	**1,956**	**—**	14,263	—
Deferred income tax	**—**	**17,592**	—	13,602
Premium receivable allowance	**(1,696)**	**—**	—	—
Pension and postretirement	**(4,711)**	**79,235**	(2,700)	52,757
Foundations	**22,791**	**77,468**	20,935	54,677
Other nonadmitted	**—**	**102,290**	—	62,885
GAAP-basis amounts	**$ 261,102**	**$ 1,382,403**	$ 264,807	$ 1,097,439

Other significant accounting practices are as follows:

Use of Estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Investments

Bonds not backed by loans are stated at amortized cost, with amortization calculated based on the scientific method, using lower of yield to call or yield to maturity. Prepayment assumptions for mortgage-backed securities and structured securities were obtained from broker-dealer survey values. These assumptions are consistent with the current interest rate and economic environment. The retrospective adjustment method is used to value all mortgage-backed securities.

Common stocks are stated at market values as determined by the NAIC Securities Valuation Office.

Unrealized gains and losses on common stocks are reflected directly in surplus unless there is deemed to be an other-than-temporary decline in value, in which case the loss is charged to income. Realized gains and losses on investments sold are determined using the specific identification method and are included in income. Amortization of bond premium and accretion of bond discount are recognized on a yield-basis method. Security transactions are accounted for on a trade-date basis, with any unsettled transactions recorded as due to or from investment broker and included as receivable and payable for securities in the Company's admitted assets and liabilities, respectively.

Investment income is recognized as income when earned. The Company periodically reviews the portfolio of securities to determine whether an other-than-temporary impairment has occurred. Any identified other-than-temporary impairment is recorded as part of net realized investment gains.

Cash equivalents are short-term highly liquid investments with original maturities of three months or less and are principally stated at amortized cost. Short-term investments include investments with remaining maturities of one year or less at the time of acquisition and are principally stated at amortized cost.

2. Summary of Significant Accounting Policies (continued)

Real Estate

Land is recorded at cost, and other real estate, which includes expenditures for significant improvements, is recorded at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful life of 40 years. Accumulated depreciation at December 31, 2004 and 2003 was $606 and $263, respectively.

In August 2003, the Company purchased land and a building with 311,800 square feet of office space in Quincy, Massachusetts for a net purchase price of approximately $32,000. This facility will consolidate operations from three separate locations. The lease agreements on the current locations were extended into 2004 and 2005 in order to facilitate building renovations.

In addition, in October 2003, the Company signed a purchase and sale agreement with a developer to purchase land and construct a new office facility with an anticipated occupancy date in early 2006. Both purchase transactions have been approved by the DOI.

Furniture and Equipment

The admitted value of the Company's electronic data processing equipment and operating software is limited to three percent of adjusted surplus. The admitted portion is reported at cost, less accumulated depreciation of $31,285 and $34,740 at December 31, 2004 and 2003, respectively. Electronic data processing equipment and operating software is depreciated using the straight-line method over the lesser of its useful life or three years. Nonoperating software is depreciated using the straight-line method over the lesser of its useful life or three years. Other furniture and equipment is depreciated using the straight-line method over its estimated useful life. Depreciation expense charged to income in 2004 and 2003 was $12,779 and $11,982, respectively.

Health care Claim Reserves

The provision for health care claim reserves is actuarially determined based on historical claims payment experience and other statistics. This liability is subject to the impact of changes in claim severity and frequency, as well as numerous other factors. Management believes that the liability is adequate, but the ultimate net cost of settling this liability may vary from the estimated amount.

The methods used to develop the reserves for claims incurred but not yet reported are subject to continuing review and refinement, and any necessary adjustments are recorded in operations in the year in which they are determined to be necessary. An estimate of future claim payments is not recorded for ASC claims.

Aggregate policy reserves represent a reserve for unearned premium income and a reserve for rate credits and experience rating refunds.

Premium

The Company receives premium revenue from insured business. Member premiums are billed in advance of their respective coverage periods. Premium receivable and revenue are recorded when due. Earned income is recorded during the coverage period. Unearned premium reserves are established to cover the unexpired portion of premiums written and are computed by pro-rata methods for direct business. Expenses incurred in connection with acquiring new insurance business, including acquisition costs such as sales commissions, are charged to income as incurred. The premium paid by subscribers prior to the effective date is recorded in the balance sheet as premiums received in advance and subsequently credited to income as earned during the coverage period.

Administrative Services Contract (ASC) and Administrative Service Only (ASO)

ASC and ASO are referred to as uninsured business under the NAIC SSAP. ASC is a business where the Company pays benefits on the behalf of employers using the Company's check stock. ASO is a business where the Company pays benefits on the behalf of employers using the employer's check stock. The Company receives an administrative fee for providing these services. Premiums and claim expenses are not included in the Company's financial statements. The administrative fees earned are reported as a reduction to operating expenses in the Company's statements of income.

ASC and ASO accounts are billed monthly, in arrears, for actual medical claims plus administrative fees. The remaining balance of receivables from uninsured plans, after assessment for collectibility, and group deposits received in advance, are included in the Company's admitted assets and liabilities, respectively. In 2004, the Company set up a $10,500 provision to recognize certain estimated provider settlements related to prior disputed claim payments made on ASC and ASO accounts.

Health care Receivables

The Company enters into contractual agreements with various health care providers to provide certain medical services to its members. Compensation arrangements vary by provider. Certain providers have entered into risk-sharing arrangements with the Company, whereby a settlement is calculated by comparing actual medical claims experience to a pre-approved and predetermined budgeted amount. These settlements are accrued on an estimated basis in the period the related services are rendered, and adjusted in future periods as final settlements are determined. Esti-

(DOLLARS IN THOUSANDS)

2. Summary of Significant Accounting Policies (continued)

mated settlements for these risk-sharing arrangements are reflected in health care receivables on the Company's balance sheets.

Other amounts included in health care receivables represent claims overpayments, advances to the providers and capitation arrangement receivables. Claim overpayments occur as a result of several events, including, but not limited to, claim payments paid in error to a provider. The Company also makes advances to a large group of providers, when those advances are supported by legally enforceable contracts and are generally entered into at the request of the providers. Advances to the providers under a capitation arrangement are usually made in anticipation of the future services, and used in connection with some managed care contracts, when a physician or other medical provider is paid a flat amount.

Income Taxes

For federal income tax purposes, the Company is treated as a stock property and casualty insurance company subject to special provisions of the tax code applicable to a Blue Cross and Blue Shield organization. The Company is exempt from Massachusetts state income taxes.

Impairment of Long-Lived Assets

The Company continually evaluates the recoverability of long-lived assets by assessing whether the carrying amount of asset balances can be recovered as measured against the future undiscounted net cash flows expected to be generated by the assets. The future undiscounted net cash flows are based on historical trends, revenue forecasts and market trends projected over the remaining life of the long-lived assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. At December 31, 2004, the Company recorded $3,000 related to impairment of certain furniture and fixtures.

Fair Value of Financial Instruments

The fair value of investment securities is estimated based on NAIC quoted prices for those or similar investment securities. The carrying amounts of cash, cash equivalents, short-term investment, and other assets and liabilities approximate fair value because of the short maturity of these instruments.

Reclassification

Certain amounts for the year ended December 31, 2003 have been reclassified to be consistent with the presentation of the amounts for the year ended December 31, 2004.

3. Cash and Investments

The cost or amortized cost, gross unrealized gains (losses) and NAIC fair value of cash and investments are as follows:

	December 31, 2004			
	Cost or Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Cash, cash equivalents and short-term investments	**$ 269,836**	**$ —**	**$ —**	**$ 269,836**
Bonds:				
U.S. Government securities	**308,075**	**1,428**	**(147)**	**309,356**
Industrial and miscellaneous	**256,166**	**11,089**	**(339)**	**266,916**
Mortgage-backed securities	**204,822**	**4,021**	**(338)**	**208,505**
Total bonds	**769,063**	**16,538**	**(824)**	**784,777**
Common stocks	**837,545**	**148,867**	**(882)**	**985,530**
Total cash and investments	**$ 1,876,444**	**$ 165,405**	**$ (1,706)**	**$ 2,040,143**

	December 31, 2003			
	Cost or Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Cash, cash equivalents and short-term investments	$ 99,064	$ —	$ —	$ 99,064
Bonds:				
U.S. Government securities	259,504	3,234	(105)	262,633
Industrial and miscellaneous	328,711	18,778	(565)	346,924
Mortgage-backed securities	337,615	38	—	337,653
Total bonds	925,830	22,050	(670)	947,210
Common stocks	776,001	106,295	(1,435)	880,861
Total cash and investments	$ 1,800,895	$ 128,345	$ (2,105)	$ 1,927,135

At December 31, 2004, included in the Company's investments are unrealized losses deemed to be temporary. The total unrealized loss relating to these securities is $1,706, of which the amount greater than 12 months is immaterial. These investments reflect a range of industries, and the Company deems the current market volatility as temporary.

(DOLLARS IN THOUSANDS)

3. Cash and Investments (continued)

Cash, cash equivalents and investments include $115,184 and $98,792 at December 31, 2004 and 2003, respectively, of securities that are pledged as collateral for a Depository Agreement with the Blue Cross and Blue Shield Association to meet certain licensure standards. The Company has $1,000 in assets on deposit with regulatory agencies at December 31, 2004, as required by M.G.L. c.176G section 26.

Fair values of publicly traded bonds and unaffiliated stocks are generally based on independently quoted market prices, which may differ from NAIC fair values. The fair values of bonds were $784,777 and $947,210 at December 31, 2004 and 2003, respectively. The fair values of unaffiliated common stocks were $985,530 and $880,861 at December 31, 2004 and 2003, respectively. Accrued investment income of $7,264 and $8,625 at December 31, 2004 and 2003, respectively, is defined as investment income earned as of the reporting date but not legally due to be paid to the Company until subsequent to the reporting date.

The amortized cost and fair value of bonds at December 31, 2004, by stated maturity, are shown below. Fixed maturities subject to early or unscheduled prepayments have been included based upon their stated maturity dates. Actual maturities may differ from stated maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	Cost or Amortized Cost	Fair Value
Within 1 year	**$ 79,051**	$ 79,361
After 1 year through 5 years	**310,813**	314,045
After 5 years through 10 years	**148,845**	154,812
After 10 years	**230,354**	236,559
Total bonds	**$769,063**	$784,777

Proceeds from the sale of investment securities were approximately $1,308,553 and $478,963 for the years ended December 31, 2004 and 2003, respectively. Gross realized investment gains and losses are as follows:

	2004	2003
Gross gains	**$ 28,151**	$16,604
Gross losses	**(10,046)**	(2,736)
Net realized investment gains	**$ 18,105**	$13,868

In 2004 and 2003, there was no write-down of debt or equity securities with a decline in market value that was determined by management to be other-than-temporary.

Included in other invested assets is a $10,000 surplus note purchased by the Company in November 2003. The note was issued by Neighborhood Health Plan, Inc. (NHP), and bears an initial interest rate of 5.3% per annum through September 30, 2008. Accrued interest payments on this note, subject to approval from the DOI, are due semi-annually in arrears on or before each April 1 and October 1, commencing on April 1, 2004, until payment in full of all amounts are received. Principal payments on this note, subject to approval from the DOI, are due and payable in semi-annual installments, commencing on April 1, 2014, with a final installment due and payable on October 1, 2018. There are no payments outstanding from NHP at December 31, 2004.

4. Health Care Claims Reserves

Activity in health care claims reserves is summarized in the reconciliation of the beginning and ending balances of claims payable and claims incurred but not yet reported as follows:

	2004	2003
Balance at January 1	**$ 531,720**	$ 552,477
Incurred related to:		
Current year	**4,237,803**	3,655,117
Prior years	**(33,742)**	(85,514)
Total incurred	**4,204,061**	3,569,603
Paid related to:		
Current year	**3,836,939**	3,133,527
Prior years	**479,770**	456,833
Total paid	**4,316,709**	3,590,360
Balance at December 31	**$ 419,072**	$ 531,720

The Company uses estimates for determining its claims incurred but not yet reported which are based on historical claim payment patterns, health care trends and membership, and includes a provision for adverse changes in claim patterns and severity. Lower than anticipated claims resulted in adjustments to claims incurred in prior years of $33,742 and $85,514 in 2004 and 2003, respectively. The change in claims payable and claims incurred but not reported from prior year is due to certain systems enhancements related to the provider reimbursement strategy which accelerated the processing of claims payments. Claims incurred in 2004 include a $19,500 charge to recognize certain estimated provider settlements related to prior disputed claim payments.

(DOLLARS IN THOUSANDS)

4. Health Care Claims Reserves (continued)

A reconciliation of incurred claims reported above to health care benefits in the Company's statements of income is as follows at December 31:

	2004	2003
Total incurred claims per above	**$ 4,204,061**	$ 3,569,603
Medical incentive pool and bonus payments incurred	**42,819**	45,501
Health care benefits	**$ 4,246,880**	$ 3,615,104

Subrogation credits naturally flow through the claims payments which are used to calculate reserves. Therefore, reserves at December 31, 2004 and 2003 have an inherent amount for subrogation credits.

5. Pension and Other Postretirement Benefit Plans

All employees are eligible to participate in the Retirement Income Trust Plan (RIT), which grants benefits to retired employees at various levels based on age and years of service. The Company also participates in two noncontributory retirement plans for eligible employees, and sponsors a defined benefit plan covering medical, life and dental benefits. The Company uses a December 31 measurement date for the majority of its plans.

A summary of assets, obligations and assumptions of the RIT pension and other postretirement benefit plans are as follows:

	Pension Benefits		Other Benefits	
	2004	2003	2004	2003
Change in benefit obligation				
Benefit obligation at beginning of year	**$ 325,356**	$ 270,870	**$ 107,129**	$ 105,384
Service cost	**12,043**	10,144	**3,709**	2,611
Interest cost	**19,772**	17,984	**6,008**	6,920
Actuarial (gain) loss	**23,000**	39,873	**8,687**	(1,731)
Benefits paid	**(15,873)**	(17,178)	**(6,175)**	(6,055)
Administrative expenses paid	**(307)**	(400)	**—**	—
Plan amendments	**—**	4,063	**—**	—
Benefit obligation at end of year	**$ 363,991**	$ 325,356	**$ 119,358**	$ 107,129

	Pension Benefits		Other Benefits	
	2004	2003	2004	2003
Change in plan assets				
Fair value of plan assets at beginning of year	**$ 327,530**	$ 247,114	**$ —**	$ —
Actual return on plan assets	**38,053**	60,994	**—**	—
Employer contribution	**40,000**	37,000	**6,175**	6,055
Benefits paid	**(15,874)**	(17,178)	**(6,175)**	(6,055)
Administrative fees paid	**(307)**	(400)		—
Fair value of plan assets at end of year	**$ 389,402**	$ 327,530	**$ —**	$ —
Reconciliation of funded status				
Funded status	**$ 25,411**	$ 2,174	**$ (119,359)**	$(107,129)
Unrecognized net loss	**79,347**	70,893	**48,000**	40,939
Transition gain	**—**	—	**22,974**	25,846
Unrecognized prior service cost	**3,318**	3,690	**—**	—
Prepaid assets or accrued liabilities	**$ 108,076**	$ 76,757	**$ (48,385)**	$ (40,344)
Benefit obligation for nonvested employees	**$ 14,728**	$ 15,486	**N/A**	N/A
Components of net periodic benefit cost				
Service cost	**$ 12,043**	$ 10,144	**$ 3,709**	$ 2,611
Interest cost	**19,772**	17,984	**6,008**	6,920
Expected return on plan assets	**(27,041)**	(20,270)	**—**	—
Amortization of unrecognized transition liability	**—**	—	**2,872**	2,872
Amount of recognized losses	**3,535**	4,470	**1,627**	2,314
Amount of prior service cost recognized	**372**	372	**—**	—
Total net periodic benefit cost	**$ 8,681**	$ 12,700	**$ 14,216**	$ 14,717

(DOLLARS IN THOUSANDS)

5. Pension and Other Postretirement Benefit Plans (continued)

A minimum pension liability is required when the actuarial present value of accumulated benefits exceeds plan assets and accrued pension liabilities. The minimum liability adjustment, less allowable intangible assets, net of tax benefit, is reported as a change in surplus. At December 31, 2004 and 2003, respectively, the additional minimum pension liability was $243 and $907, respectively.

The noncontributory retirement plans include projected benefit obligations in excess of plan assets of $26,759 and $25,061, and accumulated benefit obligations in excess of plan assets of $26,759 and $19,184, at December 31, 2004 and 2003, respectively.

Weighted-average assumptions as of December 31, 2004 and 2003 are as follows:

	Pension Benefits		Other Benefits	
	2004	**2003**	**2004**	**2003**
Discount rate	**5.75%**	6.25%	**5.75%**	6.25%
Expected return on plan assets	**8.50**	8.50	**N/A**	N/A
Rate of compensation increase	**4.50**	4.00	**N/A**	N/A

For measurement purposes, the rate of increase in the per capita cost of covered health care benefits was assumed to be in the range of 10% to 12% for 2004. The rate is assumed to decrease gradually to the range of 5% to 6% for 2015, and remain at that level thereafter.

The Company's pension benefit weighted-average asset allocations at December 31, 2004 and 2003, by asset category, are as follows:

	Pension Benefits		Other Benefits	
	2004	**2003**	**2004**	**2003**
Asset category				
Equity securities	**58%**	57%	**N/A**	N/A
Debt securities	**26**	31	**N/A**	N/A
Other	**16**	12	**N/A**	N/A
Total	**100%**	100%		

The Company has a nonpension postretirement benefit plan. On December 31, 2004 and 2003, the Company's other benefits, included in its postretirement plan, are medical, dental and life benefits for retired employees. The health care plans and life insurance benefits are noncontributory. This program is funded on a "pay-as-you-go basis" in that assets are not set aside for this program. The Company's contributions for the fiscal year ending December 31, 2005 are expected to be $20,000 for its pension plan and $8,165 for its postretirement benefit plan.

At December 31, 2004, the Company's projected benefit payments are as follows:

	Pension Benefits	Other Benefits	Medicare Subsidy
2005	$ 22,562	$ 8,165	$ —
2006	23,149	8,781	622
2007	24,239	9,324	694
2008	25,568	9,828	766
2009	27,029	10,525	829
Next five years	152,610	63,644	3,132

In 2004, the Company adopted Financial Accounting Standards Board Staff Position 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003* (FSP 106-2). The Company and its actuarial advisors determined that benefits provided by the plan as of the date of the enactment were at least actuarially equivalent to Medicare Part D, and, accordingly, the Company will be entitled to the federal subsidy. The Company determined that the aggregate effect on the service cost, interest cost, and amortization of the actuarial experience gains and losses result in a reduction of $937 in 2004 annual net periodic postretirement benefit cost due to the effect of FSP 106-2. The calculation excludes nonvested employees costs per INT 04-17: *Impact of Medicare Modernization Act on Postretirement Benefits.*

The Company also has a savings (401k) plan for eligible employees. Under the employee savings plan, the Company contributes an amount equal to 65% of employee contributions, up to a maximum of 6% of each employee's compensation, subject to pretax Internal Revenue Service limits of $13,000 and $12,000 in 2004 and 2003, respectively. Contributions are maintained in investment funds established under the employee savings plan. Total Company contributions charged to income amounted to $5,478 and $5,400 in 2004 and 2003, respectively.

(DOLLARS IN THOUSANDS)

6. Income Taxes

The Company's tax rate is less than the regular tax rate of 35% for corporations due to utilization of the special deduction available to Blue Cross and Blue Shield Plans under Internal Revenue Code section 833. The special deduction subjects the Company to the alternative minimum tax (AMT) provisions. The AMT provisions tax income at a rate of 20% and limits utilization of net operating loss carryforwards to 90% of taxable income.

Under the asset and liability method, the Company's temporary differences represent the estimated future tax effects attributable to future taxable or deductible temporary differences between amounts recognized in the financial statements and income tax returns. These items primarily represent depreciation and amortization, postretirement benefits, certain accrued liabilities, accrued pension costs and discounting of unpaid claims liabilities and expenses. The temporary differences are tax effected at the AMT rate of 20%.

The components of the net deferred tax asset (liability) at December 31, 2004 and 2003 are as follows:

	2004	2003
Total of gross deferred tax assets	**$ 81,304**	$ 69,829
Total of deferred tax liabilities	**(29,597)**	(20,972)
Net deferred tax asset	**51,707**	48,857
Deferred tax asset nonadmitted	**50,271**	36,630
Net admitted deferred tax asset	**$ 1,436**	$ 12,227
Increase in nonadmitted deferred tax asset	**$ 13,641**	$ 8,682

The provisions for incurred taxes on earnings for the year ended December 31, 2004 and 2003 are:

	2004	2003
Federal income tax on operations	**$ 54,994**	$ 67,142
Federal income tax on net capital gains	**3,621**	2,774
Provision for federal income taxes	**$ 58,615**	$ 69,916

The tax effect of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are as follows:

	2004	2003
Deferred tax assets:		
Postretirement benefits	**$ 14,392**	$ 11,874
Other-than-temporary impairment of securities	**18,817**	20,436
Fixed assets	**22,105**	22,333
Accrued expenses	**25,990**	15,186
Total deferred tax assets	**81,304**	69,829
Nonadmitted deferred tax assets	**50,271**	36,630
Admitted deferred tax assets	**31,033**	33,199
Deferred tax liabilities:		
Unrealized gains on securities	**29,597**	20,972
Total deferred tax liabilities	**29,597**	20,972
Net admitted deferred tax asset	**$ 1,436**	$ 12,227

During 2004, the Internal Revenue Service completed an examination and administrative settlement of the Company's federal income tax returns for the calendar tax years 1992 through 2000. The Company established a liability in prior years for all amounts of federal income tax related to this examination period.

The Company's effective rate differs from the Company's applicable statutory rate of 20% due to the effect of adjustments for dividend received deductions, meals and entertainment expenses, revisions to prior year estimates and the impact of nonadmitted assets.

The amount of federal income taxes incurred and available for recoupment in the event of future net losses is $49,753 and $60,602 from 2004 and 2003, respectively.

7. Surplus

Chapter 160 of the Acts of 1988 requires that the Company maintain surplus of not less than 5% of all expenses and insured claims incurred in each year. At December 31, 2004 and 2003, BCBSMA's surplus is in excess of the regulatory Chapter 160 requirements.

(DOLLARS IN THOUSANDS)

7. Surplus (continued)

In addition, the NAIC has imposed regulatory health risk-based capital (HRBC) requirements on health insurance companies, including the Company. The HRBC calculation serves as a benchmark for the regulation of health insurance companies' solvency by state insurance regulators. At December 31, 2004 and 2003, the Company's total adjusted capital is in excess of the regulatory HRBC requirements.

Lastly, the Commonwealth of Massachusetts enacted in 2003, to take effect January 1, 2004, Chapter 141, which applies requirements of unfair insurance competition under Chapter 176D to health maintenance organizations (HMOs) and HMOs operated as a line of business. Chapter 141 requires an HMO to have adjusted net worth of $1,500 when initially licensed. Thereafter, an HMO must maintain a minimum adjusted net worth in an amount determined by the DOI based initially on a sliding scale over a seven-year phase in period effective December 31, 2004. HMOs must maintain a minimum deposit of at least $1,000 with a trustee acceptable to the DOI. Mergers and other transactions to acquire control of an HMO must be approved by the DOI. The Company met and exceeded all regulatory Chapter 141 requirements at December 31, 2004.

8. Permitted Statutory Accounting Practices

State insurance laws and regulations prescribe accounting practices for determining statutory net income and surplus for insurance companies. In addition, state regulators may permit statutory accounting practices that differ from prescribed practices. The Company had no permitted practices that would have an effect on statutory surplus at December 31, 2004 and 2003.

9. Federal Employees Program

The Federal Employees Program (FEP) is a national contract between Blue Cross and Blue Shield plans (participating plans) and the U.S. Office of Personnel Management under which participating plans provide health coverage to U.S. Government employees. The Company's share of revenue, expenses, assets and liabilities under the FEP contract is reported in the Company's financial statements. Amounts receivable from FEP represent funds being held in a letter of credit account (FEP account) maintained specifically for FEP benefits. As checks and electronic payments clear its bank accounts, the Company reimburses itself by drawing funds from the FEP account.

10. Related Party Transactions

The Company is the sole corporate member of two Foundations for which it provided substantial financial support of $24,165 and $17,563 in 2004 and 2003, respectively. The Health Care Assistance Foundation, Inc.'s (HCAF) mission is to promote the care of elderly, disabled and other persons who are experiencing financial hardship, and to provide limited assistance for the care of such persons. The Blue Cross Blue Shield of Massachusetts Foundation, Inc.'s (BCBSF) mission is to provide and support education and research, foster health care innovation, and reform and develop, promote and support programs to improve the quality of health care access.

In July 2003, BCBSF formed Massachusetts Medicaid Policy Institute, Inc. (MMPI) to provide and support education and research, to promote programs to improve the quality of health care access and delivery, and to foster health care innovation reform and development. BCBSF is the sole corporate member of MMPI, and as such, has a variety of powers, including appointment and approval of board members.

At December 31, 2004, the Company has payables to BCBSF and HCAF of $11,883 and $2,051, respectively, and a receivable from BCBSF of $291. At December 31, 2003, the Company has payables to BCBSF and HCAF of $500 and $4,176, respectively, and a receivable from BCBSF of $100.

11. Leases

The Company has a long-term operating lease agreement for approximately 500,000 square feet of office space for its corporate headquarters. The term of the lease is 15 years, commencing in May 2000, with an option to extend for one period of four years and eleven months. The Company has entered into several other long-term noncancelable operating lease agreements for office space that expire at various dates through 2010. For the years ended December 31, 2004 and 2003, the Company recorded rental expense of approximately $21,121 and $24,300, respectively.

At December 31, 2004, minimum rental commitments on significant noncancelable operating leases are as follows:

2005	$28,106
2006	22,886
2007	15,167
2008	15,103
2009	15,002
Thereafter	87,047

In addition, the Company has an agreement with an outside vendor to provide certain information technology services for substantially all of the Company's business operations. The agreement was amended in June 2002 to increase the minimum resource utilization and further amended in December 2004 to extend the contract expiration

(DOLLARS IN THOUSANDS)

11. Leases (continued)

from 2007 to 2012. The Company's minimum commitments under this agreement are approximately $12,100 per year.

12. Revolving Line of Credit

The Company has a $50,000 revolving credit agreement. Borrowings under this line of credit bear interest at LIBOR (London Interbank Offered Rate) plus 50 basis points. Whenever the outstanding principal balance exceeds 50% of the principal balance available under the credit facility, the borrowing rate is increased an additional seven basis points. The credit facility is secured by margined collateral, which includes U.S. Treasury, Agency and Corporate Bonds. The line of credit matures in August 2006. There are no amounts outstanding under this credit facility at December 31, 2004.

13. Retrospectively Rated Contracts and Contracts Subject to Redetermination

The Company estimates accrued retrospective premium adjustments for its retrospectively rated business through a mathematical approach consistent with the Company's underwriting rules and experience rating practices.

The amount of net premiums written by the Company for the years ended December 31, 2004 and 2003 that are subject to retrospective rating features was $11,700 and $9,300, that represented 0.2% and 0.2%, respectively, of the total net premiums written for the Company. No other premiums written by the Company are subject to retrospective rating features.

14. Risk Sharing Receivable

To the extent that receivables and payables with the same provider are netted, the Company's risk sharing receivable balances are as follows at December 31, 2004 and 2003:

Calendar Year	Risk Sharing Receivable as Estimated in the Prior Year	Risk Sharing Receivable Adjusted in the Current Year	Risk Sharing Receivable Received	Risk Sharing Receivable as Estimated in the Current Year
2004	**$ 737**	**$ 8,419**	**$ 4,573**	**$ 4,583**
2003	$ 7,770	$ (2,296)	$ 4,737	$ 737

15. ASO and ASC Business

The Company provides certain claim administration services for its uninsured customers through ASO or ASC arrangements. The net gain from income related to these contracts is as follows at December 31, 2004 and 2003, respectively:

	ASO Uninsured Plans	
	2004	2003
Net reimbursement for administrative expenses (including administrative fees) in excess of actual expenses	**$ 114**	$ 2,393
Net gain from operations	**$ 114**	$ 2,393
Total claim payment volume	**$ 19,267**	$ 38,957

	ASC Uninsured Plans	
	2004	2003
Gross reimbursement for medical cost incurred	**$ 4,090,877**	$ 3,451,207
Gross expenses incurred (claims and administrative)	**4,060,705**	3,434,256
Net gain from operations	**$ 30,172**	$ 16,951

16. Commitments and Contingencies

The Company is involved in pending and threatened litigation of the character incidental to its business or arising out of its insurance operations, and is from time to time involved as a party in various governmental and administrative proceedings. Management continues to monitor these matters, and believes the Company has accrued adequate reserves against potential liabilities.