Report of Management on Blue Cross and Blue Shield of Massachusetts, Inc.'s Internal Control Over Financial Reporting

February 10, 2006

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, 2005 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, 2005 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. The attestation is included in our annual report.

Blue Cross and Blue Shield of Massachusetts, Inc.

by ______________________________

Cleve L. Killingsworth, *President and Chief Executive Officer*

by ______________________________

Allen Maltz, *Executive Vice President and Chief Financial Officer*

by ______________________________

Brett Painchaud, *Controller*

by ______________________________

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

Auditor's 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 statutory financial reporting as of December 31, 2005 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 statutory financial reporting and for its assessment of the effectiveness of internal control over statutory 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 statutory 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 statutory financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over statutory 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 statutory 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 statutory 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 statutory financial statements.

Because of its inherent limitations, internal control over statutory 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 statutory financial reporting as of December 31, 2005 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 statutory financial reporting as of December 31, 2005, 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, 2005 and 2004, and the related statutory-basis statements of income, change in surplus and cash flows for the years then ended, and our report dated February 10, 2006 expressed an unqualified opinion thereon.

Ernst + Young LLP

Boston, Massachusetts
February 10, 2006

Report of Management on Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.'s Internal Control Over Financial Reporting

February 10, 2006

We, as members of management of Blue Cross and Blue Shield of Massachusetts HMO Blue, 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, 2005 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, 2005 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. The attestation is included in our annual report.

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

by ______________________

Cleve L. Killingsworth, *President and Chief Executive Officer*

by ______________________

Allen Maltz, *Executive Vice President and Chief Financial Officer*

by ______________________

Brett Painchaud, *Controller*

by ______________________

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

Auditor's Opinion on Management's Assessment and the Effectiveness of Internal Control over Financial Reporting

Board of Directors
Blue Cross and Blue Shield of Massachusetts HMO Blue, 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 HMO Blue, Inc. (the Company) maintained effective internal control over statutory financial reporting as of December 31, 2005 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 statutory financial reporting and for its assessment of the effectiveness of internal control over statutory 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 statutory 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 statutory financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over statutory 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 statutory 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 statutory 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 statutory financial statements.

Because of its inherent limitations, internal control over statutory 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 statutory financial reporting as of December 31, 2005 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 statutory financial reporting as of December 31, 2005, 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 HMO Blue, Inc. at December 31, 2005 and the related statutory-basis statements of income, change in surplus and cash flows for the year then ended, and our report dated February 10, 2006 expressed an unqualified opinion thereon.

Ernst & Young LLP

Boston, Massachusetts
February 10, 2006

2005 Report of the Human Resources Committee on Compensation

Competitive Compensation Assessment

Watson Wyatt & Company conducted a review of Blue Cross Blue Shield of Massachusetts' compensation programs for the Human Resources Committee (HRC).

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 HRC engaged Watson Wyatt directly, and it annually commissions a competitive assessment of Blue Cross Blue Shield of Massachusetts (BCBSMA) compensation programs.

The 2005 review was designed to determine whether 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; and
- Incentive pay provided through the Associate Performance Plan, Leadership Performance Plan, and Long-Term Incentive Plan (short-term and long-term incentive programs).

Watson Wyatt concluded that 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-term and long-term incentive performance measures to ensure that the programs continue to support BCBSMA's business needs and are aligned with current strategic objectives. The HRC will continue to evaluate programs on an ongoing basis relative to market trends and business needs.

Compensation Philosophy and Programs

BCBSMA's compensation philosophy was most recently reviewed and approved by the HRC in November 2005. This review indicates that the philosophy continues to effectively support business needs and reflects 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 with the opportunity to supplement competitive base salaries.
- 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 with 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 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 2005 are currently based on Statutory Net Income, Member Satisfaction, and Loyalty measures, as well as progress against our strategic plan, all key indicators of BCBSMA's success. 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 2005 through 2007 performance cycle is membership growth combined with a minimum level of statutory reserves and progress against the strategic plan.

By encouraging the delivery of cost-effective products that provide access to high-quality health care as a means to increase membership, the Long-Term Incentive Plan focuses senior leaders on the cost and quality of care.

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

The HRC, on behalf of BCBSMA, conducts regular annual reviews of CEO and 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 versus 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 large health insurers and managed care companies.

Key findings of the 2005 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 (+/-15%) of median industry market practice, including the CEO position.
Total Cash Compensation (TCC—base salary plus target bonus)	Target total cash compensation is competitive with median market practice for the CEO and EVPs.
Total Direct Compensation (TDC—base salary plus target bonus and target long-term incentives)	BCBSMA target total direct compensation levels (base salary plus bonus and long-term incentives) for the CEO and EVPs are at 92% 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.
Supplemental Retirement Program (SRP)	The supplemental retirement program is limited to select participants voted on by the Board; it provides retirement benefits that are necessary to attract and retain talented individuals to lead the organization.

Blue Cross and Blue Shield of Massachusetts, Inc.

Audited Statutory-Basis Financial Statements

Years Ended December 31, 2005 and 2004

CONTENTS

Report of Independent Auditors

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, 2005 and 2004, 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 3 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 3.

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 U.S. generally accepted accounting principles, the financial position of Blue Cross and Blue Shield of Massachusetts Inc. at December 31, 2005 and 2004, 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, 2005 and 2004, 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 standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over statutory financial reporting as of December 31, 2005, 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 10, 2006 expressed an unqualified opinion thereon.

Ernst & Young LLP

Boston, Massachusetts
February 10, 2006

Blue Cross and Blue Shield of Massachusetts, Inc.

Statutory-Basis Balance Sheets

(IN THOUSANDS)

	December 31	
	2005	**2004**
Admitted assets		
Bonds	**$ 408,830**	$ 769,063
Preferred stock	**2,465**	—
Common stock	**186,092**	458,097
Real estate, less accumulated depreciation	**60,440**	59,328
Cash, cash equivalents and short-term investments	**22,850**	269,836
Receivable for securities	**71**	1,326
Other invested assets	**369,323**	537,433
Total cash and invested assets	**1,050,071**	2,095,083
Accrued investment income	**3,634**	7,264
Premiums receivable	**561**	2,472
Receivable related to uninsured plans	**350,122**	369,770
Current income tax recoverable	**15,254**	4,772
Net deferred tax asset	**12,852**	1,436
Data processing equipment	**5,235**	9,853
Receivable from affiliates	**75,787**	291
Health care receivables	**10,543**	34,459
Due from Federal Employees Program	**44,144**	31,884
Other assets	**36,429**	36,673
Total admitted assets	**$ 1,604,632**	$ 2,593,957
Liabilities and surplus		
Health care claim reserves	**197,784**	$ 419,072
Accrued medical incentive pool and bonus payments	**9,599**	39,723
Aggregate policy reserves	**31,187**	44,166
Premiums received in advance	**47,930**	165,814
Federal income taxes payable	**25,677**	42,369
Accounts payable and accrued liabilities	**402,074**	358,595
Payable to affiliates	**12,877**	13,934
Payable for securities	**3,363**	1,833
Uninsured group advance deposits	**358,692**	369,081
Liability for post-retirement benefits	**50,082**	48,385
Total liabilities	**1,139,265**	1,502,972
Surplus	**465,367**	1,090,985
Total liabilities and surplus	**$ 1,604,632**	$ 2,593,957

See accompanying notes.

Blue Cross and Blue Shield of Massachusetts, Inc.

Statutory-Basis Statements of Income

(IN THOUSANDS)

	Years Ended December 31	
	2005	**2004**
Premiums earned	**$1,976,829**	$4,927,604
Health care benefits	**1,695,031**	4,246,880
General and claim adjustment expenses	**198,843**	479,592
Total expenses	**1,893,874**	4,726,472
Underwriting gain	**82,955**	201,132
Net investment income	**34,141**	82,140
Net realized capital gains, less capital gains tax of $1,883 and $3,621 in 2005 and 2004, respectively	**21,781**	14,484
Net income before federal income tax expense	**138,877**	297,756
Federal income tax expense	**11,154**	54,994
Net income	**$ 127,723**	$ 242,762

See accompanying notes.

Blue Cross and Blue Shield of Massachusetts, Inc.

Statutory-Basis Statements of Changes in Surplus

(IN THOUSANDS)

	Years Ended December 31	
	2005	**2004**
Balance prior to net assets transferred to HMO Blue	**$ 1,090,985**	$ —
Net assets transferred to HMO Blue	**(636,379)**	—
Balance at January 1	**454,606**	887,645
Net assets transferred to HMO Blue on April 1	**(60,000)**	—
Net income	**127,723**	242,762
Change in net unrealized gains, net of taxes	**(9,524)**	28,031
Change in nonadmitted assets	**(47,700)**	(138,201)
Change in net deferred income taxes	**(5,433)**	70,217
Pension liability adjustment, net of taxes	**(230)**	531
Adjustment from the MRA	**5,925**	—
Balance at December 31	**$ 465,367**	$1,090,985

See accompanying notes.

Blue Cross and Blue Shield of Massachusetts, Inc.

Statutory-Basis Statements of Cash Flow

(IN THOUSANDS)

	Years Ended December 31 2005	2004
Operating activities		
Premiums received	**$ 1,944,374**	$ 4,964,523
Health care benefits paid	**(1,722,978)**	(4,362,164)
General and claim adjustment expenses paid	**(142,909)**	(492,183)
Net investment income received	**35,664**	83,501
Federal income taxes paid	**(41,781)**	(118,947)
Net cash provided by operating activities	**72,370**	74,730
Investing activities		
Sales, maturities and redemptions of investments	**829,034**	1,646,910
Cost of investments acquired	**(888,262)**	(1,537,724)
Acquisition of real estate	**(28,739)**	(28,448)
Other invested assets	**1,003**	(3,309)
Net cash (used in) provided by investing activities	**(86,964)**	77,429
Financing or miscellaneous activities		
Net assets transferred to HMO Blue	**(88,315)**	—
Other sources, net	**(144,077)**	18,613
Net cash (used in) provided by financing or miscellaneous activities	**(232,392)**	18,613
Net (decrease) increase in cash, cash equivalents and short-term investments	**(246,986)**	170,772
Cash, cash equivalents and short-term investments:		
Beginning of year	**269,836**	99,064
End of year	**$ 22,850**	$ 269,836

See accompanying notes.

Notes to Statutory-Basis Financial Statements

December 31, 2005 and 2004
(*Dollars in thousands*)

1. Master Reorganization

On January 1, 2005, pursuant to a Master Reorganization Agreement ("MRA"), Blue Cross and Blue Shield of Massachusetts, Inc. ("BCBSMA" or the "Company") transferred its insured health maintenance organization line of business (with the exception of Blue Care 65, which was transferred on April 1, 2005) to Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. ("HMO Blue"), a separately incorporated, not-for-profit subsidiary of BCBSMA (the "Transfer"). HMO Blue was formed on February 7, 1997 as a not-for-profit corporation pursuant to Chapter 180 of Massachusetts General Laws, and was formerly known as XYZ Managed Care Corporation. HMO Blue is a wholly controlled subsidiary of BCBSMA. From the date of its formation until January 1, 2005, HMO Blue had been a shell entity pending the Transfer. Since January 1, 2005, HMO Blue has provided hospitalization, medical and other health benefits as a licensed health maintenance organization. Effective January 1, 2005, HMO Blue received a health maintenance organization ("HMO") license from the Commonwealth of Massachusetts Division of Insurance ("DOI"). HMO Blue operates as a nonprofit, charitable organization and qualifies as a tax-exempt social welfare organization under Section 501(c)(4) of the Internal Revenue Code. The impact of this transaction as of January 1, 2005 is a reduction of $636,379 and deferred tax adjustment of $5,925 from BCBSMA's December 31, 2004 statutory surplus.

Significant components of the assets and liabilities transferred to HMO Blue on January 1, 2005 are as follows:

Cash and investments	$ 955,727
Real estate, less accumulated depreciation	27,291
Health care and other receivables	22,215
Premiums receivable	4,644
Data processing equipment	4,533
Other admitted assets	15,063
Total admitted assets	$1,029,473
Health care claim reserves	$ 204,813
Premiums received in advance	87,417
Accounts payable and accrued liabilities	57,867
Accrued medical incentive pool and bonus payments	29,210
Other liabilities	13,787
Total liabilities	$ 393,094

Under the MRA, both BCBSMA and HMO Blue (collectively referred to as the "Companies") have an undivided interest in what had been BCBSMA's property and equipment. The initial basis of the property and equipment were systematically allocated to each company at the date of the transaction. Ongoing depreciation expenses are charged to each company based on utilization.

Under the MRA, existing employees of the Companies (the "Associates") are either concurrently employed by both BCBSMA and HMO Blue or solely employed by BCBSMA. Those individuals solely employed by BCBSMA include senior level management ("SLM"). The compensation, benefits and administrative expenses of the concurrently employed Associates are charged to BCBSMA and HMO Blue in accordance with their provision of services to each company. With respect to individuals solely employed by BCBSMA, the pro-rata portion of compensation, benefits, and administrative expenses attributable to services provided to HMO Blue is charged to HMO Blue on an arm's length basis, including a mark-up. A common paymaster arrangement has been set up for payroll and payroll-related benefits. An agency arrangement has been set up for payment of claims and operating expenses and receipt of funds. The Companies' pension and post-retirement benefits plans ("Benefit Plans") continue to be sponsored by BCBSMA, and BCBSMA will continue to be financially responsible for the Benefit Plans. BCBSMA charges HMO Blue, as a participating employer of the Benefit Plans, a fee based on HMO Blue's allocated share of the Benefit Plans' expenses.

As a condition of granting an HMO license to HMO Blue, the DOI required the Companies to enter into an agreement with the DOI granting the DOI discretionary authority to require either company to issue a surplus note to the other company if either of the company's health risk-based capital ("RBC") is more than 75 percentage points higher than the other company's RBC. Under the terms of its license with Blue Cross and Blue Shield Association, BCBSMA has also entered into a unilateral agreement with HMO Blue to guarantee all current and future financial obligations of HMO Blue.

BCBSMA's surplus as of December 31, 2004 was allocated between the Companies, in accordance with the MRA, so that the post-reorganization RBC levels of BCBSMA and HMO Blue were within 15 points of each other. The RBC levels of BCBSMA and HMO Blue on January 1, 2005, including the anticipated incorporation of the rebalancing of the Companies' investment portfolio during the first quarter of 2005, were 605% and 620%, respectively. On April 1, 2005, in connection with the transfer of Blue Care 65 to HMO Blue, BCBSMA transferred surplus of $60,000 to HMO Blue so that the RBC levels of the two Companies would remain within 15 points of each other. As a result of this transfer, on April 1, 2005 the RBC levels for BCBSMA and HMO Blue were 600% and 615%, respectively.

2. Nature of Business

The Company is a nonprofit hospital and medical service corporation in the Commonwealth of Massachusetts, subject to regulation by the 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. 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, preferred provider networks, nongroup plans, Medicare extension, dental, and other supplementary programs for the benefit of its members.

3. 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 and preferred stock are reported at amortized cost or fair 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 is based on values specified by the NAIC rather than on actual or estimated market values and, therefore, is 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 "non-admitted," 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.

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, Electronic Data Processing ("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 post-retirement 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.

Consolidation: Wholly-controlled subsidiaries are not consolidated for individual entity statutory reporting. Under GAAP, financial statements of wholly-controlled subsidiaries are consolidated with the parent.

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, are as follows:

3. Summary of Significant Accounting Policies (continued)

	Year Ended December 31, 2005		Year Ended December 31, 2004	
	Net Income	Surplus	Net Income	Surplus
Statutory-basis amounts	**$127,723**	**$ 465,367**	$242,762	$1,090,985
Investments	**25,301**	**10,246**	—	14,833
Federal income taxes	**(46,373)**	**—**	1,956	—
Deferred income tax	**—**	**(24,131)**	—	17,592
Premium receivable allowance	**(1,937)**	**—**	(1,696)	—
Pension and post-retirement	**—**	**88,964**	(4,711)	79,235
Foundations	**9,688**	**87,155**	22,791	77,468
Other nonadmitted	**(3,797)**	**95,463**	—	102,290
GAAP-basis amounts	**$110,605**	**$ 723,064**	$261,102	$1,382,403
HMO Blue GAAP –basis amounts	**160,636**	**847,909**	—	—
GAAP-basis consolidated amounts	**$271,241**	**$1,570,973**	$261,102	$1,382,403

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 fair value as determined by the NAIC Securities Valuation Office ("SVO"). Preferred stocks are stated at cost, amortized cost or fair value based on the underlying characteristics and NAIC designation. Other invested assets are stated at fair value of the underlying securities. The Company has various ownership interests in partnerships and similar investments. The Company carries these investments based on its ownership interest in the underlying GAAP equity of the investee.

Unrealized gains and losses on stocks and other invested assets 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 payable or receivable 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. The Company did not recognize any impairment write-down for its investments during the years ended December 31, 2005 and 2004.

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.

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, 2005 and 2004 was $664 and $606, respectively.

The Company and HMO Blue jointly own land and building with 311,800 square feet of office space in Quincy, Massachusetts. The renovation of this facility was completed for occupancy in October 2005.

Under the Statutory reporting guidelines, the Company is required to calculate imputed rental income for owner-occupied real estate. The method for calculating imputed rental income is based on estimated rental rates of like property in the same area times rentable square feet. These imputed amounts are reported as investment income and operating expense in the statement of income and expenses reflecting that the Company had paid rent on the invested asset of $1,130 for 2005.

The Company and HMO Blue jointly entered into a Tri-Party agreement as disclosed in Note 17 with a developer to construct a new office facility in Hingham, Massachusetts with an anticipated occupancy date in 2007.

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 Company's admitted portion is reported at cost, less accumulated depreciation of $19,280 and $31,285 at December 31, 2005 and 2004, respectively. Electronic data processing equipment and operating and non-operating software are depreciated using the straight-line method over the lesser of its useful life or three years. Other furniture and

3. Summary of Significant Accounting Policies (continued)

equipment is depreciated using the straight-line method over its estimated useful life. Depreciation expense charged to income in 2005 and 2004 was $5,682 and $12,779, 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 Deficiency

The Company evaluates its health care contracts to determine if it is probable that a loss will be incurred. A premium deficiency loss is recognized when it is probable that expected future paid claims, administrative expenses and reserves will exceed existing reserves plus anticipated future premiums on existing contracts. Anticipated investment income and overhead expenses are also considered in the calculation of premium deficiency losses. For all the periods presented, no premium deficiencies were recorded.

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, are included in the Company's admitted assets and liabilities, respectively. The Company recorded a provision of $10,500 in 2004 and made an adjustment of $(2,800) in 2005 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. Estimated 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.

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 Internal Revenue Code applicable to Blue Cross and Blue Shield organizations. 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, 2005 and 2004, the Companies recorded impairment charge of $833 and $3,000, respectively, related to furniture and fixtures.

3. Summary of Significant Accounting Policies (continued)

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, 2004 have been reclassified to be consistent with the presentation of the amounts for the year ended December 31, 2005.

4. 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, 2005			
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	NAIC Fair Value
Cash, cash equivalents and short-term investments	**$ 22,850**	**—**	**—**	**$ 22,850**
Bonds:				
U.S. Government securities	**147,393**	**863**	**(697)**	**147,559**
Industrial and miscellaneous	**111,019**	**2,221**	**(770)**	**112,470**
Mortgage-backed securities	**150,418**	**638**	**(1,473)**	**149,583**
Total bonds	**408,830**	**3,722**	**(2,940)**	**409,612**
Common stocks	**180,907**	**10,258**	**(5,073)**	**186,092**
Preferred stocks	**2,465**	**50**	**—**	**2,515**
Other invested assets	**322,277**	**47,914**	**(868)**	**369,323**
Total cash and investments	**$937,329**	**$ 61,944**	**$ (8,881)**	**$990,392**

	December 31, 2004			
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	NAIC 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	384,397	74,471	(771)	458,097
Other invested assets	463,148	74,396	(111)	537,433
Total cash and investments	$1,886,444	$165,405	$(1,706)	$2,050,143

At December 31, 2005, included in the Company's investments are unrealized losses deemed to be temporary. The total unrealized loss relating to these securities is $8,881 at December 31, 2005 and $1,706 at December 31, 2004, of which the amount greater than 12 months was less than $1,000. These investments reflect a range of industries, and the Company deems the current market volatility as temporary.

Cash and investments include $119,609 and $115,184 at December 31, 2005 and 2004, respectively, of securities that were pledged as collateral for a Depository Agreement with the Blue Cross and Blue Shield Association to meet certain licensure standards. Included in Bonds is $1,000 in assets which the Company had on deposit with regulatory agencies at December 31, 2005, 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 NAIC fair values of bonds were $409,612 and $784,777 at December 31, 2005 and 2004, respectively. The NAIC fair values of unaffiliated common stocks were $186,092 and $458,097 at December 31, 2005 and 2004, respectively. The NAIC fair value of unaffiliated preferred stocks was $2,515 at December 31, 2005. The NAIC fair value of other invested assets was $369,323 and $537,433 at December 31, 2005 and 2004, respectively. Accrued investment income of $3,634 and $7,264 at December 31, 2005 and 2004, 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 NAIC fair value of bonds at December 31, 2005, 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	NAIC Fair Value
Within 1 year	**$ 37,613**	**$ 37,475**
After 1 year through 5 years	**156,136**	**155,394**
After 5 years through 10 years	**64,070**	**64,622**
After 10 years	**151,011**	**152,121**
Total bonds	**$ 408,830**	**$409,612**

Proceeds from the sale of investment securities were approximately $699,827 and $1,308,553 for the years ended December 31, 2005 and 2004, respectively. Gross realized investment gains and losses are as follows:

	2005	2004
Gross gains	**$ 26,910**	$ 28,151
Gross losses	**(3,246)**	(10,046)
Net realized investment gains	**$ 23,664**	$ 18,105

4. Cash and Investments (continued)

In 2005 and 2004, 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, 2004. 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, 2005, 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, 2005.

5. 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:

	2005	2004
Balance at January 1	**$ 419,072**	$ 531,720
Amount transferred to HMO Blue	**204,813**	—
Adjusted balance at January 1	**214,259**	$ 531,720
Incurred related to:		
Current year	**1,717,145**	4,237,803
Prior years	**(22,114)**	(33,742)
Total incurred	**1,695,031**	4,204,061
Paid related to:		
Current year	**1,532,985**	3,836,939
Prior years	**178,521**	479,770
Total paid	**1,711,506**	4,316,709
Balance at December 31	**$ 197,784**	$ 419,072

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 frequency and severity. Lower than anticipated claims resulted in adjustments to claims incurred in prior years of $22,114 and $33,742 in 2005 and 2004, respectively. Claims incurred in 2004 include a charge of $19,500 to recognize certain estimated provider settlements related to prior disputed claim payments.

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

	2005	2004
Total incurred claims per above	**$ 1,695,031**	$ 4,204,061
Medical incentive pool and bonus payments incurred	—	42,819
Health care benefits	**$ 1,695,031**	$ 4,246,880

Subrogation credits naturally flow through the claims payments which are used to calculate reserves. Therefore, reserves at December 31, 2005 and 2004 had an inherent amount for subrogation credits.

6. Pension and Other Post-retirement 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 post-retirement benefit plans are as follows:

	Pension Benefits		Other Benefits	
	2005	2004	2005	2004
Change in benefit obligation				
Benefit obligation at beginning of year	**$363,991**	$325,356	**$ 119,359**	$107,129
Service cost	**13,488**	12,043	**5,058**	3,709
Interest cost	**20,281**	19,772	**6,628**	6,008
Actuarial (gain) loss	**12,911**	23,000	**(3,656)**	8,687
Benefits paid	**(16,121)**	(15,873)	**(6,653)**	(6,175)
Administrative expenses paid	**(363)**	(307)	**—**	—
Benefit obligation at end of year	**$394,187**	$363,991	**$120,736**	$119,358

6. Pension and Other Post-Retirement Benefit Plans (continued)

	Pension Benefits		Other Benefits	
	2005	2004	**2005**	2004
Change in plan assets				
Fair value of plan assets at beginning of year	**$ 389,402**	$ 327,530	**$ —**	$ —
Actual return on plan assets	**27,877**	38,053	**152**	—
Employer contribution	**20,000**	40,000	**15,653**	6,175
Benefits paid	**(16,121)**	(15,874)	**(6,653)**	(6,175)
Administrative fees paid	**(363)**	(307)	**—**	—
Fair value of plan assets at end of year	**$ 420,795**	$ 389,402	**$ 9,152**	$ —
Reconciliation of funded status				
Funded status	**$ 26,608**	$ 25,411	**$ (111,585)**	$ (119,359)
Unrecognized net loss	**92,206**	79,347	**41,401**	48,000
Transition gain	**—**	—	**20,102**	22,974
Unrecognized prior service cost	**2,945**	3,318	**—**	—
Prepaid assets or accrued liabilities	**$ 121,759**	$ 108,076	**$ (50,082)**	$ (48,385)
Benefit obligation for nonvested employees	**$ 17,786**	$ 14,728	**N/A**	N/A
Components of net periodic benefit cost				
Service cost	**$ 13,488**	$ 12,043	**$ 5,058**	$ 3,709
Interest cost	**20,281**	19,772	**6,628**	6,008
Expected return on plan assets	**(32,114)**	(27,041)	**—**	—
Amortization of unrecognized transition liability	**—**	—	**2,872**	2,872
Amount of recognized losses	**4,289**	3,535	**2,791**	1,627
Amount of prior service cost recognized	**373**	372	**—**	—
Total net periodic benefit cost	**$ 6,317**	$ 8,681	**$ 17,349**	$ 14,216

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, 2005 and 2004, the additional minimum pension liability was $531 and $243, respectively.

The noncontributory nonqualified retirement plans include projected benefit obligations in excess of plan assets of $30,742 and $26,759, and accumulated benefit obligations in excess of plan assets of $29,899 and $26,759, at December 31, 2005 and 2004, respectively.

Weighted-average assumptions as of December 31, 2005 and 2004 are as follows:

	Pension Benefits		Other Benefits	
	2005	2004	**2005**	2004
Discount rate	**5.75%**	5.75%	**5.75%**	5.75%
Expected return on plan assets	**8.50**	8.50	**8.50**	N/A
Rate of compensation increase	**4.50**	4.50	**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 2005. The rate is assumed to decrease gradually to 5% for 2015, and remain at that level thereafter.

The Company's pension benefit weighted-average asset allocations at December 31, 2005 and 2004, by asset category, are as follows:

	Pension Benefits		Other Benefits	
	2005	2004	**2005**	2004
Asset category				
Equity securities	**58%**	58%	**58%**	N/A
Debt securities	**25**	26	**25**	N/A
Real Estate	**5**	4	**5**	N/A
Other	**12**	12	**12**	N/A
Total	**100%**	100%	**100%**	

The Company has a nonpension post-retirement benefit plan. On December 31, 2005 and 2004, the Company's other benefits, included in its post-retirement plan, are medical, dental, and life benefits for retired employees. The 401(h) account was instituted by BCBSMA in December 2003, and a contribution of $9,000 was made in December 2005. The Company's contributions for the year ending December 31, 2006 are not expected for its pension plan and expected to be $8,649 for its post-retirement benefit plan.

At December 31, 2005, the Company's projected benefit payments are as follows:

	Pension Benefits	Other Benefits	Medicare Subsidy
2006	$ 23,339	$ 8,649	$ 657
2007	24,414	9,055	731
2008	25,657	9,413	798
2009	27,941	9,922	865
2010	29,193	10,472	936
Next five years	170,182	58,262	1,987

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 due to FSP 106-2 is a reduction in annual net periodic post-retirement benefit cost of $887 and $937 in 2005 and 2004,

6. Pension and Other Post-Retirement Benefit Plans (continued)

respectively. The calculation excludes nonvested employees costs per INT 04-17: *Impact of Medicare Modernization Act on Post-retirement Benefits*.

The Company also has a savings 401(k) 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 Code limits of $14,000 and $13,000 in 2005 and 2004, respectively. Contributions are maintained in investment funds established under the employee savings plan. Total Company contributions charged to income amounted to $6,718 and $5,478 in 2005 and 2004, respectively.

7. 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, post-retirement benefits, certain accrued liabilities, accrued pension costs, and discounting of unpaid claims liabilities and expenses.

The components of the net deferred tax asset (liability) at December 31, 2005 and 2004 are as follows:

	2005	2004
Total of gross deferred tax assets	**$ 361,775**	$ 409,592
Total of deferred tax liabilities	**(21,061)**	(51,795)
Net deferred tax asset	**340,714**	357,797
Deferred tax asset non-admitted	**327,862**	356,361
Net admitted deferred tax asset	**$12,852**	$ 1,436
Increase/(decrease) in non-admitted deferred tax asset	**$ (28,499)**	$ 65,681

The provisions for incurred taxes on earnings for the year ended December 31, 2005 and 2004 are:

	2005	2004
Federal income tax on operations	**$ 11,154**	$ 54,994
Federal income tax on net capital gains	**1,883**	3,621
Federal income taxes incurred	**$ 13,037**	$ 58,615

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

	2005	2004
Deferred tax assets:		
Post-retirement benefits	**$ 27,438**	$ 25,186
Other-than-temporary impairment of securities	**7,492**	32,930
Fixed assets	**22,042**	38,684
Net operating losses and AMT credits	**280,347**	267,310
Accrued expenses	**24,456**	45,482
Total deferred tax assets	**361,775**	409,592
Non-admitted deferred tax assets	**(327,862)**	(356,361)
Admitted deferred tax assets	**33,913**	53,231
Deferred tax liabilities:		
Investment in LLC and LP	**(2,975)**	—
Unrealized gains on securities	**(18,086)**	(51,795)
Total deferred tax liabilities	**(21,061)**	(51,795)
Net admitted deferred tax asset	**$ 12,852**	$ 1,436

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, and, during 2005, the IRS initiated an examination of the tax years 2001 through 2003. In the Company's opinion, the Company has established an adequate provision for all amounts of federal income tax related to the years under examination and all subsequent tax years.

The Company's effective rate differs from the Company's applicable statutory rate of 35% due to the Section 833 deduction, changes in estimates of prior year tax liabilities, changes in deferred taxes related to the MRA, and the impact of non-admitted assets.

The amount of federal income taxes incurred and available for recoupment in the event of future net losses is $13,037 and $55,939 from 2005 and 2004, respectively.

As of December 31, 2005 and December 31, 2004, the Company had $80,284 of regular tax operating loss carryforwards originating in 1992 through 1996 that will expire in years 2007 through 2011. The Company does not have any AMT operating loss carryforwards available to offset future income.

The Company had $252,248 and $232,911 of AMT credits as of December 31, 2005 and December 31, 2004, respectively. The AMT credits are available to offset future regular tax and will not expire.

8. 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, 2005 and 2004, the Company's surplus was in excess of the regulatory Chapter 160 requirements.

In addition, the NAIC has imposed regulatory RBC requirements on health insurance companies, including the Company. The RBC calculation serves as a benchmark for the regulation of health

8. Surplus (continued)

insurance companies' solvency by state insurance regulators. At December 31, 2005 and 2004, the Company's total adjusted capital was in excess of the regulatory RBC requirements.

9. 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, 2005 and 2004.

10. 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 (the "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.

11. Related Party Transactions

The Company entered into a bilateral intercompany agreement with HMO Blue as a result of the MRA to settle any claims, fees, administrative cost expense allocation and pass-through cash, and expenses paid by one company on behalf of the other company. At December 31, 2005, the Company had a receivable from HMO Blue of $75,702.

The Company is the sole corporate member of two Foundations: The Health Care Assistance Foundation, Inc. ("HCAF") and the Blue Cross Blue Shield of Massachusetts Foundation ("BCBSF"). The Company provided the two Foundations with financial support of $8,799 and $24,165 in 2005 and 2004, respectively.

The mission of HCAF is to promote the care of the elderly, disabled, and other persons who are experiencing financial hardship and to provide limited financial assistance for their care. Effective December 31, 2005, HCAF discontinued the prescription drug reimbursement and Medex Gold assistance programs.

The mission of BCBSF is to promote and support programs, research, and policies that will help to expand access to high quality, affordable health care for Massachusetts residents. BCBSF is the sole corporate member of the Massachusetts Medicaid Policy Institute, Inc., which provides independent research and support on matters related to Medicaid in Massachusetts.

At December 31, 2005, the Company had payables to BCBSF and HCAF of $12,658 and $219, respectively, and a receivable from BCBSF of $85. At December 31, 2004, the Company had payables to BCBSF and HCAF of $11,883 and $2,051, respectively, and a receivable from BCBSF of $291.

12. Leases

The Company and HMO Blue jointly have 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 11 months.

The Company and HMO Blue jointly entered into several other long-term, non-cancelable operating lease agreements for office space that expire at various dates through 2010. For the years ended December 31, 2005 and 2004, the Company recorded rental expense of approximately $14,906 and $21,121, respectively.

At December 31, 2005, minimum rental commitments on significant noncancelable operating leases for the Companies are as follows:

2006	$ 23,295
2007	20,552
2008	15,103
2009	15,003
2010	15,796
Thereafter	71,251

In addition, the Companies have an agreement with an outside vendor to provide certain information technology services for substantially all of the Companies' business operations. The Companies minimum commitments under this agreement are approximately $51,770 per year.

13. Revolving Line of Credit

The Company has a $30,000 revolving credit agreement. Borrowings under this line of credit bear interest at London Interbank Offered Rate ("LIBOR") 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, 2005.

14. 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, 2005 and 2004 that are subject to retrospective.

14. Retrospectively Rated Contracts and Contracts Subject to Redetermination (continued)

rating features was $14,100 and $11,700, that represented 0.7% 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.

15. 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:

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
2005	**$ 4,583**	**$ (758)**	**$ 2,313**	**$ 1,512**
2004	737	8,419	4,573	4,583
2003	7,770	(2,296)	4,737	737

16. 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, 2005 and 2004:

	ASO Uninsured Plans 2005	ASO Uninsured Plans 2004
Net reimbursement for administrative expenses (including administrative fees) in excess of actual expenses	**$ 193**	$ 114
Net gain from operations	**$ 193**	$ 114
Total claim payment volume	**$ 12,192**	$ 19,267

	ASC Uninsured Plans 2005	ASC Uninsured Plans 2004
Gross reimbursement for medical cost incurred	**$4,637,587**	$4,090,877
Gross expenses incurred (claims and administrative)	**4,626,749**	4,060,705
Net gain from operations	**$ 10,838**	$ 30,172

At December 31, 2005 and 2004, the Company recorded gross ASO and ASC administrative fees accrued and not billed of $21,782 and $21,467, respectively.

17. 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.

In March, 2005, the Companies entered into a Tri-Party agreement with Citizens Bank of Massachusetts ("Citizens") and Perry South Develop, LLC (the "Developer") with respect to obligations of the Companies pursuant to a Purchase and Sale Agreement with the Developer for the construction and development of a building and related improvements. As a result of the Tri-Party agreement, BCBSMA and HMO Blue each pledged assets in the amount of $75,000 to Citizens for the Developer's rights and interests under the Purchase and Sale agreement. At December 31, 2005, the fair market value of the Company's pledged assets was $85,402.

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

Audited Statutory-Basis Financial Statement

Year Ended December 31, 2005

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Report of Independent Auditors

Board of Directors
Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

We have audited the accompanying statutory-basis balance sheet of Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. (the "Company") as of December 31, 2005 and the related statutory-basis statements of income, changes in surplus, and cash flow for the year 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 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 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 audit provides a reasonable basis for our opinion.

As described in Note 3 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 3.

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 U.S. generally accepted accounting principles, the financial position of Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. at December 31, 2005, or the results of its operations or its cash flow for the year 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 HMO Blue, Inc., at December 31, 2005, and the results of its operations and its cash flow for the year 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 standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over statutory financial reporting as of December 31, 2005, 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 10, 2006 expressed an unqualified opinion thereon.

Ernst & Young LLP

Boston, Massachusetts
February 10, 2006

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

Statutory-Basis Balance Sheet

December 31, 2005
(IN THOUSANDS)

Admitted assets	
Bonds	**$ 485,534**
Preferred stock	**578**
Common stock	**211,199**
Real estate, less accumulated depreciation	**53,598**
Cash, cash equivalents and short-term investments	**47,677**
Receivable for securities	**83**
Other invested assets	**411,522**
Total cash and invested assets	**1,210,191**
Accrued investment income	**4,602**
Premiums receivable	**12,930**
Data processing equipment	**4,643**
Health care and other receivables	**20,977**
Other assets	**494**
Total admitted assets	**$ 1,253,837**
Liabilities and surplus	
Health care claim reserves	**$ 246,007**
Accrued medical incentive pool and bonus payments	**25,942**
Aggregate policy reserves	**15,687**
Premiums received in advance	**89,609**
Accounts payable and accrued liabilities	**34,142**
Payable to affiliates	**75,702**
Payable for securities	**2,967**
Total liabilities	**490,056**
Surplus	**763,781**
Total liabilities and surplus	**$ 1,253,837**

See accompanying notes.

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

Statutory-Basis Statement of Income

Year Ended December 31, 2005
(IN THOUSANDS)

Premiums earned	**$ 3,641,564**
Health care benefits	**3,214,718**
General and claim adjustment expenses	**365,301**
Total expenses	**3,580,019**
Underwriting gain	**61,545**
Net investment income	**35,047**
Net realized investment gains	**40,463**
Net income	**$ 137,055**

See accompanying notes.

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

Statutory-Basis Statement of Changes in Surplus

Year Ended December 31, 2005
(IN THOUSANDS)

Balance at January 1, 2005	**$ 636,379**
Net assets transferred from BCBSMA on April 1	**60,000**
Net income	**137,055**
Change in net unrealized gains	**(29,879)**
Change in nonadmitted assets	**(39,774)**
Balance at December 31, 2005	**$ 763,781**

See accompanying notes.

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

Statutory-Basis Statement of Cash Flow

Year Ended December 31, 2005
(IN THOUSANDS)

Operating activities	
Premiums received	**$ 3,640,138**
Health care benefits paid	**(3,175,554)**
General and claim adjustment expenses paid	**(363,198)**
Net investment income received	**35,210**
Net cash provided by operating activities	**136,596**
Investing activities	
Sales, maturities and redemptions of investments	**639,608**
Cost of investments acquired	**(873,708)**
Acquisition of real estate	**(26,617)**
Other invested assets	**3,510**
Net cash used in investing activities	**(257,207)**
Financing or miscellaneous activities	
Net assets transferred from BCBSMA	**88,315**
Other sources, net	**79,973**
Net cash provided by financing or miscellaneous activities	**168,288**
Net increase in cash, cash equivalents and short-term investments	**47,677**
Cash, cash equivalents and short-term investments:	
Beginning of year	**—**
End of year	**$ 47,677**

See accompanying notes.

Notes to Statutory-Basis Financial Statement

December 31, 2005
(Dollars in thousands)

1. Master Reorganization

On January 1, 2005, pursuant to a Master Reorganization Agreement ("MRA"), Blue Cross and Blue Shield of Massachusetts, Inc. ("BCBSMA") transferred its insured health maintenance organization line of business (with the exception of Blue Care 65, which was transferred on April 1, 2005) to Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. ("HMO Blue" or the "Company"), a separately incorporated, not-for-profit subsidiary of BCBSMA (the "Transfer"). HMO Blue was formed on February 7, 1997 as a not-for-profit corporation pursuant to Chapter 180 of Massachusetts General Laws, and was formerly known as XYZ Managed Care Corporation. HMO Blue is a wholly controlled subsidiary of BCBSMA. From the date of its formation until January 1, 2005, HMO Blue had been a shell entity pending the Transfer. Since January 1, 2005, HMO Blue has provided hospitalization, medical and other health benefits as a licensed health maintenance organization as disclosed in Note 2. Effective January 1, 2005, HMO Blue received a health maintenance organization ("HMO") license from the Commonwealth of Massachusetts Division of Insurance ("DOI"). HMO Blue operates as a nonprofit, charitable organization and qualifies as a tax-exempt social welfare organization under Section 501(c)(4) of the Internal Revenue Code.

Significant components of the assets and liabilities transferred to HMO Blue on January 1, 2005 are as follows:

Cash and investments	$ 955,727
Real estate, less accumulated depreciation	27,291
Health care and other receivables	22,215
Premiums receivable	4,644
Data processing equipment	4,533
Other admitted assets	15,063
Total admitted assets	$1,029,473
Health care claim reserves	$ 204,813
Premiums received in advance	87,417
Accounts payable and accrued liabilities	57,867
Accrued medical incentive pool and bonus payments	29,210
Other liabilities	13,787
Total liabilities	$ 393,094

Under the MRA, both BCBSMA and HMO Blue (collectively referred to as the "Companies") have an undivided interest in what had been BCBSMA's property and equipment. The initial basis of the property and equipment were systematically allocated to each company at the date of the transaction. Ongoing depreciation expenses are charged to each company based on utilization.

Under the MRA, existing employees of the Companies (the "Associates") are either concurrently employed by both BCBSMA and HMO Blue or solely employed by BCBSMA. Those individuals solely employed by BCBSMA include Senior Level Management ("SLM"). The compensation, benefits, and administrative expenses of the concurrently employed Associates are charged to BCBSMA and HMO Blue in accordance with their provision of services to each company. With respect to individuals solely employed by BCBSMA, the pro-rata portion of compensation, benefits, and administrative expenses attributable to services provided to HMO Blue is charged to HMO Blue on an arm's length basis, including a mark-up. A common paymaster arrangement has been set up for payroll and payroll related benefits. An agency arrangement has been set up for payment of claims and operating expenses and receipt of funds. The Companies' pension and post-retirement benefits plans ("benefit plans") continue to be sponsored by BCBSMA. BCBSMA charges HMO Blue, as a participating employer of the benefit plans, a fee based on HMO Blue's allocated share of the benefit plans' expenses.

As a condition of granting an HMO license to HMO Blue, the DOI required the Companies to enter into an agreement with the DOI granting the DOI discretionary authority to require either company to issue a surplus note to the other company if either of the company's health risk-based capital ("RBC") is more than seventy-five percentage points higher than the other company's RBC. Under the terms of its license with Blue Cross and Blue Shield Association, BCBSMA has also entered into a unilateral agreement with HMO Blue to guarantee all current and future financial obligations of HMO Blue.

BCBSMA's surplus as of December 31, 2004 was allocated between the Companies, in accordance with the MRA, so that the post-reorganization RBC levels of BCBSMA and HMO Blue were within 15 points of each other. The RBC levels of BCBSMA and HMO Blue on January 1, 2005, including the anticipated incorporation of the rebalancing of the Companies' investment portfolio during the first quarter of 2005, were 605% and 620%, respectively. On April 1, 2005, in connection with the transfer of Blue Care 65 to HMO Blue, BCBSMA transferred surplus of $60,000 to HMO Blue so that the RBC levels of the two Companies would remain within 15 points of each other. As a result of this transfer, on April 1, 2005 the RBC levels for BCBSMA and HMO Blue were 600% and 615%, respectively.

2. Nature of Business

The Company is a Massachusetts corporation organized under Chapter 180 of the Massachusetts General Laws and holds a health maintenance organization license pursuant to Massachusetts General Laws Chapter 176G. The Company provides hospitalization, medical, and other health benefits to members through contracts with hospitals, participating physicians, skilled nursing facilities, nursing homes, and other health care providers and organizations. The Company offers a variety of HMO and other supplementary programs for the benefit of its members.

3. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying financial statement has 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 and preferred stocks are reported at amortized cost or fair 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 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 sheet and are charged directly to surplus. Under GAAP, such assets are included in the balance sheet.

Statement of Cash Flows: Cash, cash equivalents, and short-term investments in the statement 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, 2005	
	Net Income	Surplus
Statutory-basis amounts	$ 137,055	$ 763,781
Investments	24,043	1,134
Other nonadmitted	(462)	82,994
GAAP-basis amounts	$ 160,636	$ 847,909

Other significant accounting practices are as follows:

Use of Estimates

The preparation of the 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 statement and the reported amounts of revenues and expenses during the reported period. 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 fair values as determined by the NAIC Securities Valuation Office ("SVO"). Preferred stocks are stated at cost, amortized cost or fair value based on the underlying characteristics and NAIC designation. Other invested assets are stated at fair value of the underlying securities. The Company has various ownership interests in partnerships and similar investments. The Company carries these investments based on its ownership interest in the underlying GAAP equity of the investee.

Unrealized gains and losses on stocks and other invested assets 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

3. Summary of Significant Accounting Policies (continued)

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 payable or receivable 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. HMO Blue did not recognize any impairment write-down for its investments during the year ended December 31, 2005.

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.

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, 2005 was $588.

The Company and BCBSMA jointly own land and building with 311,800 square feet of office space in Quincy, Massachusetts. The renovation of this facility was completed for occupancy in October 2005.

Under statutory reporting guidelines, the Companies are required to calculate imputed rental income for owner-occupied real estate. The method for calculating imputed rental income is based on estimated rental rates of like property in the same area times rentable square feet. These imputed amounts are reported as investment income and operating expense in the statement of income and expenses reflecting that the Company had paid rent on the invested asset of $1,002 for 2005.

The Company and BCBSMA jointly entered into a Tri-Party agreement as disclosed in Note 12 with a developer to construct a new office facility in Hingham, Massachusetts with an anticipated occupancy date in 2007.

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 Company's admitted portion is reported at cost, less accumulated depreciation of $17,097 at December 31, 2005. Electronic data processing equipment, operating and non-operating software are 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 2005 was $5,038.

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.

Aggregate policy reserves represent a reserve for unearned premium income.

Premium Deficiency

The Company evaluates its health care contracts to determine if it is probable that a loss will be incurred. A premium deficiency loss is recognized when it is probable that expected future paid claims, administrative expenses, and reserves will exceed existing reserves plus anticipated future premiums on existing contracts. Anticipated investment income and overhead expenses are also considered in the calculation of premium deficiency losses. For the year ended December 31, 2005 no premium deficiency losses were recorded.

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.

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

3. Summary of Significant Accounting Policies (continued)

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.

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, 2005, the Companies recorded impairment charge of $833 related to 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.

4. Cash and Investments

The cost or amortized cost, gross unrealized gains (losses), and NAIC fair value of cash and investments at December 31, 2005 are as follows:

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	NAIC Fair Value
Cash, cash equivalents and short-term investments	$ 47,677	$ —	$ —	$ 47,677
Bonds:				
U.S. Government securities	146,466	898	(868)	146,496
Industrial and miscellaneous	146,730	3,368	(1,041)	149,057
Mortgage-backed securities	192,338	696	(2,167)	190,867
Total bonds	485,534	4,962	(4,076)	486,420
Common stocks	207,793	7,697	(4,291)	211,199
Preferred stocks	578	—	—	578
Other invested assets	362,436	49,621	(535)	411,522
Total cash and investments	$1,104,018	$ 62,280	$ (8,902)	$1,157,396

At December 31, 2005, included in the Company's investments are unrealized losses deemed to be temporary. The total unrealized loss relating to these securities is $8,902 at December 31, 2005, of which the amount greater than 12 months was less than $1,000. These investments reflect a range of industries, and the Company deems the current market volatility as temporary.

Included in Bonds is $1,000 in assets which the Company had on deposit with regulatory agencies at December 31, 2005 as required by M.G.L. c.176G section 26.

Fair value of publicly traded bonds and unaffiliated stocks are generally based on independently quoted market prices, which may differ from NAIC fair values. The NAIC fair value of bonds was $486,420 at December 31, 2005. The NAIC fair value of unaffiliated common stocks was $211,199 at December 31, 2005. The NAIC fair value of unaffiliated preferred stocks was $578 at December 31, 2005. The NAIC fair value of other invested assets was $411,522 at December 31, 2005. Accrued investment income of $4,602 at December 31, 2005 is defined as investment income earned as of the reporting date but is not contractually due to be paid to the Company until subsequent to the reporting date.

The amortized cost and NAIC fair value of debt securities at December 31, 2005, 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	NAIC Fair Value
Within 1 year	$ 49,784	$ 49,601
After 1 year through 5 years	161,785	161,419
After 5 years through 10 years	87,329	88,120
After 10 years	186,636	187,280
Total bonds	$ 485,534	$ 486,420

Proceeds from the sale of investment securities was approximately $583,677 for the year ended December 31, 2005. Gross realized investment gains and losses included in net investment income for 2005 are as follows:

Gross gains	$ 42,172
Gross losses	(1,709)
Net realized investment gains	$ 40,463

In 2005, there was no write-down of debt or equity securities with a decline in fair value that was determined by management to be other-than-temporary.

5. 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 in 2005 as follows:

Balance at January 1, 2005	$ 204,813
Incurred related to:	
Current year	3,219,163
Prior years	(26,332)
Total incurred	3,192,831
Paid related to:	
Current year	2,987,928
Prior years	163,709
Total paid	3,151,637
Balance at December 31, 2005	$ 246,007

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 frequency and severity. Lower than anticipated claims resulted in adjustments to claims incurred in prior years of $26,332 in 2005.

A reconciliation of incurred claims reported above to health care benefits in the Company's statements of income was as follows at December 31, 2005:

Total incurred claims per above	$ 3,192,831
Medical incentive pool and bonus payments incurred	21,887
Health care benefits	$ 3,214,718

Subrogation credits naturally flow through the claims payments, which are used to calculate reserves. Therefore, reserves at December 31, 2005 had an inherent amount for subrogation credits.

6. Pension and Other Post-Retirement Benefit Plans

The pension and other post-retirement benefit plans ("Plans") are sponsored by BCBSMA and the associated costs are shared by the Companies. All employees are eligible to participate in BCBSMA's Retirement Income Trust Plan ("RIT"), which grants benefits to retired employees at various levels based on age and years of service. BCBSMA also participates in two noncontributory retirement plans for eligible employees. BCBSMA uses a December 31 measurement date for the majority of its plans. Effective January 1, 2005, the Company is an active participating employer of the Plans. The pension and other post-retirement benefits costs allocated to the Company in 2005 is $12,866.

BCBSMA also sponsors a defined benefit plan covering medical, life and dental benefits. The 401(h) account was instituted by BCBSMA in December 2003, and a contribution of $9,000 was made in December 2005. BCBSMA also has a savings 401(k) plan for eligible employees. Under the employee savings plan, BCBSMA 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.

7. Surplus

The NAIC has imposed regulatory RBC requirements on health insurance companies, including the Company. The RBC calculation serves as a benchmark for the regulation of health insurance companies' solvency by state insurance regulators. At December 31, 2005, the Company's total adjusted capital was in excess of the regulatory RBC requirements.

Chapter 141, which applies requirements of unfair insurance competition under Chapter 176D to HMOs and HMOs operated as a line of business, 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. The Company met and exceeded all regulatory Chapter 141 requirements at December 31, 2005.

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, 2005.

9. Related Party Transactions

The Company entered into a bilateral intercompany agreement with BCBSMA as a result of the MRA to settle any claims, fees, administrative cost expense allocation, and pass-through cash and expenses paid by one company on behalf of the other company. At December 31, 2005, the Company had a payable to BCBSMA of $75,702.

The Company provided support of $6,734 to the Blue Cross and Blue Shield of Massachusetts Foundation, Inc. ("BCBSF"). The mission of BCBSF is to promote and support programs, research, and policies that will help expand access to high quality, affordable health care for Massachusetts residents.

10. Leases

The Company and BCBSMA jointly have 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 11 months.

The Company and BCBSMA jointly entered into several other long-term, non-cancelable operating lease agreements for office space that expire at various dates through 2010. For the year ended December 31, 2005, the Company recorded rental expense of approximately $11,802. At December 31, 2005, minimum rental commitments on significant noncancelable operating leases for the Companies are as follows:

2006	$ 23,295
2007	20,552
2008	15,103
2009	15,003
2010	15,796
Thereafter	71,251

In addition, the Companies have an agreement with an outside vendor to provide certain information technology services for substantially all of the Companies' business operations. The Companies' minimum commitments under this agreement are approximately $51,770 per year.

11. 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:

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
2005	**$ 2,999**	**$ 8,735**	**$ 8,391**	**$ 3,343**

12. 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.

In March 2005, the Companies entered into a Tri-Party agreement with Citizens Bank of Massachusetts ("Citizens") and Perry South Development, LLC (the "Developer") with respect to obligations of the Companies pursuant to a Purchase and Sale Agreement with the Developer for the construction and development of a building and related improvements. As a result of the Tri-Party agreement, BCBSMA and HMO Blue each pledged assets in the amount of $75,000 to Citizens for the Developer's rights and interests under the Purchase and Sale agreement. At December 31, 2005, the fair market value of HMO pledged assets was $84,806.