WELLPOINT, INC
Form 10-Q
April 28, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period ended March 31, 2010

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission file number: 001-16751

WELLPOINT, INC.

(Exact name of registrant as specified in its charter)

INDIANA	**35-2145715**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**
120 MONUMENT CIRCLE; INDIANAPOLIS, INDIANA	**46204-4903**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (317) 488-6000

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for at least the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer , accelerated filer , and smaller reporting company in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer	x	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date:

Title of Each Class	**Outstanding at April 15, 2010**
Common Stock, $0.01 par value	**427,187,403 shares**

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WellPoint, Inc.

Quarterly Report on Form 10-Q

For the Period Ended March 31, 2010

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

WellPoint, Inc.

Consolidated Balance Sheets

(In millions, except share data)	March 31, 2010 (Unaudited)	December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	$ 3,526.2	$ 4,816.1
Investments available-for-sale, at fair value:		
Fixed maturity securities (amortized cost of $15,031.7 and $15,203.1)	15,601.1	15,696.9
Equity securities (cost of $793.9 and $799.1)	1,056.6	1,010.7
Other invested assets, current	19.3	26.5
Accrued investment income	170.7	172.8
Premium and self-funded receivables	3,298.6	3,281.0
Other receivables	1,038.1	879.5
Securities lending collateral	600.5	394.8
Deferred tax assets, net	481.6	523.8
Other current assets	1,323.8	1,268.6
Total current assets	27,116.5	28,070.7
Long-term investments available-for-sale, at fair value:		
Fixed maturity securities (amortized cost of $222.4 and $223.0)	229.6	230.4
Equity securities (cost of $32.4 and $33.4)	31.9	32.5
Other invested assets, long-term	802.4	775.3
Property and equipment, net	1,144.5	1,099.6
Goodwill	13,265.7	13,264.6
Other intangible assets	8,177.8	8,259.3
Other noncurrent assets	412.5	393.0
Total assets	$ 51,180.9	$ 52,125.4
Liabilities and shareholders equity		
Liabilities		
Current liabilities:		
Policy liabilities:		
Medical claims payable	$ 5,487.3	$ 5,450.5
Reserves for future policy benefits	59.4	62.6
Other policyholder liabilities	1,652.9	1,617.6
Total policy liabilities	7,199.6	7,130.7
Unearned income	1,117.7	1,050.0
Accounts payable and accrued expenses	2,686.7	2,994.1
Income taxes payable	380.8	1,228.7
Security trades pending payable	263.6	37.6
Securities lending payable	602.0	396.6
Current portion of long-term debt	759.9	60.8
Other current liabilities	1,800.2	1,775.2
Total current liabilities	14,810.5	14,673.7
Long-term debt, less current portion	7,630.4	8,338.3
Reserves for future policy benefits, noncurrent	663.8	664.6
Deferred tax liabilities, net	2,501.0	2,470.4
Other noncurrent liabilities	1,056.0	1,115.1

Total liabilities		26,661.7		27,262.1
Commitments and contingencies Note 10				
Shareholders equity				
Preferred stock, without par value, shares authorized 100,000,000; shares issued and outstanding none				
Common stock, par value $0.01, shares authorized 900,000,000; shares issued and outstanding: 431,360,762 and 449,789,672		4.3		4.5
Additional paid-in capital		14,552.5		15,192.2
Retained earnings		9,795.6		9,598.5
Accumulated other comprehensive income		166.8		68.1
Total shareholders equity		24,519.2		24,863.3
Total liabilities and shareholders equity	$	51,180.9	$	52,125.4

See accompanying notes.

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WellPoint, Inc.

Consolidated Statements of Income

(Unaudited)

(In millions, except per share data)	Three Months Ended March 31 2010	2009
Revenues		
Premiums	$ 13,909.9	$ 14,203.2
Administrative fees	952.9	941.5
Other revenue	5.9	154.0
Total operating revenue	14,868.7	15,298.7
Net investment income	201.1	197.1
Net realized gains (losses) on investments	48.4	(47.5)
Other-than-temporary impairment losses on investments:		
Total other-than-temporary impairment losses on investments	(27.9)	(305.0)
Portion of other-than-temporary impairment losses recognized in other comprehensive income	8.2	
Other-than-temporary impairment losses recognized in income	(19.7)	(305.0)
Total revenues	15,098.5	15,143.3
Expenses		
Benefit expense	11,381.4	11,724.4
Selling, general and administrative expense:		
Selling expense	402.4	432.0
General and administrative expense	1,798.2	1,796.9
Total selling, general and administrative expense	2,200.6	2,228.9
Cost of drugs		112.4
Interest expense	99.4	116.1
Amortization of other intangible assets	60.7	67.9
Impairment of other intangible assets	21.1	
Total expenses	13,763.2	14,249.7
Income before income tax expense	1,335.3	893.6
Income tax expense	458.5	313.2
Net income	$ 876.8	$ 580.4
Net income per share		
Basic	$ 1.99	$ 1.17
Diluted	$ 1.96	$ 1.16

See accompanying notes.

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WellPoint, Inc.

Consolidated Statements of Cash Flows

(Unaudited)

(In millions)	Three Months Ended March 31 2010	2009
Operating activities		
Net income	$ 876.8	$ 580.4
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Net realized (gains) losses on investments	(48.4)	47.5
Other-than-temporary impairment losses recognized in income	19.7	305.0
(Gain) loss on disposal of assets	(0.5)	0.3
Deferred income taxes	40.2	(10.5)
Amortization, net of accretion	111.9	109.6
Impairment of other intangible assets	21.1	
Depreciation expense	27.6	26.1
Share-based compensation	14.1	24.8
Excess tax benefits from share-based compensation	(21.6)	(0.7)
Changes in operating assets and liabilities, net of effect of business combinations:		
Receivables, net	(279.8)	(486.1)
Other invested assets, current	7.0	13.8
Other assets	(74.5)	(7.5)
Policy liabilities	68.1	31.2
Unearned income	67.7	65.4
Accounts payable and accrued expenses	(288.8)	120.3
Other liabilities	(21.2)	16.8
Income taxes	(830.3)	347.1
Other, net	(12.0)	8.5
Net cash (used in) provided by operating activities	(322.9)	1,192.0
Investing activities		
Purchases of fixed maturity securities	(1,642.1)	(2,051.0)
Proceeds from fixed maturity securities:		
Sales	960.6	869.5
Maturities, calls and redemptions	1,213.7	289.5
Purchases of equity securities	(37.4)	(31.3)
Proceeds from sales of equity securities	45.6	168.4
Purchases of other invested assets	(28.8)	(18.8)
Proceeds from sales of other invested assets	7.4	0.9
Changes in securities lending collateral	(205.4)	54.9
Purchases of subsidiaries, net of cash acquired	(0.3)	(1.1)
Purchases of property and equipment	(120.2)	(68.9)
Proceeds from sales of property and equipment	3.1	0.2
Other, net	(4.3)	(3.2)
Net cash provided by (used in) investing activities	191.9	(790.9)
Financing activities		
Net proceeds from (repayments of) commercial paper borrowings	0.1	(273.1)
Repayment of long-term borrowings	(15.1)	(228.1)
Proceeds from long-term borrowings		990.3
Net proceeds from short-term borrowings		2.0
Changes in securities lending payable	205.4	(54.9)
Changes in bank overdrafts	(50.8)	19.5
Repurchase and retirement of common stock	(1,388.4)	(681.2)
Proceeds from exercise of employee stock options and employee stock purchase plan	69.5	17.9

Excess tax benefits from share-based compensation	21.6	0.7
Net cash used in financing activities	(1,157.7)	(206.9)
Effect of foreign exchange rates on cash and cash equivalents	(1.2)	
Change in cash and cash equivalents	(1,289.9)	194.2
Cash and cash equivalents at beginning of period	4,816.1	2,183.9
Cash and cash equivalents at end of period	$ 3,526.2	$ 2,378.1

See accompanying notes.

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WellPoint, Inc.

Consolidated Statements of Shareholders Equity

(Unaudited)

(In millions)

	Common Stock					
					Accumulated	
	Number of Shares	Par Value	Additional Paid-in Capital	Retained Earnings	Other Comprehensive Income (Loss)	Total Shareholders Equity
January 1, 2010	449.8	$ 4.5	$ 15,192.2	$ 9,598.5	$ 68.1	$ 24,863.3
Net income				876.8		876.8
Change in net unrealized gains/losses on investments					99.2	99.2
Non-credit component of other-than-temporary impairment losses on investments, net of taxes					(3.1)	(3.1)
Change in net unrealized gains/losses on cash flow hedges					0.2	0.2
Change in net periodic pension and postretirement costs					3.4	3.4
Foreign currency translation adjustments					(1.0)	(1.0)
Comprehensive income						975.5
Repurchase and retirement of common stock	(20.9)	(0.2)	(708.5)	(679.7)		(1,388.4)
Issuance of common stock under employee stock plans, net of related tax benefits	2.5		68.8			68.8
March 31, 2010	431.4	$ 4.3	$ 14,552.5	$ 9,795.6	$ 166.8	$ 24,519.2
January 1, 2009	503.2	$ 5.0	$ 16,843.0	$ 5,479.4	$ (895.7)	$ 21,431.7
Net income				580.4		580.4
Change in net unrealized gains/losses on investments					152.6	152.6
Change in net unrealized gains/losses on cash flow hedges					(2.2)	(2.2)
Change in net periodic pension and postretirement costs					(0.2)	(0.2)
Comprehensive income						730.6
Repurchase and retirement of common stock	(17.7)	(0.2)	(591.8)	(89.2)		(681.2)
Issuance of common stock under employee stock plans, net of related tax benefits	0.8		26.9			26.9
March 31, 2009	486.3	$ 4.8	$ 16,278.1	$ 5,970.6	$ (745.5)	$ 21,508.0

See accompanying notes.

WellPoint, Inc.

Notes to Consolidated Financial Statements

(Unaudited)

March 31, 2010

(In Millions, Except Per Share Data or Otherwise Stated Herein)

1. Organization

References to the terms we , our , us , WellPoint or the Company used throughout these Notes to Consolidated Financial Statements refer to WellPoint, Inc., an Indiana corporation, and unless the context otherwise requires, its direct and indirect subsidiaries.

We are the largest health benefits company in terms of commercial membership in the United States, serving 33.8 medical members as of March 31, 2010. We offer a broad spectrum of network-based managed care plans to large and small employer, individual, Medicaid and senior markets. Our managed care plans include: preferred provider organizations, or PPOs; health maintenance organizations, or HMOs; point-of-service, or POS, plans; traditional indemnity plans and other hybrid plans, including consumer-driven health plans, or CDHPs; and hospital only and limited benefit products. In addition, we provide a broad array of managed care services to self-funded customers, including claims processing, underwriting, stop loss insurance, actuarial services, provider network access, medical cost management, disease management, wellness programs and other administrative services. We also provide an array of specialty and other products and services such as life and disability insurance benefits, dental, vision, behavioral health benefit services, radiology benefit management, analytics-driven personal health care guidance, long-term care insurance and flexible spending accounts. We are licensed to conduct insurance operations in all 50 states through our subsidiaries.

We are an independent licensee of the Blue Cross and Blue Shield Association, or BCBSA, an association of independent health benefit plans. We serve our members as the Blue Cross licensee for California; the Blue Cross and Blue Shield, or BCBS, licensee for Colorado, Connecticut, Georgia, Indiana, Kentucky, Maine, Missouri (excluding 30 counties in the Kansas City area), Nevada, New Hampshire, New York (as the BCBS licensee in 10 New York City metropolitan and surrounding counties and as the Blue Cross or BCBS licensee in selected upstate counties only), Ohio, Virginia (excluding the Northern Virginia suburbs of Washington, D.C.) and Wisconsin. In a majority of these service areas we do business as Anthem Blue Cross, Anthem Blue Cross Blue Shield or Empire Blue Cross Blue Shield (in our New York service areas). We also serve customers throughout much of the country as UniCare.

During the first quarter of 2010, the U.S. Congress passed and the President signed into law the Patient Protection and Affordable Care Act as well as the Health Care and Education Reconciliation Act of 2010, which represent significant changes to the current U.S. health care system. The legislation is far-reaching and is intended to expand access to health insurance coverage over time by increasing the eligibility thresholds for most state Medicaid programs and providing certain other individuals and small businesses with tax incentives to subsidize a portion of the cost of health insurance coverage. The legislation includes a requirement that most individuals obtain health insurance coverage beginning in 2014 and that most large employers offer coverage to their employees or they will be required to pay a financial penalty. In addition, the new laws encompass certain new taxes and fees, including an excise tax on high premium insurance policies, limitations on the amount of compensation that is tax deductible and new fees on companies in our industry which may not be deductible for income tax purposes. The legislation also imposes new regulations on the health insurance sector, including, but not limited to, guaranteed coverage requirements, prohibitions on some annual and all lifetime limits on amounts paid on behalf of or to our members, increased restrictions on rescinding coverage, establishment of minimum medical loss ratio requirements, a requirement to cover preventative services on a first dollar basis, the establishment of state insurance exchanges and essential benefit packages, and greater limitations on how we price certain of our products. The legislation also reduces the reimbursement levels for health plans participating in the Medicare Advantage program over time.

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WellPoint, Inc.

Notes to Consolidated Financial Statements (Continued)

Some provisions of the health care reform legislation become effective this year including those that bar health insurance companies from placing lifetime limits on insurance coverage and those related to the increased restrictions on rescinding coverage. However, some of the more significant changes, including the annual fees on health insurance companies, the excise tax on high premium insurance policies, the guaranteed coverage requirements and the requirement that individuals obtain coverage, do not become effective until 2014 or later. The establishment of minimum medical loss ratios, which could have a significant impact on our operations, will take effect for certain of our businesses beginning in 2011.

Many of the details of the new law, including, but not limited to, the medical loss ratio requirements, require additional guidance and specificity to be provided by the Department of Health and Human Services, National Association of Insurance Commissioners, Department of Labor and Treasury Department. Accordingly, while it is too early to fully understand the impacts of the legislation on our business, certain of the provisions are likely to have significant impacts on our future operations, which, in turn, could impact the value of our business model and results of operations. The Company will continue to evaluate the impact of this legislation as additional guidance is provided by the Department of Health and Human Services, National Association of Insurance Commissioners, Department of Labor and Treasury Department.

In addition, federal and state regulatory agencies may restrict our ability to implement changes in premium rates. Our ability to secure sufficient premium rates, including regulatory approval for and implementation of such rates on a timely basis, may be restricted by additional changes in federal and state regulations or by the application of existing federal and state regulations. A limitation on our ability to increase or maintain our premium rates could adversely affect our business, cash flows, financial condition and results of operations.

2. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles, or GAAP, for interim financial reporting. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments, including normal recurring adjustments, necessary for a fair statement of the consolidated financial statements as of and for the three months ended March 31, 2010 and 2009 have been recorded. The results of operations for the three months ended March 31, 2010 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2010. These unaudited consolidated financial statements should be read in conjunction with our audited consolidated financial statements for the year ended December 31, 2009 included in our Annual Report on Form 10-K.

Certain of our subsidiaries operate outside of the United States and have functional currencies other than the U.S. dollar, or USD. We translate the assets and liabilities of those subsidiaries to USD using the exchange rate in effect at the end of the period. We translate the revenues and expenses of those subsidiaries to USD using the average exchange rates in effect during the period. The net effect of these translation adjustments is included in Foreign currency translation adjustments in our consolidated statements of shareholders equity.

Our benefit expense includes costs of care for health services consumed by our members, such as outpatient care, inpatient hospital care, professional services (primarily physician care) and pharmacy benefit costs. Beginning January 1, 2010, we began classifying certain claims-related costs, which were historically classified as administrative expense, as benefit expense to better reflect costs incurred for our members traditional medical care as well as those expenses which improve our members health and medical outcomes. These reclassified costs are comprised of expenses incurred for: (i) medical management, including case and utilization management; (ii) health and wellness, including disease management services for such things as diabetes, high-risk pregnancies, congestive heart failure and asthma management and wellness initiatives like weight-loss programs and smoking cessation treatments; and (iii) clinical health policy. These types of claims-related costs ultimately lower our members cost of care. Prior year amounts have been reclassified to conform to the new presentation.

Certain other prior year amounts have been reclassified to conform to the current year presentation.

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WellPoint, Inc.

Notes to Consolidated Financial Statements (Continued)

3. Investments

We evaluate our investment securities for other-than-temporary declines based on qualitative and quantitative factors. Other-than-temporary impairment losses recognized in income totaled $19.7 and $305.0 for the three months ended March 31, 2010 and 2009, respectively. There were no individually significant other-than-temporary impairment losses on investments by issuer during the three months ended

March 31, 2010 and 2009. We continue to review our investment portfolios under our impairment review policy. Given the current market conditions and the significant judgments involved, there is a continuing risk that further declines in fair value may occur and additional material other-than-temporary impairment losses on investments may be recorded in future periods.

The changes in the amount of the credit component of other-than-temporary impairment losses on fixed maturity securities recognized in income, for which a portion of the other-than-temporary impairment losses was recognized in other comprehensive income, was not material for the three months ended March 31, 2010.

A summary of current and long-term investments, available-for-sale, at March 31, 2010 and December 31, 2009 is as follows:

			Gross Unrealized Losses			Non-Credit Component of Other-Than-Temporary Impairments Recognized in AOCI
	Cost or Amortized Cost	Gross Unrealized Gains	Less than 12 Months	Greater than 12 Months	Estimated Fair Value	
March 31, 2010:						
Fixed maturity securities:						
United States Government securities	$ 610.5	$ 14.0	$ (0.7)	$ (0.3)	$ 623.5	$
Government sponsored securities	434.1	7.9	(0.1)		441.9	
States, municipalities and political subdivisions - tax-exempt	4,157.7	160.6	(7.0)	(32.5)	4,278.8	
Corporate securities	6,257.6	383.3	(10.9)	(14.5)	6,615.5	(0.9)
Options embedded in convertible debt securities	92.3				92.3	
Residential mortgage-backed securities	3,219.0	127.4	(5.1)	(40.2)	3,301.1	(6.0)
Commercial mortgage-backed securities	148.2	5.2		(3.5)	149.9	
Other debt obligations	334.7	10.5	(2.2)	(15.3)	327.7	(1.3)
Total fixed maturity securities	15,254.1	708.9	(26.0)	(106.3)	15,830.7	$ (8.2)
Equity securities	826.3	270.9	(8.7)		1,088.5	
Total investments, available-for-sale	$ 16,080.4	$ 979.8	$ (34.7)	$ (106.3)	$ 16,919.2	
December 31, 2009:						
Fixed maturity securities:						
United States Government securities	$ 715.4	$ 14.8	$ (2.4)	$ (0.2)	$ 727.6	$
Government sponsored securities	632.8	8.3	(0.4)		640.7	

States, municipalities and political subdivisions - tax-exempt	4,019.4	167.0	(5.7)	(34.4)	4,146.3	(0.5)
Corporate securities	6,219.3	352.2	(12.9)	(34.5)	6,524.1	(3.3)
Options embedded in convertible debt securities	88.3				88.3	
Residential mortgage-backed securities	3,295.0	120.0	(7.9)	(47.0)	3,360.1	(9.0)
Commercial mortgage-backed securities	137.6	3.6	(0.1)	(4.9)	136.2	
Other debt obligations	318.3	8.7	(1.1)	(21.9)	304.0	(5.7)
Total fixed maturity securities	15,426.1	674.6	(30.5)	(142.9)	15,927.3	$ (18.5)
Equity securities	832.5	221.9	(11.2)		1,043.2	
Total investments, available-for-sale	$ 16,258.6	$ 896.5	$ (41.7)	$ (142.9)	$ 16,970.5	

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WellPoint, Inc.

Notes to Consolidated Financial Statements (Continued)

At March 31, 2010, we owned $3,451.0 of mortgage-backed securities and $327.7 of asset-backed securities out of a total available-for-sale investment portfolio of $16,919.2. These securities included sub-prime and Alt-A securities with fair values of $105.1 and $276.7, respectively. These sub-prime and Alt-A securities had accumulated net unrealized losses of $10.8 and $32.2, respectively. The average credit rating of the sub-prime and Alt-A securities was BB and BB , respectively.

The following table summarizes for fixed maturity securities and equity securities in an unrealized loss position at March 31, 2010 and December 31, 2009, the aggregate fair value and gross unrealized loss by length of time those securities have been continuously in an unrealized loss position.

	12 Months or Less			**Greater than 12 Months**		
	Number of Securities	**Fair Value**	**Gross Unrealized Loss**	**Number of Securities**	**Fair Value**	**Gross Unrealized Loss**
(Securities are whole amounts)						
March 31, 2010:						
Fixed maturity securities:						
United States Government securities	18	$ 130.6	$ (0.7)	4	$ 5.0	$ (0.3)
Government sponsored securities	14	82.9	(0.1)			
States, municipalities and political subdivisions - tax-exempt	210	583.9	(7.0)	172	267.4	(32.5)
Corporate securities	436	893.7	(10.9)	130	258.0	(14.5)
Residential mortgage-backed securities	177	355.1	(5.1)	123	239.1	(40.2)
Commercial mortgage-backed securities	2	1.2		4	8.2	(3.5)
Other debt obligations	16	71.2	(2.2)	48	62.4	(15.3)
Total fixed maturity securities	873	2,118.6	(26.0)	481	840.1	(106.3)
Equity securities	628	71.2	(8.7)			
Total fixed maturity and equity securities	1,501	$ 2,189.8	$ (34.7)	481	$ 840.1	$ (106.3)
December 31, 2009:						
Fixed maturity securities:						
United States Government securities	18	$ 286.8	$ (2.4)	3	$ 3.1	$ (0.2)
Government sponsored securities	17	149.3	(0.4)			
States, municipalities and political subdivisions - tax-exempt	162	417.6	(5.7)	185	314.8	(34.4)
Corporate securities	462	914.5	(12.9)	233	404.3	(34.5)
Residential mortgage-backed securities	219	439.0	(7.9)	128	256.1	(47.0)
Commercial mortgage-backed securities	7	9.8	(0.1)	14	39.9	(4.9)
Other debt obligations	24	112.5	(1.1)	49	61.0	(21.9)
Total fixed maturity securities	909	2,329.5	(30.5)	612	1,079.2	(142.9)
Equity securities	788	99.0	(11.2)			
Total fixed maturity and equity securities	1,697	$ 2,428.5	$ (41.7)	612	$ 1,079.2	$ (142.9)

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WellPoint, Inc.

Notes to Consolidated Financial Statements (Continued)

The amortized cost and fair value of fixed maturity securities at March 31, 2010, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties.

	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 992.4	$ 1,001.0
Due after one year through five years	4,895.6	5,161.1
Due after five years through ten years	3,561.1	3,731.5
Due after ten years	2,437.8	2,486.1
Mortgage-backed securities	3,367.2	3,451.0
Total available-for-sale fixed maturity securities	$ 15,254.1	$ 15,830.7

During the three months ended March 31, 2010, we sold $1,006.2 of fixed maturity and equity securities which resulted in gross realized gains of $56.1 and gross realized losses of $14.6. In the ordinary course of business, we may sell securities at a loss for a number of reasons, including, but not limited to: (i) changes in the investment environment; (ii) expectation that the fair value could deteriorate further; (iii) desire to reduce exposure to an issuer or an industry; (iv) changes in credit quality; or (v) changes in expected cash flow.

All securities sold resulting in investment gains and losses are recorded on the trade date. Realized gains and losses are determined on the basis of the cost or amortized cost of the specific securities sold.

4. Derivative Instruments and Hedging Activities

In accordance with Financial Accounting Standards Board, or FASB, guidance, all investments in derivatives are recorded as assets or liabilities at fair value. A derivative is typically defined as an instrument whose value is derived from an underlying instrument, index or rate, has a notional amount, requires little or no initial investment and can be net settled. We typically invest in the following types of derivative financial instruments: interest rate swaps, forward contracts, call options, credit default swaps, embedded derivatives and warrants. Derivatives embedded within non-derivative instruments (such as options embedded in convertible fixed maturity securities) are bifurcated from the host instrument when the embedded derivative is not clearly and closely related to the host instrument.

Our use of derivatives is limited by statutes and regulations promulgated by the various regulatory bodies to which we are subject, and by our own derivative policy. Our derivative use is generally limited to hedging purposes and we generally do not use derivative instruments for speculative purposes.

We have exposure to economic losses due to interest rate risk arising from changes in the level or volatility of interest rates. We attempt to mitigate our exposure to interest rate risk through active portfolio management, which includes rebalancing our existing portfolios of assets and liabilities, as well as changing the characteristics of investments to be purchased or sold in the future. In addition, derivative financial instruments are used to modify the interest rate exposure of certain liabilities or forecasted transactions. These strategies include the use of interest rate swaps and forward contracts, which are used to lock interest rates or to hedge (on an economic basis) interest rate risks associated with variable rate debt. We have used these types of instruments as designated hedges against specific liabilities.

If certain correlation, hedge effectiveness and risk reduction criteria are met, a derivative may be specifically designated as a hedge of exposure to changes in fair value or cash flow. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the nature of any hedge

WellPoint, Inc.

Notes to Consolidated Financial Statements (Continued)

designation thereon. Amounts excluded from the assessment of hedge effectiveness, if any, as well as the ineffective portion of the gain or loss, are reported in results of operations immediately. We test for hedge effectiveness at hedge inception and re-assess at the end of each reporting period. No amounts were excluded from the assessment of hedge effectiveness. If the derivative is not designated as a hedge, the gain or loss resulting from the change in the fair value of the derivative is recognized in results of operations in the period of change.

We discontinue hedge accounting prospectively when it is determined that one of the following has occurred: (i) the derivative is no longer highly effective in offsetting changes in the fair value or cash flows of a hedged item; (ii) the derivative expires or is sold, terminated or exercised; (iii) the derivative is no longer designated as a hedge instrument because it is unlikely that a forecasted transaction will occur; (iv) a hedged firm commitment no longer meets the definition of a firm commitment; or (v) we otherwise determine that the designation of the derivative as a hedge instrument is no longer appropriate.

If hedge accounting is discontinued, the derivative will continue to be carried on our consolidated balance sheets at its fair value. When hedge accounting is discontinued because the derivative no longer qualifies as an effective fair value hedge, the related hedged asset or liability will no longer be adjusted for fair value changes. When hedge accounting is discontinued because it is probable that a forecasted transaction will not occur, the accumulated unrealized gains and losses included in accumulated other comprehensive income will be recognized immediately in results of operations. When hedge accounting is discontinued because the hedged item no longer meets the definition of a firm commitment, any asset or liability that was recorded pursuant to the firm commitment will be removed from the balance sheet and recognized as a gain or loss in current period results of operations. In all other situations in which hedge accounting is discontinued, changes in the fair value of the derivative are recognized in current period results of operations.

From time to time, we may also purchase derivatives to hedge, on an economic basis, our exposure to foreign currency exchange fluctuations associated with the operations of certain of our subsidiaries. We generally use futures or forward contracts for these transactions. We generally do not designate these contracts as hedges in accordance with the guidance and, accordingly, the changes in fair value of these derivatives are recognized in income immediately.

Credit exposure associated with non-performance by the counterparties to derivative instruments is generally limited to the uncollateralized fair value of the asset related to instruments recognized in the consolidated balance sheets. We attempt to mitigate the risk of non-performance by selecting counterparties with high credit ratings and monitoring their creditworthiness and by diversifying derivatives among multiple counterparties. At March 31, 2010, we believe there were no material concentrations of credit risk with any individual counterparty.

Our derivative agreements do not contain any credit support provisions that require us to post collateral if there are declines in the derivative value or our credit rating.

The contractual or notional amounts for derivatives are used to calculate the exchange of contractual payments under the agreements and are not representative of the potential for gain or loss on these instruments. Interest rates and equity prices may affect the fair value of derivatives. The fair values generally represent the estimated amounts that we would expect to receive or pay upon termination of the contracts at the reporting date. Fair values of options embedded in convertible debt securities are generally based on quoted market prices in active markets. Fair values of interest rate swaps are based on the quoted market prices by the financial institution that is the counterparty to the swap. We independently verify prices provided by the counterparties using valuation models that incorporate market observable inputs for similar interest rate swaps.

WellPoint, Inc.

Notes to Consolidated Financial Statements (Continued)

A summary of the aggregate contractual or notional amounts, balance sheet location and estimated fair values of derivative financial instruments at March 31, 2010 and December 31, 2009 is as follows:

	Contractual/ Notional Amount	Balance Sheet Location	Estimated Fair Value Asset	Estimated Fair Value (Liability)
March 31, 2010:				
Hedging instruments				
Swaps	$ 1,680.0	Other noncurrent assets/Other noncurrent liabilities	$ 90.4	$ (0.2)
Non-hedging instruments				
Derivatives embedded in convertible debt securities	384.0	Fixed maturity securities	92.3	
Credit default swaps	22.1	Equity securities		(0.3)
Subtotal non-hedging instruments	406.1		92.3	(0.3)
Total derivatives	$ 2,086.1		$ 182.7	$ (0.5)
December 31, 2009:				
Hedging instruments				
Swaps	$ 1,775.0	Other noncurrent assets/Other noncurrent liabilities	$ 85.1	$ (0.3)
Non-hedging instruments				
Derivatives embedded in convertible debt securities	359.5	Fixed maturity securities	88.3	
Credit default swaps	19.3	Equity securities		(0.2)
Subtotal non-hedging instruments	378.8		88.3	(0.2)
Total derivatives	$ 2,153.8		$ 173.4	$ (0.5)

Fair Value Hedges

During the year ended December 31, 2009, we entered into a fair value hedge with a total notional value of $600.0. The hedge is an interest rate swap agreement to receive a fixed 5.000% rate and pay a LIBOR-based floating rate and expires on January 15, 2011.

During the year ended December 31, 2006, we entered into two fair value hedges with a total notional value of $440.0. The first hedge is a $240.0 notional amount interest rate swap agreement to receive a fixed 6.800% rate and pay a LIBOR-based floating rate and expires on August 1, 2012. The second hedge is a $200.0 notional amount interest rate swap agreement to receive a fixed 5.000% rate and pay a LIBOR-based floating rate and expires on December 15, 2014.

During the year ended December 31, 2005, we entered into two fair value hedges with a total notional value of $660.0, which was subsequently reduced to $440.0 during 2008. The first hedge is a $240.0 notional amount interest rate swap agreement to exchange a fixed 6.800% rate for a LIBOR-based floating rate and expires on August 1, 2012. The second hedge is a $200.0 notional amount interest rate swap agreement to exchange a fixed 5.000% rate for LIBOR-based floating rate and expires December 15, 2014.

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WellPoint, Inc.

Notes to Consolidated Financial Statements (Continued)

A summary of the effect of fair value hedges on our income statement for the three months ended March 31, 2010 and 2009 is as follows:

Type of Fair Value Hedge	Income Statement Location of Derivative Gain (Loss)	Hedge Gain (Loss) Recognized	Hedged Item	Income Statement Location of Hedged Item Gain (Loss)	Hedged Item Gain (Loss) Recognized
Three Months Ended March 31, 2010:					
Swaps	Interest expense	$ 11.6	Fixed rate debt	Interest expense	$ (11.6)
Three Months Ended March 31, 2009:					
Swaps	Interest expense	$ 8.1	Fixed rate debt	Interest expense	$ (8.1)

Cash Flow Hedges

During the year ended December 31, 2009 and into the first quarter of 2010, we entered into a series of forward starting pay fixed swaps with total outstanding notional amounts of $200.0. The objective of this series of hedges is to eliminate the variability of the cash flows in the interest payments on our senior term loan. We agreed to receive a LIBOR-based floating rate and pay a fixed rate. The swaps start to expire on a monthly basis beginning on April 30, 2010; the final swap in the series expires on September 30, 2010.

In January 2009, we entered into forward starting pay fixed swaps with an aggregate notional amount of $800.0. The objective of these hedges was to eliminate the variability of cash flows in the interest payments on the debt securities issued in February 2009. These swaps were terminated in February 2009, and we paid a net $3.2, the net fair value at the time of termination. In addition, we recorded a loss of $2.1, net of tax, in other comprehensive income. Following the February 5, 2009 issuance of debt securities, the unamortized fair value of the forward starting pay fixed swaps included in accumulated other comprehensive income began amortizing into earnings, as an increase to interest expense. In addition, we have amounts recorded in accumulated other comprehensive income for certain forward starting pay fixed swaps that were terminated in prior years. The hedged debt securities have maturity dates ranging from 2014 to 2036.

The unrecognized losses for all cash flow hedges included in accumulated other comprehensive income at March 31, 2010 and December 31, 2009 were $10.6 and $10.8, respectively. As of March 31, 2010, the total amount of amortization over the next twelve months for all cash flow hedges will increase interest expense by approximately $0.4.

A summary of the effect of cash flow hedges on our financial statements for the three months ended March 31, 2010 and 2009 is as follows:

	Effective Portion			Ineffective Portion	
Type of Cash Flow Hedge	Pretax Hedge Gain (Loss) Recognized in Other Comprehensive Income	Income Statement Location of Gain (Loss) Reclassified from Accumulated Other Comprehensive Income	Hedge Gain (Loss) Reclassified from Accumulated Other Comprehensive Income	Income Statement Location of Gain (Loss) Recognized	Hedge Gain (Loss) Recognized
Three Months Ended March 31, 2010:					
Forward starting pay fixed swaps	$	Interest expense	$ 0.2	None	$

Other fixed pay swaps	$	Interest expense	$	0.2	None	$
Three Months Ended March 31, 2009:						
Forward starting pay fixed swaps	$ (3.2)	Interest expense	$	0.1	None	$

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WellPoint, Inc.

Notes to Consolidated Financial Statements (Continued)

Non-Hedging Derivatives

A summary of the effect of non-hedging derivatives on our income statement and included in net realized gains on investments for the three months ended March 31, 2010 and 2009 is as follows:

Type of Non-hedging Derivatives	Income Statement Location of Gain (Loss) Recognized	Derivative Gain (Loss) Recognized
Three Months Ended March 31, 2010:		
Derivatives embedded in convertible debt securities	Net realized gain on investments	$ 7.0
Three Months Ended March 31, 2009:		
Derivatives embedded in convertible debt securities	Net realized gain (loss) on investments	$ 9.4
Credit default swaps	Net realized gain (loss) on investments	2.0
Options	Net realized gain (loss) on investments	2.8
Futures	Net realized gain (loss) on investments	(3.4)
Total		$ 10.8

5. Fair Value

Assets and liabilities recorded at fair value in the consolidated balance sheets are categorized based upon the level of judgment associated with the inputs used to measure their fair value. Level inputs, as defined by FASB guidance for fair value measurements and disclosures, are as follows:

Level Input:	Input Definition:
Level I	Inputs are unadjusted, quoted prices for identical assets or liabilities in active markets at the measurement date.
Level II	Inputs other than quoted prices included in Level I that are observable for the asset or liability through corroboration with market data at the measurement date.
Level III	Unobservable inputs that reflect management s best estimate of what market participants would use in pricing the asset or liability at the measurement date.

Transfers between Levels, if any, are recorded as of the beginning of the reporting period.

The following methods and assumptions were used to determine the fair value of each class of the following assets and liabilities recorded at fair value in the consolidated balance sheets:

Cash equivalents: Cash equivalents primarily consist of highly rated money market funds with maturities of three months or less, and are purchased daily at par value with specified yield rates. Due to the high ratings and short-term nature of the funds, we designate all cash equivalents as Level I.

Fixed maturity securities, available-for-sale: Fair values of available-for-sale fixed maturity securities are based on quoted market prices, where available. These fair values are obtained primarily from third party pricing services, which generally use Level I or Level II inputs, for the determination of fair value to facilitate fair value measurements and disclosures. United States Government securities represent Level I securities, while Level II securities primarily include corporate securities, securities from states, municipalities and political subdivisions

WellPoint, Inc.

Notes to Consolidated Financial Statements (Continued)

and residential mortgage-backed securities. For securities not actively traded, the third party pricing services may use quoted market prices of comparable instruments or discounted cash flow analyses, incorporating inputs that are currently observable in the markets for similar securities. Inputs that are often used in the valuation methodologies include, but are not limited to, broker quotes, benchmark yields, credit spreads, default rates and prepayment speeds. We also have certain fixed maturity securities, primarily corporate debt and other fixed maturity securities, that are designated Level III securities. For these securities, the valuation methodologies may incorporate broker quotes or assumptions for benchmark yields, credit spreads, default rates and prepayment speeds that are not observable in the markets.

Equity securities, available-for-sale: Fair values of equity securities are generally designated as Level I and are based on quoted market prices. For certain equity securities, quoted market prices for the identical security are not always available and the fair value is estimated by reference to similar securities for which quoted prices are available. These securities are designated Level II. We also have certain equity securities, including private equity securities, for which the fair value is estimated based on each security s current condition and future cash flow projections. Such securities are designated Level III.

Other invested assets, current: Other invested assets, current include securities held in rabbi trusts that are classified as trading. Fair values are based on quoted market prices.

Securities lending collateral: Fair values of securities lending collateral are based on quoted market prices, where available. These fair values are obtained primarily from third party pricing services, which generally use Level I or Level II inputs, for the determination of fair value to facilitate fair value measurements and disclosures.

Derivatives interest rate swaps: Fair values are based on the quoted market prices by the financial institution that is the counterparty to the swap. We independently verify prices provided by the counterparties using valuation models that incorporate market observable inputs for similar interest rate swaps.

We obtain only one quoted price for each security from third party pricing services, which are derived through recently reported trades for identical or similar securities making adjustments through the reporting date based upon available market observable information. As we are responsible for the determination of fair value, we perform monthly analysis on the prices received from third parties to determine whether the prices are reasonable estimates of fair value. Our analysis includes a review of month-to-month price fluctuations. If unusual fluctuations are noted in this review, we may obtain additional information from other pricing services to validate the quoted price. There were no adjustments to quoted market prices obtained from third party pricing services during the three months ended March 31, 2010 and 2009 that were material to the consolidated financial statements.

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Notes to Consolidated Financial Statements (Continued)

A summary of fair value measurements by level for assets measured at fair value on a recurring basis at March 31, 2010 and December 31, 2009 is as follows:

	Level I	Level II	Level III	Total
March 31, 2010:				
Assets:				
Cash equivalents	$ 3,098.0	$	$	$ 3,098.0
Investments available-for-sale:				
Fixed maturity securities:				
United States Government securities	623.5			623.5
Government sponsored securities		441.9		441.9
States, municipalities and political subdivisions - tax-exempt		4,278.8		4,278.8
Corporate securities		6,379.8	235.7	6,615.5
Options embedded in convertible debt securities		92.3		92.3
Residential mortgage-backed securities		3,301.1		3,301.1
Commercial mortgage-backed securities		142.5	7.4	149.9
Other debt obligations		221.9	105.8	327.7
Total fixed maturity securities	623.5	14,858.3	348.9	15,830.7
Equity securities	1,024.7	59.3	4.5	1,088.5
Other invested assets, current	19.3			19.3
Securities lending collateral	538.8	61.7		600.5
Derivatives excluding embedded options (reported with other noncurrent assets)		90.4		90.4
Total	$ 5,304.3	$ 15,069.7	$ 353.4	$ 20,727.4
Liabilities:				
Derivatives (reported with other noncurrent liabilities)	$	$ (0.2)	$	$ (0.2)
December 31, 2009:				
Assets:				
Cash equivalents	$ 4,461.0	$	$	$ 4,461.0
Investments available-for-sale:				
Fixed maturity securities:				
United States Government securities	727.6			727.6
Government sponsored securities		640.7		640.7
States, municipalities and political subdivisions - tax-exempt		4,146.3		4,146.3
Corporate securities		6,292.4	231.7	6,524.1
Options embedded in convertible debt securities		88.3		88.3
Residential mortgage-backed securities		3,358.1	2.0	3,360.1
Commercial mortgage-backed securities		129.1	7.1	136.2
Other debt obligations		198.0	106.0	304.0
Total fixed maturity securities	727.6	14,852.9	346.8	15,927.3
Equity securities	980.4	58.3	4.5	1,043.2
Other invested assets, current	26.5			26.5
Securities lending collateral	305.3	89.5		394.8
Derivatives excluding embedded options (reported with other noncurrent assets)		85.1		85.1

Total	$	6,500.8	$	15,085.8	$	351.3	$	21,937.9
Liabilities:								
Derivatives (reported with other noncurrent liabilities)	$		$	(0.3)	$		$	(0.3)

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WellPoint, Inc.

Notes to Consolidated Financial Statements (Continued)

A reconciliation of the beginning and ending balances of assets measured at fair value on a recurring basis using Level III inputs for the three months ended March 31, 2010 and 2009 is as follows:

	Corporate Securities	Residential Mortgage-backed Securities	Commercial Mortgage-backed Securities	Other Debt Obligations	Equity Securities	Total
Three Months Ended March 31, 2010:						
Beginning balance at January 1, 2010	$ 231.7	$ 2.0	$ 7.1	$ 106.0	$ 4.5	$ 351.3
Total gains (losses):						
Recognized in net income				(1.6)	(0.8)	(2.4)
Recognized in accumulated other comprehensive income	4.9		0.5	4.1	0.8	10.3
Purchases, sales, issuances and settlements, net	(0.9)	(2.0)	(0.2)	(2.7)		(5.8)
Transfers into Level III						
Transfers out of Level III						
Ending balance at March 31, 2010	$ 235.7	$	$ 7.4	$ 105.8	$ 4.5	$ 353.4
Change in unrealized losses included in net income related to assets still held for the three months ended March 31, 2010	$	$	$	$ (0.1)	$ (0.8)	$ (0.9)
Three Months Ended March 31, 2009:						
Beginning balance at January 1, 2009	$ 191.1	$ 7.0	$ 9.7	$ 138.7	$ 11.2	$ 357.7
Total gains (losses):						
Recognized in net income	(0.2)			(32.7)	(0.4)	(33.3)
Recognized in accumulated other comprehensive income	(10.6)	1.4	(1.0)	14.2	0.7	4.7
Purchases, sales, issuances and settlements, net	(11.2)	(0.4)	(0.3)	(6.6)	(4.9)	(23.4)
Transfers into Level III	18.9					18.9
Transfers out of Level III	(1.2)					(1.2)
Ending balance at March 31, 2009	$ 186.8	$ 8.0	$ 8.4	$ 113.6	$ 6.6	$ 323.4
Change in unrealized losses included in net income related to assets still held for the three months ended March 31, 2009	$	$	$	$	$	$

There were no transfers between Levels I, II or III during the first quarter of 2010.

During the first quarter of 2009, certain mortgage-backed, asset-backed and corporate inverse floating rate securities were thinly traded due to concerns in the securities markets and resulting lack of liquidity. Consequently, observable inputs were not always available and the fair values of these securities were estimated using internal estimates for inputs including, but not limited to, prepayment speeds, credit spreads, default rates and benchmark yields.

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Notes to Consolidated Financial Statements (Continued)

The carrying values and estimated fair values of financial instruments not recorded at fair value on our consolidated balance sheet at March 31, 2010 and December 31, 2009 are as follows:

	March 31, 2010		December 31, 2009	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets:				
Other invested assets, long-term	$ 802.4	$ 802.4	$ 775.3	$ 775.3
Liabilities:				
Debt:				
Commercial paper	500.7	500.7	500.6	500.6
Notes, term loan and capital leases	7,889.6	8,230.5	7,898.5	8,128.8

The following methods and assumptions were used to estimate the fair value of each class of the following financial instruments:

Other invested assets, long-term: Other invested assets, long-term include primarily our investments in limited partnerships, joint ventures and other non-controlled corporations, as well as the cash surrender value of corporate-owned life insurance policies. Investments in limited partnerships, joint ventures and other non-controlled corporations are carried at our share in the entities undistributed earnings, which approximates fair value. The carrying value of corporate-owned life insurance policies are the cash surrender value as reported by the respective insurer.

Long-term debt commercial paper: The carrying amount for commercial paper approximates fair value as the underlying instruments have variable interest rates at market value.

Long-term debt notes, term loan and capital leases: The fair value of notes and amounts due under our senior term loan is based on quoted market prices for the same or similar debt, or, if no quoted market prices were available, on the current rates estimated to be available to us for debt of similar terms and remaining maturities. Capital leases are carried at the unamortized present value of the minimum lease payments, which approximates fair value.

Non-financial instruments such as real estate, property and equipment, other current assets, deferred income taxes and intangible assets, and certain financial instruments such as policy liabilities are excluded from the fair value disclosures. Therefore, the fair value amounts cannot be aggregated to determine our underlying economic value.

The carrying amounts reported in the consolidated balance sheets for cash, accrued investment income, premium and self-funded receivables, other receivables, unearned income, accounts payable and accrued expenses, income taxes payable, security trades pending payable, securities lending payable and certain other current liabilities approximate fair value because of the short term nature of these items. These assets and liabilities are not listed in the table above.

6. Income Taxes

As of March 31, 2010, as further described below, certain of our tax years are being examined by the Internal Revenue Service, or IRS, and various state and local authorities. In addition, we continue to discuss certain industry issues with the IRS.

WellPoint, Inc.

Notes to Consolidated Financial Statements (Continued)

As of March 31, 2010, the examinations of our 2008, 2007, 2006, 2005 and 2004 tax years are nearing conclusion. In addition, there are several years with ongoing disputes related to our companies pre-acquisition years that are nearing conclusion. Many of the issues in open tax years have been resolved; however, several of the examinations still require approval from the Joint Committee on Taxation before they can be finalized.

During the three months ended March 31, 2010 and 2009, we recognized income tax expense of $458.5 and $313.2, respectively, which represents effective tax rates of 34.3% and 35.0%, respectively.

During the three months ended March 31, 2010, we made tax payments of $1,208.0 to the IRS, principally related to the gain we realized on the sale of our prescription benefits management, or PBM, business which occurred in the fourth quarter of 2009.

In March 2010, the Court of Appeals in the Seventh Circuit issued a decision ruling that various payments made to several states in prior years should be a deferred tax asset and not a current tax deduction for the year being litigated. The ruling did not have a material impact on our results of operations, financial position or cash flow.

7. Goodwill and Other Intangible Assets

In the first quarter of 2010, we recognized an impairment charge of $21.1 for certain intangible assets associated with the UniCare provider networks, due to a decision we made to transfer certain membership to an alternative network.

8. Retirement Benefits

The components of net periodic benefit (credit) cost included in the consolidated statements of income for the three months ended March 31, 2010 and 2009 are as follows:

	Pension Benefits		**Other Benefits**	
	2010	**2009**	**2010**	**2009**
Service cost	$ 4.3	$ 5.5	$ 1.9	$ 1.8
Interest cost	22.2	22.7	8.7	7.9
Expected return on assets	(34.9)	(35.5)	(2.6)	(0.6)
Recognized actuarial loss	6.4	0.6	1.9	1.7
Amortization of prior service credit	(0.2)	(0.2)	(2.4)	(2.4)
Net periodic benefit (credit) cost	$ (2.2)	$ (6.9)	$ 7.5	$ 8.4

For the year ending December 31, 2010, no material contributions are expected to be necessary to meet the Employee Retirement Income Securities Act, or ERISA, required funding levels; however, we may elect to make discretionary contributions up to the maximum amount deductible for income tax purposes. Contributions of $15.0 were made to our retirement benefit plans during the three months ended March 31, 2010.

9. Debt

We have a senior revolving credit facility, or the facility, with certain lenders for general corporate purposes. The facility, as amended, provides credit up to $2,392.0, which matures on September 30, 2011. The interest rate on this facility is based on either (i) the LIBOR rate plus a predetermined percentage rate based on our credit rating at the date of utilization, or (ii) a base rate as defined in the facility agreement. Our ability to

WellPoint, Inc.

Notes to Consolidated Financial Statements (Continued)

borrow under this facility is subject to compliance with certain covenants. There were no amounts outstanding under this facility as of March 31, 2010 or during the three months then ended. At March 31, 2010, we had $2,392.0 available under this facility.

We have an authorized commercial paper program of up to $2,500.0, the proceeds of which may be used for general corporate purposes. At March 31, 2010, we had $500.7 outstanding under this program. Commercial paper borrowings have been classified as long-term debt at March 31, 2010 and December 31, 2009 in accordance with FASB guidance for short-term obligations expected to be refinanced, as our practice and intent is to replace short-term commercial paper outstanding at expiration with additional short-term commercial paper for an uninterrupted period extending for more than one year or our ability to redeem our commercial paper with borrowings under the senior credit facility described above.

We are a member of the Federal Home Loan Bank of Indianapolis and the Federal Home Loan Bank of Cincinnati, collectively, the FHLBs, and as a member we have the ability to obtain cash advances subject to certain requirements. In order to obtain cash advances, we are required to pledge securities as collateral to the FHLBs, initially equal to a certain percentage of the cash borrowings, depending on the type of securities pledged as collateral. The market value of the collateral is monitored daily by the FHLBs, and if it falls below the required percentage of the cash borrowings, we are required to pledge additional securities as collateral or repay a portion of the outstanding cash advance balance. In addition, our borrowings may be limited based on the amount of our investment in the FHLBs common stock. Our investment in the FHLBs common stock at March 31, 2010 totaled $9.4, which is reported in Investments available-for- sale Equity securities on the consolidated balance sheets. There were no advances outstanding from the FHLBs under this facility as of March 31, 2010 or at any time during the three months then ended. Subsequent to March 31, 2010, we borrowed $100.0 under this facility for a two year term at a fixed rate of 1.43%. Securities, primarily certain U.S. government sponsored mortgage-backed securities, with a fair value of $234.3 at March 31, 2010, have been pledged as collateral. The securities pledged are reported in Investments available-for-sale Fixed maturity securities on the consolidated balance sheets.

Subsequent to March 31, 2010, we repaid our 9.125% surplus notes with a remaining outstanding face amount of $42.0.

10. Commitments and Contingencies

Litigation

In various California state courts, we are defending a number of individual lawsuits, including one filed by the Los Angeles City Attorney, and four purported class actions alleging the wrongful rescission of individual insurance policies. The suits name WellPoint as well as Blue Cross of California, or BCC, and BC Life & Health Insurance Company, or BCL&H (which name changed to Anthem Blue Cross Life and Health Insurance Company in July 2007), both WellPoint subsidiaries. The lawsuits generally allege breach of contract, bad faith and unfair business practices in a purported practice of rescinding new individual members following the submission of large claims. The parties agreed to mediate most of these lawsuits and the mediation resulted in the resolution of some of these lawsuits. In addition, the California Department of Managed Health Care and California Department of Insurance conducted investigations of the allegations. In June 2007, the California Department of Insurance issued its final report in which it issued a number of citations alleging violations of fair-claims handling laws.

On February 12, 2008, Empire Blue Cross Blue Shield, along with 15 other health benefit companies, was served with a subpoena by the New York Attorney General. The subpoena was part of an industry-wide

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investigation of how insurance companies use databases maintained by Ingenix, Inc., or Ingenix, a wholly-owned subsidiary of UnitedHealth Group, in determining out-of network reimbursement. Since the beginning of the investigation, we have been cooperating fully with the Attorney General s office and have complied with the Attorney General s requests for information regarding out-of-network reimbursement in New York. On February 18, 2009, we announced that we reached an agreement with the New York Attorney General regarding the manner in which out-of-network reimbursement to providers will be determined. We agreed to discontinue the use of the Ingenix database, which some of our subsidiaries use in determining out-of-network reimbursement for certain products and in certain states. We also agreed to contribute $10.0 towards the funding of a not-for profit entity that will develop a database of provider charges that can be accessed both by health care plans and their members. This payment was made on October 2, 2009. The settlement did not have a material effect on our consolidated financial position or results of operations.

We are currently defending several putative class actions filed as a result of the 2001 Anthem Insurance Companies, Inc., or AICI, demutualization. The suits name AICI as well as Anthem, Inc., or Anthem, n/k/a WellPoint, Inc. The suits are captioned as *Ronald Gold, et al. v. Anthem, Inc. et al.; Mary E. Ormond, et al. v. Anthem, Inc,. et al.; Ronald E. Mell, Sr., et al. v. Anthem, Inc., et al; and Jeffrey D. Jorling, et al., v. Anthem, Inc. (n/k/a WellPoint, Inc.) et al.* AICI s 2001 Plan of Conversion, or the Plan, provided for the conversion of AICI from a mutual insurance company into a stock insurance company pursuant to Indiana law. Under the Plan, AICI distributed the fair value of the company at the time of conversion to its Eligible Statutory Members, or ESMs, in the form of cash or Anthem common stock in exchange for their membership interests in the mutual company. The lawsuits generally allege that AICI distributed value to the wrong ESMs or distributed insufficient value to the ESMs. In *Gold*, cross motions for summary judgment were granted in part and denied in part with regard to the issue of sovereign immunity asserted by co-defendant, the State of Connecticut (the State). The State has appealed this denial to the Connecticut Supreme Court. We filed a cross-appeal. Oral argument was held in November 2008 and the parties are awaiting a ruling. In the *Ormond* suit, our Motion to Dismiss was granted in part and denied in part on March 31, 2008. The court dismissed the claims for violation of federal and state securities laws, for violation of the Indiana Demutualization Law and for unjust enrichment. On September 29, 2009, a class was certified in the *Ormond* suit. The class consists of all ESMs residing in Ohio, Indiana, Kentucky or Connecticut who received cash compensation in connection with the demutualization. The class does not include employers located in Ohio and Connecticut that received compensation under the Plan. On November 4, 2009 a class was certified in the *Mell* suit. That class consisted of persons who were employees or retirees who were continuously enrolled in the health benefit plan sponsored by the City of Cincinnati between the dates of June 18, 2001 and November 2, 2001. On March 3, 2010, the Court issued an order granting our motion for summary judgment. As a result, the Mell suit has been dismissed. The plaintiffs have filed a notice of appeal. We intend to vigorously defend these suits; however, their ultimate outcome cannot be presently determined.

We are currently a defendant in a putative class action relating to Out-of-Network, or OON, reimbursement of dental claims called *American Dental Association v. WellPoint Health Networks, Inc. and Blue Cross of California*. The lawsuit was filed in March 2002 by the ADA and three dentists who are suing on behalf of themselves and are seeking to sue on behalf of a nationwide class of all non-participating dental providers who were paid less than their actual charges for dental services provided to WellPoint dental members. The complaint alleges that WellPoint Health Networks Inc., Blue Cross of California and other WellPoint affiliates and subsidiaries (collectively, WellPoint) improperly set usual, customary and reasonable payment for OON dental services based on HIAA/Ingenix data. The plaintiffs claim, among other things, that the HIAA/Ingenix databases fail to account for differences in geography, provider specialty, outlier (high) charges, and complexity of procedure. The complaint further alleges that WellPoint was aware that this data was inappropriate to set usual, customary and reasonable rates. The dentists sue as assignees of their patients rights to benefits under WellPoint s dental plans and assert that WellPoint breached its contractual obligations in violation of ERISA by

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routinely paying OON dentists less than their actual charges and representing that its OON payments were properly determined usual, customary and reasonable rates. The suit is currently pending in the United States District Court for the Southern District of Florida. We filed a motion for summary judgment, which is pending. We intend to vigorously defend this lawsuit; however, its ultimate outcome cannot be presently determined.

We are currently a defendant in eleven putative class actions relating to out-of-network reimbursement. The cases have been made part of a WellPoint-only multi-district litigation called *In re WellPoint, Inc. Out-of-Network UCR Rates Litigation* and are pending in the United States District Court for the Central District of California. The first lawsuit *(Darryl and Valerie Samsell v. WellPoint, Inc., WellPoint Health Networks, Inc. and Anthem, Inc.*) was filed in February 2009 by two former members on behalf of a putative class of members who received out-of-network services for which the defendants paid less than billed charges. The plaintiffs in that case allege that the defendants violated RICO, the Sherman Antitrust Act, ERISA, and federal regulations by relying on databases provided by Ingenix in determining out-of-network reimbursement. The second lawsuit *(AMA et al. v. WellPoint, Inc.)* was brought in March 2009 by the American Medical Association, or AMA, four state medical associations and two individual physicians on behalf of a putative class of out-of-network physicians. The third lawsuit *(Roberts v. UnitedHealth Group, Inc. et al.)* was brought in March 2009 by a WellPoint member as a putative class action on behalf of all persons or entities who have paid premiums for out-of-network health insurance coverage. The fourth lawsuit *(JBW v. UnitedHealth Group, Inc. et al.*) was brought in April 2009 by a WellPoint member as a putative class action on behalf of all persons who have paid premiums for out-of-network health insurance coverage. The fifth lawsuit *(O Brien, et al. v. WellPoint, Inc., et al*.) was brought in May 2009 by three WellPoint members as a putative class action on behalf of all persons who received out-of-network services. The sixth lawsuit *(Higashi, D.C. d/b/a Mar Vista Institute of Health v. Blue Cross of California d/b/a WellPoint, Inc*.) was brought in June 2009 by an out-of-network chiropractor as a putative class action on behalf of all out-of-network chiropractors. The seventh suit *(North Peninsula Surgical Center v. WellPoint,Inc., et al*.) was brought in June 2009 by an out-of-network surgical center as a putative class action on behalf of all out-of-network surgical centers. The eighth lawsuit *(American Podiatric Medical Association, et al. v. WellPoint, Inc*.) was brought in June 2009 by the American Podiatric Medical Association, California Chiropractic Association, California Psychological Association and an out-of-network clinical psychologist as a putative class action on behalf of out-of-network podiatrists, chiropractors and psychologists. The ninth lawsuit *(Michael Pariser, et al. v. WellPoint, Inc.)* was brought in July 2009 by an out-of-network psychologist as a putative class action on behalf of all out-of-network providers who are not medical doctors or doctors of osteopathy. The tenth lawsuit (*Harold S. Bernard, Ph.D., et al. v. WellPoint, Inc.*) was brought in July 2009 by an out-of-network psychologist as a putative class action on behalf of all non-medical doctor health care providers. The eleventh lawsuit (*Ken Unmacht, Psy.D., et al. v. WellPoint, Inc.*) was brought in August 2009 by an out-of-network licensed psychotherapist as a putative class action on behalf of all non-medical doctor health care providers. A consolidated complaint has been filed for the eleven cases. We filed a motion to dismiss, which is pending, and a motion to enjoin the claims brought by the medical doctors and doctors of osteopathy based on prior litigation releases. We intend to vigorously defend these suits; however, their ultimate outcomes cannot be presently determined.

Other Contingencies

From time to time, we and certain of our subsidiaries are parties to various legal proceedings, many of which involve claims for coverage encountered in the ordinary course of business. We, like HMOs and health insurers generally, exclude certain health care and other services from coverage under our HMO, PPO and other plans. We are, in the ordinary course of business, subject to the claims of our enrollees arising out of decisions to restrict or deny reimbursement for uncovered services. The loss of even one such claim, if it results in a significant punitive damage award, could have a material adverse effect on us. In addition, the risk of potential

WellPoint, Inc.

Notes to Consolidated Financial Statements (Continued)

liability under punitive damage theories may increase significantly the difficulty of obtaining reasonable settlements of coverage claims.

In addition to the lawsuits described above, we are also involved in other pending and threatened litigation of the character incidental to our business, arising out of our operations and our revision of earnings guidance in 2008, and are from time to time involved as a party in various governmental investigations, audits, reviews and administrative proceedings. These investigations, audits, reviews and administrative proceedings include routine and special inquiries by state insurance departments, state attorneys general, the U.S. Attorney General and subcommittees of the U.S. Congress. Such investigations, audits, reviews and administrative proceedings could result in the imposition of civil or criminal fines, penalties, other sanctions and additional rules, regulations or other restrictions on our business operations. Any liability that may result from any one of these actions, or in the aggregate, could have a material adverse effect on our consolidated financial position or results of operations.

The National Organization of Life & Health Insurance Guaranty Associations, or NOLHGA, is a voluntary association consisting of the state life and health insurance guaranty organizations located throughout the U.S. State life and health insurance guaranty organizations, working together with NOLHGA, provide a safety net for their state s policyholders, ensuring that they continue to receive coverage even if their insurer is declared insolvent. We are aware that the Pennsylvania Insurance Commissioner, or Insurance Commissioner, has recently placed Penn Treaty Network America Insurance Company and its subsidiary American Network Insurance Company, or collectively Penn Treaty, in rehabilitation, an intermediate action before insolvency. The Insurance Commissioner has petitioned the state court for liquidation, however, we do not know when a decision will be made. In the event that Penn Treaty is declared insolvent and placed in liquidation, we and other insurers may be required to pay a portion of their policyholder claims through NOLHGA guaranty association assessments in future periods. We will continue to monitor the situation and may record a liability and expense in future reporting periods, which could be material to our operating results.

Contractual Obligations and Commitments

During 2009, we entered into an agreement with Affiliated Computer Services, Inc. to provide certain print and mailroom services that were previously performed in-house. Our remaining commitment under this agreement at March 31, 2010 was $377.1 over a six year period. We have the ability to terminate this agreement upon the occurrence of certain events, subject to early termination fees.

During the first quarter of 2010, we entered into a new agreement with International Business Machines Corporation to provide information technology infrastructure services. This new agreement supersedes certain prior agreements and also includes provisions for additional services. Our commitment under this agreement at March 31, 2010 was $1,222.7 over a five year period. We have the ability to terminate this agreement upon the occurrence of certain events, subject to early termination fees.

11. Capital Stock

Stock Repurchase Program

We regularly review the appropriate use of capital. Accordingly, under our Board of Directors authorization, we maintain a common stock repurchase program. Repurchases may be made from time to

time at prevailing market prices, subject to certain restrictions on volume, pricing and timing. The repurchases are effected from time to time in the open market, in private transactions, including accelerated share repurchase agreements, and through plans designed to comply with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended.

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During the three months ended March 31, 2010, we repurchased and retired approximately 20.9 shares at an average per share price of $62.22 (calculated including the final settlement shares of the accelerated share repurchase program discussed below), for an aggregate cost of $1,388.4. Under the share repurchase program, on February 24, 2010, we entered into an accelerated share repurchase, or ASR, program with a counterparty. The agreement provides for a repurchase of a number of shares, equal to $500.0, as determined by the dollar volume weighted average share price during a one to two month period. At March 31, 2010 we had repurchased 6.7 shares under the agreement and the counterparty is purchasing shares of our stock in the open market at prevailing market prices over the remaining term of the ASR. At the end of the term of the ASR, the initial amount of shares will be adjusted up or down based on the dollar volume weighted average price during the same period. The agreement allowed us to settle any negative final adjustment at our option in either cash or shares of our stock. Accordingly, we reported the effects of this agreement within shareholders equity. The shares repurchased under the ASR are included in the amount disclosed above as shares repurchased during the three months ended March 31, 2010. Subsequent to March 31, 2010, we repurchased an additional 1.3 shares, for a total of 8.0 shares repurchased pursuant to the ASR, and settled the agreement with our counterparty. The shares repurchased under the ASR subsequent to March 31, 2010 are included in the amount disclosed below as shares repurchased through April 15, 2010. During the three months ended March 31, 2009, we repurchased and retired approximately 17.7 shares at an average per share price of $38.55, for an aggregate cost of $681.2. The excess of cost of the repurchased shares over par value is charged on a pro rata basis to additional paid-in capital and retained earnings.

On January 26, 2010, our Board of Directors increased the share repurchase authorization by $3,500.0. As of March 31, 2010, $2,495.4 remained authorized for future repurchases. Subsequent to March 31, 2010, we repurchased and retired approximately 4.2 shares for an aggregate cost of approximately $180.2, leaving approximately $2,315.2 for authorized future repurchases at April 15, 2010. Our stock repurchase program is discretionary as we are under no obligation to repurchase shares. We repurchase shares under the program when we believe it is a prudent use of capital.

***Stock Incentive Plan*s**

A summary of stock option activity for the three months ended March 31, 2010 is as follows:

	Number of Shares	Weighted-Average Option Price per Share	Weighted-Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2010	26.5	$ 56.98		
Granted	2.9	62.05		
Exercised	(1.4)	37.12		
Forfeited or expired	(0.8)	66.33		
Outstanding at March 31, 2010	27.2	58.27	5.2	$ 304.7
Exercisable at March 31, 2010	18.6	63.08	4.8	$ 152.8

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Notes to Consolidated Financial Statements (Continued)

A summary of the status of nonvested restricted stock activity, including restricted stock units, for the three months ended March 31, 2010 is as follows:

	Restricted Stock Shares And Units	Weighted-Average Grant Date Fair Value per Share
Nonvested at January 1, 2010	4.2	$ 36.02
Granted	1.6	62.05
Vested	(1.4)	39.25
Forfeited	(0.1)	37.12
Nonvested at March 31, 2010	4.3	44.56

12. Earnings per Share

The denominator for basic and diluted earnings per share for the three months ended March 31, 2010 and 2009 is as follows:

	Three Months Ended March 31	
	2010	2009
Denominator for basic earnings per share weighted average shares	441.1	496.0
Effect of dilutive securities employee and director stock options and non-vested restricted stock awards	5.5	2.2
Denominator for diluted earnings per share	446.6	498.2

During the three months ended March 31, 2010 and 2009, weighted average shares related to certain stock options of 16.2 and 21.1, respectively, were excluded from the denominator for diluted earnings per share because the stock options were anti-dilutive.

During the three months ended March 31, 2010, we issued approximately 1.6 restricted stock units under our stock incentive plans, 0.3 of whose vesting is contingent upon us meeting specified annual operating gain targets for 2010. The 0.3 restricted stock units have been excluded from the denominator for diluted earnings per share and will be included only if and when the contingency is met.

13. Segment Information

Our organizational structure is comprised of three reportable segments: Commercial, Consumer and Other. Our Commercial and Consumer segments both offer a diversified mix of managed care products, including PPOs, HMOs, traditional indemnity benefits and POS plans, as well as a variety of hybrid benefit plans, including CDHPs, hospital only and limited benefit products.

Our Commercial segment includes Local Group (including UniCare), National Accounts and certain other ancillary business operations (dental, vision, life and disability and workers compensation). Business units in the Commercial segment offer fully-insured products and provide a broad array of managed care services to self-funded customers, including claims processing, underwriting, stop loss insurance, actuarial services, provider network access, medical cost management, disease management, wellness programs and other administrative services.

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Our Consumer segment includes Senior, State-Sponsored and Individual business. Senior business includes services such as Medicare Part D, Medicare Advantage, and Medicare Supplement, while State-Sponsored business includes our managed care alternatives for the Medicaid and State Children s Health Insurance Plan programs.

Our Other segment includes the Comprehensive Health Solutions Business unit, or CHS, that brings together our resources focused on optimizing the quality of health care and cost of care management. CHS

included our prescription benefits management, or PBM, business until its sale to Express Scripts on December 1, 2009, and also includes provider relations, care and disease management, employee assistance programs, including behavioral health, radiology benefit management and analytics-driven personal health care guidance. Our Other segment also includes results from our Federal Government Solutions, or FGS, business. FGS business includes the Federal Employee Program and National Government Services, Inc., which acts as a Medicare contractor in several regions across the nation. The Other segment also includes other businesses that do not meet the quantitative thresholds for an operating segment, as well as intersegment sales and expense eliminations and corporate expenses not allocated to the other reportable segments.

As a result of cost-reduction initiatives implemented in 2009, we recorded liabilities for employee termination costs and lease and other contract exit costs. Activity related to these liabilities for the three months ended March 31, 2010 is as follows:

	Commercial	Consumer	Other	Total
Employee termination costs:				
Beginning balance at January 1, 2010	$ 89.7	$ 19.6	$ 9.9	$ 119.2
Payments	(16.9)	(3.6)	(1.9)	(22.4)
Employee termination costs ending balance at March 31, 2010	72.8	16.0	8.0	96.8
Lease and other contract exit costs:				
Beginning balance at January 1, 2010	31.8	3.2	9.1	44.1
Payments	(3.3)		(0.1)	(3.4)
Lease and other contract termination costs ending balance at March 31, 2010	28.5	3.2	9.0	40.7
Total 2009 cost-reduction initiatives ending balance at March 31, 2010	$ 101.3	$ 19.2	$ 17.0	$ 137.5

Financial data by reportable segment for the three months ended March 31, 2010 and 2009 is as follows:

	Commercial	Consumer	Other and Eliminations	Total
Three Months Ended March 31, 2010				
Operating revenue from external customers	$ 9,103.8	$ 4,013.1	$ 1,751.8	$ 14,868.7
Operating gain (loss)	978.4	326.0	(17.7)	1,286.7
Three Months Ended March 31, 2009				
Operating revenue from external customers	$ 9,367.5	$ 4,035.4	$ 1,895.8	$ 15,298.7
Intersegment revenue			715.2	715.2
Elimination of intersegment revenue			(715.2)	(715.2)

Operating gain	902.7	218.7	111.6	1,233.0

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Notes to Consolidated Financial Statements (Continued)

A reconciliation of reportable segments operating revenues to total revenues reported in the consolidated statements of income for the three months ended March 31, 2010 and 2009 is as follows:

	Three Months Ended March 31	
	2010	2009
Reportable segments operating revenues	$ 14,868.7	$ 15,298.7
Net investment income	201.1	197.1
Net realized gains (losses) on investments	48.4	(47.5)
Other-than-temporary impairment losses recognized in income	(19.7)	(305.0)
Total revenues	$ 15,098.5	$ 15,143.3

A reconciliation of reportable segments operating gain to income before income tax expense included in the consolidated statements of income for the three months ended March 31, 2010 and 2009 is as follows:

	Three Months Ended March 31	
	2010	2009
Reportable segments operating gain	$ 1,286.7	$ 1,233.0
Net investment income	201.1	197.1
Net realized gains (losses) on investments	48.4	(47.5)
Other-than-temporary impairment losses recognized in income	(19.7)	(305.0)
Interest expense	(99.4)	(116.1)
Amortization of other intangible assets	(60.7)	(67.9)
Impairment of other intangible assets	(21.1)	
Income before income tax expense	$ 1,335.3	$ 893.6

14. Comprehensive Income

The components of comprehensive income for the three months ended March 31, 2010 and 2009 are as follows:

	Three Months Ended March 31	
	2010	2009
Net income	$ 876.8	$ 580.4
Change in net unrealized gains/losses on investments	99.2	152.6
Change in non-credit component of other-than-temporary impairment losses on investments	(3.1)	
Change in net unrealized gains/losses on cash flow hedges	0.2	(2.2)
Change in net periodic pension and postretirement costs	3.4	(0.2)
Foreign currency translation adjustments	(1.0)	

Comprehensive income	$ 975.5	$ 730.6

15. Subsequent Events

We have evaluated subsequent events for recognition or disclosure in our consolidated financial statements filed on Form 10-Q with the SEC and no events, other than those described in these notes, have occurred that require disclosure.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

References to the terms we , our or us used throughout this Management s Discussion and Analysis of Financial Condition and Results of Operations, or MD&A, refer to WellPoint, Inc., an Indiana corporation, and unless the context otherwise requires, its direct and indirect subsidiaries.

Certain prior year amounts have been reclassified to conform to current year presentation.

The structure of our MD&A is as follows:

I. Executive Summary

II. Overview

III. Significant Transactions

IV. Membership March 31, 2010 Compared to March 31, 2009

V. Cost of Care

VI. Results of Operations Three Months Ended March 31, 2010 Compared to the Three Months Ended March 31, 2009

VII. Critical Accounting Policies and Estimates

VIII. Liquidity and Capital Resources

IX. Safe Harbor Statement Under the Private Securities Litigation Reform Act of 1995

This MD&A should be read in conjunction with our audited consolidated financial statements as of and for the year ended December 31, 2009 and the MD&A included in our 2009 Form 10-K, and in conjunction with our unaudited consolidated financial statements and accompanying notes as of and for the three months ended March 31, 2010 included in this Form 10-Q. Results of operations, cost of care trends, investment yields and other measures for the three month period ended March 31, 2010 are not necessarily indicative of the results and trends that may be expected for the full year ending December 31, 2010. Also see Item 1A. Risk Factors in Part I of our 2009 Form 10-K and Part II of this Form 10-Q.

I. Executive Summary

We are the largest health benefits company in terms of medical membership in the United States, serving 33.8 million medical members as of March 31, 2010. We are an independent licensee of the Blue Cross and Blue Shield Association, or BCBSA, an association of independent health benefit plans. We serve our members as the Blue Cross licensee in California and as the Blue Cross and Blue Shield, or BCBS, licensee for: Colorado, Connecticut, Georgia, Indiana, Kentucky, Maine, Missouri (excluding 30 counties in the Kansas City area), Nevada, New Hampshire, New York (as BCBS in 10 New York City metropolitan and surrounding counties, and as Blue Cross or BCBS in selected upstate counties only), Ohio, Virginia (excluding Northern Virginia suburbs of Washington, D.C.) and Wisconsin. In a majority of these service areas we do business as Anthem Blue Cross, Anthem Blue Cross Blue Shield or Empire Blue Cross Blue Shield (in our New York service areas). We

also serve customers throughout much of the country as UniCare. We are licensed to conduct insurance operations in all 50 states through our subsidiaries.

Operating revenue for the three months ended March 31, 2010 was $14.9 billion, a decrease of $430.0 million, or 3%, from the three months ended March 31, 2009. This decrease was primarily due to fully-insured membership declines, primarily in our Local Group business, resulting from the current economic conditions as well as certain UniCare members transitioning to Health Care Services Corporation, or HCSC, beginning January 1, 2010. In addition, the sale of our prescription benefit management business, or PBM business, and the

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loss in 2010 of the Medicare Part D auto-assigned Low-Income Subsidy, or Part D LIS, membership within our Senior business contributed to the operating revenue decline. These decreases were partially offset by higher premium revenue necessary to cover cost trends, which include health care costs and selling, general and administrative expenses. In addition, our operating revenue in 2010 also benefited from increased reimbursement in the Federal Employees Program, or FEP.

Net income for the three months ended March 31, 2010 was $876.8 million, a 51% increase from the three months ended March 31, 2009. The increase in net income was primarily driven by lower benefit expense, lower other-than-temporary impairment losses on investments recognized in income and increased realized gains on investments, partially offset by lower premiums. Our fully-diluted earnings per share, or EPS, was $1.96 for the three months ended March 31, 2010, which was a 69% increase over the EPS of $1.16 for the three months ended March 31, 2009. The increase in EPS resulted primarily from increased net income as well as the lower number of shares outstanding in 2010 due to share buy back activity under our share repurchase program.

Our results of operations discussed throughout this MD&A are determined in accordance with U.S. generally accepted accounting principles, or GAAP. We also calculate adjusted net income and adjusted EPS, which are non-GAAP measures, to further aid investors in understanding and analyzing our core operating results and comparing them period-over-period. Adjusted net income and adjusted EPS exclude realized gains and losses on investments, other-than-temporary losses on investments recognized in income, impairment of other intangible assets and certain other items, if applicable, that we do not consider to be part of our core operating results. The table below reconciles net income and EPS calculated in accordance with GAAP to adjusted net income and adjusted EPS for the three months ended March 31, 2010 and 2009.

	March 31			
(in millions)	**2010**	**2009**	**Change**	**% Change**
Net income	$ 876.8	$ 580.4	$ 296.4	51%
Less (net of tax):				
Net realized gains (losses) on investments, net of tax expense (benefit) of $17.0 million and $(16.7) million, respectively	31.4	(30.8)	62.2	
Other-than-temporary impairment losses on investments, net of tax benefit of $6.9 million and $107.4 million, respectively	(12.8)	(197.6)	184.8	
Impairment of other intangible assets, net of tax benefit of $7.4 million and $0.0 million, respectively	(13.7)		(13.7)	
Adjusted net income	$ 871.9	$ 808.8	$ 63.1	8%
EPS	$ 1.96	$ 1.16	$ 0.80	69%
Less (net of tax):				
Net realized gains (losses) on investments	0.07	(0.06)	0.13	
Other-than-temporary impairment losses on investments	(0.03)	(0.40)	0.37	
Impairment of intangibles	(0.03)		(0.03)	
Adjusted EPS	$ 1.95	$ 1.62	$ 0.33	20%

Operating cash flow for the three months ended March 31, 2010 was $(322.9) million, which included a $1.2 billion tax payment in March 2010 to the Internal Revenue Service, or IRS, related to the gain we realized on our PBM sale on December 1, 2009. Operating cash flow for the three months ended March 31, 2009 was $1.2 billion, or 2.0 times net income. The decrease in operating cash flow from 2009 of $1.5 billion was driven primarily by the $1.2 billion tax payment, increased incentive compensation payments in 2010, reduction in Part D LIS membership and claims payment run-out associated with our UniCare transition in Texas and Illinois.

II. Overview

We manage our operations through three reportable segments: Commercial; Consumer; and Other.

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Our Commercial and Consumer segments both offer a diversified mix of managed care products, including preferred provider organizations, or PPOs; health maintenance organizations, or HMOs; traditional indemnity benefits and point-of-service plans, or POS plans; as well as a variety of hybrid benefit plans, including consumer-driven health plans, or CDHPs, hospital only and limited benefit products.

Our Commercial segment includes Local Group (including UniCare), National Accounts and certain other ancillary business operations (dental, vision, life and disability and workers compensation). Business units in the Commercial segment offer fully-insured products and provide a broad array of managed care services to self-funded customers, including claims processing, underwriting, stop loss insurance, actuarial services, provider network access, medical cost management, disease management, wellness programs and other administrative services.

Our Consumer segment includes Senior, State-Sponsored and Individual businesses. Senior business includes services such as Medicare Part D, Medicare Advantage and Medicare Supplement, while State-Sponsored business includes our managed care alternatives for the Medicaid and State Children s Health Insurance Plan programs.

The Other segment includes our Comprehensive Health Solutions Business unit, or CHS, that brings together our resources focused on optimizing the quality of health care and cost of care management. CHS included our PBM business until its sale to Express Scripts, Inc., or Express Scripts, on December 1, 2009, and also encompasses provider relations, care and disease management, employee assistance programs, including behavioral health, radiology benefit management and analytics-driven personal healthcare guidance. Our Other segment also contains results from our Federal Government Solutions, or FGS, business. FGS business is comprised of the FEP and National Government Services, Inc., or NGS, which acts as a Medicare contractor in several regions across the nation. Finally, the Other segment also includes other businesses that do not meet the quantitative thresholds for an operating segment as defined in Financial Accounting Standards Board, or FASB, guidance for disclosures about segments of an enterprise and related information, as well as intersegment sales and expense eliminations and corporate expenses not allocated to the other reportable segments.

Our operating revenue consists of premiums, administrative fees and other revenue. Premium revenue comes from fully-insured contracts where we indemnify our policyholders against costs for covered health and life benefits. Administrative fees come from contracts where our customers are self-insured, or where the fee is based on either processing of transactions or a percent of network discount savings realized. Additionally, we earn administrative fee revenues from our Medicare processing business and from other health-related businesses, including disease management programs. Other revenue was principally generated from member co-payments and deductibles associated with the mail-order sale of drugs by our PBM business prior to its sale on December 1, 2009.

Our benefit expense primarily includes costs of care for health services consumed by our members, such as outpatient care, inpatient hospital care, professional services (primarily physician care) and pharmacy benefit costs. All four components are affected both by unit costs and utilization rates. Unit costs include the cost of outpatient medical procedures per visit, inpatient hospital care per admission, physician fees per office visit and prescription drug prices. Utilization rates represent the volume of consumption of health services and typically vary with the age and health status of our members and their social and lifestyle choices, along with clinical protocols and medical practice patterns in each of our markets. A portion of benefit expense recognized in each reporting period consists of actuarial estimates of claims incurred but not yet paid by us. Any changes in these estimates are recorded in the period the need for such an adjustment arises. While we offer a diversified mix of managed care products, including PPO, HMO, POS and CDHP products, our aggregate cost of care can fluctuate based on a change in the overall mix of these products. In recent periods, we have seen an increase in COBRA coverage within these product offerings that can further impact our cost of care. COBRA is named for the Consolidated Omnibus Budget Reconciliation Act of 1986, which provides unemployed group members with coverage for up to 18 months after losing their job. On February 17, 2009, the American Recovery and

Reinvestment Act of 2009, or ARRA, was signed into law. ARRA originally provided for a temporary subsidy of COBRA premiums for individuals that were involuntarily terminated from employment (for reasons other than gross misconduct) between September 1, 2008 and February 28, 2010. The eligibility period has been extended twice and now runs through May 31, 2010. The COBRA subsidy under ARRA has caused more individuals to elect COBRA coverage.

Beginning January 1, 2010, we began classifying certain claims-related costs, which were historically classified as administrative expenses, as benefit expense to better reflect costs incurred for our members traditional medical care as well as those expenses which improve our members health and medical outcomes. These reclassified costs are comprised of expenses incurred for: (i) medical management, including case and utilization management; (ii) health and wellness, including disease management services for such things as diabetes, high-risk pregnancies, congestive heart failure and asthma management and wellness initiatives like weight-loss programs and smoking cessation treatments; and (iii) clinical health policy. These types of claims-related costs ultimately lower our members cost of care. Prior year amounts have been reclassified to conform to the new presentation.

Our selling expense consists of external broker commission expenses and generally varies with premium volume. Our general and administrative expense consists of fixed and variable costs. Examples of fixed costs are depreciation, amortization and certain facilities expenses. Other costs are variable or discretionary in nature. Certain variable costs, such as premium taxes, vary directly with premium volume. Other variable costs, such as salaries and benefits, do not vary directly with changes in premium, but are more aligned with changes in membership. The acquisition or loss of a significant block of business would likely impact staffing levels, and thus associate compensation expense. Examples of discretionary costs include professional and consulting expenses and advertising. Other factors can impact our administrative cost structure, including systems efficiencies, inflation and changes in productivity.

Our cost of drugs historically consisted of the amounts we paid to pharmaceutical companies for the drugs we sold to third parties via mail order through our PBM and specialty pharmacy companies until the sale of our PBM operations on December 1, 2009. This amount excluded the cost of drugs related to our members which is recorded in benefit expense. Our cost of drugs were influenced by the volume of prescriptions in our PBM business, as well as cost changes, driven by prices set by pharmaceutical companies and the mix of drugs sold. Following the sale of our PBM business, we no longer record any cost of drugs on our income statement as these third party mail order sales were part of the PBM business sold to Express Scripts.

Our results of operations depend in large part on our ability to accurately predict and effectively manage health care costs through effective contracting with providers of care to our members and our medical management and health and wellness programs. Several economic factors related to health care costs, such as regulatory mandates of coverage as well as direct-to-consumer advertising by providers and pharmaceutical companies, have a direct impact on the volume of care consumed by our members. While we price our business so that expected premium yield exceeds total cost trends, where total cost trend includes health care costs and selling, general and administrative expenses, the potential effect of escalating health care costs, any changes in our ability to negotiate competitive rates with our providers and any regulatory or market driven restrictions on our ability to obtain adequate premium rates to offset overall inflation in health care costs, including increases in unit costs and utilization resulting from the aging of the population and other demographics, as well as advances in medical technology may impose further risks to our ability to profitably underwrite our business, and may have a material impact on our results of operations.

Our future results of operations may also be impacted by certain external forces and resulting changes in our business model and strategy. During the first quarter of 2010, the U.S. Congress passed and the President signed into law the Patient Protection and Affordable Care Act as well as the Health Care and Education Reconciliation Act of 2010, which represent significant changes to the current U.S. health care system. The legislation is far-reaching and is intended to expand access to health insurance coverage over time by increasing the eligibility thresholds for most state Medicaid programs and providing certain other individuals and small businesses with tax incentives to subsidize a portion of the cost of health insurance coverage. The legislation includes a requirement that most individuals obtain health insurance coverage beginning in 2014 and that most large

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employers offer coverage to their employees or they will be required to pay a financial penalty. In addition, the new laws encompass certain new taxes and fees, including an excise tax on high premium insurance policies, limitations on the amount of compensation that is tax deductible and new fees on companies in our industry which may not be deductible for income tax purposes. The legislation also imposes new regulations on the health insurance sector, including, but not limited to, guaranteed coverage requirements, prohibitions on some annual and all lifetime limits on amounts paid on behalf of or to our members, increased restrictions on rescinding coverage, establishment of minimum medical loss ratio requirements, a requirement to cover preventative services on a first dollar basis, the establishment of state insurance exchanges and essential benefit packages, and greater limitations on how we price certain of our products. The legislation also reduces the reimbursement levels for health plans participating in the Medicare Advantage program over time.

Some provisions of the health care reform legislation become effective this year including those that bar health insurance companies from placing lifetime limits on insurance coverage and those related to the increased restrictions on rescinding coverage. However, some of the more significant changes, including the annual fees on health insurance companies, the excise tax on high premium insurance policies, the guaranteed coverage requirements and the requirement that individuals obtain coverage, do not become effective until 2014 or later. The establishment of minimum medical loss ratios, which could have a significant impact on our operations, will take effect for certain of our businesses beginning in 2011.

Many of the details of the new law, including, but not limited to, the medical loss ratio requirements, require additional guidance and specificity to be provided by the Department of Health and Human Services, National Association of Insurance Commissioners, Department of Labor and Treasury Department. Accordingly, while it is too early to fully understand the impacts of the legislation on our business, certain of the provisions are likely to have significant impacts on our future operations, which, in turn, could impact the value of our business model and results of operations. The Company will continue to evaluate the impact of this legislation as additional guidance is provided by the Department of Health and Human Services, National Association of Insurance Commissioners, Department of Labor and Treasury Department.

In addition, federal and state regulatory agencies may restrict our ability to implement changes in premium rates. Our ability to secure sufficient premium rates, including regulatory approval for and implementation of such rates on a timely basis, may be restricted by additional changes in federal and state regulations or by the application of existing federal and state regulations. A limitation on our ability to increase or maintain our premium rates could adversely affect our business, cash flows, financial condition and results of operations.

In addition to external forces discussed in the preceding paragraphs, our results of operations are impacted by levels and mix of membership. During 2009, we experienced both fully-insured and self-funded membership declines. Given the current economic conditions in the U.S., it is expected that unemployment levels will remain high throughout 2010, which may impact our ability to increase or even maintain current membership levels. These membership trends could have a material adverse effect on our future results of operations.

The National Organization of Life & Health Insurance Guaranty Associations, or NOLHGA, is a voluntary association consisting of the state life and health insurance guaranty organizations located throughout the U.S. State life and health insurance guaranty organizations, working together with NOLHGA, provide a safety net for their state s policyholders, ensuring that they continue to receive coverage even if their insurer is declared insolvent. We are aware that the Pennsylvania Insurance Commissioner, or Insurance Commissioner, has recently placed Penn Treaty Network America Insurance Company and its subsidiary American Network Insurance Company, or collectively Penn Treaty, in rehabilitation, an intermediate action before insolvency. The Insurance Commissioner has petitioned the state court for liquidation, however, we do not know when a decision will be made. In the event that Penn Treaty is declared insolvent and placed in liquidation, we and other insurers may be required to pay a portion of their policyholder claims through NOLHGA guaranty association assessments in future periods. We will continue to monitor the situation and may record a liability and expense in future reporting periods, which could be material to our operating results.

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III. Significant Transactions

Stock Repurchase Program

We regularly review the appropriate use of capital. Accordingly, under our Board of Directors authorization, we maintain a common stock repurchase program. Repurchases may be made from time to time at prevailing market prices, subject to certain restrictions on volume, pricing and timing. The repurchases are effected from time to time in the open market, in private transactions, including accelerated share repurchase agreements, and through plans designed to comply with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended.

During the three months ended March 31, 2010, we repurchased and retired approximately 20.9 million shares at an average per share price of $62.22 (calculated including the final settlement shares of the accelerated share repurchase program discussed below), for an aggregate cost of $1.4 billion. Under the share repurchase program, on February 24, 2010, we entered into an accelerated share repurchase, or ASR, program with a counterparty. The agreement provides for a repurchase of a number of our shares, equal to $500.0 million, as determined by the dollar volume weighted average share price during a one to two month period. At March 31, 2010 we had repurchased 6.7 million shares under the agreement and the counterparty is purchasing shares of our stock in the open market at prevailing market prices over the remaining term of the ASR. At the end of the term of the ASR, the initial amount of shares will be adjusted up or down based on the dollar volume weighted average price during the same period. The agreement allowed us to settle any negative final adjustment at our option in either cash or shares of our stock. Accordingly, we reported the effects of this agreement within shareholders equity. The shares repurchased under the ASR are included in the amount disclosed above as shares repurchased during the three months ended March 31, 2010. Subsequent to March 31, 2010, we repurchased an additional 1.3 million shares, for a total of 8.0 million shares repurchased pursuant to the ASR, and settled the agreement with our counterparty. The shares repurchased under the ASR subsequent to March 31, 2010 are included in the amount disclosed below as shares repurchased through April 15, 2010. During the three months ended March 31, 2009, we repurchased and retired approximately 17.7 million shares at an average per share price of $38.55, for an aggregate cost of $681.2 million. The excess of cost of the repurchased shares over par value is charged on a pro rata basis to additional paid-in capital and retained earnings.

On January 26, 2010, our Board of Directors increased the share repurchase authorization by $3.5 billion. As of March 31, 2010, $2.5 billion remained authorized for future repurchases. Subsequent to March 31, 2010, we repurchased and retired approximately 4.2 million shares for an aggregate cost of approximately $180.2 million, leaving approximately $2.3 billion for authorized future repurchases at April 15, 2010. Our stock repurchase program is discretionary as we are under no obligation to repurchase shares. We repurchase shares under the program when we believe it is a prudent use of capital.

IV. Membership March 31, 2010 Compared to March 31, 2009

Our medical membership includes seven different customer types: Local Group, Individual, National Accounts, BlueCard, Senior, State-Sponsored and FEP. BCBSA-branded business generally refers to members in our service areas licensed by the BCBSA. Non-BCBSA-branded business refers to UniCare members predominately outside of our BCBSA service areas.

- Local Group (including UniCare) consists of those employer customers with less than 5% of eligible employees located outside of the employer s headquarter state, as well as customers with more than 5% of eligible employees located outside of the headquarter state with up to 2,500 eligible employees.

- Individual consists of individual customers under age 65 (including UniCare) and their covered dependents.

- National Accounts generally consist of multi-state employer groups primarily headquartered in a WellPoint service area with at least 5% of the eligible employees located outside of the headquarter state and with more than 2,500 eligible employees. Some exceptions are allowed based on broker relationships.

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BlueCard host members represent enrollees of Blue Cross and/or Blue Shield plans not owned by WellPoint who receive health care services in our BCBSA licensed markets. BlueCard membership consists of estimated host members using the national BlueCard program. Host members are generally members who reside in or travel to a state in which a WellPoint subsidiary is the Blue Cross and/or Blue Shield licensee and who are covered under an employer-sponsored health plan issued by a non-WellPoint controlled BCBSA licensee (i.e., the home plan). We perform certain administrative functions for BlueCard members, for which we receive administrative fees from the BlueCard members home plans. Other administrative functions, including maintenance of enrollment information and customer service, are performed by the home plan. Host members are computed using, among other things, the average number of BlueCard claims received per month.

Senior members are Medicare-eligible individual members age 65 and over who have enrolled in Medicare Advantage, a managed care alternative for the Medicare program, or who have purchased Medicare Supplement benefit coverage.

State-Sponsored membership represents eligible members with State-Sponsored managed care alternatives in Medicaid and State Children s Health Insurance Plan programs.

FEP members consist of United States government employees and their dependents within our geographic markets through our participation in the national contract between the BCBSA and the U.S. Office of Personnel Management.

In addition to reporting our medical membership by customer type, we report by funding arrangement according to the level of risk that we assume in the product contract. Our two funding arrangement categories are fully-insured and self-funded. Fully-insured products are products in which we indemnify our policyholders against costs for health benefits. Self-funded products are offered to customers, generally larger employers, who elect to retain most or all of the financial risk associated with their employees health care costs. Some self-funded customers choose to purchase stop-loss coverage to limit their retained risk.

The following table presents our medical membership by customer type, funding arrangement and reportable segment as of March 31, 2010 and 2009. Also included below are other businesses key metrics, including prescription volume for our PBM companies and other membership by product. The medical membership and other businesses metrics presented are unaudited and in certain instances include estimates of the number of members represented by each contract at the end of the period.

	March 31			
(In thousands)	2010	2009	Change	% Change
Medical Membership				
Customer Type				
Local Group	15,311	16,071	(760)	(5)%
Individual	1,987	2,235	(248)	(11)
National:				
National Accounts	7,208	7,034	174	2
BlueCard	4,885	4,836	49	1
Total National	12,093	11,870	223	2
Senior	1,252	1,256	(4)	
State-Sponsored	1,745	1,742	3	
FEP	1,447	1,385	62	4
Total Medical Membership by Customer Type	33,835	34,559	(724)	(2)
Funding Arrangement				
Self-Funded	18,801	18,646	155	1
Fully-Insured	15,034	15,913	(879)	(6)
Total Medical Membership by Funding Arrangement	33,835	34,559	(724)	(2)
Reportable Segment				
Commercial	27,439	28,141	(702)	(2)
Consumer	4,949	5,033	(84)	(2)
Other	1,447	1,385	62	4
Total Medical Membership by Reportable Segment	33,835	34,559	(724)	(2)
Other Membership				
Behavioral Health	23,444	23,525	(81)	
Life and Disability	5,235	5,470	(235)	(4)
Dental[1]	4,131	4,374	(243)	(6)
Managed dental[1]	4,311		4,311	NM[2]
Vision	3,368	2,782	586	21
Medicare Part D	1,227	1,705	(478)	(28)

1 Dental membership as of March 31, 2010 includes DeCare Dental, LLC, or DeCare, members not included in managed dental membership, which were acquired on April 9, 2009. Managed dental membership includes members acquired through the DeCare acquisition for which we provide administrative services only.

2 NM = Not meaningful.

Medical Membership

During the twelve months ended March 31, 2010, total medical membership decreased 724,000, or 2%, primarily due to decreases in Local Group (including UniCare) and Individual businesses, partially offset by increases in our National Accounts, FEP and BlueCard membership. The majority of the decline was in our Local Group business and primarily reflects the loss of non-BCBSA-branded membership resulting from

the transition

of UniCare members to HCSC beginning January 1, 2010 as well as lapses and net unfavorable in-group change caused by higher unemployment resulting from the current economic conditions, partially offset by new sales. In-group enrollment change represents membership changes within a group that still remains our customer.

Self-funded medical membership increased 155,000, or 1%, primarily due to an increase in self-funded National Account membership resulting from additional sales and ongoing conversions to self-funded arrangements, partially offset by declines in self-funded Local Group membership resulting primarily from non-BCBSA-branded membership declines, including the transition of UniCare members to HCSC.

Fully-insured membership decreased 879,000 members, or 6%, primarily due to declines in fully-insured Local Group and National Accounts membership resulting from lapses and net unfavorable in-group enrollment change caused by higher unemployment, the transition of UniCare members to HCSC and reduced Individual membership due to the economic conditions, partially off-set by FEP membership increases.

Local Group membership decreased 760,000, or 5%, primarily due to membership declines in our non-BCBSA branded membership and, to a lesser extent, a decline in BCBSA-branded business. The majority of the non-BCBSA branded decline is due to the UniCare transition to HCSC. The BCBSA-branded business declines were primarily related to lapses and net unfavorable in-group enrollment changes associated with the current economic conditions partially offset by new sales.

Individual membership decreased 248,000, or 11%, due to the transition of UniCare members to HCSC, and, to a lesser extent, a decline in BCBSA-branded business, resulting from competitive pricing pressures and overall economic conditions.

National Accounts membership increased 174,000, or 2%, primarily driven by additional sales, reflective of our extensive and cost-effective provider networks and a broad and innovative product portfolio. These increases were partially offset by lapses and net unfavorable in-group enrollment changes due to the current economic conditions.

BlueCard membership increased 49,000, or 1%, primarily due to increased utilization by other BCBSA licensee members who reside in or travel to our licensed areas.

Senior membership decreased 4,000, or less than 1%, primarily due to lower membership in Medicare Supplement plans, partially offset by increases in our Medicare Advantage plans.

State-Sponsored membership increased 3,000, or less than 1%, primarily due to growth in Indiana and Virginia, partially offset by lower membership in California resulting from state budgetary and administrative issues.

Other Membership

Our Other products are often ancillary to our health business, and can therefore be impacted by corresponding changes in our medical membership.

Behavioral health membership decreased 81,000, or less than 1%, primarily due to higher unemployment resulting from the current economic downturn, partially offset by growth in certain products.

Life and disability membership decreased 235,000, or 4%, primarily due to the UniCare membership transition to HCSC beginning January 1, 2010. Life and disability products are generally offered as a part of Commercial medical fully-insured membership sales.

Dental membership decreased 243,000, or 6%, primarily due to the UniCare membership transition to HCSC net unfavorable in-group enrollment changes and lapses due to the current economic conditions, partially offset by new sales to several groups and members acquired with DeCare on April 9, 2009.

Managed dental membership increased 4,311,000 reflecting our acquisition of DeCare on April 9, 2009.

Vision membership increased 586,000, or 21%, primarily due to continued sales and market penetration of our Blue View vision product, partially offset by lapses and net unfavorable in-group changes.

Medicare Part D membership decreased 478,000, or 28%, primarily reflecting the loss of the Part D LIS membership in 2010.

V. Cost of Care

The following discussion summarizes our aggregate underlying cost of care trends for the rolling 12 months ended March 31, 2010 for our Local Group fully-insured business only. As previously discussed, these costs are influenced by our mix of managed care products, including PPO, HMO, POS and CDHP products, in addition to changes in the unit costs and utilization levels.

Our cost of care trends are calculated by comparing the year-over-year change in average per member per month claim costs, including member co-payments and deductibles. While our cost of care trend varies by geographic location, based on underlying medical cost trends, we believe our 2010 cost of care trend estimate of 8.0% plus or minus 50 basis points is appropriate.

Overall, our medical cost trend continued to be driven by unit costs. Utilization is still a significant contributor to trend due to influences like H1N1 and increased COBRA membership that are still impacting our experience period. Inpatient hospital trend was in the low double digit range and was primarily related to increases in cost per admission. Developing trend indicates that approximately 85% of the inpatient trend is cost driven, while 15% is utilization driven. Primary contributors to unit cost trends include elevated average case acuity (intensity) as well as negotiated rate increases with hospitals. As we are successful in moving lower intensity procedures to lower cost outpatient services, the remaining inpatient procedures are of higher average intensity. Both the inpatient admission counts per thousand members and the inpatient day counts per thousand members were higher than the prior year. The average length of inpatient stays also increased over prior year levels. Respiratory admissions as well as knee/hip replacements represent a few of the categories contributing to the increased utilization. Continued clinical management and re-contracting efforts are in place to help mitigate the inpatient trend increases. Programs such as the enterprise-wide enhanced *360º Health* care management programs, the industry s first program to integrate all care management programs and tools into a centralized, consumer-friendly resource, continue to aid our members in accessing the most comprehensive and appropriate care available. Focused review efforts are in place for inpatient behavioral health stays, neo-natal intensive care unit cases, and spinal surgery cases, among others. Additionally, we have introduced new programs related to readmission management, focused utilization management at high costs facilities and post-discharge follow-up care.

Outpatient trend was in the low double digit range and was 60% cost driven and 40% utilization driven. Outpatient costs are a collection of different types of expenses, such as outpatient facilities, labs, x-rays, emergency room, and occupational and physical therapy. Per visit costs are still the largest contributor to overall outpatient trend, influenced by price increases within certain provider contracts. Outpatient utilization (visits per thousand members) is higher than prior year. The increase is spanning multiple categories of outpatient care. ER management programs, behavioral health reviews and initiatives to help optimize site of service decisions are serving to encourage appropriate utilization of outpatient services. Additionally, we continued to see the positive impact of incorporating the technology of our American Imaging Management, Inc., or AIM, subsidiary. This is allowing us to achieve greater efficiencies in the high trend area of radiology, ensuring that consumers receive the quality tests they need. Leveraging AIM s platform and expertise in areas such as nuclear cardiology management, specialty pharmacy reviews and myocardial perfusion imaging is aiding our efforts to mitigate trend increases.

Physician services trend was in the mid single digit range and was 40% cost driven and 60% utilization driven. Increases in the physician care category were partially driven by contracting changes as well as increased utilization in late 2009 related to H1N1. We continue to collaborate with physicians to improve quality of care through pay-for-performance programs.

Pharmacy trend was in the low double digit range and was 80% unit cost (cost per prescription) related and 20% utilization (prescriptions per member per year) driven. Recent inflation in the average wholesale price of drugs is applying upward pressure to the overall cost per prescription as is the increased use of specialty drugs. Specialty drugs, also known as biotech drugs, are generally higher cost and are being utilized more frequently. The increase in cost per prescription measures were mitigated by increases in our generic usage rates, benefit plan design changes and continued management of contracting arrangements and fee schedules. We are continuously evaluating our drug formulary to ensure the most effective pharmaceutical therapies are available to our members.

In response to cost trends, we continue to pursue contracting and plan design changes, promote and implement performance-based contracts that reward clinical outcomes and quality, and expand our radiology management, disease management and advanced care management programs. Expansion continues on *360º Health,* which assists patients in navigating the health care system, using their health benefits and accessing the most comprehensive and appropriate care available. Additionally, our Resolution Health, Inc. subsidiary is allowing us to fully integrate their suite of products aimed to improve healthcare quality and reduce healthcare costs. As an example, My Health Advantage is a Resolution Health product that uses market-leading technology to analyze medical claims, pharmacy claims, lab results, benefits plan information and personal health information to identify opportunities to help close gaps between recommended care and the care that members actually receive. Furthermore, the sale of our PBM business and the resulting strategic alliance with Express Scripts is bringing with it greater capabilities and resources, allowing members to leverage more cost-effective solutions and state-of-the-art PBM services.

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VI. Results of Operations Three Months Ended March 31, 2010 Compared to the Three Months Ended March 31, 2009

Our consolidated results of operations for the three months ended March 31, 2010 and 2009 are discussed in the following section.

	Three Months Ended March 31			
	2010	2009	$ Change	% Change
(In millions, except per share data)				
Premiums	$ 13,909.9	$ 14,203.2	$ (293.3)	(2)%
Administrative fees	952.9	941.5	11.4	1
Other revenue	5.9	154.0	(148.1)	(96)
Total operating revenue	14,868.7	15,298.7	(430.0)	(3)
Net investment income	201.1	197.1	4.0	2
Net realized gains (losses) on investments	48.4	(47.5)	95.9	NM[1]
Other-than-temporary impairment losses on investments:				
Total other-than-temporary impairment losses on investments	(27.9)	(305.0)	277.1	(91)
Portion of other-than-temporary impairment losses recognized in other comprehensive income	8.2		8.2	NM[1]
Other-than-temporary impairment losses recognized in income	(19.7)	(305.0)	285.3	(94)
Total revenues	15,098.5	15,143.3	(44.8)	
Benefit expense	11,381.4	11,724.4	(343.0)	(3)
Selling, general and administrative expense:				
Selling expense	402.4	432.0	(29.6)	(7)
General and administrative expense	1,798.2	1,796.9	1.3	
Total selling, general and administrative expense	2,200.6	2,228.9	(28.3)	(1)
Cost of drugs		112.4	(112.4)	(100)
Interest expense	99.4	116.1	(16.7)	(14)
Amortization of other intangible assets	60.7	67.9	(7.2)	(11)
Impairment of other intangible assets	21.1		21.1	NM[1]
Total expenses	13,763.2	14,249.7	(486.5)	(3)
Income before income tax expense	1,335.3	893.6	441.7	49
Income tax expense	458.5	313.2	145.3	46
Net income	$ 876.8	$ 580.4	$ 296.4	51
Average diluted shares outstanding	446.6	498.2	(51.6)	(10)%
Diluted net income per share	$ 1.96	$ 1.16	$ 0.80	69%
Benefit expense ratio[2]	81.8%	82.5%		(70)bp[3]
Selling, general and administrative expense ratio[4]	14.8%	14.6%		20bp[3]
Income before income taxes as a percentage of total revenue	8.8%	5.9%		290bp[3]
Net income as a percentage of total revenue	5.8%	3.8%		200bp[3]

Certain of the following definitions are also applicable to all other results of operations tables in this discussion:

[1] NM = Not meaningful
[2] Benefit expense ratio = Benefit expense ÷ Premiums.
[3] bp = basis point; one hundred basis points = 1%.
[4] Selling, general and administrative expense ratio = Total selling, general and administrative expense ÷ Total operating revenue.

Premiums decreased $293.3 million, or 2%, to $13.9 billion in 2010, primarily due to fully-insured membership declines in our Local Group business, resulting from the current economic conditions as well as certain UniCare members transitioning to HCSC beginning January 1, 2010. In addition, the loss in 2010 of the Part D LIS membership within our Senior business contributed to the decline in premiums. These decreases were partially offset by higher premium revenues necessary to cover cost trends, as discussed above, increased reimbursement in the FEP program and increased membership in our Senior Medicare Advantage business and certain State-Sponsored programs.

Administrative fees increased $11.4 million, or 1%, to $952.9 million in 2010, primarily due to increased membership and revenue in our self-funded National Accounts, and revenue from DeCare which was acquired on April 9, 2009. These increases were partially offset by reductions of certain PBM related revenues earned in 2009 and lower revenues in our NGS Medicare business.

The majority of other revenue was historically comprised of co-payments and deductibles associated with the sale of mail-order prescription drugs by our PBM companies to third party clients. We sold our PBM business to Express Scripts on December 1, 2009, including third party mail order sales, and will not record other revenue for this business in 2010. Other revenue of $5.9 million recorded in 2010 is primarily associated with miscellaneous activities.

Net investment income increased $4.0 million, or 2%, to $201.1 million in 2010, primarily resulting from increased investment balances.

A summary of our net realized gains (losses) on investments for the three months ended March 31, 2010 and 2009 is as follows:

	Three Months Ended March 31		
	2010	2009	$ Change
(In millions)			
Net realized gains (losses) on investments			
Net realized gains (losses) from the sale of fixed maturity securities	$ 43.1	$ (9.9)	$ 53.0
Net realized gains (losses) from the sale of equity securities	5.4	(37.3)	42.7
Other net realized losses on investments	(0.1)	(0.3)	0.2
Net realized gains (losses) on investments	48.4	(47.5)	95.9
Other-than-temporary impairment losses recognized in income			
Other-than-temporary impairment losses equity securities	(9.1)	(169.7)	160.6
Other-than-temporary impairment losses fixed maturity securities	(10.6)	(135.3)	124.7
Other-than-temporary impairment losses recognized in income	(19.7)	(305.0)	285.3
Net realized gains (losses) on investments and other-than-temporary impairment losses recognized in income	$ 28.7	$ (352.5)	$ 381.2

Net realized gains on investments increased in 2010 primarily due to increased gains from the sale of fixed maturity securities and reduced net realized losses from the sale of equity securities.

Other-than-temporary impairment losses recognized in income decreased in 2010. Other-than-temporary impairment losses recognized in income in 2009 were related to both impairment of fixed maturity securities, primarily from declines in credit ratings, and impairment of equity securities due to declines in stock prices. There were no individually significant other-than-temporary impairments of investments by issuer during the three months ended March 31, 2010 or 2009.

Benefit expense decreased $343.0 million, or 3%, to $11.4 billion in 2010, primarily due to fully-insured membership declines in our Local Group business, including certain UniCare members transitioning to HCSC beginning January 1, 2010. In addition, the 2010 loss of the Part D LIS membership within our Senior business

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contributed to the decline in benefit expense. Finally, lower benefit expense in certain State-Sponsored programs resulting from operational changes, including provider capitation in California, decreased benefit expense. These decreases were partially offset by increases in benefit costs in our Local Group BCBSA-branded, Senior Medicare Advantage and FEP businesses. We receive reimbursement for FEP costs plus a fee. The increase in Local Group BCBSA-branded benefit expense was driven by higher unit costs and the impact of the recession on business mix changes, including higher COBRA membership year over year. Medicare Advantage increases were due to higher membership.

Our benefit expense ratio decreased 70 basis points to 81.8% in 2010, due to improvements in both our Consumer and Commercial segments. The Consumer segment benefited from improvement in State-Sponsored programs, primarily in California. The decline in the Consumer segment benefit expense ratio was also driven by improvements in our Senior business, primarily due to the loss in 2010 of the Part D LIS members, which have historically higher benefit ratios. Improvements in the Commercial segment were primarily related to our Local Group BCBSA-branded business, which reflected disciplined pricing and lower flu-related costs.

Selling, general and administrative expense decreased $28.3 million, or 1%, to $2.2 billion in 2010. Our selling, general and administrative expense decreased due to lower selling expenses and compensation costs, partially offset by increases in outside services. The selling expense decline included reduced amounts related to our UniCare business that transitioned to HCSC. Our 2010 general and administrative expenses do not include the administrative expenses formerly incurred by our PBM business, as these operations were sold to Express Scripts in December 2009. The expenses associated with administering PBM products to our medical members are now reflected in the drug prices charged to us by Express Scripts as part of our ten year contract and are included in benefit expense described above. While overall selling, general and administrative expense decreased, our selling, general and administrative expense ratio increased 20 basis points to 14.8% in 2010, primarily due to a decline in operating revenue.

Cost of drugs sold decreased $112.4 million, or 100%, due to no PBM activity in 2010 as compared to 2009, resulting from the sale of our PBM business to Express Scripts on December 1, 2009. These cost of drugs sold were associated with other revenue generated from mail order sales of drugs to third parties. Following the sale of our PBM business, we do not record any cost of drugs on our income statement.

Interest expense decreased $16.7 million, or 14%, to $99.4 million in 2010, primarily due to lower debt balances and lower short term rates on floating rate debt.

Amortization of other intangible assets decreased $7.2 million, or 11%, to $60.7 million in 2010, primarily due to reduced balances of certain amortizable intangible assets acquired in prior years.

In the first quarter of 2010, we recognized an impairment charge of $21.1 million for certain intangible assets associated with the UniCare provider networks, due to a decision we made to transfer certain membership to an alternative network.

Income tax expense increased $145.3 million, or 46%, to $458.5 million in 2010. The effective tax rates in 2010 and 2009 were 34.3% and 35.0%, respectively.

Our net income as a percentage of total revenue increased 200 basis points to 5.8% in 2010 as compared to 2009 as a result of all factors discussed above.

Reportable Segments

We use operating gain to evaluate the performance of our reportable segments, as described in FASB guidance, which are Commercial, Consumer and Other. Operating gain is calculated as total operating revenue less benefit expense, selling, general and administrative expense and cost of drugs. It does not include net investment income, net realized gains or losses on investments, interest expense, amortization or impairment of

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other intangible assets or income taxes, as these items are managed in a corporate shared service environment and are not the responsibility of operating segment management. For additional information, see Note 13 to our unaudited consolidated financial statements for the three months ended March 31, 2010 included in this Form 10-Q. The discussions of segment results for the three months ended March 31, 2010 and 2009 presented below are based on operating gain, as described above, and operating margin, which is calculated as operating gain divided by operating revenue. Our definitions of operating gain and operating margin may not be comparable to similarly titled measures reported by other companies.

Commercial

Our Commercial segment s summarized results of operations for the three months ended March 31, 2010 and 2009 are as follows:

	Three Months Ended March 31			
(In millions)	2010	2009	$ Change	% Change
Operating revenue	$ 9,103.8	$ 9,367.5	$ (263.7)	(3)%
Operating gain	$ 978.4	$ 902.7	$ 75.7	8%
Operating margin	10.7%	9.6%		110 bp

Operating revenue decreased $263.7 million, or 3%, to $9.1 billion in 2010, primarily due to fully-insured membership declines in our Local Group BCBSA-branded business due to economic factors, as well as certain UniCare members transitioning to HCSC beginning January 1, 2010. These decreases were partially offset by higher premium revenue necessary to cover cost trend, as discussed above, increased revenue and membership in our self-funded National Accounts business and revenues from DeCare following the acquisition.

Operating gain increased $75.7 million, or 8%, to $978.4 million in 2010 primarily due to improvements in our Local Group BCBSA-branded business, partially offset by lower operating gain resulting from the transition of our UniCare members. The improvement in our Local Group BCBSA-branded business reflected higher premium revenue necessary to cover cost trend and lower flu-related costs.

The operating margin in 2010 was 10.7%, a 110 basis point increase over 2009 primarily due to the factors discussed in the preceding two paragraphs.

Consumer

Our Consumer segment s summarized results of operations for the three months ended March 31, 2010 and 2009 are as follows:

	Three Months Ended March 31			
(In millions)	2010	2009	$ Change	% Change
Operating revenue	$ 4,013.1	$ 4,035.4	$ (22.3)	(1)%
Operating gain	$ 326.0	$ 218.7	$ 107.3	49%
Operating margin	8.1%	5.4%		270 bp

Operating revenue decreased $22.3 million, or 1%, to $4.0 billion in 2010, primarily due to our loss in 2010 of the Part D LIS membership, partially offset by increases in our Medicare Advantage business.

Operating gain increased $107.3 million, or 49%, to $326.0 million in 2010, primarily due to improved

results in our Senior and State-Sponsored businesses. The improvement in the Senior business reflects the impact of the reduced Part D LIS membership, partially offset by lower operating gain in our Medicare Advantage business due to reimbursement changes for 2010. The State-Sponsored operating gain increased due to operational changes, including provider capitation arrangements in California, and increased reimbursement levels.

The operating margin in 2010 was 8.1%, a 270 basis point increase over 2009 primarily due to the factors discussed in the preceding two paragraphs.

Other

Our Other segment s summarized results of operations for the three months ended March 31, 2010 and 2009 are as follows:

	Three Months Ended March 31			
	2010	**2009**	**$ Change**	**% Change**
(In millions)				
Operating revenue	$ 1,751.8	$ 1,895.8	$ (144.0)	(8)%
Operating gain	$ (17.7)	$ 111.6	$ (129.3)	NM[1]

Operating revenue decreased $144.0 million, or 8%, to $1.8 billion in 2010, primarily due to the sale of the PBM business on December 1, 2009 and lower administrative fees in our NGS Medicare business, partially offset by growth in our FEP business.

Operating gain decreased $129.3 million to an operating loss of $17.7 million in 2010, primarily due to the sale of the PBM business on December 1, 2009 and lower operating gains in our Health Care Management subsidiary and NGS Medicare businesses.

VII. Critical Accounting Policies and Estimates

We prepare our consolidated financial statements in conformity with U.S. generally accepted accounting principles, or GAAP. Application of GAAP requires management to make estimates and assumptions that affect the amounts reported in our consolidated financial statements and accompanying notes and within this MD&A. We consider some of our most important accounting policies that require estimates and management judgment to be those policies with respect to liabilities for medical claims payable, income taxes, goodwill and other intangible assets, investments and retirement benefits, which are discussed below. Our significant accounting policies are summarized in Note 2 to our audited consolidated financial statements as of and for the year ended December 31, 2009 included in our 2009 Annual Report on Form 10-K.

We continually evaluate the accounting policies and estimates used to prepare the consolidated financial statements. In general, our estimates are based on historical experience, evaluation of current trends, information from third party professionals and various other assumptions that we believe to be reasonable under the known facts and circumstances.

Medical Claims Payable

The most judgmental accounting estimate in our consolidated financial statements is our liability for medical claims payable. At March 31, 2010, this liability was $5.5 billion and represented 21% of our total consolidated liabilities. We record this liability and the corresponding benefit expense for incurred but not paid claims, including the estimated costs of processing such claims. Incurred but not paid claims include (1) an estimate for claims that are incurred but not reported, as well as claims reported to us but not yet processed through our systems, which approximated 97%, or $5.3 billion, of our total medical claims liability as of

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March 31, 2010; and (2) claims reported to us and processed through our systems but not yet paid, which approximated 3%, or $155.6 million, of the total medical claims liability as of March 31, 2010. The level of claims payable processed through our systems but not yet paid may fluctuate from one period end to the next, from 1% to 5% of our total medical claims liability, due to timing of when claim payments are made.

Liabilities for both claims incurred but not reported and reported but not yet processed through our systems are determined in aggregate, employing actuarial methods that are commonly used by health insurance actuaries and meet Actuarial Standards of Practice. Actuarial Standards of Practice require that the claim liabilities be adequate under moderately adverse circumstances. We determine the amount of the liability for incurred but not paid claims by following a detailed actuarial process that entails using both historical claim payment patterns as well as emerging medical cost trends to project our best estimate of claim liabilities. Under this process, historical paid claims data is formatted into claim triangles, which compare claim incurred dates to the dates of claim payments. This information is analyzed to create completion factors that represent the average percentage of total incurred claims that have been paid through a given date after being incurred. Completion factors are applied to claims paid through the period end date to estimate the ultimate claim expense incurred for the period. Actuarial estimates of incurred but not paid claim liabilities are then determined by subtracting the actual paid claims from the estimate of the ultimate incurred claims.

For the most recent incurred months (typically the most recent two months), the percentage of claims paid for claims incurred in those months is generally low. This makes the completion factor methodology less reliable for such months. Therefore, incurred claims for recent months are not projected from historical completion and payment patterns; rather they are projected by estimating the claims expense for those months based on recent claims expense levels and health care trend levels, or trend factors.

Because the reserve methodology is based upon historical information, it must be adjusted for known or suspected operational and environmental changes. These adjustments are made by our actuaries based on their knowledge and their estimate of emerging impacts to benefit costs and payment speed. Circumstances to be considered in developing our best estimate of reserves include changes in utilization levels, unit costs, mix of business, benefit plan designs, provider reimbursement levels, processing system conversions and changes, claim inventory levels, claim processing patterns, claim submission patterns and operational changes resulting from business combinations. A comparison of prior period liabilities to re-estimated claim liabilities based on subsequent claims development is also considered in making the liability determination. In our comparison of prior year, the methods and assumptions are not changed as reserves are recalculated; rather the availability of additional paid claims information drives our changes in the re-estimate of the unpaid claim liability. To the extent appropriate, changes in such development are recorded as a change to current period benefit expense.

In addition to incurred but not paid claims, the liability for medical claims payable includes reserves for premium deficiencies, if appropriate. Premium deficiencies are recognized when it is probable that expected claims and administrative expenses will exceed future premiums on existing medical insurance contracts without consideration of investment income. Determination of premium deficiencies for longer duration life and disability contracts includes consideration of investment income. For purposes of premium deficiencies, contracts are grouped in a manner consistent with our method of acquiring, servicing and measuring the profitability of such contracts. No premium deficiencies were established at March 31, 2010.

We regularly review and set assumptions regarding cost trends and utilization when initially establishing claim liabilities. We continually monitor and adjust the claims liability and benefit expense based on subsequent paid claims activity. If it is determined that our assumptions regarding cost trends and utilization are significantly different than actual results, our income statement and financial position could be impacted in future periods. Adjustments of prior year estimates may result in additional benefit expense or a reduction of benefit expense in the period an adjustment is made. Further, due to the considerable variability of health care costs, adjustments to claim liabilities occur each quarter and are sometimes significant as compared to the net income recorded in that quarter. Prior period development is recognized immediately upon the actuary s judgment that a portion of the

prior period liability is no longer needed or that an additional liability should have been accrued. That determination is made when sufficient information is available to ascertain that the re-estimate of the liability is reasonable.

While there are many factors that are used as a part of the estimation of our medical claims payable liability, the two key assumptions having the most significant impact on our incurred but not paid liability as of March 31, 2010 were the completion and trend factors. As discussed above, these two key assumptions can be influenced by other operational variables including system changes, provider submission patterns and business combinations.

There is variation in the reasonable choice of completion factors by duration for durations of three months through 12 months where the completion factors have the most significant impact. As previously discussed, completion factors tend to be less reliable for the most recent months and therefore are not specifically utilized for months one and two. In our analysis for the claim liabilities at March 31, 2010, the variability in months three to five was estimated to be between 90 and 120 basis points, while months six through twelve have much lower variability ranging from 10 to 70 basis points.

The difference in completion factor assumptions, assuming moderately adverse experience, results in variability of 5%, or approximately $255.0 million, in the March 31, 2010 incurred but not paid claim liability, depending on the completion factors chosen. It is important to note that the completion factor methodology inherently assumes that historical completion rates will be reflective of the current period. However, it is possible that the actual completion rates for the current period will develop differently from historical patterns and therefore could fall outside the possible variations described herein.

The other major assumption used in the establishment of the March 31, 2010 incurred but not paid claim liability was the trend factors. In our analysis for the period ended March 31, 2010, there was a 640 basis point differential in the high and low trend factors assuming moderately adverse experience. This range of trend factors would imply variability of 9%, or approximately $484.0 million, in the incurred but not paid claims liability, depending upon the trend factors used. Because historical trend factors are often not representative of current claim trends, the trend experience for the most recent six to nine months, plus knowledge of recent events likely affecting current trends, have been taken into consideration in establishing the incurred but not paid claim liability at March 31, 2010.

Note 11 to our audited consolidated financial statements as of and for the year ended December 31, 2009 included in our 2009 Annual Report on Form 10-K provides historical information regarding the accrual and payment of our medical claims liability. Components of the total incurred claims for each year include amounts accrued for current year estimated claims expense as well as adjustments to prior year estimated accruals. In Note 11 to our audited consolidated financial statements, the line labeled Net incurred medical claims: Prior years redundancies accounts for those adjustments made to prior year estimates. The impact of any reduction of Net incurred medical claims: Prior years redundancies claims may be offset as we establish the estimate of Net incurred medical claims: Current year . Our reserving practice is to consistently recognize the actuarial best estimate of our ultimate liability for our claims. When we recognize a release of the redundancy, we disclose the amount that is not in the ordinary course of business, if material. We believe we have consistently applied our methodology in determining our best estimate for unpaid claims liability at each reporting date.

We have not provided an unpaid claims progression for the three months ended March 31, 2010, as we believe there is not sufficient data available to provide a meaningful progression of the prior year ending liability. Consistent with past practices, we expect to provide this information in our second quarter, third quarter and annual filings.

Income Taxes

We account for income taxes in accordance with FASB guidance, which requires, among other things, the separate recognition of deferred tax assets and deferred tax liabilities. Such deferred tax assets and deferred tax

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liabilities represent the tax effect of temporary differences between financial reporting and tax reporting measured at tax rates enacted at the time the deferred tax asset or liability is recorded. A valuation allowance must be established for deferred tax assets if it is more likely than not that all or a portion may be unrealized. Our judgment is required in determining an appropriate valuation allowance.

At each financial reporting date, we assess the adequacy of the valuation allowance by evaluating each of our deferred tax assets based on the following:

- the types of temporary differences that created the deferred tax asset;
- the amount of taxes paid in prior periods and available for a carry-back claim;
- the forecasted future taxable income, and therefore, likely future deduction of the deferred tax item; and
- any significant other issues impacting the likely realization of the benefit of the temporary differences.

We, like other companies, frequently face challenges from tax authorities regarding the amount of taxes due. These challenges include questions regarding the timing and amount of deductions that we have taken on our tax returns. In evaluating any additional tax liability associated with various positions taken in our tax return filings, we record additional liabilities for potential adverse tax outcomes. Based on our evaluation of our tax positions, we believe we have appropriately accrued for uncertain tax benefits, as required by the guidance. To the extent we prevail in matters we have accrued for, our future effective tax rate would be reduced and net income would increase. If we are required to pay more than accrued, our future effective tax rate would increase and net income would decrease. Our effective tax rate and net income in any given future period could be materially impacted.

In the ordinary course of business, we are regularly audited by federal and other tax authorities, and from time to time, these audits result in proposed assessments. We believe our tax positions comply with applicable tax law and intend to defend our positions vigorously through the federal, state and local appeals processes. We believe we have adequately provided for any reasonable foreseeable outcome related to these matters. Accordingly, although their ultimate resolution may require additional tax payments, we do not anticipate any material impact on our results of operations from these matters. As of March 31, 2010, the examinations of our 2008, 2007, 2006, 2005 and 2004 tax years are being concluded by the Internal Revenue Service, or IRS. In addition, we have several tax years for which there are ongoing disputes related to companies pre-acquisition years that are being concluded by the IRS. We joined the IRS Compliance Assurance Process, or CAP, in 2007 and continue to remain a participant. The objective of CAP is to reduce taxpayer burden and uncertainty while assuring the IRS of the accuracy of tax returns prior to filing, thereby reducing or eliminating the need for post-filing examinations. Administrative tax appeals and proceedings also continue for certain subsidiaries for tax years prior to being included in our consolidated tax return.

In March 2010, the Court of Appeals in the Seventh Circuit issued a decision ruling that various payments made to several states in prior years should be a deferred tax asset and not a current tax deduction for the year being litigated. The ruling did not have a material impact on our results of operations, financial position or cash flow.

For additional information, see Note 7 to our audited consolidated financial statements as of and for the year ended December 31, 2009 included in our Annual Report on Form 10-K.

Goodwill and Other Intangible Assets

Our consolidated goodwill at March 31, 2010 was $13.3 billion and other intangible assets were $8.2 billion. The sum of goodwill and intangible assets represented 42% of our total consolidated assets and 87% of our consolidated shareholders equity at March 31, 2010.

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We follow FASB guidance for business combinations and goodwill and other intangible assets, which specifies the types of acquired intangible assets that are required to be recognized and reported separately from goodwill. Under the guidance, goodwill and other intangible assets (with indefinite lives) are not amortized but are tested for impairment at least annually. Furthermore, goodwill and other intangible assets are allocated to reporting units for purposes of the annual impairment test. Our impairment tests require us to make assumptions and judgments regarding the estimated fair value of our reporting units, which include goodwill and other intangible assets. In addition, certain other intangible assets with indefinite lives, such as trademarks, are also tested separately.

In the first quarter of 2010, we recognized an impairment charge of $21.1 million for certain intangible assets associated with the UniCare provider networks, due to a decision we made to transfer certain membership to an alternative network.

Fair value is estimated using the income and market approaches for our goodwill reporting units and the income approach for our indefinite lived intangible assets. The income and market approaches for our goodwill impairment test reflects our view that both valuation methodologies provide a reasonable estimate of fair value.

The income approach is developed using assumptions about future revenue, expenses and net income derived from our internal planning process. These estimated future cash flows are then discounted. Our assumed discount rate is based on our industry s weighted average cost of capital. The discount rate used in the 2009 valuation had increased from the discount rate used in 2008, which reflects an increase in stock volatility and higher risk and uncertainty related to health care reform.

Market valuations are based on observed multiples of certain measures including membership, revenue, EBITDA (earnings before interest, taxes, depreciation and amortization) and book value as well as market capitalization analysis of WellPoint and other comparable companies.

As a result of our annual and interim impairment tests during 2009, 2008 and 2007, we recorded impairment of goodwill and other intangible assets of $262.5 million, $141.4 million and $0.0 million, respectively.

While we believe we have appropriately allocated the purchase price of our acquisitions, this allocation requires many assumptions to be made regarding the fair value of assets and liabilities acquired. In addition, estimated fair values developed based on our assumptions and judgments might be significantly different if other reasonable assumptions and estimates were to be used. If estimated fair values are less than the carrying values of goodwill and other intangible assets with indefinite lives in future annual impairment tests, or if significant impairment indicators are noted relative to other intangible assets subject to amortization, we may be required to record impairment losses against future income.

For additional information, see Note 9 to our audited consolidated financial statements as of and for the year ended December 31, 2009 included in our 2009 Annual Report on Form 10-K.

Investments

Current and long-term available-for-sale investment securities were $16.9 billion at March 31, 2010 and represented 33% of our total consolidated assets at March 31, 2010. We classify the fixed maturity and equity securities in our investment portfolio as available-for-sale or trading and report those securities at fair value. Certain fixed maturity securities are available to support current operations and, accordingly, we classify such investments as current assets without regard to their contractual maturity. Investments used to satisfy contractual, regulatory or other requirements are classified as long-term, without regard to contractual maturity.

Investment income is recorded when earned, and realized gains or losses, determined by specific identification of investments sold, are included in income when securities are sold.

We review investment securities to determine if declines in fair value below cost are other-than-temporary. This review is subjective and requires a high degree of judgment. We conduct this review on a quarterly basis, using both qualitative and quantitative factors, to determine whether a decline in value is other-than-temporary. Such factors considered include the length of time and the extent to which a security s market value has been less than its cost, the reasons for the decline in value (i.e., credit event compared to liquidity, general credit spread widening, currency exchange rate or interest rate factors), financial condition and near term prospects of the issuer, including the credit ratings and changes in the credit ratings of the issuer, recommendations of investment advisors, and forecasts of economic, market or industry trends. In addition, for equity securities, we determine whether we have the intent and ability to hold the security for a period of time to allow for a recovery of its fair value above its carrying amount. If any declines of equity securities are determined to be other-than-temporary, we charge the losses to income when that determination is made.

Certain Financial Accounting Standards Board other-than-temporary impairment, or FASB OTTI, guidance applies to fixed maturity securities and provides guidance on the recognition and presentation of other-than- temporary impairments. In addition, this FASB OTTI guidance requires additional disclosures related to other-than-temporary impairments. If a fixed maturity security is in an unrealized loss position and we have the intent to sell the fixed maturity security, or it is more likely than not that we will have to sell the fixed maturity security before recovery of its amortized cost basis, the decline in value is deemed to be other-than-temporary and is recorded to other-than-temporary impairment losses recognized in income in our consolidated income statements. For impaired fixed maturity securities that we do not intend to sell or it is more likely than not that we will not have to sell such securities, but we expect that we will not fully recover the amortized cost basis, the credit component of the other-than-temporary impairment is recognized in other-than-temporary impairment losses recognized in income in our consolidated income statements and the non-credit component of the other-than-temporary impairment is recognized in other comprehensive income. Furthermore, unrealized losses entirely caused by non-credit related factors related to fixed maturity securities for which we expect to fully recover the amortized cost basis continue to be recognized in accumulated other comprehensive income.

The credit component of an other-than temporary impairment is determined by comparing the net present value of projected future cash flows with the amortized cost basis of the fixed maturity security. The net present value is calculated by discounting our best estimate of projected future cash flows at the effective interest rate implicit in the fixed maturity security at the date of acquisition. For mortgage-backed and asset-backed securities, cash flow estimates are based on assumptions regarding the underlying collateral including prepayment speeds, vintage, type of underlying asset, geographic concentrations, default rates, recoveries and changes in value. For all other debt securities, cash flow estimates are driven by assumptions regarding probability of default, including changes in credit ratings, and estimates regarding timing and amount of recoveries associated with a default. We have a committee of certain accounting and investment associates and management that is responsible for managing the impairment review process. The current economic environment and volatility of securities markets increase the difficulty of assessing investment impairment and the same influences tend to increase the risk of potential impairment of these assets. Other-than-temporary impairment losses recognized in income totaled $19.7 million and $305.0 million, for the three months ended March 31, 2010 and 2009, respectively. There were no individually significant other-than-temporary impairment losses on investments by issuer during the three months ended March 31, 2010 or 2009. As of March 31, 2010, we had approximately $141.0 million of gross unrealized losses on investments recognized in accumulated other comprehensive income, $132.3 million of which related to fixed maturity securities and $8.7 million of which related to equity securities.

We believe we have adequately reviewed our investment securities for impairment and that our investment securities are carried at fair value. However, over time, the economic and market environment may provide additional insight regarding the fair value of certain securities, which could change our judgment regarding impairment. This could result in other-than-temporary impairment losses on investments being charged against future income. Given the current market conditions and the significant judgments involved, there is continuing risk that further declines in fair value may occur and additional, material other-than-temporary impairment losses on investments may be recorded in future periods.

A primary objective in the management of fixed maturity and equity portfolios is to maximize total return relative to underlying liabilities and respective liquidity needs. In achieving this goal, assets may be sold to take advantage of market conditions or other investment opportunities as well as tax considerations. Sales will generally produce realized gains and losses. In the ordinary course of business, we may sell securities at a loss for a number of reasons, including, but not limited to: (i) changes in the investment environment; (ii) expectations that the fair value could deteriorate further; (iii) desire to reduce exposure to an issuer or an industry; (iv) changes in credit quality; or (v) changes in expected cash flow.

We maintain various rabbi trusts to account for the assets and liabilities under certain deferred compensation plans. Under these deferred compensation plans, the participants can defer certain types of compensation and elect to receive a return on the deferred amounts based on the changes in fair value of various investment options, primarily a variety of mutual funds. We also generally purchase corporate-owned life insurance policies on participants in the deferred compensation plans. The cash surrender value of the corporate-owned life insurance policies is reported in Other invested assets, long-term in the consolidated balance sheets. The change in cash surrender value is reported as an offset to the premium expense of the policies, classified as general and administrative expenses.

In addition to available-for-sale investment securities, we held additional long-term investments of $802.4 million, or 2% of total consolidated assets, at March 31, 2010. These long-term investments consist primarily of real estate, cash surrender value of corporate-owned life insurance policies and certain other investments. Due to their less liquid nature, these investments are classified as long-term.

We participate in securities lending programs whereby marketable securities in our investment portfolio are transferred to independent brokers or dealers based on, among other things, their creditworthiness in exchange for cash collateral initially equal to at least 102% of the value of the securities on loan and is thereafter maintained at a minimum of 100% of the market value of the securities loaned (calculated as the ratio of initial cash collateral to current market value of the securities on loan). Accordingly, the market value of the securities on loan to each borrower is monitored daily and the borrower is required to deliver additional cash collateral if the market value of the securities on loan exceeds the initial cash collateral delivered. We recognize the collateral as an asset, which is reported as securities lending collateral on our consolidated balance sheets and we record a corresponding liability for the obligation to return the collateral to the borrower, which is reported as securities lending payable . The securities on loan are reported in the applicable investment category on the consolidated balance sheets.

Through our investing activities, we are exposed to financial market risks, including those resulting from changes in interest rates and changes in equity market valuations. We manage the market risks through our investment policy, which establishes credit quality limits and limits of investments in individual issuers. Ineffective management of these risks could have an impact on our future earnings and financial position. Our investment portfolio includes fixed maturity securities with a fair value of $15.8 billion at March 31, 2010. The weighted-average credit rating of these securities was AA as of March 31, 2010. Included in this balance are investments in fixed maturity securities of states, municipalities and political subdivisions, mortgage-backed securities and corporate securities of $2.4 billion, $53.1 million and $4.3 million, respectively, that are guaranteed by third parties. With the exception of 15 securities with a fair value of $50.4 million, these securities are all investment-grade and carry a weighted-average credit rating of AA as of March 31, 2010 with the guarantee by the third party. The securities are guaranteed by a number of different guarantors and we do not have any significant exposure to any single guarantor (neither indirect through the guarantees, nor direct through investment in the guarantor). Further, due to the high underlying credit rating of the issuers, the weighted-average credit rating of these securities without the guarantee was AA as of March 31, 2010 for the securities for which such information is available.

At March 31, 2010, we owned $3.5 billion of mortgage-backed securities and $327.7 million of asset-backed securities out of a total available-for-sale investment portfolio of $16.9 billion. These securities included

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sub-prime and Alt-A securities with fair values of $105.1 million and $276.7 million, respectively. These sub-prime and Alt-A securities had accumulated net unrealized losses of $10.8 million and $32.2 million, respectively. The average credit rating of the sub-prime and Alt-A securities was BB and BB , respectively.

Fair values of available-for-sale fixed maturity and equity securities are based on quoted market prices, where available. These fair values are obtained primarily from third party pricing services, which generally use Level I or Level II inputs, in accordance with FASB guidance, for the determination of fair value in accordance with FASB guidance for fair value measurements and disclosures. We obtain only one quoted price for each security from third party pricing services, which are derived through recently reported trades for identical or similar securities making adjustments through the reporting date based upon available market observable information. For securities not actively traded, the third party pricing services may use quoted market prices of comparable instruments or discounted cash flow analyses, incorporating inputs that are currently observable in the markets for similar securities. Inputs that are often used in the valuation methodologies include, but are not limited to, broker quotes, benchmark yields, credit spreads, default rates and prepayment speeds. As we are responsible for the determination of fair value, we perform monthly analysis on the prices received from third parties to determine whether the prices are reasonable estimates of fair value. Our analysis includes a review of month-to-month price fluctuations. If unusual fluctuations are noted in this review, we may obtain additional information from other pricing services to validate the quoted price. There were no adjustments to quoted market prices obtained from third party pricing services during the three months ended March 31, 2010 and 2009 that were material to the consolidated financial statements.

In certain circumstances, it may not be possible to derive pricing model inputs from observable market activity, and therefore, such inputs are estimated internally. Such securities are designated Level III in accordance with FASB guidance. Securities designated Level III at March 31, 2010 totaled $353.4 million and represented 2% of our total assets measured at fair value on a recurring basis. Our Level III securities primarily consist of certain mortgage-backed, asset-backed and inverse floating rate securities that were thinly traded or not traded at all due to concerns in the securities markets and the resulting lack of liquidity. In addition, one or more of the inputs used to determine the securities fair value, including, but not limited to, prepayment speeds, credit spreads, default rates and benchmark yields, became unobservable, and the fair values of those securities were estimated using internal estimates for those unobservable inputs.

For additional information, see Part II, Item 7A, Quantitative and Qualitative Disclosures about Market Risk and Notes 4 and 5 to our audited consolidated financial statements for the year ended December 31, 2009 included in our 2009 Annual Report on Form 10-K.

Retirement Benefits

Pension Benefits

We sponsor defined benefit pension plans for some of our employees. These plans are accounted for in accordance with FASB guidance for retirement benefits, which requires that amounts recognized in financial statements be determined on an actuarial basis. As permitted by the guidance, we calculate the value of plan assets as described below. Further, the difference between our expected rate of return and the actual performance of plan assets, as well as certain changes in pension liabilities, are amortized over future periods.

An important factor in determining our pension expense is the assumption for expected long-term return on plan assets. As of our December 31, 2009 measurement date, we selected a long-term rate of return on plan assets of 8.00% for all plans, which is consistent with our prior year assumption of 8.00%. We use a total portfolio return analysis in the development of our assumption. Factors such as past market performance, the long-term relationship between fixed maturity and equity securities, interest rates, inflation and asset allocations are considered in the assumption. The assumption includes an estimate of the additional return expected from active management of the investment portfolio. Peer data and an average of historical returns are also reviewed for appropriateness of the selected assumption. We believe our assumption of future returns is reasonable. However,

if we lower our expected long-term return on plan assets, future contributions to the pension plan and pension expense would likely increase.

This assumed long-term rate of return on assets is applied to a calculated value of plan assets, which recognizes changes in the fair value of plan assets in a systematic manner over three years, producing the expected return on plan assets that is included in the determination of pension expense. The difference between this expected return and the actual return on plan assets is deferred and amortized over the average remaining service of the workforce as a component of pension expense. The net deferral of past asset gains or losses affects the calculated value of plan assets and, ultimately, future pension expense.

The discount rate reflects the current rate at which the pension liabilities could be effectively settled at the end of the year based on our most recent measurement date (December 31, 2009). The selected discount rate for all plans is 5.36%, which was developed using a yield curve approach. Using yields available on high-quality fixed maturity securities with various maturity dates, the yield curve approach provides a customized rate, which is meant to match the expected cash flows of our specific benefit plans. The net effect of changes in the discount rate, as well as the net effect of other changes in actuarial assumptions and experience, have been deferred and amortized as a component of pension expense in accordance with the guidance.

In managing the plan assets, our objective is to be a responsible fiduciary while minimizing financial risk. Plan assets include a diversified mix of investment grade fixed maturity securities, equity securities and alternative investments across a range of sectors and levels of capitalization to maximize the long-term return for a prudent level of risk. In addition to producing a reasonable return, the investment strategy seeks to minimize the volatility in our expense and cash flow. The target allocation for pension benefit plan assets is 54% equity securities, 35% fixed maturity securities, and 11% to all other types of investments. No plan assets were invested in WellPoint common stock as of the measurement date.

For the year ending December 31, 2010, no material contributions are expected to be necessary to meet the Employee Retirement Income Securities Act, or ERISA, required minimum funding levels; however, we may elect to make discretionary contributions up to the maximum amount deductible for income tax purposes. No contributions to our defined benefit pension plans were made during the three months ended March 31, 2010.

At March 31, 2010 our consolidated net pension liabilities were $39.0 million, including liabilities of $65.4 million for certain supplemental plans. We recognized consolidated pre-tax pension credit of $2.2 million and $6.9 million for the three months ended March 31, 2010 and 2009, respectively.

Other Postretirement Benefits

We provide most associates with certain life, medical, vision and dental benefits upon retirement. We use various actuarial assumptions including a discount rate and the expected trend in health care costs to estimate the costs and benefit obligations for our retiree benefits. We recognized a postretirement benefit liability of $471.4 million at March 31, 2010.

We recognized consolidated pre-tax other postretirement expense of $7.5 million and $8.4 million for the three months ended March 31, 2010 and 2009, respectively.

At our December 31, 2009 measurement date, the selected discount rate for all plans was 5.79% (compared to a discount rate of 5.73% for 2009 expense recognition). We developed this rate using a yield curve approach as described above.

The assumed health care cost trend rates used to measure the expected cost of other benefits at our December 31, 2009 measurement dates was 8.50% for 2010 with a gradual decline to 5.00% by the year 2017. These estimated trend rates are subject to change in the future. The health care cost trend rate assumption has a significant effect on the amounts reported.

We made tax deductible discretionary contributions totaling $15.0 million to the other postretirement benefit plans during the three months ended March 31, 2010.

For additional information regarding retirement benefits, see Note 10 to our audited consolidated financial statements as of and for the year ended December 31, 2009 included in our 2009 Annual Report on Form 10-K.

New Accounting Pronouncements

In January 2010, the FASB issued Accounting Standards Update, or ASU, No. 2010-06, *Improving Disclosures about Fair Value Measurements,* or ASU 2010-06. ASU 2010-06 amends ASC Topic 820, *Fair Value Measurements and Disclosures,* to require a number of additional disclosures regarding fair value measurements. Effective January 1, 2010, ASU 2010-06 requires disclosure of the amounts of significant transfers between Level I and Level II and the reasons for such transfers, the reasons for any transfers in or out of Level III, and disclosure of the policy for determining when transfers between levels are recognized. ASU 2010-06 also clarified that disclosures should be provided for each class of assets and liabilities and clarified the requirement to disclose information about the valuation techniques and inputs used in estimating Level II and Level III measurements. Beginning January 1, 2011, ASU 2010-06 also requires that information in the reconciliation of recurring Level III measurements about purchases, sales, issuances and settlements be provided on a gross basis. The adoption of ASU 2010-06 only required additional disclosures and did not have an impact on our consolidated financial position or results of operations.

There were no other new accounting pronouncements issued during the first three months of 2010 that had a material impact on our financial position, operating results or disclosures.

VIII. Liquidity and Capital Resources

Introduction

Our cash receipts result primarily from premiums, administrative fees, investment income, other revenue, proceeds from the sale or maturity of our investment securities, proceeds from borrowings, and proceeds from exercise of stock options and our employee stock purchase plan. Cash disbursements result mainly from claims payments, administrative expenses, taxes, purchases of investment securities, interest expense, payments on long-term borrowings, capital expenditures and repurchases of our common stock. Cash outflows fluctuate with the amount and timing of settlement of these transactions. Any future decline in our profitability would likely have an unfavorable impact on our liquidity.

We manage our cash, investments and capital structure so we are able to meet the short and long-term obligations of our business while maintaining financial flexibility and liquidity. We forecast, analyze and monitor our cash flows to enable investment and financing within the overall constraints of our financial strategy.

A substantial portion of the assets held by our regulated subsidiaries are in the form of cash and cash equivalents and investments. After considering expected cash flows from operating activities, we generally invest cash that exceeds our near term obligations in longer term marketable fixed maturity securities, to improve our overall investment income returns. Our investment strategy is to make investments consistent with insurance statutes and other regulatory requirements, while preserving our asset base. Our investments are generally available-for-sale to meet liquidity and other needs. Our subsidiaries pay out excess capital annually in the form of dividends to their respective parent companies for general corporate use, as permitted by applicable regulations.

The availability of financing in the form of debt or equity is influenced by many factors including our profitability, operating cash flows, debt levels, debt ratings, contractual restrictions, regulatory requirements and market conditions. Since 2008, credit markets have experienced a tightening of available liquidity, primarily as a result of uncertainty surrounding the economic crisis and the resulting volatility experienced in the debt and equity markets. Beginning in October 2008, the Federal government and various governmental agencies have taken a number of steps to restore liquidity in the financial markets and to help relieve the credit crisis and strengthen the regulation of the financial services market. In addition, governments around the world have

developed their own plans to provide liquidity and security in the credit markets and to ensure adequate capital in certain financial institutions.

We have a $2.5 billion commercial paper program. The commercial paper markets continue to experience increased volatility and disruption, resulting in higher costs to issue commercial paper. We continue to monitor the commercial paper markets and will act in a prudent manner. Should commercial paper issuance be unavailable, we intend to use a combination of cash on hand and/or our $2.4 billion senior credit facility to redeem our commercial paper when it matures. While there is no assurance in the current economic environment, we believe the lenders participating in our credit facility will be willing and able to provide financing in accordance with their legal obligations. In addition to the $2.4 billion senior credit facility, we expect to receive approximately $2.3 billion of ordinary dividends from our subsidiaries during 2010, which also provides further operating and financial flexibility.

The table below outlines the (decrease) increase in cash and cash equivalents for the three months ended March 31, 2010 and 2009:

(In millions)	**Three Months Ended March 31** 2010	2009
Cash flows provided by (used in):		
Operating activities	$ (322.9)	$ 1,192.0
Investing activities	191.9	(790.9)
Financing activities	(1,157.7)	(206.9)
Effect of foreign exchange rates on cash and cash equivalents	(1.2)	
(Decrease) increase in cash and cash equivalents	$ (1,289.9)	$ 194.2

Liquidity Three Months Ended March 31, 2010 Compared to Three Months Ended March 31, 2009

During the three months ended March 31, 2010, net cash flow used in operating activities was $322.9 million, compared to cash flow provided by operating activities of $1.2 billion for the three months ended March 31, 2009, a decrease of $1.5 billion. This decrease resulted primarily from tax payments of $1.2 billion to the IRS, related to the gain we realized on the 2009 sale of our PBM business, increased incentive payments, lower revenues from our UniCare member transition in Texas and Illinois and a reduction in Part D LIS membership. We expect our full year 2010 operating cash flow, as compared to historical patterns, to be unfavorably impacted by the $1.2 billion tax payment, the transition of UniCare members in Texas and Illinois, the reduction in Part D LIS membership and expected payments to Express Scripts for certain operating liabilities. Excluding these items, operating cash flow for 2010 would have been approximately $1.0 billion, or 1.2 times adjusted net income, a non-GAAP measure defined in Section I. Executive Summary in this MD&A.

In addition, we have also received notification from the IRS that it has proposed certain adjustments to our prior year tax returns currently being audited. We believe our tax positions comply with applicable tax law and intend to defend our positions vigorously through the appeals process. However, if we are not able to prevail, we will be required to make additional tax payments. While this will not impact our future results of operations, it could reduce future operating cash flow.

Net cash flow provided by investing activities was $191.9 million during the three months ended March 31, 2010, compared to cash flow used in investing activities of $790.9 million for the three months ended March 31, 2009. The increase in cash flow provided by investing activities of $1.0 billion between the two periods primarily resulted from decreases in net purchases of investments, partially offset by increases in securities lending collateral and increases in net purchases of property and equipment.

Net cash flow used in financing activities was $1.2 billion during the three months ended March 31, 2010, compared to $206.9 million for the three months ended March 31, 2009. The increase in cash flow used in financing activities of $1.0 billion primarily resulted from increases in the repurchase of common stock, including the accelerated share repurchase program, and reductions in net proceeds from borrowings, partially offset by changes in securities lending payables.

Financial Condition

We maintained a strong financial condition and liquidity position, with consolidated cash, cash equivalents and investments, including long-term investments, of $21.3 billion at March 31, 2010. Since December 31, 2009, total cash, cash equivalents and investments, including long-term investments, decreased by $1.3 billion primarily due to tax payments of $1.2 billion to the IRS principally related to the gain we realized on the sale of our PBM business, which occurred in the fourth quarter of 2009.

Many of our subsidiaries are subject to various government regulations that restrict the timing and amount of dividends and other distributions that may be paid to their respective parent companies. In addition, we have agreed to certain undertakings to regulatory authorities, including the requirement to maintain certain capital levels in certain of our subsidiaries.

At March 31, 2010, we held at the parent company approximately $3.2 billion of cash and cash equivalents and investments, which is available for general corporate use, including investment in our businesses, acquisitions, share and debt repurchases and interest payments.

Our consolidated debt-to-total capital ratio (calculated as the sum of debt divided by the sum of debt plus shareholders equity) was 25.5% as of March 31, 2010 and 25.3% as of December 31, 2009.

Our senior debt is rated A- by Standard & Poor s, A- by Fitch, Inc., Baa1 by Moody s Investor Service, Inc. and bbb+ by AM Best Company, We intend to maintain our senior debt investment grade ratings. A significant downgrade in our debt ratings could adversely affect our borrowing capacity and costs.

Future Sources and Uses of Liquidity

On December 12, 2008, we filed an updated shelf registration statement with the SEC to register an unlimited amount of any combination of debt or equity securities in one or more offerings. Specific information regarding terms and securities being offered will be provided at the time of an offering. Proceeds from future offerings are expected to be used for general corporate purposes, including the repayment of debt, capitalization of our subsidiaries, repurchases of our common stock or the financing of possible acquisitions or business expansion.

We are a member of the Federal Home Loan Bank of Indianapolis and the Federal Home Loan Bank of Cincinnati, collectively, the FHLBs, and as a member we have the ability to obtain cash advances subject to certain requirements. In order to obtain cash advances, we are required to pledge securities as collateral to the FHLBs, initially equal to a certain percentage of the cash borrowings, depending on the type of securities pledged as collateral. The market value of the collateral is monitored daily by the FHLBs, and if it falls below the required percentage of the cash borrowings, we are required to pledge additional securities as collateral or repay a portion of the outstanding cash advance balance. In addition, our borrowings may be limited based on the amount of our investment in the FHLBs common stock. Our investment in the FHLBs common stock at March 31, 2010 totaled $9.4 million, which is reported in Investments available- for-sale Equity securities on the consolidated balance sheets. There were no advances outstanding from the FHLBs under this facility as of March 31, 2010 or at any time during the three months then ended. Subsequent to March 31, 2010, we borrowed $100.0 million under this facility for a two year term at a fixed rate of 1.43%. Securities, primarily certain U.S. government sponsored mortgage-backed securities, with a fair value of $234.3 million at March 31, 2010 have

been pledged as collateral. The securities pledged are reported in Investments available-for-sale Fixed maturity securities on the consolidated balance sheets.

On November 29, 2005, we entered into a senior revolving credit facility, or the facility, with certain lenders for general corporate purposes. The facility, as amended, provides credit up to $2.4 billion and matures on September 30, 2011. The interest rate on this facility is based on either: (i) the LIBOR rate plus a predetermined percentage rate based on our credit rating at the date of utilization, or (ii) a base rate as defined in the facility agreement. Our ability to borrow under this facility is subject to compliance with certain covenants. There were no amounts outstanding under this facility as of March 31, 2010 or at any time during the three months then ended. At March 31, 2010, we had $2.4 billion available under this facility.

We have Board of Directors approval to borrow up to $2.5 billion under our commercial paper program. Proceeds from any issuance of commercial paper may be used for general corporate purposes, including the repurchase of our debt and common stock. Commercial paper notes are short-term senior unsecured notes, with a maturity not to exceed 270 days from date of issuance. When issued, the notes bear interest at the then current market rates. We had $500.7 million of borrowings outstanding under this commercial paper program as of March 31, 2010. As previously discussed in Introduction to Liquidity and Capital Resources , the commercial paper markets have experienced increased volatility and disruption. We will continue to monitor the commercial paper markets and will act in a prudent manner. We continue to classify our commercial paper as long-term debt given our intent to continually issue commercial paper or our ability to redeem our commercial paper using our $2.4 billion senior credit facility.

As discussed in Financial Condition above, many of our subsidiaries are subject to various government regulations that restrict the timing and amount of dividends and other distributions that may be paid. Based upon these requirements, we are currently estimating approximately $2.3 billion of ordinary dividends to be paid to the parent company during 2010. For the three months ended March 31, 2010, no dividends were paid by our subsidiaries.

We regularly review the appropriate use of capital. Accordingly, under our Board of Directors authorization, we maintain a common stock repurchase program. Repurchases may be made from time to time at prevailing market prices, subject to certain restrictions on volume, pricing and timing. The repurchases are effected from time to time in the open market, in private transactions, including accelerated share repurchase agreements, and through plans designed to comply with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended.

During the three months ended March 31, 2010, we repurchased and retired approximately 20.9 million shares at an average per share price of $62.22 (calculated including the final settlement shares of the accelerated share repurchase program discussed below), for an aggregate cost of $1.4 billion. Under the share repurchase program, on February 24, 2010, we entered into an accelerated share repurchase, or ASR, program with a counterparty. The agreement provides for a repurchase of a number of shares, equal to $500.0 million, as determined by the dollar volume weighted average share price during a one to two month period. At March 31, 2010 we had repurchased 6.7 million shares under the agreement and the counterparty is purchasing shares of our stock in the open market at prevailing market prices over the remaining term of the ASR. At the end of the term of the ASR, the initial amount of shares will be adjusted up or down based on the dollar volume weighted average price during the same period. The agreement allowed us to settle any negative final adjustment at our option in either cash or shares of our stock. Accordingly, we reported the effects of this agreement within shareholders equity. The shares repurchased under the ASR are included in the amount disclosed above as shares repurchased during the three months ended March 31, 2010. Subsequent to March 31, 2010, we repurchased an additional 1.3 million shares, for a total of 8.0 million shares repurchased pursuant to the ASR, and settled the agreement with our counterparty. The shares repurchased under the ASR subsequent to March 31, 2010 are included in the amount disclosed below as shares repurchased through April 15, 2010. During the three months ended March 31, 2009, we repurchased and retired approximately 17.7 million shares at an average per

share price of $38.55, for an aggregate cost of $681.2 million. The excess of cost of the repurchased shares over par value is charged on a pro rata basis to additional paid-in capital and retained earnings.

On January 26, 2010, our Board of Directors increased the share repurchase authorization by $3.5 billion. As of March 31, 2010, $2.5 billion remained authorized for future repurchases. Subsequent to March 31, 2010, we repurchased and retired approximately 4.2 million shares for an aggregate cost of approximately $180.2 million, leaving approximately $2.3 billion for authorized future repurchases at April 15, 2010. Our stock repurchase program is discretionary as we are under no obligation to repurchase shares. We repurchase shares under the program when we believe it is a prudent use of capital.

Our current pension funding strategy is to fund an amount at least equal to the minimum required funding as determined under ERISA with consideration of maximum tax deductible amounts. For the year ending December 31, 2010, no material required contributions are expected to be necessary to meet the ERISA required funding levels; however, we may elect to make discretionary contributions up to the maximum amount deductible for income tax purposes. We made tax deductible discretionary contributions totaling $15.0 million to the other postretirement benefit plans during the three months ended March 31, 2010.

Contractual Obligations and Commitments

We believe that funds from future operating cash flows, cash and investments and funds available under our credit agreement or from public or private financing sources will be sufficient for future operations and commitments, and for capital acquisitions and other strategic transactions.

As discussed above, we are aware that the Pennsylvania Insurance Commissioner, or Insurance Commissioner, has recently placed Penn Treaty in rehabilitation, an intermediate action before insolvency. The Insurance Commissioner has petitioned the state court for liquidation, however, we do not know when a decision will be made. In the event that Penn Treaty is declared insolvent and placed in liquidation, we and other insurers may be required to pay a portion of their policyholder claims through NOLHGA guaranty association assessments in future periods. We will continue to monitor the situation and may record a liability and expense in future reporting periods, which could be material to our operating results.

For additional information regarding our estimated contractual obligations and commitments at December 31, 2009, see Contractual Obligations and Commitments included in the Liquidity and Capital Resources section in our 2009 Annual Report on Form 10-K.

Risk-Based Capital

Our regulated subsidiaries states of domicile have statutory risk-based capital, or RBC, requirements for health and other insurance companies largely based on the NAIC s RBC Model Act. These RBC requirements are intended to measure capital adequacy, taking into account the risk characteristics of an insurer s investments and products. The NAIC sets forth the formula for calculating the RBC requirements, which are designed to take into account asset risks, insurance risks, interest rate risks and other relevant risks with respect to an individual insurance company s business. In general, under this Act, an insurance company must submit a report of its RBC level to the state insurance department or insurance commissioner, as appropriate, at the end of each calendar year. Our risk-based capital as of December 31, 2009, which was the most recent date for which reporting was required, was in excess of all mandatory RBC thresholds. In addition to exceeding the RBC requirements, we are in compliance with the liquidity and capital requirements for a licensee of the BCBSA and with the tangible net worth requirements applicable to certain of our California subsidiaries.

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IX. Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995

This document contains certain forward-looking information about us that is intended to be covered by the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995. Forward-looking statements are statements that are not generally historical facts. Words such as expect(s) , feel(s) , believe(s) , will , may , anticipate(s) , intend , estimate , project and similar expressions are intended to identify forward-looking statements, which generally are not historical in nature. These statements include, but are not limited to, financial projections and estimates and their underlying assumptions; statements regarding plans, objectives and expectations with respect to future operations, products and services; and statements regarding future performance. Such statements are subject to certain risks and uncertainties, many of which are difficult to predict and generally beyond our control, that could cause actual results to differ materially from those expressed in, or implied or projected by, the forward-looking information and statements. These risks and uncertainties include: those discussed and identified in our public filings with the U.S. Securities and Exchange Commission, or SEC; increased government participation in, or regulation or taxation of health benefits and managed care operations, including, but not limited to, the impact of the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010; trends in health care costs and utilization rates; our ability to secure sufficient premium rates including regulatory approval for and implementation of such rates; our ability to contract with providers consistent with past practice; competitor pricing below market trends of increasing costs; reduced enrollment, as well as a negative change in our health care product mix; risks and uncertainties regarding Medicare and Medicaid programs, including those related to non-compliance with the complex regulations imposed thereon, funding risks with respect to revenue received from participation therein and CMS sanctions; a downgrade in our financial strength ratings; litigation and investigations targeted at health benefits companies and our ability to resolve litigation and investigations within estimates; our ability to meet expectations regarding repurchases of shares of our common stock; decreased revenues, increased operating costs and potential customer and supplier losses and business disruptions that may be greater than expected following the close of the Express Scripts transaction; events that result in negative publicity for us or the health benefits industry; failure to effectively maintain and modernize our information systems and e-business organization and to maintain good relationships with third party vendors for information system resources; events that may negatively affect our license with the Blue Cross and Blue Shield Association; possible impairment of the value of our intangible assets if future results do not adequately support goodwill and other intangible assets; intense competition to attract and retain employees; unauthorized disclosure of member sensitive or confidential information; changes in the economic and market conditions, as well as regulations that may negatively affect our investment portfolios and liquidity; possible restrictions in the payment of dividends by our subsidiaries and increases in required minimum levels of capital and the potential negative effect from our substantial amount of outstanding indebtedness; general risks associated with mergers and acquisitions; various laws and our governing documents may prevent or discourage takeovers and business combinations; future bio-terrorist activity or other potential public health epidemics; and general economic downturns. Readers are cautioned not to place undue reliance on these forward-looking statements that speak only as of the date hereof. Except to the extent otherwise required by federal securities law, we do not undertake any obligation to republish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. Readers are also urged to carefully review and consider the various disclosures in our SEC reports.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As a result of our investing and borrowing activities, we are exposed to financial market risks, including those resulting from changes in interest rates and changes in equity market valuations. Our investment portfolio is exposed to three primary risks: credit quality risk, interest rate risk and market valuation risk. Our long-term debt has fixed interest rates and the fair value of these instruments is affected by changes in market interest rates. We use derivative financial instruments, specifically interest rate swap agreements, to hedge exposure in interest rate risk on our borrowings. No material changes to any of these risks have occurred since December 31, 2009.

For a more detailed discussion of our market risks relating to these activities, refer to Item 7A, Quantitative and Qualitative Disclosures about Market Risk , included in our 2009 Annual Report on Form 10-K.

ITEM 4. CONTROLS AND PROCEDURES

We carried out an evaluation as of March 31, 2010, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to us (including our consolidated subsidiaries) required to be disclosed in our reports under the Securities Exchange Act of 1934. In addition based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures.

There have been no changes in our internal control over financial reporting that occurred during the three months ended March 31, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information set forth under Litigation and Other Contingencies in Note 10 to our unaudited consolidated financial statements in Part I, Item 1 of this Form 10-Q is incorporated herein by reference.

ITEM 1A. RISK FACTORS

Except as set forth below, there have been no material changes to the risk factors disclosed in our 2009 Annual Report on Form 10-K.

Recently enacted federal health care reform legislation, as well as potential additional changes in federal or state regulations, or the application thereof, could adversely affect our business, cash flows, financial condition and results of operation.

During the first quarter of 2010, the U.S. Congress passed and the President signed into law the Patient Protection and Affordable Care Act as well as the Health Care and Education Reconciliation Act of 2010, which represent significant changes to the current U.S. health care system. The legislation is far-reaching and is intended to expand access to health insurance coverage over time by increasing the eligibility thresholds for most state Medicaid programs and providing certain other individuals and small businesses with tax incentives to subsidize a portion of the cost of health insurance coverage. The legislation includes a requirement that most individuals obtain health insurance coverage beginning in 2014 and that most large employers offer coverage to their employees or they will be required to pay a financial penalty.

In addition, the new laws encompass certain new taxes and fees, including an excise tax on high premium insurance policies, limitations on the amount of compensation that is tax deductible and new fees on companies in our industry which may not be deductible for income tax purposes. The legislation also imposes new regulations on the health insurance sector, including, but not limited to, guaranteed coverage requirements, prohibitions on some annual and all lifetime limits on amounts paid on behalf of or to our members, increased restrictions on rescinding coverage, establishment of minimum medical loss ratio requirements, a requirement to cover preventative services on a first dollar basis, the establishment of state insurance exchanges and essential benefit packages, and greater limitations on how we price certain of our products. The legislation also reduces the reimbursement levels for health plans participating in the Medicare Advantage program over time.

Some provisions of the health care reform legislation become effective this year including those that bar health insurance companies from placing lifetime limits on insurance coverage and those related to the increased restrictions on rescinding coverage. However, some of the more significant changes, including the annual fees on health insurance companies, the excise tax on high premium insurance policies, the guaranteed coverage requirements and the requirement that individuals obtain coverage, do not become effective until 2014 or later. The establishment of minimum medical loss ratios, which could have a significant impact on our operations, will take effect for certain of our businesses beginning in 2011. Many of the details of the new law, including, but not limited to, the medical loss ratio requirements, require additional guidance and specificity to be provided by the Department of Health and Human Services, National Association of Insurance Commissioners, Department of Labor and Treasury Department.

Accordingly, while it is too early to fully understand the impacts of the legislation on our business, the legislation could have a material adverse effect on our business, cash flows, financial condition and results of operations.

In addition, federal and state regulatory agencies may restrict our ability to implement changes in premium rates. Our ability to secure sufficient premium rates, including regulatory approval for and implementation of such rates on a timely basis, may be restricted by additional changes in federal and state regulations or by the application of existing federal and state regulations. A limitation on our ability to increase or maintain our premium rates could adversely affect our business, cash flows, financial condition and results of operations.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS
Issuer Purchases of Equity Securities

The following table presents information related to our repurchases of common stock for the periods indicated.

Period *(In millions, except share and per share data)*	Total Number of Shares Purchased[1]	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs[2]	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Programs[3]
January 1, 2010 to January 31, 2010	3,764,046	$ 63.36	3,760,770	$ 3,646
February 1, 2010 to February 28, 2010	7,536,964	61.25	7,536,825	3,184
March 1, 2010 to March 31, 2010	10,166,854	61.02	9,650,778	2,495
	21,467,864		20,948,373	

1 Total number of shares purchased includes 519,491 shares delivered to or withheld by us in connection with employee payroll tax withholding upon exercise or vesting of stock awards. Stock grants to employees and directors and stock issued for stock option plans and stock purchase plans in the consolidated statements of shareholders equity are shown net of these shares purchased.

2 Represents the number of shares repurchased through our repurchase program authorized by our Board of Directors. During the three months ended March 31, 2010, we repurchased approximately 20.9 million shares at a cost of $1.3 billion under the program. On January 26, 2010, our Board of Directors increased the share repurchase authorization by $3.5 billion. Remaining authorization under the program was $2.5 billion as of March 31, 2010.

3 On February 24, 2010, we entered into an accelerated share repurchase program, which provided for a repurchase of a number of shares, equal to $500.0 million, as determined by the dollar volume weighted average share price, during a one to two month period. At March 31, 2010, we had repurchased 6.7 million shares under the agreement, which are included in our March 2010 purchases above. Subsequent to March 31, 2010, we repurchased an additional 1.3 million shares pursuant to the program, which will be reported in our April purchases. However, the remaining authorization of $2,495.0 million above reflects both the March 2010 and subsequent purchases under the program.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES
None.

ITEM 4. (REMOVED AND RESERVED)

ITEM 5. OTHER INFORMATION
None.

ITEM 6. EXHIBITS

Exhibits: A list of exhibits required to be filed as part of this Form 10-Q is set forth in the Index to Exhibits, which immediately precedes such exhibits, and is incorporated herein by reference.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

WELLPOINT, INC.

Registrant

Date: April 28, 2010

By: /s/ WAYNE S. DEVEYDT
Wayne S. DeVeydt
Executive Vice President and Chief Financial Officer

(Duly Authorized Officer and Principal Financial Officer)

Date: April 28, 2010

By: /s/ MARTIN L. MILLER
Martin L. Miller
Senior Vice President, Controller, Chief Accounting Officer and Chief Risk Officer (Principal Accounting Officer)

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INDEX TO EXHIBITS

Exhibit Number	Exhibit
2.1	Stock and Interest Purchase Agreement, dated April 9, 2009, by and between the Company and Express Scripts, Inc., incorporated by reference to Exhibit 2.1 to the Company s Current Report on Form 8-K filed on April 13, 2009.
3.1	Articles of Incorporation of the Company, as amended effective May 17, 2007, incorporated by reference to Exhibit 3.1 to the Company s Current Report on Form 8-K filed on May 18, 2007.
3.2	By-Laws of the Company, amended effective October 23, 2009, incorporated by reference to Exhibit 3.2 to the Company s Current Report on Form 8-K filed on October 28, 2009.
4.1	Upon the request of the Securities and Exchange Commission, the Company will furnish copies of any other instruments defining the rights of holders of long-term debt of the Company or its subsidiaries.
10.2*	(o) Form of Nonqualified Stock Option Award Agreement under the Incentive Compensation Plan.
	(p) Form of Restricted Stock Unit Award Agreement under the Incentive Compensation Plan.
	(q) Form of Performance Share Award Agreement for 2010 under the Incentive Compensation Plan.
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Exchange Act Rules, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Exchange Act Rules, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following material from WellPoint, Inc. s Quarterly Report on Form 10-Q, for the quarter ended March 31, 2010, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Income; (iii) the Consolidated Statements of Cash Flows; (iv) the Consolidated Statements of Shareholders Equity; and (v) Notes to Consolidated Financial Statements, tagged as blocks of text.

* Indicates management contracts or compensatory plans or arrangements.

size:10pt;">

Commercial Real Estate:

Construction and land development

$
—

$
—

$
637

$
637

$
28,255

$
28,892

$

—

Other commercial real estate

965

1,659

5,065

7,689

497,430

505,119

119

Total Commercial Real Estate

965

1,659

5,702

8,326

525,685

534,011

119

Commercial and Industrial:

Other Commercial

186

329

702

1,217

196,834

198,051

21

Agricultural

42

159

198

399

27,189

27,588

155

Tax exempt

—

—

—

—

42,365

42,365

—

Total Commercial and Industrial

228

488

900

1,616

266,388

268,004

176

Total Commercial Loans

1,193

2,147

6,602

9,942

792,073

802,015

295

Residential Real Estate:

Residential mortgages

3,096

711

975

4,782

586,629

591,411

—

Total Residential Real Estate

3,096

711

975

4,782

586,629

591,411

—

Consumer:

Home equity

515

—

199

714

50,662

51,376

199

Other consumer

36

24

—

60

7,768

7,828

—

Total Consumer

551

24

199

774

58,430

59,204

199

Total Loans

$
4,840

$
2,882

$
7,776

$
15,498

$
1,437,132

$
1,452,630

$
494

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Acquired Loans

(in thousands)	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Acquired Credit Impaired	Total Loans	Past Due > 90 days and Accruing
March 31, 2018							
Commercial Real Estate:							
Construction and land development	$ —	$ —	$ —	$ —	$ 260	$ 14,800	$ —
Other commercial real estate	411	—	305	716	8,350	266,755	—
Total Commercial Real Estate	411	—	305	716	8,610	281,555	—
Commercial and Industrial:							
Other Commercial	208	97	148	453	459	65,198	—
Agricultural	—	—	—	—	—	—	—
Tax exempt	—	—	—	—	—	42,302	—
Total Commercial and Industrial	208	97	148	453	459	107,500	—
Total Commercial Loans	619	97	453	1,169	9,069	389,055	—
Residential Real Estate:							
Residential mortgages	1,376	204	771	2,351	3,168	544,512	—
Total Residential Real Estate	1,376	204	771	2,351	3,168	544,512	—
Consumer:							
Home equity	292	46	80	418	25	57,766	—
Other consumer	3	—	—	3	3	2,070	—
Total Consumer	295	46	80	421	28	59,836	—
Total Loans	$ 2,290	$ 347	$ 1,304	$ 3,941	$ 12,265	$ 993,403	$ —

Acquired Loans

(in thousands)	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Acquired Credit Impaired	Total Loans	Past Due > 90 days and Accruing
December 31, 2017							
Commercial Real Estate:							
Construction and land development	$ 124	$ 9	$ —	$ 133	$ 258	$ 16,781	$ —
Other commercial real estate	278	—	411	689	8,397	275,954	—
Total Commercial Real Estate	402	9	411	822	8,655	292,735	—
Commercial and Industrial:							
Other Commercial	125	14	49	188	632	68,069	—
Agricultural	—	—	—	—	—	—	—
Tax exempt	—	—	—	—	—	43,350	—
Total Commercial and Industrial	125	14	49	188	632	111,419	—
Total Commercial Loans	527	23	460	1,010	9,287	404,154	—
Residential Real Estate:							
Residential mortgages	752	388	614	1,754	3,259	564,271	—
Total Residential Real Estate	752	388	614	1,754	3,259	564,271	—
Consumer:							
Home equity	125	117	80	322	38	62,217	16
Other consumer	2	—	—	2	3	2,341	—
Total Consumer	127	117	80	324	41	64,558	16
Total Loans	$ 1,406	$ 528	$ 1,154	$ 3,088	$ 12,587	$ 1,032,983	$ 16

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Non-Accrual Loans

The following is summary information pertaining to non-accrual loans at March 31, 2018 and December 31, 2017:

	March 31, 2018			December 31, 2017		
(in thousands)	Business Activities Loans	Acquired Loans	Total	Business Activities Loans	Acquired Loans	Total
Commercial Real Estate:						
Construction and land development	$566	$ —	$566	$637	$ —	$637
Other commercial real estate	7,401	455	7,856	7,146	560	7,706
Total Commercial Real Estate	7,967	455	8,422	7,783	560	8,343
Commercial and Industrial:						
Other Commercial	1,532	528	2,060	703	463	1,166
Agricultural	244	—	244	43	—	43
Tax exempt	—	—	—	—	—	—
Total Commercial and Industrial	1,776	528	2,304	746	463	1,209
Total Commercial Loans	9,743	983	10,726	8,529	1,023	9,552
Residential Real Estate:						
Residential mortgages	6,527	2,021	8,548	3,408	858	4,266
Total Residential Real Estate	6,527	2,021	8,548	3,408	858	4,266
Consumer:						
Home equity	624	277	901	130	217	347
Other consumer	109	55	164	95	58	153
Total Consumer	733	332	1,065	225	275	500
Total Loans	$17,003	$ 3,336	$20,339	$12,162	$ 2,156	$14,318

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Loans evaluated for impairment as of March 31, 2018 and December 31, 2017 were as follows:

Business Activities Loans

(in thousands)	Commercial real estate	Commercial and industrial	Residential real estate	Consumer	Total
March 31, 2018					
Loans receivable:					
Balance at end of period					
Individually evaluated for impairment	$ 7,641	$ 1,504	$ 4,386	$ 362	$ 13,893
Collectively evaluated	535,525	278,201	584,079	59,318	1,457,123
Total	$ 543,166	$ 279,705	$ 588,465	$ 59,680	$ 1,471,016

Business Activities Loans

(in thousands)	Commercial real estate	Commercial and industrial	Residential real estate	Consumer	Total
December 31, 2017					
Loans receivable:					
Balance at end of period					
Individually evaluated for impairment	$ 7,604	$ 626	$ 1,404	$ 13	$ 9,647
Collectively evaluated	526,407	267,378	590,007	59,191	1,442,983
Total	$ 534,011	$ 268,004	$ 591,411	$ 59,204	$ 1,452,630

Acquired Loans

(in thousands)	Commercial real estate	Commercial and industrial	Residential real estate	Consumer	Total
March 31, 2018					
Loans receivable:					
Balance at end of period					
Individually evaluated for impairment	$ 133	$ 598	$ 503	$ —	$ 1,234
Purchased Credit Impaired	8,610	459	3,168	28	12,265
Collectively evaluated	272,812	106,443	540,841	59,808	979,904
Total	$ 281,555	$ 107,500	$ 544,512	$ 59,836	$ 993,403

Acquired Loans

(in thousands)	Commercial real estate	Commercial and industrial	Residential real estate	Consumer	Total
December 31, 2017					
Loans receivable:					
Balance at end of period					
Individually evaluated for impairment	$ 241	$ 571	$ 271	$ 63	$ 1,146
Purchased Credit Impaired	8,655	632	3,259	41	12,587
Collectively evaluated	283,839	110,216	560,741	64,454	1,019,250
Total	$ 292,735	$ 111,419	$ 564,271	$ 64,558	$ 1,032,983

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The following is a summary of impaired loans at March 31, 2018 and December 31, 2017:
Business Activities Loans

(in thousands)	March 31, 2018		
	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance:			
Construction and land development	$566	$ 2,491	$ —
Commercial real estate other	5,933	5,944	—
Commercial other	962	966	—
Agricultural	—	—	—
Tax exempt loans	—	—	—
Residential real estate	3,586	3,603	—
Home equity	362	463	—
Consumer other	—	—	—
With an allowance recorded:			
Construction and land development	$—	$ —	$ —
Commercial real estate other	1,142	1,204	433
Commercial other	542	544	132
Agricultural	—	—	—
Tax exempt loans	—	—	—
Residential real estate	800	801	84
Home equity	—	—	—
Consumer other	—	—	—
Total			
Commercial real estate	$7,641	$ 9,639	$ 433
Commercial and industrial	1,504	1,510	132
Residential real estate	4,386	4,404	84
Consumer	362	463	—
Total impaired loans	$13,893	$ 16,016	$ 649

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Acquired Loans

(in thousands)	March 31, 2018 Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance:			
Construction and land development	$—	$ —	$ —
Commercial real estate other	133	245	—
Commercial other	176	175	—
Agricultural	—	—	—
Tax exempt loans	—	—	—
Residential real estate	503	507	—
Home equity	—	—	—
Consumer other	—	—	—
With an allowance recorded:			
Construction and land development	$—	$ —	$ —
Commercial real estate other	—	—	—
Commercial other	422	436	121
Agricultural	—	—	—
Tax exempt loans	—	—	—
Residential real estate	—	—	—
Home equity	—	—	—
Consumer other	—	—	—
Total			
Commercial real estate	$133	$ 245	$ —
Commercial and industrial	598	611	121
Residential real estate	503	507	—
Consumer	—	—	—
Total impaired loans	$1,234	$ 1,363	$ 121

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Business Activities Loans

(in thousands)	December 31, 2017 Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance:			
Construction and land development	$—	$ —	$ —
Commercial real estate other	5,896	5,903	—
Commercial other	218	217	—
Agricultural	—	—	—
Tax exempt loans	—	—	—
Residential real estate	1,247	1,260	—
Home equity	13	13	—
Consumer other	—	—	—
With an allowance recorded:			
Construction and land development	$637	$ 2,563	$ 59
Commercial real estate other	1,071	1,132	388
Commercial other	408	408	3
Agricultural	—	—	—
Tax exempt loans	—	—	—
Residential real estate	157	157	9
Home equity	—	—	—
Consumer other	—	—	—
Total			
Commercial real estate	$7,604	$ 9,598	$ 447
Commercial and industrial	626	625	3
Residential real estate	1,404	1,417	9
Consumer	13	13	—
Total impaired loans	$9,647	$ 11,653	$ 459

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Acquired Loans

	December 31, 2017		
(in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance:			
Construction and land development	$ —	$ —	$ —
Other commercial real estate	241	352	—
Other commercial	571	584	—
Agricultural	—	—	—
Tax exempt	—	—	—
Residential mortgages	271	278	—
Home equity	63	156	—
Other consumer	—	—	—
With an allowance recorded:			
Construction and land development	$ —	$ —	$ —
Other commercial real estate	—	—	—
Other commercial	—	—	—
Agricultural	—	—	—
Tax exempt	—	—	—
Residential mortgages	—	—	—
Home equity	—	—	—
Other consumer	—	—	—
Total			
Commercial real estate	$ 241	$ 352	$ —
Commercial and industrial	571	584	—
Residential real estate	271	278	—
Consumer	63	156	—
Total impaired loans	$ 1,146	$ 1,370	$ —

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The following is a summary of the average recorded investment and interest income recognized on impaired loans as of March 31, 2018 and 2017:

Business Activities Loans

	Three Months Ended March 31, 2018		Three Months Ended March 31, 2017	
(in thousands)	Average Recorded Investment	Cash Basis Interest Income Recognized	Average Recorded Investment	Cash Basis Interest Income Recognized
With no related allowance:				
Construction and land development	$ 589	$ —	$ —	$ —
Commercial real estate other	5,937	—	2,592	34
Commercial other	1,334	—	226	3
Agricultural	—	—	192	2
Tax exempt loans	—	—	—	—
Residential real estate	3,591	—	1,500	22
Home equity	444	—	590	—
Consumer other	—	—	44	1
With an allowance recorded:				
Construction and land development	$ —	$ —	$ —	$ —
Commercial real estate other	1,144	—	1,723	—
Commercial other	187	—	216	—
Agricultural	—	—	—	—
Tax exempt loans	—	—	—	—
Residential real estate	802	—	321	—
Home equity	—	—	—	—
Consumer other	—	—	9	—
Total				
Commercial real estate	$ 7,670	$ —	$ 4,315	$ 34
Commercial and industrial	1,521	—	634	5
Residential real estate	4,393	—	1,821	22
Consumer	444	—	643	1
Total impaired loans	$ 14,028	$ —	$ 7,413	$ 62

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Acquired Loans

(in thousands)	Three Months Ended March 31, 2018		Three Months Ended March 31, 2017	
	Average Recorded Investment	Cash Basis Interest Income Recognized	Average Recorded Investment	Cash Basis Interest Income Recognized
With no related allowance:				
Construction and land development	$ —	$ —	$ —	$ —
Commercial real estate other	133	—	—	—
Commercial other	161	1	—	—
Agricultural	—	—	—	—
Tax exempt loans	—	—	—	—
Residential real estate	508	—	—	—
Home equity	—	—	—	—
Consumer other	—	—	—	—
With an allowance recorded:				
Construction and land development	$ —	$ —	$ —	$ —
Commercial real estate other	—	—	—	—
Commercial other	434	—	—	—
Agricultural	—	—	—	—
Tax exempt loans	—	—	—	—
Residential real estate	—	—	—	—
Home equity	—	—	—	—
Consumer other	—	—	—	—
Total				
Commercial real estate	$ 133	$ —	$ —	$ —
Commercial and industrial	595	1	—	—
Residential real estate	508	—	—	—
Consumer	—	—	—	—
Total impaired loans	$ 1,236	$ 1	$ —	$ —

Troubled Debt Restructuring Loans

The Company’s loan portfolio also includes certain loans that have been modified in a Troubled Debt Restructuring ("TDR"), where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from the Company’s loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions. Certain TDRs are classified as nonperforming at the time of restructure and may only be returned to performing status after considering the borrower’s sustained repayment performance for a reasonable period, generally six months. TDRs are evaluated individually for impairment and may result in a specific allowance amount allocated to an individual loan.

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The following tables include the recorded investment and number of modifications identified during the three months ended March 31, 2018 and for the three months ended March 31, 2017, respectively. The table includes the recorded investment in the loans prior to a modification and also the recorded investment in the loans after the loans were restructured. The modifications for the three months ended March 31, 2018 were attributable to interest rate concessions, maturity date extensions, reamortization or a combination of two concessions. The modifications for the three months ending March 31, 2017 were attributable to interest rate concessions, maturity date extensions, or a combination of both.

	Three Months Ended March 31, 2018		
(Dollars in thousands)	Number of Modifications	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings			
Commercial installment	2	$ 452	$ 448
Agricultural	1	2	2
Commercial real estate	1	167	—
Residential real estate	5	1,105	1,099
Consumer other	1	1	1
Total	10	$ 1,727	$ 1,550

	Three Months Ended March 31, 2017		
(Dollars in thousands)	Number of Modifications	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings			
Commercial installment	1	$ 80	$ 80
Residential real estate	2	575	574
Consumer other	1	38	37
Total	4	$ 693	$ 691

For the three months ended March 31, 2018, there were no loans restructured that had subsequently defaulted during the period.

The evaluation of certain loans individually for specific impairment includes loans that were previously classified as TDRs or continue to be classified as TDRs.

Foreclosure

As of March 31, 2018, the Company maintained foreclosed residential real estate property with a fair value of $216 thousand. Additionally, residential mortgage loans collateralized by real estate property that are in the process of foreclosure as of March 31, 2018 and December 31, 2017 totaled $1.6 million and $843 thousand, respectively. As of December 31, 2017, foreclosed residential real estate property totaled $122 thousand.

Mortgage Banking

Total residential loans included held for sale loans of $4.8 million and $13.4 million at March 31, 2018 and December 31, 2017, respectively.

NOTE 4. LOAN LOSS ALLOWANCE

The allowance for loan losses is maintained at a level considered adequate to provide for our estimate of probable credit losses inherent in the loan portfolio. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs. Loans are charged against the allowance for loan losses when we believe that collectability is unlikely. While we use the best information available to make our evaluation, future adjustments may be necessary if there are significant changes in conditions.

The allowance is comprised of four distinct reserve components: (1) specific reserves related to loans individually evaluated, (2) quantitative reserves related to loans collectively evaluated (3) qualitative reserves related to loans collectively evaluated and (4) a temporal estimate is made for incurred loss emergence period for each loan category within the collectively evaluated pools.

A summary of the methodology we employ on a quarterly basis with respect to each of these components in order to evaluate the overall adequacy of our allowance for loan losses is as follows:

Specific Reserve for Loans Individually Evaluated
First, we identify loan relationships having aggregate balances in excess of $150 thousand and that may also have credit weaknesses. Such loan relationships are identified primarily through our analysis of internal loan evaluations, past due loan reports and loans adversely classified internally or by regulatory authorities. Each loan so identified is then individually evaluated for impairment. Loans are considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the original loan agreement. Substantially all of our impaired loans have historically been collateral dependent, meaning repayment of the loan is expected or is considered to be provided solely from the sale of the loan's underlying collateral. For such loans, we measure impairment based on the fair value of the loan's collateral, which is generally determined utilizing current appraisals. A specific reserve is established in an amount equal to the excess, if any, of the recorded investment in each impaired loan over the fair value of its underlying collateral, less estimated costs to sell. Our policy is to re-evaluate the fair value of collateral dependent loans at least every twelve months unless there is a known deterioration in the collateral's value, in which case a new appraisal is obtained.

Purchase credit impaired (“PCI”) loans are collectively evaluated, but are not included in the general reserve as described below. The evaluation of the PCI loans requires continued quarterly assessment of key assumptions and estimates similar to the initial fair value estimate, including changes in the severity of loss, timing and speed of payments, collateral value changes, expected cash flows and other relevant factors. The quarterly assessment is compared to the initial fair value estimate and a determination is made if an adjustment to the allowance for loan loss is deemed necessary.

Quantitative Reserve for Loans Collectively Evaluated
Second, we stratify the loan portfolio into two general business loan pools: substandard (7 risk rated) and pass-rated (0 to 6 rated) by loan type. Substandard rated loans are subject to higher credit loss rates in the allowance for loan loss calculation. The Company utilizes historical loss rates for commercial real estate and commercial and industrial loans assessed by internal risk rating. Historical loss rates on residential real estate and consumer loans are not risk graded. Residential real estate and consumer loans are considered as part of the pass-rated portfolio unless removed due to specific reserve evaluation based on past due status and/or other indications of credit deterioration. Quantitative reserves relative to each loan pool are established as follows: for all loan segments an allocation equaling 100% of the respective pool's average 3-year historical net loan charge-off rate (determined based upon the most recent 12 quarters) is applied to the aggregate recorded investment in the pool of loans. Purchased performing loans are collectively evaluated as their own separate category within each loan pool.

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Qualitative Reserve for Loans Collectively Evaluated
Third, we consider the necessity to adjust our average historical net loan charge-off rates relative to each of the above two loan pools for potential risks factors that could result in actual losses deviating from prior loss experience. Such qualitative risk factors considered are: (1) lending policies and procedures, (2) business conditions, (3) volume and nature of the loan portfolio, (4) experience, ability and depth of lending management, (5) problem loan trends, (6) quality of the Bank's loan review system, (7) concentrations in the portfolio, (8) competition, legal, and regulatory environment and (9) collateral coverage and loan-to-value.

Loss Emergence Period for Loans Collectively Evaluated
Fourth, the general allowance related to loans collectively evaluated includes an estimate of incurred losses over an estimated loss emergence period ("LEP"). The LEP was generated utilizing a charge-off look-back analysis, which studied the time from the first indication of elevated risk of repayment (or other early event indicating a problem) to eventual charge-off to support the LEP considered in the allowance calculation. This reserving methodology established the approximate number of months of LEP that represents incurred losses for each loan portfolio within each portfolio segment in addition to the qualitative reserves.

Activity in the allowance for loan losses for the three months ended March 31, 2018 and 2017 was as follows:

Business Activities Loans	At or for the Three Months Ended March 31, 2018				
(in thousands)	Commercial real estate	Commercial and industrial	Residential real estate	Consumer	Total
Balance at beginning of period	$6,037	$ 2,373	$ 3,357	$ 386	$12,153
Charged-off loans	—	(84)	—	(170)	(254)
Recoveries on charged-off loans	15	2	1	2	20
Provision/(releases) for loan losses	(54)	321	(54)	282	495
Balance at end of period	$5,998	$ 2,612	$ 3,304	$ 500	$12,414
Individually evaluated for impairment	433	132	84	—	649
Collectively evaluated	5,565	2,480	3,220	500	11,765
Total	$5,998	$ 2,612	$ 3,304	$ 500	$12,414

Business Activities Loans	At or for the Three Months Ended March 31, 2017				
(in thousands)	Commercial real estate	Commercial and industrial	Residential real estate	Consumer	Total
Balance at beginning of period	$5,145	$ 1,952	$ 2,721	$ 601	$10,419
Charged-off loans	(107)	(17)	(199)	(21)	(344)
Recoveries on charged-off loans	4	—	1	9	14
Provision/(releases) for loan losses	265	208	283	39	795
Balance at end of period	$5,307	$ 2,143	$ 2,806	$ 628	$10,884
Individually evaluated for impairment	302	172	45	8	527
Collectively evaluated	5,005	1,971	2,761	620	10,357
Total	$5,307	$ 2,143	$ 2,806	$ 628	$10,884

Acquired Loans	At or for the Three Months Ended March 31, 2018				
(in thousands)	Commercial real estate	Commercial and industrial	Residential real estate	Consumer	Total
Balance at beginning of period	$97	$ 16	$ 59	$ —	$172
Charged-off loans	(106)	(58)	—	(43)	(207)
Recoveries on charged-off loans	—	—	—	—	—
Provision/(releases) for loan losses	92	166	(1)	43	300
Balance at end of period	$83	$ 124	$ 58	$ —	$265
Individually evaluated for impairment	—	121	—	—	121
Collectively evaluated	83	3	58	—	144
Total	$83	$ 124	$ 58	$ —	$265

There was no allowance for loans meeting the definition of acquired for the three month period ending March 31, 2017.

Loan Origination/Risk Management: The Bank has certain lending policies and procedures in place are designed to maximize loan income within an acceptable level of risk. The Bank’s Board of Directors reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management and the Bank's Board of Directors with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies and non-performing loans and potential problem loans. The Bank seeks to diversify the loan portfolio as a means of managing risk associated with fluctuations in economic conditions.

Credit Quality Indicators/Classified Loans: In monitoring the credit quality of the portfolio, management applies a credit quality indicator and uses an internal risk rating system to categorize commercial loans. These credit quality indicators range from one through nine, with a higher number correlating to increasing risk of loss. These ratings are used as inputs to the calculation of the allowance for loan losses. Consistent with regulatory guidelines, the Bank provides for the classification of loans which are considered to be of lesser quality as special mention, substandard, doubtful, or loss (i.e. risk rated 6, 7, 8 and 9, respectively).

The following are the definitions of the Bank’s credit quality indicators:

Pass: Loans within all classes of commercial portfolio segments that are not adversely rated, are contractually current as to principal and interest, and are otherwise in compliance with the contractual terms of the loan agreement. Management believes there is a low risk of loss related to these loans considered pass rated.

Special mention: Loans that do not expose the Bank to risk sufficient to warrant classification in one of the subsequent categories, but which possess some weaknesses, are designated as special mention. A special mention loan has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution’s credit position at some future date. This might include loans which the lending officer may be unable to supervise properly because of: (i) lack of expertise, inadequate loan agreement; (ii) the poor condition of or lack of control over collateral; or (iii) failure to obtain proper documentation or any other deviations from prudent lending practices. Economic or market conditions which may, in the future, affect the obligor may warrant special mention of the asset. Loans for which an adverse trend in the borrower's operations or an imbalanced position in the balance sheet which has not reached a point where the liquidation is jeopardized may be included in this classification. Special mention loans are not adversely classified and do not expose the Bank to sufficient risks to warrant classification.

Substandard: The Bank considers a loan substandard if it is inadequately protected by the current net worth and paying capacity of the borrower or of the collateral pledged, if any. Substandard loans have a well-defined weakness that jeopardizes liquidation of the debt. Substandard loans include those loans where there is the distinct possibility of some loss of principal, if the deficiencies are not corrected.

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Doubtful: Loans the Bank classifies as doubtful have all of the weaknesses inherent in those loans that are classified as substandard.These loans have the added characteristic of the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is high but because of certain important and reasonably specific pending factors which may work to the advantage and strengthening of the loan, its classification as loss is deferred until its more exact status is determined. Pending factors include proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral and refinancing plans. The entire amount of the loan might not be classified as doubtful when collection of a specific portion appears highly probable. Loans are generally not classified doubtful for an extended period of time (i.e., over a year).

Loss: Loans the Bank classifies as losses are those considered uncollectible and of such little value that their continuance as an asset is not warranted and the uncollectible amounts are charged-off. This classification does not mean the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this worthless asset even though partial recovery may be affected in the future. Losses are taken in the period in which they are determined to be uncollectible.

The following tables present the Company's loans by risk rating at March 31, 2018 and December 31, 2017:

Business Activities Loans
Commercial Real Estate
Credit Risk Profile by Creditworthiness Category

	Construction and land development		Commercial real estate other		Total commercial real estate	
(in thousands)	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017
Grade:						
Pass	$30,433	$28,180	$489,702	$483,711	$520,135	$511,891
Special mention	73	73	7,740	5,706	7,813	5,779
Substandard	567	639	14,651	15,702	15,218	16,341
Total	$31,073	$28,892	$512,093	$505,119	$543,166	$534,011

Commercial and Industrial
Credit Risk Profile by Creditworthiness Category

	Commercial other		Agricultural		Tax exempt loans		Total commercial and industrial	
(in thousands)	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017
Grade:								
Pass	$206,217	$194,147	$25,700	$27,046	$42,935	$42,208	$274,852	$263,401
Special mention	2,115	1,933	68	63	157	157	2,340	2,153
Substandard	1,972	1,971	541	479	—	—	2,513	2,450
Total	$210,304	$198,051	$26,309	$27,588	$43,092	$42,365	$279,705	$268,004

Residential Real Estate and Consumer Loans
Credit Risk Profile Based on Payment Activity

	Residential real estate	Home equity	Other consumer	Total Residential real estate and consumer
(in thousands)				

	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017
Performing	$581,938	$588,003	$51,476	$51,246	$7,471	$7,733	$640,885	$646,982
Nonperforming	6,527	3,408	624	130	109	95	7,260	3,633
Total	$588,465	$591,411	$52,100	$51,376	$7,580	$7,828	$648,145	$650,615

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Acquired Loans
Commercial Real Estate
Credit Risk Profile by Creditworthiness Category

	Commercial construction and land development		Commercial real estate other		Total commercial real estate	
(in thousands)	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017
Grade:						
Pass	$14,436	$16,523	$256,806	$266,477	$ 271,242	$ 283,000
Special mention	81	235	2,543	2,440	2,624	2,675
Substandard	283	23	7,406	7,037	7,689	7,060
Total	$14,800	$16,781	$266,755	$275,954	$ 281,555	$ 292,735

Commercial and Industrial
Credit Risk Profile by Creditworthiness Category

	Commercial other		Agricultural		Tax exempt loans		Total commercial and industrial	
(in thousands)	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017
Grade:								
Pass	$58,199	$60,300	$ —	$ —	$42,302	$43,350	$100,501	$103,650
Special mention	5,003	5,753	—	—	—	—	5,003	5,753
Substandard	1,996	2,016	—	—	—	—	1,996	2,016
Total	$65,198	$68,069	$ —	$ —	$42,302	$43,350	$107,500	$111,419

Residential Real Estate and Consumer Loans
Credit Risk Profile Based on Payment Activity

	Residential real estate		Home equity		Other consumer		Total Residential real estate and consumer	
(in thousands)	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017	Mar 31, 2018	Dec 31, 2017
Performing	$541,464	$562,516	$57,490	$62,000	$2,015	$2,283	$600,969	$626,799
Nonperforming	3,049	1,755	277	217	55	58	3,381	2,030
Total	$544,513	$564,271	$57,767	$62,217	$2,070	$2,341	$604,350	$628,829

The following table summarizes information about total classified and criticized loans loans as of March 31, 2018 and December 31, 2017:

	March 31, 2018			December 31, 2017		
(in thousands)	Business Activities	Acquired Loans	Total	Business Activities	Acquired Loans	Total
Non-accrual	$17,003	$3,336	$20,339	$12,140	$2,156	$14,296
Substandard accruing	7,988	6,145	14,133	10,284	7,833	18,117
Total classified	24,991	9,481	34,472	22,424	9,989	32,413
Special mention	10,153	7,627	17,780	7,932	8,428	16,360
Total Criticized	$35,144	$17,108	$52,252	$30,356	$18,417	$48,773

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NOTE 5. BORROWED FUNDS

Borrowed funds at March 31, 2018 and December 31, 2017 are summarized, as follows:

	March 31, 2018			December 31, 2017		
(dollars in thousands)	Carrying Value	Weighted Average Rate		Carrying Value	Weighted Average Rate	
Short-term borrowings						
Advances from the FHLB	$567,372	1.80	%	$608,792	1.49	%
Other borrowings	31,615	0.89		40,706	0.59	
Total short-term borrowings	598,987	1.75		649,498	1.43	
Long-term borrowings						
Advances from the FHLB	143,211	1.83		137,190	1.72	
Subordinated borrowings	38,018	5.36		38,033	4.88	
Junior subordinated borrowings	5,000	5.41		5,000	4.89	
Total long-term borrowings	186,229	2.65		180,223	2.47	
Total	$785,216	1.96	%	$829,721	1.66	%

Short term debt includes Federal Home Loan Bank of Boston (“FHLB”) advances with an original maturity of less than one year. The Bank also maintains a $1.0 million secured line of credit with the FHLB that bears a daily adjustable rate calculated by the FHLB. There was no outstanding balance on the FHLB line of credit for the periods ended March 31, 2018 and December 31, 2017.

The Bank also had capacity to borrow funds on a secured basis utilizing the Borrower in Custody program and the Discount Window at the Federal Reserve Bank of Boston (the “FRB”). At March 31, 2018, the Bank’s available secured line of credit at the FRB was $118.0 million. The Bank has pledged certain loans and securities to the FRB to support this arrangement. There were no borrowings with the FRB for the periods ended March 31, 2018 and December 31, 2017.

Long-term FHLB advances consist of advances with a maturity of more than one year. The advances outstanding at March 31, 2018 include callable advances totaling $25.0 million, and amortizing advances totaling $676 thousand. The advances outstanding at December 31, 2017 include callable advances totaling $27.0 million, and $683 thousand amortizing advances. All FHLB borrowings, including the line of credit, are secured by a blanket security agreement on certain qualified collateral, principally all residential first mortgage loans and certain securities.

A summary of maturities of FHLB advances as of March 31, 2018 is as follows:

	March 31, 2018		
(in thousands, except rates)	Carrying Value	Weighted Average Rate	
Fixed rate advances maturing:			
2018	$531,680	1.78	%
2019	146,661	1.88	
2020	29,929	1.88	
2021	1,637	2.35	
2022	—	—	
2023 and thereafter	676	2.87	
Total FHLB advances	$710,583	1.81	%

In April 2008, the Bank issued fifteen year junior subordinated notes in the amount of $5.0 million. These debt securities qualify as Tier 2 capital for the Company and the Bank. The subordinated debt securities are callable by the Bank after five years without penalty. The interest rate is three-month LIBOR plus 3.45%. At March 31, 2018 and December 31, 2017 the interest rate was 5.57% and 5.04%, respectively.

The Company has $17.0 million of subordinated debt issued on October 29, 2014, in connection with the execution of a Subordinated Note Purchase Agreement with an aggregate of $17.0 million of subordinated notes (the “Notes”) to the accredited investors. The Notes have a maturity date of November 1, 2024, and will bear interest at a fixed rate of 6.75% per annum. The Company may, at its option, beginning with the interest payment date of November 1, 2019, and on any interest payment date thereafter, redeem the Notes, in whole or in part, at par plus accrued and unpaid interest to the date of redemption. Any partial redemption will be made pro rata among all of the noteholders. The Notes are not subject to repayment at the option of the noteholders. The Notes are unsecured, subordinated obligations of the Company and rank junior in right of payment to the Company’s senior indebtedness and to the Company’s obligations to its general creditors.

The Company also has $20.6 million in floating Junior Subordinated Deferrable Interest Debentures ("Debentures") issued by NHTB Capital Trust II ("Trust II") and NHTB Capital Trust III ("Trust III"), which are both Connecticut statutory trusts. The Debentures were issued on March 30, 2014, carry a variable interest rate of 3-month LIBOR plus 2.79%, and mature in 2034. The debt is callable by the Company at the time when any interest payment is made. Trust II and Trust III are considered variable interest entities for which the Company is not the primary beneficiary. Accordingly, Trust II and Trust III are not consolidated into the Company’s financial statements.

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NOTE 6. DEPOSITS

A summary of time deposits is as follows:

(in thousands)	March 31, 2018	December 31, 2017
Time less than $100,000	$587,046	$ 579,856
Time $100,000 or more	297,802	286,490
Total time deposits	$884,848	$ 866,346

At March 31, 2018 and December 31, 2017, the scheduled maturities by year for time deposits were as follows:

(in thousands)	March 31, 2018	December 31, 2017
Within 1 year	$474,956	$ 406,295
Over 1 year to 2 years	274,329	305,895
Over 2 years to 3 years	102,272	115,878
Over 3 years to 4 years	13,647	24,459
Over 4 years to 5 years	19,617	13,685
Over 5 years	27	134
Total	$884,848	$ 866,346

Included in time deposits are brokered deposits of $450.4 million and $428.3 million at March 31, 2018 and December 31, 2017, respectively. Included in the deposit balances contained on the balance sheet are reciprocal deposits of $35.5 million and $49.7 million at March 31, 2018 and December 31, 2017, respectively.

NOTE 7. CAPITAL RATIOS AND SHAREHOLDERS' EQUITY

The actual and required capital ratios were as follows:

	March 31, 2018		Regulatory Minimum to be "Well Capitalized"		December 31, 2017		Regulatory Minimum to be "Well Capitalized"	
Company (consolidated)								
Total capital to risk weighted assets	13.9	%	10.5	%	13.7	%	10.5	%
Common equity tier 1 capital to risk weighted assets	11.4		6.5		11.3		6.5	
Tier 1 capital to risk weighted assets	12.3		8.0		12.2		8.0	
Tier 1 capital to average assets	8.2		5.0		8.1		5.0	
Bank								
Total capital to risk weighted assets	13.7	%	10.5	%	13.7	%	10.5	%
Common equity tier 1 capital to risk weighted assets	12.9		6.5		12.9		6.5	
Tier 1 capital to risk weighted assets	12.9		8.0		12.9		8.0	
Tier 1 capital to average assets	8.6		5.0		8.6		5.0	

At each date shown, the Company and the Bank met the conditions to be classified as "well capitalized" under the relevant regulatory framework. To be categorized as "well capitalized," an institution must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table above.

Effective January 1, 2015, the Company and the Bank became subject to the Basel III rule that requires the Company and the Bank to assess their Common equity tier 1 capital to risk weighted assets and the Company and the Bank each exceed the minimum to be "well capitalized." In addition, the final capital rules added a requirement to maintain a minimum conservation buffer, composed of common equity tier 1 capital, of 2.5% of risk-weighted assets, to be phased in over three years and applied to the common equity tier 1 risk-based capital ratio, the Tier 1 risk-based capital ratio and the Total risk-based capital ratio. Accordingly, banking organizations, on a fully phased in basis no later than January 1, 2019, must maintain a minimum Common equity tier 1 risk-based capital ratio of 7.0%, a minimum Tier 1 risk-based capital ratio of 8.5% and a minimum Total risk-based capital ratio of 10.5%.

The required minimum conservation buffer began to be phased in incrementally, starting at 0.625% on January 1, 2016 and increasing to 1.25% on January 1, 2017. The buffer increased to 1.875% on January 1, 2018 and will increase to 2.5% on January 1, 2019. The final capital rules impose restrictions on capital distributions and certain discretionary cash bonus payments if the minimum capital conservation buffer is not met.

At March 31, 2018, the capital levels of both the Company and the Bank exceeded all regulatory capital requirements and their regulatory capital ratios were above the minimum levels required to be considered "well capitalized" for regulatory purposes. The capital levels of both the Company and the Bank at March 31, 2018 also exceeded the minimum capital requirements including the currently applicable capital conservation buffer of 1.875%.

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Accumulated other comprehensive loss

Components of accumulated other comprehensive income is as follows:

(in thousands)	March 31, 2018	December 31, 2017
Other accumulated comprehensive income (loss), before tax:		
Net unrealized loss on AFS securities	$(13,443)	$ (2,741)
Net unrealized loss on effective cash flow hedging derivatives	(2,934)	(3,588)
Net unrealized loss on post-retirement plans	(905)	(946)
Income taxes related to items of accumulated other comprehensive loss:		
Net unrealized loss on AFS securities	3,211	1,030
Net unrealized loss on effective cash flow hedging derivatives	698	1,338
Net unrealized loss on post-retirement plans	217	353
Accumulated other comprehensive loss	$(13,156)	$ (4,554)

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The following table presents the components of other comprehensive income (loss) for the three months ended March 31, 2018 and 2017:

(in thousands)	Before Tax	Tax Effect	Net of Tax
Three Months Ended March 31, 2018			
Net unrealized gain on AFS securities:			
Net unrealized gain arising during the period	$ (10,702)	$ 2,550	$ (8,152)
Less: reclassification adjustment for gains (losses) realized in net income	—	—	—
Net unrealized gain on AFS securities	(10,702)	2,550	(8,152)
Net unrealized loss on derivative hedges:			
Net unrealized loss arising during the period	654	(155)	499
Less: reclassification adjustment for gains (losses) realized in net income	—	—	—
Net unrealized loss on derivative hedges	654	(155)	499
Net unrealized loss on post-retirement plans:			
Net unrealized loss arising during the period	41	(10)	31
Less: reclassification adjustment for gains (losses) realized in net income	—	—	—
Net unrealized loss on post-retirement plans	41	(10)	31
Other comprehensive loss	$ (10,007)	$ 2,385	$ (7,622)
Three Months Ended March 31, 2017			
Net unrealized gain on AFS securities:			
Net unrealized gain arising during the period	$ 1,116	$ (348)	$ 768
Less: reclassification adjustment for gains (losses) realized in net income	—	—	—
Net unrealized gain on AFS securities	1,116	(348)	768
Net unrealized loss on derivative hedges:			
Net unrealized loss arising during the period	(223)	83	(140)
Less: reclassification adjustment for gains (losses) realized in net income	—	—	—
Net unrealized loss on derivative hedges	(223)	83	(140)
Net unrealized loss on post-retirement plans:			
Net unrealized loss arising during the period	57	(21)	36
Less: reclassification adjustment for gains (losses) realized in net income	—	—	—
Net unrealized loss on post-retirement plans	57	(21)	36
Other comprehensive income (loss)	$ 950	$ (286)	$ 664

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The following table presents the changes in each component of accumulated other comprehensive income (loss), for the three months ended March 31, 2018 and 2017:

(in thousands)	Net unrealized holding gain on AFS Securities	Net loss on effective cash flow hedging derivatives	Net unrealized holding loss on pension plans	Total
Three Months Ended March 31, 2018				
Balance at beginning of period	$ (1,713)	$ (2,250)	$ (591)	$ (4,554)
Other comprehensive gain/(loss) before reclassifications	(8,152)	499	31	(7,622)
Less: amounts reclassified from accumulated other comprehensive income for ASU 2018-02	(367)	(485)	(128)	(980)
Total other comprehensive loss	(8,519)	14	(97)	(8,602)
Balance at end of period	$ (10,232)	$ (2,236)	$ (688)	$ (13,156)
Three Months Ended March 31, 2017				
Balance at beginning of period	$ (2,125)	$ (1,798)	$ (403)	$ (4,326)
Other comprehensive gain/(loss) before reclassifications	768	(140)	36	664
Less: amounts reclassified from accumulated other comprehensive income	—	—	—	—
Total other comprehensive loss	768	(140)	36	664
Balance at end of period	$ (1,357)	$ (1,938)	$ (367)	$ (3,662)

The Company did not have any reclassifications from any component of accumulated other comprehensive income (loss) for the three months ended March 31, 2018 and 2017.

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NOTE 8. EARNINGS PER SHARE

Earnings per share have been computed based on the following (average diluted shares outstanding are calculated using the treasury stock method):

	Three Months Ended March 31,	
(in thousands, except per share and share data)	2018	2017
Net income	$7,812	$ 4,211
Average number of basic common shares outstanding	15,448,338	14,471,147
Plus: dilutive effect of stock options and awards outstanding	104,631	120,126
Average number of diluted common shares outstanding	15,552,969	14,591,273
Anti-dilutive options excluded from earnings calculation	1,230	—
Earnings per share:		
Basic	$0.51	$ 0.29
Diluted	$0.50	$ 0.29

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NOTE 9. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

As part of its overall asset and liability management strategy, the Bank periodically uses derivative instruments to minimize significant unplanned fluctuations in earnings and cash flows caused by interest rate volatility. The Bank's interest rate risk management strategy involves modifying the re-pricing characteristics of certain assets or liabilities so the changes in interest rates do not have a significant effect on net interest income.

The Company recognizes its derivative instruments on the consolidated balance sheet at fair value. On the date the derivative instrument is entered into, the Bank designates whether the derivative is part of a hedging relationship (i.e., cash flow or fair value hedge). The Bank formally documents relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking hedge transactions. The Bank also assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives used in hedging transactions are highly effective in offsetting the changes in cash flows or fair values of hedged items.

Changes in fair value of derivative instruments that are highly effective and qualify as cash flow hedges are recorded in other comprehensive income or loss. Any ineffective portion is recorded in earnings. The Bank discontinues hedge accounting when it is determined the derivative is no longer effective in offsetting changes of the hedged risk on the hedged item, or management determines the designation of the derivative as a hedging instrument is no longer appropriate.

Information about derivative assets and liabilities at March 31, 2018 and December 31, 2017, was as follows:

	March 31, 2018		
	Notional Amount	Weighted Average Maturity	Estimated Fair Value Asset (Liability)
	(in thousands)	(in years)	(in thousands)
Cash flow hedges:			
Interest rate caps agreements	$90,000	4.9	$ 1,215
Total cash flow hedges	90,000	4.9	1,215
Economic hedges:			
Forward sale commitments	5,658	0.2	(51)
Total economic hedges	5,658	0.2	(51)
Non-hedging derivatives:			
Interest rate lock commitments	4,375	0.2	7
Total non-hedging derivatives	4,375	0.2	7
Total	$100,033		$ 1,171

	December 31, 2017		
	Notional Amount	Weighted Average Maturity	Estimated Fair Value Asset (Liability)
	(in thousands)	(in years)	(in thousands)
Cash flow hedges:			
Interest rate caps agreements	$90,000	5.1	$ 669
Total cash flow hedges	90,000	5.1	669
Economic hedges:			
Forward sale commitments	20,352	0.2	(221)
Total economic hedges	20,352	0.2	(221)
Non-hedging derivatives:			
Interest rate lock commitments	19,853	0.2	(1)
Total non-hedging derivatives	19,853	0.2	(1)
Total	$130,205		$ 447

Information about derivative assets and liabilities for the three months ended March 31, 2018 and 2017, was as follows:

	Three Months Ended March 31,	
(in thousands)	2018	2017
Cash flow hedges:		
Interest rate cap agreements		
Realized (loss) in interest expense	$(108)	$(39)
Economic hedges:		
Forward commitments		
Realized gain/(loss) in other non-interest income	170	(78)
Non-hedging derivatives:		
Interest rate lock commitments		
Realized gain in other non-interest income	8	2

Cash flow hedges

In 2014, interest rate cap agreements were purchased to limit the Bank's exposure to rising interest rates on four rolling, three-month borrowings indexed to three-month LIBOR. Under the terms of the agreements, the Bank paid total premiums of $4.6 million for the right to receive cash flow payments if 3-month LIBOR rises above the caps of 3.00%, thus effectively ensuring interest expense on the borrowings at maximum rates of 3.00% for the duration of the agreements. The interest rate cap agreements were designated as cash flow hedges. The fair values of the interest rate cap agreements are included in other assets on the Company's consolidated balance sheets. Changes in the fair value, representing unrealized gains or losses, are recorded in accumulated other comprehensive income, net of tax. The premiums paid on the interest rate cap agreements are being recognized as increases in interest expense over the duration of the agreements using the caplet method.

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Economic hedges

The Company utilizes forward sale commitments to hedge interest rate risk and the associated effects on the fair value of interest rate lock commitments and loans originated for sale. The forward sale commitments are accounted for as derivatives with changes in fair value recorded in current period earnings. The Company typically uses mandatory delivery contracts, which are loan sale agreements where the Company commits to deliver a certain principal amount of mortgage loans to an investor at a specified price on or before a specified date. Generally, the Company may enter into mandatory delivery contracts shortly after the loan closes with a customer.

Non-hedging derivatives

The Company enters into interest rate lock commitments (“IRLCs”) for residential mortgage loans, which commit the Company to lend funds to a potential borrower at a specific interest rate and within a specified period of time. IRLCs relate to the origination of mortgage loans will be held for sale are considered derivative financial instruments under applicable accounting guidance. Outstanding IRLCs expose the Company to the risk that the price of the mortgage loans underlying the commitments may decline due to increases in mortgage interest rates from inception of the rate lock to the funding of the loan. The IRLCs are free-standing derivatives which are carried at fair value with changes recorded in non-interest income in the Company’s consolidated statements of income. Changes in the fair value of IRLCs subsequent to inception are based on changes in the fair value of the underlying loan resulting from the fulfillment of the commitment and changes in the probability when the loan will fund within the terms of the commitment, which is affected primarily by changes in interest rates and the passage of time.

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NOTE 10. FAIR VALUE MEASUREMENTS

A description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below. These valuation methodologies were applied to all of the Company's financial assets and financial liabilities that are carried at fair value.

Recurring Fair Value Measurements

The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis as of March 31, 2018 and December 31, 2017, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value.

	March 31, 2018			
(in thousands)	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Available for sale securities:				
Obligations of US Government sponsored enterprises	$ —	$ 6,977	$ —	$ 6,977
Mortgage-backed securities:				
US Government-sponsored enterprises	—	449,175	—	449,175
US Government agency	—	90,396	—	90,396
Private label	—	616	—	616
Obligations of states and political subdivisions thereof	—	135,277	—	135,277
Corporate bonds	—	36,118	—	36,118
Derivative assets	—	1,215	7	1,222
Derivative liabilities	—	—	(51)	(51)

	December 31, 2017			
(in thousands)	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Available for sale securities:				
Obligations of US Government sponsored enterprises	$ —	$ 6,972	$ —	$ 6,972
Mortgage-backed securities:				
US Government-sponsored enterprises	—	443,003	—	443,003
US Government agency	—	95,596	—	95,596
Private label	—	674	—	674
Obligations of states and political subdivisions thereof	—	140,200	—	140,200
Corporate bonds	—	30,797	—	30,797
Derivative assets	—	669	—	669
Derivative liabilities			(222)	(222)

Securities Available for Sale: All securities and major categories of securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from independent pricing providers. The fair value measurements used by the pricing providers consider observable data may include dealer quotes, market maker quotes and live trading systems. If quoted prices are not readily available, fair values are determined using matrix pricing models, or other model-based valuation techniques requiring observable inputs other than quoted prices such as market pricing spreads, credit information, callable features, cash flows, the U.S. Treasury yield curve, trade execution data, market consensus prepayment speeds, default rates, and the securities' terms and conditions, among other things.

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Derivative Assets and Liabilities

Interest Rate Lock Commitments. The Company enters into IRLCs for residential mortgage loans, which commit the Company to lend funds to a potential borrower at a specific interest rate and within a specified period of time. The estimated fair value of commitments to originate residential mortgage loans for sale is based on quoted prices for similar loans in active markets. However, this value is adjusted by a factor which considers the likelihood of a loan in a lock position will ultimately close. The closing ratio is derived from the Bank's internal data and is adjusted using significant management judgment. As such, IRLCs are classified as Level 3 measurements.

Forward Sale Commitments. The Company utilizes forward sale commitments as economic hedges against potential changes in the values of the IRLCs and loans originated for sale. The fair values of the Company's mandatory delivery loan sale commitments are determined similarly to the IRLCs using quoted prices in the market place that are observable. However, closing ratios included in the calculation are internally generated and are based on management's judgment and prior experience, which are not considered observable factors. As such, mandatory delivery forward commitments are classified as Level 3 measurements.

The table below presents the changes in Level 3 assets and liabilities that were measured at fair value on a recurring basis for the three months ended March 31, 2018.

(in thousands)	Assets (Liabilities) Interest Rate Lock Commitments	Forward Commitments
Three Months Ended March 31, 2018		
December 31, 2017	$ (1)	$ (221)
Realized gain recognized in non-interest income	8	170
March 31, 2018	$ 7	$ (51)

Quantitative information about the significant unobservable inputs within Level 3 recurring assets and liabilities is as follows:

(in thousands, except ratios)	Fair Value March 31, 2018	Valuation Techniques	Unobservable Inputs	Significant Unobservable Input Value
Assets (Liabilities)				
Interest Rate Lock Commitment	$ 7	Historical trend	Closing Ratio	90 %
		Pricing Model	Origination Costs, per loan	$ 1.7
Forward Commitments	(51)	Quoted prices for similar loans in active markets.	Freddie Mac pricing system	Pair-off contract price
Total	$ (44)			

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Non-Recurring Fair Value Measurements

The Company is required, on a non-recurring basis, to adjust the carrying value or provide valuation allowances for certain assets using fair value measurements in accordance with GAAP. The following is a summary of applicable non-recurring fair value measurements. There are no liabilities measured at fair value on a non-recurring basis.

	March 31, 2018	December 31, 2017	Three Months Ended March 31, 2018	Fair Value Measurement Date as of March 31, 2018
(in thousands)	Level 3 Inputs	Level 3 Inputs	Total Gains (Losses)	Level 3 Inputs
Assets				
Impaired loans	$ 15,127	$ 10,793	$ (4,334)	March 2018
Capitalized servicing rights	4,695	4,158		March 2018
Other real estate owned	216	122		Jan 2017 - March 2018
Total	$ 20,038	$ 15,073	(4,334)	

Quantitative information about the significant unobservable inputs within Level 3 non-recurring assets is as follows:

(in thousands, except ratios)	Fair Value March 31, 2018	Valuation Techniques	Unobservable Inputs	Range (Weighted Average)(a)	
Assets					
Impaired loans	$ 13,364	Fair value of collateral -appraised value	Loss severity	0% to 54%	
			Appraised value	$100 to $6,915	
Impaired loans	1,763	Discount cash flow	Discount rate	2.88% to 9.5%	
			Cash flows	$26 to $570	
Capitalized servicing rights	4,695	Discounted cash flow	Constant prepayment rate (CPR)	9.22	%
			Discount rate	10.10	%
Other real estate owned	216	Fair value of collateral	Appraised value	$216	
Total	$ 20,038				

(a) Where dollar amounts are disclosed, the amounts represent the lowest and highest fair value of the respective assets in the population except for adjustments for market/property conditions, which represents the range of adjustments to individuals properties.

(in thousands, except ratios)	Fair Value December 31, 2017	Valuation Techniques	Unobservable Inputs	Range (Weighted Average)[a]	
Assets					
Impaired loans	$ 8,586	Fair value of collateral -appraised value	Loss severity	15.7% to 45.28%	
			Appraised value	$100 to $7,545	
Impaired loans	2,207	Discount cash flow	Discount rate	2.63% to 9.50%	
			Cash flows	$6 to $320	
Capitalized servicing rights	4,158	Discounted cash flow	Constant prepayment rate (CPR)	10.97	%
			Discount rate	10.10	%
Other real estate owned	122	Fair value of collateral	Appraised value	122	
Total	$ 15,073				

(a) Where dollar amounts are disclosed, the amounts represent the lowest and highest fair value of the respective assets in the population except for adjustments for market/property conditions, which represents the range of adjustments to individuals properties.

There were no Level 1 or Level 2 non-recurring fair value measurements for the periods ended March 31, 2018 and December 31, 2017.

Impaired Loans. Loans are generally not recorded at fair value on a recurring basis. Periodically, the Company records non-recurring adjustments to the carrying value of loans based on fair value measurements for partial charge-offs of the uncollectible portions of those loans. Non-recurring adjustments can also include certain impairment amounts for collateral-dependent loans calculated when establishing the allowance for credit losses. Such amounts are generally based on the fair value of the underlying collateral supporting the loan and, as a result, the carrying value of the loan less the calculated valuation amount does not necessarily represent the fair value of the loan. Real estate collateral is typically valued using appraisals or other indications of value based on recent comparable sales of similar properties or assumptions generally observable in the marketplace. However, the choice of observable data is subject to significant judgment, and there are often adjustments based on judgment in order to make observable data comparable and to consider the impact of time, the condition of properties, interest rates, and other market factors on current values. Additionally, commercial real estate appraisals frequently involve discounting of projected cash flows, which relies inherently on unobservable data. Therefore, non-recurring fair value measurement adjustments relating to real estate collateral have generally been classified as Level 3. Estimates of fair value for other collateral supporting commercial loans are generally based on assumptions not observable in the marketplace and therefore such valuations have been classified as Level 3.

Capitalized loan servicing rights. A loan servicing right asset represents the amount by which the present value of the estimated future net cash flows to be received from servicing loans exceed adequate compensation for performing the servicing. The fair value of servicing rights is estimated using a present value cash flow model. The most important assumptions used in the valuation model are the anticipated rate of the loan prepayments and discount rates. Adjustments are only recorded when the discounted cash flows derived from the valuation model are less than the carrying value of the asset. Although some assumptions in determining fair value are based on standards used by market participants, some are based on unobservable inputs and therefore are classified in Level 3 of the valuation

hierarchy.

Other real estate owned ("OREO"). OREO results from the foreclosure process on residential or commercial loans issued by the Bank. Upon assuming the real estate, the Company records the property at the fair value of the asset less the estimated sales costs. Thereafter, OREO properties are recorded at the lower of cost or fair value less the estimated sales costs. OREO fair values are primarily determined based on Level 3 data including sales comparables and appraisals.

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Summary of Estimated Fair Values of Financial Instruments. The estimated fair values, and related carrying amounts, of the Company’s financial instruments follow. Certain financial instruments and all non-financial instruments are excluded from disclosure requirements. Accordingly, the aggregate fair value amounts presented herein may not necessarily represent the underlying fair value of the Company.

	March 31, 2018				
(in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial Assets					
Cash and cash equivalents	$47,813	$47,813	$47,813	$—	$ —
Securities available for sale	718,559	718,559	—	718,559	—
FHLB bank stock	38,105	38,105	—	38,105	—
Net loans	2,451,740	2,408,902	—	—	2,408,902
Accrued interest receivable	3,243	3,243	—	3,243	—
Cash surrender value of bank-owned life insurance policies	58,433	58,433	—	58,433	—
Derivative assets	1,222	1,222	—	1,215	7
Financial Liabilities					
Total deposits	$2,341,400	$2,260,874	$—	$2,260,874	$ —
Securities sold under agreements to repurchase	31,615	31,589	—	31,589	—
Federal Home Loan Bank advances	710,583	707,998	—	707,998	—
Subordinated borrowings	38,018	38,018	—	38,018	—
Junior subordinated borrowings	5,000	3,809	—	3,809	—
Derivative liabilities	(51)	(51)	—	—	(51)

	December 31, 2017				
(in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial Assets					
Cash and cash equivalents	$90,685	$90,685	$90,685	$—	$ —
Securities available for sale	717,242	717,242	—	717,242	—
FHLB bank stock	38,105	38,105	—	38,105	—
Net loans	2,473,288	2,433,557	—	—	2,433,557
Accrued interest receivable	3,347	3,347	—	3,347	—
Cash surrender value of bank-owned life insurance policies	57,997	57,997	—	57,997	—
Derivative assets	669	669	—	669	—
Financial Liabilities					
Total deposits	$2,352,085	$2,348,574	$—	$2,348,574	$ —
Securities sold under agreements to repurchase	40,706	40,680	—	40,680	—
Federal Home Loan Bank advances	745,982	744,006	—	744,006	—
Subordinated borrowings	38,033	38,033	—	38,033	—
Junior subordinated borrowings	5,000	3,782	—	3,782	—
Derivative liabilities	(222)	(222)	—	—	(222)

Other than as discussed above, the following methods and assumptions were used by management to estimate the fair value of significant classes of financial instruments for which it is practicable to estimate that value.

Cash and cash equivalents. Carrying value is assumed to represent fair value for cash and cash equivalents that have original maturities of 90 days or less.

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FHLB bank stock and restricted securities. Carrying value approximates fair value based on the redemption provisions of the issuers.

Cash surrender value of life insurance policies. Carrying value approximates fair value.

Loans, net. As of March 31, 2018, the fair value of loans were calculated on an individual basis with consideration given to the loans' underlying characteristics, including account types, remaining terms, annual interest rates or coupons, interest types, timing of principal and interest payments, current market rates, risk ratings, credit ratings and remaining balances. A discounted cash flow model is used to estimate the fair value of the loans using assumptions for the coupon rates, remaining maturities, prepayment speeds, liquidity premiums, projected default probabilities, losses given defaults, and estimates of prevailing discount rates. As of December 31, 2017, the fair value of loans was estimated by discounting future cash flows using the current interest rates at which similar loans with similar terms would be made to borrowers of similar credit quality.

Accrued interest receivable. Carrying value approximates fair value.

Deposits. The fair value of demand, non-interest bearing checking, savings and money market deposits is determined as the amount payable on demand at the reporting date. The fair value of time deposits is estimated by discounting the estimated future cash flows using market rates offered for deposits of similar remaining maturities.

Borrowed funds. The fair value of borrowed funds is estimated by discounting the future cash flows using market rates for similar borrowings. Such funds include all categories of debt and debentures in the table above.

Subordinated borrowings. The Company utilizes a pricing service along with internal models to estimate the valuation of its junior subordinated debentures. The junior subordinated debentures re-price every 90 days.

Off-balance-sheet financial instruments. Off-balance-sheet financial instruments include standby letters of credit and other financial guarantees and commitments are considered immaterial to the Company’s financial statements.

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NOTE 11. SUBSEQUENT EVENTS

There were no significant subsequent events between March 31, 2018 and through the date the financial statements are available to be issued.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

Management's discussion and analysis of financial condition and results of operations is intended to assist in understanding the financial condition and results of operations of the Company. The following discussion and analysis should be read in conjunction with the Company's consolidated financial statements and the notes thereto appearing in Part I, Item 1 of this document and with the Company's consolidated financial statements and the notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's 2017 Annual Report on Form 10-K. In the following discussion, income statement comparisons are against the same period of the previous year and balance sheet comparisons are against the previous fiscal year-end, unless otherwise noted. Operating results discussed herein are not necessarily indicative of the results for the full year 2018 or any future period. In management's discussion and analysis of financial condition and results of operations, certain reclassifications have been made to make prior periods comparable.

Bar Harbor Bankshares ("the Company", "we", "our", or "us") is the parent of Bar Harbor Bank & Trust ("the Bank"), a true community bank in New England with branches in Maine, New Hampshire and Vermont. As a true community bank, the Company recognizes, appreciates, and supports the unique people and cultures in the places we call home.

The Company's corporate goal is to be among the most profitable banks in New England, and its business model is centered on the following:

- Employee and customer experience is the foundation of superior performance, which leads to significant financial benefit to shareholders
- Geography, heritage and performance are key while remaining true to a community culture
- Strong commitment to risk management while balancing growth and earnings
- Service and sales driven culture with a focus on core business growth
- Investment in processes, products, technology, training, leadership and infrastructure
- Expansion of the Company's brand and business to deepen market presence
- Opportunity and growth for existing employees while adding catalyst recruits across all levels of the Company

Shown below is a profile of the Company as of March 31, 2018:

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FORWARD-LOOKING STATEMENTS

Certain statements contained in this document that are not historical facts may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended ("Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended ("Exchange Act"), and are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. When used in this Form 10-Q the words "may," "will," "should," "could," "would," "plan," "potential," "estimate," "project," "believe," "intend," "anticipate," "expect," "target" and similar expressions are intended to identify forward-looking statements, but these terms are not the exclusive means of identifying forward-looking statements. These forward-looking statements are subject to significant risks, assumptions and uncertainties, including among other things, changes in general economic and business conditions, increased competitive pressures, changes in the interest rate environment, legislative and regulatory change, changes in the financial markets, and other risks and uncertainties disclosed from time to time in documents that the Company files with the Securities and Exchange Commission, including but not limited to those discussed in the section titled "Risk Factors" in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2017. Because of these and other uncertainties, the Company’s actual results, performance or achievements, or industry results, may be materially different from the results indicated by these forward-looking statements. In addition, the Company’s past results of operations do not necessarily indicate future results. You should not place undue reliance on any of the forward-looking statements, which speak only as of the dates on which they were made. The Company is not undertaking an obligation to update forward-looking statements, even though its situation may change in the future, except as required under federal securities law. The Company qualifies all of its forward-looking statements by these cautionary statements.

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SELECTED FINANCIAL DATA

The following summary data is based in part on the consolidated financial statements and accompanying notes and other information appearing elsewhere in this or prior Forms 10-Q.

	Three Months Ended March 31,	
	2018	2017
PER SHARE DATA		
Net earnings, diluted	$0.50	$0.29
Adjusted earnings, diluted [1] [2]	0.52	0.43
Total book value	22.78	22.17
Tangible book value [2]	15.78	15.07
Market price at period end	27.72	33.08
Dividends	0.19	0.19
PERFORMANCE RATIOS [3]		
Return on assets	0.90 %	0.50 %
Adjusted return on assets [1] [2]	0.93	0.74
Return on equity	9.01	5.34
Adjusted return on equity [1] [2]	9.31	7.88
Adjusted return on tangible equity [1] [2]	13.72	12.27
Net interest margin, fully taxable equivalent (FTE) [2][4]	2.97	3.11
Net interest margin (FTE), excluding purchased loan accretion [2][4]	2.85	3.01
Efficiency ratio [2]	60.44	61.21
GROWTH (Year-to-date)		
Total commercial loans, (organic annualized) [2]	2.2 %	20.0 %
Total loans, (organic annualized) [2]	(3.4)	13.3
Total deposits, (organic annualized) [2]	(1.8)	(10.2)
FINANCIAL DATA (In millions)		
Total assets	$3,511	$3,427
Total earning assets	3,221	3,139
Total investments	757	767
Total loans	2,464	2,372
Allowance for loan losses	13	11
Total goodwill and intangible assets	108	109
Total deposits	2,341	2,174
Total shareholders' equity	352	341
Net income	8	4
Adjusted income [2]	8	6
ASSET QUALITY AND CONDITION RATIOS		
Net charge-offs (current quarter annualized)/average loans	0.07 %	0.06 %
Allowance for loan losses/total loans	0.51	0.46
Loans/deposits	105	109
Shareholders' equity to total assets	10.03	9.95
Tangible shareholders' equity to tangible assets [2]	7.17	6.99

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(1) Adjusted measurements are non-GAAP financial measures that are adjusted to exclude net non-operating charges primarily related to acquisitions, and gain on sale of securities. Refer to the Reconciliation of Non-GAAP Financial Measures section of Management's Discussion and Analysis for additional information.
(2) Non-GAAP financial measure.
(3) All performance ratios are annualized and are based on average balance sheet amounts, where applicable.
(4) Fully taxable equivalent considers the impact of tax advantaged investment securities and loans.

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BAR HARBOR BANKSHARES
CONSOLIDATED LOAN & DEPOSIT ANALYSIS - UNAUDITED

LOAN ANALYSIS

(in thousands)	March 31, 2018	December 31, 2017	September 30, 2017	June 30, 2017	March 31, 2017	Annualized Growth % March 31, 2018
Commercial real estate	$824,721	$ 826,746	$ 793,572	$738,584	$779,635	(1.0)%
Commercial and industrial	301,811	293,707	270,759	269,960	236,526	11.0
Total commercial loans	1,126,532	1,120,453	1,064,331	1,008,544	1,016,161	2.2
Residential real estate	1,132,977	1,155,682	1,152,628	1,160,832	1,155,436	(7.9)
Consumer	119,516	123,762	125,590	127,229	127,370	(13.7)
Tax exempt and other	85,394	85,716	86,313	80,042	73,469	(1.5)
Total loans	$2,464,419	$ 2,485,613	$ 2,428,862	$2,376,647	$2,372,436	(3.4)%

DEPOSIT ANALYSIS

(in thousands)	March 31, 2018	December 31, 2017	September 30, 2017	June 30, 2017	March 31, 2017	Annualized Growth % March 31, 2018
Demand	$342,192	$ 349,055	$ 357,398	$332,339	$349,896	(7.9)%
NOW	448,992	466,610	442,085	451,171	242,876	(15.1)
Savings	361,591	364,799	373,118	360,306	511,091	(3.5)
Money Market	303,777	305,275	300,398	285,312	349,491	(2.0)
Total non-maturity deposits	1,456,552	1,485,739	1,472,999	1,429,128	1,453,354	(7.9)
Total time deposits	884,848	866,346	802,110	783,876	720,899	8.5
Total deposits	$2,341,400	$ 2,352,085	$ 2,275,109	$2,213,004	$2,174,253	(1.8)%

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AVERAGE BALANCES AND AVERAGE YIELDS/RATES

The following table presents average balances and an analysis of average rates and yields on an annualized fully taxable equivalent basis for the periods included:

	Three Months Ended March 31,					
	2018			2017		
(in thousands)	Average Balance	Yield/Rate (FTE basis) [3]		Average Balance	Yield/Rate (FTE basis) [3]	
Assets						
Commercial real estate	$819,531	4.41	%	$762,676	4.24	%
Commercial and industrial	380,029	4.41		293,903	4.73	
Residential	1,147,010	3.87		1,161,911	3.74	
Consumer	121,467	4.47		127,850	4.16	
Total loans [1]	2,468,037	4.16		2,346,340	4.00	
Securities and other [2]	765,328	3.16		746,653	3.01	
Total earning assets	3,233,365	3.92	%	3,092,993	3.76	%
Other non-earning assets	278,436			246,629		
Total assets	$3,511,801			$3,339,622		
Liabilities						
NOW	$447,026	0.34	%	$456,967	0.14	%
Savings	362,508	0.18		340,555	0.14	
Money market	305,105	0.68		334,225	0.40	
Time deposits	857,796	1.39		666,267	0.98	
Total interest bearing deposits	1,972,435	0.82		1,798,014	0.52	
Borrowings	819,576	1.80		856,328	1.25	
Total interest-bearing liabilities	2,792,011	1.11	%	2,654,342	0.76	%
Non-interest-bearing demand deposits	339,349			350,497		
Other non-earning liabilities	29,000			19,334		
Total liabilities	3,160,360			3,024,173		
Total shareholders' equity	351,441			315,449		
Total liabilities and shareholders' equity	$3,511,801			$3,339,622		
Net interest spread		2.81	%		3.00	%
Net interest margin		2.97			3.11	

(1) The average balances of loans include nonaccrual loans and deferred fees and costs.

(2) The average balance for securities available for sale is based on amortized cost. The average balance of equity also reflects this adjustment.

(3) Fully taxable equivalent considers the impact of tax advantaged investment securities and loans.

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NON-GAAP FINANCIAL MEASURES

This document contains certain non-GAAP financial measures in addition to results presented in accordance with accounting principles generally accepted in the United States of America ("GAAP"). These non-GAAP measures are intended to provide the reader with additional supplemental perspectives on operating results, performance trends, and financial condition. Non-GAAP financial measures are not a substitute for GAAP measures; they should be read and used in conjunction with the Company's GAAP financial information. A reconciliation of non-GAAP financial measures to GAAP measures is provided below. In all cases, it should be understood that non-GAAP measures do not depict amounts that accrue directly to the benefit of shareholders. An item which management excludes when computing non-GAAP adjusted earnings can be of substantial importance to the Company's results for any particular quarter or year. The Company's non-GAAP adjusted earnings information set forth is not necessarily comparable to non- GAAP information which may be presented by other companies. Each non-GAAP measure used by the Company in this report as supplemental financial data should be considered in conjunction with the Company's GAAP financial information.

The Company utilizes the non-GAAP measure of adjusted earnings in evaluating operating trends, including components for adjusted revenue and expense. These measures exclude amounts which the Company views as unrelated to its normalized operations, including securities gains/losses, acquisition costs, restructuring costs, legal settlements, and systems conversion costs. Non-GAAP adjustments are presented net of an adjustment for income tax expense.

The Company also calculates adjusted earnings per share based on its measure of adjusted earnings. The Company views these amounts as important to understanding its operating trends, particularly due to the impact of accounting standards related to acquisition activity. Analysts also rely on these measures in estimating and evaluating the Company's performance. Management also believes that the computation of non-GAAP adjusted earnings and adjusted earnings per share may facilitate the comparison of the Company to other companies in the financial services industry. The Company also adjusts certain equity related measures to exclude intangible assets due to the importance of these measures to the investment community.

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RECONCILIATION OF NON-GAAP FINANCIAL MEASURES

The following table summarizes the reconciliation of non-GAAP items recorded for the time periods and dates indicated:

		Three Months Ended March 31,	
(in thousands)		2018	2017
Net income		$7,812	$4,211
Adj: Loss on sale of fixed assets, net		—	95
Adj: Acquisition, conversion and other expenses		335	3,112
Adj: Income taxes [1]		(81)	(1,205)
Adj: Tax reform charge		—	—
Total adjusted income [2]	(A)	$8,066	$6,213
Net-interest income	(B)	$23,158	$21,372
Plus: Non-interest income		6,238	5,946
Total Revenue		29,396	27,318
Adj: Net security gains		—	—
Total adjusted revenue [2]	(C)	$29,396	$27,318
Total non-interest expense		$18,852	$20,831
Less: Loss on sale of fixed assets, net		—	(95)
Less: Acquisition expense		(335)	(3,112)
Adjusted non-interest expense [2]	(D)	$18,517	$17,624
(in millions)			
Total average earning assets	(E)	$3,233	$3,093
Total average assets	(F)	3,512	3,340
Total average shareholders' equity	(G)	351	315
Total average tangible shareholders' equity [2] [3]	(H)	243	206
Total tangible shareholders' equity, period-end [2][3]	(I)	244	232
Total tangible assets, period-end [2] [3]	(J)	3,403	3,318
(in thousands)			
Total common shares outstanding, period-end	(K)	15,459	15,385
Average diluted shares outstanding	(L)	15,553	14,591
Adjusted earnings per share, diluted	(A/L)	$0.52	$0.43
Tangible book value per share, period-end [2]	(I/K)	15.78	15.07
Securities adjustment, net of tax	(M)	(10,232)	(1,357)
Tangible book value per share, excluding securities adjustment	(I+M)/K	16.44	15.16
Total tangible shareholders' equity/total tangible assets[2]	(H/J)	7.17	6.99

Performance ratios			
GAAP return on assets		0.90 %	0.50 %
Adjusted return on assets [2]	(A/F)	0.93	0.74
GAAP return on equity		9.01	5.34
Adjusted return on equity [2]	(A/G)	9.31	7.88
Adjusted return on tangible equity [2] [4]	(A/I)	13.72	12.27
Efficiency ratio [2][5]	(D-O-Q)/(C+N)	60.44	61.21
Net interest margin	(B+P)/E	2.97	3.11
Supplementary data (in thousands)			
Taxable equivalent adjustment for efficiency ratio	(N)	$645	$977
Franchise taxes included in non-interest expense	(O)	152	126
Tax equivalent adjustment for net interest margin	(P)	503	754
Intangible amortization	(Q)	207	180

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(1) Assumes a marginal tax rate of 24.15% in 2018 and 37.57% in 2017.

(2) Non-GAAP financial measure.

(3) Total tangible shareholders' equity is computed by taking total shareholders' equity less the intangible assets at period-end. Total tangible assets is computed by taking total assets less the intangible assets at period-end.

(4) Adjusted return on tangible equity are computed by dividing the total core income adjusted for the tax-effected amortization of intangible assets, assuming a marginal rate of 24.15% in 2018 and 37.57% in 2017, by tangible equity.

(5) Efficiency ratio is computed by dividing total core tangible non-interest expense by the sum of total net interest income on a fully taxable equivalent basis and total core non-interest income. The Company uses this non-GAAP measure to provide important information about its operating efficiency.

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FINANCIAL SUMMARY

The Company reported first quarter 2018 net income of $7.8 million, or 50 cents per diluted share, compared with $4.2 million, or 29 cents per diluted share in the same quarter of 2017. Adjusted earnings in the first quarter 2018 totaled $8.1 million, or 52 cents per share, up 21% from $6.2 million, or 43 cents in the first quarter of 2017. As discussed in an earlier section, the Company uses the non-GAAP measure of adjusted earnings, and related metrics, to evaluate the results of its operations.

First quarter financial highlights include the following (comparisons are to the first quarter 2017 unless otherwise stated):

- $29.4 million vs. $27.3 million in total revenue (non-GAAP measure)
- 8% increase in net interest income
- 11% annualized commercial and industrial loan growth
- 0.93% adjusted return on assets (non-GAAP measure)
- 9.31% adjusted return on equity (non-GAAP measure)

In the first quarter 2018, the Company achieved both revenue and net income expectations. Total revenue increased 8% and adjusted earnings per share were up 21% on a year-over-year basis as the Company expanded its market presence throughout Northern New England. The Company continued to deliver profitable growth during the first quarter through the use of various revenue streams coupled with disciplined expense management.

The Company’s management teams were active and performed very well in the first quarter. While some loan closings were delayed during the first quarter, our loan pipelines remain strong. The Bank opened over 3,200 new deposit accounts while branch colleagues came together under new leadership, and the Company’s wealth management team continued to drive significant fee income.

In the first quarter of 2018 many growth and strategic initiatives were launched throughout the Company including:

- Expanded Treasury Management Services platform.
- Brand consolidation of Retail and Commercial business lines under the name Bar Harbor Bank and Trust and common leadership.
- Migration of the Company’s two trust services for Bar Harbor Trust and Charter Trust onto a common operating platform.

The expansion of the Company’s Treasury Management Services platform is expected to be a significant contributor to fee revenue and deposit growth in 2018. While the Company has preserved its banking franchise and banking culture since the acquisition of Lake Sunapee Bank Group, the consolidation of the Company’s brand is expected to bring value from stream-lining businesses processes to delivering products more efficiently. Fee income remains a focus of the Company and wealth management is a strong source of these revenue streams. The combined platform is expected to improve operational efficiencies and deepen customer relationships, allowing for further market penetration and cross-sell opportunities which are central themes to our sales objectives.

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COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED MARCH 31, 2018 AND 2017

Summary
Net income in the first quarter 2018 increased $3.6 million to $7.8 million from $4.2 million in the same quarter of 2017. Net income in 2017 was reduced by $2.4 million related to acquisition and conversion activities. Adjusted earnings in the first quarter 2018 increased to $8.1 million from $6.2 million in the same quarter of 2017 on an 8% increase in net interest and realized operational efficiencies.

The return on assets ratio during the first quarter 2018 was 0.90% compared to 0.50% in the prior year. The prior year ratio includes the impact of $3.1 million of acquisition costs. The Company's adjusted return on assets ratio improved 19 basis points over the prior year to 0.93% and reflects higher net interest income, wealth management and customer service fee income. Return on equity in the first quarter 2018 was 9.01% compared to 5.34% in the prior year. Adjusted return on equity in the first quarter increased to 9.31% from 7.88% in the prior year due to higher net income and improved operational efficiencies. The increase in profitability reflects the Company's focus and realization of the earn-back period of the acquisition made in 2017.

Net Interest Income
First quarter net interest income increased by $1.8 million to $23.2 million in 2018 compared with $21.4 million in 2017 despite higher funding costs. The 8% increase in 2018 is primarily due to higher total revenue driven by earning asset growth in average balances and related yields. Interest income from earnings assets increased to the Company's highest quarter of $30.8 million with a yield of 3.92%.

Net interest margin for the first quarter of 2018 was 2.97%, compared with 3.11% in the first quarter of 2017.The ratio includes a 5 basis point reduction due to lower tax equivalency adjustments. Purchased loan accretion increased net interest margin by 12 basis points in the first quarter 2018 compared to 10 basis points in same period of 2017. The Company continues to address margin compression by organically shifting its liability sensitivity position by rebalancing deposits and alternative borrowings while originating variable rate loans. This strategy results in short-term incremental costs, but secures the Company's longer term net interest margin goals and funding requirements.

Non-Interest Income
Non-interest income was $6.2 million in the first quarter of 2018 as compared to $5.9 million in the same quarter of 2017. The increase is principally due to higher customer service fees and trust and investment management fee income due to higher transaction volume.

Loan Loss Provision
The provision for loan losses was $795 thousand in the first quarter of 2018 and 2017. The amount of the provision exceeded net charge-offs in all periods since the first quarter of 2017 resulting from loan growth. The provision for loan losses is a charge to earnings in an amount sufficient to maintain the allowance for loan losses at a level deemed adequate by the Company. It is an estimate of the probable and estimable loan losses in the portfolio as of period-end.

Non-Interest Expense
Non-interest expense decreased to $18.9 million in the first quarter 2018 compared from $20.8 million in 2017. The decrease is principally due to lower acquisition, conversion and other expenses which totaled $335 thousand in 2018 compared to $3.1 million in 2017. These costs in 2018 are primarily from activities associated with the wealth management system conversion, while costs in 2017 are related to the acquisition. The efficiency ratio was 60% for the quarter compared to 61% in the first quarter of 2017. That improvement includes realized cost savings from the acquisition balanced with higher salary and benefit expense due to seasonally higher employer payroll taxes and recent strategic new hires.

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Income Tax Expense

The effective tax was 20% in the first quarter of 2018 compared to 26% in the same quarter of 2017. The rate in 2018 benefited from the 14% reduction in the Federal tax rate due to the Tax Reform and Jobs Act of 2017. The rate in 2017 benefited from lower taxable income related to acquisition related expenses.

COMPARISON OF FINANCIAL CONDITION AT MARCH 31, 2018 AND DECEMBER 31, 2017

Summary

Total assets measured $3.5 billion at the end of first quarter 2018 compared with $3.6 billion at year end 2017. The decrease is primarily due to decreases in loan balances and excess cash used to pay-down borrowings. The loan to deposit ratio improved to 105% from 106% at year-end 2017 due to seasonally lower loan growth. Asset quality remains strong as the ratio of net charge-offs to total loans has been close to zero and the ratio of allowance for loan losses to total loans has been in the 50 basis point range over the past five quarters. Excluding security adjustments, the Company's tangible book value (non-GAAP measure) per share increased to $16.44 from $16.05 at the end of 2017 primarily due to strong first quarter earnings.

Securities

Total securities increased $1.3 million during the first quarter to $756.7 million, which includes purchases of $30.5 million of shorter duration mortgage-backed securities guaranteed by US Government-sponsored enterprises and $5.9 million of corporate bonds. That increase was offset by $24.4 million of maturities, calls and pay-downs of amortizing securities and $10.7 reduction in fair value. The reduction in fair value was largely due to a decline in bond prices tied to longer term interest rates during the first quarter 2018. The weighted average yield on the Company’s security portfolio at the end the first quarter 2018 was 3.16% compared to 3.06% at year-end 2017. At March 31, 2018, the securities held by the Company had an average life 5.8 years and a duration of 4.3 years compared to 5.2 years and 4.1 years at the end of 2017, respectively.

Loans

Total loans decreased $21.2 million during the first quarter 2018 compared to year-end 2017 as certain loan closings were delayed into the second quarter. While ending balance in the first quarter was down compared with year-end 2018, the quarterly average balance was up $34 million. Despite the overall decrease in loans, commercial and industrial loans grew 11% on annualized basis reflecting the Company’s commitment to generating higher yields. Growth in total loans is expected to improve in the second quarter due to a strong pipeline, particularly in the Company’s commercial product lines. The total yield from loans increased 16 basis points over the first quarter 2017, which included the benefit of higher short-term rates. Loan yields increased across all product lines with the exception of commercial and industrial loans, which declined 32 basis points due to a lower tax equivalency adjustment on tax exempt loans related to the new 2018 Federal tax rate.

Asset Quality

Asset quality metrics remained favorable during the first quarter 2018 with a ratio of net charge-offs to total loans of 0.07%. The ratio of non-accruing loans to total loans increased to 0.83% at the end of the first quarter 2018 from 0.58% at year-end 2017 primarily due to one large residential relationship. Based on an impairment analysis, the entire carrying value of that obligation is expected to be recovered upon settlement.

The allowance for loan losses increased to $12.7 million during the first quarter 2018 from $12.3 million at year-end 2017 due to higher specific reserves on impaired loans. While overall loan balances decreased during the first quarter, there was no related benefit to the allowance as the majority of the decrease was experienced the in acquired loan portfolios. Under accounting standards for business combinations, acquired loans are recorded at fair value with no allowance for loan losses on the date of acquisition. An allowance for loan losses is recorded by the Company for the emergence of new probable and estimable losses on acquired loans which were not impaired as of the acquisition date.

Deposits
Non-maturity ("Core") deposits decreased $29.2 million to $1.457 billion from $1.486 billion at year-end 2017. The Bank's deposit market area has been seasonal with lower deposits in the winter and spring months and higher deposits in the summer and autumn months. Core deposits are still the primary funding source for loans, which declined during

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the first quarter as described above. Time deposits increased $18.5 million during the first quarter, which reflected the Company’s strategy to target funding durations and support the capital leverage initiative. The yield from total deposits increased to 0.82% in the first quarter 2018 from 0.52% in the same period of 2017 reflecting the impact of several Federal Fund rate increases.

Borrowings
Total borrowings decreased by $44.5 million during the first quarter from $829.7 million at year-end as excess cash was used to pay-down mostly short term FHLB advances. Due to the same reason as core deposits, the yield on borrowings increased to 1.80% in the first quarter 2018 compared with the 1.25% for the same period of 2017.

Equity
Equity was $352.2 million at the end of the first quarter 2018 compared with $354.6 million at year-end 2017. Net after-tax fair value adjustments to securities reduced equity by $10.2 in the first quarter 2018 compared to $1.7 million at year-end 2017. Excluding fair value adjustments, tangible equity (non-GAAP measure) increased to $254.2 million in first quarter from $247.9 million at year-end 2017, or an increase of 10.1% an annualized basis. The Company evaluates changes in tangible book value, a non-GAAP financial measure, which is a commonly considered valuation metric used by the investment community and which parallels some regulatory capital measures. The Company and the Bank remained "well capitalized" under regulatory guidelines at period-end.

Liquidity and Cash Flows
Liquidity is measured by the Company’s ability to meet short-term cash needs at a reasonable cost or minimal loss. The Company seeks to obtain favorable sources of liabilities and to maintain prudent levels of liquid assets in order to satisfy varied liquidity demands. Besides serving as a funding source for maturing obligations, liquidity provides flexibility in responding to customer initiated needs. Many factors affect the Company’s ability to meet liquidity needs, including variations in the markets served by its network of offices, its mix of assets and liabilities, reputation and credit standing in the marketplace, and general economic conditions.

The Bank actively manages its liquidity position through target ratios established under its Asset Liability Management Policy. Continual monitoring of these ratios, by using historical data and through forecasts under multiple rate and stress scenarios, allows the Bank to employ strategies necessary to maintain adequate liquidity. The Bank’s policy is to maintain a liquidity position of at least 4% of total assets. A portion of the Bank’s deposit base has been historically seasonal in nature, with balances typically declining in the winter months through late spring, during which period the Bank’s liquidity position tightens.

The Bank also had capacity to borrow funds on a secured basis utilizing the Borrower in Custody program and the Discount Window at the Federal Reserve Bank of Boston (the “FRB”). At March 31, 2018, the Bank’s available secured line of credit at the FRB stood at $118.0 million or 3.4% of the Bank’s total assets. The Bank also has access to the national brokered deposit market, and has used this funding source to bolster its on balance sheet liquidity position.

The Bank maintains a liquidity contingency plan approved by the Bank’s Board of Directors. This plan addresses the steps that would be taken in the event of a liquidity crisis, and identifies other sources of liquidity available to the Company. Company management believes the level of liquidity is sufficient to meet current and future funding requirements. However, changes in economic conditions, including consumer savings habits and availability or access to the brokered deposit market could potentially have a significant impact on the Company’s liquidity position.

Off-Balance Sheet Arrangements

The Company is, from time to time, a party to certain off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the Company's financial condition, changes in financial condition, revenues

or expenses, results of operations, liquidity, capital expenditures or capital resources, that may be material to investors.

The Company's off-balance sheet arrangements are limited to standby letters of credit whereby the Bank guarantees the obligations or performance of certain customers. These letters of credit are sometimes issued in support of third-party debt. The risk involved in issuing standby letters of credit is essentially the same as the credit risk involved in

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extending loan facilities to customers, and they are subject to the same origination, portfolio maintenance and management procedures in effect to monitor other credit products. The amount of collateral obtained, if deemed necessary by the Bank upon issuance of a standby letter of credit, is based upon management's credit evaluation of the customer.

The Company’s off-balance sheet arrangements have not changed materially since previously reported in our Annual Report on Form 10-K for the year ended December 31, 2017.

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APPLICATION OF CRITICAL ACCOUNTING POLICIES AND ACCOUNTING ESTIMATES, AND RECENT ACCOUNTING PRONOUNCEMENTS

The Company's significant accounting policies are described in Note 1 to the consolidated financial statements in this Form 10-Q and in the most recent Form 10-K. Please see those policies in conjunction with this discussion. The accounting and reporting policies followed by the Company conform, in all material respects, to accounting principles generally accepted in the United States and to general practices within the financial services industry. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. While the Company bases estimates on historical experience, current information and other factors deemed to be relevant, actual results could differ from those estimates.

The SEC defines "critical accounting policies" as those that require application of management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in future periods. Please see those policies in conjunction with this discussion. Management believes that the following policies would be considered critical under the SEC's definition:

Allowance for Loan Losses: The allowance for loan losses represents probable credit losses that are inherent in the loan portfolio at the financial statement date and which may be estimated. Management uses historical information, as well as current economic data, to assess the adequacy of the allowance for loan losses as it is affected by changing economic conditions and various external factors, which may impact the portfolio in ways currently unforeseen. Although management believes that it uses appropriate available information to establish the allowance for loan losses, future additions to the allowance may be necessary if certain future events occur that cause actual results to differ from the assumptions used in making the evaluation. Conditions in the local economy and real estate values could require the Company to increase provisions for loan losses, which would negatively impact earnings.

Acquired Loans: Loans that the Company acquired in business combinations are initially recorded at fair value with no carryover of the related allowance for credit losses. Determining the fair value of the loans involves estimating the amount and timing of principal and interest cash flows initially expected to be collected on the loans and discounting those cash flows at an appropriate market rate of interest. Going forward, the Company continues to evaluate reasonableness of expectations for the timing and the amount of cash to be collected. Subsequent decreases in expected cash flows may result in changes in the amortization or accretion of fair market value adjustments, and in some cases may result in the loan being considered impaired. For collateral dependent loans with deteriorated credit quality, the Company estimates the fair value of the underlying collateral of the loans. These values are discounted using market derived rates of return, with consideration given to the period of time and costs associated with the foreclosure and disposition of the collateral.

Income Taxes: Significant management judgment is required in determining income tax expense and deferred tax assets and liabilities. The Company uses the asset and liability method of accounting for income taxes in which deferred tax assets and liabilities are established for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities. The realization of the net deferred tax asset generally depends upon future levels of taxable ordinary income and taxable capital gain income. A valuation allowance would be established for deferred tax assets that management estimates are more likely than not to be unrealizable based on available evidence at the time the estimate is made.

Goodwill and Identifiable Intangible Assets: Goodwill and identifiable intangible assets are recorded as a result of business acquisitions and combinations. These assets are evaluated for impairment annually or whenever events or changes in circumstances indicate the carrying value of these assets may not be recoverable. When these assets are evaluated for impairment, if the carrying amount exceeds fair value, an impairment charge is recorded to income. The

fair value is based on observable market prices, when practicable. Other valuation techniques may be used when market prices are unavailable, including estimated discounted cash flows and analysis of market pricing multiples. These types of analyses contain uncertainties because they require management to make assumptions and to apply judgment to estimate industry economic factors and the profitability of future business strategies. In the event of future changes in fair value, the Company may be exposed to an impairment charge that could be material.

Determination of Other-Than-Temporary Impairment of Securities: The Company evaluates debt and equity securities within the Company's available for sale for other-than-temporary impairment (OTTI), at least quarterly. If the fair value of a debt security is below the amortized cost basis of the security, OTTI is required to be recognized if any of the following are met: (1) the Company intends to sell the security; (2) it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis; or (3) for debt securities, the present value of expected cash flows is not sufficient to recover the entire amortized cost basis. For all impaired debt securities that the Company intends to sell, or more likely than not will be required to sell, the full amount of the loss is recognized as OTTI through earnings. Credit-related OTTI for all other impaired debt securities is recognized through earnings. Noncredit related OTTI for such debt securities is recognized in other comprehensive income, net of applicable taxes. In evaluating its marketable equity securities portfolios for OTTI, the Company considers its intent and ability to hold an equity security to recovery of its cost basis in addition to various other factors, including the length of time and the extent to which the fair value has been less than cost and the financial condition and near term prospects of the issuer. Any OTTI on marketable equity securities is recognized immediately through earnings. Should actual factors and conditions differ materially from those expected by management, the actual realization of gains or losses on investment securities could differ materially from the amounts recorded in the financial statements.

Fair Value of Financial Instruments: The Company uses fair value measurements to record fair value adjustments to certain financial instruments and to determine fair value disclosures. Trading assets, securities available for sale, and derivative instruments are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a non-recurring basis, or to establish a loss allowance or write-down based on the fair value of impaired assets. Further, the notes to financial statements include information about the extent to which fair value is used to measure assets and liabilities, the valuation methodologies used and its impact to earnings. For financial instruments not recorded at fair value, the notes to financial statements disclose the estimate of their fair value. Due to the judgments and uncertainties involved in the estimation process, the estimates could result in materially different results under different assumptions and conditions.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk

Market risk is the risk of loss in a financial instrument arising from adverse changes in market rates/prices, such as interest rates, foreign currency exchange rates, commodity prices and equity prices. Interest rate risk is the most significant market risk affecting the Company. Other types of market risk do not arise in the normal course of the Company's business activities.

The responsibility for interest rate risk management oversight is the function of the Bank's Asset and Liability Committee ("ALCO"), chaired by the Chief Financial Officer and composed of various members of senior management. ALCO meets regularly to review balance sheet structure, formulate strategies in light of current and expected economic conditions, adjust product prices as necessary, implement policy, monitor liquidity, and review performance against guidelines established to control exposure to the various types of inherent risk.

Interest Rate Risk: Interest rate risk can be defined as an exposure to movement in interest rates that could have an adverse impact on the Bank's net interest income. Interest rate risk arises from the imbalance in the re-pricing, maturity and or cash flow characteristics of assets and liabilities. Management's objectives are to measure, monitor and develop strategies in response to the interest rate risk profile inherent in the Bank's balance sheet. The objectives in managing the Bank's balance sheet are to preserve the sensitivity of net interest income to actual or potential changes in interest rates, and to enhance profitability through strategies that promote sufficient reward for understood and controlled risk.

The Bank's interest rate risk measurement and management techniques incorporate the re-pricing and cash flow attributes of balance sheet and off-balance sheet instruments as each relate to current and potential changes in interest rates. The level of interest rate risk, measured in terms of the potential future effect on net interest income, is determined through the use of modeling and other techniques under multiple interest rate scenarios. Interest rate risk is evaluated in depth on a quarterly basis and reviewed by ALCO and the Company's Board of Directors.

The Bank's Asset Liability Management Policy, approved annually by the Bank's Board of Directors, establishes interest rate risk limits in terms of variability of net interest income under rising, flat, and decreasing rate scenarios. It is the role of the ALCO to evaluate the overall risk profile and to determine actions to maintain and achieve a posture consistent with policy guidelines.

Interest Rate Sensitivity Modeling: The Bank utilizes an interest rate risk model widely recognized in the financial industry to monitor and measure interest rate risk. The model simulates the behavior of interest income and expense for all balance sheet and off-balance sheet instruments, under different interest rate scenarios together with a dynamic future balance sheet. Interest rate risk is measured in terms of potential changes in net interest income based upon shifts in the yield curve.

The interest rate risk sensitivity model requires that assets and liabilities be broken down into components as to fixed, variable, and adjustable interest rates, as well as other homogeneous groupings, which are segregated as to maturity and type of instrument. The model includes assumptions about how the balance sheet is likely to evolve through time and in different interest rate environments. The model uses contractual re-pricing dates for variable products, contractual maturities for fixed rate products, and product-specific assumptions for deposit accounts, such as money market accounts, that are subject to re-pricing based on current market conditions. Re-pricing margins are also determined for adjustable rate assets and incorporated in the model. Investment securities and borrowings with call provisions are examined on an individual basis in each rate environment to estimate the likelihood of a call. Prepayment assumptions for mortgage loans and mortgage-backed securities are developed from industry median

estimates of prepayment speeds, based upon similar coupon ranges and degree of seasoning. Cash flows and maturities are then determined, and for certain assets, prepayment assumptions are estimated under different interest rate scenarios. Interest income and interest expense are then simulated under several hypothetical interest rate conditions including:

- A flat interest rate scenario in which current prevailing rates are locked in and the only balance sheet fluctuations that occur are due to cash flows, maturities, new volumes, and re-pricing volumes consistent with this flat rate assumption;

- A 200 basis point rise or decline in interest rates applied against a parallel shift in the yield curve over a twelve-month horizon together with a dynamic balance sheet anticipated to be consistent with such interest rate changes;
- Various non-parallel shifts in the yield curve, including changes in either short-term or long-term rates over a twelve-month horizon, together with a dynamic balance sheet anticipated to be consistent with such interest rate changes; and
- An extension of the foregoing simulations to each of two, three, four and five year horizons to determine the interest rate risk with the level of interest rates stabilizing in years two through five. Even though rates remain stable during this two to five year time period, re-pricing opportunities driven by maturities, cash flow, and adjustable rate products will continue to change the balance sheet profile for each of the interest rate conditions.

Changes in net interest income based upon the foregoing simulations are measured against the flat interest rate scenario and actions are taken to maintain the balance sheet interest rate risk within established policy guidelines.

As of March 31, 2018 interest rate sensitivity modeling results indicate that the Bank's balance sheet was moderately liability sensitive over the one- and two-year horizons (i.e., moderately exposed to rising interest rates).

Assuming short-term and long-term interest rates decline 100 basis points from current levels (i.e., a parallel yield curve shift) and the Bank's balance sheet structure and size remain at current levels, management believes net interest income will improve slightly over the one year horizon (+.3% versus the base case) while mildly deteriorating over the two-year horizon (-.7% versus the base case). Should the yield curve steepen as rates fall, the model suggests that accelerated earning asset prepayments will slow, resulting in a more stabilized level of net interest income. Management anticipates that moderate to strong earning asset growth will be needed to meaningfully increase the Bank's current level of net interest income should both long-term and short-term interest rates decline in parallel.

Assuming the Bank's balance sheet structure and size remain at current levels and the Federal Reserve increases short-term interest rates by 200 basis points with the balance of the yield curve shifting in parallel with these increases, management believes net interest income will decline moderately over the one and two-year horizons as increased funding costs outpace increases in earning asset yields. The interest rate sensitivity simulation model suggests that as interest rates rise, the Bank's funding costs will initially re-price disproportionately with earning asset yields to a moderate degree. As funding costs begin to stabilize early in the third year of the simulation, the model suggests that the earning asset portfolios will continue to re-price at prevailing interest rate levels and cash flows from the Bank's earning asset portfolios will be reinvested into higher yielding earning assets, resulting in a widening of spreads and a stabilization of net interest income over the three year horizon and beyond. Management believes moderate to strong earning asset growth will be necessary to meaningfully increase the current level of net interest income over the one-year and two-year horizons should short-term and long-term interest rates rise in parallel.

As compared to December 31, 2017, the year-one sensitivity in the down 100 basis points scenario increased for the quarter (+.1% prior, versus +.3% current). The year-two sensitivities in the down 100 basis points scenario changed going from +.3% to -.7%. In the year-one up 200 basis points scenario, results were unchanged from the prior quarter. Year-two, up 200 basis points shows a slightly more negative result (-8.1% prior, versus -9.2% current), although on balance, the current aggregate position is consistent with the prior quarter's.

Despite six rate increases over the last 27 months, the Federal Reserve continues to maintain short-term interest rates at low levels, threatening net interest income. Net interest income exposure is also significantly affected by the shape and level of the U.S. Government securities and interest rate swap yield curve, and changes in the size and composition of the Bank's loan, investment and deposit portfolios.

The preceding sensitivity analysis does not represent a Company forecast and should not be relied upon as being indicative of expected operating results. These hypothetical estimates are based upon numerous assumptions

including: the nature and timing of interest rate levels and yield curve shape, prepayment speeds on loans and securities, deposit rates, pricing decisions on loans and deposits, reinvestment or replacement of asset and liability cash flows, and renegotiated loan terms with borrowers. While assumptions are developed based upon current economic and local

market conditions, the Company cannot make any assurances as to the predictive nature of these assumptions including how customer preferences or competitor influences might change.

As market conditions vary from those assumed in the sensitivity analysis, actual results may also differ due to: prepayment and refinancing levels deviating from those assumed; the impact of interest rate changes, caps or floors on adjustable rate assets; the potential effect of changing debt service levels on customers with adjustable rate loans; depositor early withdrawals and product preference changes; and other such variables. The sensitivity analysis also does not reflect additional actions that the Bank's Senior Executive Team and Board of Directors might take in responding to or anticipating changes in interest rates, and the anticipated impact on the Bank's net interest income.

The Bank engages an independent consultant to periodically review its interest rate risk position and the reasonableness of assumptions used, with periodic reports provided to the Bank's Board of Directors. At March 31, 2018, there were no significant differences between the views of the independent consultant and management regarding the Bank's interest rate risk exposure.

ITEM 4. CONTROLS AND PROCEDURES

a) Disclosure controls and procedures.

The principal executive officers, including the Chief Executive Officer and the Chief Financial Officer, based on their evaluation of disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this Quarterly Report on Form 10-Q, have concluded that the Company's disclosure controls and procedures were effective as of March 31, 2018.
b) Changes in internal control over financial reporting.
There were no changes in the Company's internal control over financial reporting that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II

ITEM 1. LEGAL PROCEEDINGS

The Company and its subsidiaries are parties to certain ordinary routine litigation incidental to the normal conduct of their respective businesses, which in the opinion of management based upon currently available information will have no material effect on the Company's consolidated financial statements.

ITEM 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the factors discussed below and in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2017, which could materially affect our business, financial condition or future results. The risks described in this form are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results. There have been no material changes to the risk factors previously disclosed in our Annual Report of Form 10-K for the year ended December 31, 2017.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(a) Not applicable.
(b) Not applicable.
(c) The following table provides certain information with regard to shares repurchased by the Company in the first quarter of 2018:

Period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as a part of publicly announced plans or programs	Maximum number of shares that may yet be purchased under the plans or programs[(1)]
January 1-31, 2018	—	$ —	—	404,706
February 1-28, 2018	—	—	—	404,706
March 1-31, 2018	—	—	—	404,706
Total	—	$ —	—	404,706

(1) In August 2008, the Company's Board of Directors approved a twenty-four month program to repurchase up to 450,000 shares of the Company's common stock, or approximately 10.2% of the shares then outstanding. The Company's Board of Directors authorized the continuance of this program for additional twenty-four month periods in August 2010, 2012 and 2014. On August 16, 2016, Bar Harbor Bankshares issued a press release announcing the Company's Board of Directors has approved the continuation of the Company's existing stock repurchase plan through August 16, 2018. No other changes were made to the plan. Depending on market conditions and other factors, stock repurchases may be commenced or suspended at any time, or from time to time, without prior notice and may be made in the open market or through privately negotiated transactions. The Company records repurchased shares as treasury stock.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

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ITEM 6. EXHIBITS

3.1	Articles of Incorporation, as amended to date	Incorporated herein by reference to Form 10-Q, Part II, Item 6, Exhibit 3.1, filed with the commission on November 5, 2015 (Commission File No. 00113349).
3.2	Bylaws, as amended to date	Incorporated herein by reference to Form 8-K, Item 5.03, Exhibit 3.2, filed with the Commission on November 29, 2011.
4.1	Certificate of Designations, Fixed Rate Cumulative Perpetual Preferred Stock, Series A	Incorporated herein by reference to Form 8-K, Exhibit 3.1, filed with the Commission on January 21, 2009 (Commission File No. 00113349).
4.2	Form of Specimen Stock Certificate for Series A Preferred Sock	Incorporated by reference to Form 8-K, Exhibit 4.1, filed with the Commission on January 21, 2009 (Commission File No. 00113349).
4.3	Debt Securities Purchase Agreement	Incorporated herein by reference to Form 10-K, Part IV, Item 15, Exhibit 4.5, filed with the commission on March 16, 2009 (Commission File No. 00113349).
4.4	Form of Subordinated Debt Security of Bar Harbor Bank & Trust	Incorporated herein by reference to Form 10-K, Part IV, Item 15, Exhibit 4.6, filed with the commission on March 16, 2009 (Commission File No. 00113349).
4.5	Description of Company Common Stock	Incorporated by reference to Form 8-K, Items 8.01 and 9.01, Exhibit 99.1, filed August 7, 2015 (Commission File No. 00113349).
10.1	Employment Agreement, dated as of February 22, 2018, between Bar Harbor Bankshares, Bar Harbor Bank & Trust and Curtis C. Simard	Incorporated herein by reference to Form 8-K, Item 5.02, Exhibit 10.1, filed February 22, 2018 (Commission File No. 00113349)
31.1	Certification of Chief Executive Officer under Rule 13a-14(a)/15d-14(a)	Filed herewith
31.2	Certification of Chief Financial Officer under Rule 13a-14(a)/15d-14(a)	Filed herewith
32.1	Certification of Chief Executive Officer under 18 U.S.C. Sec. 1350.	Furnished herewith
32.2	Certification of Chief Financial Officer under 18 U.S.C. Sec. 1350.	Furnished herewith

101 The following financial information from the Company’s Annual Report on Form 10-Q for the quarter ended March 31, 2018 is formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Condensed Statements of Income, (ii) the Condensed Consolidated Balance Sheets, (iii) the Condensed Consolidated Statements of Changes in Shareholders’ Equity, (iv) Consolidated Statements of Cash Flows and (v) Notes to the

Consolidated Condensed Financial Statements

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

BAR HARBOR BANKSHARES

Dated: May 8, 2018 By: /s/ Curtis C. Simard
Curtis C. Simard
President & Chief Executive Officer

Dated: May 8, 2018 By: /s/ Josephine Iannelli
Josephine Iannelli
Executive Vice President, Chief Financial Officer, & Principal Accounting Officer