

notes

Notes to Consolidated Financial Statements

(dollars in thousands, except share and per share data)

1. Organization and For-Profit Conversion

WellChoice, Inc. ("WellChoice") was formed in August 2002 as a Delaware corporation to be the for-profit parent holding company for Empire HealthChoice, Inc. ("EHC") following the for-profit conversion. WellChoice owns a health maintenance organization ("HMO") and two health insurance companies through its investment in WellChoice Holdings of New York, Inc. ("WellChoice Holdings").

On November 7, 2002, EHC converted from a not-for-profit health service corporation to a for-profit accident and health insurer under the New York State insurance laws and the converted EHC issued all its authorized capital stock to the New York Public Asset Fund (the "Fund") and The New York Charitable Asset Foundation (the "Foundation"). The Fund and the Foundation then received their respective shares of WellChoice common stock in exchange for the transfer of all the outstanding shares of EHC to WellChoice Holdings. Pursuant to the plan of conversion, WellChoice issued 82,300,000 shares to the Fund and the Foundation and completed an initial public offering of 19,199,000 shares of common stock, consisting of 18,008,523 shares that were sold by the Fund and Foundation and 1,190,477 newly issued shares of common stock sold by WellChoice. After deducting the underwriting discount, net proceeds to WellChoice were approximately \$27,990.

WellChoice Holdings is a non-insurance holding company which wholly-owns Empire HealthChoice Assurance Inc. ("EHCA") d/b/a, Empire Blue Cross Blue Shield. In connection with EHC's conversion to a for-profit entity, EHC merged with EHCA. EHCA wholly-owns Empire HealthChoice HMO, Inc. ("EHC HMO") and WellChoice Insurance of New Jersey, Inc. ("WCINJ"). EHC HMO is an HMO licensed under Article 44 of the New York Public Health Law and is also licensed to operate an HMO in the State of New Jersey. WCINJ is a credit, life, accident and health insurance company licensed in eleven states, which currently writes business only in New Jersey. Prior to its dissolution in February 2002, NexxtHealth, Inc. was a wholly-owned subsidiary of EHC primarily engaged in the development of software to link healthcare systems to the Internet.

EHCA and its subsidiaries offer a comprehensive array of insurance products to employer groups and individuals. Products include traditional comprehensive indemnity health coverage and managed care products and services offered through an HMO, preferred provider organization ("PPO") and exclusive

Notes to Consolidated Financial Statements *(continued)*

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provider organization (“EPO”). EHCA and its subsidiaries also process claims for self-insured employers and government programs. EHCA and EHC HMO are members of the Blue Cross Blue Shield Association (“BCBSA”) which provides EHCA and EHC HMO the ability to participate with other Blue Cross Blue Shield plans in BCBSA sponsored programs and entitles it to use the Blue Cross and Blue Shield names and marks in the New York City metropolitan area and one or both of these names and marks in select upstate New York counties.

WellChoice also has, through a subsidiary investment, a 24.97% interest in National Accounts Service Company, LLC (“NASCO”), a limited liability company, which processes national account claims for the Company and other Blue Cross Blue Shield plans. See footnote 9.

2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States (“GAAP”). The consolidated financial statements include the accounts of WellChoice and its wholly-owned subsidiaries (collectively, the “Company”). All significant intercompany transactions have been eliminated.

The preparation of financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known, which could impact the amounts reported and disclosed herein.

Conversion

The conversion was accounted for as a reorganization using the historical carrying values of EHC and its subsidiaries assets and liabilities. Immediately following the conversion, EHC’s unassigned reserves were reclassified to par value of common stock and additional paid-in capital. The costs of the conversion were recognized as an expense.

Investments—Fixed Maturities and Marketable Equity Securities

The Company has classified all of its fixed maturity and marketable equity security investments as available for sale and, accordingly, they are carried at fair value. The fair value of investments in fixed maturities and marketable equity securities are based on quoted market prices. Unrealized gains and losses are reported as a separate component of other comprehensive income, net of deferred income taxes. The amortized cost of fixed maturities, including certain trust preferred securities, is adjusted for amortization of premiums and accretion of discounts to maturity, which is included in investment income. Amortization of premiums and discounts on collateralized mortgage obligations are adjusted for prepayment patterns using the retrospective method. Investment income is shown net of investment expenses. The cost of securities sold is based on the specific identification method. When the fair value of an investment is lower than its cost and such a decline is determined to be other than temporary, the cost of the investment is written down to fair value and the amount of the write down is charged to net income as a realized loss.

Short-Term Investments

Short-term investments are carried at fair value, and consist principally of U.S. Treasury bills, commercial paper and money market investments. The Company considers securities with maturities greater than three months and less than one year at the date of purchase as short-term investments. The fair value of short-term investments is based on quoted market prices.

Other Long-Term Equity Investments

Other long-term equity investments include joint ventures and warrants. Joint ventures are accounted for under the equity method. The Company's warrants are considered derivatives and are carried at fair value. The warrants are not classified as hedging instruments. Fair values of warrants are determined using the Black-Scholes options valuation model. Changes in the fair values of warrants are recorded as realized gains or losses.

Cash and Cash Equivalents

The Company considers all bank deposits, highly liquid securities and certificates of deposit with maturities of three months or less at the date of purchase to be cash equivalents. These cash equivalents are carried at cost which approximates fair value.

Pharmaceutical Rebate Sharing Program

The Company participates in pharmaceutical rebate sharing programs with drug manufacturers through a third party pharmacy benefit manager. Rebates for fully insured groups are recorded as a reduction to the cost of benefits provided. Rebates for self-funded groups are recorded as administrative service fee revenue. The Company records an estimate for pharmacy rebates earned but not yet received. These estimates are adjusted as new information becomes known and such adjustments are included in current period operations. Pharmacy rebates included in miscellaneous receivables were \$15,813 and \$19,004 at December 31, 2003 and 2002, respectively.

Market Stabilization and Stop Loss Pools

The Company is required to participate in Market Stabilization and Stop Loss Pools ("Pools") as established by the State of New York. Contributions and recoveries under the Pools are estimated based on interpretations of applicable regulations and are recorded as an addition or a reduction to cost of benefits provided. These estimates are adjusted as new information becomes known and such adjustments are included in current period operations. In 2003, the Company received a distribution from the Pool for Medicare Supplemental Pool years 2000 through 2002 and 2003 of \$34,882 and \$5,972, respectively. The distribution was recorded as a reduction to cost of benefits provided. The Company was required to issue premium refunds of approximately \$19,663 related to the distribution received for years 2000 through 2003. Pool recoverables included in miscellaneous receivables were \$23,877 and \$18,390 at December 31, 2003 and 2002, respectively.

Notes to Consolidated Financial Statements *(continued)*

(dollars in thousands, except share and per share data)

Receivables

Receivables are reported net of allowance for doubtful accounts of \$14,661 and \$13,724 at December 31, 2003 and 2002, respectively. The allowance for doubtful accounts calculation is based upon historical experience, which takes into consideration the length of time the receivable has been outstanding.

Property, Equipment and Information Systems

Property, equipment and information systems are reported at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, which are not greater than twenty-one years for property and improvements and three to ten years for equipment and furniture. Purchased software is capitalized and depreciated for a period not to exceed three years. The Company capitalizes certain costs incurred during the application development stage related to developing internal use software. These capitalized costs are amortized over a three-year period beginning when the software is placed into production. Computer software costs that are incurred in the preliminary project stages and post-implementation/operation stages, are expensed as incurred.

Unpaid Claims and Claims Adjustment Expenses

The cost of unpaid claims, both for reported claims and claims incurred but not yet reported to the Company, is calculated based upon claim history, claim inventory, number of claims received, changes in product mix, number of contracts in force, recent trend experience, unit costs and the regulatory environment. The estimated expense of processing these claims is also included in the consolidated financial statements as a component of administrative expense. These estimates are subject to the effects of medical claim trends and other uncertainties. Although considerable variability is inherent in such estimates, management believes that the reserves for claims and claims adjustment expenses are adequate. The estimates are continually reviewed and adjusted as experience develops or new information becomes known. Such adjustments are included in current period operations.

Advance Deposits

Under certain funding arrangements, customers are contractually obligated to remit funds on a paid claims basis. Funds received prior to payment of claims are classified as advance deposits.

Retirement Benefits

Retirement benefits represent outstanding obligations for certain retiree healthcare and life insurance benefits and any unfunded liabilities related to defined benefit pension plans. Unfunded liabilities for pension benefits are accrued in accordance with SFAS No. 87, *Employers' Accounting for Pensions*. Medical and life insurance benefits for retirees are accrued in accordance with SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*.

Revenue

Membership contracts are generally for a period of one year and are subject to cancellation by the employer group upon 60 days written notice. Premiums are normally due monthly and are recognized as revenue during the period in which the Company is obligated to provide services to members. Premiums received prior to such periods are recorded as unearned premiums. Premiums on retrospectively rated

group contracts are accrued by making estimates based on past claims experience on such contracts. Premiums collected on retrospectively rated group contracts in excess of premiums earned are classified as group and other contract liabilities.

Administrative service fees are recognized in the period the related services are performed. All benefit payments under these programs are excluded from revenue and cost of benefits provided.

Cost of Benefits Provided

Cost of benefits provided includes claims paid, claims in process and pending, and an estimate of unreported claims for healthcare service provided to enrolled members during benefits and pool recoveries. Costs of benefits are reported net of pharmacy rebates, coordination of benefits and pool recoveries.

Acquisition Costs

Marketing and other costs associated with the acquisition of membership contracts are expensed as incurred.

Income Taxes

The Company accounts for income taxes using the liability method. Accordingly, deferred tax assets and liabilities are recognized for the future tax consequences attributable to the difference between the financial reporting and tax bases of assets and liabilities.

Premium Deficiency

A premium deficiency reserve is established when expected claim payments or incurred costs, claims adjustment expenses and administrative costs exceed the premiums to be collected for the remainder of a contract period. For purposes of determining if a premium deficiency reserve exists, contracts are grouped in a manner consistent with how policies are marketed, serviced and measured. Anticipated investment income is not utilized in the premium deficiency reserve calculation. At December 31, 2003 and 2002, a premium deficiency reserve of \$402 and \$3,300, respectively, is included in group and other contract liabilities.

Stock-Based Compensation

The Company has an incentive stock plan that provides for stock-based compensation, including stock options, restricted stock awards, restricted stock units and an employee stock purchase plan. Stock options are granted for a fixed number of shares with an exercise price equal to the fair value of the shares at the date of the grant. Restricted stock awards and restricted stock units are valued at the fair value of the stock on the grant date, with no cost to the grantee. The employee stock purchase plan, in accordance with the Section 423 of the Internal Revenue Code, allows for a purchase price per share to be 85% of the lower of the fair value of a share of common stock on (i) the first trading day of the offering period, or (ii) the last trading day of the offering period. The Company accounts for stock-based compensation using the intrinsic method under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and, accordingly, if the exercise price is equal to the fair market value of the shares at the date of the grant, the Company recognizes no compensation expense related to stock options. For grants of restricted stock and restricted stock units, unearned compensation, equivalent to the fair

Notes to Consolidated Financial Statements *(continued)*
(dollars in thousands, except share and per share data)

value of the shares at the date of grant, is recorded as a separate component of shareholders' equity and subsequently amortized to compensation expense over the vesting period. The Company has adopted the disclosure-only provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended.

Earnings Per Share

For 2003, earnings per share amounts, on a basic and diluted basis, have been calculated based upon the weighted-average common shares outstanding for the year. For 2002, earnings per share amounts, on a basic and diluted basis, have been calculated based upon the weighted-average common shares outstanding for the period from November 7, 2002, the date of the for-profit conversion and initial public offering, to December 31, 2002.

Basic earnings per share excludes dilution and is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per share include the dilutive effect of all stock options, and restricted stock awards, using the treasury stock method. Under the treasury stock method, the exercise of stock options and restricted stock unit awards is assumed, with the proceeds used to purchase common stock at the average market price for the period. The difference between the number of shares assumed issued and number of shares assumed purchased represents the dilutive shares.

Pro Forma Disclosure

The pro forma information regarding net income and earnings per share has been determined as if the Company accounted for its stock-based compensation using the fair value method. The fair value for the stock options was estimated at the date of grant using a Black-Scholes option valuation model with the following weighted-average assumptions:

	2003
Risk-free interest rate	3.47%
Volatility factor	42%
Dividend yield	—
Expected life	5 years

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's stock option grants have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its stock option grants.

For purposes of pro forma disclosures, compensation expense is increased for the estimated fair value of the options amortized over the options' vesting periods and for the difference between the

market price of the stock and discounted purchase price of the shares on the purchase date for the employee stock purchases. The Company's pro forma information is as follows:

Year ended December 31	2003	2002	2001
Reported net income	\$201,126	\$376,559	\$130,978
Total stock-based employee compensation determined under fair value based method for stock options, net of tax	(255)	—	—
Pro forma net income	\$200,871	\$376,559	\$130,978

	2003 As Reported	2003 Pro Forma
Earnings per share:		
Basic net income per common share	\$ 2.41	\$ 2.41
Diluted net income per common share	\$ 2.41	\$ 2.41
Weighted-average fair value of options granted during the year	—	\$12.92
Weighted-average fair value of restricted stock awards granted during the year	\$31.03	\$31.03
Weighted-average fair value of restricted stock unit awards granted during the year	\$31.03	\$31.03

Recent Accounting Pronouncements

In December 2003, the Financial Accounting Standard Board issued SFAS No. 132 (Revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*. This Statement amends Statements No. 87, *Employers' Accounting for Pensions*, No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. However, the Statement does not change the recognition and measurement requirements of those Statements. This Statement retains the disclosure requirements contained in SFAS No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, which it replaces and requires additional disclosure. Additional new disclosure includes actual mix of plan assets by category, a description of investment strategies and policies used, a narrative description of the basis for determining the overall expected long-term rate of return on asset assumption and aggregate expected contributions.

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 ("Modernization Act") was signed into law. The Modernization Act introduced a voluntary Medicare part D prescription drug benefit and created a new 28% federal subsidy for the sponsors of the postretirement prescription drug benefits that are at least actuarially equivalent to the new Medicare Part D benefit. Under SFAS No. 106-1, *Accounting for Postretirement Benefits Other Than Pensions*, sponsors must consider the two new features in measuring the Accumulated Postretirement Benefit Obligation ("APBO") and net periodic postretirement benefit cost. In accordance with SFAS No. 106-1, the Company made a one-time election to defer recognition of the impact on SFAS No. 106 accounting. Any measures of APBO and net periodic postretirement benefit cost in the financial statements and the related footnotes for the year ended December 31, 2003 do not reflect the effects of the Modernization Act. Currently, specific authoritative guidance on accounting for the federal subsidy is pending and

Notes to Consolidated Financial Statements *(continued)*
(dollars in thousands, except share and per share data)

that guidance when issued could require the Company to change previously reported information. The Company does not anticipate that the adoption of SFAS 106-1 will materially affect the financial statements.

3. Investments

Available-for-sale investments are as follows:

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
At December 31, 2003				
Fixed maturities:				
U.S. Treasury Notes	\$ 94,032	\$ 518	\$ (54)	\$ 94,496
U.S. Government Agency obligations	457,514	987	(6,197)	452,304
U.S. Government Agency mortgage-backed securities	84,812	242	(797)	84,257
Public utility bonds	5,361	—	(26)	5,335
Corporate securities	395,028	7,299	(1,464)	400,863
Total fixed maturities	1,036,747	9,046	(8,538)	1,037,255
Marketable equity securities:				
Common stock	42,834	7,354	(172)	50,016
Non-redeemable preferred stock	10,056	342	—	10,398
Total marketable equity securities	52,890	7,696	(172)	60,414
Total fixed maturities and marketable equity securities investments	\$1,089,637	\$16,742	\$(8,710)	\$1,097,669
At December 31, 2002				
Fixed maturities:				
U.S. Treasury Notes	\$ 76,042	\$ 2,081	\$ —	\$ 78,123
U.S. Government Agency obligations	234,300	2,011	(156)	236,155
U.S. Government Agency mortgage-backed securities	129,522	1,299	(127)	130,694
Public utility bonds	20,000	368	(4)	20,364
Corporate securities	386,753	13,059	(1,858)	397,954
Total fixed maturities	846,617	18,818	(2,145)	863,290
Marketable equity securities:				
Common stock	31,966	—	(2,724)	29,242
Non-redeemable preferred stock	15,056	250	—	15,306
Total marketable equity securities	47,022	250	(2,724)	44,548
Total fixed maturities and marketable equity securities investments	\$ 893,639	\$19,068	\$(4,869)	\$ 907,838

The following table shows our investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2003:

Description of Securities	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury notes and U.S. Government Agency obligations	\$213,595	\$(6,251)	\$ —	\$ —	\$213,595	\$(6,251)
U.S. Government Agency mortgage-backed securities	57,764	(797)	—	—	57,764	(797)
Public utility bonds	5,335	(26)	—	—	5,335	(26)
Corporate securities	108,603	(1,130)	11,444	(334)	120,047	(1,464)
Total fixed maturities	385,297	(8,204)	11,444	(334)	396,741	8,538
Common stock	522	(172)	—	—	522	(172)
Total temporarily impaired securities	\$385,819	\$(8,376)	\$11,444	\$(334)	\$397,263	\$(8,710)

The amortized cost and fair value of fixed maturities, by contractual maturity, are shown below:

December 31, 2003	Amortized Cost	Fair Value
Due in 1 year or less	\$ 72,347	\$ 73,144
Due after 1 year through 5 years	259,288	261,377
Due after 5 years through ten years	70,337	70,895
Due after ten years	634,775	631,839
Total	\$1,036,747	\$1,037,255

Mortgage-backed securities do not have a single maturity date and have been included in the above table based on the year of final maturity. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Proceeds from sales of available-for-sale securities for the years ended December 31, 2003, 2002 and 2001 were \$268,062, \$231,840 and \$154,137, respectively. The Company's investment portfolio is not significantly concentrated in any particular industry or geographic region.

Notes to Consolidated Financial Statements *(continued)*
(dollars in thousands, except share and per share data)

Investment income, net is summarized as follows:

Year ended December 31	2003	2002	2001
Fixed maturities	\$41,759	\$57,507	\$61,690
Marketable equity securities	1,100	1,081	1,200
Short-term investments and cash equivalents	8,237	7,775	15,583
Other long-term equity investments	23	117	—
Interest and dividend income	51,119	66,480	78,473
Equity in earnings (losses) of joint ventures	1,364	(229)	(571)
Less investment expenses including interest on advance deposits	(1,248)	(1,445)	(8,546)
Investment income, net	\$51,235	\$64,806	\$69,356

Realized and unrealized gains and losses on investments were as follows:

Year ended December 31	2003	2002	2001
Realized gains:			
Fixed maturities	\$ 9,480	\$ 4,447	\$ 2,351
Equity securities	2,602	375	—
Short-term investments and cash equivalents	4	6	3,994
Total realized gains	12,086	4,828	6,345
Realized losses:			
Fixed maturities	—	(1,747)	(2,402)
Equity securities	(287)	(476)	(10,816)
Short-term investments and cash equivalents	—	(1)	(5,530)
Total realized losses	(287)	(2,224)	(18,748)
Net realized gains (losses)	11,799	2,604	(12,403)
Changes in unrealized (losses) gains:			
Fixed maturities	(16,236)	6,305	23,249
Equity securities	7,300	(2,531)	11,193
Short-term investments	(119)	23	(9)
Net unrealized (losses) gains	(9,055)	3,797	34,433
Total realized and unrealized gains (losses)	\$ 2,744	\$ 6,401	\$ 22,030

In 2001, the Company recorded a loss of \$10,521 due to management's determination that the decline in value of a common stock investment was other than temporary.

The components of other comprehensive (loss) income are as follows:

Year ended December 31	2003	2002	2001
Unrealized gains from investments, net of taxes of \$(118), \$(2,186), and \$(6,503)	\$ 857	\$ 4,059	\$15,527
Reclassification adjustment for (gains) losses included in net income, net of taxes of \$3,511, \$857 and \$(4,341)	(6,519)	(1,591)	8,062
Other comprehensive (loss) income	\$(5,662)	\$ 2,468	\$23,589

In 2003, the Company participated in a security lending program, whereby certain securities from its portfolio are loaned to qualified brokers in exchange for cash collateral, equal to at least 102% of the market value of the securities loaned. The securities lending agent indemnified the Company against loss in the event of default by the borrower. Income generated by the securities lending program is reported as a component of net investment income. As of December 31, 2003, fixed maturity securities of \$191,958 were loaned under the program.

The Company is required by BCBSA to maintain a deposit for the benefit and security of out-of-state policyholders. At December 31, 2003, the fair value and amortized cost of the investment on deposit were \$8,530 and \$8,404, respectively. The Company also maintains a deposit to satisfy the requirements of its workers' compensation insurance carrier. At December 31, 2003, the fair value and amortized cost of the investment on deposit were \$1,855 and \$1,846, respectively.

4. Property and Equipment

Property and equipment, including capitalized lease arrangements, are as follows:

December 31	2003	2002
Buildings and improvements	\$126,466	\$102,600
Equipment and furniture	68,719	52,575
Software systems	66,777	57,807
Total property and equipment	261,962	212,982
Less accumulated depreciation and amortization	148,436	112,192
Net property and equipment	\$113,526	\$100,790

All property and equipment is used by the Company for its operations and includes two facilities and certain equipment leased under agreements, which are accounted for as capital leases. Depreciation expense, including depreciation on assets held under capital leases totaled \$38,870, \$34,168 and \$27,332 for the years ended December 31, 2003, 2002 and 2001, respectively.

For the year ended December 31, 2003, the cost and accumulated depreciation of assets retired were \$5,639 and \$3,480, respectively. Of these retirements, cost and accumulated depreciation of \$1,681 and \$638, respectively, was for information system equipment and personal computers.

For the year ended December 31, 2002, the cost and accumulated depreciation of assets retired were \$2,278 and \$1,077, respectively. Of these retirements, cost and accumulated depreciation of \$2,213 and \$1,036, respectively, was for information system equipment and personal computers.

Notes to Consolidated Financial Statements *(continued)*
(dollars in thousands, except share and per share data)

For the year ended December 31, 2001, the cost and accumulated depreciation of assets retired were \$16,463 and \$6,770, respectively. Of these, the cost and accumulated depreciation of the World Trade Center assets that were written-off were \$14,703 and \$5,761, respectively. The cost and accumulated depreciation of all other assets retired, all of which was for information systems equipment and personal computers, was \$1,760 and \$1,009, respectively.

5. Claim Reserves

Activity in unpaid claims and certain claims adjustment expenses is summarized as follows:

Year ended December 31	2003	2002	2001
Balance as of January 1	\$ 563,224	\$ 634,130	\$ 672,419
Incurred related to:			
Current period	4,244,356	3,993,607	3,792,241
Prior periods	(82,110)	(46,225)	(53,420)
Total incurred	4,162,246	3,947,382	3,738,821
Paid related to:			
Current period	3,693,619	3,493,244	3,257,090
Prior periods	421,958	525,044	520,020
Total paid	4,115,577	4,018,288	3,777,110
Balance at end of period	\$ 609,893*	\$ 563,224*	\$ 634,130

*Includes \$402 and \$3,300 of premium deficiency reserve in WCINJ included in group and other contract liabilities as of December 31, 2003 and 2002, respectively.

The provision for claims and claims adjustment expenses attributable to prior year incurrals had a favorable development of \$82,110, \$46,225, and \$53,420 in 2003, 2002 and 2001 respectively, due to healthcare trends being lower than anticipated when the reserves were established. Moreover, actual claims payment lags were shorter than assumed in determining the reserves, due to continued improvement in the claim adjudication process. The favorable development in 2003 included \$34,882 of recoveries from the New York Market Stabilization Pools for Medicare Supplemental policies for Pool Years 2000, 2001 and 2002, and \$2,898 of amortization of the premium deficiency reserve in WCINJ. Additionally, the development of the prior years' claim liability impacts premiums for retrospectively rated contracts. Accordingly, the Company's favorable (unfavorable) development of \$25,118, (\$1,532) and \$46,416 in 2003, 2002, and 2001, respectively, on such contracts, was largely offset by decreases (increases) in premiums.

6. Income Taxes

The significant components of the provision for income tax (expense) benefit are as follows:

Year ended December 31	2003	2002	2001
Current tax expense	\$ (86,690)	\$ (83,526)	\$(34,963)
Deferred tax (expense) benefit	(55,806)	151,373	34,828
Income tax (expense) benefit	\$(142,496)	\$ 67,847	\$ (135)

A reconciliation of income tax computed at the federal statutory tax rate of 35% to total income tax is as follows:

Year ended December 31	2003	2002	2001
Income tax at prevailing corporate tax rate applied to pre-tax income	\$(120,268)	\$(108,049)	\$(45,890)
Increase (decrease):			
Change in valuation allowance	—	195,698	1,147
IRC Sec. 833(b) special deduction	—	—	54,249
State and local income taxes, net of federal income tax benefit	(8,933)	(5,077)	(88)
Other	(13,295)	(14,725)	(9,553)
Income tax (expense) benefit	\$(142,496)	\$ 67,847	\$ (135)

WellChoice and its subsidiaries file a consolidated federal income tax return. WellChoice currently has a tax sharing agreement in place with all of its subsidiaries. In accordance with the Company's tax sharing agreement, the Company's subsidiaries pay federal income taxes to WellChoice based on a separate company calculation.

Prior to 2002, EHC maintained a valuation allowance on its regular tax net operating loss carryforwards and certain other temporary differences due to uncertainty in its ability to utilize these assets within an appropriate period. The use of these assets was largely dependent on the conversion and future positive taxable income. Because the approval of EHC's plan of conversion by the New York State Insurance Department (the "Department"), removed the uncertainty of the conversion, the Company concluded in the third quarter of 2002 that the valuation allowance related to these assets was no longer necessary. Accordingly, the income tax benefit for 2002 includes the reversal of the valuation allowance of \$174,977 related to the Company's regular tax operating loss carryforwards.

As a result of the conversion to a for-profit accident and health insurance company in 2002, the Company adjusted its deferred tax assets for temporary differences related to Empire HealthChoice Assurance, Inc.'s liability for state and local taxes which resulted in the recognition of a \$5,374 deferred tax asset. In May 2003, the New York State Legislature enacted budget legislation that eliminates the net income portion of the New York State franchise tax applicable to every insurance company other than life insurance companies effective January 1, 2003. As a result, the Company's tax provision for 2003 was increased by \$5,374, reflecting the reversal of the previously recorded deferred tax asset.

Prior to January 1, 1987, EHC was exempt from federal income taxes. With the enactment of the Tax Reform Act of 1986, EHC, and all other Blue Cross and Blue Shield plans, became subject to federal

Notes to Consolidated Financial Statements *(continued)*
(dollars in thousands, except share and per share data)

income tax. Among other provisions of the Internal Revenue Code, these plans were granted a special deduction (the "833(b) deduction") for regular tax calculation purposes. As a result of the 833(b) deduction, EHC has incurred no regular tax liability but in profitable years, has paid taxes at the alternative minimum tax rate of 20%.

The 833(b) deduction is calculated as the excess of 25% of the incurred claims and claims adjustment expenses for the tax year over adjusted surplus, as defined, limited to taxable income. The amount of 833(b) deductions utilized in each tax year is accumulated in an adjusted surplus balance. Once the cumulative adjusted surplus balance exceeds the 833(b) deduction for the current taxable year, the deduction is eliminated.

During the fourth quarter of 2002, the Company reevaluated its tax position for financial statement purposes related to EHC's ability to utilize the Section 833(b) deduction and determined that when EHC converted to a for-profit entity, its ability to utilize the Section 833(b) deduction was uncertain. No authority directly addresses whether a conversion transaction will render the 833(b) deduction unavailable. The Company is aware, however, that the IRS has taken the position related to other Blue Cross Blue Shield plans that a conversion could result in the inability of a Blue Cross Blue Shield plan to utilize the 833(b) deduction. In light of the absence of governing authority, while the Company intends to continue to take the deduction on its tax returns after the conversion, the Company has assumed, for financial statement reporting purposes, that the deduction will be disallowed. Accordingly, the Company has utilized \$77,000 of regular operating loss carryforwards for financial statement purposes in excess of those utilized for tax purposes.

The Company's position with gross deferred tax assets and liabilities are as follows:

December 31	2003	2002
Deferred tax assets:		
Regular tax operating loss carryforwards	\$ —	\$ 57,593
Alternative minimum tax credit carryforward	149,801	134,064
Fixed assets	7,387	4,807
Loss reserve discounting	3,982	4,933
Post-retirement benefits other than pensions	49,960	50,308
Post-employment benefits	3,834	3,901
Bad debts	5,523	5,621
Deferred compensation	6,003	6,250
Unpaid expense accruals	14,339	10,858
Other temporary differences	5,739	21,366
Total deferred tax assets	246,568	299,701
Deferred tax liabilities:		
Unrealized gains on investments	8,705	12,339
Pension income adjustment	20,352	17,264
Bonds and bond discount	977	1,150
Total deferred tax liabilities	30,034	30,753
Net deferred tax assets	\$216,534	\$268,948

The Company's regular tax loss carryforwards for income tax purposes of \$259,000 expire between the years 2004 and 2023. The Company's alternative minimum tax credit carryforward for income tax purposes of \$191,000 has no expiration date.

The Company completed a study of the intangible assets, which existed at January 1, 1987 and has filed amended returns for 1989 and 1990 and 1996 claiming a refund for taxes paid. The Company is aware that the IRS and other Blue Cross Blue Shield plans are currently in litigation to determine whether intangible assets that existed at January 1, 1987 are entitled to tax basis and therefore are deductible in future years' tax returns. If the Company prevails, these potential future tax benefits of up to \$100,000 will be available to the Company. As of December 31, 2003 the Company has not recognized this potential benefit in its financial statements.

The Company paid federal income taxes of \$58,000, \$84,000 and \$13,349 in 2003, 2002 and 2001, respectively.

7. Information Technology Outsourcing

In June 2002, the Company entered into a ten-year outsourcing agreement with International Business Machines Corporation ("IBM"). Under the terms of the contract, IBM is responsible for operating the Company's data center, a portion of the core applications development and technical help desk. IBM has entered into a separate agreement to sublease the Company's data center. IBM's charges under the contract include personnel, calculated as a function of IBM's cost for personnel dedicated to the outsourcing; computer equipment, based on equipment usage rates; space, based on actual usage rates; and certain other costs.

IBM is expected to invoice the Company approximately \$586,100 over the remaining term of the agreement for operating the Company's data center and technical help desk as follows:

2004	\$ 84,900
2005	88,000
2006	74,800
2007	67,200
2008	65,200
2009	62,900
2010	60,400
2011	58,600
2012	24,100
Total	\$586,100

Notes to Consolidated Financial Statements *(continued)*
(dollars in thousands, except share and per share data)

The agreement provides for IBM to assist the Company in developing new IT systems. The original agreement required the Company to purchase \$65,000 of enhancement and modernization services and equipment from IBM over a five-year term. Effective September 2003, the agreement was amended and the Company's purchase obligation was reduced to \$55,000 and the term extended to seven years with a remaining target purchase rate as follows:

2004	\$14,826
2005	14,100
2006	9,900
2007	4,800
2008	1,200
Total	\$44,826

The Company may defer the purchase of services beyond the target date, provided that to the extent purchases are delayed more than one year beyond the target year, the Company shall pay a premium to IBM of 10% per annum of purchases so delayed.

In addition, the Company accelerated the repayment of price concessions of \$7,339 granted under the original contract. The refunding of the price concessions had no impact on the income statement. At December 31, 2003 and 2002 other liabilities include \$10,000 and \$11,143, respectively of cash flow concessions the Company has taken on monthly invoices from IBM. In accordance with the terms of the IBM contract the Company is required to repay these amounts in the future.

Additionally, IBM, in coordination with deNovis, Inc. ("deNovis"), has agreed to develop a new claims payment software system and to license it to the Company. Subject to the successful completion and acceptance of the claims payment system, the Company will pay a development and license fee of \$50,000. Under the terms of the contract with IBM, the Company will pay \$25,000 of this fee in four equal installments upon the achievement of specified milestones, the last of which is the Company's acceptance of the claims payment system. The achievement of these milestones is anticipated to occur in 2006. The remaining \$25,000 will be paid one year following the date the Company accepts the claims payment system. Following the expiration of the one-year warranty period that begins upon the payment of the final installment, the Company will pay IBM an annual fee of \$10,000 for maintenance and support services. Under the terms of the contract, the Company is entitled to 2% of IBM's gross revenues from licensing the claims payment system to third parties for the term of the IBM outsourcing contract, including any extensions. The Company will have no obligation to pay the development and license fee and the annual fee if the successful completion and delivery of the claims payment system does not occur.

The Company will own all software developed by IBM under the agreement, other than the claims payment system. All such software in which the Company will have all rights, title and interest will be accounted for in accordance with SOP 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use."

During 2002, in connection with the agreement, the Company sold computer equipment with a net book value of \$1,736 to IBM. No gain or loss on the sale of the computer equipment was recognized. Also in connection with the agreement, the Company licensed to IBM its Internet portal technology for an upfront initial license fee of \$2,000. In accordance with SOP 98-1, the Company applied the proceeds from the license of the Internet portal technology to the book value of the assets and no gain or loss was recorded. Under the agreement, IBM has the right to sublicense the Internet portal technology to third parties and the Company will receive 4% of IBM's gross revenues from its licensing for fifteen years. The Company received no licensing revenue for the years ended December 31, 2003 and 2002.

The outsourcing agreement can be terminated by either the Company or IBM in certain circumstances for cause without penalty. The Company can terminate the contract without cause after two years or if it experiences a change in control and, in such instances, would be obligated to pay certain termination costs, which vary based on the duration of the contract but are significant in the early years, to IBM. During the term of the agreement, the Company may not perform the outsourced services itself or through a third party without the consent of IBM.

During the second quarter of 2002, in connection with the IBM outsourcing, the Company began the implementation of a restructuring plan relating to its information technology personnel. Certain employees were involuntarily terminated in accordance with a plan of termination, certain employees were retained by the Company and certain employees were transitioned to IBM. Severance and other costs accrued at June 30, 2002 relating to the plan of termination were \$5,351. Payments related to these costs of approximately \$4,889 were made through December 31, 2003. To help retain its employees and to help IBM retain its newly transitioned employees, the Company offered stay bonuses for these individuals. The estimated maximum cost of these bonuses assuming all individuals remain with the Company or IBM through the required dates, which range from 2003 to 2004, is approximately \$8,518. The Company recognizes the cost of these stay bonuses as these employees provide service. For the years ended December 31, 2003 and 2002, approximately \$4,571 and \$3,889, respectively, was expensed for these bonuses. Through December 31, 2003, payments of \$3,993 were made.

8. Restructuring

In November 2002, as part of the Company's continuing focus on increasing overall productivity, and in part as a result of the implementation of the technology outsourcing strategy, the Company continued streamlining certain operations and adopted a plan to terminate approximately 500 employees across all segments of its business. Severance and other costs of \$13,472 were accrued relating to the plan for the year ended December 31, 2002. Through December 31, 2003, payments related to these costs of \$13,180 were made. In an effort to facilitate the restructuring plan certain employees were offered stay bonuses. The Company recognizes the cost of these stay bonuses as these employees provide service. For the years ended December 31, 2003 and 2002, approximately \$788 and \$243, respectively, was expensed for these bonuses. Through December 31, 2003, payments of \$501 were made.

Notes to Consolidated Financial Statements *(continued)*

(dollars in thousands, except share and per share data)

9. Statutory Information

Insurance companies, including HMOs are subject to certain Risk-Based Capital ("RBC") requirements as specified by the National Association of Insurance Commissioners (the "NAIC"). Under those requirements, the amount of capital and statutory-basis surplus maintained by an insurance company is to be determined based on the various risk factors related to it. At December 31, 2003, EHCA and each of its wholly-owned insurance subsidiaries met the RBC requirements.

EHCA and its subsidiaries are subject to minimum capital requirements under the state insurance laws. Combined statutory-basis surplus of EHCA and its subsidiaries at December 31, 2003 and 2002 of \$935,995 and \$819,756, respectively, exceeded their respective requirements. Combined statutory-basis net income of EHCA and its subsidiaries was \$259,340, \$316,936 and \$114,462, for the years ended December 31, 2003, 2002 and 2001, respectively.

In accordance with the rules of the Department, the maximum amount of dividends which can be paid by the Company's subsidiaries without approval of the Department is subject to restrictions relating to statutory surplus and adjusted net income or adjusted net investment income.

On June 30, 2003 and November 8, 2002 WellChoice received a dividend payment from its subsidiary, EHCA, in the amount of \$140,000 and \$225,000 respectively. The dividend payments were approved by the Department. No dividends were received or paid during the year ended December 31, 2001.

EHCA made cash contributions to its HMO and insurance subsidiaries of approximately, \$65,000 and \$10,000 during 2002 and 2001, respectively. The capital contributions were made to ensure that each subsidiary had sufficient surplus under applicable BCBSA and state licensing requirements. There were no cash contributions made during 2003.

In 2003, WellChoice began the process of dissolving ENASCO. In connection with the dissolution, WellChoice transferred the investment interest in NASCO to EHCA in the form of a capital contribution. EHCA immediately transferred the NASCO investment interest to WCINJ in the form of a capital contribution.

10. Contingencies

The Company is subject to a number of lawsuits, investigations and claims, some of which are class actions arising out of the conduct of its business. The Company believes that it has meritorious defenses in all of these matters and intends to vigorously defend its respective positions. The outcome of these matters is not currently predictable and the damages, if any, are also uncertain. The Company is also involved in and is subject to numerous claims, contractual disputes and uncertainties in the ordinary course of business. In the opinion of management, after consultation with legal counsel, the ultimate disposition of these matters will not have a material adverse effect on the Company's consolidated financial condition or results of operations.

In June 2002, the Company settled a class action lawsuit for an estimated \$23,000 in claims and legal fees. During the period from June 2002 to September 2002, the members of the class were informed of their right to receive payment, were required to respond, and the payments due to respondents were determined. Based on the number of respondents to the class action mailing through August 24, 2002 and the Company's estimate of the number of late respondents to the mailing, the Company revised its

best estimate of the ultimate liability for this action to \$14,600. This change in estimate has been recorded in the consolidated financial statements for year ended December 31, 2002. At December 31, 2003 unpaid claims and claims adjustments expense included \$150 related to this estimate.

In October 2003, the Company renewed its existing credit and guaranty agreement with The Bank of New York, as Issuing Bank and Administrative Agent, and several other financial institutions as agents and lenders, which provides the Company with a credit facility. The Company is able to borrow under the credit facility for general working capital purposes. The total outstanding amounts under the credit facility cannot exceed \$100,000. The facility has a term of 364 days with a current maturity date of October 15, 2004, subject to extension for additional periods of 364 days with the consent of the lenders. Borrowings under the facility will bear interest, at the Company's option, at The Bank of New York's prime commercial rate (or, if greater, the federal funds rate plus 0.50%) as in effect from time to time plus a margin of between zero and 1.0%, or LIBOR plus a margin of between 1.125% and 2.250%, with the applicable margin to be determined based on our financial strength rating. As of December 31, 2003, there were no funds drawn against this line of credit.

The Company also maintains a \$607 secured letter of credit from HSBC Bank USA to support one of its rental lease obligations.

11. Commitments

The Company leases office facilities and equipment under capital and operating lease arrangements. Future minimum payments for capital leases and noncancelable operating leases, including escalation clauses, as of December 31, 2003 are as follows:

	Capital Leases	Operating Leases
2004	\$12,401	\$ 35,602
2005	12,686	30,494
2006	12,882	31,780
2007	13,126	31,385
2008	13,418	31,499
Future years	23,752	275,844
Net minimum lease payment	88,265	<u>\$436,604</u>
Less:		
Interest	26,902	
Maintenance, taxes, etc.	13,018	
Present value of minimum lease payments	<u>\$48,345</u>	

The average imputed interest rate on the capital leases was 14% in 2003. Rent expense under operating leases was \$46,762, \$54,082 and \$50,540 for the years ended December 31, 2003, 2002 and 2001, respectively.

The schedule above includes rent commitments for the Company's Staten Island facility. However, as part of the information technology outsourcing agreement with IBM (see footnote 7), the Company

Notes to Consolidated Financial Statements *(continued)*

(dollars in thousands, except share and per share data)

entered into a sublease agreement with IBM for this property. The Company expects to receive net sublease income of approximately \$1,436 per year until 2012.

During the third quarter of 2003, management determined that based on current and projected occupancy requirements, the Company would not receive economic benefit from certain unoccupied leased office space.

The Company recognized an administrative expense of \$13,367 for the year ended December 31, 2003, representing the net present value difference between the fair value of estimated sublease rentals and the remaining lease obligation for this space. At December 31, 2003, \$12,764 of these costs are included in other liabilities.

12. Related Party Transactions

Administrative expenses incurred related to NASCO services totaled \$17,818, \$14,673 and \$13,281 for the years ended December 31, 2003, 2002 and 2001, respectively. Accounts payable as of December 31, 2003 and 2002, includes amounts due to NASCO of \$1,919 and \$3,515, respectively.

Active Health Management, Inc., ("AHM") an entity in which the Company has a 0.8% ownership interest, provides certain medical management services to the Company. Administrative expenses incurred related to AHM services totaled \$3,521, \$5,882 and \$4,869 for the years ended December 31, 2003, 2002 and 2001, respectively. There are no accounts payable as of December 31, 2003 and 2002, due to AHM.

An Executive Vice President of a labor union account was a member of the Company's Board of Directors until June 2003. For the years ended December 31, 2003, 2002 and 2001, the Company earned premium revenue \$17,793, \$18,019 and \$16,280, respectively from the union. Billed premiums receivable at December 31, 2003 and 2002 includes amounts due from the union of \$2,058 and \$2,730, respectively. In addition, the Company recorded administrative service fees revenue of \$2,384, \$2,957 and \$2,863 for the years ended December 31, 2003, 2002, and 2001. Other amounts due from customers at December 31, 2003 and 2002 includes \$829 and \$856 for service fees due from the union.

A member of the Company's Board of Directors is an Executive Vice President and Chief Operating Officer of a provider in our network. For the years ended December 31, 2003, 2002 and 2001, the Company made payments to the provider in the amount of \$130,605, \$101,998 and \$82,523, respectively, for the reimbursement of claims to this provider.

A physician in a group practice, which is a provider in our network, was a member of the Company's Board of Directors until June 2003. For the years ended December 31, 2003, 2002 and 2001, the Company made payments in the amount of \$309, \$313 and \$330, respectively, to this group practice for the reimbursement of claims.

13. Insurance Proceeds

In December 2002, the Company and its insurance carrier settled the Company's business property protection and blanket earnings and extra expense claim related to loss of the Company's offices located at the World Trade Center for \$74,000. During 2002 and 2001, the Company recorded gains

related to the business property portion of the claim of \$7,959 and \$6,784, respectively, which were included in other income. Administrative expense for the year ended December 31, 2002 includes a gain of \$19,300 representing extra expense settlement proceeds for items expensed in 2001 and extra expenses that have not yet been incurred. Administrative expense for the year ended December 31, 2001 includes expenses of \$3,535 related to the Company's recovery efforts.

14. Pension Benefits

The Company had several noncontributory, defined benefit pension plans covering substantially all of its employees. In May 1998, the Company's Board of Directors approved a consolidation of the Company's defined benefit pension plans into one "cash balance" defined benefit plan (the "Cash Balance Plan"). The redesigned plan, effective January 1, 1999, provides employees with an opening balance based on the previous benefits attributed to the employee under prior plans with increases through contributions by the Company based on the employee's age and length of service. The benefit provided at retirement is the sum of all contributions and interest earned.

Prior to the redesign, the Company's pension benefits were provided through three plans. Although the manner in which these plans were funded differed, the benefits relating to each were similar.

As part of the consolidation of the plans, the Cash Balance Plan assumed the assets and benefit obligations of the previous plans, some of which were previously retained by an insurer under an annuity purchase contract. As a result of the consolidation of the plans, the Company is amortizing the amount of the plan assets in excess of the benefit obligation assumed from the insurer, \$116,865 over the average remaining service life of plan participants (10.5 years).

The effect of the change in pension benefits reduced the benefit obligation by \$20,606 which will be amortized over the remaining service life of the Cash Balance Plan members (13 years).

The Company also has an unfunded, nonqualified supplemental plan to provide benefits in excess of ERISA limitations on recognized salary or benefits payable from the qualified pension plans and the Company's Deferred Compensation Plan and Executive Savings Plan. This supplemental plan is accounted for using the projected unit credit actuarial cost method.

Notes to Consolidated Financial Statements *(continued)*
(dollars in thousands, except share and per share data)

The following table sets forth the plans' change in the actuarially determined benefit obligation, plan assets and information on the plan's funded status.

December 31	2003	2002
Change in benefit obligation		
Benefit obligation at beginning of period	\$400,268	\$368,042
Service cost	16,307	15,977
Interest cost	23,760	26,144
Plan amendments	—	11
Actuarial (gain) loss	(7,806)	33,563
Benefits paid	(39,458)	(43,469)
Benefit obligation at end of period	393,071	400,268
Change in plan assets		
Fair value of plan assets at beginning of period	450,977	467,523
Actual return on plan assets	33,916	27,641
Administrative expenses	(870)	(900)
Employer contributions	945	182
Benefits paid	(39,457)	(43,469)
Fair value of plan assets at end of period	445,511	450,977
Information on funded status and amounts recognized		
Funded status	\$ 52,440	\$ 50,709
Unrecognized net transition asset	(525)	(715)
Unrecognized prior service credits	(58,263)	(70,951)
Unrecognized net loss from past experience different from that assumed	59,863	66,166
Prepaid benefit cost	\$ 53,515	\$ 45,209

Based on the funded status of the pension plan, the Company does not anticipate any contributions to be made during 2004 for the Cash Balance Plan. The Company expects to contribute approximately \$126 to the non-qualified plan in 2004.

Actuarial assumptions used were as follows:

December 31	2003	2002
Discount rate	6.5%	7.0%
Rate of increase in future compensation levels	4.0	4.0
Expected long-term rate of return	7.5	8.0

As of December 31, 2003 measurement date the expected long-term rate of return on assets assumption is 7.5%. As defined in SFAS No. 87, this assumption represents the rate of return on plan assets reflecting the average rate of earnings expected on the funds invested or to be invested to provide for the benefits included in the benefit obligation. The assumption has been determined by reflecting expectations regarding future rates of return for the investment portfolio, with consideration given to the distribution of investments by asset class and historical rates of return for each individual asset class.

The following table sets forth the percentage of total plan assets for each major category of assets:

December 31	2003	2002
Asset allocation by asset class		
Equity securities	25.4%	21.3%
Debt securities	74.6	78.7
Total	100.0%	100.0%

The plan is diversified across three broad asset classes—large cap equity, international equity and domestic fixed income with the target allocation of 20% to large cap, 5% to international equities and the remaining 75% to fixed income. The Pension committee has retained the services of investment managers to implement the Plan's strategies.

Net pension income for the actuarially developed plans included the following components:

Year ended December 31	2003	2002	2001
Service cost	\$ 16,307	\$ 15,977	\$ 14,443
Interest cost on projected benefit obligation	23,760	26,144	23,783
Expected return on plan assets	(34,590)	(36,054)	(33,984)
Net amortization and deferral	(12,836)	(12,070)	(12,894)
Net pension income	\$ (7,359)	\$ (6,003)	\$ (8,652)

The Company administers two noncontributory defined contribution plans offering employees the opportunity to accumulate funds for their retirement. The Deferred Compensation Plan, which is closed to new contributions, and the Executive Savings Plan are nonqualified plans designed to provide executives with an opportunity to defer a portion of their base salary and/or incentive compensation. At December 31, 2003, the plan assets of \$16,515 are included as components of cash and investments and an offsetting liability to plan participants is included in other liabilities.

The Company also administers a contributory 401(k) Deferred Savings Plan which is offered to all eligible employees. The Company matches contributions of participating employees; 50% of the first 6% of employee contributions or \$5,247, \$5,921 and \$5,880 for the years ended December 31, 2003, 2002 and 2001, respectively.

15. Other Postretirement Employee Benefits

In addition to pension benefits, the Company provides certain healthcare and life insurance benefits for retired employees. Substantially all employees may become eligible for those benefits if they reach retirement age while working for the Company.

Notes to Consolidated Financial Statements *(continued)*
(dollars in thousands, except share and per share data)

The change in benefit obligation, plan assets and information on the plans' funded status and the components of the net periodic benefit cost are as follows:

December 31	2003	2002	
Change in benefit obligation			
Benefit obligation at beginning of period	\$ 120,726	\$ 124,481	
Service cost	1,597	1,500	
Interest cost	6,975	7,686	
Actuarial gain	(2,457)	(7,154)	
Benefits paid	(9,030)	(5,787)	
Benefit obligation at end of period	117,811	120,726	
Change in plan assets			
Fair value of plan assets at beginning of period	—	—	
Employer contributions	9,030	5,787	
Benefits paid	(9,030)	(5,787)	
Fair value of plan assets at end of period	—	—	
Information on funded status and amounts recognized			
Funded status	(117,811)	(120,726)	
Unrecognized net actuarial gain	(63,647)	(66,027)	
Unrecognized transition obligation	38,715	43,017	
Accrued postretirement benefit cost	\$(142,743)	\$(143,736)	
December 31			
	2003	2002	2001
Components of net periodic benefit cost			
Service cost	\$ 1,597	\$ 1,500	\$ 1,639
Interest cost	6,975	7,686	8,434
Amortization of transition obligation	4,302	4,301	4,302
Amortization of actuarial gain	(4,837)	(4,699)	(4,738)
Net periodic postretirement benefit cost	\$ 8,037	\$ 8,788	\$ 9,637

Actuarial gains or losses for postretirement life and health benefits are recorded separately when they exceed 10% of their respective accumulated postretirement benefit obligations and, at that time, the entire amount of the gain is amortized over the period in which eligibility requirements are fulfilled (20 years).

The actuarial assumptions used for determining the accumulated postretirement benefit obligation as measured on December 31, 2003 and 2002 are as follows:

December 31	2003	2002
Weighted-average discount rate	6.5%	7.0%
Healthcare trend rates:		
Participants under age 65 in EPO and PPO Plans	10.0%–4.5%	11.0%–4.5%
Participants under age 65 in other plans	10.0%–4.5%	11.0%–4.5%
Participants age 65 and over in Medicare HMOs	30.7%–4.5%	21.9%–4.5%
Participants age 65 and over in Indemnity Plans	9.0%–4.5%	10.0%–4.5%
Caps on Company paid portion of healthcare premiums for participants who retire on or after May 1, 1996 (in whole dollars):		
Participants age 65 and older with Medicare Carve-out Plans	\$2,358	\$2,358
Participants under age 65 with POS—Point of Service Plans	\$4,926	\$4,926

The trend rate ranges shown indicate the trend rates will decrease 1.0% annually, other than the Medicare HMO and the Indemnity Plan, until ultimately leveling out at 4.5%. The annual trend rate for the Medicare HMO is 30.7%, 22.8%, and 10.1% for the next three years and then decreases annually until ultimately leveling out at 4.5%. The annual trend rate for the Indemnity Plan is 9.0% and 8.0% for the next two years and then decreases 1.0% annually until ultimately leveling out at 4.5%.

The healthcare cost trend rate assumptions have a significant effect on the amounts reported. Increasing and decreasing the assumed healthcare cost trend rates by one percentage point in each year would increase and decrease the postretirement benefit obligation as of December 31, 2003 by \$6,890 and \$6,174, respectively, and increase and decrease the service and interest cost components of net periodic postretirement benefit cost for December 31, 2003 by \$445 and \$405, respectively.

16. Concentration of Business

The Company's business is concentrated in New York and New Jersey, with more than 98% of its premium revenue received from New York business. As a result, future acts of terrorism, changes in regulatory, market or healthcare provider conditions in either of these states, particularly New York, could have a material adverse effect on the Company's business, financial condition or results of operations.

The Company earns revenue from its contracts with the Center for Medicare and Medicaid Services (CMS), the federal agency that administers the Medicare program. Specifically, the Company has a contract with CMS to provide HMO Medicare+Choice coverage to Medicare beneficiaries in certain New York counties and the Company has a contract to serve as fiscal intermediary for the Medicare Part A program and a carrier for the Medicare Part B program (collectively, referred to as "Medicare Services"). The Company's Medicare+Choice product and Medicare Services represented 9% and 27% of total premium earned and administrative service fee revenue, respectively, during 2003.

The Company earns revenue from its contracts to provide healthcare services to New York State and New York City employees. The New York State and New York City PPO business represented approximately 18% and 14% of total premium earned, respectively, during 2003.

Notes to Consolidated Financial Statements *(continued)*
(dollars in thousands, except share and per share data)

17. Segment Information

WellChoice has two reportable segments: commercial managed care and other insurance products and services. The commercial managed care segment includes group PPO, HMO (including Medicare+Choice), EPO and other products, as well as the Company's New York City and New York State PPO business. The other insurance products and services segment consists of the Company's traditional indemnity products, Medicare supplemental, individual hospital only, state sponsored individual plans, government mandated individual plans and government contracts with CMS to act as a fiscal intermediary for Medicare Part A program beneficiaries and as a carrier for Medicare Part B program beneficiaries.

Income from continuing operations before income tax expense for the period ended December 31, 2003 include administrative expenses of \$10,717 and \$2,650, for the managed care and other insurance products and services segments, respectively, related to unoccupied leased office space, see footnote 11.

The reportable segments follow the Company's method of internal reporting by products and services. The financial results of the Company's segment are presented consistent with the accounting policies described in Note 2. Administrative expenses, investment income, and other income, but not assets, are allocated to the segments. There are no intersegment sales or expenses.

The following table presents information by reportable segment:

	Commercial Managed Care	Other Insurance Products and Services	Total
Year ended December 31, 2003			
Revenues from external customers	\$4,373,643	\$ 947,602	\$5,321,245
Investment income and net realized gains	52,885	10,149	63,034
Other loss	(1,450)	(274)	(1,724)
Income from continuing operations before income tax expense	292,667	50,955	343,622
Year ended December 31, 2002			
Revenues from external customers	3,935,234	1,089,004	5,024,238
Investment income and net realized gains	54,047	13,363	67,410
Other revenue	11,272	2,740	14,012
Income from continuing operations before income tax expense	253,424	56,344	309,768
Year ended December 31, 2001			
Revenues from external customers	3,401,900	1,166,252	4,568,152
Investment income and net realized gains	41,704	15,249	56,953
Other revenue	4,667	1,434	6,101
Income from continuing operations before income tax expense	121,113	26,452	147,565

The following table presents our revenue from external customers by products and services:

Year ended December 31	2003	2002	2001
Revenues from external customers:			
Commercial managed care:			
Premiums earned:			
PPO	\$2,561,614	\$2,349,911	\$2,016,580
HMO	1,231,239	1,133,637	948,865
EPO	297,891	234,112	250,651
Other	8,764	5,343	31,719
Administrative service fees	274,135	212,231	154,085
Total commercial managed care	4,373,643	3,935,234	3,401,900
Other insurance products and services			
Premiums earned:			
Indemnity	312,519	397,175	489,947
Individual	463,353	507,857	508,406
Administrative service fees	171,730	183,972	167,899
Total other insurance products and services	947,602	1,089,004	1,166,252
Total revenues from external customers	\$5,321,245	\$5,024,238	\$4,568,152

18. Stock Compensation

The Company's incentive plan provides for the grant of stock options, stock appreciation rights, restricted stock awards, restricted stock units and cash awards. On March 26, 2003, the Company's Board of Directors adopted the 2003 Omnibus Incentive Plan (the "2003 Incentive Plan"). In accordance with the 2003 Incentive Plan the maximum of 6,250,000 shares of common stock may be issued, including 1,875,000 shares solely for issuance under grants of restricted stock awards and restricted stock units. A maximum of 500,000 shares may be issued to non-employee Directors. Awards are granted by the Compensation Committee of the Board of Directors. Options vest and expire over terms set by the Committee at the time of grant.

Notes to Consolidated Financial Statements *(continued)*
(dollars in thousands, except share and per share data)

Stock Option Grants

In accordance with the 2003 Incentive Plan, the Company's Compensation Committee granted options to purchase shares of common stock to the Company's Officers and Directors at the fair market value at the date of grant. These options generally vest over a three-year vesting period and expire ten years after the grant date. A summary of the stock option activity for the year ended December 31, 2003 is as follows:

	Number of Options	Weighted-Average Exercise Price per share
Balance at January 1, 2003	—	—
Granted	790,981	\$31.05
Balance at December 31, 2003	790,981	\$31.05

There were no options exercised, forfeited or expired for the year ended December 31, 2003. No stock options were granted or outstanding prior to 2003.

Information about stock options outstanding at December 31, 2003 is summarized as follows:

Range of Exercise Prices	Options Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price
\$31.03–\$34.85	790,981	9.88	\$31.05

There were no options exercisable as of December 31, 2003.

Restricted Stock Awards

During 2003, the Company granted 185,969 shares of the Company's stock as restricted stock awards to certain eligible executives valued at the fair value of the stock on the grant date with no cost to the employee. Restricted stock awards generally vest over a three-year period. The fair value of these awards is being amortized to compensation expense over the vesting period. Administrative expense for the year ended December 31, 2003 includes \$497 of compensation expense related to these awards. Unearned restricted stock compensation as of December 31, 2003 includes \$5,274 related to the restricted stock awards.

Restricted Stock Unit Awards

In 2003, the Company granted 27,076 shares of common stock as restricted unit awards to non-employee members of the Board of Directors. Stock Units are settled in shares of WellChoice common stock and dividend equivalents. The restricted stock unit award will 100% vest on February 1, 2005 provided the grantee serves as a Director and has not terminated other than due to retirement prior to the vesting date. The fair value of the restricted unit awards is being amortized to compensation expense over the vesting period. Administrative expense for the year ended December 31, 2003 includes \$87 of compensation expense related to these awards. Unearned restricted stock compensation as of December 31, 2003 includes \$753 related to the restricted stock units.

19. Earnings Per Share

The denominator for basic and diluted earnings per share for 2003, and for the period from November 7, 2002 (date of for-profit conversion and initial public offering) through December 31, 2002 is as follows:

	2003	2002
Denominator for basic earnings per common share—weighted-average shares	83,490,478	83,490,478
Effect of dilutive securities—employee and director stock options and non-vested restricted stock awards	27,689	—
Denominator for diluted earnings per common share	83,518,167	83,490,478

Weighted-average shares used for basic earnings per share assumes that shares issued in the initial public offering were issued on the effective date of the initial public offering. Weighted-average shares used for basic earnings per share also assumes that adjustments, if any, to the common stock issued in the initial public offering occurred at the beginning of the quarter in which changes were identified.

There were no shares or dilutive securities outstanding prior to the for-profit conversion and initial public offering. For comparative pro forma earnings per share presentation, the weighted-average shares outstanding and the effect of dilutive securities for the period from November 7, 2002 to December 31, 2002, are shown above.

Stock options, restricted stock awards, and restricted stock units are not considered outstanding in computing the weighted-average number of shares outstanding for basic earnings per share. Stock options and restricted stock awards are included, from the grant date, in determining diluted earnings per share using the treasury stock method. The stock options are dilutive in periods when the average market price exceeds the grant price. The restricted stock unit awards are dilutive when the aggregate fair value exceeds the amount of unearned compensation remaining to be amortized.

Notes to Consolidated Financial Statements *(continued)*
(dollars in thousands, except share and per share data)

20. Quarterly Financial Data (Unaudited)

The following unaudited quarterly financial data are presented on a consolidated basis for each of the years ended December 31, 2003 and 2002.

Quarter ended	March 31	June 30	September 30	December 31
2003 Data				
Total revenues	\$1,292,078	\$1,374,511	\$1,339,339	\$1,376,627
Income from continuing operations before income tax expense	82,983	85,436	87,461	87,742
Net income	47,741	48,775	52,058	52,552
Basic and diluted net income per common share	\$0.57	\$0.59	\$0.62	\$0.63
Shares used to compute basic earnings per share, based on weighted-average shares outstanding for the quarter	83,490,478	83,490,478	83,490,478	83,490,478
Shares used to compute dilutive earnings per share, based on weighted-average shares outstanding for the quarter	83,490,478	83,490,478	83,490,478	83,892,582
2002 Data				
Total revenues	\$1,280,100	\$1,321,642	\$1,221,204	\$1,282,714
Income from continuing operations before income tax expense	79,704	60,092	87,224	82,748
Income from continuing operations	79,681	60,095	254,409	(16,570)
Loss from discontinued operations	(1,050)	(6)	—	—
Net income (loss)	78,631	60,089	254,409	(16,570)
Net loss for the period from November 7, 2002 (date of initial public offering) to December 31, 2002				(38,542)
Basic and diluted net loss per common share for the period from November 7, (date of initial public offering) to December 31, 2002				(0.46)
Shares used to compute earnings per share, based on weighted-average shares outstanding November 7, 2002 (date of conversion and initial public offering) to December 31, 2002				83,333,244

For the quarter ended September 30, 2002, income from continuing operations includes a deferred tax benefit of \$167,185 primarily resulting from the reversal of the valuation allowance for deferred tax assets. For the quarter ended December 31, 2002, loss from continuing operations includes income tax expense of \$99,318 primarily resulting from the elimination of the section 833(b) deduction that had previously been assumed during the first three quarters of 2002. Refer to footnote 6.