COVENTRY
HEALTH CARE, INC.

FOCUSED ON OUR FUTURE

1998
ANNUAL REPORT

LETTER TO SHAREHOLDERS

We've chosen "Focused on our Future" as the theme of this year's annual report. Appropriately enough, the visual image we are using to convey that theme is represented by the binoculars on our cover. Since we began restructuring Coventry over two years ago, we have focused on solving the most immediate and glaring problems. We have done what we said we were going to do, and we believe we can now turn our attention to future opportunities and growth strategies.

1998 was a critical year because of the challenges we successfully met and the progress we achieved. In last year's report, we said that we would successfully integrate Principal Health Care, execute the basics of our business better, attract and retain the best executives possible, and reduce general and administrative expenses. We have done these things, as well as put the bankruptcy of one of our major providers behind us. Now we can look ahead, reviewing the changing health care landscape in our search for improved products, increased membership and added value for our shareholders. Though a great deal of work remains, we are solidly profitable and essentially debt free, with an exceptional portfolio of health plans and an outstanding management team.

Perhaps the best way to understand fully where we've been and where we are going is to bring into focus the results and key events of 1998 and our goals and strategies for the future. First, key events of 1998:

Financial Results

For the year ended December 31, 1998, operating revenues were $2.1 billion, up 72% over the prior year's revenues of $1.2 billion. Excluding non-recurring charges, net earnings were $26.3 million, or $0.49 per share, compared with net earnings of $2.9 million, or $0.08 per share, for the year earlier period. Including non-recurring items, the net loss for 1998 was $11.7 million, or $0.22 per share, compared with net earnings of $11.9 million, or $0.35 per share in 1997.

Coventry ended the year in the strongest financial condition in its history. Our balance sheet substantiates that claim. Cash and investments have increased from $168 million at the end of 1996 to $614 million at the end of 1998. During that same period, bank debt has been eliminated while our net worth has increased four-fold. In addition, tangible net worth has risen from a negative $18 million at the end of 1996 to a positive $141 million at the end of 1998.

AHERF Recovery

The major surprise, disappointment, and challenge of 1998 was the unexpected bankruptcy of the Allegheny Health, Education and Research Foundation (AHERF). AHERF was responsible for a full risk contract in Western Pennsylvania, which covered approximately 250,000 of our members. Their insolvency made it necessary for us to establish claim and other reserves for those members. As a result, Coventry recorded a $55 million charge in the second quarter of 1998. While AHERF was a major disappointment in 1998, hindsight has proven our charge adequate, and our Western Pennsylvania plan is back on track and continues to represent an excellent market for our company. Clearly, without AHERF, 1998 would have been one of the most successful years in Coventry's history.

Principal Health Care

We closed the merger with Principal Health Care on schedule

during the first quarter, and the subsequent integration has gone very well. In fact, it has proceeded more smoothly than we had hoped, and with few surprises. The Principal transaction helped strengthen our balance sheet, provided some excellent additional markets, and diminished our dependence on what was really only two major markets. The merger also provided some outstanding additions to our management team.

Medicare

We exited several Medicare counties during the past year. In total, exiting these counties resulted in a loss of approximately 8,000 members. Our exit is market specific and does not represent a negative attitude toward Medicare. In the markets that we exited, reimbursements were low and provider contracting was difficult. We continue to believe that managed care is the best vehicle for providing quality care and comprehensive benefits in a cost-effective way to senior citizens. We will devote increased resources in 1999 to improving the lifestyle of our senior membership and to improving health care delivery to this important group.

Sale of Chicago and Florida Health Plans

We completed the sale of the Chicago and Florida health plans in the fourth quarter. To be successful, the Chicago plan would have required more time and management resources than we believed prudent at the time. The sale of our Florida business allowed us to focus resources on our other core markets, eliminate all bank debt, and further strengthen our balance sheet.

Let us now turn our attention to some of the keys to Coventry's success in 1999:

Pricing

We are making real progress in our pricing due in large part to the controls we initiated two years ago, which included new processes to monitor all rates. Accelerating our progress, commercial premium pricing generally improved in 1998, a trend which is continuing into 1999. In the fourth quarter of 1998, premium rate increases exceeded 10%. We expect our rates to increase in the range of 6% to 8% during 1999. When the competition prices irrationally or purchasers make unreasonable demands, we will not participate.

Service

Service levels to our members continue to improve. In many areas, we believe our service levels are the best in the market and, where this is currently not the case, we are rapidly improving.

We expect that by the end of 1999, we will have reduced the number of health plan service centers from 21 to three. We anticipate that these service centers will further improve service levels and reduce costs by consolidating claims, billing and enrollment processes and some customer service functions. Our decision to take this action was based on prior experience that demonstrated both improved service and reduced costs in similarly structured realignments.

Y2K Compliance

We began preparing for Year 2000 in July 1997 and primarily focused our efforts on critical programs in our corporate office and health plan operations, including upgrading our operating systems and financial applications, and replacing older PCs. As a result, we achieved Y2K readiness in our integrated managed care systems with good lead-time to continue testing the systems. We have third party confirmation that Coventry's current status regarding Y2K compliance "is exemplary and could well serve as a model for others," and that "Coventry is clearly ahead of the pack and an industry leader in Y2K preparedness."

SG&A

We have made Y2K investments, added to the strength of our management team, grown our business, undertaken the service center consolidation and, even so, have reduced overhead by $2 million a month since the merger of our two companies. For example, as we continue to hold the line on absolute spending levels into 1999, we anticipate significant progress towards our goal of expense levels of 11% to 12% of revenues.

Strong Management Team

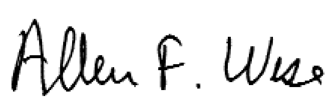
The foundation of every successful company is solid management. We succeeded in making additions to our management team during 1998, and some of our progress this year can be credited to these individuals. These recent hires, the addition of some excellent individuals from Principal Health Care, and the individuals in place prior to 1998 all add up to one of the strongest teams in our industry.

Focused on our Future

I am more comfortable and optimistic about our future than I've been since joining the Company over two years ago. Coventry is a solid company that is essentially debt free, profitable and growing, all of which add up to good choices in the future. We believe managed care is now, and will continue to be, the means to deliver the highest quality and most cost-effective health care, and we're confident that we will perform well in this environment. We believe that our decisions, resources, and execution of our strategy will have a far greater positive impact for our shareholders than the negatively perceived external industry environment would suggest. Our company is more determined than ever to price its products prudently, control SG&A, and gain better control of medical costs. Today, we are much better positioned to devote resources to tomorrow's opportunities than we have been in the recent past.

We know how to manage health plans. It's our only business. And, we have proven that we can overcome adversity, stay focused, and still achieve profitability, which puts us firmly back on course. In addition, the pricing environment is improving, we have an exceptionally strong management team, and we entered 1999 solidly profitable. We have, as a result of the Principal Health Care merger, some very strong, profitable franchises today and others that have huge future potential. I appreciate the efforts of our management team and employees in bringing Coventry to this point. With your continued support, we expect to become a leader in this industry by managing our business and staying "focused on our future."

Sincerely,



Allen F. Wise
President and Chief Executive Officer

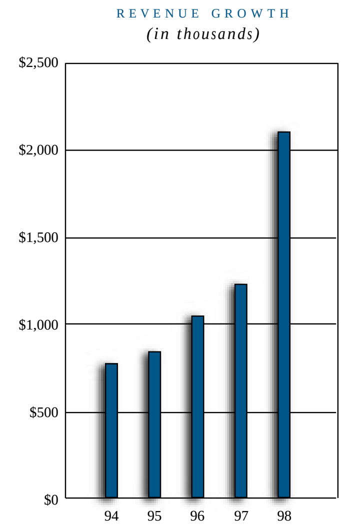
FINANCIAL HIGHLIGHTS

"In 1998, we focused on creating the financial strength we require for flexibility in managing and growing our business."

Dale B. Wolf
Chief Financial Officer

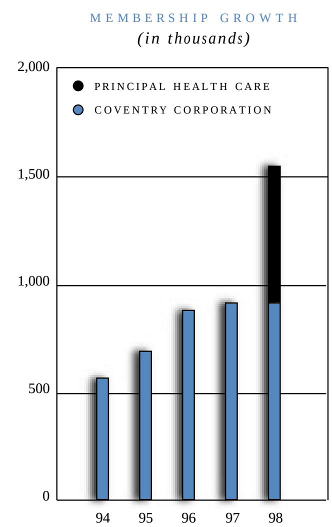
- **Revenues and Earnings**

  For 1998, revenues increased 72% and net earnings increased eight-fold over 1997 results, before one-time adjustments.



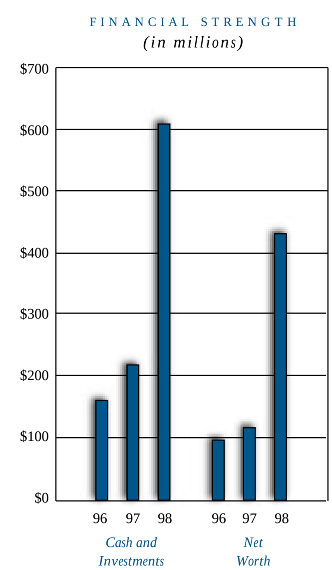
- **Membership**

  Coventry had 1.5 million members at year-end, 1.4 million of which were in operations that continued into 1999. Same-plan membership is expected to increase in 1999, despite Coventry's exit from some Medicare counties and continued price increases.

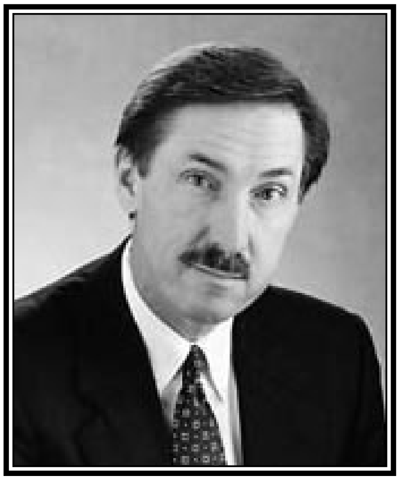


- **Balance Sheet**

  Coventry ended the year in the strongest financial condition in its history. Cash and investments increased 156% from 1997 to 1998, bank debt was eliminated and net worth increased four-fold.



KEY AREAS OF FOCUS

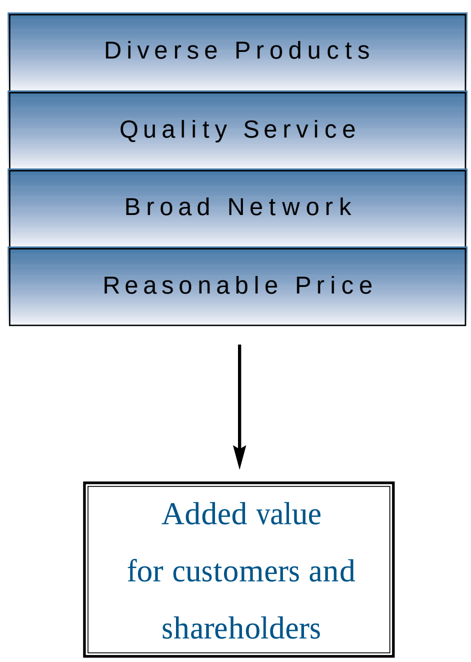


"Improving the fundamental performance of our business was the major focus of our activity in 1998. Key to this success was the installation of new medical management protocols, the improvement in our customer service operations, a disciplined pricing strategy, and the sales growth achieved through proven enhancements to our processes and organizational structure. With this strong foundation in place, we are well positioned for the future."

Thomas P. McDonough
Chief Operating Officer

Coventry Health Care's only business is managing health plans. Coventry's goal is simple – superior performance. To achieve this, Coventry recruited new leadership and installed new processes to enhance the key operational functions of managing health plans. Working in partnership with the leadership in each of our health plans, Coventry made significant progress in all key areas in 1998.

OPERATIONAL STRATEGY



"At Coventry, we understand the importance of offering high quality, affordable health care for our members. We are able to achieve this goal by focusing on the basics: access to excellent providers, comprehensive benefits and minimal hassles. We recognize that health care is complex, but it does not have to be complicated. Above all else, we will measure our success by our ability to provide the highest quality health care possible."

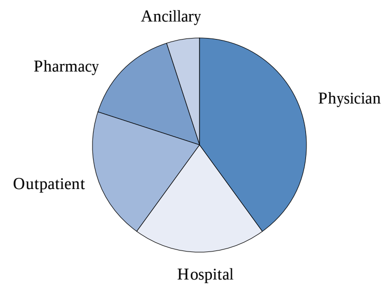
Bernard J. Mansheim, M.D.
Chief Medical Officer

Focus on: Medical Management

Increasing Consistency

Each health plan's medical department is organized in the same streamlined structure. Medical data is captured in well-defined categories and the information is used to focus efforts in a disciplined way.

MEDICAL COST ALLOCATION



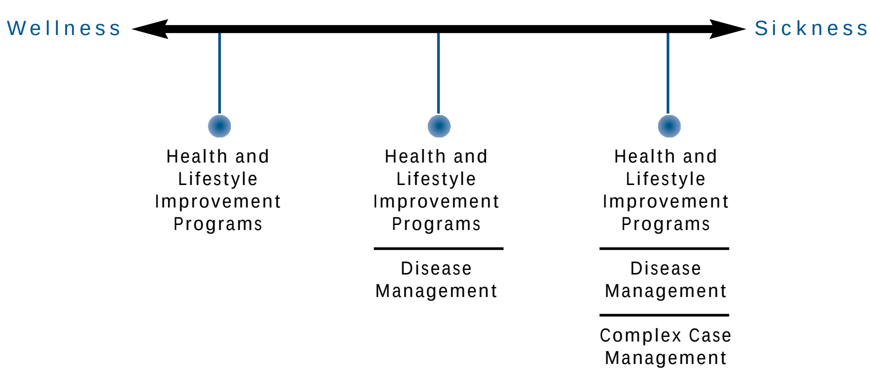
Quality Management

Coventry has taken a unique approach to quality and developed and implemented a set of quality standards that offer a consistent, uniform approach among all health plans. These standards were derived from best practices in the industry, as well as external accreditation organizations, and coordinate three key elements: internal process, health care delivery and service.

Senior Life Management™

Coventry's goal is to improve health care rather than simply provide medical care. One example is a two-year project studying the feasibility of improving health care in the senior population by using an intensive, personalized approach that begins with improving life styles and extends through the entire spectrum of health and medical care needs.

SENIOR LIFE MANAGEMENT™ PROGRAM



"We believe in pursuing the needs of our customers and shareholders with equal intensity. Building a new service model will significantly enhance the quality of our service while creating operational efficiencies and shareholder value."

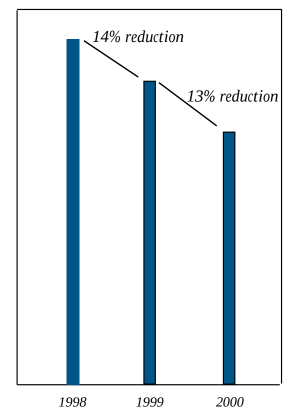
James E. McGarry
Senior Vice President
Customer Service

Focus On: Customer Service

Cost-effective Regional Service Centers

In 1998, Coventry moved to reduce costs and improve service by beginning the process of consolidating the 21 service units located in each of the health plans into three regional service centers over an 18-month period.

PER MEMBER PER MONTH
CUSTOMER SERVICE
ESTIMATED COST REDUCTIONS



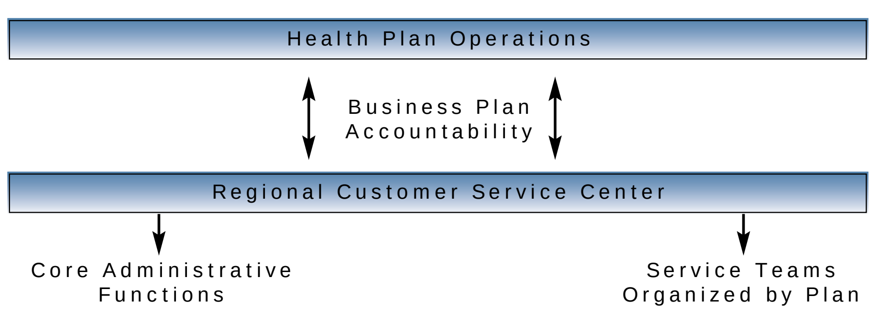
Technology-driven Processes

Coventry dedicated significant resources to leverage the latest systems and technology. These applications, along with being Year 2000 ready, will allow Coventry to increase operational efficiency.

Innovative Service Delivery Model

Unique in the industry, the regional centers will support market-centered, cross-functional service teams focused and dedicated to each health plan. This structure aligns accountability and local health plan objectives to better address specific market service requirements.

SERVICE CENTER ALIGNMENT



"1998's focus was on developing a world-class sales organization. We have now installed the right systems and the right people to achieve profitable growth."

Stewart Lavelle
Senior Vice President
Marketing & Sales

Focus On: Sales and Marketing

Revitalized Sales and Marketing Organization

In 1998, Coventry strengthened its sales and sales management talent with a focus on experience, a history of results in sales, and leadership skills. A strong sales team is fundamental to profitably growing Coventry's business.

SALES STRATEGY

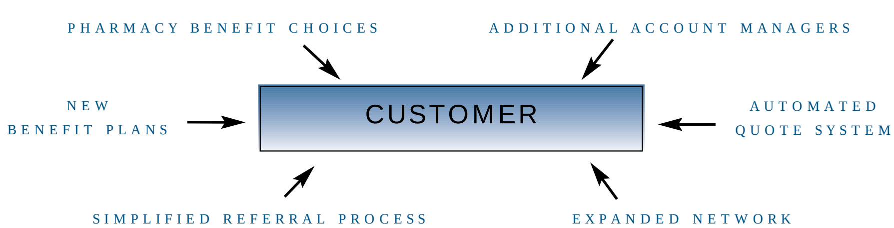
Installed a Systematic Approach to Sales

By implementing technology and process solutions for prospect management and improving communications with brokers and employer groups, Coventry has created a systematic approach that is performance based and designed to deliver results. Since its implementation in April 1998, the sales process has resulted in more than 3,500 new groups sold.

Renewed Focus on Customer

Coventry initiated a number of changes to become more customer oriented that, among other things, enhance member choice in medical and pharmacy benefits and reduce the "hassle factor" experienced in competitors' plans. Coventry's goal is to increase value to members, employers and brokers, resulting in new business growth and improved retention at appropriate premium levels.

CUSTOMER FOCUS



SELECTED FINANCIAL DATA

(in thousands, except per share data)

	december 31, 1998	1997	1996	1995	1994
Operations Statement Data [1]					
Operating revenues	$ 2,110,383	$ 1,228,351	$ 1,057,129	$ 852,390	$ 776,643
Operating earnings (loss)	(36,195)	5,739	(91,346)	(1,275)	55,023
Net earnings (loss)	(11,741)	11,903	(61,287)	18	29,288
Net earnings (loss) per share - basic [2]	(0.22)	0.36	(1.87)	-	0.96
Net earnings (loss) per share - diluted [2]	(0.22)	0.35	(1.87)	-	0.93
Weighted average common shares outstanding - basic [2][4]	52,477	33,210	32,818	31,526	30,511
Weighted average common shares outstanding - diluted [2][4]	52,477	33,912	32,818	32,150	31,550
Balance Sheet Data [1]					
Cash and investments	$ 614,582	$ 240,091	$ 168,423	$ 147,777	$ 133,975
Total assets	1,090,593	487,182	448,945	385,675	343,771
Long-term obligations and notes payable (including current maturities)	88,367	109,268	102,985	77,868	73,643
Stockholders' equity and partners' capital [3]	436,539	117,818	100,427	153,851	134,124

(1) *Amounts presented for 1998 reflect the acquisition of the Principal Health Care, Inc. ("PHC") health plans as of December 31, 1998 and include the results of operations of the acquired PHC health plans beginning April 1, 1998, the date of acquisition. See Management's Discussion and Analysis of Financial Condition and Results of Operations.*

(2) *Reflects the two-for-one split of the Company's common stock which occurred in August 1994.*

(3) *Predecessor company of a wholly owned subsidiary of the Company was an S Corporation.*

(4) *Restated to comply with SFAS 128, "Earnings per share."*

SELECTED FINANCIAL DATA

(in thousands, except per share data)

Supplementary Financial Information

The following is a summary of unaudited quarterly results of operations (in thousands, except per share data) for the years ended December 31, 1998 and 1997.

	Quarter Ended			
	March 31, 1998	June 30, 1998[1][2]	September 30, 1998	December 31, 1998[3]
Operating revenues	$ 330,209	$ 583,804	$ 593,278	$ 603,092
Operating earnings (loss)	7,178	(51,238)	2,179	5,686
Net earnings (loss)	4,707	(27,756)	5,068	6,240
Net earnings (loss) per share - basic	0.14	(0.47)	0.09	0.11
Net earnings (loss) per share - diluted	0.13	(0.47)	0.09	0.11

	Quarter Ended			
	March 31, 1997 [4]	June 30, 1997[5]	September 30, 1997[6]	December 31, 1997
Operating revenues	$ 299,345	$ 301,081	$ 306,694	$ 321,231
Operating earnings (loss)	(8,021)	1,997	5,976	5,787
Net earnings (loss)	(851)	6,590	2,658	3,506
Net earnings (loss) per share - basic	(0.03)	0.20	0.08	0.11
Net earnings (loss) per share - diluted	(0.03)	0.19	0.08	0.10

(1) *Effective April 1, 1998, the Company completed its acquisition of certain assets of PHC from Principal Life Insurance Company ("Principal Life"). The acquisition was accounted for using the purchase method of accounting and, accordingly, the operations of PHC have been included in the Company's consolidated financial statements since the date of acquisition. As a result of the merger, an estimated reserve of $7.8 million was established for the costs related to the relocation of the corporate office from Nashville, Tennessee to Bethesda, Maryland and other merger related expenses.*

(2) *The second quarter 1998 operating results were affected by the establishment of a reserve for the costs incurred by members covered by the AHERF agreement and other potential charges as a result of the bankruptcy filing by AHERF. The establishment of the reserves resulted in a charge to earnings of $55.0 million.*

(3) *The merger costs were less than the reserve established in the second quarter of 1998, resulting in a credit to earnings of $1.3 million.*

(4) *Effective March 31, 1997, the Company completed the sale of the majority of its medical offices in Pittsburgh, Pennsylvania associated with HealthAmerica Pennsylvania, Inc. ("HAPA") to a major health care provider organization. The sale price was $20.0 million and the transaction resulted in a pretax gain of approximately $6.0 million.*

(5) *Effective May 1, 1997, the Company completed the sale of the medical offices associated with Group Health Plan, Inc., its health plan in St. Louis, Missouri, to a major health care provider organization. The sale price was $26.9 million and the transaction resulted in a pretax gain of approximately $9.6 million.*

(6) *In August 1997, the Company entered into an agreement to sell the medical offices associated with HAPA's health plan operations in Harrisburg, Pennsylvania. The sale price was $2.0 million and the transaction resulted in a pretax loss of $0.2 million. Also in the third quarter, the Company sold its two remaining medical offices located in Pittsburgh, Pennsylvania for $0.3 million in cash and recorded a pretax loss of $0.4 million.*

The following discussion should be read in conjunction with the accompanying audited consolidated financial statements and notes.

RESULTS OF OPERATIONS

The following table (in thousands, except percentages and membership data) is provided to facilitate a more meaningful discussion regarding the results of the Company's operations for the three years ended December 31, 1998.

	1998				1997			1996	
	Amount	Percent of Operating Revenues	Percent Increase (Decrease)	Amount	Percent of Operating Revenues	Percent Increase (Decrease)	Amount	Percent of Operating Revenues
Operating revenues:								
Managed care premiums	$ 2,033,372	96.4%	68.3%	$ 1,208,149	98.4%	16.6%	$ 1,035,778	98.0%
Management services	77,011	3.6%	281.2%	20,202	1.6%	(5.4%)	21,351	2.0%
Total operating revenues	2,110,383	100.0%	71.8%	1,228,351	100.0%	16.2%	1,057,129	100.0%
Operating expenses:								
Health benefits [1]	1,767,374	83.7%	70.0%	1,039,860	84.7%	11.7%	940,532	89.0%
Selling, general and administrative	291,919	13.8%	71.7%	170,017	13.8%	3.0%	165,081	15.6%
Depreciation and amortization	25,793	1.2%	102.5%	12,735	1.0%	(70.3%)	42,862	4.1%
AHERF charge	55,000	2.6%	-	-	-	-	-	-
Merger costs	6,492	0.3%	-	-	-	-	-	-
Operating earnings (loss)	(36,195)	(1.7%)	(730.7%)	5,739	0.5%	106.3%	(91,346)	(8.6%)
Other income, net	27,251	1.3%	9.5%	24,880	2.0%	86.0%	13,379	1.3%
Interest expense	(8,566)	(0.4%)	(16.6%)	(10,275)	(0.8%)	64.2%	(6,257)	(0.6%)
Earnings (loss) before income taxes and minority interest	(17,510)	(0.8%)	(186.1%)	20,344	1.7%	124.2%	(84,224)	(8.0%)
Net earnings (loss)	$ (11,741)			$ 11,903			$ (61,287)	
Membership at December 31:								
Commercial	1,000,699			622,942			599,218	
Governmental Programs	166,342			142,881			141,889	
Non-risk	218,273			148,910			152,969	
	1,385,314			914,733			894,076	

[1] *The medical loss ratio (health benefits as a percentage of managed care premiums) was 86.9%, 86.1% and 90.8% in 1998, 1997 and 1996, respectively.*

GENERAL

Effective April 1, 1998, the Company completed its acquisition of certain assets of PHC from Principal Life for a total purchase price of $330.2 million including transaction costs of approximately $5.7 million. The acquisition was accounted for using the purchase method of accounting, and accordingly, the operating results of the PHC plans have been included in the Company's consolidated financial statements since the date of acquisition.

Coincident with the closing of the transaction, the Company entered into a Marketing Services Agreement and a Management Services Agreement with Principal Life. Both agreements extend through December 31, 1999. Pursuant to these agreements, the Company recognized approximately $23.0 million for the year ended December 31, 1998, and expects to receive payments of approximately $26.4 million in 1999.

As a result of the transaction, the Company assumed an agreement with Principal Life, whereby Principal Life pays a fee for access to the Company's PPO network based on a fixed rate per each employee entitled to access the PPO network and a percentage of savings realized by Principal Life. Under this agreement, the Company recognized approximately $12.0 million

MANAGEMENT'S DISCUSSION AND ANALYSIS

for the year ended December 31, 1998. The maximum amount that can be paid under the percentage of savings component of the agreement is $8.0 million for 1999.

Effective November 30, 1998, the Company sold its subsidiary, Principal Health Care of Illinois, Inc. for $4.3 million in cash. This plan had approximately 56,000 risk members and approximately 2,400 non-risk members as of November 30, 1998 and reported $71.1 million in revenues since April 1, 1998, the date of acquisition.

Effective December 31, 1998, the Company sold its subsidiary, Principal Health Care of Florida, Inc. for $95.0 million in cash. The Florida Health plan had approximately 156,000 risk members and approximately 5,500 non-risk members at December 31, 1998 and reported $172.5 million in revenues since April 1, 1998, the date of acquisition.

The proceeds from both sales were used to retire the Credit Facility, to assist in improving the capital position of the Company's regulated subsidiaries, and for other general corporate purposes.

In March 1997, the Company entered into a global capitation agreement with Allegheny Health, Education and Research Foundation ("AHERF") covering approximately 250,000 members in the western Pennsylvania market. Under the Agreement AHERF received 78% to 82% of the premium to cover all of the medical expenses of the capitated members. In July 1998, AHERF filed for bankruptcy protection under Chapter 11. As a result, the Company, which is ultimately responsible for the medical costs of the capitated members, recorded a charge of $55.0 million to establish a reserve for the medical costs incurred by members covered by the AHERF agreement at the time of the bankruptcy filing and other potential bankruptcy charges. Under applicable bankruptcy laws, AHERF could reject and refuse to perform under the global capitation agreement. Generally, under Chapter 11, a debtor company such as AHERF may affirm or reject its contractual obligations prior to confirmation of a plan of reorganization, and if a contract is rejected, the contractual damages become an unsecured claim in the Chapter 11 proceeding. Although AHERF has not formally rejected the risk- sharing agreement as of the date of this filing, the parties are negotiating a resolution of the arrangement and, currently, neither AHERF nor the Company is operating under the existing agreement. The Company has filed a lawsuit against certain hospital subsidiaries of AHERF that were not included in the bankruptcy filing. The lawsuit is seeking a court order declaring that the Company is not liable for the payment of $21.5 million of medical services provided by the hospitals to the Company's members prior to the date of AHERF's bankruptcy filing and compelling the hospitals to fulfill their contractual obligations to continue to provide health care services to the membership in western Pennsylvania. The lawsuit also includes a claim for damages to recover the losses incurred by the Company as a consequence of AHERF's default of its obligations under the risk-sharing agreement. In response to the lawsuit, the hospitals have filed a counterclaim alleging that HAPA, notwithstanding AHERF's assumption of the payment obligation, is liable to the hospitals for the payment of medical services provided prior to AHERF's bankruptcy. The Company intends to vigorously defend against the counterclaim. The Company believes that the reserve established is adequate to provide for the claims incurred with respect to the AHERF arrangement and other related AHERF bankruptcy uncertainties. For the year ended December 31, 1998, $33.8 million has been paid for medical claims related to this reserve.

During the three years ended December 31, 1998, the Company experienced substantial growth in operating revenues due primarily to membership growth, much of which was attributable to the acquisition of the PHC plans effective April 1, 1998. Additional membership growth was achieved through marketing efforts, acquisitions, geographic expansion and increased product offerings.

The Company's managed care premium revenues during the three years ended December 31, 1998 were comprised primarily of premiums from its commercial HMO products and flexible provider products, including PPO and POS products for which the Company assumes full underwriting risk. Premiums for such PPO/POS products are typically lower than HMO premiums due to medical underwriting and higher deductibles and copayments that are required from the PPO/POS members. Prior to the sale of the Company's medical offices discussed below, additional revenue was received from other medical services provided on a fee- for-service basis in those medical offices.

Premium rates for commercial HMO products are reviewed by various state agencies based on rate filings. While the Company has not had such filings modified, no assurance can be given that approvals for rate submissions will continue. Premium rates for the Medicaid and Medicare risk products are established by governmental regulatory agencies and may be reduced by regulatory action.

The Company's management services revenues result from operations in which the Company's health plans provide administrative and other services to self-insured employers and to employer group beneficiaries that have elected HMO coverage under products jointly marketed with Principal Life. The Company receives an administrative fee for these services, but does not assume underwriting risk. In addition, the Company also offers a PPO product to other third party payors, under which it provides rental of and access to the Company's PPO network, claims repricing and utilization review, and does not assume underwriting risk.

The Company's operating expenses are primarily medical costs including medical claims under contracted relationships with a wide variety of providers, capitation payments and, prior to their sale in 1997, expenses relating to the operation of the Company's health centers. Medical claims expense also includes an estimate of claims incurred but not reported ("IBNR"). The Company believes that the estimates for IBNR liabilities relating to its businesses are adequate in order to satisfy its ultimate claims liability with respect thereto. In determining the Company's medical claims reserves, the Company employs plan by plan standard actuarial reserving methods (specific to the plan's membership, product characteristics, geographic territories and provider network) that consider utilization frequency and unit costs of inpatient, outpatient, pharmacy, and other medical costs as well as claim payment backlogs and the changing timing of provider reimbursement practices. Calculated reserves are reviewed by underwriting, finance and accounting, and other appropriate plan and corporate personnel and judgments are then made as to the necessity for reserves in addition to the above calculated amounts. Changes in assumptions for medical costs caused by changes in actual experience, changes in the delivery system, changes in pricing due to ancillary capitation and fluctuations in the claims backlog could cause these estimates to change in the near term. The Company periodically monitors and reviews IBNR, and as actual settlements are made or reserves adjusted, differences are reflected in current operations.

Comparison of 1998 to 1997

Managed care premiums increased in 1998 $825.2 million, or 68.3%, compared to 1997. The PHC plans accounted for approximately $697.7 million, or 84.6%, of the increase. Exclusive of the PHC plans, the Medicare risk membership increased by 25,285 members, or 66.0%. Medicare risk membership has a significantly higher per member per month premium (approximately three times) when compared to commercial risk membership and represented an increase in premiums, exclusive of the PHC plans, of $117.9 million from $161.1 million in 1997 to $279.0 million in 1998. The increase in Medicare risk membership was offset by a 20,047 decrease in Medicaid risk membership primarily resulting from the Company's decision to exit the Medicaid market in Pennsylvania in the first quarter of 1998. In addition, revenues per member per month, exclusive of the PHC plans, increased by 3.3% for HMO members, 8.3% for PPO/POS members and 5.5% for Medicaid members in 1998 over 1997. Excluding Medicaid membership, risk membership grew by 25,885, or 3.9%. The Company continues to implement rate increases that averaged approximately 7% in the fourth quarter of 1998 and expects similar rate increases to be implemented in 1999.

The Company has exited the Medicare program in several counties representing approximately 18,000 members as of December 31, 1998. Approximately 10,000 of those members were in the Illinois and Florida health plans that were sold effective November 30, 1998 and December 31, 1998, respectively. The remaining markets are being exited because the reimbursement rates are not adequate and/or the Company was not successful in negotiating adequate reimbursement rates.

Management services revenue increased $56.8 million for the year ended December 31, 1998, or 281.2%, from the prior year. Management services and marketing services agreements that were entered into coincident with the acquisition of the PHC plans accounted for approximately $23.0 million, or 40.5%, of the increase. Approximately $30.5 million, or 53.7%, of the increase is primarily attributable to the PHC Administrative Services Only ("ASO") operations and PPO access fees. Exclusive of the PHC plans and the related agreements with Principal Life, management services revenue increased approximately $3.3 million, or 5.8%, attributable to transition services related to global capitation agreements and rate increases to ASO customers.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Membership

	Commercial Risk		Governmental Risk			
	HMO	PPO/POS	Medicare	Medicaid	Non-Risk	Total
1998						
Pennsylvania	207,067	194,539	25,571	-	103,288	530,465
St. Louis [(1)]	138,031	62,615	38,028	81,505	23,029	343,208
Richmond	51,980	264	-	3,015	14,812	70,071
Nebraska	34,598	-	-	-	720	35,318
Kansas City	51,993	-	-	-	5,526	57,519
Wichita	35,342	-	-	-	399	35,741
Louisiana	39,730	-	-	-	161	39,891
Delaware	37,500	-	-	16,829	58,062	112,391
Iowa	77,912	-	-	1,394	10,778	90,084
Indiana	27,280	-	-	-	750	28,030
Georgia	20,273	-	-	-	748	21,021
Carolina	21,575	-	-	-	-	21,575
Total	743,281	257,418	63,599	102,743	218,273	1,385,314
1997						
Pennsylvania	238,122	174,157	12,141	23,683	111,087	559,190
St. Louis	103,456	52,932	26,173	78,323	21,281	282,165
Richmond	54,095	180	-	2,561	16,542	73,378
Total	395,673	227,269	38,314	104,567	148,910	914,733

[(1)] *St. Louis includes PHC of St. Louis membership in 1998.*

Health benefits expense increased $727.5 million for the year ended December 31, 1998, or 70.0%, compared to 1997. The PHC plans accounted for approximately $612.5 million, or 84.2%, of the increase. The Company's medical loss ratio increased slightly to 86.9% from 86.1% in the previous year, primarily as a result of increases in Medicare membership.

The Company continues to focus intensely on ways to control its medical costs, including implementation of best practices to reduce inpatient days and improvement of the overall quality and level of care. The Company is also continuously monitoring and renegotiating with its provider networks to improve reimbursement rates and improve access to the network for its members.

As previously discussed, in July 1998, AHERF, the global capitation provider organization in western Pennsylvania, filed for bankruptcy protection under Chapter 11. As a result, the extent to which AHERF will perform its obligations under the global capitation agreement is uncertain. In addition to the charge to provide for the estimated claims that were incurred but not reported ("IBNR") on behalf of the globally capitated members at the date of the bankruptcy filing, the medical loss ratio for the globally capitated members was negatively impacted compared to the percentage of premium paid to AHERF under the global capitation agreement. In addition, the Company increased administrative staff for patient utilization and medical management in western Pennsylvania.

Medical claim liability accruals are periodically monitored and reviewed with differences for actual settlements from reserves reflected in current operations. In addition to the procedures for determining reserves as discussed above, the Company reviews the actual payout of claims relating to prior period accruals, which may take up to six months to fully develop. Medical costs are affected by a variety of factors, including the severity and frequency of claims, that are difficult to predict and may not be entirely within the Company's control. The Company continually refines its reserving practices to incorporate new cost events and trends.

Selling, general and administrative ("SGA") expense for the year ended December 31, 1998 increased $121.9 million, or 71.7%, compared to 1997. The PHC plans accounted for approximately $92.8 million, or 76.1%, of the increase. The remainder of the increase in SGA is primarily attributable to the increased costs relating to administrative processes, particularly in claims processing, associated with the growth of the Medicare product in certain markets. SGA expense as a percent of revenue remained at 13.8% for the year ended 1998. In an effort to control costs and improve customer service, the Company is in the process of migrating certain of its operating activities (e.g., customer service, claims processing, billing and enrollment) to regional service centers. It is anticipated that the service centers will be fully operational in the fourth quarter of 1999.

Depreciation and amortization for the year ended December 31, 1998 increased $13.1 million, or 102.5%, compared to 1997. Depreciation expense from the PHC plans accounted for approximately $2.3 million, or 17.6%, of the increase. The remainder of the increase is attributable to the amortization of intangibles and goodwill recorded in connection with the acquisition of the PHC plans.

Loss from operations was $36.2 million for the year ended December 31, 1998. Excluding the $61.5 million of charges associated with the AHERF bankruptcy and the relocation of the corporate headquarters and other merger related costs, operating earnings were $25.3 million for the year ended December 31, 1998 compared to $5.7 million for the corresponding period in 1997. The increase in the operating earnings, exclusive of the $61.5 million of charges in 1998, is attributable to various factors as previously described.

Other income, net of interest expense, increased $4.1 million for the year ended December 31, 1998, or 27.9%, from the corresponding period in the prior year. Other income, net of interest expense, related to the PHC plans accounted for approximately $10.1 million, or 246.3%, of the increase. Exclusive of the PHC plans, other income, net of interest expense, decreased by $6.0 million. This reduction was primarily attributable to a $15.0 million pre-tax gain related to the sale of medical offices that was recognized in the prior year, offset by increased investment income resulting from the increase in invested assets subsequent to the acquisition of the PHC plans.

The Company's net loss was $11.7 million for the year ended December 31, 1998. Net loss per common and common equivalent share was $0.22 for the year ended December 31, 1998 compared to earnings per common and common equivalent share of $0.35 for the corresponding period in 1997. Excluding the $61.5 million of charges associated with the AHERF bankruptcy and the relocation of the corporate headquarters and other merger related costs, the Company reported earnings per common and common equivalent share of $0.50 in 1998. The weighted average number of common shares outstanding were approximately 52,477,000 and 33,912,000 for the years ended December 31, 1998 and 1997, respectively. The increase in the weighted average number of shares outstanding in 1998 was primarily attributable to the shares issued in April 1998 related to the acquisition of the PHC plans. Effective in the fourth quarter of 1997, the Company adopted SFAS 128, "Earnings Per Share." Accordingly, prior periods have been restated.

Comparison of 1997 to 1996

Managed care premiums increased $172.4 million, or 16.6% to $1,208 million for 1997 compared to 1996. The revenue increase for the year was enhanced by the growth in Medicare risk membership of 18,024 (which has a significantly higher per member per month premium when compared to the commercial and Medicaid products and represented an increase in premiums of $98.2 million from $62.9 million in 1996 to $161.1 million in 1997) and increases in premium rates as members renew. Premium yields on HMO, PPO/POS and Medicaid members increased by 3.0%, 3.1% and 4.5% in 1997 compared to 1996, respectively. The revenue increase is also a result of risk membership growth of 20,657, or 2.3%, from the prior year. The relatively small growth in risk membership reflects the closing of the Florida Medicaid plan effective June 30, 1997, which had 21,747 members. Excluding the impact of exiting Florida, risk membership grew by 52,758, or 7.4%.

Membership	Commercial Risk		Governmental Risk			
	HMO	PPO/POS	Medicare	Medicaid	Non-Risk	Total
1997						
Pennsylvania	238,122	174,157	12,141	23,683	111,087	559,190
St. Louis	103,456	52,932	26,173	78,323	21,281	282,165
Richmond	54,095	180	-	2,561	16,542	73,378
Jacksonville	-	-	-	-	-	-
Total	395,673	227,269	38,314	104,567	148,910	914,733
1996						
Pennsylvania	267,733	136,756	5,359	14,134	117,465	541,447
St. Louis	97,689	39,579	14,931	76,829	24,574	253,602
Richmond	57,047	104	-	2,904	10,930	70,985
Jacksonville	310	-	-	27,732	-	28,042
Total	422,779	176,439	20,290	121,599	152,969	894,076

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Health benefits expense increased $109.1 million, or 11.7%, in 1997, compared to 1996, as a result of the increase in risk enrollment and increases in medical costs. The Company's medical loss ratio decreased to 86.1% from 89.9% in the previous year. Medical loss ratios in western Pennsylvania and St. Louis decreased due to the global capitation agreements signed in 1997. Approximately $232.9 million and $70.8 million (22.4% and 6.8% of health benefit expense for the 1997 period) represented amounts paid or accrued with respect to global capitation agreements with AHERF and BJC, respectively. See "Risk Factors — Risks of Agreements with Providers" for a discussion of the credit and operational risk associated with global capitation agreements with single provider organizations. Medical loss ratios increased in the central Pennsylvania region due to increases in inpatient alternatives (such as outpatient surgery), referrals to specialists, pharmacy and increased health benefit expense associated with the Medicaid membership. Significant medical cost increases in the Medicare risk product in St. Louis, Missouri were a result of increased Medicare risk membership and utilization of inpatient services.

The Company determined, at the end of 1996, that its Florida operations were not sufficiently profitable to justify a continued presence in the Florida market and, as a result, the Company discontinued operations in the Florida HMO market on June 30, 1997. The Company established a reserve of $1.2 million at December 31, 1996 to reflect the anticipated costs of exiting this market and the reserve is believed to be sufficient to cover the anticipated costs. During the third quarter of 1997, the Company began to exit its Medicaid operations in Pennsylvania. The Company fully exited the western and central Pennsylvania Medicaid markets effective December 31, 1997 and March 31, 1998, respectively.

Medical claim liability accruals are periodically monitored and reviewed with differences for actual settlements reflected in current operations. In addition to the Company's procedures for determining reserves as discussed above, the Company reviews the actual payout of claims relating to prior period accruals, which may take up to six months to fully develop. Medical costs are affected by a variety of factors, including the severity and frequency of claims, that are difficult to predict and may not be entirely within the Company's control. The Company continually refines its reserving practices to incorporate new cost events and trends.

Selling, general and administrative ("SGA") expense increased $4.9 million, or 3.0%, from the prior year, but as a percent of revenue decreased from 15.6% in 1996 to 13.8% in 1997. SGA in 1996 included termination costs of $8.1 million and charge-off of capitalized new market development costs of $4.3 million. The increase in SGA in 1997 is primarily attributable to the increase in full risk membership, additional personnel costs relating to the re-engineering of administrative processes in claims processing, information systems and customer services and costs associated with the growth of the Company's Medicare risk product.

Depreciation and amortization decreased $30.1 million, or 70.3%, from 1996. This decrease is primarily the result of the medical office sales in 1997, write-off of $20.1 million of goodwill related to the acquisition of PARTNERS Health Plan of Pennsylvania, Inc. due to application of SFAS 121 and APB 17 in 1996 and charge-offs of $4.3 million of property and equipment due to application of the impairment criteria of SFAS 121 in 1996.

Income from operations was $5.8 million, a $97.1 million improvement over the prior year. Excluding the 1996 termination costs, contract loss provisions, capitalized costs, goodwill and other charge-offs, operating income in 1997 was a $56.3 million improvement over the loss for 1996. This $56.3 million improvement in operating income for 1997 is primarily attributable to strong membership and revenue increases, a lower medical loss ratio, a lower SGA expense ratio and lower depreciation and amortization resulting from the medical office sales.

Other income increased $11.5 million. Effective March 31, 1997, the Company sold substantially all of its western Pennsylvania medical offices to AHERF. The sales price was $20 million and the transaction resulted in a pretax gain of approximately $6.0 million. Also, effective May 1, 1997, the Company completed the sale of its St. Louis, Missouri medical offices to BJC. The sales price was $26.9 million and the transaction resulted in a pretax gain of approximately $9.6 million. During the third quarter, the Company completed the sale of the remaining medical offices in Pennsylvania. The sales price for the third quarter transactions was $2.4 million and resulted in a pretax loss of $0.6 million. Other income for 1996 included a $4.9 million gain on the sale of Champion Dental Services, Inc., a subsidiary of Group Health Plan, Inc.

Investment income increased $2.4 million primarily due to higher cash and investments when compared to the prior year. Interest expense increased $4.0 million due primarily to a higher interest rate on the Company's term loan.

The Company's net income was $11.9 million, or $73.2 million more than the prior year. Net income per common and common equivalent share was $0.35 per share in 1997 compared to a $1.87 loss per share in 1996. The weighted average number of common shares outstanding were approximately 33,912,000 and 32,818,000 for the year ended December 31, 1997 and 1996, respectively. Effective in the fourth quarter, the Company adopted SFAS 128, "Earnings Per Share." Accordingly, prior periods have been restated.

Liquidity and Capital Resources

The Company's total cash and investments, excluding deposits of $12.8 million restricted under state regulations, increased $367.7 million to $601.8 million at December 31, 1998 from $234.1 million at December 31, 1997. The increase is primarily attributable to the acquisition of the PHC plans that increased cash and investments by $250.3 million as of April 1, 1998, the date of acquisition, as well as the net proceeds from the sale of the Florida and Illinois health plans that were effective December 31, 1998 and November 30, 1998, respectively. The Company's investment guidelines emphasize investment grade fixed income instruments in order to provide short-term liquidity and minimize the risk to principal. The Company believes that since its long-term investments are available for sale, the amount of such investments should be added to current assets when assessing the Company's working capital and liquidity; on such basis, current assets plus long-term investments available for sale less short-term liabilities increased to $187.3 million at December 31, 1998 from $76.4 million at December 31, 1997.

The Company's HMOs and insurance company subsidiary are required by state regulatory agencies to maintain minimum surplus balances, thereby limiting the dividends the Company may receive from its HMOs and insurance company subsidiary. After giving effect to these statutory reserve requirements, the Company's regulated subsidiaries had surplus in excess of statutory requirements of approximately $93.4 million and $52.9 million at December 31, 1998 and December 31, 1997, respectively. The Company will be required to provide additional capital to its regulated subsidiaries to provide for additional medical claim liabilities related to the AHERF bankruptcy. Excluding funds held by entities subject to regulation, the Company had cash and investments of approximately $96.8 million and $28.6 million at December 31, 1998 and December 31, 1997, respectively, which are available to pay intercompany balances to regulated subsidiaries and for general corporate purposes. The Company also has entered into agreements with certain of its regulated subsidiaries to provide additional capital if necessary to prevent the subsidiary's insolvency.

On December 29, 1997, the Company entered into a credit agreement with a group of banks (the "Credit Facility"), which replaced a prior credit agreement. Using a portion of the proceeds received from the sale of its Florida health plan, the Company retired the Credit Facility and the $42.2 million balance then outstanding effective December 31, 1998. On December 31, 1998, the effective interest rate on the indebtedness retired was 7.0625%.

During the quarter ending June 30, 1997, the Company entered into a securities purchase agreement ("Warburg Agreement") with Warburg, Pincus Ventures, L.P. ("Warburg") and Franklin Capital Associates III, L.P. ("Franklin") for the purchase of $40 million of Coventry's 8.3% Convertible Exchangeable Senior Subordinated Notes ("Coventry Notes"), together with warrants to purchase 2.35 million shares of the Company's common stock for $42.35 million. The Coventry Notes are convertible into 4.0 million shares of the Company's common stock and are exchangeable at the Company's or Warburg's option for shares of convertible preferred stock. Interest is payable in additional Coventry Notes and, as a result, the accrued interest at December 31, 1998 has been added to the outstanding indebtedness, resulting in $45.5 million of Coventry Notes outstanding at such date.

Projected capital investments in 1999 of approximately $16.9 million consist primarily of computer hardware, software and related equipment costs associated with the development and implementation of improved operational and communications systems.

The Company believes that cash flows generated from operations, cash on hand and investments, and excess funds in certain of its regulated subsidiaries will be sufficient to fund continuing operations through December 31, 1999.

Legislation and Regulation

Numerous proposals have been introduced in the United States Congress and various state legislatures relating to health care reform. Some proposals, if enacted, could among other things, restrict the Company's ability to raise prices and to contract independently with employers and providers. Certain reform proposals favor the growth of managed health care, while others would adversely affect managed care. Although the provisions of any legislation adopted at the state or federal level cannot be accurately predicted at this time, management of the Company believes that the ultimate outcome of currently proposed legislation would not have a material adverse effect on the Company and its results of operations in the short-term.

Litigation and Insurance

The Company may be subject to certain types of litigation, including medical malpractice claims, claim disputes pertaining to contracts and other arrangements with providers, employer groups and their employees and individual members, and disputes relating to HMO denials of coverage for certain types of medical procedures or treatments. In addition, the Company has contingent litigation risk in connection with certain discontinued operations. Such litigation may result in losses to the Company. The Company maintains insurance coverage in amounts it believes to be adequate, including professional liability (medical

MANAGEMENT'S DISCUSSION AND ANALYSIS

malpractice) and general liability insurance. Contracting physicians are required to maintain professional liability insurance. In addition, the Company carries "stop-loss" reinsurance to reimburse it for costs resulting from catastrophic injuries or illnesses to its members. Nonetheless, no assurance can be given as to the future availability or cost of such insurance and reinsurance or that litigation losses will not exceed the limits of the insurance coverage and reserve. In the opinion of management and based on the facts currently known, the outcome of these actions should not have a material adverse effect on the financial position or results of operations of the Company.

New Accounting Standards

The Financial Accounting Standards Board ("FASB") has issued Statement of Financial Accounting Standards ("SFAS") No. 128 "Earnings Per Share" which is effective for both interim and annual reporting periods ending after December 15, 1997. The Company adopted the new standard in its reporting for the quarter and the year ended December 31, 1997, including required restatement of prior periods. The adoption of this standard did not have a material impact on earnings per share.

The FASB has also issued SFAS No. 130, "Reporting Comprehensive Income," which is effective for fiscal years beginning after December 15, 1997 and requires restatement of earlier financial statements for comparative purposes. SFAS No. 130 requires that changes in the amounts of certain items, including unrealized gains and losses on certain securities, be reflected in the financial statements. The Company adopted SFAS 130 effective January 1, 1998. The adoption of this standard did not have a material effect on the Company's consolidated financial statements.

The FASB has also issued SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information." This standard requires that a public business enterprise report financial and descriptive information about its reportable operating segments. Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. SFAS No. 131 also requires that all public business enterprises report information about the revenues derived from the enterprise's products or services (or groups of similar products and services), about the countries in which the enterprise earns revenues and holds assets and about major customers regardless of whether that information is used in making operating decisions. Effective December 31, 1998, the Company adopted SFAS 131.

In June 1998, the FASB issued SFAS 133, "Accounting for Derivative Instruments and Hedging Activities." This Statement requires companies to record derivatives on the balance sheet as assets or liabilities, measured at fair value. Gains or losses resulting from changes in the values of those derivatives would be accounted for depending on the use of the derivative and whether they qualify for hedge accounting. This standard is effective for fiscal years beginning after June 15, 1999. The Company does not believe that adoption of this standard will have a material effect on its future results of operations.

In March 1998, the American Institute of Certified Public Accountants ("AICPA") issued Statement of Position 98-1 ("SOP 98-1"), "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." SOP 98-1 provides authoritative guidance for the capitalization of certain costs related to computer software developed or obtained for internal applications, such as external direct costs of materials and services, payroll costs for employees and certain interest costs. Costs incurred during the preliminary project stage, as well as training and data conversion costs, are to be expensed as incurred. SOP 98-1 is effective for fiscal years beginning after December 15, 1998. The Company does not believe that adoption of this standard will have a material effect on its future results of operations.

Inflation

Health care cost inflation has exceeded the general inflation rate and the Company has implemented cost control measures and risk sharing arrangements which seek to reduce the effect of health care cost inflation. During 1998, the Company implemented increases in premiums rates designed to offset at least a portion of inflationary cost increases while maintaining competitive rates within its markets.

1999 Outlook

The Company's membership in January 1999 was approximately 1,397,000 members, an increase of 52.5% over January 1998. The increase was primarily attributable to the acquisition of the PHC plans. Of the January 1999 membership, approximately 1,156,000 were risk members and approximately 241,000 were non-risk members.

The Company operates in highly competitive markets, but generally believes that the pricing environment is improving in its existing markets, thus creating the opportunity for reasonable price increases. However, there is no assurance that the Company will be able to increase premiums at rates equal to or in excess of increases in its health care costs.

MANAGEMENT'S DISCUSSION AND ANALYSIS

For 1999, the Company continues to pursue ways to improve its underwriting processes and oversight in both risk and management services products with the objective of increasing premium yields and profitable growth in its markets. The Company's migration of certain of its operating activities (e.g., customer service, claims processing, billing and enrollment) to regional service centers is expected to be completed by the fourth quarter of 1999. The Company expects that the regional service centers will allow it to provide improved levels of service in a more cost effective manner. The integration of the PHC health plans has allowed the Company to strengthen its balance sheet and gain entry into additional markets. Management believes that existing markets have potential for growth for the Company's commercial and governmental products. Management believes that the foregoing should result in progressive improvements in 1999, although realization is dependent upon a variety of factors, some of which may be outside the control of the Company.

Impact of Year 2000

The Company's business is significantly dependent on information systems. The Company has implemented a Year 2000 readiness program designed to prevent material information system disruption associated with the Millennium date change. The program includes an inventory and review of all core application systems, networks, desktop systems, infrastructure and critical information supply chains. The Company's Year 2000 readiness program can be broken down into five categories: 1) IS hardware, software and networks, 2) office equipment which relies on microchips or telecommunications, 3) buildings and facilities, 4) business partners and customers, and 5) business risk and contingency planning. It is anticipated that the program will be substantially completed by the end of the second quarter of 1999. The total estimated cost of the program is approximately $13.1 million, of which $9.0 million has been incurred through December 31, 1998. The cost of Year 2000 modifications is based on management's best estimates. Actual costs, however, may differ from those currently anticipated. All Year 2000 initiatives are monitored by a steering committee made up of management personnel representing the Company's legal, compliance, finance, actuarial, medical and IS departments. The steering committee reports the status of the Company's Year 2000 readiness program to senior management who report to the board of directors.

While the Company currently believes that its planning efforts and anticipated modifications to existing systems and purchases of new systems will be adequate to address its Year 2000 concerns, there can be no assurance that the systems of other companies on which the Company's systems and operations rely will be converted on a timely basis and will not have a material adverse effect on the Company.

The specific phases of the Year 2000 readiness program are as follows:

IS Hardware, Software and Networks

The Company has historically purchased its core software applications rather than build them. The Company is currently operating on two different platforms for its core managed health care software applications. The former Coventry Corporation health plans use the IDX managed care system. The current release of that system is vendor certified to be Year 2000 compliant and the Company has converted its applications to that current release. Final testing of the conversion is in process. All integration testing and operating system upgrades are scheduled for completion by May 30, 1999. The former PHC health plans are using a different third party product, which has been customized and is no longer supported by the vendor. That system utilizes Julian dates for all internal processes and is Year 2000 compliant. As part of the Company's readiness program, the entire application has been reviewed and necessary changes identified. Those programming modifications have been completed, tested and are in production. The computer operating systems are tested and two are in production. It is anticipated that the remaining systems will be in production by April 15, 1999.

The Company has requested all vendors of currently installed software to disclose their products' current Year 2000 readiness and their plan for achieving Year 2000 readiness. All internally developed systems were inventoried and plans were made to either upgrade, modify or replace them as necessary to make them Year 2000 compliant. All vendor software code except as noted is certified to be Year 2000 ready. All network and server hardware and software systems have been tested and repaired and are now Year 2000 compliant with the exception of PC upgrades which will be completed by September 30, 1999.

Other major purchased applications that are non-compliant are being replaced by upgraded software from vendors or replaced by new purchased systems. Those applications include replacements for the Company's general ledger and financial reporting applications, a data warehouse for financial and medical information decision support, and a proposal and rating system to support the underwriting and marketing processes. The general ledger, underwriting and data warehouse systems are complete and in production. Non critical financial and human resource systems are scheduled to be completed by July 31, 1999.

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Office Equipment

The Company has requested its significant office equipment vendors to submit Year 2000 readiness statements about their products. The Company expects that it will receive substantially all of such statements by June 1999 and is determining the extent to which nonconforming office equipment should be upgraded or replaced. Second notices to non-conforming or non-responding vendors have been issued.

Buildings and Facilities

All landlords and building management companies have been sent surveys with respect to each key operating and security system in Company locations. The Company currently anticipates that this process will be complete by June 1999. Surveys received have been evaluated to assess potential risks. Second requests have been sent to landlords and management companies that have not yet responded.

Business Partners and Customers

The Company is in the process of communicating with its key business associates, such as financial institutions, third party vendors, provider and hospital networks, contractors and service providers to ensure that those parties have appropriate plans to remediate Year 2000 issues where their systems interface with the Company's systems or otherwise impact its operations. The Company is assessing the extent to which its operations are vulnerable should those organizations fail to remediate properly their computer systems. The Company anticipates that these communications will be completed by June 1999; however, the Company has little or no control over the efforts of those key business associates and other suppliers to become Year 2000 compliant. Certain of the services provided by those parties, particularly telecommunications providers, financial institutions and major hospitals and medical care providers, could have a material adverse effect on the Company's financial condition and results of operations if these services or operations are not Year 2000 compliant.

Risk Assessment and Contingency Planning

The Company is reviewing its existing contingency plans for necessary modifications to address specific Year 2000 issues, and expects to continue this process through September 30, 1999. As part of its contingency planning the Company is analyzing the most reasonable likely worst case scenario that could result from Year 2000-related failures. The Company's best estimate of that scenario, based on current information would involve a combination of major operational disruptions by its principal depository financial institutions, utility and telecommunication suppliers and its largest hospital and provider networks in its Pennsylvania and Missouri markets. The Company's Year 2000 readiness program and contingency planning efforts are designed to prevent and/or mitigate the effects of such possible failures.

Risk Factors

Risks of Governmental Programs and Regulations

The Company's industry is heavily regulated and the laws and rules governing the industry and interpretations of those laws and rules are subject to frequent change. Existing or future laws and rules could force the Company to change how it does business and may restrict the Company's revenue and/or enrollment growth and/ or increase its health care and administrative costs. Regulatory approvals must be obtained and maintained to market many of the products and services of the Company. Delays in obtaining or failure to obtain or maintain such approvals could adversely affect the Company's revenue or the number of covered lives, or could increase costs.

The Company is subject to risks associated with offering Medicaid and Medicare risk products, including pricing and other regulatory restrictions, potentially higher medical loss ratios and risks associated with entering new markets. The Company currently intends to continue to expand these products, and its exposure to such risks will increase. The Company's HMO subsidiaries that provide managed health care services under the Federal Employees Health Benefits Program are subject to audit, in the normal course of business, by the OPM, and such audits could result in material adjustments. As discussed in "Government Regulation," the Company's financial results are also susceptible to future state and federal regulatory measures, including health care reform. Recently, the Clinton Administration and various leaders of the U.S. Congress have proposed legislation which could result in increased costs to managed care providers.

Limitations on Ability to Increase Revenues

Increases in the Company's revenues will be generally dependent upon its ability to increase premiums and membership as well as the mix of the products sold. The Company's membership, excluding the membership acquired from PHC, recently has shown only moderate increases. Although premium rates for managed care plans generally have increased recently, competitive pressures, regulatory restrictions and consumer preference for lower-priced health care options may cause decreases or severely limit increases in the future. The premiums from governmental programs, such as Medicare or Medicaid, are generally not based on an individual company's anticipated costs and cannot be adjusted by the Company. Recent legislation has limited Medicare premium increases substantially compared to prior years. Certain of the Company's customers represent a significant percentage of the membership of one or more of its respective health plans, and the loss of one or more of such customers could cause a material adverse effect on the revenues of the Company in the future.

Limits on Ability to Project Actual Health Care Costs

A substantial portion of the revenue received by the Company is expected to pay the costs of health care services or supplies delivered to persons covered by its health plan and insurance products. The total health care costs incurred by the Company are affected by the number of individual services rendered and the cost of each service. Much of the premium revenue is set in advance of the actual delivery of services and the related incurring of the cost, usually on a prospective annual basis. While the Company attempts to base the premiums it charges at least in part on its estimate of expected health care costs over the fixed premium period, competition, regulations and other circumstances may limit the Company's ability to fully base premiums on estimated costs. In addition, many factors may and often do cause actual health care costs to exceed those estimated, including increased cost of individual services, catastrophes, epidemics, seasonality, general inflation, new mandated benefits or other regulatory changes and insured population characteristics. Accordingly, there may be discrepancies between reserves for incurred-but-not-reported liabilities and the actual amount of such liabilities. Historically, increases in health care prices and utilization have caused health care costs to rise faster than general inflation. While these increases have moderated recently, there can be no assurance that health care prices or utilization will not again increase at a more rapid pace.

Risks of Agreements with Providers

Prior to 1997, the Company's St. Louis and Pennsylvania health plans offered members access to Company-owned and Company-staffed medical centers, as well as to networks of contracting providers. During 1997, the Company's medical centers were sold to provider systems which have contracted to provide care to the Company's members continuing to use such centers. The Company expects that substantially all its members will be serviced by providers contracting with the Company to provide the requisite medical care. The ability of the Company to contract successfully with a sufficiently large number of providers in a given geographic market will impact the relative attractiveness of its managed care products in those markets. The terms of such provider contracts also have a material impact on the Company's medical costs and its ability to control such costs. In certain markets currently served by the Company, certain provider systems have significant market positions, and may compete with the Company. If such provider systems refuse to contract with the Company, place the Company at a competitive disadvantage or use their market position to negotiate contracts unfavorable to the Company, the Company's product offerings or profitability in such market areas could be adversely affected.

Among the medical cost control techniques the Company has utilized are capitation agreements with providers pursuant to which providers are paid a fixed dollar amount per member per month under the agreement, with the provider obligated to provide all of a particular type of medical service required by the members, and global capitation agreements, pursuant to which a single integrated hospital-physician provider system provides substantially all hospital and medical services to a large number of members for a fixed percentage of the premium charged by the Company with respect to those members. While these systems may shift to the contracting provider system the risk that medical costs will exceed the amounts anticipated, the Company is exposed to the risk that the provider systems will be financially unable or unwilling to fulfill their payment or medical care obligations under the capitation agreements, and to the risk that members may prefer other providers in the market.

Recent Operating Losses

The Company's operating loss in 1998 was primarily attributable to charges related to the establishment of reserves related to the AHERF bankruptcy and the relocation of the corporate headquarters and other merger related costs. The Company's management believes that its operating results will continue to improve in 1999 and 2000, as to which, however, there can be no assurance.

Information Systems and Administrative Expense Risks

The level of administrative expense is a significant factor in the Company's operating results. While the Company attempts to effectively manage such expenses, increases in staff-related and other administrative expenses may occur from time

MANAGEMENT'S DISCUSSION AND ANALYSIS

to time due to business or product start-ups or expansions, growth or changes in business, acquisitions, regulatory requirements or other reasons. Such expense increases are not clearly predictable and increases in administrative expenses may adversely affect results.

Financing Risk

The Company's recent financial losses may make it more difficult to obtain financing on satisfactory terms in the future. In addition, operating losses by a subsidiary may require the Company to make investments in, or to refinance loans to, such subsidiary in order to maintain required capital levels. Many of the state regulatory authorities in states in which the Company conducts business are expected to increase capital requirements for managed care companies in the next two years.

The National Association of Insurance Commissioners has proposed that states adopt risk-based capital standards that, if implemented, would require new minimum capitalization limits for health care coverage provided by HMOs and other risk-bearing health care entities. To date, no state where the Company has HMO operations has adopted those standards. The Company does not expect this legislation to have a material impact on its consolidated financial position in the near future. The Company believes that cash flows from operations will be sufficient to fund any additional regulatory risk-based capital.

Risk of Competition

The Company operates in a highly competitive industry. In many of its geographic and product markets, the Company competes with a number of entities, some of which may have certain characteristics or capabilities that give them a competitive advantage. The Company believes that there are few barriers to entry in these markets, so that the addition of new competitors can occur relatively easily. Certain of the Company's existing customers may decide to perform for themselves functions or services formerly provided by the Company resulting in a decrease in the Company's revenues. In addition, significant merger and acquisition activity has occurred in the managed care industry as well as in other segments of the health care industry, both nationally and in various local markets. This activity may create stronger competitors and/or result in higher health care costs. To the extent that there is strong competition or that competition intensifies in any market, the Company's ability to retain or increase customers, its revenue growth, its pricing flexibility, its control over medical costs trends and its marketing expenses may all be adversely affected.

Marketing Risk

The Company markets its products and services through both employed sales people and independent sales agents. Although the Company has a number of such sales employees and agents, if certain key sales employees or agents or a large subset of such individuals were to leave, the Company's ability to retain existing customers and members could be impaired. In addition, certain of the customers or potential customers of the Company consider rating, accreditation or certification of the Company by various private or governmental bodies or rating agencies necessary or important. Certain of the Company's health plans or other business units may not have obtained or may not desire or be able to obtain or maintain such accreditation or certification which could adversely affect the Company's ability to obtain or retain business with such customers. The managed care industry has recently received significant amounts of negative publicity. Such general publicity, or any negative publicity regarding the Company in particular, could adversely affect the Company's ability to sell its products or services or could create regulatory problems for the Company.

Litigation and Insurance Risk

The health care industry in general is susceptible to litigation and insurance risks, including medical malpractice liability, disputes relating to the denial of coverage and the adequacy of "stop-loss" reinsurance for costs resulting from catastrophic injuries or illnesses. The Company has contingent litigation risk with certain discontinued operations. Such litigation may result in losses to the Company which could have a material adverse effect on the operations, financial performance, cash flows or prospects of the Company.

Stock Market Risk

Recently, the market prices of the securities of certain of the publicly-held companies in the industry in which the Company operates have shown volatility and sensitivity in response to many factors, including public communications regarding managed care, legislative or regulatory actions, health care cost trends, pricing trends, competition, earnings or membership reports of particular industry participants, and acquisition activity. There can be no assurance regarding the level or stability of the Company's share price at any time or of the impact of these or any other factors on the share price.

Management of Indemnity Health Insurance Policies

Upon the closing of the acquisition of the PHC health plans, Principal Life and the Company entered into a management services agreement ("Management Services Agreement"), a renewal rights agreement ("Renewal Rights Agreement"), and a co-insurance agreement ("Coinsurance Agreement") whereby the Company manages certain of Principal Life's indemnity health insurance policies ("Indemnity Health Insurance Policies") in the markets where the Company does business on December 31, 1999, and would offer to renew such policies in force at that time. The Company has no recent experience in the management or operation of a substantial indemnity health insurance business, and there can be no assurance that existing customers will renew their existing Indemnity Health Insurance Policies with Principal Life while the Management Services Agreement is effective, or that such customers will agree to renew such policies with a Company subsidiary formed for such purpose (CHLIC) at the expiration of the Management Services Agreement and there can be no assurance that benefits from the Management Service Agreement will be realized. The Management Services Agreement expires on December 31, 1999. There can be no assurance that revenues received under that agreement can be replaced from other sources. In addition, to the extent policy holders elect to renew the Indemnity Health Insurance Policies with Principal Life after December 31, 1999, CHLIC will be required to reinsure such policies which will require that CHLIC increase its capital by an amount estimated to be between $50 million to $100 million. There can be no assurance that the Company will be able to restructure its operations to make existing capital available, generate sufficient funds from operations to increase CHLIC's capital to required levels prior to December 31, 1999 or will be able to raise such capital from external sources. The Company is currently in negotiation with Principal Life to terminate the Renewal Rights and Coinsurance Agreement.

Risk of Substantial Beneficial Ownership of the Company by Principal Life and Affiliates

As a result of the Company's acquisition of the PHC health plans, Principal Life and its affiliates (collectively, "Principal Life") owns approximately 40% of the Company's common stock, on a fully diluted basis. Although it has agreed to a limitation on acquiring additional shares of the Company's common stock and from taking certain other actions, "Principal Life" will be permitted under certain circumstances to acquire additional shares in order to maintain ownership of up to 40% of the common stock, and has the right to elect at least one member of the Company's Board of Directors for each 6% ownership of the Company's common stock, until April 2003 or certain other actions are taken by the Company. After April 2003, or after a third party acquires more voting securities than those held by Principal Life, there will be no restrictions on the acquisition of the Company's common stock by Principal Life. Prior to September 1999, as long as Principal Life maintains ownership of 40% of the Company's Common Stock, it is highly unlikely that any matter involving a shareholder vote, including the issuance of more than 20% of the Company's common stock, or an acquisition of the Company by merger, consolidation, share exchange or other transaction could be effectuated if Principal Life were opposed thereto. Thereafter, from September 1999 and until April 2003, Principal Life has agreed to vote its shares in favor of an acquisition required to be approved by shareholders that the Board has recommended and has been approved by a majority of the Company's shareholders, other than Principal Life. After April 2003, there will be no restrictions on the acquisition of additional shares of the Company's common stock by Principal Life, and as a result, Principal Life, in addition to having an effective veto over transactions involving a shareholder vote (assuming it were to continue to beneficially own 40% of the Company's common stock), could acquire over 50% of the Company's common stock and exercise actual control of the Company without a vote of the remaining Company's shareholders.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Board of Directors
of Coventry Health Care, Inc.:

We have audited the accompanying consolidated balance sheets of Coventry Health Care, Inc. (successor in interest to Coventry Corporation) and subsidiaries as of December 31, 1998 and 1997, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Coventry Health Care, Inc. and subsidiaries as of December 31, 1998 and 1997, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1998 in conformity with generally accepted accounting principles.

Arthur Andersen LLP

Baltimore, Maryland
February 16, 1999

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share data)

	December 31, 1998	December 31, 1997
Assets		
Cash and cash equivalents	$ 408,823	$ 153,979
Short-term investments	43,689	3,870
Accounts receivable, net of allowance for doubtful accounts of $12,023 and $7,378, respectively	46,204	40,005
Other receivables	19,754	16,663
Deferred income taxes	65,521	35,771
Prepaid expenses and other current assets	7,054	4,687
Total current assets	591,045	254,975
Long-term investments	162,070	82,242
Property and equipment, net	35,820	21,937
Goodwill and intangible assets, net	295,966	108,637
Other assets	5,692	19,391
Total assets	$ 1,090,593	$ 487,182
Liabilities and Stockholders' Equity		
Medical claims liabilities	$ 355,806	$ 118,022
Accounts payable and other accrued liabilities	163,469	102,981
Deferred revenue	46,412	39,093
Current portion of long-term debt and notes payable	166	765
Total current liabilities	565,853	260,861
Convertible exchangeable subordinated notes	45,538	42,042
Long-term debt and notes payable	820	43,677
Other long-term liabilities	41,843	22,784
Stockholders' equity:		
Common stock, $.01 par value; 200,000,000 shares authorized; 59,274,370 shares issued and 58,834,810 outstanding in 1998; and 33,712,665 shares issued and 33,273,105 outstanding in 1997	593	337
Additional paid-in capital	476,430	146,426
Accumulated other comprehensive earnings	794	592
Accumulated deficit	(36,278)	(24,537)
Treasury stock, at cost, 439,560 shares	(5,000)	(5,000)
Total stockholders' equity	436,539	117,818
Total liabilities and stockholders' equity	$ 1,090,593	$ 487,182

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	Year Ended December 31, 1998	1997	1996
Operating revenues:			
Managed care premiums	$ 2,033,372	$ 1,208,149	$ 1,035,778
Management services	77,011	20,202	21,351
Total operating revenues	2,110,383	1,228,351	1,057,129
Operating expenses:			
Health benefits	1,767,374	1,039,860	940,532
Selling, general and administrative	291,919	170,017	165,081
Depreciation and amortization	25,793	12,735	42,862
AHERF charge	55,000	-	-
Merger costs	6,492	-	-
Total operating expenses	2,146,578	1,222,612	1,148,475
Operating earnings (loss)	(36,195)	5,739	(91,346)
Other income, net	27,251	24,880	13,379
Interest expense	(8,566)	(10,275)	(6,257)
Earnings (loss) before income taxes and minority interest	(17,510)	20,344	(84,224)
Provision for (benefit from) income taxes	(5,769)	8,422	(22,860)
Minority interest in earnings (loss) of consolidated subsidiary, net of income tax	-	19	(77)
Net earnings (loss)	$ (11,741)	$ 11,903	$ (61,287)
Net earnings (loss) per share:			
Basic	$ (0.22)	$ 0.36	$ (1.87)
Diluted	$ (0.22)	$ 0.35	$ (1.87)

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Years Ended December 31, 1998, 1997 and 1996 (in thousands)

	Common Stock	Additional Paid-In Capital	Accumulated Other Comprehensive Earnings	Earnings (Accumulated Deficit)	Treasury Stock at Cost	Total Stockholders' Equity
Balance, December 31, 1995	$ 323	$ 128,119	$ 562	$ 24,847	$ -	$ 153,851
Comprehensive earnings (loss)						
Net loss				(61,287)		(61,287)
Unrealized gain (loss) on securities, net of reclassifications			(167)			(167)
Comprehensive earnings (loss)						(61,454)
Issuance of common stock, including exercise of options and warrants	7	5,739				5,746
Tax benefit of stock options exercised		2,284				2,284
Balance, December 31, 1996	330	136,142	395	(36,440)	-	100,427
Comprehensive earnings (loss)						
Net earnings				11,903		11,903
Unrealized gain (loss) on securities, net of reclassifications			197			197
Comprehensive earnings (loss)						12,100
Issuance of common stock, including exercise of options and warrants	7	7,722			(5,000)	2,729
Issuance of warrants		2,353				2,353
Tax benefit of stock options exercised		209				209
Balance, December 31, 1997	337	146,426	592	(24,537)	(5,000)	117,818
Comprehensive earnings (loss)						
Net loss				(11,741)		(11,741)
Unrealized gain (loss) on securities, net of reclassifications			202			202
Comprehensive earnings (loss)						(11,539)
Issuance of common stock, including exercise of options and warrants	256	304,888				305,144
Issuance of warrants		25,000				25,000
Tax benefit of stock options exercised		116				116
Balance, December 31, 1998	$ 593	$ 476,430	$ 794	$(36,278)	$(5,000)	$ 436,539

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Year Ended December 31,		
	1998	1997	1996
Cash flows from operating activities:			
Net earnings (loss)	$ (11,741)	$ 11,903	$ (61,287)
Adjustments to reconcile net earnings (loss) to cash provided by operating activities:			
Depreciation and amortization	25,793	12,735	42,862
Deferred income tax benefit	(19,439)	(11,701)	(15,989)
Gain on sales of medical offices & property disposals	(399)	(13,338)	-
Increase in receivable due to sale of subsidiary	-	-	(5,500)
Non-cash interest on convertible debt	3,496	2,042	-
Other	3,608	(383)	84
Changes in assets and liabilities, net of effects of the purchase of subsidiaries:			
Accounts receivable	11,425	(2,432)	(5,285)
Other receivables	16,049	715	(6,749)
Prepaid expenses and other current assets	(422)	2,013	(907)
Other assets	2,373	2,874	(5,652)
Medical claims liabilities	61,247	(28,060)	49,350
Accounts payable and other accrued liabilities	(23,603)	26,000	41,838
Deferred revenue	577	24,205	549
Other long-term liabilities	(685)	(4,312)	1,251
Net cash provided by operating activities	68,279	22,261	34,565
Cash flows from investing activities:			
Capital expenditures, net	(3,236)	(7,218)	(12,688)
Sales of investments	122,871	37,329	75,511
Purchases of investments & other	(138,076)	(34,137)	(80,049)
Payments for purchases of subsidiaries, net of cash acquired	-	-	(27,256)
Proceeds from sales of subsidiaries & medical offices	99,277	53,977	-
Cash acquired from acquisition of PHC	148,600	-	-
Net cash provided by (used in) investing activities	229,436	49,951	(44,482)
Cash flows from financing activities:			
Proceeds from issuance of convertible exchangeable notes	-	40,000	40,164
Payments on long-term debt	(44,286)	(48,961)	(14,474)
Net proceeds from issuance of stock	1,415	2,729	5,746
Proceeds from issuance of stock warrants	-	2,353	-
Net cash (used in) provided by financing activities	(42,871)	(3,879)	31,436
Net increase in cash and cash equivalents	254,844	68,333	21,519
Cash and cash equivalents at beginning of period	153,979	85,646	64,127
Cash and cash equivalents at end of period	$ 408,823	$ 153,979	$ 85,646
Supplemental disclosure of cash flow information:			
Cash paid for interest	$ 3,386	$ 7,572	$ 5,862
Income taxes paid (refunded), net	$ 9,487	$ (4,456)	$ 1,309

See notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A. Organization and Summary of Significant Accounting Policies

Coventry Health Care, Inc. (together with its subsidiaries, the "Company") is a managed health care company that provides comprehensive health benefits and services to a broad cross section of employer and government-funded groups in the Midwest, Mid-Atlantic and Southeastern United States. Health care services are provided through a variety of full-risk health care plans, including health maintenance organization ("HMO"), point of service ("POS") and preferred provider organization ("PPO") products. Additionally, the Company administers self-insured health plans of certain large employers.

The Company began operations in 1987 with the acquisition of the American Service Companies ("ASC") entities, including the Coventry Health and Life Insurance Company ("CHLIC"). In 1988, the Company acquired HealthAmerica Pennsylvania, Inc. ("HAPA"), a Pennsylvania HMO. In 1990, the Company acquired Group Health Plan, Inc. ("GHP"), a St. Louis, Missouri HMO. Southern Health Services, Inc. ("SHS"), a Richmond, Virginia, HMO, was acquired by the Company in 1994. In 1995, the Company acquired HealthCare USA, Inc. ("HCUSA"), a Jacksonville, Florida-based Medicaid managed care company. On April 1, 1998, the Company acquired certain assets of Principal Health Care, Inc. ("PHC") from Principal Mutual Life Insurance Company, now known as Principal Life Insurance Company ("Principal Life"). See Note B to consolidated financial statements.

Principles of Consolidation - The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany transactions have been eliminated. Interests of other investors in the Company's majority owned (or otherwise effectively-controlled) subsidiaries are accounted for as minority interests and are included in other long-term liabilities for financial reporting purposes.

Use of Estimates - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents - Cash and cash equivalents consist principally of overnight repurchase agreements, money market funds, commercial paper and certificates of deposit. The Company considers all highly liquid securities purchased with an original maturity of three months or less to be cash equivalents. The carrying amounts of cash and cash equivalents reported in the accompanying consolidated balance sheets approximate fair value.

Investments - The Company accounts for investments in accordance with Statement of Financial Accounting Standards No. 115 ("SFAS" 115), "Accounting for Certain Investments in Debt and Equity Securities". The Company considers all of its investments as available-for-sale, and accordingly, records unrealized gains and losses, net of deferred income taxes, as a separate component of stockholders' equity. Realized gains and losses on the sale of these investments are determined on a specific identification basis.

Investments with original maturities in excess of three months and less than one year are classified as short-term investments and generally consist of time deposits, U.S. Treasury Notes, and obligations of various states and municipalities. Long-term investments have original maturities in excess of one year and primarily consist of debt securities.

Other Receivables - Other receivables include interest receivable, reinsurance claims receivable, receivables from providers and suppliers and any other receivables that do not relate to premiums.

Property and Equipment - Property and equipment are recorded at cost. Depreciation is computed using the straight-line method over the estimated lives of the related assets or, if shorter, over the terms of the respective leases.

Long-lived Assets - The Company has adopted Statement of Financial Accounting Standards No. 121 ("SFAS 121"), "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of." In accordance with SFAS 121, the Company evaluates long-lived assets to be held for events or changes in circumstances that would indicate that the carrying value may not be recoverable. In making that determination, the Company considers a number of factors, including undiscounted future cash flows, prior to interest expense. The Company measures an impairment loss by comparing the fair value of the assets to its carrying value. Fair values are determined by using market prices for similar assets, if available, or discounted future estimated cash flows, prior to interest expense. Assets held for sale are recorded at the lower of the carrying amount or fair value, less any cost of disposition.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Goodwill and Intangible Assets - Goodwill and intangible assets consist of costs in excess of the fair value of the net assets of subsidiaries or operations acquired. Goodwill is amortized using the straight-line method over periods ranging from 15 to 35 years. The remaining unamortized goodwill and intangible asset balances at December 31, 1998 are as follows (in thousands):

Description	Useful Life	Amount	Accumulated Amortization	Net Book Value
Marketing Service Agreement	1.75 years	$ 1,500	$ 643	$ 857
Customer Lists	5 years	11,700	6,222	5,478
HMO Licenses	15-20 years	10,700	655	10,045
Management Services Agreement	1.75 years	4,688	2,009	2,679
Renewal Rights Agreement	35 years	20,312	435	19,877
Goodwill	15-35 years	307,750	50,720	257,030
Total		$ 356,650	$ 60,684	$ 295,966

Amortization expense for the years ended December 31, 1998, 1997 and 1996 was approximately $13.6 million, $3.8 million and $27.2 million, respectively. In accordance with SFAS 121 and Accounting Principles Board ("APB") Opinion No.17, the Company periodically evaluates the realizability of goodwill and intangible assets and the reasonableness of the related lives in light of factors such as industry changes, individual market competitive conditions, and operating income. The 1996 amount includes a write-off of $20.1 million of goodwill that was determined to be impaired in accordance with SFAS 121.

Other Assets - Other assets consist of loan acquisition costs, assets related to the supplemental executive retirement plan (See Note N to consolidated financial statements), restricted assets, deferred charges and certain costs incurred to develop new service areas and new products prior to the initiation of revenues. Loan acquisition costs are amortized over the term of the related debt while the other assets are amortized over their expected periods of benefit, where applicable. The preoperational new service area and new product costs were amortized over their expected period of benefit up to eight years. Effective April 1, 1997, the Company adopted a one-year period for amortization of new service area and new product costs. $2.7 million of expense was included in selling, general and administrative expense due to this change. These costs were fully amortized at December 31, 1997. Accumulated amortization of other assets was approximately $3.4 million and $9.1 million at December 31, 1998 and 1997, respectively.

Medical Claims Liabilities - Medical claims liabilities consist of actual claims reported but not paid and estimates of health care services incurred but not reported. The estimated claims incurred but not reported are based on historical data, current enrollment, health service utilization statistics, and other related information. Although considerable variability is inherent in such estimates, management believes that the liability is adequate. The Company also establishes reserves, if required, for the probability that anticipated future health care costs and maintenance costs under the group of existing contracts will exceed anticipated future premiums and reinsurance recoveries on those contracts. The estimated future costs include fixed and variable, direct and allocable, indirect costs. These accruals are continually monitored and reviewed, and as settlements are made or accruals adjusted, differences are reflected in current operations. Changes in assumptions for medical costs caused by changes in actual experience could cause these estimates to change in the near term.

Revenue Recognition - Managed care premiums are recorded as revenue in the month in which members are entitled to service. Premiums collected in advance are recorded as deferred revenue. Employer contracts are typically on an annual basis, subject to cancellation by the employer group or the Company upon thirty days written notice. Management services revenues are recognized in the period in which the related services are performed. Premiums for services to federal employee groups are subject to audit and review by the Office of Personnel Management ("OPM") on a periodic basis. Such audits are usually a number of years in arrears. The Company provides reserves, on an estimated basis annually, based on the appropriate guidelines. Any differences between actual results and estimates are recorded in the year the audits are finalized. Such adjustments have not been material to the financial statements of the Company.

Reinsurance - Premiums paid to reinsurers are reported as health benefits expense and the related reinsurance recoveries are reported as deductions from health benefits expense.

Income Taxes - The Company files a consolidated tax return for the Company and its wholly owned consolidated subsidiaries. The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards No. 109 ("SFAS 109"). The deferred tax assets and/or liabilities are determined by multiplying the differences between the financial reporting and tax reporting bases for assets and liabilities by the enacted tax rates expected to be in effect when such differences are recovered or settled. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. See Note G for disclosures related to income taxes.

Minority Interest - For 1997 and 1996, the minority interest represents a joint venture interest of 51% in Pennsylvania HealthMate, Inc. ("HealthMate").

Stock-based Compensation - The Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 123 ("SFAS 123"), "Accounting for Stock-Based Compensation." As permitted by SFAS 123, the Company has elected to continue to account for stock-based compensation to employees under APB Opinion No. 25, and complies with the disclosure requirements for SFAS 123. See Note J for disclosures related to stock-based compensation.

Earnings per Share - In the fourth quarter of 1997, the Company adopted Statement of Financial Accounting Standards No. 128 ("SFAS 128"), "Earnings per Share." SFAS 128 establishes new standards for computing and presenting earnings per share ("EPS"), replacing primary EPS with "basic EPS." Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. The adoption of SFAS 128 did not have a material effect on the Company's earnings per share. All prior periods have been restated to comply with SFAS 128. See Note Q for calculation of EPS.

Comprehensive Earnings - Effective January 1, 1998, the Company adopted Statement of Financial Accounting Standards No. 130 ("SFAS 130"), "Reporting Comprehensive Income." SFAS 130 requires that changes in the amounts of certain items, including unrealized gains and losses on certain securities, be shown in the financial statements. The adoption of this standard did not have a material effect on the Company's consolidated financial statements.

Segment reporting - Effective December 31, 1998, the Company adopted Statement of Financial Accounting Standards No. 131 ("SFAS 131"), "Disclosures about Segments of an Enterprise and Related Information." This standard requires that a public business enterprise report financial and descriptive information about its reportable operating segments. Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. SFAS 131 also requires that all public business enterprises report information about the revenues derived from the enterprise's products or services (or groups of similar products and services), about the countries in which the enterprise earns revenues and holds assets and about major customers regardless of whether that information is used in making operating decisions. The Company has two reportable segments: Commercial products and Government products. The products are provided to a cross section of employer groups through the Company's health plans in the Midwest, Mid-Atlantic, and Southeastern United States. Commercial products include HMO, PPO, and POS products. HMO products provide comprehensive health care benefits to enrollees through a primary care physician. PPO and POS products permit members to participate in managed care but allow them the flexibility to utilize out of network providers in exchange for an increase in out-of-pocket costs to the member. Governmental products include Medicare Risk, Medicare Cost, and Medicaid. The Company provides comprehensive health benefits to members participating in government programs and receives premium payments from federal and state governments. The Company evaluates the performance of its operating segments and allocates resources based on gross margin. Assets are not allocated to specific products and, accordingly, cannot be reported by segment. See Note S for disclosures on segment reporting.

Other New Pronouncements- In June 1998, the FASB issued Statement of Financial Accounting Standards No.133 ("SFAS 133"), "Accounting for Derivative Instruments and Hedging Activities." This Statement requires companies to record derivatives on the balance sheet as assets or liabilities, measured at fair value. Gains or losses resulting from changes in the values of those derivatives would be accounted for depending on the use of the derivative and whether it qualifies for hedge accounting. This Statement is effective for fiscal years beginning after June 15, 1999. The Company does not believe that adoption of this standard will have a material effect on its future results of operations.

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In March 1998, the American Institute of Certified Public Accountants ("AICPA") issued Statement of Position 98-1 ("SOP 98-1"), "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." SOP 98-1 provides authoritative guidance for the capitalization of certain costs related to computer software developed or obtained for internal applications, such as external direct costs of materials and services, payroll costs for employees and certain interest costs. Costs incurred during the preliminary project stage, as well as training and data conversion costs, are to be expensed as incurred. SOP 98-1 is effective for fiscal years beginning after December 15, 1998. The Company does not believe that adoption of this standard will have a material effect on its future results of operations.

Reclassifications - Certain 1996 and 1997 amounts have been reclassified to conform to the 1998 presentation.

B. Acquisitions and Dispositions

Effective April 1, 1998, the Company completed its acquisition of certain assets of PHC from Principal Life for a total purchase price of approximately $330.2 million including transaction costs of approximately $5.7 million. The acquisition was accounted for using the purchase method of accounting, and accordingly the operating results of PHC have been included in the Company's consolidated financial statements since the date of acquisition. The purchase price consisted of 25,043,704 shares of the Company's common stock at an assigned value of $11.96 per share. In addition, a warrant valued at $25.0 million ("the Warrant") was issued that gives Principal Life the right to acquire additional shares of stock in the event that their ownership percentage is diluted below 40%. The warrant is included as a component of additional paid-in capital in the accompanying consolidated financial statements. Through April 2003, Principal Life is restricted from buying additional shares of the Company's common stock to increase its ownership percentage above 40%.

Coincident with the closing of the transaction, the Company entered into a Marketing Services Agreement and a Management Services Agreement with Principal Life. Both agreements extend through December 31, 1999. The Company recognized revenue of approximately $23.0 million for the year ended December 31, 1998 related to these agreements, and expects to receive payments of approximately $26.4 million in 1999.

The Company also entered into a Renewal Rights Agreement and a Coinsurance Agreement with Principal Life, whereby the Company manages certain of Principal Life's indemnity health insurance policies in the markets where the Company does business and, on December 31, 1999, would offer to renew such policies in force at that time.

As a result of the transaction, the Company assumed an agreement with Principal Life, whereby Principal Life pays a fee for access to the Company's PPO network based on a rate per contract and a percentage of savings realized by Principal Life. The Company recognized revenue of approximately $12.0 million for the year ended December 31, 1998 related to this agreement. The maximum amount that can be paid under the percentage of savings component of the agreement is $8.0 million for 1999.

On December 31, 1998, the Company sold its subsidiary, Principal Health Care of Florida, Inc., for $95.0 million in cash. The Florida health plan accounted for approximately 156,000 risk members and approximately 5,500 non-risk members as of December 31, 1998 and reported approximately $172.5 million in revenues since April 1, 1998, the date of acquisition.

Effective November 30, 1998, the Company sold its subsidiary, Principal Health Care of Illinois, Inc., for $4.3 million in cash. The Illinois health plan accounted for approximately 56,000 risk members and approximately 2,400 non-risk members as of November 30, 1998 and reported approximately $71.1 million in revenues since the date of acquisition.

The proceeds from both sales were used to retire the Credit Facility, to assist in improving the capital position of the Company's regulated entities, and for other general corporate purposes. Given the short time period between the respective acquisition and sale dates and the lack of events or other evidence which would indicate differing values, no gain or loss was recognized on the sales of the Florida and Illinois health plans, as the sales prices were considered by management to be equivalent to the fair values allocable to these plans at the date of their acquisition from PHC in April 1998.

In connection with the acquisition of certain PHC health plans, and the sales of the Florida and Illinois plans, the Company recorded reserves in purchase accounting of approximately $33.0 million for the estimated transition costs of the PHC plans. These reserves are primarily comprised of severance costs related to involuntary terminations of former PHC employees, relocation costs of former PHC personnel, lease termination costs and contract termination costs. For the year ended December 31, 1998, the Company has expended approximately $18.2 million related to these reserves. The Company expects to make payments on the remaining reserves through July 2002.

The purchase price for certain of the PHC plans, net of the impact of the sales of the Florida and Illinois health plans, was allocated to the assets, including the identifiable intangible assets, and liabilities based on estimated fair values. The excess of purchase price, over the net identified tangible and intangible assets acquired of approximately $134.4 million, was allocated to goodwill. The amounts allocated to the identifiable intangible assets and goodwill and their related useful lives are as follows:

Description	Amount	Useful Life
Marketing Services Agreement	$ 1,500,000	1.75 years
Customer Lists	7,233,000	5 years
HMO Licenses	10,000,000	20 years
Management Services Agreement	4,687,500	1.75 years
Renewal Rights and Coinsurance Agreements	20,312,500	35 years
Goodwill	156,795,028	35 years
Total	$ 200,528,028	

The following unaudited pro-forma condensed consolidated results of operations assumes the PHC acquisition and the sales of the Florida and Illinois health plans occurred on January 1, 1998 and 1997 and excludes the one-time charge to merger costs of $6.5 million, see Note D:

	Year Ended December 31,	
	1998	1997
(in thousands, except per share data)	*(unaudited)*	*(unaudited)*
Operating revenues	$ 2,021,580	$ 1,875,411
Net loss	(32,165)	(22,694)
Earnings per share, basic	(0.55)	(0.39)

In August 1997, the Company entered into agreements to sell certain medical offices associated with HealthAmerica, its health plan in Harrisburg, Pennsylvania. The sales price was $2.1 million and the transaction resulted in a pretax loss of $0.2 million. Additionally, in the third quarter of 1997, the Company sold its two remaining medical offices in Pittsburgh, Pennsylvania for $0.3 million in cash and recorded a pretax loss of $0.4 million. All gains or losses resulting from medical office sales are reflected in other income, net in the accompanying Consolidated Statement of Operations.

Effective May 1, 1997, the Company completed its sale of the medical offices associated with GHP, its health plan in St. Louis, Missouri, to a major health care provider organization. The sales price was $26.9 million and the transaction resulted in a pretax gain of approximately $9.6 million. Coincident with the sale, the Company entered into a long-term global capitation agreement with the purchaser covering approximately 83,000 members, pursuant to which the provider organization receives a fixed percentage of premiums to cover all of the medical treatment the globally capitated members receive.

Effective March 31, 1997, the Company completed its sale of the medical offices associated with HealthAmerica Pennsylvania, Inc., its health plan in Pittsburgh, Pennsylvania, to a major health care provider organization. The sales price was $20.0 million and the transaction resulted in a pretax gain of approximately $6.0 million. Coincident with the sale, the Company entered into a long-term global capitation agreement with the purchaser which increased the globally capitated membership in western Pennsylvania to approximately 250,000 members. Under the agreement, the provider organization will receive a fixed percentage of premiums to cover all of the medical treatment the globally capitated members will receive.

Effective March 22, 1996, the Company purchased 81% of the common stock of PARTNERS Health Plan of Pennsylvania, Inc. and acquired the remaining 19% of the common stock through the merger of a subsidiary of the Company with and into PARTNERS, whose name was changed to Coventry Health Plan of Pennsylvania, Inc.("CHP"). CHP is the holding company for Coventry Health Plan of Western Pennsylvania, Inc., which, at the time of acquisition, was known as Aetna Health Plan of Western Pennsylvania, Inc. and served approximately 16,000 HMO members in the Pittsburgh area. Consideration for the transaction was approximately $35 million in cash, of which approximately $32.1 million was recorded as goodwill. The acquisition was accounted for under the purchase method of accounting and, accordingly, the net assets were included in the consolidated financial statements from the effective date of acquisition. During 1996, the Company determined that the intangible assets acquired were impaired and $20.1 million of the goodwill was written off through amortization expense. The Company believes the remaining intangible is realizable on a discounted cash flow basis.

C. AHERF CHARGE

In March 1997, the Company entered into a global capitation agreement with Allegheny Health, Education and Research Foundation ("AHERF") covering approximately 250,000 members in the western Pennsylvania market. Under the agreement,

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AHERF was paid 78% to 82% of the premium to cover all of the medical expenses of the capitated members. In July 1998, AHERF filed for bankruptcy protection under Chapter 11. As a result, the Company, which is ultimately responsible for the medical costs of the capitated members, recorded a charge of $55.0 million to establish a reserve for the medical costs incurred by members covered by the AHERF agreement at the time of the bankruptcy filing and other potential bankruptcy charges. Under applicable bankruptcy laws, AHERF could reject and refuse to perform under the global capitation agreement. Generally, under Chapter 11 a debtor company such as AHERF may affirm or reject its contractual obligations prior to confirmation of a plan of reorganization, and if a contract is rejected, the contractual damages become an unsecured claim in the Chapter 11 proceeding. Although AHERF has not formally rejected the risk-sharing agreement as of the date of this filing, the parties are negotiating a resolution of the arrangement and, currently, neither AHERF nor the Company is operating under the existing agreement. The Company has filed a lawsuit against certain hospital subsidiaries of AHERF that were not included in the bankruptcy filing. The lawsuit is seeking a court order declaring that the Company is not liable for the payment of $21.5 million of medical services provided by the hospitals to the Company's members prior to the date of AHERF's bankruptcy filing and compelling the hospitals to fulfill their contractual obligations to continue to provide health care services to the membership in western Pennsylvania. The lawsuit also includes a claim for damages to recover the losses incurred by the Company as a consequence of AHERF's default of its obligations under the risk-sharing agreement. In response to the lawsuit, the hospitals have filed a counterclaim alleging that HAPA, notwithstanding AHERF's assumption of the payment obligation, is liable to the hospitals for the payment of medical services provided prior to AHERF's bankruptcy. The Company intends to vigorously defend against the counterclaim. The Company believes that the reserve established is adequate to provide for claims incurred related to the AHERF arrangement and other related AHERF bankruptcy uncertainties. For the year ended December 31, 1998, $33.8 million has been paid for medical claims related to this reserve.

D. Merger Costs

In connection with the acquisition of PHC, the Company relocated its Corporate Headquarters from Nashville, Tennessee to Bethesda, Maryland. As a result, the Company established a one-time reserve of approximately $6.5 million for the incurred and anticipated costs related to the relocation of the corporate office and other direct merger related costs. The reserve is primarily comprised of severance costs related to involuntary terminations, relocation costs for management personnel, and lease costs, net of sublease income, related to the unused space remaining at the old headquarters location. For the year ended December 31, 1998, the Company has paid approximately $4.4 million related to the reserve. The Company expects to make payments through December 2002 related to these charges.

E. Property and Equipment

Property and equipment is comprised of the following (in thousands):

	December 31,	
	1998	1997
Land	$ 481	$ 481
Buildings and leasehold improvements	11,922	9,583
Equipment	54,353	40,795
	66,756	50,859
Less accumulated depreciation	(30,936)	(28,922)
Property and equipment, net	$ 35,820	$ 21,937

Depreciation expense for the years ended December 31, 1998, 1997, and 1996 was approximately $12.2 million, $8.9 million, and $15.7 million, respectively.

F. Investments in Debt and Equity Securities

The Company considers all of its investments as available-for-sale securities and, accordingly, records unrealized gains and losses, as other comprehensive earnings, in the stockholders' equity section of its consolidated balance sheets. As of December 31, 1998 and 1997, stockholders' equity was increased by approximately $0.3 million and $0.6 million, respectively, net of a deferred tax cost of approximately $0.1 million and $0.4 million, respectively, to reflect the net unrealized investment gain on securities.

The amortized cost, gross unrealized gain or loss and estimated fair value of short-term and long-term investments by security type were as follows at December 31, 1998 and 1997 (in thousands):

1998	Amortized Cost	Unrealized Gain	Unrealized Loss	Fair Value
State and municipal bonds	$ 55,355	$ 548	$ (290)	$ 55,613
Asset-backed securities	10,728	71	(174)	10,625
Mortgage-backed securities	46,304	1,276	(141)	47,439
US Treasury & agencies securities	51,246	661	(316)	51,591
Other debt securities	40,003	529	(41)	40,491
	$203,636	$ 3,085	$ (962)	$205,759

1997	Amortized Cost	Unrealized Gain	Unrealized Loss	Fair Value
State and municipal bonds	$ 50,438	$ 769	$ -	$ 51,207
Asset-backed securities	9,935	74	-	10,009
Mortgage-backed securities	11,621	37	-	11,658
US Treasury securities	10,854	81	-	10,935
Other debt securities	2,278	25	-	2,303
	$ 85,126	$ 986	$ -	$ 86,112

The amortized cost and estimated fair value of short-term and long-term investments by contractual maturity were as follows at December 31, 1998 and December 31, 1997 (in thousands):

	Amortized Cost	Fair Value
1998		
Maturities:		
Within 1 year	$ 46,451	$ 46,915
1 to 5 years	57,362	57,949
6 to 10 years	29,382	29,423
Over 10 years	70,441	71,472
Total short-term and long-term securities	$ 203,636	$ 205,759
1997		
Maturities:		
Within 1 year	$ 10,040	$ 10,009
1 to 5 years	29,073	29,396
6 to 10 years	12,707	12,879
Over 10 years	33,306	33,828
Total short-term and long-term securities	$ 85,126	$ 86,112

Proceeds from the sale of investments were approximately $122.9 million and $37.3 million for the years ended December 31, 1998 and 1997, respectively. Gross investment gains of approximately $860,000 and no gross investment losses were realized on these sales for the year ended December 31, 1998 compared to gross investment gains of approximately $275,000 and gross investment losses of $194,000 for the year ended December 31, 1997.

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G. Income Taxes

The provision (benefit) for income taxes consists of the following (in thousands):

	Year Ended December 31,		
	1998	1997	1996
Current provision (benefit):			
Federal	$ 12,907	$ 16,439	$ (6,181)
State	763	3,684	(690)
Deferred provision (benefit):			
Federal	(14,695)	(9,943)	(15,565)
State	(4,744)	(1,758)	(424)
	$ (5,769)	$ 8,422	$ (22,860)

The expected tax provision based on the statutory rate of 35% differs from the Company's effective tax rate as a result of the following:

	Year Ended December 31,		
	1998	1997	1996
Statutory federal tax rate	(35.00%)	35.00%	(35.00%)
Effect of:			
State income taxes, net of federal benefit	(4.04%)	6.15%	(1.40%)
Amortization of goodwill	18.60%	5.98%	10.26%
Tax exempt interest income	(13.77%)	(5.54%)	(1.25%)
Other	1.27%	(0.19%)	0.25%
Income tax provision (benefit)	(32.94%)	41.40%	(27.14%)

The effect of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 1998 and 1997 are presented below (in thousands):

	December 31,	
	1998	1997
Deferred tax assets:		
Deferred revenue	$ 2,804	$ 3,123
Medical liabilities	5,799	4,590
Accounts receivable	7,921	5,128
Deferred compensation	4,211	3,776
Accrued professional fees	1,689	622
Provision for long-term contracts	1,675	778
Accrued acquisition	3,123	604
Property and equipment	-	1,811
Other assets	7,911	4,966
Contingent liabilities	31,173	19,445
Net operating loss carryforward	3,769	1,433
Gross deferred tax assets	70,075	46,276
Less valuation allowance	(3,252)	(916)
Deferred tax asset	66,823	45,360
Deferred tax liability:		
Property and equipment	(982)	-
Intangibles	(12,562)	-
Other	-	(383)
Gross deferred tax liabilities	(13,544)	(383)
Net deferred tax asset	$ 53,279	$ 44,977

The valuation allowance for deferred tax assets as of December 31, 1998 is $3.3 million due to the Company's belief that the realization of a large portion of the deferred tax asset resulting from federal and state net operating loss carryforwards is doubtful. The valuation allowance provided at December 31, 1998 will be allocated to reduce goodwill and other intangible assets if the realization of the net operating loss carryforwards becomes more likely than not.

H. Convertible Exchangeable Subordinated Notes

The Company has issued to Warburg, Pincus Ventures, L.P. ("Warburg") and Franklin Capital Associates III L.P. ("Franklin" and collectively with Warburg the "Investors") $40 million of the Convertible Exchangeable Subordinated Notes of the Company (the "Coventry Convertible Notes"), together with warrants to purchase 2.35 million shares of the Company's common stock, for $42.4 million. The Coventry Convertible Notes are exchangeable at the Company's or Warburg's option for shares of Series A Convertible Preferred Stock ("Preferred Stock"). The authorization of 6,000,000 shares of Preferred Stock has been approved by the Company's shareholders.

The Coventry Convertible Notes accrue interest at 8.3% payable in interest notes semiannually in arrears for the first two years and at 5.0% payable in cash or in interest notes semiannually in arrears, thereafter. The interest notes accrue interest from the point of issuance under the same terms and conditions as the Coventry Convertible Notes. The Coventry Convertible Notes are required to be repaid in an amount equal to 33%, 50% and 100%, respectively, of the aggregate principal amount outstanding as of the fifth, sixth and seventh anniversaries of the respective Coventry Convertible Note's issuance date. The Coventry Convertible Notes may be prepaid at the option of the Company after the third anniversary date of issuance if the market price of the Company's common stock exceeds certain targets.

The Coventry Convertible Notes and interest notes are exchangeable for Preferred Stock at a $10 per share conversion rate. The Preferred Stock accrues dividends at 8.3% until May 29, 1999. Dividends are payable in additional shares of Preferred Stock. The Preferred Stock may be called and is required to be repaid with the same repayment terms as the Coventry Convertible Notes. The Preferred Stock is convertible into common stock on a share for share basis.

The Coventry Convertible Notes and interest notes are convertible into common stock at a $10 per share conversion rate.

I. Long-Term Debt and Notes Payable

Long-term debt and notes payable consists of the following (in thousands):

	December 31, 1998	December 31, 1997
Borrowings under the Credit Facility	$ -	$ 42,824
Notes payable to U.S. DHHS	781	1,173
Other notes payable	205	445
	986	44,442
Less current portion	(166)	(765)
Total long-term debt and notes payable	$ 820	$ 43,677

On December 29, 1997, the Company entered into a credit agreement with a group of banks (the "Credit Facility"). The Credit Facility refinanced the previous agreement and totaled $42.8 million. The effective rate on the indebtedness under the Credit Facility was 7.0625% at December 31, 1998. The Credit Facility was paid in full on December 31, 1998.

Notes payable to the U. S. Department of Health and Human Services ("U.S. DHHS") represent obligations which were assumed in the acquisition of HAPA. Under the terms of the notes, principal is payable in various annual installments through June 30, 2000 with interest payable semi-annually at rates ranging from 7.75% to 9.125%. The notes are secured by certain assets of the Company.

The fair value of the Company's long-term borrowings is based on quoted market rates. The carrying amount of the Company's borrowings approximates fair value.

Maturities of long-term debt during each of the ensuing two years ending December 31 are as follows (in thousands):

Year	Amount
1999	$ 166
2000	820
	$ 986

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Interest expense for the year ended December 31, 1998 was $8.6 million, which includes $3.2 million related to the Credit Facility and $3.5 million related to the Coventry Convertible Notes.

J. Stock Options, Warrants and Employee Stock Purchase plan

As of December 31, 1998, the Company had one stock incentive plan, the Amended and Restated 1998 Stock Incentive Plan (the “1998 Plan”), with an aggregate of 7 million shares of common stock authorized for issuance thereunder to key employees, consultants and directors in the form of stock options, restricted stock and other stock-based awards. At April 1, 1998, the 1998 Plan assumed the obligations of six stock option plans of Coventry Corporation with total outstanding options representing 3,322,714 shares, and one stock option plan of Principal Health Care, Inc. with total outstanding options representing 750,000 shares, as a result of the acquisition of the PHC plans. Under the 1998 Plan, the terms and conditions of grants are established on an individual basis with the exercise price of the options being equal to not less than 100% of the market value of the underlying stock at the date of grant. Options generally become exercisable after one year in 20% to 25% increments per year and expire ten years from the date of grant. The 1998 Plan is authorized to grant either incentive stock options or nonqualified stock options at the discretion of the Compensation and Benefits Committee of the Board of Directors.

As of September 10, 1998, employees of the Company were offered an opportunity to exchange their existing options (issued at a higher exercise price) for a reduced number of new options (issued at a lower exercise price) equivalent to the same value as their existing options, based upon a Black-Scholes equal valuation model. Employees could choose to decline the offer of new options and keep their existing options. As a result, the Company cancelled approximately 4,370,100 shares, and reissued repriced options equal to approximately 3,714,182 shares. The options canceled were at exercise prices ranging from a high of $22.750 to a low of $6.3750. The options were reissued in accordance with an exchange formula (using the Black-Scholes equal valuation model) that issued one-half of the new options at an exercise price of the then current market value ($5.00) and the remaining one-half at 150% of the then current market value ($7.50). The resulting value of the repriced options was the same as the exchanged options.

The assumed plans are the Coventry Corporation 1997 Stock Incentive Plan, the Coventry Corporation 1993 Stock Option Plan (as amended), the Southern Health Management Corporation 1993 Stock Option Plan, the Coventry Corporation 1993 Outside Directors Stock Option Plan (as amended), the Coventry Corporation Third Amended and Restated 1989 Stock Option Plan, the Coventry Corporation Amended and Restated 1987 Statutory-Nonstatutory Stock Option Plan, and the Principal Health Care, Inc. 1997 Non-Qualified Stock Option Plan.

At various dates in 1996, the Company canceled, repriced, and reissued approximately 1.3 million shares under option. The options canceled were at prices ranging from a high of $25.00 to a low of $15.63. The shares were reissued at market on the date of reissue and the prices ranged from a high of $18.13 to a low of $12.75.

During 1997, the Company adopted the 1997 Stock Incentive Plan (the “1997 Plan”). Under the 1997 Plan, the Company may grant options and other rights with respect to the Company's common stock to officers, other key employees, consultants and outside directors of the Company. A total of 1,600,000 shares of common stock was reserved for this issuance.

With the merger of SHS in December 1994, the Company assumed SHS's incentive stock option plan. The Company issued options for 146,030 shares of common stock in exchange for 42,500 options to acquire shares of SHS common stock granted under SHS's incentive stock option plan. These options were exercisable upon the completion of the merger with SHS and expire in 2003.

The Company follows APB No. 25, under which no compensation cost has been recognized in connection with stock option grants. Had compensation cost for these plans been determined consistent with Statement of Financial Accounting Standards No. 123 (“SFAS 123”), “Accounting for Stock-Based Compensation,” the Company's net income and earnings per share would have been reduced to the following pro forma amounts:

	1998	1997	1996
Net income (loss):			
As Reported	$ (11,741)	$ 11,903	$ (61,287)
Pro Forma	(14,224)	8,790	(63,949)
EPS, basic			
As Reported	$ (0.22)	$ 0.36	$ (1.87)
EPS, diluted			
As Reported	(0.22)	0.35	(1.87)
EPS, basic & diluted			
Pro Forma	(0.27)	0.26	(1.95)

Because the SFAS 123 method of accounting has not been applied to options granted prior to January 1, 1995, the resulting pro forma compensation cost may not be representative of that to be expected in future years.

Transactions with respect to the plans for the three years ended December 31, 1998 were as follows (shares in thousands):

	1998		1997		1996	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	3,261	$ 13	2,858	$ 13	2,381	$ 14
Granted	7,627	8	1,584	15	2,898	13
Exercised	(110)	12	(166)	12	(621)	6
Canceled	(5,337)	13	(1,015)	14	(1,800)	17
Outstanding at end of year	5,441	8	3,261	13	2,858	13
Exercisable at end of year	837	$ 11	819	$ 13	708	$ 15

The following table summarizes information about stock options outstanding at December 31, 1998 (shares in thousands):

	Options Outstanding		Options Exercisable			
Range of Exercise Prices	Number Outstanding at 12/31/98	Weighted Average Remaining Contractual Life	Weighted Average Exercise Prices	Number Exercisable at 12/31/98	Weighted Average Exercise Price
$4 - $5	1,697	8.8	$ 5	154	$ 5
$5 - $7	880	9.4	7	43	7
$7 - $8	1,518	8.5	8	149	8
$8 - $15	1,066	8.3	13	303	12
$15 - $25	280	7.6	17	188	18
$4 - $25	5,441	8.6	$ 8	837	$ 11

The fair value of the stock options included in the pro forma amounts shown above was estimated as of the grant date using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	1998	1997	1996
Dividend yield	0%	0%	0%
Expected volatility	73%	64%	56%
Risk-free interest rate	5%	6%	6%
Expected life	4 years	5 years	5 years

The weighted-average grant date fair values for options granted in 1998, 1997 and 1996 were $4.53, $8.77, and $6.61, respectively.

At December 31, 1998, the Company had outstanding warrants granting holders the right to purchase 6,075,373 shares of common stock. In July 1995, 100,000 warrants were issued at a price of $14.125 and expire in July 2000. In December 1993, warrants were issued granting holders the right to purchase 800,000 shares at an exercise price of $21.00. Of the 800,000 shares, 550,300 were exercised before the expiration of the warrants in December 1995, and the remaining 249,700 shares expired. During the first half of 1996, warrants for 170,000 shares were exercised at a price of $6.75 per share.

On July 7, 1997, the Company finalized the sale of $40 million of Coventry Convertible Exchangeable Subordinated Notes, together with warrants to purchase 2.35 million shares at $10.625 per share of common stock. The purchase price for the warrants was $1.00 per share, valued by Coventry and the purchaser. The warrants expire seven years from the purchase date.

On April 1, 1998, the Company issued a warrant to PHC (the "Principal Warrant") to purchase that number of shares of common stock equal to 66-2/3% of the total number of shares of common stock actually issued upon the exercise or conversion of the Company's employee stock options issued and outstanding at March 31, 1998, on the same terms and conditions as set forth in the respective options and warrants. Options and warrants that terminated or expired and are not exercised, are also

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

canceled in the Principal Warrant. At March 31, 1998, the Company had options and warrants outstanding for 5,800,480 shares of common stock, representing the right to purchase 3,866,986 shares under the Principal Warrant. At December 31, 1998, the Principal Warrant represented the right to purchase 3,462,368 shares, taking into account cancellations.

On May 18, 1998, the Company issued warrants to four individual consultants to purchase 40,000 shares of common stock at an exercise price of $13.625 per share, expiring in 2003. On October 22, 1998, the Company issued warrants to certain providers to purchase 10,000 shares of common stock at an exercise price of $7.625 per share, expiring in 2003. On December 21, 1998, the Company issued a warrant to an individual in connection with the acquisition of a health plan to purchase 85,239 shares of common stock at an exercise price of $8.32 per share, expiring in 2003.

The Company implemented an Employee Stock Purchase Plan in 1994, which allows substantially all employees who meet length of service requirements to set aside a portion of their salary for the purchase of the Company's common stock. At the end of each plan year, the Company will issue the stock to participating employees at an issue price equal to 85% of the lower of the stock price at the end of the plan year or the average stock price, as defined. The Company has reserved 1.0 million shares of stock for this plan and has issued 15,016, 7,074, and 19,465 shares in 1998, 1997, and 1996, respectively.

K. Reinsurance

The Company has reinsurance agreements, through its subsidiary CHLIC, with American Continental Insurance Company and Continental Assurance Company for portions of the risk it has underwritten through its products. These reinsurance agreements do not release the Company of its primary obligations to its membership. Reinsurance premiums for the years ended December 31, 1998, 1997 and 1996, were approximately $1.0 million, $0.7 million and $1.8 million respectively. Reinsurance recoveries for the same periods were approximately $0.6 million, $0.4 million and $1.5 million. The Company remains liable to its membership if the reinsurers are unable to meet their contractual obligations under the reinsurance agreements. All reinsurance agreements are subject to certain limits on hospital costs per patient-day. To minimize its exposure to significant losses from reinsurer insolvencies, the Company evaluates the financial condition of its reinsurers on an annual basis. American Continental Insurance Company and Continental Assurance Company are both currently A rated by the A.M. Best Company.

Medicaid risk exposures in Missouri are reinsured through the State of Missouri mandated program with retention of $50,000 per member per year and 20% coinsurance. Reinsurance recoveries for the years ended December 31, 1998 and 1997 were approximately $4.0 million and $1.2 million, respectively. There were no reinsurance recoveries for the year ended December 31, 1996.

L. Commitments

The Company operates primarily in leased facilities with original lease terms of up to ten years with options for renewal. The Company also leases computer equipment with lease terms of approximately three years. Leases that expire generally are expected to be renewed or replaced by other leases.

The minimum rental commitments payable and minimum sublease rentals to be received by the Company during each of the next five years ending December 31 and thereafter for noncancellable operating leases are as follows (in thousands):

Year	Rental Commitments	Sublease Income
1999	$ 14,826	$ 3,632
2000	12,375	3,446
2001	11,336	3,327
2002	9,636	3,205
2003	7,389	2,926
Thereafter	6,718	2,885
	$ 62,280	$ 19,421

Total rent expense was approximately $14.6 million, $8.3 million and $11.7 million for the years ended December 31, 1998, 1997 and 1996, respectively.

M. Concentration of Credit Risk

Financial instruments which potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents, investments in marketable securities and accounts receivable. The Company invests its excess cash in interest bearing deposits with major banks, commercial paper and money market funds. Investments in marketable securities are managed within guidelines established by the Board of Directors which emphasize investment-grade fixed income securities and limit the amount that may be invested in any one issuer. The fair value of the Company's financial instruments is substantially equivalent to their carrying value and, although there is some credit risk associated with these instruments, the Company believes this risk to be minimal.

As discussed in Notes B and C to consolidated financial statements, the Company entered into long-term global capitation arrangements with two integrated provider organizations. To the extent that the Company becomes a party to global capitation agreements with a single provider organization serving substantial membership, the Company becomes exposed to credit risk with respect to such organizations. The Company may utilize the following to manage such risk: 1) contract with providers with significant net worth and cash reserves; 2) require letters of credit or cash to be reserved for claims payment and 3) monitor the providers' financial condition in regard to the Company membership.

Concentration of credit risk with respect to accounts receivable is limited due to the large number of customers comprising the Company's customer base and their breakdown among geographical locations. See Note A for additional information with respect to accounting policies for accounts receivable.

The Company believes the allowance for doubtful collections adequately provides for estimated losses as of December 31, 1998. The Company has a risk of incurring loss if such allowances are not adequate.

As discussed in Note K to consolidated financial statements, the Company has reinsurance agreements with a major insurance company. The Company monitors the insurance companies' financial ratings to determine compliance with standards set by state law. The Company has a credit risk associated with these reinsurance agreements to the extent the reinsurer is unable to pay valid reinsurance claims of the Company.

N. Benefit Plans

On July 1, 1994, Coventry Corporation adopted an employee defined contribution retirement plan qualifying under IRC Section 401(k), the Coventry Corporation Retirement Savings Plan (the "Plan"), which covers substantially all employees of Coventry Corporation and its subsidiaries who meet certain requirements as to age and length of service and who elect to participate in the Plan. Similar retirement savings plans offered by (1) both HAPA and GHP and (2) both CHMC and HCUSA were merged into the Plan effective July 1, 1994 and January 1, 1996, respectively. Effective March 31, 1998, the Company was formed as the parent company of an affiliated group of companies that includes Coventry Corporation. The Company, with the approval of Coventry Corporation, adopted and became sponsor of the Plan effective April 1, 1998. On April 1, 1998, the Coventry Health Care, Inc. Retirement Savings Plan (the "New Plan") was adopted and any prior PHC and certain affiliated participant account balances included in the assets of the former PHC qualified retirement plan were rolled over into the New Plan at the election of the former PHC employees. Effective October 1, 1998, the Plan was merged with the New Plan. All employees that were participants under the Plan became participants in the New Plan. On October 1, 1998, the assets of the Plan were merged and transferred to: (1) Principal Life Insurance Company, as funding agent of the assets held under the terms of the Flexible Investment Annuity Contract with Coventry Health Care, Inc., (2) Delaware Charter Guarantee and Trust Company, as custodial trustee of the mutual funds and (3) Bankers Trust Company, as custodial trustee of the New Plan's participant loans and the Coventry Health Care, Inc. Common Stock.

Prior to 1998, under the Plan, employees were able to defer up to 15% of their compensation, limited by the maximum compensation deferral amount permitted by applicable law. The Company made matching contributions equal to 100% of the employee's contribution on the first 3% of the employee's compensation deferral and equal to 50% of the employee's contribution on the second 3% of the employee's compensation deferral. Prior to 1998, employees vested in the Company's matching contributions in 20% increments annually over a period of 5 years, based on length of service with the Company and/or its subsidiaries. Effective January 1, 1998, under the Plan and the New Plan, employees may defer up to 15% of their compensation, limited by the maximum compensation deferral amount permitted by applicable law. The Company makes matching contributions of the Company's common stock equal to 100% of the employee's contribution on the first 3% of the employee's compensation deferral and equal to 50% of the employee's contribution on the second 3% of the employee's compensation deferral. Employees will vest in the Company's matching contributions in 50% increments annually over a period of 2 years, based on length of service with the Company and/or its subsidiaries. All costs of the Plan and the New Plan are funded by the Company as they are incurred.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

On July 1, 1994, Coventry Corporation adopted a supplemental executive retirement plan (the "SERP"), which covers employees of Coventry Corporation and its subsidiaries who (1) meet certain requirements as to age and management responsibilities and/or salary, (2) are designated as being eligible to participate in the SERP by the Compensation and Benefits Committee of the Board of Directors of the Company, and (3) elect to participate in the SERP and the New Plan. A similar supplemental executive retirement plan offered by HAPA was merged into the SERP effective July 1, 1994. Effective April 1, 1998, the SERP plan name changed to the Coventry Health Care, Inc. Supplemental Executive Retirement Plan. Under the SERP, employees may defer up to 15% of their base salary, and up to 100% of any bonus awarded, over and beyond the compensation deferral limits of the Plan. The Company makes matching contributions equal to 100% of the employee's contribution on the first 3% of the employee's compensation deferral and 50% of the employee's contribution on the second 3% of the employee's compensation deferral. Prior to January 1, 1998, employees vested in the Company's matching contributions in 20% increments annually over a period of 5 years, based on length of service with the Company and/or its subsidiaries. Effective January 1, 1998, employees vest in the Company's matching contributions ratably over two years, based on length of service. All costs of the SERP are funded by the Company as they are incurred.

The cost, principally employer matching contributions, of the benefit plans charged to operations for 1998, 1997 and 1996 was approximately $4.0 million, $1.8 million and $2.4 million, respectively.

O. Statutory Information

The Company's HMO subsidiaries are required by the respective domicile states to maintain minimum statutory capital and surplus in the aggregate of approximately $35.0 million at December 31, 1998. Combined statutory capital and surplus of the Company's HMOs was approximately $128.4 million. The states in which the Company's HMOs operate require the HMOs to maintain deposits with the Department of Insurance. These deposits totaled $12.8 million at December 31, 1998.

CHLIC's authorized control level Risk-Based Capital is approximately $12.7 million. Total adjusted statutory capital and surplus of CHLIC as of December 31, 1998 was approximately $33.2 million. Statutory deposits for CHLIC as of December 31, 1998 totaled approximately $3.4 million.

P. Other Income

Other income for the years ended December 31, 1998, 1997, and 1996 includes investment income of approximately $25.5, $10.8 million, and $8.4 million, respectively. As described in Note B, other income includes $15.0 million in 1997 from the sale of medical offices. Additionally, in 1996, other income includes a non-recurring gain of approximately $4.9 million as a result of the sale of Champion Dental Service, Inc., a subsidiary GHP, for $5.5 million in cash.

Q. Earnings Per Share

Basic earnings per share ("EPS") is based on the weighted average number of common shares outstanding during the year. Diluted EPS assumes the conversion of convertible notes and the exercise of all options and warrants using the treasury stock method. Net earnings is increased for interest expense on the convertible notes. In all cases, however, losses are not diluted.

The following table summarizes the earnings and the average number of common shares used in the calculation of basic and diluted EPS (in thousands, except for per share amounts):

	1998		
	Earnings (Loss) (Numerator)	Shares (Denominator)	Per Share Amount
Net Earnings (Loss)	$ (11,741)		
Basic EPS	$ (11,741)	52,477	$ (0.22)
Effect of Dilutive Securities			
Options and warrants			
Convertible notes			
Diluted EPS	$ (11,741)	52,477	$ (0.22)

	1997		
	Earnings (Loss) (Numerator)	Shares (Denominator)	Per Share Amount
Net Earnings (Loss)	$ 11,903		
Basic EPS	$ 11,903	33,210	$ 0.36
Effect of Dilutive Securities			
Options and warrants		702	
Convertible Notes			
Diluted EPS	$ 11,903	33,912	$ 0.35

	1996		
	Earnings (Loss) (Numerator)	Shares (Denominator)	Per Share Amount
Net Earnings (Loss)	$ (61,287)		
Basic EPS	$ (61,287)	32,818	$ (1.87)
Effect of Dilutive Securities			
Options and warrants			
Diluted EPS	$ (61,287)	32,818	$ (1.87)

R. Legal Proceedings

In the normal course of business, the Company has been named as defendant in various legal actions seeking payments for claims denied by the Company, medical malpractice, and other monetary damages. The claims are in various stages of proceedings and some may ultimately be brought to trial. Incidents occurring through December 31, 1998 may result in the assertion of additional claims. With respect to medical malpractice, the Company carries professional malpractice and general liability insurance for each of its operations on a claims made basis with varying deductibles for which the Company maintains reserves. In the opinion of management, the outcome of these actions will not have a material adverse effect on the financial position or results of operations of the Company.

The Company's industry is heavily regulated and the laws and rules governing the industry and interpretations of those laws and rules are subject to frequent change. Existing or future laws could have significant impact on the Company's operations.

S. Segment Information

	For the Year Ended December 31, 1998 (in $000s)		
	Commercial	Government Programs	Total
Revenues	$ 1,561,640	$ 471,732	$ 2,033,372
Gross Margin	165,299	45,699	210,998

	For the Year Ended December 31, 1997 (in $000s)		
	Commercial	Government Programs	Total
Revenues	$ 886,237	$ 321,912	$ 1,208,149
Gross Margin	132,340	35,949	168,289

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	For the Year Ended December 31, 1996 (in $000s)		
	Commercial	Government Programs	Total
Revenues	$ 839,850	$ 195,928	$ 1,035,778
Gross Margin	65,538	29,708	95,246

Following are reconciliations of reportable segment information to financial statement amounts:

	For The Years Ended December 31,		
	1998	1997	1996
Revenues			
Reportable Segments	$ 2,033,372	$ 1,208,149	$ 1,035,778
Other	77,011	20,202	21,351
Total revenues	$ 2,110,383	$ 1,228,351	$ 1,057,129
Earnings (Loss) Before			
Income Taxes:			
Gross margin from reportable segments	$ 210,998	$ 168,289	$ 95,246
Other revenues	77,011	20,202	21,351
Selling, general and administrative	(291,919)	(170,017)	(165,081)
Depreciation and amortization	(25,793)	(12,735)	(42,862)
Merger costs	(6,492)	-	-
Other income, net	27,251	24,880	13,379
Interest expense	(8,566)	(10,275)	(6,257)
Total earnings (loss) before income taxes	$ (17,510)	$ 20,344	$ (84,224)

T. QUARTERLY FINANCIAL DATA *(unaudited)*

The following is a summary of unaudited quarterly results of operations (in thousands, except per share data) for the years ended December 31, 1998 and 1997.

	Quarter Ended			
	March 31, 1998	June 30, 1998 (1)(2)	September 30, 1998	December 31, 1998(3)
Operating revenues	$ 330,209	$ 583,804	$ 593,278	$ 603,092
Operating earnings (loss)	7,178	(51,238)	2,179	5,686
Net earnings (loss)	4,707	(27,756)	5,068	6,240
Net earnings (loss) per share-basic	0.14	(0.47)	0.09	0.11
Net earnings (loss) per share-diluted	0.13	(0.47)	0.09	0.11

	Quarter Ended			
	March 31, 1997(4)	June 30, 1997 (5)	September 30, 1997 (6)	December 31, 1997
Operating revenues	$ 299,345	$ 301,081	$ 306,694	$ 321,231
Operating earnings (loss)	(8,021)	1,997	5,976	5,787
Net earnings (loss)	(851)	6,590	2,658	3,506
Net earnings (loss) per share-basic	(0.03)	0.20	0.08	0.11
Net earnings (loss) per share-diluted	(0.03)	0.19	0.08	0.10

(1) *Effective April 1, 1998, the Company completed its acquisition of certain assets of PHC from Principal Life. The acquisition was accounted for using the purchase method of accounting and, accordingly, the operations of PHC have been included in the Company's consolidated financial statements since the date of acquisition. As a result of the merger, an estimated reserve of $7.8 million was established for the costs related to the relocation of the corporate office from Nashville, Tennessee to Bethesda, Maryland and other merger related expenses.*

(2) *The second quarter 1998 operating results were affected by the establishment of a reserve for the costs incurred by members covered by the AHERF agreement and other potential charges as a result of the bankruptcy filing by AHERF. The establishment of the reserves resulted in a charge to earnings of $55.0 million.*

(3) *The merger costs were less than the reserve established in the second quarter of 1998, resulting in a credit to earnings of $1.3 million.*

(4) *Effective March 31, 1997, the Company completed the sale of the majority of its medical offices in Pittsburgh, Pennsylvania associated with HAPA to a major health care provider organization. The sale price was $20.0 million and the transaction resulted in a pretax gain of approximately $6.0 million.*

(5) *Effective May 1, 1997, the Company completed the sale of the medical offices associated with Group Health Plan, Inc., its health plan in St. Louis, Missouri, to a major health care provider organization. The sale price was $26.9 million and the transaction resulted in a pretax gain of approximately $9.6 million.*

(6) *In August 1997, the Company entered into an agreement to sell the medical offices associated with HAPA's health plan operations in Harrisburg, Pennsylvania. The sale price was $2.0 million and the transaction resulted in a pretax loss of $0.2 million. Also in the third quarter, the Company sold its two remaining medical offices located in Pittsburgh, Pennsylvania for $0.3 million in cash and recorded a pretax loss of $0.4 million.*

DIRECTORS AND OFFICERS

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Chairman of Coventry Health Care and Chairman and Chief Executive Officer of Arcadian Management Services

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President and Chief Executive Officer
Coventry Health Care

Thomas L. Blair
Chief Executive Officer
United Payors and United Providers, Inc.

David J. Drury
Chairman and Chief Executive Officer
Principal Financial Group

Emerson D. Farley, Jr., M.D.
Private Medical Practice

Thomas J. Graf
Executive Vice President
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Patrick T. Hackett
Managing Director
E.M. Warburg, Pincus & Company

Lawrence N. Kugelman
Former President and Chief Executive Officer
Coventry Corporation

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E.M. Warburg, Pincus & Company

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Dale B. Wolf
Executive Vice President, Chief Financial Officer and Treasurer

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Senior Vice President, Government Programs, Compliance, Information Systems and Human Resources

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Thomas A. Davis
Senior Vice President of Coventry Health Care and Chief Executive Officer of Principal Health Care of Georgia, Inc.

Davina C. Lane
Senior Vice President of Coventry Health Care and Chief Executive Officer of Group Health Plan, Inc.

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Senior Vice President and Chief Marketing and Sales Officer of Coventry Health Care

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Senior Vice President and Chief Medical Officer

James E. McGarry
Senior Vice President, Customer Service

Shirley R. Smith
Senior Vice President, General Counsel and Secretary

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Harvey Pollak
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John J. Stelben
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Joseph M. Tagliareni
Vice President, Finance