



FINANCIAL STATEMENTS

Magellan Health Services of Arizona, Inc.
Years Ended June 30, 2010 and 2011
With Report of Independent Auditors

Ernst & Young LLP

 **ERNST & YOUNG**

Magellan Health Services of Arizona, Inc.

Financial Statements

Years Ended June 30, 2010 and 2011

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Report of Independent Auditors

Magellan Health Services of Arizona, Inc.

We have audited the accompanying balance sheets of Magellan Health Services of Arizona, Inc., (the “Company”) as of June 30, 2010 and 2011, and the related statements of income, changes in stockholder’s equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Magellan Health Services of Arizona, Inc. at June 30, 2010 and 2011, and the results of its operations and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

December 8, 2011

Magellan Health Services of Arizona, Inc.

Certification Statement

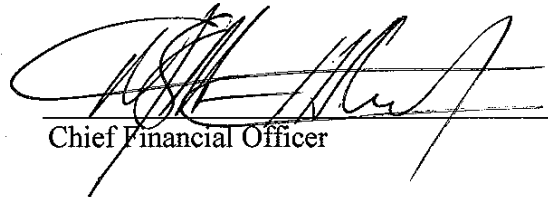
Year Ended June 30, 2011

CERTIFICATION STATEMENT OF MAGELLAN HEALTH SERVICES OF ARIZONA
FOR THE MONTH ENDED June 30, 2011 Final

Name of Preparer: Merrick Morgan
Title: CFO
Phone No: 602-572-8380

I hereby attest that the information submitted in the reports herein is current, complete and accurate to the best of my knowledge. I understand that whoever knowing and willfully makes or causes to be made a false statement or representation with this report may be prosecuted under applicable federal and/or state laws. In addition, knowing and willfully failing to fully and accurately disclose the information requested might result in denial of a request to participate, or where the entity already participates, a termination of a T/RBHA's agreement or contract with Arizona Department of Health Services.

12/7/11
Date Signed



Chief Financial Officer

Magellan Health Services of Arizona, Inc.

Balance Sheets

	June 30	
	2010	2011
Assets		
Cash and cash equivalents	\$ 81,267,000	\$ 14,871,199
Short-term investments	63,919,328	86,043,156
Accounts receivable	2,617,773	77,370,999
Other accounts receivable	2,087,774	6,485,754
Deferred income taxes	1,445,987	2,622,870
Prepaid expenses	553,673	229,306
Total current assets	<u>151,891,535</u>	<u>187,623,284</u>
Property and equipment, net	947,591	3,448,505
Long-term investments	27,586,013	4,122,153
Deferred income taxes	560,447	–
Other noncurrent assets	233,105	108,854
Total assets	<u>\$ 181,218,691</u>	<u>\$ 195,302,796</u>
Liabilities and stockholder's equity		
Current liabilities:		
Medical claims payable	\$ 17,705,854	\$ 20,065,619
Payable to ADHS	15,544,546	14,086,522
Accounts payable and accrued expenses	994,553	140,822
Other medical liabilities	8,317,530	4,111,505
Due to affiliates, net	26,431,226	59,116,354
Deferred revenue	375,000	7,955,075
Other current liabilities	6,105,559	10,313,351
Total current liabilities	<u>75,474,268</u>	<u>115,789,248</u>
Maricopa Comcare trust	591,356	78
Deferred income taxes	–	879,007
Other long-term liabilities	126,575	28,919
Total liabilities	<u>76,192,199</u>	<u>116,697,252</u>
Stockholder's equity:		
Common stock, \$0.10 par value; 1,000 shares authorized, issued, and outstanding	100	100
Additional paid-in capital	62,000,000	62,000,000
Retained earnings	43,000,210	16,535,815
Accumulated other comprehensive income, net	26,182	69,629
Total stockholder's equity	<u>105,026,492</u>	<u>78,605,544</u>
Total liabilities and stockholder's equity	<u>\$ 181,218,691</u>	<u>\$ 195,302,796</u>

See accompanying notes.

Magellan Health Services of Arizona, Inc.

Statements of Income

	Year Ended June 30	
	2010	2011
Revenues:		
Contract revenues	\$ 772,490,766	\$ 779,578,507
Other revenues	89,429	32,218
Interest income	4,174,363	5,844,161
Total revenues	<u>776,754,558</u>	<u>785,454,886</u>
Expenses:		
Cost of care	665,905,159	656,352,502
General and administrative expenses	43,439,496	60,387,087
Total expenses	<u>709,344,655</u>	<u>716,739,589</u>
Net income before income taxes	67,409,903	68,715,297
Allocated corporate income tax provision	25,630,929	27,179,692
Net income	<u>41,778,974</u>	<u>41,535,605</u>
Other comprehensive (loss) income ⁽¹⁾	(73,200)	43,447
Comprehensive income	<u>\$ 41,705,774</u>	<u>\$ 41,579,052</u>

⁽¹⁾ Net of income tax provision (benefit) of \$(48) thousand and \$28 thousand for the years ended June 30, 2010 and 2011, respectively.

See accompanying notes.

Magellan Health Services of Arizona, Inc.

Statements of Changes in Stockholder's Equity

	Common Stock	Additional Paid-in Capital	(Accumulated Deficit) Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholder's Equity
Balance, June 30, 2009	\$ 100	\$ 62,000,000	\$ 1,221,236	\$ 99,382	\$ 63,320,718
Net income	–	–	41,778,974	–	41,778,974
Other comprehensive loss, net	–	–	–	(73,200)	(73,200)
Balance, June 30, 2010	\$ 100	62,000,000	43,000,210	26,182	105,026,492
Net income	–	–	41,535,605	–	41,535,605
Dividends paid	–	–	(68,000,000)	–	(68,000,000)
Other comprehensive income, net	–	–	–	43,447	43,447
Balance, June 30, 2011	\$ 100	\$ 62,000,000	\$ 16,535,815	\$ 69,629	\$ 78,605,544

See accompanying notes.

Magellan Health Services of Arizona, Inc.

Statements of Cash Flows

	Year Ended June 30	
	2010	2011
Operating activities		
Net income	\$ 41,778,974	\$ 41,535,605
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	649,711	536,359
Deferred income tax provision	7,706,086	186,320
Changes in assets and liabilities:		
Accounts receivable	13,442,113	(74,753,226)
Other accounts receivable	2,315,364	(4,397,980)
Prepaid expenses	966,941	324,367
Other assets	517,978	124,251
Medical claims payable	(3,957,234)	2,359,765
Payable to ADHS	(948,411)	(1,458,023)
Deferred revenue	375,000	7,580,075
Accounts payable and other accrued liabilities	(1,205,258)	2,665,132
Other medical liabilities	6,401,926	(4,206,025)
Due to affiliates, net	17,493,824	32,685,124
Other	2,788,888	5,151,606
Net cash provided by operating activities	<u>88,325,902</u>	<u>8,333,350</u>
Investing activities		
Proceeds from the sale of property and equipment	393,150	192,935
Purchases of property and equipment	(191,134)	(3,230,210)
Maturity of investments	43,977,000	82,835,579
Purchases of investments	(87,374,908)	(86,527,455)
Net cash used in investing activities	<u>(43,195,892)</u>	<u>(6,729,151)</u>
Financing activities		
Dividends paid	–	(68,000,000)
Payments of capital lease obligation	(13,906)	–
Net cash used in financing activities	<u>(13,906)</u>	<u>(68,000,000)</u>
Net change in cash and cash equivalents	45,116,104	(66,395,801)
Cash and cash equivalents, beginning of year	<u>36,150,896</u>	<u>81,267,000</u>
Cash and cash equivalents, end of year	<u>\$ 81,267,000</u>	<u>\$ 14,871,199</u>

See accompanying notes.

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements

Years Ended June 30, 2010 and 2011

1. Organization

Magellan Health Services of Arizona, Inc. (the “Company”) is a wholly owned subsidiary of Magellan Behavioral Health, Inc. (the “Parent”), which is a wholly owned subsidiary of Magellan Health Services, Inc. (“Magellan”). Magellan is engaged in the specialty managed health care business, and provides managed behavioral health care services, radiology benefits management, specialty pharmaceutical management, and Medicaid administration.

Magellan coordinates and manages the delivery of behavioral health care treatment services that are provided through its contracted network of third-party treatment providers, which includes psychiatrists, psychologists, other behavioral health professionals, psychiatric hospitals, general medical facilities with psychiatric beds, residential treatment centers and other treatment facilities.

The Company was incorporated and organized in 2004 as a behavioral health organization. In 2007, the Company was awarded a contract with the Arizona Department of Health Services (“ADHS”), which commenced September 1, 2007 and expires September 30, 2013 (the “Contract”). In accordance with the Contract, the Company has been designated as the Regional Behavioral Health Authority (“RBHA”) for the geographic service area of Maricopa County. The Company is responsible for managing and maintaining an organized, comprehensive behavioral health care delivery system for the benefit of eligible members within its geographic service area. All of the Company’s revenues are from the Contract.

Effective with the commencement of the Contract, the Company was required to purchase 24 behavioral health direct care facilities (the “Clinics”) from the vendor that previously serviced Maricopa County. The total purchase price for the Clinics was \$10.8 million, with such purchase price allocated as follows (amounts in millions):

Fixed assets	\$	7.0
Other assets		1.6
Contract start-up costs		2.2
Total	\$	<u>10.8</u>

The Contract start-up costs were immediately expensed.

As of June 30, 2010, the Company has divested all of the 24 clinics, including the fixed assets.

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies

Basis of Presentation

These financial statements have been prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States.

The Company evaluated all events or transactions that occurred after June 30, 2011 and through December 8, 2011, the date the Company issued these financial statements. Other than as described in Note 8 “Subsequent Events,” the Company did not have any material recognizable subsequent events, during this period.

Recent Accounting Pronouncements

In January 2010, the FASB issued Accounting Standards Update (“ASU”) No. 2010-06, “Improving Disclosures about Fair Value Measurements” (“ASU 2010-06”). ASU 2010-06 amends ASC Topic 820, “Fair Value Measurements and Disclosures,” to require a number of additional disclosures regarding fair value measurements. Effective January 1, 2010, thereby reflected in the fiscal year 2010 and subsequent financial statements, ASU 2010-06 requires disclosure of the amounts of significant transfers between Level I and Level II and the reasons for such transfers, the reasons for any transfers in or out of Level III, and disclosure of the policy for determining when transfers between levels are recognized. ASU 2010-06 also clarified that disclosures should be provided for each class of assets and liabilities and clarified the requirement to disclose information about the valuation techniques and inputs used in estimating Level II and Level III measurements. Beginning January 1, 2011, therefore reflected within the fiscal year 2011 financial statements, ASU 2010-06 also requires that information in the reconciliation of recurring Level III measurements about purchases, sales, issuances, and settlements be provided on a gross basis. The adoption of ASU 2010-06 only required additional disclosures and did not have an impact on the consolidated financial statements.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Significant estimates of the Company include, among other things, accounts receivable realization, medical claims payable, and legal liabilities. Actual results could differ from those estimates.

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Cash and Cash Equivalents

The Company considers all liquid investments with an original maturity of three months or less when purchased to be cash equivalents.

Fair Value Measurements

The Company currently does not have nonfinancial assets and nonfinancial liabilities that are required to be measured at fair value on a recurring basis. Financial assets and liabilities are to be measured using inputs from the three levels of the fair value hierarchy, which are as follows:

- Level 1 – Inputs are unadjusted quoted prices in active markets for identical assets or liabilities that we have the ability to access at the measurement date.
- Level 2 – Inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (i.e., interest rates, yield curves), and inputs that are derived principally from or corroborated by observable market data by correlation or other means (market corroborated inputs).
- Level 3 – Unobservable inputs that reflect our assumptions about the assumptions that market participants would use in pricing the asset or liability. The Company develops these inputs based on the best information available, including the Company's data.

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

In accordance with the fair value hierarchy described above, the following table shows the fair value of the Company's financial assets and liabilities that are required to be measured at fair value as of June 30, 2010 and June 30, 2011, respectively:

Fair Value Measurements at June 30, 2010				
	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	\$ —	\$ 81,267,000	\$ —	\$ 81,267,000
Investments:				
Corporate debt securities	—	88,778,759	—	88,778,759
Taxable municipals	—	2,726,582	—	2,726,582
	<u>\$ —</u>	<u>\$ 172,772,341</u>	<u>\$ —</u>	<u>\$ 172,772,341</u>

Fair Value Measurements at June 30, 2011				
	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	\$ —	\$ 14,871,199	\$ —	\$ 14,871,199
Investments:				
Corporate debt securities	—	87,545,309	—	87,545,309
Taxable municipals	—	2,620,000	—	2,620,000
	<u>\$ —</u>	<u>\$ 105,036,508</u>	<u>\$ —</u>	<u>\$ 105,036,508</u>

All of the Company's investments are classified as "available-for-sale" and are carried at fair value, based on quoted market prices for similar assets. The Company's policy is to classify all investments with contractual maturities within one year as current. Investment income is recognized when earned and reported net of investment expenses. Net unrealized holding gains or losses are excluded from earnings and are reported, net of tax, as "accumulated other comprehensive income (loss)" in the accompanying balance sheets and statements of income until realized, unless the losses are deemed to be other than temporary. Realized gains or losses, including any provision for other-than-temporary declines in value, are included in the statements of income.

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

If a debt security is in an unrealized loss position and the Company has the intent to sell the debt security, or it is more likely than not that the Company will have to sell the debt security before recovery of its amortized cost basis, the decline in value is deemed to be other than temporary and is recorded to other-than-temporary impairment losses recognized in income in the statements of income. For impaired debt securities that the Company does not intend to sell or it is more likely than not that the Company will not have to sell such securities, but the Company expects that it will not fully recover the amortized cost basis, the credit component of the other-than-temporary impairment is recognized in other-than-temporary impairment losses recognized in income in the statements of income and the noncredit component of the other-than-temporary impairment is recognized in other comprehensive (loss) income.

The credit component of an other-than-temporary impairment is determined by comparing the net present value of projected future cash flows with the amortized cost basis of the debt security. The net present value is calculated by discounting the best estimate of projected future cash flows at the effective interest rate implicit in the debt security at the date of acquisition. Cash flow estimates are driven by assumptions regarding probability of default, including changes in credit ratings, and estimates regarding timing and amount of recoveries associated with a default. Furthermore, unrealized losses entirely caused by noncredit related factors related to debt securities for which the Company expects to fully recover the amortized cost basis continue to be recognized in accumulated other comprehensive income.

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

As of June 30, 2010 and 2011, there were no unrealized losses that the Company believed to be other than temporary. No realized gains or losses were recorded for either of the years ended June 30, 2010 or 2011. The following is a summary of short-term and long-term investments at June 30, 2010 and 2011:

	June 30, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Corporate debt securities	\$ 88,786,240	\$ 80,130	\$ (87,611)	\$ 88,778,759
Taxable Municipals	2,740,766	–	(14,184)	2,726,582
Total investments at June 30, 2010	<u>\$ 91,527,006</u>	<u>\$ 80,130</u>	<u>\$ (101,795)</u>	<u>\$ 91,505,341</u>
	June 30, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Corporate debt securities	\$ 87,446,948	\$ 119,104	\$ (20,743)	\$ 87,545,309
Taxable Municipals	2,620,330	–	(330)	2,620,000
Total investments at June 30, 2011	<u>\$ 90,067,278</u>	<u>\$ 119,104</u>	<u>\$ (21,073)</u>	<u>\$ 90,165,309</u>

The maturity dates of the Company's investments as of June 30, 2011, are summarized below:

	Amortized Cost	Estimated Fair Value
Due in fiscal year 2012	\$ 85,944,705	\$ 86,043,156
Due in fiscal year 2013	4,122,573	4,122,153
Total investments at June 30, 2011	<u>\$ 90,067,278</u>	<u>\$ 90,165,309</u>

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

The carrying value for the Company's financial instruments classified as current assets (other than short-term investments) and current liabilities approximate their fair value due to their short maturities.

Revenue Recognition

The Company receives a portion of its Contract funding in the form of capitation revenue, which is recognized over the applicable coverage period on a per member basis for covered members. Under this arrangement, the Company is paid a per member fee for all enrolled members, and this fee is recorded as revenue in the month in which members are entitled to service. The Company adjusts its revenue for retroactive membership terminations, additions, and other changes, when such adjustments are identified, with the exception of retroactivity that can be reasonably estimated. Any fees received prior to the month of service are recorded as deferred revenue. Capitation revenues were approximately \$677.4 million and \$685.1 million for the years ended June 30, 2010 and 2011, respectively. The Contract is partially funded by federal, state, county and block grant money, which represent annual appropriations. The Company recognizes revenue from block grant activity ratably over the period to which the block grant funding applies. Non-title revenues, including block grants, were approximately \$109.8 million and \$109.5 million for the years ended June 30, 2010 and 2011, respectively.

Contract revenue is also limited by the terms of the Contract to a maximum profit percentage of four percent. Contract revenue that cannot be recognized due to the profit limits or approximately \$14.7 million for the year ended June 30, 2010, and \$13.9 million for the year ended June 30, 2011, are included in "payable to ADHS" on the accompanying balance sheets and represent a reduction to service revenue.

Deferred Revenue

During the current year the company recorded \$8.0 million of deferred revenue. This amount represents the non-title county profit payable which the state has approved to be recognized as revenue and used for services in fiscal year 2012.

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Cost of Care, Medical Claims Payable, and Other Medical Liabilities

Cost of care includes costs incurred by the Company to operate the Clinics, as well as costs incurred related to care that has been provided by third parties. Expenses for the Clinics include salaries, rent, utilities, and other operating costs, all of which are recognized as incurred.

Cost of care provided by third parties is recognized in the period in which members receive managed health care services. In addition to actual benefits paid, cost of care includes the impact of accruals for estimates of medical claims payable. Medical claims payable represents the liability for health care claims reported but not yet paid and claims incurred but not yet reported (“IBNR”) related to the Company’s managed health care business. Such liabilities are determined by employing actuarial methods that are commonly used by health insurance actuaries and meet actuarial standards of practice.

The IBNR portion of medical claims payable is estimated based on past claims payment experience for member groups, enrollment data, utilization statistics, authorized health care services, and other factors. This data is incorporated into contract-specific actuarial reserve models and is further analyzed to create “completion factors” that represent the average percentage of total incurred claims that have been paid through a given date after being incurred. Factors that affect estimated completion factors include benefit changes, enrollment changes, shifts in product mix, seasonality influences, provider reimbursement changes, changes in claims inventory levels, the speed of claims processing, and changes in paid claim levels. Completion factors are applied to claims paid through the financial statement date to estimate the ultimate claim expense incurred for the current period. Actuarial estimates of claim liabilities are then determined by subtracting the actual paid claims from the estimate of the ultimate incurred claims. For the most recent incurred months (generally the most recent two months), the percentage of claims paid for claims incurred in those months is generally low. This makes the completion factor methodology less reliable for such months. Therefore, incurred claims for any month with a completion factor that is less than 70% are generally not projected from historical completion and payment patterns; rather they are projected by estimating claims expense based on recent monthly estimated cost incurred per member per month times membership, taking into account seasonality influences, benefit changes, and health care trend levels, collectively considered to be “trend factors.”

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Other Medical Liabilities largely consists of funds accrued for the restructuring, development, and start-up costs associated with network resizing and to address changes associated with system transition. Funds designated in this manner made up \$7.2 million and \$1.6 million for the years ended June 30, 2010 and 2011, respectively. The remaining balances represent other miscellaneous nonclaim balances due to providers.

Other Current Liabilities

Other current liabilities consists primarily of community reinvestment which is contractually calculated as 7% of net earnings. Community reinvestment was \$3.5 million and \$6.5 million as of June 30, 2010 and 2011, respectively.

Expense Allocation

Certain direct, indirect, and administrative expenses are incurred, which benefit more than one program. Such common expenses are allocated based upon an ADHS approved cost allocation plan as submitted by the Company.

Long-lived Assets

Long-lived assets, including property and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount should be addressed pursuant to ASC 360-10-20. Pursuant to this guidance, impairment is determined by comparing the carrying value of these long-lived assets to management's best estimate of the future undiscounted cash flows expected to result from the use of the assets and their eventual disposition. The cash flow projections used to make this assessment are consistent with the cash flow projections that management uses internally in making key decisions. In the event an impairment exists, a loss is recognized based on the amount by which the carrying value exceeds the fair value of the asset, which is generally determined by using quoted market prices or the discounted present value of expected future cash flows. No impairment of long-lived assets was identified during the years ended June 30, 2010 or 2011.

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Property and Equipment

Property and equipment is stated at cost, except for assets that have been impaired, for which the carrying amount has been reduced to estimated fair value. Expenditures for renewals and improvements are capitalized to the property accounts. Replacements and maintenance and repairs that do not improve or extend the life of the respective assets are expensed as incurred. Amortization of capital lease assets is included in depreciation expense and is included in accumulated depreciation as reflected in the table below. Depreciation expense was \$0.6 million and \$0.5 million for the years ended June 30, 2010 and 2011, respectively.

The Company provides for depreciation using the straight-line method over the following general range of estimated useful lives:

Computer hardware and software	3-5 years
Furniture	9-15 years
Equipment	5 years
Leasehold improvements	5 years
Capital leases – equipment	4 years
Clinic assets	18 months

Property and equipment consisted of the following as of June 30:

	<u>2010</u>	<u>2011</u>
Furniture and equipment	\$ 2,348,776	\$ 4,891,680
Leasehold improvements	567,807	328,795
	<u>2,916,583</u>	<u>5,220,475</u>
Accumulated depreciation	(1,968,992)	(1,771,970)
Property and equipment, net	<u>\$ 947,591</u>	<u>\$ 3,448,505</u>

3. Contract Requirements

In accordance with the Contract, the Company is required to maintain certain minimum financial reporting and viability measures.

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

3. Contract Requirements (continued)

The Company must maintain unrestricted, minimum capitalization of at least 90% of the monthly capitation and block payments received under the Contract. At June 30, 2010 and 2011, the Company was in compliance with this requirement.

The Contract contains various quarterly financial performance requirements, including required minimum liquidity ratio, administrative cost percentage, and service expense percentages. The Company was not in compliance with certain administrative expense percentages and certain service expense percentages for the years ended June 30, 2010 and 2011; however, such noncompliance does not constitute a breach of contract, nor does it have a material impact on the accompanying financial statements.

Should the Company be in default of any material obligations under the Contract, ADHS may, at its discretion, in addition to other remedies, either adjust the amount of future payments or withhold future payment until satisfactory resolution of the default or exception. In addition, although it has not expressed an intention to do so, ADHS has the right to terminate the Contract in whole or in part without cause by giving the Company 90 days written notice. Further, if monies are not appropriated by the State or are not otherwise available, the Contract may be cancelled upon written notice until such monies are so appropriated or available.

As of June 30, 2009, the Company reported less than the minimum number of encounters as stipulated in the contract and accrued an encounter withhold of \$10.4 million. The Company had until February 28, 2010, to submit encounters related to the year ended June 30, 2009. As of February 28, 2010, the Company reported less than the minimum number of encounters and was subject to an encounter withhold of \$0.05 million, which was repaid to ADHS in June 2010. Accordingly, the 2009 encounter withhold was reversed in fiscal year 2010.

As of June 30, 2010, the Company reported less than the minimum number of encounters as stipulated in the Contract and accrued an encounter withhold of \$0.05 million. The Company had until February 28, 2011, to submit encounters related to the year ended June 30, 2010. As of February 28, 2011, the Company reported less than the minimum number of encounters and was subject to an encounter withhold of \$0.02 million, which is included in the Payable to ADHS at June 30, 2011. The Company continues to submit encounters regularly; however, an encounter withhold was not recorded for the current year as it is no longer required under the terms of the contract. In addition, the Company is limited by the terms of the Contract to profit that can be earned under the various programs. Contract profit limitations are applied on an after-tax basis.

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

3. Contract Requirements (continued)

During the current year, ADHS changed its reporting requirements to include interpretive services within administrative expenses. These expenses were previously recorded within cost of care. For the years ended June 30, 2010 and 2011, interpretive service expenses were \$6.4 million and \$7.5 million, respectively.

Contract revenue is limited by terms of the Contract to a maximum profit percentage of four percent. Contract revenue that cannot be recognized due to the profit limits or approximately \$14.7 million for the year ended June 30, 2010, and \$13.9 million for year ended June 30, 2011, are included in “payable to ADHS” in the accompanying balance sheets.

4. Allocated Corporate Income Tax Provision

For federal income tax reporting purposes, the Company’s operations are included in Magellan’s consolidated federal income tax returns. The Company files a separate state income tax return. Both Magellan and the Company file their federal and state returns on a calendar year basis.

The Company has a tax-sharing allocation agreement with Magellan. Under the terms of this agreement, Magellan has allocated a \$23.8 million federal tax provision for the year ended June 30, 2010, and a \$24.1 million federal tax provision for the year ended June 30, 2011. The agreement calls for an allocation based on Magellan’s federal statutory rate and the applicable state rate before reflecting the allocation and after affecting for permanent differences. For the year ended June 30, 2011, the Company’s permanent differences mainly consisted of \$0.04 million of overhead allocations for tax purposes, which exceeded those recorded for book purposes due to limitations under the Contract. In accordance with the tax allocation agreement, allocated corporate federal income taxes payable or recoverable are required to be settled within 30 days after the filing by Magellan of any annual federal income tax return that includes the activities of the Company. The income taxes payable amounts listed below have been accrued within the “Due to affiliates, net” account in the accompanying balance sheets.

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

4. Allocated Corporate Income Tax Provision (continued)

The provision (benefit) for income taxes for the years ended June 30, 2010 and 2011, consisted of the following:

	<u>2010</u>	<u>2011</u>
Income taxes currently payable:		
Federal	\$ 15,928,602	\$ 23,858,143
State	2,061,206	3,087,379
	<u>17,989,808</u>	<u>26,945,522</u>
Deferred income taxes:		
Federal	7,872,977	207,339
State	(231,856)	26,831
	<u>7,641,121</u>	<u>234,170</u>
	<u>\$ 25,630,929</u>	<u>\$ 27,179,692</u>

Under the tax sharing allocation agreement, any federal deferred tax assets not utilized at the Company level can be utilized at the consolidated level and therefore no valuation allowance has been established for any federal deferred tax assets. As of June 30, 2010 and 2011, the Company had no valuation allowances recorded for deferred tax assets.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities at June 30, 2010 and 2011, are as follows:

	<u>2010</u>	<u>2011</u>
Current deferred tax assets:		
Other contract liabilities	\$ 1,445,987	\$ 2,622,870
Total current deferred tax assets	1,445,987	2,622,870
Valuation allowance	-	-
Current deferred tax assets after valuation allowance	<u>\$ 1,445,987</u>	<u>\$ 2,622,870</u>
Noncurrent deferred tax assets:		
Property and depreciation	\$ 132,472	\$ (1,299,630)
Other	427,975	420,623
Total noncurrent deferred tax assets (liabilities)	560,447	(879,007)
Valuation allowance	-	-
Noncurrent deferred tax assets (liabilities) after valuation allowance	<u>\$ 560,447</u>	<u>\$ (879,007)</u>

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

5. Related-Party Balances and Transactions

Magellan and affiliated companies provide administrative and other services to the Company, including systems functions, accounts payable, and payroll processing. Included in general and administrative expenses is an allocation of the costs of the administrative services provided by affiliated companies. The Company's allocation was \$19.6 million and \$17.2 million for the years ended June 30, 2010 and 2011, respectively. Amounts due to affiliated companies are due on demand and are non-interest bearing.

The Company declared and paid dividends of \$0 and \$68.0 million for the years ended June 30, 2010 and 2011, respectively.

Effective September 1, 2010, the Company entered into an agreement with Magellan Medicaid Administration ("MMA"), a subsidiary of Magellan Health Services, Inc., to provide pharmacy benefit management services to eligible enrollees on a risk basis. The Company paid MMA \$67.6 million for these services for the year ended June 30, 2011, which was recorded as cost of care. Prior to September 1, 2010, such benefits were being provided to the Company by an independent third-party administrator.

6. Claims Unpaid

Claims unpaid balances are continually monitored and reviewed. If it is determined that the Company's assumptions in estimating such liabilities are significantly different than actual results, the Company's results of operations and financial position could be impacted in future periods. Adjustments of prior period estimates may result in additional claims costs or a reduction of claims costs in the period an adjustment is made. Further, due to the considerable variability of health care costs, adjustments to claims unpaid occur each period and are sometimes significant as compared to net income recorded in that period. Prior period development is recognized immediately upon the actuary's judgment that a portion of the prior period liability is no longer needed or that additional liability should have been accrued.

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

6. Claims Unpaid (continued)

The following table presents the components of the change in claims unpaid for the years ended June 30, 2010 and 2011:

	<u>2010</u>	<u>2011</u>
Medical claims payable, beginning of period	\$ 21,663,088	\$ 17,705,854
Cost of care:		
Current year	675,896,045	663,450,115
Prior years	(9,990,886)	(7,097,613)
Total cost of care	<u>665,905,159</u>	<u>656,352,502</u>
Payments related to cost of care:		
Current year	(658,593,205)	(643,686,602)
Prior years	(11,269,188)	(10,306,135)
Total payments related to cost of care	<u>(669,862,393)</u>	<u>(653,992,737)</u>
Medical claims payable, end of period	<u>\$ 17,705,854</u>	<u>\$ 20,065,619</u>

Actuarial standards of practice require that claims unpaid be adequate under moderately adverse circumstances. Adverse circumstances are situations in which the actual claims experience could be higher than the otherwise estimated value of such claims. In many situations, the claims paid amount experienced will be less than the estimate that satisfies the actuarial standards of practice.

Due to the existence of risk-sharing provisions in the contract, a change in the estimate of claims unpaid does not necessarily result in an equivalent impact on claims costs.

The Company believes that the amount of claims unpaid is adequate to cover its ultimate liability for unpaid claims as of June 30, 2010 and 2011; however, actual claims payments may differ from established estimates.

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

7. Commitments and Contingencies

Operating Leases

Operating leases have been executed for various operating facilities and equipment, which are used to support the Company's business. Certain of these leases have been executed by the Parent on behalf of the Company, and other leases have been executed by the Company itself. The leases generally require the payment of all maintenance, property taxes, and insurance costs. For leases that have been executed by the Parent, actual lease costs incurred are charged directly to the Company. Total rent expense, inclusive of costs related to leases executed by the Parent, was \$6.9 million and \$3.6 million for the years ended June 30, 2010 and 2011, respectively. Leases executed by the Company expire at various dates through October 31, 2016. Reimbursements for subleases totaled \$5.6 million and \$2.1 million for the years ended June 30, 2010 and 2011, respectively.

At June 30, 2011, aggregate amounts of future minimum payments under operating leases, which have been executed by the Company, were as follows:

Year ending June 30:	
2012	\$ 1,841,304
2013	1,642,907
2014	1,651,323
2015	1,626,065
2016	1,214,178
Thereafter	208,403
	<u>\$ 8,184,180</u>

The total minimum rentals to be received in the future under noncancellable subleases are \$2.5 million.

Regulatory Issues

The specialty managed health care industry is subject to numerous laws and regulations. The subjects of such laws and regulations cover, but are not limited to, matters such as licensure, accreditation, government health care program participation requirements, information privacy and security, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Over the past several years, government activity has increased with respect to investigations

Magellan Health Services of Arizona, Inc.

Notes to Financial Statements (continued)

7. Commitments and Contingencies (continued)

and/or allegations concerning possible violations of fraud and abuse and false claims statutes and/or regulations by health care organizations and insurers. Entities that are found to have violated these laws and regulations may be excluded from participating in government health care programs, subjected to fines or penalties or required to repay amounts received from the government for previously billed patient services. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time.

Legal

From time to time, the Company is involved in legal actions arising in the ordinary course of business. After taking into consideration legal counsel's evaluation of such actions, management believes that the resolution of such legal actions will not have a material adverse effect on the Company's financial condition or results of operations; however, there can be no assurance in this regard.

Insurance

The Company is covered under Magellan's general and managed care liability insurance policies with unaffiliated insurers for a one year period, with the current policy extending from June 17, 2011 through June 17, 2012. The general liability policies are written on an "occurrence" basis and the managed care errors and omissions liability policies are written on a "claims-made" basis.

In relation to the Company's divestiture of the Clinics, the Company purchased professional and general liability tail insurance coverage.

8. Subsequent Events

Effective August 29, 2011, the Company declared and paid a dividend to the parent of \$20.0 million.

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