

# CLARITY

2004-2005 PALMETTO GBA REPORT



**Palmetto GBA** has 40 years of experience providing services, products and solutions for an ever-changing business environment. Our solid customer-focused history has cultivated an ability to anticipate and develop new capabilities, react quickly and readily develop processes as we deliver on-demand business solutions.

Headquartered in Columbia, South Carolina, Palmetto GBA is a wholly-owned subsidiary of BlueCross BlueShield of South Carolina. With more than 3,500 employees and nine offices in six states, Palmetto GBA spans the nation serving more than nine million beneficiaries in all 50 states.

Our uncompromising values serve as the building block of our corporate compliance program and form the foundation of our business and government partnerships. Ethical and lawful business practices are essential to maintaining a transparent organization. Our ability to provide clarity in an rapidly changing business environment has fueled our success and will be the foundation we build upon in the future.

Palmetto GBA brings the ability to develop and implement innovative business solutions that maximize capabilities and deliver responsive and quantifiable results. We offer stability, a capacity to innovate and are adept at business plan execution.

We are committed to developing superior business solutions that are carefully integrated and aligned with our partner organizations' strategic goals and organizational direction. We use proven techniques to gain **clarity** about our customers essential requirements. We provide tight controls for all aspects of the business solution from planning and development to implementation.



**Bill Horton**

President & COO  
Government Programs  
BlueCross BlueShield of South Carolina

At Palmetto GBA, we work hard to deliver what our customers have grown to expect from us – excellence. And we couldn't have done it without the passion that we all have for Palmetto GBA. That feeling is tangible – you can see it in our smiles when we pass in the hallway, when you hear us laughing together at lunch and share in it when we all work together to improve the communities of which we're a part.

The pride that we feel comes from knowing that we are the best at what we do. That we earned our #1 position and 20 percent market share through years of dedication, hard work and a serious commitment to doing things right. After 40 years of processing Medicare claims, we've become the leader in our industry. With more than 3,500 associates in nine offices, each location has a refined area of expertise in the Medicare business segments – Medicare Part A, Medicare Part B, Durable Medical Equipment or Regional Home Health and Hospice.

The relationship we've developed over the years with the Centers for Medicare & Medicaid Services (CMS) has given us many opportunities to help improve their business by testing programs, generating solutions and making professional recommendations that no other company has the scope or ability to do. Our experience working with CMS has defined who we are – it makes Palmetto GBA a natural partner in CMS's future. CMS comes to us with a problem; we provide a solution. That's why we were selected to administer the 1-800-MEDICARE contract – we provide solutions.

The expertise we've gained through the years has opened many avenues for the future. Our specialized abilities are a commodity we can market to other businesses. We have the ability to generate solutions where none existed before. We know how to take those solutions from the drawing board, develop them and make them work.

As we look forward to those opportunities that lie ahead, we continue to grow and evolve as a company. All efforts at Palmetto GBA drive us to one goal – Partners in Excellence. The key to achieving our goal is commitment – to quality, to our customers and to our associates.



William R. Horton  
President and Chief Operating Officer  
Government Programs  
BlueCross BlueShield of South Carolina



**Bruce Hughes**  
President & COO  
Palmetto GBA



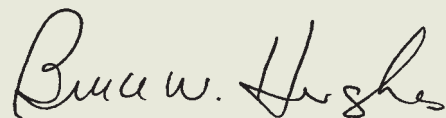
Palmetto GBA has faced many challenges and has met them with talent and determination allowing us to become an industry leader. That talent and determination will be called upon as we evolve and grow in the coming years. The clarity of vision of our employees toward achieving our strategic goals will ensure our continued success.

We have been recognized for the excellent quality of our customer service. Our Customer Service Strategy Division obtained and implemented two large contracts related to 1-800-MEDICARE. Getting all of the elements necessary to ramp up for this contract required tremendous teamwork. But together, we made it happen. Meeting this challenge was very rewarding because it met a critical need for CMS as well as provided significant growth for Palmetto GBA.

Our success substantiates our commitment to our customers' needs. We surpassed CMS's expectations in our role as the Medicare Part A pilot contractor for the Health Care Integrated General Ledger Accounting System (HIGLAS). Our success allowed us to help other contractors implement the system. This validated the quality job we're doing and the high level of satisfaction we're giving our customers.

We must continue to meet and exceed the expectations of our existing customers as we actively pursue new avenues to diversify our company. These new avenues will provide us with opportunities unlike any we have faced in the past. However, Palmetto GBA will rely on the capabilities and commitment of our associates along with our wealth of experience to continue to grow our company.

I look forward to meeting the future that lies ahead together. I stand proud with the associates of Palmetto GBA as we continue to provide solutions for our customers.



Bruce W. Hughes  
President and Chief Operating Officer  
Palmetto GBA

# Clarity is the underlying source of Palmetto GBA's success. This clarity comes from having a strategic plan and developing a roadmap to achieve those goals. All we do as an organization reflects back on that single plan.

With the implementation of the Medicare Prescription Drug, Improvement and Modernization Act of 2003, the number of Medicare beneficiaries seeking information from the federal government about coverage options, prescription drug information and general Medicare information skyrocketed. To respond to this, CMS consolidated all of its help lines and created one phone number – 1-800-MEDICARE.

Palmetto GBA was awarded a one-year sole source contract from CMS in May 2004 to provide support to 1-800-MEDICARE. This sole source contract added more than 550 permanent positions (and up to 1,100 new positions with our use of temporary staffing) to Palmetto GBA. To ramp up for this contract, we were able to successfully recruit and train 1,000 customer service representatives to facilitate a very quick transition of call volume, all within only two weeks. In 2005, we successfully re-bid this contract for an additional two-year service period. This new workload has expanded Palmetto GBA's operations and workforce. The new contract generates approximately \$270 million in revenue.

## HIGLAS

Palmetto GBA continued its key role in the development and implementation of CMS's HIGLAS. In May 2005, HIGLAS was implemented for the Part A South Carolina and Regional Home Health Intermediary contracts. HIGLAS will be implemented across all Medicare contractors over the next several years.

## MIP (Medicare Intergrity Program) Savings

Our program safeguard activities result in significant savings for Medicare. Through September 2005, Palmetto GBA's efforts resulted in the Medicare savings detailed below:

	Part A	Part B (SC)	DMERC	OH-WV	RRB
<b>BI</b>	\$342,441	\$78,208	\$384,484,932	N/A	\$176,937
<b>MSP</b>	\$141,269,936	\$39,071,946	\$19,949,543	\$83,295,971	\$7,377,258
<b>MR</b>	\$35,398,870	\$8,359,953	\$210,593,743	\$150,938,701	\$3,938,366
<b>TOTAL</b>	\$177,011,247	\$47,510,107	\$615,028,218	\$234,234,672	\$11,492,561

Our commitment to our customers, to our employees and to uncompromising integrity forms the foundation of our business. From the organizational level to the associate level, we also are actively engaged in improving the communities where our employees live and work. As community partners, Palmetto GBA continues to positively impact the lives of thousands of people each year.

Our annual campaign to support the United Way provides a widespread, positive influence on local communities. Our employees gave \$245,133 during our annual campaign. Through our continued support of the United Way, local organizations receive the financial support necessary to carry out crucial services and meet needs that otherwise would go unmet. Whether it is providing food for the hungry, clothes for the needy or job training for those less fortunate, Palmetto GBA and its associates are passionate about giving.

**But beyond the corporate-supported campaigns, individuals and divisions within our company identify needs in their communities and provide the solutions through financial, material or other support. Palmetto GBA employees give their time, their talents and their hearts to help those less fortunate.**

Nothing better exemplified the heart of our organization than our combined efforts with our parent company BlueCross BlueShield of South Carolina to assist those devastated by Hurricane Katrina. We provided hope for people who had lost everything. We welcomed them into our city, into our company and into our hearts. We learned their stories, we felt their pain and rejoiced in seeing them restart their lives.

We will continue to reach out to the communities where we work and live to help provide hope.

It is who we are. Our clarity of vision to help those around us only motivates us to do more.

As an organization our most important responsibility is to ensure the company always conducts business with the utmost integrity. The transparency of our organization is a key component in our relationship with CMS. We do not just speak to compliance but we incorporate it into the very fiber of our company.

**We have always conducted business adhering to the highest ethical standards. We began the development of our structured *Compliance Program* in the mid-1990s. Over the years, we have seen compliance move from being a “function” or “program” to being the very essence of our culture. Our culture of compliance is the most critical factor to our continued success.**

Palmetto GBA is registered to the ISO 9001:2000 standard. This registration assures our customers that we maintain our competitive edge by improving the quality and consistency of the services we provide.

Palmetto GBA has been successful for many reasons; its people, technology, financial resources and past performance. These factors will lead to future success as we continue to develop our culture of compliance.

Our company’s Board of Directors is committed to an aggressive *Compliance Program* and conducting business in an honest and ethical manner. With our current customers, as well as those we partner with in the future, corporate transparency and clarity will be the cornerstone of our success.



**The future presents tremendous opportunity and challenges. To manage the impact of Contracting Reform legislation as part of the Medicare Modernization Act, we have tailored our Strategic Planning Model to best position our organization to sustain and grow our core business.**

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We must tirelessly pursue all avenues, to diversify, to continue to build our company brand and align ourselves with partners that hold the same values and dedication to compliance that we do. This will direct the organization to perform at peak efficiency to remain competitive.

Where we continue to maintain a strategic advantage is our dedication to our customers and our ability to innovate. Our employees are the backbone that drives our innovation. We must continue to nurture and develop those skills while maintaining a cost-conscious approach to our business endeavors.

Our organization has the foresight to stay true to our core values: providing solutions to our customers, providing support to our associates who drive our success and maintaining our corporate responsibility to do all that we do in the highest ethical standard. These values make it clear that Palmetto GBA is a Partner In Excellence.

**PALMETTO GBA, LLC**

(a single-member limited liability company owned by  
Blue Cross and Blue Shield of South Carolina)

# Consolidated Financial Statements

*Years ended December 31, 2005 and 2004  
with Report of Independent Auditors*

**PALMETTO GBA, LLC**

(a single-member limited liability company owned by  
Blue Cross and Blue Shield of South Carolina)

December 31, 2005

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**REPORT OF INDEPENDENT AUDITORS**

Board of Directors  
Palmetto GBA, LLC

We have audited the accompanying consolidated balance sheets of Palmetto GBA, LLC (the "Company") as of December 31, 2005 and 2004, and the related consolidated statements of operations, changes in member's equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Palmetto GBA, LLC at December 31, 2005 and 2004, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

*Derrick, Stubbs & Stith, L.L.P.*

February 14, 2006

Member: American Institute of Certified Public Accountants / South Carolina Association of Certified Public Accountants

**PALMETTO GBA, LLC**

(a single-member limited liability company owned by  
Blue Cross and Blue Shield of South Carolina)

**CONSOLIDATED BALANCE SHEETS**

(in thousands)

	December 31,	
	2005	2004
<u>Assets</u>		
<i>Current assets:</i>		
Cash and cash equivalents	\$ 16,619	\$ 14,784
Accounts receivable, net	61,714	42,946
Accounts receivable from affiliate	3,288	821
Accrued revenue	6,363	-
Prepaid expenses	360	31
Deferred income taxes	1,197	2,797
Total current assets	<u>89,541</u>	<u>61,379</u>
<i>Long-term assets:</i>		
Fixed assets, net of accumulated depreciation of \$4,492 and \$2,504 in 2005 and 2004, respectively	6,703	6,744
Long-term investments	3,688	3,421
Investment in affiliate	1,892	1,701
Deferred income taxes	372	309
Total long-term assets	<u>12,655</u>	<u>12,175</u>
Total assets	<u>\$ 102,196</u>	<u>\$ 73,554</u>
<u>Liabilities and member's equity</u>		
<i>Current liabilities:</i>		
Accrued payroll, taxes and benefits	\$ 21,344	\$ 19,731
Payable to parent	20,726	16,999
Other liabilities	24,401	7,271
Total current liabilities	<u>66,471</u>	<u>44,001</u>
<i>Long-term liabilities:</i>		
Deferred income taxes	51	135
Total long-term liabilities	<u>51</u>	<u>135</u>
<i>Member's equity:</i>		
Contributed capital	23,789	22,158
Retained earnings	11,497	6,965
Accumulated other comprehensive income	388	295
Total member's equity	<u>35,674</u>	<u>29,418</u>
Total liabilities and member's equity	<u>\$ 102,196</u>	<u>\$ 73,554</u>

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

## CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands)

	Year ended December 31,	
	2005	2004
<i>Revenues:</i>		
Medicare Part A	\$ 52,972	\$ 52,523
Medicare Part B	50,686	56,755
Durable Medical Equipment Regional Carrier	71,189	67,738
Railroad Retirement Board	19,339	19,962
CMS 1-800	81,333	25,466
Pearson	11,634	7,375
Q2 Administrators	2,316	-
Other revenues	18,395	8,227
Total revenues	<u>307,864</u>	<u>238,046</u>
<i>Expenses:</i>		
Medicare Part A	53,315	52,783
Medicare Part B	51,106	57,043
Durable Medical Equipment Regional Carrier	70,480	68,057
Railroad Retirement Board	19,445	20,055
CMS 1-800	78,476	23,393
Pearson	10,950	7,107
Q2 Administrators	2,092	-
Other expenses	16,309	6,368
Total expenses	<u>302,173</u>	<u>234,806</u>
Gain from operations	5,691	3,240
Investment income, net	1,150	735
Income before income taxes	6,841	3,975
Provision for income taxes	2,309	686
Net income	<u>\$ 4,532</u>	<u>\$ 3,289</u>

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

**PALMETTO GBA, LLC**

(a single-member limited liability company owned by  
Blue Cross and Blue Shield of South Carolina)

**CONSOLIDATED STATEMENTS OF CHANGES IN MEMBER'S EQUITY**

(in thousands)

	Contributed Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance January 1, 2004	\$ 10,187	\$ 3,676	\$ 173	\$ 14,036
Net income	-	3,289	-	3,289
Change in unrealized gains on securities classified as available-for-sale	-	-	122	122
Total comprehensive income				3,411
Contribution of capital	11,971	-	-	11,971
Balance December 31, 2004	22,158	6,965	295	29,418
Net income	-	4,532	-	4,532
Change in unrealized gains on securities classified as available-for-sale	-	-	93	93
Total comprehensive income				4,625
Contribution of capital	1,631	-	-	1,631
Balance December 31, 2005	<u>\$ 23,789</u>	<u>\$ 11,497</u>	<u>\$ 388</u>	<u>\$ 35,674</u>

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## CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Year ended December 31,	
	2005	2004
<i>Cash Flows From Operating Activities:</i>		
Net income	\$ 4,532	\$ 3,289
Adjustments to reconcile net income to net cash provided from (used in) operating activities:		
Depreciation and amortization	2,028	1,700
Loss on fixed asset disposals	86	464
Realized gain on investments	(130)	(27)
Equity in income of affiliate	(191)	(217)
Deferred income tax provision	1,403	(1,208)
Changes in operating assets and liabilities:		
Increase in accounts receivable	(18,768)	(16,593)
Increase in receivables from affiliates	(2,467)	(8)
Increase in accrued revenue	(6,363)	-
Increase in prepaid expense	(329)	(28)
Increase in accrued payroll, taxes and benefits	1,613	2,474
Increase in payable to parent	3,727	8,690
Increase (decrease) in other liabilities	17,130	(80)
Net cash provided from (used in) operating activities	<u>2,271</u>	<u>(1,544)</u>
<i>Cash Flows From Investing Activities:</i>		
Fixed assets purchased	(2,073)	(3,816)
Investments redeemed - held-to-maturity	168	208
Investments sold - available-for-sale	965	10,045
Investments purchased - held-to-maturity	-	(82)
Investments purchased - available-for-sale	(1,127)	(6,330)
Net cash (used in) provided from investing activities	<u>(2,067)</u>	<u>25</u>
<i>Cash Flows From Financing Activities:</i>		
Capital contribution from parent	1,631	11,971
Net cash provided from financing activities	<u>1,631</u>	<u>11,971</u>
Net increase in cash and cash equivalents	1,835	10,452
Cash and cash equivalents, beginning of year	14,784	4,332
Cash and cash equivalents, end of year	<u>\$ 16,619</u>	<u>\$ 14,784</u>
Supplemental disclosures of cash paid during the year for:		
Interest	\$ 3	\$ -
Income taxes	\$ 2,953	\$ 1,915

The accompanying notes are an intergral part of these financial statements.

**PALMETTO GBA, LLC**

(a single-member limited liability company owned by  
Blue Cross and Blue Shield of South Carolina)

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2005

**Note 1 | Basis Of Presentation And Summary Of Significant Accounting Policies**

Palmetto GBA, LLC (the "Company") is a single-member limited liability company organized on January 1, 1998. The Company's sole member is Blue Cross and Blue Shield of South Carolina ("BCBSSC"). The Company is engaged in the business of providing Medicare Part A fiscal intermediary services, Medicare Part B carrier services and Medicare Durable Medical Equipment Regional Carrier services in various states. These services include health insurance claims processing and payment, customer service for Medicare beneficiaries and health care providers, and payment safeguard functions designed to detect and prevent fraud and abuse in the Medicare program. The Company provides services to Medicare beneficiaries residing in several states, Puerto Rico and the U.S. Virgin Islands. The Company's major customer is the Centers for Medicare and Medicaid Services ("CMS"), the federal agency with fiduciary responsibility for the Medicare program.

The Company has one wholly-owned subsidiary, Q<sup>2</sup> Administrators, LLC ("Q<sup>2</sup>A"). Q<sup>2</sup>A was formed in 2004 and acts as a Qualified Independent Contractor responsible for implementing a new appeals process for Medicare claim denials.

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP"). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Significant accounting policies and the methods of applying those policies are summarized below.

**Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. All significant inter-company balances and transactions have been eliminated in consolidation.

**Cash Equivalents**

Cash equivalents represent certificates of deposit that have maturities of less than three months at date of purchase and money market fund investments.

**Financial instruments**

The Company holds certain financial instruments as defined by Financial Accounting Standards Board Statement No. 107, including cash and accounts receivable. Management believes that the carrying values of financial instruments approximate fair value. The Company also holds investments for which the fair values are disclosed in Note 3.

### **Asset valuation allowances**

The Company recorded an allowance for uncollectible receivables in the amount of \$9,758 and \$9,835 at December 31, 2005 and 2004, respectively.

### **Fixed assets**

Fixed assets are stated at cost. Depreciation on new assets purchased is computed using the straight-line method over the estimated useful lives of the respective assets: four to eight years for furniture and fixtures, three to five years for data processing equipment and software, and four years for automobiles. Leasehold improvements are depreciated over the lesser of the remaining lease term or estimated useful life of the asset. Depreciation on used assets purchased is computed by using the straight-line method over the estimated remaining useful lives at the time of purchase of the respective assets.

### **Investments**

Investments are comprised of common stocks, bonds, United States Government mortgage-backed securities and money market mutual funds. These assets are accounted for in accordance with Financial Accounting Standards Board Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities ("Statement No. 115"). Statement No. 115 requires that fixed maturities are to be classified as either "held-to-maturity," "available-for-sale," or "trading"

Management determines the appropriate classification of its fixed maturity securities at the time of purchase and reevaluates such designation as of each balance sheet date. Fixed maturity securities are classified as held-to-maturity when the Company has the positive intent and ability to hold them to maturity. Held-to-maturity securities are stated at amortized cost, adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization as well as interest earned is included in investment income.

Fixed maturity and equity securities not classified as held-to-maturity are classified as available-for-sale. Available-for-sale securities are carried at fair value, with the unrealized gains and losses reported in member's equity. The amortized cost of debt securities in this category is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and interest earned is included in investment income. The cost of securities sold is based on the specific identification method. At December 31, 2005 and 2004, the Company classified all of its debt securities as held-to-maturity and all of its equity securities as available-for-sale. The Company's equity investments are substantially concentrated in industrial stocks. Fair values for fixed maturities are based on quoted market prices, where available. For fixed maturities not actively traded, fair values are estimated using values obtained from independent pricing services. The fair values for common stocks are based on quoted market prices.

### **Investment in affiliate**

The Company has a 25% interest in TriCenturion, Inc. that is accounted for using the equity method. The Company's proportionate share of earnings or losses of this affiliate are reflected in income as earned and dividends or distributions are credited against investment in affiliate when received.

Assets, liabilities and results of operations for TriCenturion, Inc. were as follows:

	Year ended December 31,	
	2005	2004
	(in thousands)	
Assets	\$ 11,836	\$ 11,351
Liabilities	\$ 4,189	\$ 4,665
Net Income	\$ 961	\$ 758

### Revenue recognition policies

The Company recognizes revenues based upon allowable costs incurred which are reimbursable under the terms of the following contracts:

- Medicare Part A Fiscal Intermediary subcontract between the Company and the Blue Cross Blue Shield Association (BCBSA) (this includes the Regional Home Health Intermediary subcontract)
- Medicare Part B Carrier Services contract between the Company and CMS
- Durable Medical Equipment Regional Carrier (DMERC) contract between the Company and CMS (this includes the National Supplier Clearinghouse contract and the Statistical Analysis DMERC contract)
- National 1-800 Beneficiary Telephone Inquiries (IDIQ) contract between the Company and CMS (this includes the Managed Care Disenrollment task order)
- Railroad Retirement Board Part B Carrier contract between the Company and the Railroad Retirement Board

The Company recognizes revenue on the DDI System Access contracts with various third parties when services are performed and billable.

The Company recognizes revenue on the CMS 1-800, Pearson, Standardization, and Single Testing Contractor contracts on cost plus a fixed fee basis. Award fees for these contracts are recognized upon completion of milestones or when amounts are determinable.

### Reclassifications

Certain reclassifications have been made to the 2004 amounts to conform to the 2005 presentation.

## Note 2 | Fixed Assets

Fixed assets consist of the following:

	December 31,	
	2005	2004
	(in thousands)	
Leasehold improvements	\$ 390	\$ 452
Equipment, furniture and fixtures	9,517	7,758
Software	1,267	1,017
Automobiles	21	21
	11,195	9,248
Accumulated depreciation	(4,492)	(2,504)
	<u>\$ 6,703</u>	<u>\$ 6,744</u>

Depreciation expense was \$2,028,000 and \$1,669,000 for the years ended December 31, 2005 and 2004, respectively.



### Note 3 | Investments

There were no short term investments at December 31, 2005 and 2004. There were realized losses of \$0 and \$68,000 during the year ended December 31, 2005 and 2004, respectively.

Long-term investments consist of the following:

	Amortized Cost Or Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(in thousands)			
<i>December 31, 2005</i>				
Bonds and mortgage-backed securities - held-to-maturity	\$ 640	\$ 19	\$ 23	\$ 636
Common stocks – available-for-sale	2,452	668	72	3,048
	<u>\$ 3,092</u>	<u>\$ 687</u>	<u>\$ 95</u>	<u>\$ 3,684</u>
<i>December 31, 2004</i>				
Bonds and mortgage-backed securities - held-to-maturity	\$ 808	\$ 43	\$ 15	\$ 836
Common stocks – available-for-sale	2,159	503	49	2,613
	<u>\$ 2,967</u>	<u>\$ 546</u>	<u>\$ 64</u>	<u>\$ 3,449</u>

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#### Expected maturities of debt securities

The amortized cost and estimated market values of held-to-maturity debt securities, by contractual maturity, at December 31, 2005 are as follows:

	Book Value	Market Value
	(in thousands)	
Held-to-maturity securities:		
Due in one year or less	\$ –	\$ –
Due in one year through five years	305	311
Due in five years through ten years	198	211
Due after ten years	–	–
	<u>503</u>	<u>522</u>
Mortgage-backed securities	137	114
Total held-to-maturity	<u>\$ 640</u>	<u>\$ 636</u>

There were gross realized gains of \$163,000 and gross realized losses of \$33,000 during the year ended December 31, 2005. There were gross realized gains of \$122,000 and gross realized losses of \$27,000 during the year ended December 31, 2004. Gross unrealized holding gains and (losses) on securities classified as available-for-sale in the amounts of \$668,000 and \$72,000, respectively, at December 31, 2005 and gross unrealized holding gains and (losses) of \$503,000 and \$49,000, respectively, at December 31, 2004, are reported in accumulated other comprehensive income in the accompanying balance sheets. No cash or assets are pledged or restricted for any purpose.

The Company experienced an unrealized loss on certain stock investments during 2005. The aggregate amount of unrealized loss on investments that had been in an unrealized loss position for less than twelve months was \$54,000 and the aggregate estimated fair value was \$481,000. For investments that had been in an unrealized loss position for more than twelve months, the aggregate amount of unrealized loss was \$18,000 and the aggregate estimated fair value was \$47,000. Unrealized losses in available-for-sale securities are considered temporary in light of the extent and duration of the decline in value. The Company recorded no other-than-temporary losses on investments in 2005 and 2004. Market value declines in available-for-sale securities that have been in an unrealized position for less than 12 months are considered temporary in light of the extent and duration of the decline in value absent any evidence of bankruptcy or other significant negative information. Market value declines in available-for sale securities that have been in an unrealized loss position for more than 12 months includes one security and is not significant.

## Note 4 | Income Taxes

As a single-member limited liability company, “disregarded entity” status has been elected for federal income tax purposes. Therefore, the Company’s taxable income is included as a division of its owner, BCBSSC. Under a written tax-sharing agreement, BCBSSC allocates the tax provision to each company within the consolidated group based upon the company’s proportionate share of the consolidated federal income tax liability computed on a stand-alone basis, multiplied by the total consolidated federal income tax return liability.

The Company had an income tax receivable from BCBSSC of \$187,000 at December 31, 2005 and an income tax payable to BCBSSC of \$1,860,000 at December 31, 2004, which are included in the net payables to the parent. The Company made payments to BCBSSC for income taxes of \$2,953,000 and \$1,915,000 during the years ended December 31, 2005 and 2004, respectively.

The Company recognized a provision for income taxes as follows (in thousands):

	Year ended December 31,	
	2005	2004
Current	\$ 906	\$ 1,894
Deferred	1,403	(1,208)
	<u>\$ 2,309</u>	<u>\$ 686</u>

Unrealized gains on investments credited directly to equity have been reduced by income tax expense of \$50,128 and \$158,703 for the years ended December 31, 2005 and 2004, respectively.

The provision for income taxes differs from the amount computed by applying the federal statutory tax rate of 35% to income before income taxes primarily due to the dividends received deduction allowed for tax, changes in tax contingency reserve, the true-up of prior year deferreds, investment in subsidiaries, and benefits derived from filing on a consolidated basis versus separate company basis. The temporary differences that give rise to deferred tax assets and liabilities are primarily related to accrued expenses, fixed assets, and investments. There was no valuation allowance at December 31, 2005 and 2004.

Deferred tax assets and liabilities are classified as current and long-term based on the classification of the related asset or liability, as follows (in thousands):

	December 31,	
	2005	2004
Deferred tax assets:		
Current	\$ 1,197	\$ 2,797
Long-term	372	309
	<u>\$ 1,569</u>	<u>\$ 3,106</u>
Deferred tax liabilities:		
Current	\$ —	\$ —
Long-term	51	135
	<u>\$ 51</u>	<u>\$ 135</u>
Net deferred tax asset	<u>\$ 1,518</u>	<u>\$ 2,971</u>

## Note 5 | Related Parties

The Company is a single-member limited liability company owned by BCBSSC. Certain offices, other facilities and services are provided by BCBSSC pursuant to an administrative services agreement. Expenses associated with the administrative services agreement allocated from BCBSSC to the Company totaled \$136,619,000 and \$138,890,000 for the years ended December 31, 2005 and 2004, respectively. The Company paid \$130,460,000 and \$133,470,000 during the years ended December 31, 2005 and 2004, respectively, to BCBSSC for expenses paid on behalf of the Company.

BCBSSC made capital contributions related to the job tax credit to the Company of \$1,631,000 and \$471,000 during the years ended December 31, 2005 and 2004, respectively.

There are certain administrative services provided by the Company to other subsidiaries of BCBSSC. The Company received \$4,147,000 and \$3,536,000 from various subsidiaries for these services during the year ended December 31, 2005 and 2004, respectively.

## Note 6 | Commitments And Contingencies

A financial guarantee has been issued by BCBSSC, which equals the Company's estimated annual net operating expenses multiplied by 8.33%, less current capitalization. This guarantee is estimated to be \$0 at December 31, 2005. BCBSSC has also executed an indemnification agreement, pursuant to minimum reserve and other requirements established by the Blue Cross and Blue Shield Association ("BCBSA"). BCBSSC is therefore liable to the Company to the extent of its financial guarantee and to the BCBSA to the full extent of its assets for any claims asserted against the BCBSA resulting from the contractual and financial obligations of the Company arising out of its Medicare Part A subcontract with the BCBSA.

In consideration of the novation of the fiscal intermediary and carrier contracts from BCBSSC to the Company, BCBSSC has issued a financial guarantee which equals 20 percent of the administrative costs of the contracts contained in the Notice of Budget Approval, less current capitalization. This guarantee is estimated to be \$0 at December 31, 2005. The financial guarantee agreement remains in effect until both the contracts and intermediary agreement expire, are non-renewed or are terminated.

In addition, BCBSSC has executed a statutorily required financial guarantee of \$75,000 on behalf of the Company in order for the Company to obtain a Third Party Administrator's license pursuant to the South Carolina insurance laws.

The Company recorded an estimated contingent liability for potential repayments of costs claimed on its contracts with CMS. The liability was \$1,062,000 and \$882,000 at December 31, 2005 and 2004, respectively.

The Company is obligated for additional capital contributions of up to \$726,000 to its affiliate, TriCenturion, Inc.

The Company has entered into certain non-cancelable operating leases in excess of one year as of December 31, 2005. The future minimum lease payments required under these leases are as follows (in thousands):

Year	Amount
2006	\$ 2,894
2007	2,285
2008	2,175
2009	2,195
2010	727
Thereafter	61
	\$ 10,337

Total rent expense was \$9,743,000 and \$9,699,000 during the years ended December 31, 2005 and 2004, respectively.

In the ordinary course of business, there are various legal proceedings pending against the Company. Management believes the aggregate liabilities, if any, arising from legal actions would not have a material adverse effect on the financial position of the Company.

## **Note 7 | CMS Contract Novation Status**

Since January 1, 1999, BCBSSC's Medicare administrative services contracts were executed through the Company through a special power of attorney. Effective October 1, 2005, the Medicare administrative services contracts were novated to the Company.

## **Note 8 | Other Employee Benefit Plans**

The Company's employees are part of the 401(k) plan sponsored by BCBSSC. Eligible employees may defer up to 15% in 2004 and up to 50% of their salary starting in 2005 and the Company matched 50% of the first 6% deferred in 2005 and 2004. For employees hired after January 1, 2003, there is a 2-year cliff-vesting schedule on the match contribution. For certain employees not covered by the BCBSSC defined benefit pension plan, the Company makes a discretionary contribution to the 401(k) plan which is 50% vested for employees with one year of service and fully vested for employees with two years of service. Employees must be employed on the last day of the year to be eligible for the discretionary contribution, unless terminated during the year due to retirement (age 55 and 5 years of service), death or disability. The discretionary contribution for 2005 and 2004 was 6% of salary.

The cost of providing the 401(k) discretionary contribution was \$4,636,000 and \$4,079,000 for the years ended December 31, 2005 and 2004, respectively. The pension expense allocated to the Company under the BCBSSC pension plan was \$9,453,000 and \$7,255,000 for the years ended December 31, 2005 and 2004, respectively.

# Corporate Officers



Neal Burkhead, VP, Medicare Integrity Program Operations (A/B/DMERC/RHHI);  
Mike Barlow, VP, Part B Operations-Ohio/West Virginia; Sheri Thompson, AVP, Part A Operations

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Susan Pendley, AVP, Customer Service Strategies; Ann Archibald, VP & Compliance Officer



Jean Catalano, AVP, Railroad Medicare; Sharon Cook-McEwen, AVP, South Carolina Part B Operations;  
Joe Johnson, AVP, EDI Systems/Government Programs

## Corporate Officers



Roz Catoe, VP, Processing & Customer Service  
Elaine Myers, VP Customer Service Strategies  
Steve Smith, AVP Customer Service Strategies





**Bruce W. Hughes**, President & COO;

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**Dickie Butler**, VP, Systems & Tech Support/  
Government Programs EDI;

**Robin Spires**, VP, DMERC Operations & Education



**Rex Brown**, AVP Customer Service Strategies & Education;

**William R. Horton**, President and COO, Government Programs, BlueCross BlueShield of South Carolina



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