SIERRA HEALTH SERVICES INC
Form 10-Q
April 27, 2005

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2005

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 April 22, 2005, there were 26,718,000 shares of common stock outstanding.

SIERRA HEALTH SERVICES, INC.
Quarterly Report on Form 10-Q
For the period ended March 31, 2005

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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)

	March 31, 2005	December 31, 2004
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 112,400	$ 205,290
Investments	279,525	147,264
Accounts receivable (less allowance for doubtful accounts: 2005 - $5,565; 2004 - $5,380)	14,379	15,150
Military accounts receivable (less allowance for doubtful accounts: 2005 and 2004 - $100)	5,679	25,452
Current portion of deferred tax asset	19,680	17,560
Prepaid expenses and other current assets	57,719	36,106
Assets of discontinued operations	3,961	4,152
Total Current Assets	493,343	450,974
Property and equipment, net	69,669	71,152
Restricted cash and investments	15,436	20,353
Goodwill (less accumulated amortization: 2005 and 2004 - $6,972)	14,782	14,782
Deferred tax asset (less current portion)	12,251	13,275
Note receivable (less valuation allowance: 2005 and 2004 - $15,000)	47,000	47,000
Other assets	73,472	72,244
Total Assets	$ 725,953	$ 689,780
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accrued and other current liabilities	$ 109,738	$ 75,646
Trade accounts payable	8,026	7,123
Accrued payroll and taxes	23,236	27,668
Medical claims payable	128,135	119,337
Unearned premium revenue	13,925	50,763
Military health care payable	16,500	17,061
Current portion of long-term debt	97	100
Liabilities of discontinued operations	1,961	610
Total Current Liabilities	301,618	298,308
Long-term debt (less current portion)	125,374	125,395
Other liabilities	61,798	64,380

Total Liabilities	488,790	488,083
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; 2005 - 35,993; 2004 - 35,573 shares issued	180	178
Treasury stock: 2005 - 9,321; 2004 - 9,192 common stock shares	(246,993)	(237,876)
Additional paid-in capital	302,610	286,571
Deferred compensation		(288)
Accumulated other comprehensive loss	(684)	(245)
Retained earnings	182,050	153,357
Total Stockholders' Equity	237,163	201,697
Total Liabilities And Stockholders' Equity	$ 725,953	$ 689,780

See accompanying notes to 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 March 31,	
	2005	**2004**
Operating Revenues:		
Medical premiums	$311,355	$265,438
Military contract revenues	6,359	127,624
Professional fees	9,853	9,478
Investment and other revenues	8,271	5,650
Total	335,838	408,190

Operating Expenses:		
Medical expenses	244,962	208,065
Military contract expenses	4,107	120,797
General and administrative expenses	41,445	37,168
Total	290,514	366,030
Operating Income From Continuing Operations	45,324	42,160
Interest expense	(1,631)	(1,165)
Other income (expense), net	99	122

Income From Continuing Operations Before Income Taxes	43,792	41,117
Provision for income taxes	(15,225)	(14,802)
Income From Continuing Operations	28,567	26,315
Income (loss) from discontinued operations (net of income tax benefit of $838 and $761)	838	(486)
Net Income	$29,405	$25,829
Earnings Per Common Share:		
Income from continuing operations	$1.07	$0.97
Income (loss) from discontinued operations	0.03	(0.01)

Net Income	$1.10	$0.96
Earnings Per Common Share Assuming Dilution:		
Income from continuing operations	$0.85	$0.75
Income (loss) from discontinued operations	0.02	(0.01)
Net Income	$0.87	$0.74

See accompanying notes to consolidated financial statements.

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SIERRA HEALTH SERVICES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Three Months Ended March 31,	
	2005	**2004**
Cash Flows From Operating Activities:		
Net income	$29,405	$ 25,829
Adjustments To Reconcile Net Income To Net Cash Provided By Operating Activities:		
(Gain) loss from discontinued operations	(838)	486
Depreciation	3,714	4,075
Stock based compensation expense	1,224	22
Provision for doubtful accounts	403	445
Loss on property and equipment dispositions		

20

Change In Operating Assets And Liabilities:

Military accounts receivable

19,773 2,701

Deferred tax asset

5,335 7,205

Other current assets

5,477 575

Other assets

(1,290) 60

Accrued payroll and taxes

(4,432) 7,852

Medical claims payable

8,798 3,530

Military health care payable

(561) 2,241

Other current liabilities

(4,206) 2,049

Unearned premium revenue

(36,838) (23,914)

Other liabilities

(2,582) (929

)

Net Cash Provided By Operating Activities Of Continuing Operations	23,402	32,227
Cash Flows From Investing Activities:		
Capital expenditures, net of dispositions	(2,252)	(1,491)
Change in investments	(115,469)	19,401
Net Cash (Used For) Provided By Investing Activities Of Continuing Operations	(117,721)	17,910
Cash Flows From Financing Activities:		
Payments on debt and capital leases	(24)	(1,490)
Purchase of treasury stock	(10,354)	(31,944)

Exercise of stock in connection with stock plans	9,432	9,846
Net Cash Used For Financing Activities Of Continuing Operations	(946)	(23,588)
Net cash provided by discontinued operations	2,375	3,414
Net (Decrease) Increase In Cash And Cash Equivalents	(92,890)	29,963
Cash And Cash Equivalents At Beginning Of Period	205,290	118,473
Cash And Cash Equivalents At End Of Period	$112,400	$148,436

Supplemental Condensed Consolidated Continuing Operations Statement Of Cash Flows Information:

Cash paid during the period for interest (net of amount capitalized)	$3,109	$ 1,430
Net cash paid during the period for income taxes	2,493	22
Non-Cash Investing And Financing Activities:		
Assets and liabilities recorded in conjunction with the sale of the workers' compensation operations		54,060
Stock issued for exercise of options and related tax benefits	6,198	6,040

See accompanying notes to consolidated financial statements.

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SIERRA HEALTH SERVICES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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, 2004. 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.

Certain amounts in the condensed consolidated financial statements for the three months ended March 31, 2004 have been reclassified to conform with the current year presentation.

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2. EMPLOYEE STOCK PLANS

The Company accounts for its stock-based compensation using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," (APB No. 25) 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.

The following table represents the effect on net income and earnings per share if the Company had applied the fair value based method and recognition provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS No. 123), to stock-based compensation:

	Three Months Ended March 31,	
	2005	**2004**
(In thousands, except per share data)		
Net income, as reported	$29,405	$25,829
Less: total stock-based employee compensation expense determined under fair value based methods for all awards, net of tax	(1,143)	(1,358)
Pro Forma Net Income	$28,262	$24,471
Net income per share, as reported		

$1.10 $0.96

Pro forma net income, per share

1.06 0.90

Net income per share assuming dilution, as reported

$0.87 $0.74

Pro forma net income, per share

0.84 0.70

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" (SFAS 123R), which replaces SFAS No. 123 and supercedes APB Opinion No. 25. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. Under SFAS 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R. The retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. Prior periods may be restated either as of the beginning of the year of adoption or for all periods presented.

On April 14, 2005, the Securities and Exchange Commission announced that the effective date of SFAS 123R will be suspended until January 1, 2006, for calendar year companies. The Company anticipates adopting the prospective method of SFAS 123R in 2006 but it has not yet determined the financial statement impact of adopting SFAS 123R.

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3. INVESTMENTS

Of the cash and cash equivalents and current unrestricted investments that total $391.9 million in the accompanying Consolidated Balance Sheet at March 31, 2005, $250.0 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 trust deed mortgage notes. At March 31, 2005, approximately 73% of the Company's investment portfolio is invested in U.S. Government and its agencies' securities and municipal bonds. All non-restricted investments that are designated as available-for-sale are classified as current assets and stated at fair value. Fair value is estimated primarily from published market values at the balance sheet date. 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. The Company does not have any held-to-maturity investments.

The Company's investment in trust deed mortgage notes are stated at cost and 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 does not believe any of its investments are other than temporarily impaired at March 31, 2005.

The Company entered into a short sale of U.S. Treasury Bonds during the quarter. The short sale does not meet the accounting definition of a hedge. The position was adjusted to fair value at March 31, 2005 and a gain of $500,000 was included in investment and other revenues for the period. At March 31, 2005, the restricted proceeds from the sale of $27.2 million were included in prepaid expenses and other current assets and the fair value of the securities sold, not yet purchased of $26.7 million was included in accrued and other current liabilities. Income on the proceeds of the sale is included in investment and other revenues and the interest expense on the short position is included in interest expense. The current asset and liability associated with the transaction have been presented on a net basis in the Condensed Consolidated Statement of Cash Flows.

4. LONG-TERM DEBT

Sierra Debentures

- In March 2003, the Company issued $115.0 million aggregate principal amount of its 2 ¼% senior convertible debentures due March 15, 2023. The debentures are not guaranteed by any of Sierra's subsidiaries. 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. Beginning December 2003 and for each subsequent period, the market price of the Company's common stock has exceeded 120% of the conversion price for at least 20 trading days in a period of 30 consecutive trading days. 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.

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. The facility was set to expire on April 30, 2006. Effective October 19, 2004, the facility was amended to extend the maturity of the facility to December 31, 2009, increase the availability to $100.0 million and reduce the interest rate. The current interest rate on the facility is LIBOR plus 1.2%. The facility is available for general corporate purposes. At March 31, 2005, the Company has drawn $10.0 million on this facility, which is unchanged from December 31, 2004.

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 its 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.

5. SHARE REPURCHASES

From January 1, 2005 through March 31, 2005, the Company purchased 178,000 shares of its common stock, in the open market or through negotiated transactions, for $10.4 million at an average cost per share of $58.14. Since the repurchase program began in early 2003 and through March 31, 2005, the Company had purchased, in the open market or through negotiated transactions, 8.9 million shares for $243.6 million at an average cost per share of $27.39. On May 20, 2004, and December 7, 2004, the Company's Board of Directors authorized the Company to purchase an additional $70.0 million and $50.0 million worth of its common stock, respectively. At March 31, 2005, $61.1 million was still available under the Board of Directors' authorized plan.

The Company's revolving credit facility, as amended, currently allows for unlimited stock repurchases based on meeting a certain covenant ratio. The Company has repurchased 53,000 shares for $3.2 million at an average cost of $60.91 subsequent to March 31, 2005 through April 25, 2005.

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6. 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:

	March 31, 2005	December 31, 2004
	(In thousands)	
ASSETS		
Cash and cash equivalents	$ 1,137	$ 2,329
Investments	2,801	1,811
Other assets	23	12
Total Assets	3,961	4,152
LIABILITIES		
Accounts payable and other liabilities	1,961	610
Net Assets Of Discontinued Operations	$ 2,000	$ 3,542

Management believes that the remaining liabilities, at March 31, 2005, are appropriate and that no further revisions to the estimates are necessary at this time. The increase in liabilities at March 31, 2005, is the result of an increase in the income tax liability for discontinued operations. 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.

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

	Three Months Ended March 31,	
	2005	2004
	(In thousands)	
Operating revenues	$ 21	$ 36
Medical expenses	(7)	(175)
General and administrative expenses	28	(136)
Interest expense and other, net		73

Income From Discontinued Operations Before Income Tax		274
Income tax benefit (provision)	838	(78)
Net Income From Discontinued Operations	$ 838	$ 196

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The income tax benefit for the three months ended March 31, 2005 is the result of a tax benefit due to a reconciliation of the Company's tax accounts to the previously filed income tax returns offset by an increase in the income tax liability for discontinued operations.

7. CII FINANCIAL, INC. DISCONTINUED OPERATIONS

On January 15, 2003, the Company announced that it was exploring strategic alternatives to dispose of its workers' compensation company, CII. Sierra's Board of Directors approved the sale of 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.

On March 31, 2004, the Company completed the sale of California Indemnity Insurance Company (Cal Indemnity). 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 final closing date balance sheet. The $2.7 million adjustment is a timing difference and 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 $62.0 million 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.

During the fourth quarter of 2004, the Company engaged a new independent actuary to evaluate the loss development. Based on the independent actuarial projections, the Company recorded a $15.0 million valuation allowance at December 31, 2004 reducing the note receivable to $47.0 million. The Company was required to engage a new actuary to avoid a potential conflict of interest with its former actuary, who is still engaged by Cal Indemnity, and the resulting impact to internal controls. At March 31, 2005, the Company received an updated independent actuarial projection. The updated projection was consistent with the projection received during the fourth quarter of 2004 and no further adjustment is required at this time.

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. Although the evaluation of the third-party claims administrator performance is controlled by Cal Indemnity's new parent company, Sierra will be responsible for this administrator's costs. Sierra must also provide 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. For the quarter ended March 31, 2005, the Company recorded $700,000 in administrative services revenue and $700,000 in operating expenses to provide the contractual administrative services.

The Company had previously estimated that the revenues and funds the Company expected to receive would not cover the expected cost to provide the contractual administrative services so the Company accrued additional liabilities at March 31, 2004 to cover the expected deficiency. Due to actual revenues

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exceeding estimates and actual expenses being less than projected expenses, the Company reduced the accrued liabilities by $5.5 million during the quarter ended December 31, 2004.

Due to the disposal of the assets and liabilities of Cal Indemnity at March 31, 2004 the Company's Consolidated Balance Sheet beginning March 31, 2004 does not include the assets and liabilities of Cal Indemnity.

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

		Three Months Ended March 31, 2004
		(In thousands)
Operating Revenues:		
Specialty product revenues	$	19,015
Investment and other revenues		1,290
Total Revenues		20,305
Operating Expenses:		
Specialty product expenses		21,917
Interest expense and other, net		(91)
Total Expenses		21,826
Loss From Discontinued Operations Before Income Tax		(1,521)
Income tax benefit		839
Net Loss From Discontinued Operations	$	(682)

The activity for 2004 is through the disposal date, March 31, 2004. There is no activity for the discontinued operations beyond that date. Any subsequent activity related to this disposal has been reflected in continuing operations. 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.

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8. EARNINGS PER SHARE:

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

	Three Months Ended March 31,	
	2005	2004
	(In thousands, except per share data)	
Basic Income (Loss) Per Share:		
Income from continuing operations	$ 28,567	$ 26,315
Income (loss) from discontinued operations	838	(486)
Net Income	$ 29,405	$ 25,829
Weighted average common shares outstanding	26,622	27,041
Earnings Per Common Share:		
Income from continuing operations	$ 1.07	$ 0.97
Income (loss) from discontinued operations	0.03	(0.01)
Net Income	$ 1.10	$ 0.96
Diluted Income (Loss) Per Share:		
Income from continuing operations	$ 28,567	$ 26,315
Income (loss) from discontinued operations	838	(486)
Net Income	29,405	25,829
Interest expense on Sierra debentures, net of tax	420	420
Income For Purposes Of Computing Diluted Net Income Per Share	$ 29,825	$ 26,249
Weighted average common shares outstanding	26,622	27,041
Dilutive options and restricted shares outstanding	1,215	2,213

9. DEFINED BENEFIT PLAN

The Company previously disclosed that it expected to contribute approximately $784,000 to its defined benefit plan in 2005 to fund expected benefit payments. As of March 31, 2005, the Company has contributed $513,000 to the plan to fund benefit payments and anticipates making approximately $548,000 in additional contributions during 2005. The additional contribution during the first quarter of 2005 was related to a lump sum payout, which will reduce future expected payments.

	Three Months Ended March 31,	
	2005	2004
	(In thousands)	
Components Of Net Periodic Benefit Cost:		
Service cost	$ 94	$ 106
Interest cost	321	418
Amortization of prior service credits	303	303
Recognized actuarial loss		109
Net Periodic Benefit Cost	$ 718	$ 936

10. COMPREHENSIVE INCOME

The following table presents comprehensive income for the periods indicated:

	Three Months Ended March 31,	
	2005	2004
	(In thousands)	
Net income	$ 29,405	$ 25,829
Change in unrealized holding loss on available-for-sale investments	(439)	782
Comprehensive Income	$ 28,966	$ 26,611

11. 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 segment includes managed health care services provided through 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, other ancillary services and corporate operations. The military health services segment administered a managed care federal contract for the Department of Defense's TRICARE program in Region 1.

Sierra Military Health Services LLC (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 TRICARE Region 1 contract. On September 1, 2004, SMHS commenced an eight-month phase-out of operations at prices previously negotiated with the Department of Defense (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.

SMHS anticipates negotiating the final bid price adjustment settlement with the DoD for option period six (June 1, 2003 to August 31, 2004) during the second quarter of 2005. This settlement will include the

final revenue adjustments and a final adjustment for updated health care expense estimates for this option period. At the conclusion of the settlement, SMHS will pay the DoD the estimated portion of the remaining military health care payable. As with previous settlements, this final settlement may have a material impact on the Company's results of operations.

Through participation in Medicare, TRICARE and the Federal Employees Health Benefit Plan programs, the Company generated approximately 39% and 57% of its total consolidated revenues from agencies of the U.S. government for the three months ended March 31, 2005 and 2004, respectively. The TRICARE revenue is presented below in the military health services operations segment and the remainder of the revenue described above is included in the managed care and corporate operations segment.

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.

Information concerning the operations of the reportable segments is as follows:

	Managed Care And Corporate Operations	Military Health Services Operations	Total
		(In thousands)	
Three Months Ended March 31, 2005			
Medical premiums	$ 311,355	$ —	$ 311,355
Military contract revenues	—	6,359	6,359
Professional fees	9,853	—	9,853
Investment and other revenues	8,129	142	8,271
Total Revenue	$ 329,337	$ 6,501	$ 335,838
Segment operating profit	$ 42,930	$ 2,394	$ 45,324
Interest expense	(1,622)	(9)	(1,631)
Other income (expense), net	74	25	99
Income Before Income Taxes	$ 41,382	$ 2,410	$ 43,792
Three Months Ended March 31, 2004			
Medical premiums	$ 265,438	$ —	$ 265,438
Military contract revenues	—	127,624	127,624
Professional fees	9,478	—	9,478
Investment and other revenues	5,005	645	5,650
Total Revenue	$ 279,921	$ 128,269	$ 408,190
Segment operating profit	$ 34,688	$ 7,472	$ 42,160
Interest expense	(1,147)	(18)	(1,165)
Other income (expense), net	127	(5)	122
Income Before Income Taxes	$ 33,668	$ 7,449	$ 41,117

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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 March 31, 2005, the future lease payments due under the lease agreement total $5.1 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. The fair value of this obligation is considered immaterial.

Litigation and Legal Matters.

Although the Company has not been sued, it was identified in discovery submissions in pending class action litigation against major managed care companies, as having allegedly participated in an unlawful conspiracy to improperly deny, diminish or delay payments to physicians. *In Re: Managed Care Litigation*, MDL No. 1334 (S.D.Fl.).

Beginning in 1999, a series of class action lawsuits were filed against many major firms in the health benefits business. A multi-district litigation panel has consolidated for pre-trial discovery some of these cases in the United States District Court for the Southern District of Florida, Miami Division. In the lead case, known as *Shane*, the amended complaint alleges multiple violations under the Racketeer Influenced and Corrupt Organizations Act (RICO). The suit seeks injunctive, compensatory and equitable relief as well as restitution, costs, fees and interest payments. Discovery remains ongoing. On April 7, 2003, the United States Supreme Court determined that certain claims against certain defendants should be arbitrated. Subsequent lower court rulings have further resolved which of the plaintiffs' claims are subject to arbitration. In 2004, the Court of Appeals for the Eleventh Circuit upheld a district court ruling certifying a plaintiff class in the *Shane* case. The district court has recently determined to bifurcate the case, holding a trial phase limited to liability issues, and a second, if necessary, regarding damages. A trial date has been set for September 2005. Plaintiffs in the *Shane* proceeding have stated their intention to introduce evidence at trial concerning Sierra and other parties not named as defendants in the litigation. Two of the defendants, Aetna Inc. and Cigna Corporation, have entered into settlement agreements, which have been approved by the district 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. In addition, under the terms of the note receivable due from the sale of Cal Indemnity, which is subject to adjustment based on loss development, the Company can be indirectly affected by claims for workers' compensation and claims by providers for payment of medical services rendered to injured workers. 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 for certain claims and litigation cannot be reasonably estimated or is not considered probable but the ultimate resolution of these pending legal proceedings should not have a material adverse effect on our financial condition.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

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, 2004, and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in our 2004 annual report on Form 10-K filed with the Securities and Exchange Commission on March 14, 2005, and in conjunction with our unaudited condensed consolidated financial statements and accompanying notes for the three month periods ended March 31, 2005 and 2004, 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 2004 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 2004 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 2004 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.

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	Three Months Ended March 31,		Percent Of Revenue Three Months Ended March 31,		Increase (Decrease)	
	2005	2004	2005	2004	2005 vs. 2004	
	(In thousands, except percentages, per share and membership)					
Operating Revenues:						
Medical premiums	$ 311,355	$ 265,438	92.7 %	65.0 %	$ 45,917	17.3 %
MIlitary contract revenues	6,359	127,624	1.9	31.3	(121,265)	(95.0)
Professional Fees	9,853	9,478	2.9	2.3	375	4.0
Investment and other revenues	8,271	5,650	2.5	1.4	2,621	46.4
Total	335,838	408,190	100.0	100.0	(72,352)	(17.7)