

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

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

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**FORM 10-Q**

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*(Mark One)*

☒ 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

☐ 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

(State or other jurisdiction of incorporation or organization)

88-0200415

(I.R.S. Employer Identification Number)

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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

☒ No ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes

☒ No

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

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

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(In thousands, except per share data)

(Unaudited)

|  | <b>March 31,<br/>2005</b> | <b>December<br/>31,<br/>2004</b> |
|--|---------------------------|----------------------------------|
| <b>ASSETS</b>  |                           |                                  |
| 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                       |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                           |                                  |
| 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                           |

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|  |            |            |
|--|------------|------------|
| 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)

|                               | <b>Three Months Ended<br/>March 31,</b> |
|-------------------------------|---|
|                               | <hr/>                                   |
| <b>2005</b>                   |   |
|                               | <hr/>                                   |
| <b>2004</b>                   |   |
|                               | <hr/>                                   |
| 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                                   |
|                               | <hr/>                                   |
|                               | <hr/>                                   |
|                               | <hr/>                                   |
|                               | <hr/>                                   |
| Total                         |   |
| 335,838                       | 408,190                                 |
|                               | <hr/>                                   |
|                               | <hr/>                                   |

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Operating Expenses:

Medical expenses

244,962 208,065

Military contract expenses

4,107 120,797

General and administrative expenses

41,445 37,168

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Total

290,514 366,030

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Operating Income From Continuing Operations

45,324 42,160

Interest expense

(1,631) (1,165)

Other income (expense), net

99 122

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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

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Net Cash Provided By Operating Activities Of Continuing Operations

23,402 32,227

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Cash Flows From Investing Activities:

Capital expenditures, net of dispositions

(2,252) (1,491)

Change in investments

(115,469) 19,401

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Net Cash (Used For) Provided By Investing Activities Of Continuing Operations

(117,721) 17,910

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Cash Flows From Financing Activities:

Payments on debt and capital leases

(24) (1,490)

Purchase of treasury stock

(10,354) (31,944)

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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:

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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

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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.



[Table of Contents](#)**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:

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

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:

|                                     | <b>Three Months Ended March 31,<br/>2005</b> | <b>2004</b> |
|-------------------------------------|--|-------------|
|                                     | (In thousands)                               |             |
| Operating revenues                  | \$ 21  | \$ 36       |
|                                     | <hr/>  | <hr/>       |
| Medical expenses                    | (7)  | (175)       |
| General and administrative expenses | 28   | (136)       |
| Interest expense and other, net     |  | 73          |
|                                     | <hr/>  | <hr/>       |

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|   |                   |                   |
|---|-------------------|-------------------|
| Income From Discontinued Operations Before Income Tax |                   | 274               |
| Income tax benefit (provision)                        | 838               | (78)              |
|   | <u>          </u> | <u>          </u> |
| Net Income From Discontinued Operations               | \$ 838            | \$ 196            |
|   | <u>          </u> | <u>          </u> |

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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:

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

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:

|   | <b>Three Months Ended March 31,</b>   |             |
|---|---------------------------------------|-------------|
|   | <b>2005</b>                           | <b>2004</b> |
|   | (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       |

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## 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

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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<br>Care<br>And<br>Corporate<br>Operations | Military<br>Health<br>Services<br>Operations | Total      |
|--|---|--|------------|
| (In thousands)                           |   |  |            |
| <b>Three Months Ended March 31, 2005</b> |   |  |            |
| Medical premiums                         | \$ 311,355  | \$ 151                                       | \$ 311,355 |
| Military contract revenues               | 151   | 6,359  | 6,359      |
| Professional fees                        | 9,853   | 151  | 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  |
| <b>Three Months Ended March 31, 2004</b> |   |  |            |
| Medical premiums                         | \$ 265,438  | \$ 151                                       | \$ 265,438 |
| Military contract revenues               | 151   | 127,624                                      | 127,624    |
| Professional fees                        | 9,478   | 151  | 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.FI.).

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<br>March 31, |            | Percent Of Revenue<br>Three Months Ended<br>March 31, |        | Increase<br>(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)  |
| Operating Expenses:   |                                 |            |   |        |                        |         |
| Medical expenses  | 244,962                         | 208,065    | 73.0  | 51.0   | 36,897                 | 17.7    |
| Medical Care Ratio  | 76.3%                           | 75.7%      |   |        |                        | 0.6     |
| Military contract expenses  | 4,107                           | 120,797    | 1.2   | 29.6   | (116,690)              | (96.6)  |
| General and administrative expenses   | 41,445                          | 37,168     | 12.3  | 9.1    | 4,277                  | 11.5    |
| Total   | 290,514                         | 366,030    | 86.5  | 89.7   | (75,516)               | (20.6)  |
| Operating Income From Continuing Operations   | 45,324                          | 42,160     | 13.5  | 10.3   | 3,164                  | 7.5     |
| Interest expense  | (1,631)                         | (1,165)    | (0.5)   | (0.3)  | (466)                  | 40.0    |
| Other income (expense), net   | 99                              | 122        |   |        | (23)                   | (18.9)  |
| Income From Continuing Operations Before Income Taxes                                     | 43,792                          | 41,117     | 13.0  | 10.0   | 2,675                  | 6.5     |
| Provision for income taxes  | (15,225)                        | (14,802)   | (4.5)   | (3.6)  | (423)                  | 2.9     |
| Tax Rate  | 34.8%                           | 36.0%      |   |        |                        | (1.2)   |
| Income From Continuing Operations   | 28,567                          | 26,315     | 8.5   | 6.4    | 2,252                  | 8.6     |
| Income (loss) from discontinued operations (net of income tax benefit of \$838 and \$761) | 838                             | (486)      | 0.3   | (0.1)  | 1,324                  | (272.4) |
| Net Income  | \$ 29,405                       | \$ 25,829  | 8.8 %   | 6.3 %  | \$ 3,576               | 13.8 %  |
| Earnings Per Common Share Assuming Dilution:  |                                 |            |   |        |                        |         |
| Income from continuing operations   | \$ 0.85                         | \$ 0.75    |   |        | \$ 0.10                | 13.3 %  |
| Income (loss) from discontinued operations  | 0.02                            | (0.01)     |   |        | 0.03                   | (300.0) |
| Net Income  | \$ 0.87                         | \$ 0.74    |   |        | \$ 0.13                | 17.6 %  |

|                 |                   |                   |                   |        |
|-----------------|-------------------|-------------------|-------------------|--------|
| HMO Membership: |                   |                   |                   |        |
| Commercial      | 241,300           | 212,000           | 29,300            | 13.8 % |
| Medicare        | 54,000            | 51,700            | 2,300             | 4.4    |
| Medicaid        | 49,900            | 48,400            | 1,500             | 3.1    |
|                 | <u>          </u> | <u>          </u> | <u>          </u> |        |
| Total           | 345,200           | 312,100           | 33,100            | 10.6 % |
|                 | <u>          </u> | <u>          </u> | <u>          </u> |        |

#### Overview

Our continuing operations derive revenues primarily from our health maintenance organization (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), military health care services and investment and other revenue (consisting of fees for workers' compensation third party administration, utilization management services and ancillary products).

Our principal expenses consist of medical 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, 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

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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 coordinating 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, administrative costs to operate the military health care subsidiary and subsequent to August 31, 2004 costs to phase-out the military health care operations. 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 March 31, 2005 operating results were significantly improved over 2004. Our income from continuing operations increased by 8.6% to \$28.6 million. The improvement in the 2005 operating results was primarily driven by medical premium revenue growth from new members, premium rate increases and an expansion of our operating margin. This improvement was partially offset by a decreased contribution from our military health services operation. Our HMO membership increased by 10.6% from 312,100 at March 31, 2004, to 345,200 at March 31, 2005 as a result of new accounts and in-case growth. Our aggregate premium rates increased by approximately 6.6% for the three months ended March 31, 2005 over 2004. The combination of these factors resulted in a 17.3% increase in our medical premium revenues to \$311.4 million, which was primarily offset by an increase in medical expenses, which increased by 17.7% to \$245.0 million. Medical expenses, as a percentage of medical premiums and professional fees, increased from 75.7% to 76.3%, or 60 basis points for the period. Our operating margin (operating income from continuing operations divided by total revenues) improved by 320 basis points to 13.5%.

Our military health services operations segment represented 1.9% of our operating revenues and 5.3% of our operating income from continuing operations for the quarter. This segment had operating income of \$2.4 million for the three months ended March 31, 2005 compared to \$7.5 million for the same period in 2004. 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 TRICARE contract for Region 1 ended on August 31, 2004. On September 1, 2004, we entered an eight-month phase-out period at substantially reduced revenues and reduced earnings.

For the three months ended March 31, 2005, compared to 2004, investment and other revenues increased from \$5.7 million to \$8.3 million, an increase of \$2.6 million or 46.4%. Of the increase, \$1.3 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 three months ended March 31, 2005, compared to 2004, our general and administrative (G&A) expenses increased from \$37.2 million to \$41.4 million, an increase of \$4.3 million or 11.5%. Of the increase, \$700,000 is for the cost to provide services related to the sale of the workers' compensation insurance operations referred to above. The remaining increase is primarily due to higher employee compensation related expenses, premium taxes, brokers' fees, and license fees.

We had cash flows from operating activities of continuing operations for the three months ended March 31, 2005, of \$23.4 million compared to \$32.2 million for 2004. We received two monthly payments from the Centers for Medicare and Medicaid Services during the first quarter of 2005 and 2004 as the January payments were received at the end of December. When the 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 \$64.2 million in 2005 and \$65.2 million in 2004. The slight decrease in



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cash flow from continuing operations is primarily due to the timing of accrued payroll and taxes, which represented a fluctuation of \$12.3 million between the periods. We believe presenting this adjustment for the timing of the CMS payments is useful for making a period-to-period comparison of our cash flow from continuing operations.

*Discontinued Operations.* On January 15, 2003, we announced that we were exploring strategic alternatives to dispose of CII Financial, Inc. (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 (Cal Indemnity), and its subsidiaries. Cal Indemnity was CII's only significant asset. 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 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.

**RESULTS OF OPERATIONS, THREE MONTHS ENDED MARCH 31, 2005, COMPARED TO THREE MONTHS ENDED MARCH 31, 2004**

*Medical Premiums.* The increase in premium revenue for the three months ended March 31, 2005 reflects a 13.3% increase in commercial member months (the number of months individuals are enrolled in a plan), a 12.5% increase in Medicaid member months and a 4.4% 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 the average commercial premium rate. Of the 12.5% increase in Medicaid member months, 7.1% is due to the expansion of our Medicaid service area to Reno, Nevada beginning February 2004.

HMO and POS premium rates for renewing commercial groups increased approximately 6% while the overall recorded per member per month revenue increase, including new and continuing business, was approximately 7%, net of changes in benefits. We received a 1% increase in Medicaid rates for 2005 but we did not receive an increase in 2004.

In December 2003, President Bush signed the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA), into law, which, among other changes to Medicare, alters the Medicare+Choice program. Under the MMA, Medicare+Choice plans, renamed Medicare Advantage plans, 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 was used to reduce beneficiary cost sharing, enhance benefits, and stabilize the provider network. In addition, some of the funds were placed into a benefit stabilization fund.

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. For Social HMO members, the new methodology includes a frailty adjuster that uses measures of functional impairment to predict expenditures. CMS is transitioning to the new payment methodology on a graduated basis from 2004 through 2007. In 2004, we were paid 90% based on the previous payment approach and 10% based on the new approach. Excluding the effects of MMA, the new payment methodology reduced our



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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. Our 2005 annual Medicare increase, before the effect of the new payment approach and the MMA, would have been 7.9%. The new payment approach reduced this to approximately 4% although the actual increase we received over the fourth quarter of 2004 was approximately 2% as the increased MMA funds were received over the last 10 months of the year and included a proportionate share for January and February 2004.

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 212,000 at March 31, 2004 to 241,300 at March 31, 2005. The increase in commercial membership is attributed to in-case growth, movement from self-insured plans to our commercial products and new accounts.

**Military Contract Revenues.**

The decrease in military contract revenue for the three months ended March 31, 2005 is the result of Sierra Military Health Services LLC (SMHS) completing its 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 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 we do 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 our results of operations. Based on preliminary discussions with the DoD, we believe we will have a settlement gain during the second quarter of 2005. SMHS did not have any final settlements or bid price adjustments in the first quarter of 2004 or 2005.

SMHS has recorded phase-out revenues during the first quarter of 2005 of \$5.0 million and expects phase-out revenues of approximately \$5.5 million during the second quarter of 2005. For more detail on SMHS' results of operations, see Note 11, Segment Reporting, in the Notes to the Condensed Consolidated Financial Statements.

**Professional Fees.**

The increase in professional fees is a result of increased visits due primarily to membership growth.

**Investment and Other Revenues.**

Of the increase in investment and other revenues, \$1.3 million 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 and accrued interest on the note receivable. 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

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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 March 31, 2005 was \$700,000. The cost to provide these services is reflected in our general and administrative expenses. In addition, we recorded accrued interest of approximately \$500,000 on the note receivable. The remaining increase in investment and other revenues is due primarily to an increase in yield during 2005, higher average invested balances and income on a short sale of U.S Treasury bonds as described in Note 3, Investments, in the Notes to the Condensed Consolidated Financial Statements. A portion of the increase in investment income related to our short position is offset by an increase in interest expense.

*Medical Expenses.* Our medical care ratio, which is medical expenses as a percentage of medical premiums and professional fees, increased from 75.7% to 76.3%. The increase in our medical care ratio is due primarily to higher average bed days and increased prescription drug costs. 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 March 31, 2005, was 47.1 compared to 46.9 at March 31, 2004.

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 \$32.0 million and \$26.9 million, or 13.1% and 12.9%, of our total medical expenses for 2005 and 2004, respectively.

*Military Contract Expenses.* The decrease in military contract expenses is primarily the result of SMHS completing its final month of health care operations under the TRICARE contract in August 2004. Expenses for the three months ended March 31, 2005 primarily consist of costs incurred related to the phase-out of the military health care operations as previously discussed. Included in our military contract expenses for the three months ended March 31, 2004 is an allocation of corporate overhead of \$1.0 million per quarter for direct and indirect services provided to SMHS. There was no allocation of overhead in 2005.

## General and Administrative Expenses.

G&A expenses increased primarily due to higher employee compensation related expenses, premium taxes, brokers' fees, license fees and expenses to provide services relative to our sales agreement for the workers' compensation insurance operations as discussed above. As a percentage of medical premium revenue, G&A expenses were 13.3% for 2005, compared to 14.0% for 2004. Excluding the services relative to our sales agreement for the workers' compensation insurance operations, our 2005 G&A expenses, as a percentage of medical premium revenue, were 13.1%.

*Interest Expense.* Interest expense increased due to interest expense on our short sale of U.S Treasury bonds. The increase in expense is offset by an increase in investment income. For more detail on our short position see Note 3, Investments, in the Notes to the Condensed Consolidated Financial Statements.

## Other Income (Expense), Net.

Other income (expense), net was consistent between the quarters.

## Provision for Income Taxes

. The effective tax rate for 2005 was 34.8% compared to 36.0% for 2004. Our effective tax rate is less than the statutory rate due primarily to tax-preferred investments.

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Our effective tax rate is based on actual or expected income, statutory tax rates and tax planning opportunities available to us. We may use significant estimates and judgments in determining our effective tax rate. We are occasionally audited by federal, state or local jurisdictions regarding

compliance with federal, state and local tax laws and the recognition of income and deductibility of expenses. Tax assessments may not arise until several years after tax returns are filed. While there is an element of uncertainty in predicting the outcome of tax audits, we believe that the recorded tax assets and liabilities are appropriately stated based on our analyses of probable outcomes, including interest and other potential adjustments. Our tax assets and liabilities are adjusted based on the most current facts and circumstances, including the progress of audits, case law and emerging legislation; any adjustments are included in the effective tax rate in the period of adjustment.

*Discontinued Operations* consist of our Texas HMO health care operations and the CII workers' compensation operations up to March 31, 2004, the date of the sale of the insurance operations. The Texas HMO health care operations had net income for the three months ended March 31, 2005 of \$838,000 as a result of a tax benefit related to a reconciliation of our tax accounts to the previously filed income tax returns offset by an increase in the income tax liability for discontinued operations.

Discontinued Texas HMO health care operations.

There is minimal activity remaining relative to our discontinued Texas operations. 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 ongoing activity related to this transaction, subsequent to the March 31, 2004 closing date, has been discussed above.

## LIQUIDITY AND CAPITAL RESOURCES

We had cash flows from operating activities for continuing operations of \$23.4 million for the three months ended March 31, 2005 compared to \$32.2 million in 2004. We received two monthly CMS payments during the first quarter of 2005 and 2004 as the January payments were received at the end of December. When the quarters are adjusted to reflect three monthly payments from CMS, the cash flow from continuing operations would be \$64.2 million in 2005 and \$65.2 million in 2004. We believe presenting this adjustment for the timing of the CMS payments is useful for making a period-to-period comparison of our cash flow from continuing operations. We used the majority of the cash flow to purchase investments. The slight decrease in cash flow from continuing operations is primarily due to the timing of accrued payroll and taxes, which represented a fluctuation of \$12.3 million between the periods.

We expect that the loss of the T-Nex contract will adversely affect our cash flow from operations in the second quarter of 2005. We expect that SMHS will use \$15.0 million to \$20.0 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 2005 included \$2.3 million in capital expenditures associated with the continued implementation of new computer systems, leasehold improvements on facilities, furniture and equipment and other capital purchases to support our growth. The net cash change in investments for the period was an increase in investments of \$115.5 million as cash equivalents were used to purchase investments.

Proceeds from the issuance of stock in connection with stock plans were \$9.4 million and cash of \$10.4 million was used to repurchase Sierra common stock.

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Discontinued operations provided cash of \$2.4 million in 2005, compared to cash provided of \$3.4 million in 2004. 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 2 ¼% 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. Beginning December 2003 and for each subsequent period, the market price of our 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 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 be redeemed by us for cash beginning on or after March 20, 2008.

**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 had 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 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, which is currently LIBOR plus 1.20% based on current covenant ratios. The facility is available for general corporate purposes. At March 31, 2005, we have drawn \$10.0 million on this facility, which is unchanged from December 31, 2004.

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.

Table of Contents**Sierra Share Repurchases**

From January 1, 2005 through March 31, 2005, we purchased 178,000 shares of our common stock, in the open market or through negotiated transactions, for \$10.4 million at an average cost per share of

\$58.14. On May 20, 2004, and December 7, 2004, our Board of Directors authorized us to purchase an additional \$70.0 million and \$50.0 million worth of our common stock, respectively. At March 31, 2005, \$61.1 million was still available under the Board of Directors' authorized plan.

Our revolving credit facility, as amended, currently allows for unlimited stock repurchases. We have repurchased 53,000 shares for \$3.2 million at an average cost of \$60.91 subsequent to March 31, 2005 through April 25, 2005.

**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 \$16.5 million at March 31, 2005. 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 \$113.5 million in cash and cash equivalents held at March 31, 2005, including discontinued operations, \$1.1 million was held by discontinued operations and \$62.9 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 March 31, 2005. The amounts presented below include all future payments associated with each obligation including interest expense.

|                                     | <b>Long-Term<br/>Debt</b> | <b>Capital<br/>Leases</b> | <b>Operating<br/>Leases</b> | <b>Total</b>      |
|-------------------------------------|---------------------------|---------------------------|-----------------------------|-------------------|
|                                     | (In thousands)            |                           |                             |                   |
| Payments due within 12 months       | \$ 2,588                  | \$ 135                    | \$ 18,436                   | \$ 21,159         |
| Payments due in 13 to 36 months     | 5,175                     | 264                       | 34,802                      | 40,241            |
| Payments due in 37 to 60 months     | 15,175                    | 119                       | 33,431                      | 48,725            |
| Payments due in more than 60 months | 148,637                   | 84                        | 93,234                      | 241,955           |
| <b>Total</b>                        | <b>\$ 171,575</b>         | <b>\$ 602</b>             | <b>\$ 179,903</b>           | <b>\$ 352,080</b> |

**Recently Issued Accounting Standards**

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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

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and supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." 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, we 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 would be suspended until January 1, 2006, for calendar year companies. We anticipate adopting the prospective method of SFAS 123R in 2006 but we have not yet determined the financial statement impact of adopting SFAS 123R.

## Ratings

Financial strength ratings are the opinion of the rating agencies and the significance of individual ratings varies from agency to agency. Companies with higher ratings generally, in the opinion of the rating agency, have the strongest capacity for repayment of debt or payment of claims, while companies at the bottom end of the range have the weakest capacity. Rating agencies continually review the financial performance and condition of insurers. The current financial strength ratings of Sierra's HMO and health and life insurance subsidiaries and senior convertible debt are as follows:

|                         | <b>Financial Strength Rating:<br/>HMO and health and life<br/>insurance subsidiaries</b> |                | <b>Debt Rating:<br/>Senior convertible<br/>debentures</b> |                |
|-------------------------|--|----------------|---|----------------|
|                         | <b>Rating</b>  | <b>Ranking</b> | <b>Rating</b>   | <b>Ranking</b> |
| A.M. Best Company, Inc. | B++ Very Good  | 5th of 16      | bb<br>Speculative   | 12th of 22     |
| Fitch Ratings           | BBB Good   | 9th of 23      | BB<br>Speculative   | 12th of 23     |
| Standard & Poor's Corp. | n/a  | n/a            | B+<br>Speculative   | 14th of 22     |

The financial strength ratings reflect the opinion of each rating agency on our operating performance and ability to meet obligations to policyholders and debenture holders, and are not evaluations directed toward the protection of investors in our common stock or senior convertible debentures. The ratings are unchanged from the prior quarter. A.M. Best Company, Inc. has also initially assigned "Issuer Credit Ratings" of bb for Sierra and bbb for Health Plan of Nevada, Inc. and Sierra Health and Life Insurance Company, Inc.

## Other

We have a 2005 capital budget of approximately \$30 million and are also limited in the amount of capital expenditures we can make by our revolving credit facility. The 2005 planned expenditures are primarily for the construction of 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. We believe that our existing working capital, operating cash flow and amounts available under our credit facility should be sufficient to fund our capital expenditures and liquidity needs. 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.



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**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 (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 2004 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.

Table of Contents**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 disclosure of our contingent 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 results, however, may materially differ from our calculated estimates and this difference would be reported in our current operations. Our critical accounting policies and estimates have been reviewed by the Audit Committee of our Board of Directors.

For a more detailed description of all our critical accounting policies and estimates, see Part II, Item 7 of our 2004 annual report on Form 10-K. As of March 31, 2005, 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 2004 annual report on Form 10-K.

**Membership****Number of Members at March 31,**


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**2005**


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**2004**


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HMO:

Commercial

241,300 212,000

Medicare

54,000 51,700

Medicaid

49,900 48,400

Managed indemnity

26,000 23,900

Medicare supplement

16,300 17,000

Administrative services

184,600 180,100

Subtotal

572,100 533,100

TRICARE eligibles

&#151 710,000

Total Membership

572,100 1,243,100

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

At March 31, 2005, we had unrealized holding losses on available for sale investments of \$684,000, net of tax, compared to unrealized holding losses of \$245,000, net of tax, at December 31, 2004. 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 March 31, 2005, we had outstanding \$115.0 million in aggregate principal amount of our 2 ¼% 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 1.2%. At March 31, 2005, 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 has not been sued, we were 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.

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 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.

Table of Contents**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

- (c) Below, is a summary of stock repurchases for the three months ended March 31, 2005. See Note 5 of our Notes to Condensed Consolidated Financial Statements for information regarding our stock repurchase plan.

| (In thousands, except per share data)                                  |   |   |   |  |
|--|---|---|---|--|
| <b>Period</b>  | <b>Total Number<br/>Of Shares<br/>Repurchased<br/>(1)</b> | <b>Average Price<br/>Paid Per Share</b> | <b>Total Number Of<br/>Shares Purchased As<br/>Part Of Publicly<br/>Announced Plan Or<br/>Program</b> | <b>Approximate<br/>Dollar Value Of<br/>Shares That<br/>May Yet Be<br/>Purchased Under<br/>The Plan (2)</b> |
| Beginning approximate dollar value of shares that may yet be purchased |   |   |   | \$71,444   |
| January 1, 2005 - January 31, 2005                                     | 42  | \$53.21                                 | 42  | 69,183   |
| February 1, 2005 - February 28, 2005                                   | 79  | 58.29                                   | 79  | 64,604   |
| March 1, 2005 - March 31, 2005   | 57  | 61.61                                   | 57  | 61,093   |

(1) Certain repurchases were made pursuant to a 10b5

-1 plan.

- (2) On May 20, 2004, the Company's Board of Directors authorized the Company to purchase \$70.0 million of its common stock. On December 7, 2004, the Company's Board of Directors authorized the Company to purchase an additional \$50.0 million of its common stock. The repurchase program has no stated expiration date, and commenced after the previously authorized share repurchase was completed.

**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**

- (31.1) Rule 13a - 14(a) or 15d - 14(a) Certification of Chief Executive Officer.
- (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: April 26, 2005