Group Health Cooperative and Subsidiaries

Consolidated Financial Statements as of and for the Years Ended December 31, 2007 and 2006, Federal OMB Circular A-133 Reports for the Year Ended December 31, 2007, and Independent Auditors' Report

GROUP HEALTH COOPERATIVE AND SUBSIDIARIES

TABLE OF CONTENTS

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INDEPENDENT AUDITORS' REPORT

Board of Trustees
Group Health Cooperative and Subsidiaries
Seattle, WA

We have audited the accompanying consolidated balance sheets of Group Health Cooperative (GHC), GHC's subsidiaries and controlled affiliates, Group Health Options, Inc. (GHO), KPS Health Plans (KPS), Group Health Community Foundation (the "Foundation"), Auxiliary of Group Health Cooperative of Puget Sound ("Auxiliary"), and KPS's wholly owned subsidiary, Northwest Credentials Verification Service (NCVS) (collectively, the "Group") as of December 31, 2007 and 2006, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Group as of December 31, 2007 and 2006, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the consolidated financial statements, the Group adopted Financial Accounting Standards Board (FASB) Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans — an amendment of FASB Statements No. 87, 88, 106, and 132(R)*, which changed its method of accounting for pension and postretirement benefits as of December 31, 2006.

Deloitte & Touche LLP

March 21, 2008

GROUP HEALTH COOPERATIVE AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 2007 AND 2006
(In thousands)

ASSETS	2007	2006
CURRENT ASSETS:		
Cash and cash equivalents	$ 81,139	$ 461,805
Restricted cash	58	227
Short-term marketable securities	243,498	63,254
Accounts receivable — Net	90,763	83,533
Inventories	21,488	24,276
Funds held by trustee — Current portion	18,114	830
Other	22,965	24,340
Total current assets	478,025	658,265
LONG-TERM MARKETABLE SECURITIES	696,710	437,616
FUNDS HELD BY TRUSTEE — Net of current portion	8,848	81,544
LAND, BUILDINGS, AND EQUIPMENT:		
Land	18,468	18,399
Buildings and improvements	415,520	374,986
Equipment	402,146	348,801
Total land, buildings, and equipment	836,134	742,186
Less accumulated depreciation	(551,589)	(513,797)
Construction in progress	111,155	86,326
Land, buildings, and equipment — Net	395,700	314,715
OTHER ASSETS	75,494	37,466
TOTAL	$ 1,654,777	$ 1,529,606

See notes to consolidated financial statements.

LIABILITIES AND NET ASSETS	2007	2006
CURRENT LIABILITIES:		
Accounts payable	$ 103,720	$ 125,530
External delivery services payable	152,716	133,427
Accrued employee compensation	50,639	35,693
Accrued taxes and interest	10,563	13,765
Unearned dues and deposits	24,096	17,253
Current portion of reserve for self-insurance	19,913	18,727
Current portion of retiree medical benefits	12,324	5,238
Current portion of long-term debt	5,626	6,082
Total current liabilities	379,597	355,715
NONCURRENT LIABILITIES:		
Long-term debt	199,730	205,340
Self-insurance	67,098	64,605
Retiree medical benefits	67,886	93,235
Other	43,631	35,826
Total noncurrent liabilities	378,345	399,006
Total liabilities	757,942	754,721
COMMITMENTS AND CONTINGENCIES (Note 8)		
NET ASSETS:		
Unrestricted	884,621	761,941
Temporarily restricted	4,835	5,634
Permanently restricted	7,379	7,310
Total net assets	896,835	774,885
TOTAL	$ 1,654,777	$ 1,529,606

GROUP HEALTH COOPERATIVE AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006 (In thousands)

	2007	2006
REVENUES:		
Premium revenue:		
Group dues	$ 1,647,079	$ 1,588,053
Medicare	632,152	637,370
Medicaid	32,678	33,263
Individual and family	66,153	68,135
Nonpremium revenue:		
Clinical services	176,143	162,522
Investment earnings	57,700	40,121
Other	53,396	54,280
Total revenues	2,665,301	2,583,744
EXPENSES:		
External delivery services	1,226,635	1,071,217
Employee compensation	549,052	512,143
Group Health Permanente expense	245,017	224,721
Medical and operating supplies	239,311	224,953
Purchased services	89,273	79,969
Facility and support services	72,087	64,997
Insurance and business taxes	65,970	66,830
Depreciation	48,560	46,422
Other	58,560	50,089
Total expenses	2,594,465	2,341,341
INCOME BEFORE INCOME TAX (BENEFIT) EXPENSE	70,836	242,403
INCOME TAX (BENEFIT) EXPENSE	(1,098)	4,355
NET INCOME	71,934	238,048
CHANGE IN NET UNREALIZED INVESTMENT GAINS AND LOSSES — Net of tax	4,980	7,117
FASB Statement No. 158 TRANSITION AMOUNT — Net of tax	-	(79,478)
CHANGE IN DEFINED BENEFIT PENSION AND OTHER POST RETIREMENT PLANS — Net of tax	45,921	-
CHANGE IN NET MEMBERSHIP ACTIVITY	(155)	(156)
CHANGE IN UNRESTRICTED NET ASSETS	122,680	165,531
CHANGE IN TEMPORARILY RESTRICTED NET ASSETS	(799)	1,486
CHANGE IN PERMANENTLY RESTRICTED NET ASSETS	69	227
CHANGE IN NET ASSETS	121,950	167,244
NET ASSETS:		
Beginning of year	774,885	607,641
End of year	$ 896,835	$ 774,885

See notes to consolidated financial statements.

GROUP HEALTH COOPERATIVE AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006
(In thousands)

	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Change in net assets	$ 121,950	$ 167,244
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation	48,560	46,422
Provision for self-insurance	16,531	17,163
Self-insurance claims paid	(12,852)	(8,829)
Change in net unrealized investment gains — net of tax	(4,980)	(7,117)
Other	(2,307)	(1,075)
Cash provided by (used in) operating assets and liabilities:		
Accounts receivable — net	(7,230)	381
Inventories	2,788	677
Other current assets	1,375	(543)
Other assets	(38,307)	47,119
Accounts payable	(29,542)	53,141
External delivery services payable	19,289	(15,651)
Accrued employee compensation	14,946	(3,805)
Accrued taxes and interest	(3,202)	(752)
Unearned dues and deposits	9,708	4,359
Other noncurrent liabilities	(10,391)	55,228
Net cash provided by operating activities	126,336	353,962
CASH FLOWS FROM INVESTING ACTIVITIES:		
Payments for land, buildings, and equipment	(127,310)	(85,492)
Proceeds from disposal of land, buildings, and equipment	5,812	48,288
Proceeds from sale of marketable securities	3,055,214	1,378,363
Purchases of marketable securities	(3,490,006)	(1,334,717)
Purchases of other equity investments — net	(100)	(10,475)
Funds held by trustee	55,418	(82,011)
Net cash used in investing activities	(500,972)	(86,044)

See notes to consolidated financial statements.

	2007	2006
CASH FLOWS FROM FINANCING ACTIVITIES:		
Long-term borrowings	$ -	$ 99,996
Repayment of debt	(5,875)	(5,483)
Payments for deferred financing cost	-	(5,095)
Net membership activity	(155)	(156)
Net cash (used in) provided by financing activities	(6,030)	89,262
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(380,666)	357,180
CASH AND CASH EQUIVALENTS:		
Beginning of year	461,805	104,625
End of year	$ 81,139	$ 461,805
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the year for:		
Interest	$ 10,754	$ 5,561
Income taxes	$ 333	$ 3,859

1. ORGANIZATION

The accompanying consolidated financial statements include the accounts of Group Health Cooperative (the "Cooperative" or GHC), GHC's wholly owned subsidiary, Group Health Options, Inc. (GHO), and controlled affiliates, KPS Health Plans (KPS), Group Health Community Foundation (the "Foundation"), Auxiliary of Group Health Cooperative of Puget Sound (Auxiliary), and KPS's wholly owned subsidiary, Northwest Credentials Verification Service (NCVS) (collectively, the "Group"). All significant intercompany transactions have been eliminated.

The Cooperative is a Washington nonprofit corporation registered as a health maintenance organization headquartered in Seattle, WA. The Cooperative offers comprehensive, coordinated health care to an enrolled membership for a fixed prepaid fee through its owned and leased facilities, employed providers, and contracted providers, in addition to providing certain health care services on a fee-for-service basis to both enrollees and nonenrollees.

GHO is a Washington for-profit corporation registered and operating as a health care services contractor that provides health care coverage products that feature increased customer choice, including a point of service plan benefit.

KPS is a Washington taxable nonprofit corporation registered and operating as a health care services contractor headquartered in Bremerton, WA. KPS provides health care services through contracts with participating physicians and hospitals.

NCVS, a Washington limited liability company, performs primary source credentials verification of health care providers requesting new or continued participation with KPS and contracts nationally with health plans, hospitals, and other organizations to provide credentials verification services.

The Foundation is a Washington nonprofit corporation. It is organized exclusively to benefit, perform the functions of, and carry out the purposes of the Cooperative and other affiliated tax-exempt organizations. It supports research, health careers, training, health education, GHC programs, and other projects that promote high quality health care. Grants are awarded to qualified health-related community organizations, extending the internal resources of the Cooperative to the community. The Foundation's operations are largely a function of the level of grants and donations it receives.

The Auxiliary is an unincorporated association. It is organized for the purpose of promoting and advancing the welfare of GHC through fundraising in order to provide services and gifts to the hospitals, medical centers, specialty centers, and health-related programs of the Cooperative and its patients.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Estimates — The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements. Significant estimates and assumptions are used in the recording of external delivery services payable, asset valuation, allowances for uncollectible accounts, self-insurance reserves, and the evaluation of contingencies and litigation. Changes in these estimates and assumptions may have a material impact on the consolidated financial statements.

Cash and Cash Equivalents — Cash and cash equivalents consist of liquid investments with original maturities of three months or less and are carried at cost, which approximates fair value.

Marketable Securities — Marketable securities are readily convertible to cash and are carried at fair value in accordance with Financial Accounting Standards Board (FASB) Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*. Maturities for short-term marketable securities are more than three months and less than 12 months. All investments are classified as available-for-sale securities and reported at fair value. The change in unrealized gains and losses is recorded as a separate component of net assets for GHC, GHO, KPS, and NCVS. The Foundation records the change in unrealized gains and losses to income. The Group records realized gains and losses on disposal of specific investments, which are included within investment earnings. Realized gains on sale were $3,379,000 and $3,424,000 in 2007 and 2006, respectively. Realized losses on sale were $2,722,000 and $2,293,000 in 2007 and 2006, respectively. The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity or, in the case of mortgage-backed securities, over the estimated life of the security. The discount or premium is amortized using the effective yield method. Such amortization and accretion is included in investment earnings.

Marketable securities as of December 31, 2007 and 2006, consist of the following (in thousands):

	2007				2006			
	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
Debt:								
U.S. government securities	$250,745	$ 4,913	$ (90)	$255,568	$270,296	$ 384	$(1,740)	$268,940
Corporate debt securities	369,211	1,238	(1,293)	369,156	86,558	89	(260)	86,387
Other debt securities	135,176	724	(133)	135,767	18,070	57	(122)	18,005
Mutual funds:								
Fixed income	4,387	37	(20)	4,404	7,180	108	(112)	7,176
Equity	167,871	11,738	(4,779)	174,830	110,723	9,630	-	120,353
Other	219	264	-	483	9	-	-	9
Total	$927,609	$18,914	$(6,315)	$940,208	$492,836	$10,268	$(2,234)	$500,870

Other debt securities may include mortgage-backed securities, asset-backed securities, and collateralized mortgage obligations.

The following table shows the gross unrealized losses and fair value of the Group's investments with unrealized losses that are deemed to be temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2007 (in thousands):

	Less Than 12 Months		12 Months or Greater		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
Debt:						
U.S. government securities	$ 730	$ (25)	$ 4,017	$ (65)	$ 4,747	$ (90)
Corporate debt securities	118,588	(1,160)	8,611	(133)	127,199	(1,293)
Other debt securities	11,501	(60)	3,041	(73)	14,542	(133)
Mutual funds:						
Fixed income	-	-	1,581	(20)	1,581	(20)
Equity	48,205	(4,779)	-	-	48,205	(4,779)
Total	$179,024	$(6,024)	$17,250	$(291)	$196,274	$(6,315)

The unrealized losses on the Group's investments were caused by changes in interest rates. The Group has the ability and intent to hold these investments until a recovery of market value, which may be maturity, and considers these investments to be temporarily impaired. Market conditions may change such that it might not be considered advantageous to hold until a market recovery, or a security may experience a credit downgrade. If these conditions are experienced, the Group may not continue to hold the investment in order to lower its risk.

Accounts Receivable — Accounts receivable are primarily comprised of enrollee dues, receivables for noncovered health care services, co-pays and deductibles, receivables for fee-for-service clinical services provided to nonenrollees, and receivables for self-funding claims-based reimbursements. The Group records a reduction in the related dues revenues for an estimate of amounts related to retroactive enrollment changes. Provisions for contractual adjustments are recorded on an accrual basis and are deducted from gross revenues. Bad debts related to services provided are recorded as expenses in the consolidated statements of operations and changes in net assets. The allowance for uncollectible accounts was $8,647,000 and $9,772,000 as of December 31, 2007 and 2006, respectively.

Inventories — Inventories consist of pharmaceuticals, medical, and operating supplies and are stated at the lower of weighted-average cost or market.

Funds Held by Trustee — Funds held by trustee are amounts required by the terms and conditions of the revenue bonds (see Note 3). The current portion represents funds held for bond principal and interest payable within the next 12 months, and the project fund reserve balance of $17,742,000, which was reclassified to current portion as of December 31, 2007. Established in 2006, the project fund reserve, which held the original Series 2006 revenue bond proceeds, will be maintained until all project costs have been incurred related to the construction of a medical specialty center located in Bellevue, WA, which is to be completed in 2008. The Cooperative requests reimbursement from the bond trustee as costs are incurred. The Series 2006 revenue bonds require a reserve in the amount of $8,848,000 for the benefit of the bond owners which shall be maintained as long as any Series 2006 bonds remain outstanding. The bond fund reserve is included within the long-term portion of funds held by trustee on the consolidated balance sheets as of December 31, 2007 and 2006.

Charitable Gift Annuities — As of December 31, 2007 and 2006, the Foundation had a charitable gift annuities liability of $1,161,000 and $943,000, respectively, which includes a 10% reserve as required by state law and is recorded as a component of other noncurrent liabilities in the accompanying consolidated balance sheets.

Land, Buildings, and Equipment — Land, buildings and improvements, and equipment are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets or, for leasehold improvements, over the term of the related lease, including first extension, whichever is shorter. When assets are sold or retired, their cost and related accumulated depreciation are removed from the accounts and any related gain or loss is reflected in operations. The estimated useful lives of buildings, improvements, and leasehold improvements are 5 to 40 years, and the estimated useful life of equipment is 2 to 20 years.

Construction in Progress — Construction in progress (CIP) projects include costs incurred while preparing assets for their intended use. CIP projects typically consist of major computer system installations, the construction or remodel of buildings, or the installation of major equipment.

Long-Lived Assets — In accounting for its long-lived assets, the Group makes estimates about the expected useful lives of the assets, the expected residual values of the assets, and the potential for impairment based on the fair value of the assets and the cash flows they generate. Factors indicating potential impairment include, but are not limited to, significant decreases in the market value of the long-lived assets, a significant change in the long-lived assets' condition, and operating cash flow losses associated with the use of the long-lived assets.

There is inherent risk in estimating the future cash flows used in the impairment test. If cash flows do not materialize as estimated, there is a risk the impairment charges recognized to date may be inaccurate, or further impairment charges may be necessary in the future.

In 2003, the Cooperative announced its intention to cease operations of its Eastside Campus located in Bellevue, WA, in 2008 and to consider the sale of the Eastside Campus at that time. As a result, management periodically performs an evaluation of the recoverability of the book value of the Eastside Campus assets. No impairment loss was incurred in 2007 or 2006.

In February 2008, the Cooperative placed its Eastside Campus, which houses an inpatient hospital facility, a specialty center, and a primary care clinic, for sale. This action is part of the Cooperative's overall strategic plan for the Eastside Campus. It includes relocating the primary care center to downtown Redmond and building a new specialty center in Bellevue, adjacent to the Overlake Hospital Medical Center, a not-for-profit regional medical center, where Group Health enrollees can receive hospital care. As a result, the assets of this facility were reclassified as held for sale assets in February 2008.

Self-Insurance — The Group is partially self-insured for professional liability and industrial accident claims and fully self-insured for unemployment benefits. The provision for estimated self-insurance claims was $16,531,000 and $17,163,000 for the years ended December 31, 2007 and 2006, respectively. Professional liability and industrial accident claims liabilities are determined using case-based estimates for reported claims and actuarial estimates for incurred but not reported claims. These estimates are based on historical information along with certain assumptions about future events. Changes in assumptions related to expected claims development as well as changes in actual experience could cause these estimates to change. The provision for estimated self-insurance payments includes an estimate for professional liability claims and loss adjustment expense of $11,901,000 and $14,879,000 for the years ended December 31, 2007 and 2006, respectively.

Reinsurance — The Group limits certain exposure to claims loss by ceding reinsurance to other insurance companies. GHC maintains reinsurance coverage for professional liability and industrial accident claims. Insurance coverage for professional liability claims is on a claims-made basis. Retention levels are $10,000,000 per claim with a $50,000,000 annual aggregate in 2007 and 2006. KPS purchases reinsurance to limit its exposure on all of its insured contracts except the Federal Employees Health Benefit Plan. A retention level of $500,000 per claim with a coinsurance level of 10% was held in 2007 and 2006 by KPS.

Reinsurance contracts do not relieve the Group from its obligations to claimants. Failure of reinsurers to honor their obligations could result in losses to the Group. The Group had recorded prepaid reinsurance premiums of $1,487,000 and $1,557,000 as of December 31, 2007 and 2006, respectively.

Derivatives and Hedging Activities — In certain instances, the Group enters into derivative contracts to hedge specific assets and liabilities. Prior to entering into a derivative contract designated as a hedge, the relationship between the hedging instruments and the hedged items, as well as its risk management objective and strategy, are formally documented. On the date the Group enters into a derivative contract utilized as a hedge, the derivative instrument is designated as either a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (known as a "fair value" hedge) or a hedge of the variability in expected future cash flows associated with an existing recognized asset or liability or a forecasted transaction (known as a "cash flow" hedge).

In a cash flow hedge, the effective portion of the changes in the fair value of the hedging derivative is recorded in net assets and is subsequently reclassified into earnings during the same period in which the hedged item affects earnings. The change in fair value of any ineffective portion of the hedging derivative is recognized immediately in earnings.

To qualify for hedge accounting treatment, the derivatives and related hedged items must be designated as a hedge. Both at the inception of the hedge and on an ongoing basis, the Group assesses whether the hedging relationship is expected to be highly effective in offsetting changes in fair value or cash flows of hedged items. If it is determined that the derivative instrument is not highly effective as a hedge, hedge accounting treatment is discontinued.

Revenues — Revenues are derived principally from prepaid health care dues and fee-for-service clinical service billings. Dues received in advance of the coverage period are deferred, and revenues are recognized in the period in which services are covered. Group contracts cover employee groups and are entered into with employers or union trusts. Clinical service revenues are generated through the provision of certain medical and pharmacy services not fully covered under existing benefit policies and from services provided to nonenrollees who receive care at GHC's facilities.

The Cooperative has a contract with the Centers for Medicare and Medicaid Services (CMS) to provide health care services to enrollees eligible for Medicare coverage. Under this arrangement, premiums from CMS are paid prospectively. The premium amounts vary by individual and are determined through a bidding process whereby GHC submits a bid for the projected costs of Medicare covered services. The amount of the premium is determined by the relationship of the submitted bid to CMS county-level benchmarks and then adjusted for the health risk of the enrollee. Supplemental dues are paid by individual enrollees or employer groups for benefits not covered under CMS premiums.

Other revenues mainly consist of grants awarded to the Center for Health Studies, a division of GHC, and optical sales. Also included in other revenues are unconditional promises to donate cash and other assets to the Foundation, reported at fair value at the date the promise is received. The Foundation reports gifts of cash and other assets as restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires (when a stipulated time restriction ends or purpose restriction is accomplished), temporarily restricted net assets are reclassified to unrestricted net assets.

Functional Expense — The Group's expenses are primarily related to health care delivery services, which are activities that result in goods and services being provided to consumers.

External Delivery Services — External delivery services represent health care expenses incurred by the Cooperative, GHO, and KPS for care provided by contracted and noncontracted health care facilities and practitioners. The liability reflected on the consolidated balance sheets is determined using actuarial estimates. These estimates are based on historical information along with certain assumptions about future events. Changes in assumptions, as well as changes in actual experience, could materially impact these estimates.

GHC Permanente Expense — Group Health Permanente P.C., is an independent medical group with an exclusive contract to provide medical services at GHC facilities providing primary, specialty, and inpatient care.

Advertising — Advertising costs are expensed as incurred and are recorded within purchased services in the statements of operations and changes in net assets. The Group recorded advertising expense of $7,886,000 and $7,710,000 for the years ended December 31, 2007 and 2006, respectively.

Income Taxes — GHO, KPS, and NCVS are subject to federal income taxes. These companies file federal tax returns and are not subject to any state income tax filing requirements. GHC is exempt from federal income taxes under Section 501(a) of the Internal Revenue Code (the "Code") as a charitable organization under Section 501(c)(3) of the Code, except for unrelated business income tax. The Foundation has received a determination letter from the Internal Revenue Service (IRS) that it is a tax-exempt public foundation in accordance with Section 501(c)(3) and a public charity in accordance with Section 170(b)(1)(A)(vi) of the Code. The Auxiliary has received a determination letter from the IRS that it is a tax-exempt organization in accordance with Sections 501(c)(3) and 509(a)(2) of the Code.

GHO, KPS, and NCVS recognize deferred income taxes for the tax consequences in future years of the differences between the tax basis of assets and liabilities and their financial reporting amounts at each year-end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to reverse. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized. No valuation allowance has been recorded as of December 31, 2007 and 2006.

Net Membership Activity — Net membership activity consists of changes in capital dues resulting from the change in membership.

Net Assets — Unrestricted net assets result from operations and unrestricted contributions received. Temporarily and permanently restricted net assets are accounted for within the Cooperative and the Foundation. Temporarily restricted net assets account for funds restricted by donors for specific purposes and are available to support the Cooperative and the Foundation in carrying out their missions. Permanently restricted net assets are contributions restricted by the donor to be invested in perpetuity. A portion of the income earned from permanently restricted net assets is disbursed to support the Foundation in carrying out its mission.

Reclassifications — Certain reclassifications have been made to the 2006 consolidated financial statements to conform to the 2007 consolidated financial statement presentation.

Statutory Accounting Practices — The accompanying consolidated financial statements have been prepared in accordance with GAAP, which differ from the accounting principles and practices prescribed or permitted by the Washington State Office of the Insurance Commissioner (OIC) that are used in the preparation of the statutory financial statements filed by the Cooperative, GHO, and KPS. The National Association of Insurance Commissioners (NAIC) developed the codification of statutory accounting practices (the Codification), which became effective for health-related organizations on January 1, 2001. The state of Washington adopted the Codification; however, state law supersedes the Codification should differences exist between the two.

The significant differences between GAAP and the statutory basis of accounting are:

- Certain assets are designated as nonadmitted assets for statutory purposes and are excluded from the balance sheet. Those assets are:

    - Nongovernmental receivables that are more than 90 days outstanding
    - Prepaid pension asset and prepaid expenses
    - Administrative leasehold improvements
    - Electronic Data Processing (EDP) nonoperating system software
    - EDP hardware greater than 3% of statutory surplus
    - Deferred tax assets not to be realized within one year
    - Administrative furniture and equipment
    - Assets which are unavailable to fulfill policyholder obligations due to encumbrances or other third-party interests

- Pension liability and postretirement medical benefit for nonvested employees are excluded from the statutory balance sheet.

- The Cooperative is required to report its investment in GHO and KPS based on their statutorily determined equity reduced by the value of surplus notes.

- Marketable securities with remaining maturities greater than one year are classified as long term and are not later classified as short term when the maturity becomes less than one year.

- Debt securities are reported at amortized cost.

Risk-based capital (RBC) requirements, promulgated by the NAIC and adopted by the state of Washington, establish that certain required amounts of statutory basis capital and surplus be maintained. As of December 31, 2007, the statutory capital surplus of the Cooperative, GHO, and KPS exceeded that required by the RBC formula.

Accounting Changes — In September 2006, the FASB issued FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans — an amendment of FASB Statements No. 87, 88, 106, and 132(R),* which requires companies to record a net liability or asset to report the funded status of their defined benefit pension and other postretirement benefit plans on their balance sheets. The Group adopted the recognition provisions of this statement at the end of its fiscal year, December 31, 2006.

In recognizing the provisions of this statement, a pension transition amount of $51,393,000 was recorded, resulting in a pension liability for previously unrecognized losses in the amount of $501,000, as of December 31, 2006. An additional retiree medical liability was recorded in the amount of $28,085,000, and consisted of previously unrecognized gains, prior service cost, and transition obligation. Both required an offsetting adjustment against unrestricted net assets in the amount of $79,478,000, net of tax.

New Accounting Pronouncements — In February 2007, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities — including an amendment of FASB Statement No. 115*, which permits a choice to measure many financial instruments and certain other items at fair value. This standard is effective for the 2008 fiscal year. The adoption of this standard will not have a material impact on the Group's financial position or results of operations.

In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, which establishes a framework to measure the fair value of assets and liabilities and expands disclosures about fair value measurements. This standard is effective for the 2008 fiscal year. The Group is evaluating the impact the adoption of this standard will have on its future consolidated financial position and results of operations.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109.* The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This standard is effective for the Group's 2008 fiscal year. The Group is evaluating the impact the adoption of this standard will have on its future consolidated financial position and results of operations.

3. BORROWING ARRANGEMENTS

The Cooperative has a revolving line of credit that enables it to draw up to $50,000,000. Rates under this agreement vary with short-term interest rates. The line of credit expires in May 2008, at which time the Cooperative has the option of converting any outstanding balance into a four-year term loan. The terms of this agreement require the Cooperative to comply with certain restrictive covenants. The Cooperative was in compliance with the covenants at December 31, 2007 and 2006. There were no borrowings under the line of credit during 2007 and 2006.

Revenue Bonds — In 2006, the Cooperative issued new debt to finance the acquisition, construction, and equipping of a medical specialty center located in Bellevue, WA, to be owned and operated by the Cooperative. The Series 2006 revenue bonds were issued with a principal amount of $97,965,000, plus net original issue premium in the sum of $2,031,000. The monies received from the issuance will be trusteed assets until construction costs are incurred and were included within funds held by trustee on the consolidated balance sheets as of December 31, 2007 and 2006. Approximately $5,078,000 of deferred financing costs in connection with the Series 2006 revenue bonds is included within other assets on the consolidated balance sheets in the amount of $4,900,000 and $5,078,000 as of December 31, 2007 and 2006, respectively.

The Series 2006 bonds, as well as the previously outstanding revenue bonds, were issued through the Washington Health Care Facilities Authority (the "Authority"). As security for the repayment of the bonds, the Cooperative has granted the Authority a security interest in its gross receivables and bond funds and liens against certain facilities and equipment. The loan agreements for the revenue bonds require, among other restrictions, that the Cooperative achieve certain minimum debt service coverage ratios. The Cooperative was in compliance with all debt covenants at December 31, 2007 and 2006.

Long-term debt at December 31, 2007 and 2006, consists of the following (in thousands):

	Years of Maturity	2007	2006
Revenue bonds:			
Series 2006, 4-1/2% to 5.0%, plus bond premium of $1,941 and $2,024 in 2007 and 2006, respectively	2022–2036	$ 99,906	$ 99,989
Series 2001, 3-1/4% to 5-3/8%, plus bond premium of $1,472 and $1,712 in 2007 and 2006, respectively	2006–2019	62,482	66,432
Series 1991, 6-3/5% to 7.0%, net of bond discount of $1,225 and $1,356 in 2007 and 2006, respectively	2006–2021	42,950	43,904
Other	2008	18	1,097
Subtotal		205,356	211,422
Less current portion		(5,626)	(6,082)
Total long-term debt		$ 199,730	$ 205,340

Future annual principal payments on long-term debt for each of the next five years and thereafter at December 31, 2007, are as follows (in thousands):

Years Ending December 31	
2008	$ 5,439
2009	5,675
2010	5,985
2011	6,050
2012	6,620
Thereafter	173,400
Subtotal	203,169
Add unamortized premium and discount — net	2,187
Total	$ 205,356

Interest paid during 2007 and 2006 was $10,754,000 and $5,561,000, respectively. Total interest cost incurred was $10,764,000 and $5,942,000 during 2007 and 2006, respectively, and the amount thereof capitalized was $4,943,000 and $762,000 in 2007 and 2006, respectively. Interest cost includes the effect of the interest rate swaps, which reduced the cost by $601,000 and $1,228,000 in 2007 and 2006, respectively.

Surplus Notes — KPS holds surplus notes issued to providers who were creditors pursuant to the need to rehabilitate the company in 2000. GHC acquired control of KPS pursuant to a Transfer Agreement (“Agreement”), effective October 1, 2005, between the OIC and GHC. At the time of acquisition, the fair value of the surplus notes was $5,082,000. The Agreement provided for KPS to pay tendered surplus notes at 50% of face value and to issue a new participating surplus note for the remaining 50% balance. Any surplus note not tendered by June 15, 2006, was cancelled. The new participating surplus notes are noninterest-bearing and are exempt from registration. The repayment of any principal is pursuant to a payment formula based on KPS's future earnings. The final payment of principal shall be made only upon surrender of the participating surplus note at the office of KPS. The surplus notes balance was $15,614 and $1,081,000 as of December 31, 2007 and 2006, respectively, and was recorded as a component of current portion of long-term debt in the consolidated balance sheets.

4. DERIVATIVE FINANCIAL INSTRUMENTS

The Cooperative is exposed to the effects of changing interest rates. This exposure is managed, in part, with the use of derivatives. The following is a summary of the Cooperative's risk management strategies and the effects of these strategies on the consolidated financial statements.

In January 2007, the Cooperative entered into an interest rate swap on the 2006 Series debt as part of the effort to rebalance the mix of variable and fixed rate exposure. The swap entitles GHC to receive payments based on a fixed rate and pay a variable rate based on the Bond Market Association Municipal Swap Index. The terms include a provision to cap the market value of the swap at $22,500,000, and a par termination option with a term to match the call provision of the 2006 Series bonds. The Cooperative has elected to account for the swap as a free-standing derivative; therefore, changes in the fair value are recorded in earnings and were not material in 2007. The notional amount of this derivative is $75,000,000.

The Cooperative has a total return swap considered to be a derivative financial instrument. The total return swap entitles the Cooperative to receive payments equal to the coupon rates on the 1991 Series debt and pay a variable rate that is based on the Bond Market Association Municipal Swap Index. The Cooperative has elected to account for the total return swap as a free-standing derivative; therefore, changes in the fair value are recorded in earnings and were not material in 2007 and 2006. The notional amount of this derivative was $ 44,175,000 and $45,260,000 as of December 31, 2007 and 2006, respectively.

5. DISCLOSURE ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

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

Cash and Cash Equivalents — The carrying amounts, at cost, approximate fair value due to the short maturity of those instruments.

Marketable Securities — The fair values of investments, which agree with the carrying values, are estimated based on quoted market prices for these or similar investments.

Funds Held by Trustee — The carrying amount, at cost, of funds held by trustee approximates fair value due to the short maturity of those instruments.

Long-Term Debt — The fair value of the Group's long-term debt is estimated based on the future cash flows at the discounted current rates available to the Group for debt of similar type and maturity. Any call provisions that apply are taken into account when valuing the debt. The fair value of the long-term debt was $211,898,000 and $226,274,000 as of December 31, 2007 and 2006, respectively.

Interest Rate Swaps — The fair value of interest rate swaps, which agree with carrying values, are estimated based on quoted market prices for these or similar swaps.

6. PENSION PLANS

The Group contributes to two defined benefit plans (the "Plans"), a defined contribution plan, a 401(k) plan and several union-negotiated plans that collectively cover substantially all of its employees. The Group's policy is to fund pension costs for the Plans based on actuarially determined funding requirements, thereby accumulating funds adequate to provide for all accrued benefits. Contributions for the defined contribution plan are based on a percentage of covered employees' salaries. Matching contributions to the 401(k) plan are based on a percentage of participants' contributions as set forth in the Plans agreements. The total expense for the Plans was $26,092,000 and $29,857,000 in 2007 and 2006, respectively.

The actuarial cost method used in determining the net periodic pension cost is the projected unit credit cost method. At December 31, 2007 and 2006, net periodic pension expense related to the Group's participation in the Plans for 2007 and 2006, included the following components (in thousands):

	2007	2006
Service cost	$ 21,744	$ 21,703
Interest cost on projected benefits	22,957	20,731
Expected return on Plan assets	(33,562)	(29,213)
Actuarial loss	940	5,704
Net periodic pension cost	$ 12,079	$ 18,925
Discount rate (preretirement)	5.80%–6.00 %	5.50%–5.75 %
Discount rate (postretirement)	5.00–6.00	5.00–5.75
Rate of increase in compensation levels	4.39–5.00	4.39–5.00
Expected return on plan assets	8.00–8.50	8.00–8.50

Assumptions used for the net periodic postretirement cost are based on the beginning of the year.

The Plans' funded status as of December 31, 2007 and 2006, was as follows (in thousands):

	2007	2006
Projected benefit obligation — end of year	$ 406,079	$ 402,830
Change in Plan assets:		
Fair value of Plan assets — beginning of year	$ 402,329	$ 349,382
Actual return on Plan assets	30,901	41,497
Employer contributions	20,750	25,718
Employee contributions	76	65
Benefits paid	(17,975)	(14,333)
Fair value of Plan assets — end of year	$ 436,081	$ 402,329
Funded status	$ 30,002	$ (501)
Accumulated benefit obligation — end of year	$ 361,610	$ 356,112
Discount rate (preretirement)	6.30%–6.60 %	5.80%–6.00 %
Discount rate (postretirement)	5.50–6.60	5.00–6.00
Rate of increase in compensation levels	4.39–5.00	4.39–5.00

Assumptions used for the accumulated benefit obligation are based on the end of the year.

The funded status was recorded as a component of other assets as of December 31, 2007, and other noncurrent liabilities as of December 31, 2006, in the consolidated balance sheets.

The benefit obligation was the actuarial present value of all vested and nonvested benefits for employee service before December 31, 2007 and 2006.

Certain of the Group's employees are covered by union-sponsored, collectively bargained, multiemployer defined benefit plans. Contributions are determined in accordance with the provisions of negotiated labor contracts.

Investment Policies and Strategies — The Group has adopted an investment policies for its defined benefit plans that incorporate a strategic, long-term asset allocation mix designed to best meet its long-term pension obligations. Plan fiduciaries set the investment policies and strategies for the pension trust. This includes the following:

- Selecting investment managers
- Setting long-term and short-term target asset allocations
- Periodic review of the target asset allocations, and, if necessary, making adjustments based on changing economic and market conditions
- Monitoring the actual asset allocations, and, when necessary, rebalancing to the current target allocation

As of December 31, 2007 and 2006, the following table summarizes the target allocation range defined in the investment policies compared to the actual allocations of the Group's plan assets:

	2007		2006	
	Target Allocation	**Actual Allocation**	**Target Allocation**	**Actual Allocation**
Equity securities	60%–70%	62%–64%	60%–70%	64%–65%
Debt securities	25–40	35–36	25–40	33–35
Cash equivalents	0–5	3	0–5	3
Other investments	0–5	-	0–5	-
Total		100 %		100 %

The investment policy emphasizes the following key objectives:

- Maintain a diversified portfolio among various asset classes and investment managers
- Invest in a prudent manner for the exclusive benefit of plan participants
- Preserve the funded status of the plan
- Balance between acceptable level of risk and maximizing returns
- Maintain adequate control over administrative costs
- Maintain adequate liquidity to meet expected benefit payments

Expected Long-Term Rate of Return on Assets — The Group uses an approach which analyzes historical long-term rates of return for various investment categories, as measured by appropriate indexes. The rates of return on these indexes are then weighted, based upon the percentage of plan assets in each applicable category, to determine a composite expected return. The Group reviews its expected rate of return assumption annually. However, this is considered to be a long-term assumption and hence not anticipated to change annually, unless there are significant changes in economic and market conditions.

As a result of the Group adopting the provisions of FASB Statement No. 158 at December 31, 2006, the prepaid pension asset was adjusted against unrestricted net assets resulting in a pension liability. The change to the net pension asset was $51,393,000 and is a component of the FASB Statement No. 158 transition amount in the consolidated statements of operations and changes in net assets.

There are no required employer contributions expected to be made to the Plans in 2008.

Expected amounts to be recognized as components of 2008 net periodic pension cost are (in thousands):

Service cost	$ 21,060
Interest cost on projected benefits	23,767
Expected return on Plan assets	(35,309)
Net periodic pension cost	$ 9,518

The benefits expected to be paid in each of the next five years, and in the aggregate for the five fiscal years thereafter, as of December 31, 2007, are as follows (in thousands):

Years Ending December 31	
2008	$ 24,530
2009	27,521
2010	29,755
2011	31,352
2012	34,783
2013-2017	193,758
Total	$ 341,699

7. RETIREE MEDICAL PLANS

The Cooperative provides certain medical benefits for eligible retired employees. Employees become eligible for these benefits upon retirement and attainment of a specified age and upon completion of a certain number of years of service.

At December 31, 2007 and 2006, net periodic postretirement benefit cost is comprised of the following components (in thousands):

	2007	**2006**
Service cost	$ 1,546	$ 1,634
Interest cost on accumulated benefit obligation	5,007	5,342
Amortization of loss from earlier periods	-	1,314
Amortization of unrecognized prior service cost	(544)	(544)
Amortization of unrecognized transition obligation over 20 years	2,000	2,000
Net periodic postretirement benefit cost	$ 8,009	$ 9,746

The Cooperative's accumulated postretirement benefit obligation (APBO) is unfunded. The APBO is included in the components of the retiree medical benefits liability on the consolidated balance sheets at December 31, 2007 and 2006, and is comprised of the following components (in thousands):

Accumulated postretirement benefit obligation — end of year	$ 80,210	$ 98,473
Change in plan assets:		
Employer contributions	$ 4,554	$ 4,767
Benefits paid	(4,554)	(4,767)
Fair value of plan assets — end of year	$ -	$ -
Funded status	$ (80,210)	$ (98,473)

Future benefit costs were estimated assuming medical costs would increase at a 7.0% annual rate. A 1.0% increase in this annual trend rate would have increased the APBO at December 31, 2007, by $8,077,000 and the sum of service cost and interest cost for 2007, by $889,000. A 1.0% decrease in this annual trend rate would have decreased the APBO at December 31, 2007, by $6,840,000 and the sum of service cost and interest cost for 2007, by $734,000.

The weighted-average discount rate used in determining the APBO was 6.30% in 2007 and 5.80% in 2006. The assumptions used to determine the APBO were measured at year-end. The weighted-average discount rate used in determining the net periodic postretirement benefit cost was 6.30% in 2007 and 5.80% in 2006, and was based on beginning of year assumptions.

Expected amounts to be recognized as components of 2008 net periodic postretirement benefit cost are (in thousands):

Service cost	$ 817
Interest cost on projected benefits	4,430
Amortization of prior service cost (credit)	(299)
Amortization of transition obligation	477
Net periodic pension cost	$ 5,425

The Cooperative funds the plan as benefit payments are required. The expected benefit payments to be paid and contributions to be made in each of the next five years, and in the aggregate for the five fiscal years thereafter, as of December 31, 2007, are as follows (in thousands):

Years Ending December 31	
2008	$ 4,876
2009	5,161
2010	5,430
2011	5,645
2012	5,809
2013-2017	30,539
Total	$ 57,460

In 2007, the Cooperative opted to discontinue its contribution to the premiums for staff retiring on or after December 31, 2007. These changes result in the phase-out of the benefit for the Cooperative's nonunion active employees. Approximately $7,400,000 of the accumulated benefit obligation is to be paid out in the first quarter of 2008.

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act") was enacted. The Act introduced a drug benefit under Medicare Part D, as well as a federal subsidy to sponsors of retiree health care benefit plans that provide an equivalent benefit. As of December 31, 2007, the Cooperative's retiree medical plan provides prescription drug coverage for eligible retirees.

As a result of the Cooperative adopting the provisions of FASB Statement No. 158 at December 31, 2006, an additional retiree medical liability was recorded which consisted of previously unrecognized gains, prior service cost, and transition obligations. The change in retiree medical liability was $25,085,000 and was recorded as a component of the FASB Statement No. 158 transition amount in the consolidated statements of operations and changes in net assets.

8. COMMITMENTS AND CONTINGENCIES

Leases — The Group has various operating leases for land, buildings, and equipment. Total rent expense was $18,614,000 and $16,859,000 on these leases in 2007 and 2006, respectively. Total sublease rental revenue was $1,162,000 and $1,553,000 in 2007 and 2006, respectively. Future minimum rental payments and future minimum sublease rental receipts under noncancelable operating lease and sublease agreements as of December 31, 2007, are as follows (in thousands):

Years Ending December 31	Minimum Sublease Rental Receipts	Minimum Rental Payments
2008	$ 1,838	$ 19,506
2009	1,867	19,147
2010	1,663	18,349
2011	1,402	15,904
2012	1,143	14,133
Thereafter	1,234	60,890
Total	$ 9,147	$ 147,929

In July 2006, the Cooperative entered into a sale-leaseback transaction involving the sale of its administrative main building located in Tukwila, WA, and then entered into a 10-year operating lease with the purchaser. The gain on sale was deferred, to be amortized over 120 months, and is being recognized as a component of other expense in the consolidated statements of operations and changes in net assets. The sale price was contingent upon certain conditional use permits being obtained from the city of Tukwila. If the permits were issued, then the purchaser would increase the selling price by $3,000,000, which would increase the recorded gain on sale by the same amount. In March 2007, the permitting process was completed which resulted in a total gain on sale of $28,988,000.

Labor — Approximately 60% of the Cooperative's employees are covered under collective bargaining agreements. These employees provide nursing and other technical services to the Cooperative. Bargaining disputes could adversely affect the Cooperative.

Litigation — The Group is involved in litigation and regulatory investigations arising in the normal course of business. After consultation with legal counsel, management estimates accruals, if any, that are necessary related to these matters. Management believes the recorded amounts are adequate and the ultimate outcome of the matters will not have a material adverse effect on the Group's consolidated financial position or results of operations.

9. FEDERAL INCOME TAXES

The components of income tax (benefit) expense for GHC, GHO, KPS, and NCVS related to continuing operations and the change in unrestricted net assets for the years ended December 31, 2007 and 2006, are summarized as follows (in thousands):

	2007	2006
Federal income tax (benefit) expense on operations	$ (1,098)	$ 4,355
Federal income tax (benefit) included in the change in unrestrictred net assets	(549)	(1,158)

Federal income tax (benefit) expense included in the change in unrestricted net assets is recognized as a component of changes in net unrealized investment gains and losses, FASB Statement No. 158 transition amount and defined benefit pension and other postretirement plans in the consolidated statements of operations and changes in net assets.

The deferred tax asset is recorded within other assets and the deferred tax liability is recorded as a component of accounts payable in the accompanying consolidated balance sheets at December 31, 2007 and 2006, in the following amounts (in thousands):

	2007	2006
Deferred tax asset	$ 5,885	$ 5,010
Deferred tax liability	(1,190)	(88)
Net deferred tax asset	$ 4,695	$ 4,922

The deferred tax asset results primarily from net operating loss carryforwards and temporary differences in unearned premiums, insurance reserves, compensation related items, and fixed assets that are not deductible for tax purposes in the current year. The deferred tax liability results primarily from temporary differences in unrealized investment gains, pension and postretirement accruals, accrued dividends, and the effect of an Internal Revenue Code (IRC) Section 481 adjustment due to a change in accounting method for unearned premiums. No valuation allowance has been provided for the net deferred tax asset as management believes it is more likely than not that the entire amount will be realized.

At December 31, 2007, KPS had available net operating loss carryforwards of approximately $9,210,000, which expire between 2018 and 2024, if not used by KPS to reduce income taxes payable in future periods. The annual use of KPS's net operating loss carryforwards is limited by the application of IRC Section 382. Federal income tax expense incurred differs from the amount computed by applying the expected U.S. corporate income tax rate to income before taxes for the years ended December 31, 2007 and 2006, as the result of tax exempt income, the amortization of items recorded in purchase accounting and adjustments to the prior year tax returns.

10. JOINT VENTURE AND NEW ADMINISTRATIVE BUILDING

In December 2005, GHC signed a joint venture agreement with City Investors V LLC, a real estate development company controlled by the Vulcan Corporation, to form Westlake Terry LLC. GHC has a 50% ownership interest in Westlake Terry LLC in the amount of $13,691,000 and $13,423,000 as of December 31, 2007 and 2006, respectively. Under the agreement, the joint venture developed two adjacent buildings totaling 319,000 square feet located in Seattle, WA, with GHC a major tenant of the new facility with a 10-year operating lease agreement. GHC, GHO, and the Foundation moved their administrative headquarters to this site in August 2007.

In May 2006, GHC and City Investors V LLC entered into loan guarantees with Westlake Terry LLC's lenders relating to its construction and long-term financing. Management believes the likelihood of performance on these guarantees to be remote, and therefore, has not recorded a related liability.

Westlake Terry LLC is currently in the construction phase and is expected to be completed by mid-2008. During the construction phase, GHC provided a guaranty of $40,250,000 which will remain in effect until Westlake Terry LLC meets certain conditions. Once Westlake Terry LLC has met these conditions, GHC's guaranty to the lender is reduced to a maximum liability of $22,000,000 and will remain in effect until certain additional operating conditions have been met.

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GROUP HEALTH COOPERATIVE AND SUBSIDIARIES

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED DECEMBER 31, 2007

Federal Agency/Subdivision	CFDA # or Contract #	Pass-Through Identifying #	Expenditures
Research and development awards:			
Department of Defense	12.42		$ 243,311
Pass-through funds from:			
Fred Hutchinson Cancer Research Center	12.42	DAMD 17-02-1-0691	7,336
Department of Veterans Affairs	64.RD		11,336
Environmental Protection Agency	66.514	FP-91637601-2	397
Department of Veterans Affairs			
Pass-through funds from:			
Veterans Affairs Medical Center	93.RD	1 RO1 AG0255502-02A1	1,302
Department of Health and Human Services	93.RD		1,264,228
Pass-through funds from:			
MDRC	93.RD	233-01-0012	64,658
Agency for Healthcare Research and Quality	93.226		247,355
Pass-through funds from:			
University of Washington	93.226	305865	191,389
Harvard Pilgrim Health Care, Inc.	93.226	1 U18 HS016955-01	7,238
Rutgers	93.266	7 R01 HS013654-04	6,009
Harvard Pilgrim Health Care, Inc.	93.266	HS010391	47,717
Harvard Pilgrim Health Care, Inc.	93.RD	HHSA290200500331 TO#5	6,010
RAND	93.RD	9920070022	122,944
Agency for Healthcare Research and Quality	93.242		32,693
Centers for Disease Control and Prevention	93.200-202-M-00561		10,703
Pass-through funds from:			
University of Washington	93.135	CE000670 & 159326	30,985
University of Washington	93.136	5 R49 CD000197-03	1,499
American Association of Health Plans	93.200-2002-00732	200-2002-00732	1,386,150
Center for Health Training	93.26	6 FPTPA100014-27	88,574
Southeast Alaska Regional Health Consortium	93.283	5 U58 DP024463-04	1,493
Public Health Seattle & King	93.283	5 U58 CCU02330-05	5,864
University of Washington	93.283	218694 & 315803	60,077
Public Health - Seattle & King County (PHSKC)	93.293	U58/CCU023330-04	117,872
Children's Hospital and Regional Medical Center	93.945	N14260	7,996
Food and Drug Administration			
Pass-through funds from:			
Harvard Pilgrim Health Care, Inc.	93.103	HHSF223200510012C	42,419
National Institutes of Health	93.172		752,202
Pass-through funds from:			
University of Washington	93.172	315049	2,851
National Institutes of Health	93.213		1,729,511
Pass-through funds from:			
Phoenix Biosystems, Inc.	93.213	AT003174	51,046
National Institutes of Health	93.242		2,311,856
Pass-through funds from:			
Harvard Pilgrim Health Care, Inc.	93.242	MH061941	11,112
University of Washington	93.242	MH41739, 865722, 269891	663,004
National Institutes of Health			
Pass-through funds from:			
University of Washington	93.249	D20 HP00007-08	9,681

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GROUP HEALTH COOPERATIVE AND SUBSIDIARIES

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED DECEMBER 31, 2007

Federal Agency/Subdivision	CFDA # or Contract #	Pass-Through Identifying #	Expenditures
National Institutes of Health			
Pass-through funds from:			
Harvard Pilgrim Health Care, Inc.	93.266	5 U18 HS010391-07	$ 10,206
National Institutes of Health	93.279		540,776
Pass-through funds from:			
University of California	93.279	4267SC	36,363
University of Washington	93.279	263196	210,366
National Institutes of Health	93.263-MQ-516309		46,146
National Institutes of Health	93.263-MQ-612311		25,351
National Institutes of Health	93.393		3,072,013
Pass-through funds from:			
Fred Hutchinson Cancer Research Center	93.393	591800, 593536, 611948 & 603774	221,167
SRI International	93.393	51-000598	215,080
Center for Health Research	93.393	1 R01 CA114204-01A1	17,257
University of Washington	93.393	879723	216,117
Wake Forest University	93.393	WFUHS 11357	24,565
National Institutes of Health			
Pass-through funds from:			
University of Washington	93.397	5 U54 CA116847-02	14,588
National Institutes of Health			
Pass-through funds from:			
University of Washington	93.398	5 K05 CA092002-05	4,962
National Institutes of Health	93.399		3,065,333
Pass-through funds from:			
Boston Medical Center	93.399	0184803 & 0184804	39,876
Dana Farber Cancer Institute	93.399	CA093332 & 000187507	73,887
Fred Hutchinson Cancer Research Center	93.399	588942, 610232 & 615628	18,150
University of Michigan	93.399	3000630327	592,645
University of Nebraska Medical Center	93.399	34-1905-2142-402	36,043
University of Illinois Chicago	93.399	2006-05319	32,252
National Institutes of Health	93.421		97,746
National Institutes of Health	93.837		488,179
Pass-through funds from:			
Kaiser Permanente Division of Research	93.837	1 U19 HL091179-01	390
University of Washington	93.837	590017, 570679, 763930 & 365672	330,618
National Institutes of Health	93.864		44,630
Pass-through funds from:			
Fred Hutchinson Cancer Research Center	93.864	608112	16,860
National Institutes of Health	93.865		711,617
Pass-through funds from:			
Fred Hutchinson Cancer Research Center	93.865	583599, 586890, 606170 & 588793	143,079

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GROUP HEALTH COOPERATIVE AND SUBSIDIARIES

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED DECEMBER 31, 2007

Federal Agency/Subdivision	CFDA # or Contract #	Pass-Through Identifying #	Expenditures
National Institutes of Health	93.866		$ 1,309,973
Pass-through funds from:			
Pennsylvania State University	93.866	3047-CHS-DHHS-4102 & 275205-D	16,895
Seattle Institute of Biomedical Research	93.866	CS119 & CS120	189,106
University of Washington	93.866	880565, 167307, 880565 320590 & 232203	47,908
National Institutes of Health	93.RD		65,579
Pass-through funds from:			
University of Washington	93.RD	924109	35,567
Booz Allen Hamilton, Inc.	93.RD	1435-04-04-CT-73980	18,111
National Institutes of Health			
Pass-through funds from:			
University of Washington	93.113	238986	69,626
Memorial Sloan-Kettering Cancer Center	93.121	CA079572	239,696
University of Washington	93.173	877065	710
University of Washington	93.281	190475 & 183835	68,150
University of Washington	93.390	263973	17,555
University of Washington	93.838	5 R01 HL079402-02	4,195
University of Washington	93.839	143961	112,246
University of Washington	93.848	300616	39,060
University of Washington	93.849	145698	191,451
University of Alabama	93.855	A1069509-01	25,471
Total research and development awards			22,336,379
Other awards:			
Department of Agriculture			
Pass-through funds from:			
Seattle King County Dept. of Health	10.557	D35947D	71,087
Department of Health and Human Services			
Pass-through funds from:			
Washington State Hospital Association	93.889	U3RHS05968 & U3RHS05968	16,250
Total other awards			87,337
Total federal awards			$ 22,423,716

(Concluded)

1. BASIS OF ACCOUNTING

The accompanying schedule of expenditures of federal awards has been prepared from the Group's accounting records and is presented on the accrual basis of accounting.

2. MAJOR PROGRAM

The research and development programs are determined to be a cluster of programs. A cluster of programs means a grouping of closely related programs that share common compliance requirements. A cluster of programs shall be considered as one program for determining major programs, as described in §520, Major Program Determination, of the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement*.

3. HEALTH RESOURCES AND SERVICES ADMINISTRATION — NONCASH SUBAWARD

In the year ended December 31, 2007, GHC participated in a subcontract from the Washington State Department of Health in the performance of a federal Health Resources and Services Administration Grant (CFDA 93.889). There was $100,103 of noncash property purchased and delivered by the Washington State Hospital Association (WSHA) on GHC's behalf during the year ended December 31, 2007. This noncash property purchased by WSHA on GHC's behalf is equipment that is to be used in disaster response including chemical, biological, radiological, nuclear, or explosive events. This activity is not reported on the schedule of expenditures of federal awards as GHC did not receive nor will it receive any federal funds for this effort.

4. SUBRECIPIENT AWARDS

GHC, GHO, KPS, Auxiliary, NCVS, and the Foundation passed through federal awards to subrecipients for:

CFDA # or Contract #	Program	Subrecipient	Amount
12.42	A Population-Based Randomized Trial to Assess the Effects of Short-Term Cessation of HRT on Mammography Assessments and Breast Density	University of Washington	$ 16,782
93.172	Cancer Research Network Across Healthcare Systems	Henry Ford Health System	319,201
93.172	HMO Cancer Research Network Dissemination of Intra-Peritoneal Chemotherapy	Harvard Pilgrim Health Care	13,649
		Henry Ford Health System	5,344
		Kaiser Foundation Research Institute	2,371
93.213	Evaluating the Efficacy of Acupuncture for Chronic Low Back Pain	Cancer Research and Biostatistics	45,045
		University of Washington	11,534
		Kaiser Foundation Research Institute	160,609

(Continued)

CFDA # or Contract #	Program	Subrecipient	Amount
93.226	Long-Term Healthcare Effects of Domestic Violence	Ohio State University	10,239
		University of Washington	8,031
93.242	Depression-Diabetes Care Disparities, Adverse Outcomes	University of Washington	78,437
93.242	Epidemiology and Treatment of Comorbid Obesity and Depression	Regents of the University of Minnesota	81,413
93.242	Integrating Chronic Care and Business Strategies In the Safety Net	California Health Care Safety	6,491
93.242	Patient-Centered Interventions for Mood Disorders	Depression and Bipolar Support	16,511
		University of Washington	71,759
93.242	Pilot Trial of Peer Support for Bipolar Disorder	Depression and Bipolar Support	14,318
93.242	Social Role Disability and Mental-Physical Co-Morbidity	Harvard Medical School	101,542
		University of Washington	59,302
93.242	Transition From Prison to Community: A Pilot Intervention of Adherence Support	University of Wisconsin at Madison	35,145
93.279	Long-Term Opioid Management of Chronic Pain: Trends and Risks	Kaiser Foundation Research Institute	233,587
		University of Washington	48,822
93.393	Design and Inference for Hybrid Ecological Studies	University of Washington	36,664
93.393	Multi-Center Study of Pancreatic Cancer Etiology	Fred Hutchinson Cancer Research Center	168,477
		Kaiser Foundation Research Institute	161,519
		University of Washington	224,056
93.393	Proactive Cessation Intervention with Biomarker Feedback	Free and Clear, Inc.	14,765
93.393	Statistical Coordinating Center for the Breast Cancer Surveillance Consortium	Cancer Research and Biostatistics	43,012
		University of New Mexico	15,002
93.393	Systems of Support (SOS) To Increase Colon Cancer Screening and Support	Fred Hutchinson Cancer Research Center	13,889
		Kaiser Foundation Research Institute	2,723
93.399	Long Term Costs and Outcomes of Breast Cancer Screening	Ohio State University	16,876
93.399	Increasing Effectiveness of Cancer Control Interventions	Beth Israel Deaconess Medical Center	28,521
		Harvard Pilgrim Health Care, Inc.	360,909
		Health Partners Research Foundation	168,975
		Henry Ford Health System	356,435
		Kaiser Foundation Research Institute	732,141
		Lovelace Clinic Foundation	106,602
		Marshfield Clinic	95,680
		University of Massachusetts	267,414
93.421	Adherence Intervention for Incarcerated Persons Living with HIV	University of Wisconsin at Madison	40,813

(Continued)

CFDA # or Contract #	Program	Subrecipient	Amount
93.837	Electronic Communications and Home Blood Pressure Monitoring	University of Washington	(4,844)
93.864	Ectopic Pregnancy: Assessing Long-Term Trends In Rates and Risk Factors	University of Washington	5,823
93.865	Oral Contraceptive Use and Bone Density in Young Women	Fred Hutchinson Cancer Research Center	21,690
		University of Washington	18,627
93.866	Alzheimer's Disease Patient Registry	University of Washington	440,961
93.866	HRT Decision Making in the Post-WHI Era	Fred Hutchinson Cancer Research Center	4,361
		Harvard Pilgrim Health Care, Inc.	51,381
		University of Washington	10,745
93.866	MCI, Insulin, and Cholesterol in a Community Sample	University of Washington	30,033
93.RD	Re-engineering the Clinical Research Enterprise Feasibility	Harvard Pilgrim Health Care, Inc.	117,828
		Health Partners Research Foundation	57,716
		Henry Ford Health System	149,846
		Kaiser Foundation Research Institute	441,654
		Lovelace Clinic	53,987
		University of Massachusetts	64,821
Total			$ 5,659,234

(Concluded)

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INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

To the Board of Trustees of
Group Health Cooperative and Subsidiaries
Seattle, WA

We have audited the consolidated financial statements of Group Health Cooperative (GHC), GHC's wholly owned subsidiary, Group Health Options, Inc. (GHO), and controlled affiliates, KPS Health Plans (KPS) and Group Health Community Foundation (the "Foundation") (collectively, the "Group"), as of and for the year ended December 31, 2007, and have issued our report thereon dated March 21, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Group's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Group's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Group's consolidated financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.*

We noted certain matters that we reported to the Group's management in a separate letter dated March 21, 2008.

This report is intended solely for the information and use of the Board of Trustees, management, federal awarding agencies, and pass-through entities, and is not intended to be, and should not be, used by anyone other than these specified parties.

Deloitte & Touche LLP

March 21, 2008

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INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO EACH MAJOR PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133

To the Board of Trustees of
Group Health Cooperative and Subsidiaries
Seattle, WA

Compliance

We have audited the compliance of Group Health Cooperative (GHC), GHC's wholly owned subsidiary, Group Health Options, Inc. (GHO), and controlled affiliates, KPS Health Plans (KPS) and Group Health Community Foundation (the "Foundation") (collectively, the "Group"), with the types of compliance requirements described in the U.S. *Office of Management and Budget ("OMB") Circular A-133 Compliance Supplement* that are applicable to its major federal program for the year ended December 31, 2007. The Group's major federal program is identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grant agreements applicable to its major federal program is the responsibility of the Group's management. Our responsibility is to express an opinion on the Group's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Group's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provided a reasonable basis for our opinion. Our audit does not provide a legal determination on the Group's compliance with those requirements.

In our opinion, the Group complied, in all material respects, with the requirements referred to above that are applicable to its major federal program for the year ended December 31, 2007.

Internal Control Over Compliance

The management of the Group is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts, and grant agreements applicable to federal programs. In planning and performing our audit, we considered the Group's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance.

Accordingly, we do not express an opinion on the effectiveness of the Group's internal control over compliance.

A *control deficiency* in an entity's internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

Schedule of Expenditures of Federal Awards

We have audited the basic consolidated financial statements of the Group as of and for the year ended December 31, 2007, and have issued our report thereon dated March 21, 2008. Our audit was performed for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the basic consolidated financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic consolidated financial statements taken as a whole.

This report is intended solely for the information and use of the Board of Trustees, management, federal awarding agencies, and pass-through entities, and is not intended to be, and should not be, used by anyone other than these specified parties.

Deloitte & Touche LLP

May 30, 2008

GROUP HEALTH COOPERATIVE AND SUBSIDIARIES

SCHEDULE OF FINDINGS OF NONCOMPLIANCE AND QUESTIONED COSTS
FOR THE YEAR ENDED DECEMBER 31, 2007

PART I — SUMMARY OF AUDITORS' RESULTS

Financial Statements

Type of auditor's report issued:	unqualified			
Internal control over financial reporting:				
• Material weaknesses identified?	________	Yes	X	No
• Significant deficiencies identified that are not considered to be material weaknesses	________	Yes	X	None Reported
• Noncompliance material to financial statements noted?	________	Yes	X	No

Federal Awards

Internal control over major programs:				
• Material weaknesses identified?	________	Yes	X	No
• Significant deficiencies identified that are not considered to be material weaknesses	________	Yes	X	None Reported
Type of auditor's report issued on compliance for major programs:	unqualified			
Any audit findings disclosed that are required to be reported in accordance with Circular A-133 (section .510(a))?	________	Yes	X	No

Identification of major programs:

CFDA Number	Name of Federal Program
Cluster	Research and Development

Dollar threshold used to distinguish between Type A and Type B programs:	$673,334			
Auditee qualified as low-risk auditee?	________	Yes	X	No

PART II — FINANCIAL STATEMENT FINDINGS SECTION

No matters are reportable

PART III — FEDERAL AWARD FINDINGS AND QUESTIONED COSTS SECTION

No matters are reportable

Auditor Summary of Prior Audit Findings — No findings noted related to the research and development awards during the fiscal 2006 audit.