SIERRA HEALTH SERVICES INC
Form 10-Q
October 26, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2004

OR

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

For the transition period from ________to _________

Commission file number 1-8865

Sierra Health Services, Inc.
(Exact name of registrant as specified in its charter)

Nevada	**88-0200415**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

2724 North Tenaya Way
Las Vegas, Nevada 89128

(Address of principal executive offices including zip code)

(702) 242-7000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file reports), and (2) has been subject to such filing requirements for the past 90 days. Yes

x No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes
x No

..

As of October 22, 2004, there were 26,402,000 shares of common stock outstanding.

SIERRA HEALTH SERVICES, INC.
Quarterly Report on Form 10-Q
For the period ended September 30, 2004

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SIERRA HEALTH SERVICES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)
(Unaudited)

	September 30, 2004	December 31, 2003
ASSETS		
CURRENT ASSETS:		
Cash and Cash Equivalents	$ 194,061	$ 118,473
Investments	111,735	197,573
Accounts Receivable (Less Allowance for Doubtful Accounts; 2004 - $6,635; 2003 - $7,342)	13,671	12,080
Military Accounts Receivable (Less Allowance for Doubtful Accounts; 2004 and 2003 - $100)	36,293	47,389
Current Portion of Deferred Tax Asset	22,589	33,708
Prepaid Expenses and Other Current Assets	44,088	37,478
Assets of Discontinued Operations	4,124	533,756
Total Current Assets	426,561	980,457
PROPERTY AND EQUIPMENT, NET	69,432	63,109
RESTRICTED CASH AND INVESTMENTS	20,616	17,646
GOODWILL	14,782	14,782

DEFERRED TAX ASSET (Less Current Portion)	12,617	11,501
NOTE RECEIVABLE	62,000	--
OTHER ASSETS	70,624	46,626
TOTAL ASSETS	$ 676,632	$ 1,134,121
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accrued Liabilities	$ 76,629	$ 56,327
Trade Accounts Payable	18,289	37,787
Accrued Payroll and Taxes	31,492	15,879
Medical Claims Payable	115,622	103,749
Unearned Premium Revenue	17,502	45,888
Military Health Care Payable	39,131	76,605
Current Portion of Long-Term Debt	78	163
Liabilities of Discontinued Operations	759	472,407
Total Current Liabilities	299,502	808,805
LONG-TERM DEBT (Less Current Portion)	125,352	116,645
OTHER LIABILITIES	69,060	57,907
TOTAL LIABILITIES	493,914	983,357
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Preferred Stock, $.01 Par Value, 1,000 Shares Authorized; None Issued or Outstanding		
Common Stock, $.005 Par Value, 60,000 Shares Authorized; 2004 - 35,149; 2003 - 33,173 Shares Issued	176	166
Treasury Stock: 2004 - 8,755; 2003 - 6,221 Common Stock Shares	(217,122)	(112,737)
Additional Paid-in Capital	276,299	227,417
Deferred Compensation	(2,233)	(22)
Accumulated Other Comprehensive Loss	(112)	(479)
Retained Earnings	125,710	36,419
TOTAL STOCKHOLDERS' EQUITY	182,718	150,764
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 676,632	$ 1,134,121

See accompanying notes to condensed consolidated financial statements.

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SIERRA HEALTH SERVICES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

	Three Months Ended September 30,		Nine Mon
	2004	**2003**	**200**
OPERATING REVENUES:			
Medical Premiums	$ 288,485	$ 242,875	$ 83
Military Contract Revenues	85,983	132,788	35

Professional Fees	8,705	8,984	2
Investment and Other Revenues	10,107	4,590	2
Total	393,280	389,237	1,24
OPERATING EXPENSES:			
Medical Expenses	224,219	191,248	65
Military Contract Expenses	75,830	128,966	31
General and Administrative Expenses	44,496	33,845	12
Total	344,545	354,059	1,09
OPERATING INCOME FROM CONTINUING OPERATIONS	48,735	35,178	15
Interest Expense	(1,221)	(1,295)	(
Other Income (Expense), Net	(49)	100	
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	47,465	33,983	14
PROVISION FOR INCOME TAXES	(16,738)	(11,806)	(5
INCOME FROM CONTINUING OPERATIONS	30,727	22,177	9
INCOME (LOSS) FROM DISCONTINUED OPERATIONS (net of income tax (provision) benefit of $0, ($54), $761, and $1,268), respectively	--	30	
NET INCOME	$ 30,727	$ 22,207	$ 9
EARNINGS PER COMMON SHARE:			
Income from Continuing Operations	$ 1.16	$ 0.78	$
Loss from Discontinued Operations	--	--	
Net Income	$ 1.16	$ 0.78	$
EARNINGS PER COMMON SHARE ASSUMING DILUTION:			
Income from Continuing Operations	$ 0.90	$ 0.72	$
Loss from Discontinued Operations	--	--	
Net Income	$ 0.90	$ 0.72	$

See accompanying notes to condensed consolidated financial statements.

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SIERRA HEALTH SERVICES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended Septembe	
	2004	**2003**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Income	$ 94,777	$ 57
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Loss from Discontinued Operations	486	

Depreciation	12,372	11
Stock Based Compensation Expense	4,451	
Provision for Doubtful Accounts	1,224	2
(Gain) Loss on Disposal of Assets	(126)	
Changes in Assets and Liabilities:		
Other Assets	(8,220)	(4
Deferred Tax Asset	31,490	23
Other Liabilities	(17,462)	21
Other Current Assets	5,076	(23
Military Accounts Receivable	11,096	(23
Military Health Care Payable	(37,474)	12
Medical Claims Payable	11,873	4
Accrued Payroll and Taxes	15,613	11
Unearned Premium Revenue	(28,386)	(28
Net Cash Provided by Operating Activities of Continuing Operations	96,790	68
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital Expenditures, Net of Dispositions	(16,766)	(13
Change in Investments	74,805	43
Net Cash Provided by Investing Activities of Continuing Operations	58,039	29
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments on Debt and Capital Leases	(1,544)	(60
Proceeds from Other Long-Term Debt	10,000	1
Purchase of Treasury Stock	(112,277)	(52
Exercise of Stock in Connection with Stock Plans	22,686	12
Proceeds from Senior Convertible Debentures	--	115
Debt Issue Costs	--	(5
Net Cash (Used for) Provided by Financing Activities of Continuing Operations	(81,135)	9
NET CASH PROVIDED BY (USED FOR) DISCONTINUED OPERATIONS	1,894	(25
NET INCREASE IN CASH AND CASH EQUIVALENTS	75,588	82
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	118,473	45
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 194,061	$ 128

Supplemental Condensed Consolidated Continuing Operations Statements of Cash Flows Information:		
Cash Paid During the Period for Interest (Net of Amount Capitalized)	$ (2,848)	$ (3
Net Cash Paid During the Period for Income Taxes	(7,411)	(10
Non-Cash Investing and Financing Activities:		
Assets and Liabilities Recorded in Conjunction with the Sale of the Workers' Compensation Operations	54,060	
Additions to Capital Leases	166	

See accompanying notes to condensed consolidated financial statements.

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements include the consolidated accounts of Sierra Health Services, Inc. ("Sierra", a holding company, together with its subsidiaries, collectively referred to herein as the "Company"). All material intercompany balances and transactions have been eliminated. These statements and the Company's annual audited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America; however, these statements do not contain all of the information and disclosures that would be required in a complete set of audited financial statements. They should, therefore, be read in conjunction with the Company's annual audited consolidated financial statements and related notes thereto for the year ended December 31, 2003. In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all material adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the financial results for the interim periods presented.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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. Such estimates and assumptions could change in the future as more information becomes available, which could impact the amounts reported and disclosed herein. Actual results may differ materially from estimates.

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2. EMPLOYEE STOCK PLANS

Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" requires prominent disclosures in interim as well as annual financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported net income. The Company has continued to account for its stock-based compensation using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," as amended. Accordingly, no compensation cost has been recognized for the Company's employee stock plans except for those expenses associated with restricted stock units and certain stock options in which vesting was or has been agreed to be accelerated. Had compensation cost for the Company's stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans, the Company's net income and earnings per share, would have been reduced to the pro forma amounts indicated below:

	Three Months Ended September 30,		Nine Months
	2004	2003	2004
(In thousands, except per share data)			
Net income, as reported.......................	$ 30,727	$ 22,207	$ 94,7
Less: total stock-based employee compensation expense determined under fair value based methods for all awards, net of tax.........	(1,439)	(1,451)	(6,2
Pro forma net income	$ 29,288	$ 20,756	$ 88,5
Net income per share, as reported.............	$ 1.16	$ 0.78	$ 3.
Pro forma net income, per share	1.11	0.73	3.
Net income per share			

assuming dilution, as reported.............	$ 0.90	$ 0.72	$ 2.
Pro forma net income, per share	0.86	0.67	2.

3. LONG-TERM DEBT

Sierra Debentures

- In March 2003, the Company issued $115.0 million aggregate principal amount of its 2¼% senior convertible debentures due March 15, 2023. The debentures pay interest, which is due semi- annually on March 15 and September 15 of each year. Each $1,000 principal amount of debentures is convertible, at the option of the holders, into 54.6747 shares of Sierra Health Services, Inc., common stock prior to March 15, 2023 if (i) the market price of the Company's common stock for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of the preceding fiscal quarter exceeds 120% of the conversion price per share of the Company's common stock; (ii) the debentures are called for redemption; (iii) there is an event of default with respect to the debentures; or (iv) specified corporate transactions have occurred. The conversion rate is subject to certain adjustments. This conversion rate initially represents a conversion price of $18.29 per share. Holders of the debentures may require the Company to repurchase all or a portion of their debentures on March 15 in 2008, 2013 and 2018 or upon certain corporate events including a change in control. In either case, the Company may choose to pay the purchase price of such debentures in cash or common stock or a combination of cash and common stock. The debentures can be redeemed by the Company for cash beginning on or after March 20, 2008.

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The Company evaluates the market price condition each quarter to determine whether the debentures will be convertible, at the option of the holder, during the subsequent quarter. The market price condition has been satisfied in every quarter since the fourth quarter of 2003 and as a result, the debentures have been convertible, at the option of the holder, since January 1, 2004 and are convertible at any time during the quarter ending December 31, 2004. Although no debentures were converted as of September 30, 2004, they are considered common stock equivalents and are included in the calculation of weighted average common shares outstanding assuming dilution for the three and nine months ended September 30, 2004.

Revolving Credit Facility.

On March 3, 2003, the Company entered into a $65.0 million revolving credit facility, which replaced its amended and restated credit facility. Interest on the facility was initially LIBOR plus 2.25% and has been LIBOR plus 2.00% since the third quarter of 2003. The facility was set to expire on April 30, 2006. Effective October 19, 2004, the facility has been amended to extend the maturity of the facility to December 31, 2009, increase the availability to $100.0 million and reduce the interest to LIBOR plus 1.5% based on current ratios. The facility is available for general corporate purposes. As of September 30, 2004, the Company has drawn $10.0 million on this facility.

The credit facility remains secured by guarantees by certain of the Company's subsidiaries and a first priority perfected security interest in (i) all of the capital stock of each of the Company's unregulated, material domestic subsidiaries (direct or indirect) as well as all of the capital stock of certain regulated, material domestic subsidiaries; and (ii) all other present and future assets and properties of the Company and those of its subsidiaries that guarantee the credit agreement obligations (including, without limitation, accounts receivable, inventory, real property, equipment, contracts, trademarks, copyrights, patents, license rights and general intangibles) subject, in each case, to the exclusion of the capital stock of CII Financial, Inc. ("CII") and certain other exclusions.

The revolving credit facility has covenants that limit the Company's ability and the ability of the Company's subsidiaries to dispose of assets, incur indebtedness, incur other liens, make investments, loans or advances, make acquisitions, engage in mergers or consolidations, make capital expenditures and otherwise restrict certain corporate activities. Per the most recent amendment dated October 19, 2004, based on the Company exceeding a certain leverage ratio requirement, the Company's ability to pay dividends, repurchase Company common stock and prepay other debt is unlimited provided that the Company can still maintain the required ratios after such transaction or any borrowing incurred as a result of such transaction. In addition, the Company is required to comply with specified financial ratios as set forth in the credit agreement. The Company believes it is in compliance with all covenants of the credit agreement.

4. SHARE REPURCHASES

From January 1, 2004 through September 30, 2004, the Company purchased 2.9 million shares of its common stock, in the open market or negotiated transactions, for $112.3 million at an average cost per share of $38.47. During the quarter ended September 30, 2004, the Company purchased 705,000 shares of its common stock, in the open market or negotiated transactions, for $29.5 million at an average cost per share of $41.87. Based on approval by the Company's Board of Directors on May 20, 2004, the Company currently has $43.0 million available for share repurchases. The Company's revolving credit facility, as amended, currently allows for unlimited stock repurchases subject to the Company maintaining a certain covenant ratio. The Company has not repurchased any shares subsequent to September 30, 2004 through October 21, 2004.

Included in the repurchases for the first quarter of 2004 are 500,000 shares the Company purchased from

its CEO, at $32.00 per share, for a total of $16.0 million. The closing price of the Company's common stock on the date of the transaction, February 11, 2004, was $32.35. Included in the repurchases for the second quarter of 2004 are an additional 500,000 shares the Company purchased from its CEO, at $43.20 per share, for a total of $21.6 million. The closing price of the Company's common stock on the date of the transaction, May 27, 2004, was $43.25. The independent directors of the Company's Board of Directors approved both of the purchases.

5. TEXAS DISCONTINUED OPERATIONS

During the third quarter of 2001, the Company announced its plan to exit the Texas HMO health care market and received formal approval from the Texas Department of Insurance to withdraw its HMO operations in mid-October 2001. The Company ceased providing HMO health care coverage in Texas on April 17, 2002.

The Company elected to early adopt Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"), effective January 1, 2001. In accordance with SFAS No. 144, the Company's Texas HMO health care operations were reclassified as discontinued operations.

The following are the unaudited condensed assets and liabilities of the discontinued Texas HMO health care operations:

	September 30, 2004	December 31, 2003
(In thousands)		
ASSETS		
Cash and Cash Equivalents	$ 1,964	$ 47
Investments	2,155	4,048
Other Assets	5	115
ASSETS OF DISCONTINUED OPERATIONS	4,124	4,210
LIABILITIES		
Accounts Payable and Other Liabilities	690	2,658
Medical Claims Payable	69	202
LIABILITIES OF DISCONTINUED OPERATIONS	759	2,860

NET ASSETS OF DISCONTINUED OPERATIONS................	$ 3,365	$ 1,350

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The following are unaudited condensed statements of operations of the discontinued Texas HMO health care operations:

	Three Months Ended September 30,		Nine Mo
	2004	2003	2
(In thousands)			
Operating Revenues................................	$ 10	$ 111	$
Medical Expenses................................	(87)	(70)	
General and Administrative Expenses, Net...........	97	254	
Interest Expense and Other, Net (including rental income).......................	--	(503)	
Total Expenses, Net...............................	10	(319)	
Income from Discontinued Operations Before Taxes...	--	430	
Income Tax Provision..............................	--	(179)	
Net Income from Discontinued Operations...........	$ --	$ 251	$

The operating revenues are all related to investment income. All of the discontinued Texas HMO health care operations had previously been a component of the "managed care and corporate operations" segment.

Management believes that the remaining liabilities, at September 30, 2004, are appropriate and that no further revisions to the estimates are necessary at this time. Based on the current estimated Texas HMO health care remaining liabilities, the Company believes the Texas HMO has adequate funds available and the ability to fund the anticipated obligations.

6. CII FINANCIAL, INC. DISCONTINUED OPERATIONS

On January 15, 2003, the Company announced that it was exploring strategic alternatives to sell its workers' compensation company, CII. Sierra's Board of Directors authorized the plan to sell the operations on December 31, 2002. Accordingly, beginning in the fourth quarter of 2002, the Company reclassified its workers' compensation insurance business as discontinued operations. CII represented the majority of the Company's previous workers' compensation operations segment and specialty product income and expenses.

On March 31, 2004, the Company completed the sale of CII's subsidiary, California Indemnity Insurance Company ("Cal Indemnity"), which was CII's only significant asset. Cal Indemnity's subsidiaries, which were included in the sale, are Commercial Casualty Insurance Company, Sierra Insurance Company of Texas, and CII Insurance Company.

The Company received $14.2 million in cash at the closing, which was subsequently reduced by $2.7 million based on the audited closing date balance sheet. The $2.7 million adjustment is expected to be repaid to the Company over the next few years. The transaction also includes a note receivable of $62.0 million, plus accrued interest, payable to the

Company in January 2010. The note receivable can be increased or decreased depending on favorable or adverse claim and expense development from the date of closing through December 31, 2009, and other offsets and additions based on certain agreements between the parties. The note receivable can be increased on a dollar for dollar basis for the first $15 million in positive loss reserve development and $.50 per dollar on any positive development in excess of $15 million. The note receivable can also be decreased on a dollar for dollar basis for the first $58 million in adverse loss development. To date, no valuation adjustment has been recorded on the note.

Certain other contractual assets and liabilities were recorded in conjunction with the sale including a current asset of $15.8 million and a non-current asset of $7.1 million that represent Cal Indemnity's unallocated loss adjustment expense ("ULAE") reserves to be paid to Sierra. Offsetting these assets was a current liability of $15.8 million and a non-current liability of $7.1 million, which represent the contractual services to be performed by Sierra. Including the cash proceeds, net assets of $68.3 million were recorded in conjunction with the sale of Cal Indemnity. Previously, CII had recorded valuation adjustments to reduce the business to its estimated net realizable value upon disposition. No further adjustments were required upon final disposition; therefore, no gain or loss on the sale was recorded.

A third-party claims administrator was engaged to administer claims for a period of 15 years. Under the terms of this agreement, the administrator will provide certain claims services for Cal Indemnity and its subsidiaries. Sierra will be responsible for this administrator's costs and for providing certain transition services for varying terms to Cal Indemnity. The purchaser of Cal Indemnity will pay Sierra for these costs from an account consisting of the ULAE reserves and accrued liabilities as of the closing, a percentage of premiums earned after the closing, plus accrued interest on the ULAE reserves. In addition, Sierra is providing workers' compensation managed care services at market rates to Cal Indemnity.

The Company's September 30, 2004 Condensed Consolidated Balance Sheet does not include the assets and liabilities of Cal Indemnity due to the disposal of those assets and liabilities at March 31, 2004. The Company's Condensed Consolidated Statement of Income for the nine months ended September 30, 2004 reflects the activity of the discontinued operations through the disposal date, March 31, 2004. Any subsequent activity related to this disposal will be reflected in continuing operations.

The following are the assets and liabilities of the discontinued operations of CII:

	December 31, 2003
(In thousands)	
ASSETS	
Cash and Cash Equivalents	$ 58,634
Investments	243,647
Reinsurance Recoverable	177,333
Property and Equipment, Net	1,612
Other Assets	48,320
TOTAL ASSETS	529,546
LIABILITIES	
Accounts Payable and Other Accrued Expenses	54,208
Reserve for Loss and Loss Adjustment Expenses	415,339

TOTAL LIABILITIES...............................	469,547
NET ASSETS OF DISCONTINUED OPERATIONS.............	$ 59,999

The following are the unaudited condensed statements of opertions of the discontinued operations of CII:

	Three Months Ended September 30,	Three Months Ended March 31,	Nine Months Ended September 30,
	2003	2004	2003
(In thousands)			
OPERATING REVENUES:			
Specialty Product Revenues...........	$ 25,455	$ 19,015	$ 97,499
Investment and Other Revenues........	1,616	1,290	8,916
Total Revenues..................	27,071	20,305	106,415
OPERATING EXPENSES:			
Specialty Product Expenses...........	27,480	21,917	114,227
Interest Expense and Other (Income) Expense, Net..............	(63)	(91)	(914)
Total Operating Expenses.........	27,417	21,826	113,313
Loss from Discontinued Operations Before Income Tax	(346)	(1,521)	(6,898)
Income Tax Benefit..................	125	839	3,047
Net Loss from Discontinued Operations.......................	$ (221)	$ (682)	$ (3,851)

The activity for 2004 is through the disposal date, March 31, 2004. There is no activity for the discontinued operations beyond that date. Specialty product revenues consist of workers' compensation insurance net earned premiums. Specialty product expenses consist of loss and loss adjustment expenses incurred and general and administrative expenses.

7. EARNINGS PER SHARE:

The following table provides a reconciliation of basic and diluted earnings per share:

	Three Months Ended September 30,		Nine Month
	2004	2003	2004
(In thousands, except per share data)			
BASIC INCOME (LOSS) PER SHARE			

Income from continuing operations................	$ 30,727	$ 22,177	$ 95,
Income (Loss) from discontinued operations.......	--	30	(
Net income.......................................	$ 30,727	$ 22,207	$ 94,
Weighted average common shares outstanding.......	26,498	28,423	26,
Earnings per common share:			
Income from continuing operations................	$ 1.16	0.78	$ 3
Loss from discontinued operations................	--	--	(0
Net income.......................................	1.16	0.78	3
DILUTED INCOME (LOSS) PER SHARE			
Income from continuing operations................	$ 30,727	$ 22,177	$ 95,
Income (Loss) from discontinued operations.......	--	30	(
Net income.......................................	30,727	22,207	94,
Interest expense on Sierra Debentures, net of tax..................................	421	--	1,
Income for purposes of computing diluted net income per share.........................	$ 31,148	$ 22,207	$ 96,
Weighted average common shares outstanding.......	26,498	28,423	26,
Dilutive options and restricted shares outstanding................................	1,668	2,474	1,
Dilutive impact of conversion of Sierra Debentures...........................	6,288	--	6,
Weighted average common shares outstanding assuming dilution...........................	34,454	30,897	35,
Earnings per common share assuming dilution:			
Income from continuing operations................	0.90	0.72	2
Loss from discontinued operations................	--	--	(0
Net income.......................................	0.90	0.72	2

The Company evaluates the market price condition of its convertible debentures each quarter to determine whether they will be convertible, at the option of the holder, during the subsequent quarter. The market price condition has been satisfied in every quarter since the fourth quarter of 2003 and, as a result, the debentures have been convertible, at the option of the holder, since January 1, 2004 and are convertible at any time during the quarter ending December 31, 2004. Although no debentures were

converted as of September 30, 2004, they are considered common stock equivalents and are included in the calculation of weighted average common shares outstanding assuming dilution for the three and nine months ended September 30, 2004.

The Company issued 125,000 restricted stock units ("units") to certain executives in the second quarter of 2004. For the nine months ended September 30, 2004, the units were not dilutive and, therefore, were not included in the computation of diluted earnings per share. For the nine months ended September 30, 2004, stock options to purchase 36,000 shares were not dilutive and, therefore, were also not included in the computation of diluted earnings per share.

For the three and nine months ended September 30, 2003, stock options to purchase 262,000 and 293,000 shares, respectively, were not dilutive and, therefore, were not included in the computation of diluted earnings per share.

8. DEFINED BENEFIT PLAN

The Company previously disclosed that it expects to contribute approximately $800,000 to its defined benefit plan in 2004 to fund expected benefit payments. As of September 30, 2004, the Company has contributed $588,000 to the plan to fund benefit payments and anticipates making approximately $196,000 in additional contributions during 2004.

	Three Months Ended September 30,		Nine Months En
	2004	2003	2004
(In thousands)			
Components of Net Periodic Benefit Cost:			
Service Cost................................	$ 106	$ 82	$ 318
Interest Cost...............................	418	352	1,254
Amortization of Prior Service Credits........	303	231	909
Recognized Actuarial Loss....................	109	145	327
Net Periodic Benefit Cost....................	$ 936	$ 810	$ 2,808

9. COMPREHENSIVE INCOME

The following table presents comprehensive income for the periods indicated:

	Three Months Ended September 30,		Nine Mon
	2004	2003	20
(In thousands)			
Net Income	$ 30,727	$ 22,207	$
Change in Unrealized Holding Gain on Available-for-Sale Investments, net of tax....	719	(1,400)	
Change in Minimum Pension Liability, net of tax....	--	(566)	
Comprehensive Income	$ 31,446	$ 20,241	$

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10. SEGMENT REPORTING

The Company has two reportable segments based on the products and services offered: managed care and corporate operations, and military health services operations. The managed care and corporate operations segment includes managed health care services provided through an HMO, managed indemnity plans, third-party administrative services programs for employer-funded health benefit plans and self-insured workers' compensation plans, multi-specialty medical groups, workers' compensation administration services, other ancillary services and corporate operations. The military health services segment administers a managed care federal contract for the Department of Defense's ("DoD") TRICARE program in Region 1. The military health services segment includes an allocation of corporate overhead of $1.0 million per quarter for direct and indirect services provided to Sierra Military Health Services, LLC ("SMHS").

SMHS completed the fifth year of a five-year contract in May 2003. SMHS then operated under a negotiated contract extension period, which ended August 31, 2004. The new contractor became operational on September 1, 2004 and the new contract superseded the remainder of the Company's current TRICARE Region 1 contract. On September 1, 2004, SMHS commenced a six-month phase-out of operations at prices previously negotiated with the DoD. SMHS does not meet the definition of discontinued operations since the Company does not have plans to dispose of the operations before the phase-out is complete.

The Company evaluates each segment's performance based on segment operating profit. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies.

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(In thousands)	Managed Care and Corporate Operations	Military Health Services Operations	Total
Three Months Ended September 30, 2004			
Medical Premiums	$ 288,485	$ --	$ 288,485
Military Contract Revenues	--	85,983	85,983
Professional Fees	8,705	--	8,705
Investment and Other Revenues	9,839	268	10,107
Total Revenue	$ 307,029	$ 86,251	$ 393,280
Segment Operating Profit	$ 38,314	$ 10,421	$ 48,735
Interest Expense	(1,218)	(3)	(1,221)
Other Income (Expense), Net	(54)	5	(49)
Income from Continuing Operations Before Income Taxes	$ 37,042	$ 10,423	$ 47,465
Three Months Ended September 30, 2003			
Medical Premiums	$ 242,875	$ --	$ 242,875
Military Contract Revenues	--	132,788	132,788
Professional Fees	8,984	--	8,984
Investment and Other Revenues	3,979	611	4,590
Total Revenue	$ 255,838	$ 133,399	$ 389,237
Segment Operating Profit	$ 30,745	$ 4,433	$ 35,178
Interest Expense	(1,228)	(67)	(1,295)
Other Income (Expense), Net	56	44	100
Income from Continuing Operations Before Income Taxes	$ 29,573	$ 4,410	$ 33,983
Nine Months Ended September 30, 2004			
Medical Premiums	$ 834,584	$ --	$ 834,584
Military Contract Revenues	--	354,312	354,312
Professional Fees	26,268	--	26,268

Investment and Other Revenues	26,346	1,199	27,545
Total Revenue	$ 887,198	$ 355,511	$ 1,242,709
Segment Operating Profit	$ 109,598	$ 42,464	$ 152,062
Interest Expense	(3,515)	(46)	(3,561)
Other Income (Expense), Net	146	(32)	114
Income from Continuing Operations Before Income Taxes	$ 106,229	$ 42,386	$ 148,615
Nine Months Ended September 30, 2003			
Medical Premiums	$ 717,097	$ --	$ 717,097
Military Contract Revenues	--	352,632	352,632
Professional Fees	27,403	--	27,403
Investment and Other Revenues	13,138	1,442	14,580
Total Revenue	$ 757,638	$ 354,074	$ 1,111,712
Segment Operating Profit	$ 83,784	$ 9,965	$ 93,749
Interest Expense	(4,248)	(197)	(4,445)
Other Income (Expense), Net	(649)	406	(243)
Income from Continuing Operations Before Income Taxes	$ 78,887	$ 10,174	$ 89,061

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11. INVESTMENTS

Of the cash and cash equivalents and current investments that total $305.8 million in the accompanying Consolidated Balance Sheet at September 30, 2004, $195.8 million is limited for use only by the Company's regulated subsidiaries. Such amounts are available for transfer to Sierra from the regulated subsidiaries only to the extent that they can be remitted in accordance with terms of existing management agreements and by dividends, which customarily must be approved by regulating state insurance departments. The remainder is available to Sierra on an unrestricted basis.

Investments consist primarily of U.S. Government and its agencies' securities, municipal bonds, corporate bonds, securities and first trust deed mortgage notes. At September 30, 2004, approximately 80% of the Company's investment portfolio is invested in U.S. Government and its agencies' securities and municipal bonds. All investments that have not been designated as held-to-maturity are designated as available-for-sale and are stated at fair value. Fair value is estimated primarily from published market values at the balance sheet date. All non-restricted available-for-sale investments are classified as current assets. These investments are available for use in the current operations regardless of contractual maturity dates. Restricted investments are classified as non-current assets. Realized gains and losses are calculated using the specific identification method and are included in investment and other revenues. Unrealized holding gains and losses on available-for-sale securities are included as a separate component of stockholders' equity, net of income tax effects, until realized.

Investments that the Company has the intention and ability to hold to maturity are stated at amortized cost and categorized as held-to-maturity. All non-restricted investments designated as held-to-maturity are classified as current assets if expected maturity is within one year of the balance sheet date. Otherwise, they are classified as long-term investments. The Company's held-to-maturity investments consist of first trust deed mortgage notes. The Company does not believe any of its investments are impaired.

12. COMMITMENTS AND CONTINGENCIES

On March 15, 2004, SMHS entered into a lease assignment agreement relative to one of its administrative locations. The agreement assigns the remainder of the lease term, which expires September 30, 2012. Under the assignment, SMHS remains contingently liable should the new tenant not perform under its obligation. At September 30, 2004, the future lease payments due under the lease agreement total $5.4 million. SMHS did not record a liability for its obligation under this agreement as the likelihood of non- performance is considered remote at this time and SMHS would have the ability to sublease or enter into another assignment arrangement if required to perform on this obligation.

Although the Company is not a named defendant, the Company is aware that it has been named as a co-conspirator in the class action lawsuit, In Re: Managed Care Litigation: MDL No. 1334. The following summary is based upon information obtained from certain publicly filed documents. Beginning in 1999, a series of class action lawsuits were filed against most other major entities in the health benefits business. A multi-district litigation panel has consolidated most of these cases in the Southern District Court of Florida, Miami division. The plaintiffs assert that the defendants improperly paid providers' claims and "downcoded" their claims by paying lesser amounts than they submitted. The complaint alleges, among other things, multiple violations under the Racketeer Influenced and Corrupt Organizations Act, or RICO, as well as various breaches of contract and violations of regulations governing the timeliness of claim payments. The consolidated suits seek injunctive, compensatory and equitable relief as well as restitution, costs, fees and interest payments. Discovery commenced on September 30, 2002. In

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November 2002, the Eleventh Circuit Court granted the industry defendants' petition to review the class certification order. That appeal is pending. On April 7, 2003, the United States Supreme Court determined that the RICO claims against certain defendants should be arbitrated. On September 15, 2003, the district court granted in part and denied in part the industry defendants' further motion to compel arbitration. Significantly, the court denied the industry defendants' motion with respect to plaintiffs' derivative RICO claims. On September 19, 2003, the industry defendants appealed the district court's arbitration order to the Eleventh Circuit Court of Appeals. Discovery is ongoing and a trial date has been set for March 14, 2005. In the meantime, two of the defendants, Aetna Inc. and Cigna Corporation, have entered into settlement agreements, which have been approved by the Court.

The Company is subject to other various claims and litigation in the ordinary course of business. Such litigation includes, but is not limited to, claims of medical malpractice, claims for coverage or payment for medical services rendered to HMO and other members and claims by providers for payment for medical services rendered to HMO and other members. Some litigation may also include claims for punitive damages that are not covered by insurance. These actions are in various stages of litigation and some may ultimately be brought to trial. With respect to certain pending actions, the Company maintains commercial insurance coverage with varying deductibles for which the Company maintains estimated reserves for its self-insured portion based upon its current assessment of such litigation. Due to recent unfavorable changes in the commercial insurance market, the Company has, for certain risks, purchased coverage with higher deductibles and lower limits of coverage. In the opinion of management, based on information presently available, the amount or range of any potential loss cannot be reasonably estimated but the ultimate resolution of these pending legal proceedings should not have a material adverse effect on the Company's financial condition.

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ITEM 2.

The following discussion and analysis provides information which management believes is relevant for an assessment and understanding of our consolidated financial condition and results of operations. The discussion should be read in conjunction with our audited consolidated financial statements and accompanying notes for the year ended December 31, 2003, and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in our 2003 annual report on Form 10-K filed with the Securities and Exchange Commission on March 5, 2004, and in conjunction with our unaudited condensed consolidated financial statements and accompanying notes for the three and nine month periods ended September 30, 2004 and 2003, included in this Form 10-Q. The information contained below is subject to risk factors. We urge the reader to review carefully the section "Risk Factors" in Part 1, Item 1 of our 2003 annual report on Form 10-K for a more complete discussion of the risks associated with an investment in our securities. See "Note on Forward-Looking Statements and Risk Factors" under Part 1, Item 1 of our 2003 annual report on Form 10-K.

This report on Form 10-Q contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, both as amended. The forward-looking statements regarding our business and results of operations should be considered by our stockholders or any reader of our business or financial information along with the risk factors discussed in our 2003 annual report on Form 10-K. All statements other than statements of historical fact are forward-looking statements for purposes of federal and state securities laws. The cautionary statements are made pursuant to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, as amended, and identify important factors that could cause our actual results to differ materially from those expressed in any projected, estimated or forward-looking statements relating to us. These forward-looking statements are generally identified by their use of terms and phrases such as "anticipate," "believe," "continue," "could," "estimate," "expect," "hope," "intend," "may," "plan," "predict," "project," "seeks," "will," and other similar terms and phrases, including all references to assumptions.

Although we believe that the expectations reflected in any of our forward-looking statements are reasonable, actual results could differ materially from those projected or assumed in any of our forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements that speak only as of the date hereof. We undertake no obligation to publish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Overview

Our continuing operations derive revenues from our health maintenance organization, or HMO, and managed indemnity plans. To a lesser extent, we also derive revenues from professional fees (consisting primarily of fees for providing health care services to non-members, co-payment fees received from members and ancillary products), and investment and other revenue (consisting of fees for workers' compensation third party administration, utilization management services and ancillary products).

We also receive revenues from our military health services subsidiary, which completed its contract extension August 31, 2004. We will continue to receive substantially reduced revenues from this subsidiary through a six-month phase-out of operations at prices previously negotiated with the Department of Defense, or DoD.

Our principal expenses consist of medical expenses, military contract expenses, and general and administrative expenses. Medical expenses represent capitation fees and other fee-for-service payments paid to independent contracted physicians, hospitals and other health care providers to cover members,

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pharmacy costs, as well as the aggregate expenses to operate and manage our wholly-owned multi-specialty medical group and other provider subsidiaries. As a provider of health care management services, we seek to positively affect quality of care and expenses by contracting with physicians, hospitals and other health care providers at negotiated price levels, by adopting quality assurance programs, monitoring and managing utilization of physician and hospital services and providing incentives to use cost-effective providers. Military contract expenses represent payments to providers for health care services rendered under the TRICARE program, as well as administrative costs to pay claims and operate the military health care subsidiary. General and administrative expenses generally represent operational costs other than those directly associated with the delivery of health care services and military contract services.

Executive Summary

Continuing Operations

. Our operating results for the nine months ended September 30, 2004, were significantly improved over the nine months ended September 30, 2003. Our income from continuing operations increased by 63.9% to $95.3 million. The improvement in the 2004 operating results was primarily driven by medical premium revenue growth from new members, premium rate increases, an expansion of our operating margin and contractual settlements and other adjustments at our military operation. Our HMO membership increased by 12.4% from 288,600 at September 30, 2003, to 324,300 at September 30, 2004. Our aggregate 2004 premium rates increased by approximately 5.8% over September 30, 2003. The combination of these factors resulted in a 16.4% increase in our medical premium revenues to $834.6 million, which was primarily offset by an increase in medical expenses, which increased by 13.8% to $650.7 million. Medical expenses, as a percentage of medical premiums and professional fees, decreased from 76.8% to 75.6%, or 120 basis points for the nine months ended September 30, 2004. Our operating margin, which is operating income from continuing operations divided by total revenues, improved by 380 basis points to 12.2%.

Our military health services operations segment represented 28.6% of our operating revenues and 27.9% of our operating income from continuing operations for the nine months ended September 30, 2004. This segment had operating income of $42.5 million for the nine months ended September 30, 2004, compared to $10.0 million for the same period in 2003. For 2003, excluding TRICARE Next Generation, or T-Nex, bid related expenses, the military health services operations segment would have had operating income of $18.1 million. The improvement over 2003 is primarily due to change orders and final bid price adjustments on option periods three and four of the TRICARE Region 1 contract. The impact on income before taxes of the change orders, final bid price adjustments for option periods three and four and other contractual settlements was an increase of $16.3 million.

We were not awarded the T-Nex North Region contract and our appeal to the United States General Accounting Office was denied in December 2003. Health care services under our current TRICARE contract for Region 1 ended on August 31, 2004. On September 1, 2004, we entered a six-month phase-out period at substantially reduced revenues and earnings.

For the nine months ended September 30, 2004, compared to September 30, 2003, investment and other revenues increased from $14.6 million to $27.5 million, an increase of approximately $13.0 million or 88.9%. Of the increase, $10.1 million is related to the services we are providing relative to our sales agreement for the workers' compensation insurance operations, beginning April 1, 2004. For a further description of this agreement, see below in the discussion of investment and other revenues.

For the nine months ended September 30, 2004, compared to September 30, 2003, our general and administrative, or G&A, expenses increased from $101.8 million to $126.9 million, an increase of approximately $25.1 million or 24.6%. Of the increase, $10.1 million is for the cost to provide services related to the sale of the workers' compensation insurance operations referred to above. The remaining

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increase is due to increases in payroll and benefits, premium taxes, brokers' fees and legal expenses. As a percentage of total operating revenues, G&A expenses were 10.2% for 2004, compared to 9.2% in 2003. As a percentage of medical premium revenue, G&A expenses were 15.2% for 2004, compared to 14.2% for 2003. Excluding the services relative to our sales agreement for the workers' compensation insurance operations described above, our 2004 G&A expenses, as a percentage of total operating revenues and medical premium revenue for the nine month period, were 9.4% and 14.0%, respectively.

We had cash flows from operating activities of continuing operations for the nine months ended September 30, 2004, of $96.8 million compared to $68.0 million for 2003. We received eight monthly payments from the Centers for Medicare and Medicaid Services during the first three quarters of 2004 and 2003 as the January payments were received at the end of December. When the first quarters are adjusted to reflect three monthly payments from the Centers for Medicare and Medicaid Services, or CMS, the cash flow from continuing operations would be $129.7 million in 2004 and $97.9 million in 2003. We believe presenting this adjustment for the timing of the CMS payments is useful for making a nine-month period-to-period comparison of our cash flow from continuing operations. The improvement in cash flows from continuing operations over 2003 is primarily attributable to cash from earnings.

Discontinued Operations.

On January 15, 2003, we announced that we were exploring strategic alternatives to dispose of CII Financial, Inc., or CII. Sierra's Board of Directors authorized the sale of the operations on December 31, 2002. Accordingly, beginning in the fourth quarter of 2002, we reclassified our workers' compensation insurance business as discontinued operations.

On November 25, 2003, we announced that we had reached an agreement to sell California Indemnity Insurance Company, or Cal Indemnity, and its subsidiaries. In the fourth quarter of 2003, we recorded a charge of $15.6 million, gross and net of tax, to write down the investment in Cal Indemnity to its estimated net sales proceeds.

On March 31, 2004, we completed the sale of CII's subsidiary, Cal Indemnity, which was CII's only significant asset. Cal Indemnity's subsidiaries, which were included in the sale, are Commercial Casualty Insurance Company, Sierra Insurance Company of Texas, and CII Insurance Company.

We received $14.2 million in cash at the closing, which was subsequently reduced by $2.7 million based on the audited closing date balance sheet. The $2.7 million adjustment is expected to be repaid to us over the next few years. The transaction also includes a note receivable of $62.0 million, plus accrued interest, payable to us in January 2010. The note receivable can be increased or decreased depending on favorable or adverse claim and expense development from the date of closing through December 31, 2009, and other offsets and additions based on certain agreements between the parties. The note receivable can be increased on a dollar for dollar basis for the first $15 million in positive loss reserve development and $.50 per dollar on any positive development in excess of $15 million. The note receivable can also be decreased on a dollar for dollar basis for the first $58 million in adverse loss development. To date, no valuation adjustment has been recorded on the note.

Certain other contractual assets and liabilities were recorded in conjunction with the sale including a current asset of $15.8 million and a non-current asset of $7.1 million that represent Cal Indemnity's unallocated loss adjustment expense, or ULAE, reserves to be paid to Sierra. Offsetting these assets was a current liability of $15.8 million and a non-current liability of $7.1 million, which represent the contractual services to be performed by Sierra. Including the cash proceeds, net assets of $68.3 million were recorded in conjunction with the sale of Cal Indemnity.

A third-party claims administrator was engaged to administer claims for a period of 15 years. Under the terms of this agreement, the administrator will provide certain claims services for Cal Indemnity and its

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subsidiaries. Sierra will be responsible for this administrator's costs and for providing certain transition services for varying terms to Cal Indemnity. The purchaser of Cal Indemnity will pay Sierra for these costs from an account consisting of the ULAE reserves and accrued liabilities as of the closing, a percentage of premiums earned after the closing, plus accrued interest on the ULAE reserves. In addition, Sierra is providing workers' compensation managed care services at market rates to Cal Indemnity.

RESULTS OF OPERATIONS, THREE MONTHS ENDED SEPTEMBER 30, 2004, COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2003

Total Operating Revenues

increased approximately 1.0% from $389.2 million to $393.3 million.

The change in operating revenues was comprised of the following:

- An increase in medical premiums of $45.6 million

- A decrease in military contract revenues of $46.8 million

- A decrease in professional fees of $279,000

- An increase in investment and other revenues of $5.5 million

Medical Premiums

from our HMO and managed indemnity insurance subsidiaries increased from $242.9 million to $288.5 million, an increase of $45.6 million or 18.8%. The increase in premium revenue reflects a 12.3% increase in commercial member months (the number of months individuals are enrolled in a plan), a 32.9% increase in Medicaid member months and a 5.2% increase in Medicare member months. The growth in Medicare member months contributes significantly to the increase in premium revenues as the Medicare per member premium rates are more than three times higher than the average commercial premium rate. Of the 32.9% increase in Medicaid member months, 19.8% is due to the expansion of our Medicaid service area to Reno beginning February 2004.

HMO and POS premium rates for renewing commercial groups increased over 9% while the overall recorded per member per month revenue increase, including new and continuing business, was approximately 5%, net of changes in benefits. We did not receive a Medicaid rate increase in 2004 or 2003. The basic Medicare rate increase received for 2004 was approximately 2.2%. In addition, we received a Medicare rate increase on March 1, 2004, of over 15% due to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, or MMA, as described below.

In December 2003, President Bush signed MMA into law, which, among other changes to Medicare, alters the Medicare+Choice program. Under the MMA, Medicare+Choice plans are renamed Medicare Advantage plans and received increased funding from CMS starting March 2004. Because of the way in which the increased funding was calculated, both our non-Social HMO Medicare Advantage benefit plans and our Social HMO benefit plans received the increased funding. MMA increased our Medicare premium rates by over 15% starting March 1, 2004. The increased funding must be used in one or more of the following ways: to reduce beneficiary premiums; to reduce beneficiary cost sharing; to enhance benefits; to be placed into a benefit stabilization fund; to retain providers or expand the provider network as long as the benefit stabilization fund or enhancement does not result in increased premiums, increased cost sharing or reduced benefits. We are using the additional funding to enhance various plan benefits, including a reduction in the amount of Medicare Part B premium that our members pay to the federal government, and to stabilize our provider network.

Effective January 2004, CMS adopted a new risk adjustment payment methodology for Medicare beneficiaries who are enrolled in managed care programs, including the Social HMO. In addition, CMS revised the payment factors for the Social HMO members to include a frailty adjuster that uses measures of functional impairment to predict expenditures. Under the new payment methodology, we are being paid 90% based on the previous payment approach and 10% based on the new approach for 2004. For

2004, excluding the effects of MMA, the new payment methodology reduced our rate increase by 60 basis points. The Social HMO program has been administratively extended by CMS through 2007. For 2005, 2006 and 2007, we will be paid 70%, 50% and 25% based on the previous payment approach and 30%, 50% and 75%, based on the new approach, respectively. The extension of the Social HMO program will serve as a transition plan so that we can convert to a Medicare Advantage plan in 2008.

Continued medical premium revenue growth is principally dependent upon continued enrollment in our products and upon competitive and regulatory factors.

Our commercial membership increased from 199,400 at September 30, 2003 to 222,200 at September 30, 2004. Our commercial member retention was over 95% for our third quarter 2004 renewals, which represent approximately 26% of our total commercial membership. The increase in commercial membership during the third quarter of 2004 is primarily attributed to in-case growth, movement from self-insured plans to our commercial products and new accounts.

Military Contract Revenues

decreased from $132.8 million to $86.0 million, a decrease of $46.8 million or 35.2%. The decreased revenue is the result of Sierra Military Health Services LLC, or SMHS completing its final month of health care operations under the TRICARE contract on August 31, 2004.

SMHS completed the fifth year of a five-year contract in May 2003. SMHS then operated under a negotiated contract extension period, which ended August 31, 2004. The new contractor became operational in Region 1 on September 1, 2004 and the new contract superseded the remainder of our current TRICARE Region 1 contract. On September 1, 2004, SMHS commenced a six-month phase-out of operations at prices previously negotiated with the DoD. SMHS does not meet the definition of discontinued operations since we do not have plans to dispose of the operations before the phase-out is complete.

In March 2004, SMHS entered into a definitive agreement with the new T-Nex North Region Contractor to provide certain transition services and to sell certain portions of its TRICARE business, including its provider network and certain other assets. The value of the transaction is up to $4 million with the final value contingent on SMHS' operational performance through August 2004. SMHS recorded revenue of approximately $2.0 million pursuant to this agreement in the third quarter of 2004.

Professional Fees

decreased from $9.0 million to $8.7 million, a decrease of $279,000 or 3.1% primarily as a result of the outsourcing of our eye care unit in late 2003. The outsourcing of these services reduced both our revenue and corresponding expenses.

Investment and Other Revenues

increased from $4.6 million to $10.1 million, an increase of $5.5 million or 120.2%. The primary increase in investment and other revenues is in administrative services revenue due to the services we are providing relative to our sales agreement for the workers' compensation insurance operations, beginning April 1, 2004. On March 31, 2004, we completed the sale of the workers' compensation insurance operations and we have been engaged to administer claims through a third party claims administrator for a period of fifteen years as well as perform certain transition and managed care services. Total revenue associated with these services for the three months ended September 30, 2004 was $4.3 million. The cost to provide these services is reflected in our general and administrative expenses. In addition, we recorded accrued interest of $620,000 on the $62.0 million note receivable.

Medical Expenses

increased from $191.2 million to $224.2 million, an increase of $33.0 million or 17.2%. The increase is due primarily to our increased membership, which is in part offset by a lower medical care ratio. This ratio, which is medical expenses as a percentage of medical premiums and professional fees, decreased from 75.9% to 75.4%. The favorable decrease in our medical care ratio is

due primarily to premium increases in excess of cost increases. The number of days in claims payable, which is the medical claims payable balance divided by the average medical expense per day for the period, at September 30, 2004, was 47.5 compared to 49.5 at September 30, 2003. In an effort to further improve service and customer relations with our medical providers, we have enhanced several claims processes, including electronic data interchange and optical character recognition, to reduce the time required to make claim payments. The decrease in days in claims payable is primarily a result of these enhancements.

We contract with hospitals, physicians and other independent contracted providers of health care under capitated or discounted fee-for-service arrangements, including hospital per diems, to provide medical care services to members. Capitated providers are at risk for a portion of the cost of medical care services provided to our members in the relevant geographic areas; however, we are ultimately responsible for the provision of services to our members should the capitated provider be unable to provide the contracted services. We incurred capitation expenses with non-affiliated providers of $29.0 million and $26.1 million, or 12.9% and 13.7%, of our total medical expenses for 2004 and 2003, respectively.

Military Contract Expenses

decreased from $129.0 million to $75.8 million, a decrease of $53.1 million or 41.2%. The decrease is consistent with the decrease in revenues discussed previously and includes T-Nex bid related costs of $3.8 million in 2003. Included in our military contract expenses for both periods is an allocation of corporate overhead of $1.0 million per quarter for direct and indirect services provided to SMHS.

Health care delivery expenses consist primarily of costs to provide managed health care services to eligible beneficiaries in accordance with Sierra's TRICARE contract through August 31, 2004. Under the contract, SMHS provided health care services to 710,000 eligible individuals of active duty military personnel, military retirees under the age of 65 and dependents of military retirees through a network of approximately 50,300 health care providers and certain other subcontractor partnerships. Also included in military contract expenses are costs incurred to perform specific administrative services, such as health care appointment scheduling, enrollment, medical and network management services as well as health care advice line services, and other administrative functions of the military health care subsidiary. These administrative services were performed for active duty personnel and family members as well as retired military families.

General and Administrative Expenses

increased from $33.8 million to $44.5 million, an increase of approximately $10.7 million or 31.5%. The primary increase in G&A expenses is the $4.3 million to provide services relative to our sales agreement for the workers' compensation insurance operations as discussed above. The remaining increases in G&A expenses are primarily due to increases in payroll and benefits and brokers' fees. As a percentage of revenues, G&A expenses were 11.3% for 2004, compared to 8.7% in 2003. As a percentage of medical premium revenue, G&A expenses were 15.4% for 2004, compared to 13.9% for 2003. Excluding the services relative to our sales agreement for the workers' compensation insurance operations described above, our 2004 G&A expenses, as a percentage of total operating revenues and medical premium revenue for the three month period, were 10.4% and 14.0%, respectively.

Interest Expense

decreased from $1.3 million to $1.2 million, a decrease of $74,000 or 5.7%. The decrease is due to costs incurred relative to the senior convertible debentures in 2003. We incurred a facility fee of 0.375% on our revolving credit facility through September 30, 2004. Our revolving credit facility amendment on October 19, 2004 will reduce that fee to 0.3%.

Other Income (Expense), Net

resulted in expense of $49,000 for 2004 compared to income of $100,000 for 2003. The expense in 2004 was primarily related to the loss on sale of certain assets.

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Provision for Income Taxes

was recorded at $16.7 million for 2004 compared to $11.8 million for 2003. The effective tax rate for 2004 was 35.3% compared to 34.7% for 2003. Our effective tax rate is greater than the statutory rate due to state income taxes and other non-deductible expenses.

Discontinued Operations

consist of our Texas HMO health care operations and the CII workers' compensation operations. The net income from discontinued operations for 2003 was approximately $30,000.

Discontinued Texas HMO health care operations.

There is very little activity remaining relative to our discontinued Texas operations and there was no income or loss for the current period. We have discontinued paying most Texas claims, as our evidence of coverage requires that all claims must be settled within 18 months of the time of service.

Discontinued CII workers' compensation operations.

On March 31, 2004, we completed the sale of CII's subsidiary, Cal Indemnity. The activity related to this transaction, subsequent to the March 31, 2004 closing date, has been discussed above.

The sale of Cal Indemnity includes a note receivable of $62.0 million, plus accrued interest, payable in January 2010. The note receivable can be increased or decreased depending on favorable or adverse claim and expense development from the date of closing through December 31, 2009, and other offsets and additions based on certain agreements between the parties. No adjustment to the note was recorded in the quarter. Interest accrues quarterly on the note at 4.0% per annum.

RESULTS OF OPERATIONS, NINE MONTHS ENDED SEPTEMBER 30, 2004, COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2003

Total Operating Revenues

increased approximately 11.8% from $1.11 billion to $1.24 billion.

The change in operating revenues was comprised of the following:

- An increase in medical premiums of $117.5 million
- An increase in military contract revenues of $1.7 million
- A decrease in professional fees of $1.1 million

• An increase in investment and other revenues of $13.0 million

Medical Premiums

from our HMO and managed indemnity insurance subsidiaries increased from $717.1 million to $834.6 million, an increase of $117.5 million or 16.4%. The increase in premium revenue reflects an 11.7% increase in commercial member months (the number of months individuals are enrolled in a plan), a 5.7% increase in Medicare member months and a 29.3% increase in Medicaid member months. The growth in Medicare member months contributes significantly to the increase in premium revenues as the Medicare per member premium rates are more than three times higher than the average commercial premium rate.

HMO and POS premium rates for renewing commercial groups increased approximately 7% while the overall recorded per member per month revenue increase, including new and continuing business, was approximately 4%, net of changes in benefits. We did not receive a Medicaid rate increase in 2004 or 2003. The basic Medicare rate increase received in 2004 was approximately 2.2%. Our overall Medicare rate increase was approximately 14.2% due primarily to the impact of the MMA, as previously described, which started in March 2004.

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Our commercial membership increased from 199,400 at September 30, 2003 to 222,200 at September 30, 2004. Our commercial member retention was over 95% on renewals through September 30, 2004, which represents approximately 78% of our total commercial membership.

Military Contract Revenues

increased from $352.6 million to $354.3 million, an increase of $1.7 million or 0.5%. Revenue increases were the result of increased health care bid revenue consistent with the terms of SMHS' negotiated contract extension period along with incremental change order revenues and final bid price adjustments on option periods three and four. These revenue increases were partially offset by eight months of health care delivery in 2004 compared to nine months in 2003. The final bid price adjustments resulted in revenue increases of approximately $6.1 million for option period three (June 1, 2000 to May 31, 2001), which is 3.4% of the final revenue settlement amount for that period and $4.3 million for option period four (June 1, 2001 to May 31, 2002), which is 2.3% of the final revenue settlement amount for that period. The impact on income before taxes of the final bid price adjustments for option periods three and four was an increase of $6.6 million. The total impact on income before taxes of the change orders, bid price adjustments and other contractual settlements was an increase of $16.3 million. Offsetting these increases is one less month of revenue under the contract, which ended August 31, 2004, as previously described.

In March 2004, SMHS entered into a definitive agreement with the new T-Nex North Region Contractor to provide certain transition services and to sell certain portions of its TRICARE business, including its provider network and certain other assets. The value of the transaction is up to $4 million with the final value contingent on SMHS' operational performance through August 2004. SMHS has recorded revenue of approximately $2.8 million pursuant to this agreement during 2004.

Professional Fees

decreased from $27.4 million to $26.3 million, a decrease of $1.1 million, or 4.1% primarily as a result of the outsourcing of our eye care unit in late 2003. The outsourcing of these services reduced both our revenue and corresponding expenses.

Investment and Other Revenues

increased from $14.6 million to $27.5 million, an increase of $13.0 million or 88.9%. The primary increase in investment and other revenues is in administrative services revenue due to the services we are providing relative to our sales agreement for the workers' compensation insurance operations, beginning April 1, 2004. On March 31, 2004, we completed the sale of the workers' compensation insurance operations and we have been engaged to administer claims through a third party claims administrator for a period of fifteen years as well as perform certain transition and managed care services. Total revenue associated with these services for 2004 was $10.1 million. The cost to provide these services is reflected in our general and administrative expenses. The remaining increase in investment and other revenues is due primarily to higher average invested balances.

Medical Expenses

increased from $572.0 million to $650.7 million, an increase of $78.7 million or 13.8%. The increase is due primarily to our increased membership, which is in part offset by a lower medical care ratio. This ratio, which is medical expenses as a percentage of medical premiums and professional fees, decreased from 76.8% to 75.6%. The favorable decrease in our medical care ratio is due primarily to premium increases in excess of cost increases. We incurred capitation expenses with non-affiliated providers of $85.1 million and $75.2 million, or 13.1% and 13.1%, of our total medical expenses for the nine months ended September 30, 2004 and 2003, respectively.

Military Contract Expenses

decreased from $344.1 million to $313.0 million, a decrease of $31.1 million or 9.0%. The decreased expenses are the result of SMHS completing its final month of health care operations under the TRICARE contract in August. In addition, the 2004 contract expenses included final bid price adjustments on option periods three and four of the TRICARE Region 1 contract. The final

adjustments resulted in a contract expense increase of approximately $1.9 million for option period three, which is 0.9% of the final contract expense settlement amount for that period and a contract expense increase of $1.9 million for option period four, which is 0.8 % of the final contract expense settlement amount for that period. There were no final settlements of bid price adjustments in 2003, however, 2003 includes T-Nex related costs of $8.1 million. Included in our military contract expenses for both periods is an allocation of corporate overhead of $1.0 million per quarter for direct and indirect services provided to SMHS.

General and Administrative Expenses

increased from $101.8 million to $126.9 million, an increase of approximately $25.1 million or 24.6%. The primary increase in G&A expenses is the $10.1 million to provide services relative to our sales agreement for the workers' compensation insurance operations as discussed above. The remaining increases in G&A expenses are primarily due to increases in payroll and benefits, premium taxes, and brokers' fees. As a percentage of revenues, G&A expenses were 10.2% for 2004, compared to 9.2% in 2003. As a percentage of medical premium revenue, G&A expenses were 15.2% for 2004, compared to 14.2% for 2003. Excluding the services relative to our sales agreement for the workers' compensation insurance operations described above, our 2004 G&A expenses, as a percentage of total operating revenues and medical premium revenue for the nine month period, were 9.4% and 14.0%, respectively.

Interest Expense

decreased from $4.4 million to $3.6 million, a decrease of approximately $900,000 or 19.9%. The decrease was primarily due to the write off of the remaining deferred financing fees on our amended and restated credit facility of approximately $800,000 in 2003.

Other Income (Expense), Net

resulted in income of $114,000 for 2004 compared to expense of approximately $243,000 for 2003. The expense in 2003 was primarily related to the loss on sale of certain assets.

Provision for Income Taxes

was recorded at $53.4 million for 2004 compared to $30.9 million for 2003. The effective tax rate for 2004 was 35.9% compared to 34.7% for 2003. Our effective tax rate is higher than the statutory rate due primarily to state income taxes and other non-deductible expenses.

Discontinued Operations

consist of our Texas HMO health care operations and the CII workers' compensation operations. The net loss from discontinued operations for 2004 was $486,000 compared to approximately $621,000 for 2003. The Texas HMO health care operations had net income of $196,000 for 2004, which was offset by a net loss on the CII workers' compensation operations of $682,000.

Discontinued Texas HMO health care operations.

The income from the Texas HMO health care operations for 2004 is the result of favorable development in the medical claim liabilities and legal reserves.

Discontinued CII workers' compensation operations.

On March 31, 2004, we completed the sale of CII's subsidiary, Cal Indemnity. Our Condensed Consolidated Statement of Income for the nine months ended September 30, 2004 reflects the activity of the discontinued operations through the disposal date, March 31, 2004. Any future activity related to this disposal will be reflected in continuing operations as previously discussed.

The discontinued workers' compensation operations for 2004 had a net loss of $682,000 compared to a loss of $3.9 million for 2003. Net earned premiums decreased by $78.5 million or 80.5% and investment and other revenue decreased by $7.6 million or 85.5% as the 2004 results include activity through March 31, 2004. Expenses decreased in the CII workers' compensation operations by $91.5 million or 80.7% due to the overall decrease in premiums.

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LIQUIDITY AND CAPITAL RESOURCES

We had cash flows from operating activities for continuing operations of $96.8 million for the nine months ended September 30, 2004 compared to $68.0 million in 2003. We received eight monthly CMS payments during the first nine months of 2004 and 2003 as the January payments were received at the end of December. When the first quarters are adjusted to reflect three monthly payments from CMS, the cash flow from continuing operations would be $129.7 million in 2004 and $97.9 million in 2003. We believe presenting this adjustment for the timing of the CMS payments is useful for making a nine-month period-to-period comparison of our cash flow from continuing operations. We used the majority of the cash flow for the repurchase of the Company's common stock. The improvement in cash flows from continuing operations over 2003 is primarily attributable to cash from earnings.

We expect that the loss of the T-Nex contract will adversely affect our cash flow from operations in the fourth quarter of 2004 through the first half of 2005. During the phase-out period, we expect that SMHS will use $20.0 million to $25.0 million of its cash, as the payout of the remaining liabilities will exceed SMHS' accounts receivable and other non-cash asset balances.

Net cash used for investing activities of continuing operations during 2004 included $19.6 million in capital expenditures associated with clinical expansion, continued implementation of new computer systems, leasehold improvements on facilities, furniture and equipment and other capital purchases to support our growth. The primary expenditures during the third quarter were for two separate parcels of land for future clinics totaling $8.7 million. The net cash change in investments for the year was a decrease in investments of $74.8 million as investments were converted to cash equivalents and used to repurchase the Company's common stock.

Net cash used for financing activities of continuing operations during 2004 included borrowing on our revolving credit facility of $10.0 million offset by payments of $1.5 million on other debt. Proceeds from the issuance of stock in connection with stock plans were $22.7 million and cash of $112.3 million was used to repurchase Sierra common stock.

Discontinued operations provided cash of $1.9 million in 2004, compared to cash used of $25.0 million in 2003. Cash provided in 2004 was primarily the result of the sale of Cal Indemnity.

Sierra Debentures

In March 2003, we issued $115.0 million aggregate principal amount of 2¼% senior convertible debentures due March 15, 2023. The debentures pay interest, which is due semi-annually on March 15 and September 15 of each year. Each $1,000 principal amount of debentures is convertible, at the option of the holders, into 54.6747 shares of Sierra Health Services, Inc., common stock prior to March 15, 2023 if (i) the market price of our common stock for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of the preceding fiscal quarter exceeds 120% of the conversion price per share of our common stock; (ii) the debentures are called for redemption; (iii) there is an event of default with respect to the debentures; or (iv) specified corporate transactions have occurred. The conversion rate is subject to certain adjustments. This conversion rate initially represents a conversion price of $18.29 per share. Holders of the debentures may require us to repurchase all or a portion of their debentures on March 15 in 2008, 2013 and 2018 or upon certain corporate events including a change in control. In either case, we may choose to pay the purchase price of such debentures in cash or common stock or a combination of cash and common stock. The debentures can

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be redeemed by us for cash beginning on or after March 20, 2008.

Sierra used the net proceeds of the offering to repay the $39.0 million outstanding under the then existing credit facility and to contribute $35.0 million to SMHS. The $35.0 million contribution to SMHS was subsequently repaid to Sierra in February 2004. Sierra also used $19.9 million of the proceeds to purchase 1.6 million shares of Sierra's common stock under our repurchase program. The remainder of the net proceeds were used for working capital and general corporate purposes including additional share repurchases.

Revolving Credit Facility

On March 3, 2003, we entered into a $65.0 million revolving credit facility, which replaced our amended and restated credit facility. Interest on the facility was initially LIBOR plus 2.25% and has been LIBOR plus 2.00% since the third quarter of 2003. The facility was set to expire on April 30, 2006. Effective October 19, 2004, the facility has been amended to extend the maturity of the facility to December 31, 2009, increase the availability to $100.0 million and reduce the interest to LIBOR plus 1.5% based on current ratios. The facility is available for general corporate purposes. As of September 30, 2004, the Company has drawn $10.0 million on this facility.

The credit facility is secured by guarantees by certain of our subsidiaries and a first priority perfected security interest in (i) all of the capital stock of each of our unregulated, material domestic subsidiaries (direct or indirect) as well as all of the capital stock of certain regulated, material domestic subsidiaries; and (ii) all other present and future assets and properties of ours and those of our subsidiaries that guarantee our credit agreement obligations (including, without limitation, accounts receivable, inventory, real property, equipment, contracts, trademarks, copyrights, patents, license rights and general intangibles) subject, in each case, to the exclusion of the capital stock of CII and certain other exclusions.

The revolving credit facility has covenants that limit our ability and the ability of our subsidiaries to dispose of assets, incur indebtedness, incur other liens, make investments, loans or advances, make acquisitions, engage in mergers or consolidations, make capital expenditures and otherwise restrict certain corporate activities. Per the most recent amendment, based on us exceeding a certain covenant ratio requirement, our ability to pay dividends, repurchase our common stock and prepay other debt is unlimited provided that we can still maintain the required ratios after such transaction or any borrowing incurred as a result of such transaction. In addition, we are required to comply with specified financial ratios as set forth in the credit agreement. We believe that we are in compliance with all covenants of the credit agreement.

Sierra Share Repurchases

From January 1, 2004 through September 30, 2004, we purchased 2.9 million shares of our common stock, in the open market or negotiated transactions, for $112.3 million at an average cost per share of $38.47. During the quarter ended September 30, 2004, we purchased 705,000 shares of our common stock, in the open market or negotiated transactions, for $29.5 million at an average cost per share of $41.87. Based on approval by our Board of Directors on May 20, 2004, we currently have $43.0 million available for share repurchases. Our revolving credit facility, as amended, currently allows for unlimited stock repurchases. We have not repurchased any shares subsequent to September 30, 2004 through October 21, 2004.

Included in the repurchases for the first quarter of 2004 are 500,000 shares we purchased from our CEO, at $32.00 per share, for a total of $16.0 million. The closing price of our common stock on the date of the transaction, February 11, 2004, was $32.35. Included in the repurchases for the second quarter of 2004 are an additional 500,000 shares we purchased from our CEO, at $43.20 per share, for a total of $21.6

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million. The closing price of our common stock on the date of the transaction, May 27, 2004, was $43.25. The independent directors of our Board of Directors approved both of the purchases.

Statutory Capital and Deposit Requirements

Our HMO and insurance subsidiaries are required by state regulatory agencies to maintain certain deposits and must also meet certain net worth and reserve requirements. The HMO and insurance subsidiaries, including the discontinued operations, had restricted assets on deposit in various states totaling $16.8 million at September 30, 2004. The HMO and insurance subsidiaries must also meet requirements to maintain minimum stockholders' equity, on a statutory basis, as well as minimum risk-based capital requirements, which are determined annually. In conjunction with the exit from the Texas HMO health care market, the Texas Department of Insurance approved a plan of withdrawal and Texas Health Choice, L.C., is now required to maintain deposits of $1.5 million and net worth of at least $3.5 million. We believe we are in material compliance with our regulatory requirements.

Of the $196.0 million in cash and cash equivalents held at September 30, 2004, including discontinued operations, $2.0 million was held by discontinued operations and $122.0 million was designated for use only by the regulated subsidiaries. Amounts are available for transfer to the holding company from the HMO and insurance subsidiaries only to the extent that they can be remitted in accordance with the terms of existing management agreements and by dividends. The holding company will not receive dividends from its regulated subsidiaries if such dividend payment would cause violation of statutory net worth and reserve requirements.

Obligations and Commitments

The following schedule represents our obligations and commitments for long-term debt, capital leases and operating leases at September 30, 2004. The amounts presented below include all future payments associated with each obligation including interest expense.

(In thousands)	Long-Term Debt	Capital Leases	Operating Leases	Total
Continuing Operations				
Payments due within 12 months............	$ 2,588	$ 115	$ 19,063	$ 21,766
Payments due in 13 to 36 months..........	15,175	231	35,297	50,703
Payments due in 37 to 60 months..........	5,175	123	33,265	38,563

Payments due in more than 60 months.......	149,931	100	101,977	252,008
Total Continuing Operations..........	$ 172,869	$ 569	$ 189,602	$ 363,040
Discontinued Operations				
Payments due within 12 months.............	$ --	$ 235	$ --	$ 235
Payments due in 13 to 36 months...........	--	--	--	--
Payments due in 37 to 60 months...........	--	--	--	--
Payments due in more than 60 months.......	--	--	--	--
Total Discontinued Operations........	$ --	$ 235	$ --	$ 235

Other

The 2004 planned expenditures are primarily for a new medical clinic, the purchase of computer hardware and software, furniture and equipment and other normal capital requirements. Our liquidity needs over the next 12 months will primarily be for the capital items noted above and the phase-out of the military operations. We believe that our existing working capital, operating cash flow and, if necessary,

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equipment leasing, divestitures of certain non-core assets and amounts available under our credit facility should be sufficient to fund our capital expenditures and debt service. Additionally, subject to unanticipated cash requirements, we believe that our existing working capital and operating cash flow should enable us to meet our liquidity needs on a long-term basis.

Inflation

Health care costs continue to rise at a rate faster than the Consumer Price Index. We use various strategies to mitigate the negative effects of health care cost inflation, including setting commercial premiums based on our anticipated health care costs, risk-sharing arrangements with our various health care providers and other health care cost containment measures including member co-payments. There can be no assurance, however, that in the future, our ability to manage medical costs will not be negatively impacted by items such as technological advances, competitive pressures, applicable regulations, increases in pharmacy costs, utilization changes and catastrophic items, which could, in turn, result in medical cost increases equaling or exceeding premium increases.

Government Regulation

Our business, offering health care coverage, health care management services and, to a lesser extent, the delivery of medical services, is heavily regulated at both the federal and state levels.

Government regulation of health care coverage products and services is a dynamic area of law that varies from jurisdiction to jurisdiction. Amendments to existing laws and regulations are continually being considered and interpretation of the existing laws and rules changes from time to time. Regulatory agencies generally exercise broad discretion in interpreting laws and promulgating regulations to enforce their interpretations.

While we are unable to predict what legislative or regulatory changes may occur or the impact of any particular change, our operations and financial results could be negatively affected by any legislative or regulatory requirements. For example, any proposals to eliminate or reduce the Employee Retirement Income Security Act, or ERISA, which regulates insured and self- insured health care coverage plans offered by employers, to eliminate or reduce the pre-emption of state laws that would increase litigation exposure, affect underwriting practices, limit rate increases, require new or additional benefits or affect contracting arrangements (including proposals to require HMOs and PPOs to accept any health care provider willing to abide by an HMO's or PPO's contract terms or commission arrangements) may have a material adverse effect on our business. The continued consideration and enactment of "anti-managed care" laws and regulations by federal and state bodies may make it more difficult for us to manage medical costs and may adversely affect financial results.

In addition to changes in existing laws and regulations, we are subject to audits, investigations and enforcement actions. These include, but are not limited to, possible government actions relating to ERISA, the Federal Employees Health Benefit Plan, federal and state fraud and abuse laws and laws relating to utilization management and the delivery and payment of health care. In addition, our Medicare business is subject to Medicare regulations promulgated by CMS. Violation of government laws and regulations may result in an assessment of damages, civil or criminal fines or penalties, or other sanctions, including exclusion from participation in government programs. In addition, disclosure of any adverse investigation or audit results or sanctions could negatively affect our reputation in various markets and make it more difficult for us to sell our products and services.

In addition to the items described above, we urge you to review carefully the section "Risk Factors" in Part 1, Item 1 of our 2003 Form 10-K for a more complete discussion of the risks associated with an

investment in our securities. See "Note on Forward-Looking Statements and Risk Factors" in Part 1, Item 1.

Critical Accounting Policies and Estimates

Our consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America. In preparing these financial statements, we are required to make judgments, assumptions and estimates, which we believe are reasonable and prudent based on the available facts and circumstances. These judgments, assumptions and estimates affect certain of our revenues and expenses and their related balance sheet accounts and in disclosing our contingent assets and liabilities. Our most significant accounting estimates are for our premium allowance, the liability for medical claims payable, military contract revenues and expenses, investment impairment, litigation and legal accruals and deferred tax assets and liabilities. We base our assumptions and estimates primarily on historical experience and trends and factor in known and projected trends. On an on-going basis, we re-evaluate our selection of assumptions and the method of calculating our estimates. Actual future results, however, may materially differ from our calculated estimates and this difference would be reported in our then current operations.

For a more detailed description of our critical accounting policies and estimates, see Part II, Item 7 of our 2003 annual report on Form 10-K. As of September 30, 2004, our critical accounting policies have not changed from those described on our annual report on Form 10-K. For a more extensive discussion of our accounting policies, see Note 2, Summary of Significant Accounting Policies, in the Notes to the Consolidated Financial Statements in our 2003 annual report on Form 10-K filed on March 5, 2004.

Membership

	Number of Members at September 30,	
	2004	2003
HMO		
Commercial............................	222,200	199,400
Medicare..............................	53,000	50,400

Medicaid	49,100	38,800
Managed Indemnity	25,600	23,700
Medicare Supplement	16,600	17,900
Administrative Services	186,600	191,800
Subtotal	553,100	522,000
TRICARE Eligibles	--	704,300
Total Members	553,100	1,226,300

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

At September 30, 2004, we had unrealized holding losses on available for sale investments of $112,000, net of tax, compared to unrealized holding losses of $479,000, net of tax, at December 31, 2003. We believe that changes in market interest rates, resulting in unrealized holding gains or losses, should not have a material impact on future earnings or cash flows, as it is unlikely that we would need or choose to substantially liquidate our investment portfolio.

At September 30, 2004, we had outstanding $115.0 million in aggregate principal amount of our 2¼% senior convertible debentures due March 15, 2023. The debentures are fixed rate, and therefore, the interest expense on the debentures will not be impacted by future interest rate fluctuations. The interest rate on our revolving credit facility is currently LIBOR plus 1.5%. At September 30, 2004, we have $10.0 million outstanding on this facility.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures as of the end of the period covered by this report were designed and were functioning effectively to provide reasonable assurance that the information required to be disclosed by the Company in reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. The Company believes that a system of controls, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

Change in Internal Control over Financial Reporting

No change in the Company's internal control over financial reporting occurred during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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SIERRA HEALTH SERVICES, INC. AND SUBSIDIARIES

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Although Sierra is not a named defendant, we have been notified that we have been named as a co-conspirator in the class action lawsuit, In Re: Managed Care Litigation: MDL No. 1334. The following summary is based upon information obtained from certain publicly filed documents. Beginning in 1999, a series of class action lawsuits were filed against most other major entities in the health benefits business. A multi-district litigation panel has consolidated most of these cases in the Southern District Court of Florida, Miami division. The plaintiffs assert that the defendants improperly paid providers' claims and "downcoded" their claims by paying lesser amounts than they submitted. The complaint alleges, among other things, multiple violations under the Racketeer Influenced and Corrupt Organizations Act, or RICO, as well as various breaches of contract and violations of regulations governing the timeliness of claim payments. The consolidated suits seek injunctive, compensatory and equitable relief as well as restitution, costs, fees and interest payments. Discovery commenced on September 30, 2002. In November 2002, the Eleventh Circuit Court granted the industry defendants' petition to review the class certification order. That appeal is pending. On April 7, 2003, the United States Supreme Court determined that the RICO claims against certain defendants should be arbitrated. On September 15, 2003, the district court granted in part and denied in part the industry defendants' further motion to compel arbitration. Significantly, the court denied the industry defendants' motion with respect to plaintiffs' derivative RICO claims. On September 19, 2003, the industry defendants appealed the district court's arbitration order to the Eleventh Circuit Court of Appeals. Discovery is ongoing and a trial date has been set for March 14, 2005. In the meantime, two of the defendants, Aetna Inc. and Cigna Corporation, have entered into settlement agreements, which have been approved by the Court.

We are subject to other various claims and litigation in the ordinary course of business. Such litigation includes, but is not limited to, claims of medical malpractice, claims for coverage or payment for medical services rendered to HMO and other members and claims by providers for payment for medical services rendered to HMO and other members. Some litigation may also include claims for punitive damages that are not covered by insurance. These actions are in various stages of litigation and some may ultimately be brought to trial. With respect to certain pending actions, we maintain commercial insurance coverage with varying deductibles for which we maintain estimated reserves for our self-insured portion based upon our current assessment of such litigation. Due to recent unfavorable changes in the commercial insurance market, we have, for certain risks, purchased coverage with higher deductibles and lower limits of coverage. In the opinion of management, based on information presently available, the amount or range of any potential loss cannot be reasonably estimated but the ultimate resolution of these pending legal proceedings should not have a material adverse effect on our financial condition.

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

(c) Below, is a summary of stock repurchases for the nine months ended September 30, 2004. See Note 4 of our Notes to Condensed Consolidated Financial Statements for information regarding our stock repurchase plan.

(In thousands, except per share data) Period	Total number of shares repurchased (1)	Average price paid per share	Total number of shares purchased as part of publicly announced plan or program
Beginning shares available to be purchased			
January 1, 2004 - January 31, 2004	--	--	--
February 1, 2004 - February 29, 2004 (4)	663	$ 31.86	663
March 1, 2004 - March 31, 2004	317	34.19	317
April 1, 2004 - April 30, 2004	16	34.91	16

May 1, 2004 - May 31, 2004	590	39.20	590
June 1, 2004 - June 30, 2004 (5)	628	43.20	628
July 1, 2004 - July 31, 2004	95	43.46	95
August 1, 2004 - August 31, 2004	610	41.62	610
September 1, 2004 - September 30, 2004	--	--	--

1. Certain repurchases were made pursuant to a 10b-5 plan.

2. On October 28, 2003, the Company announced that its Board of Directors had authorized the Company to purchase an additional 3.0 million shares of its common stock in addition to the 4.6 million shares that had previously been authorized. The repurchase program has no stated expiration date. Through December 31, 2003, the Company had purchased 5.3 million shares leaving 2.3 million shares authorized to be repurchased.

3. On May 20, 2004, the Company's Board of Directors authorized the Company to purchase an additional $70.0 million of its common stock. The repurchase program has no stated expiration date, and commenced after the previously authorized share repurchase was completed.

4. Includes 500,000 shares the Company purchased from its CEO at $32.00 per share.

5. Includes 500,000 shares the Company purchased from its CEO at $43.20 per share.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS

(10.5) Sierra Health Services, Inc. Deferred Compensation Plan effective May 1, 1996, as Amended and Restated August 5, 2004.

(31.1) Rule 13a - 14(a) or 15d - 14(a) Certification of Chief Executive Officer.

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(31.2) Rule 13a - 14(a) or 15d - 14(a) Certification of Chief Financial Officer.

(32.1)

Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of Principal Executive Officer.

(32.2) Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of Principal Financial Officer.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned thereto duly authorized.

SIERRA HEALTH SERVICES, INC.
Registrant
By: /s/ Paul H. Palmer
Paul H. Palmer
Senior Vice President of Finance,
Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)

Date: October 25, 2004

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