

STATUTORY-BASIS FINANCIAL STATEMENTS AND OTHER
FINANCIAL INFORMATION

Magellan Behavioral Care of Iowa, Inc.
Years Ended December 31, 2006 and 2007
With Report of Independent Auditors

Magellan Behavioral Care of Iowa, Inc.

Statutory-Basis Financial Statements and Other Financial Information

Years Ended December 31, 2006 and 2007

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Report of Independent Auditors

Magellan Behavioral Care of Iowa, Inc.

We have audited the accompanying statutory-basis statements of admitted assets, liabilities, capital and surplus of Magellan Behavioral Care of Iowa, Inc. (the “Company”), a wholly owned subsidiary of Merit Behavioral Care Corporation, as of December 31, 2006 and 2007, and the related statutory-basis statements of income and changes in capital and surplus, 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 audit.

We conducted our audit 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 audit 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 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 audit provides a reasonable basis for our opinion.

As discussed in Note 2 to the financial statements, the Company presents its financial statements in conformity with accounting practices prescribed or permitted by the State of Iowa Insurance Division, which practices differ from accounting principles generally accepted in the United States. The variances between such practices and accounting principles generally accepted in the United States and the effects on the accompanying financial statements are described in Note 2.

In our opinion, because of the effects of the matter described in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States, the financial position of Magellan Behavioral Care of Iowa, Inc. at December 31, 2006 or 2007, or the results of its operations or its cash flows for the years then ended.

However, in our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Magellan Behavioral Care of Iowa, Inc. at December 31, 2006 and 2007, and the results of its operations and its cash flows for the years then ended in conformity with accounting practices prescribed or permitted by the State of Iowa Insurance Division.

Ernst + Young LLP

May 22, 2008

Magellan Behavioral Care of Iowa, Inc.

Statements of Admitted Assets, Liabilities, Capital and Surplus—Statutory-Basis

	December 31	
	2006	2007
Admitted assets		
Current assets:		
Cash, cash equivalents and short-term investments	\$ 53,641,189	\$ 55,149,773
Investment income due and accrued	43,309	128,183
Contract receivables	2,953,028	4,009,045
Receivables for securities	2,000,000	—
Total admitted assets	<u>\$ 58,637,526</u>	<u>\$ 59,287,001</u>
Liabilities, capital and surplus		
Current liabilities:		
Claims unpaid	\$ 30,816,390	\$ 23,856,225
Amounts retained for others	4,440,811	13,596,633
General administrative expenses due or accrued	503,513	455,553
Amounts payable to parent, subsidiaries, and affiliates	1,810,762	2,929,730
Allocated federal income taxes payable	1,314,224	1,191,128
Other liabilities	742,696	36,508
Total liabilities	<u>39,628,396</u>	<u>42,065,777</u>
Capital and surplus:		
Common stock, no par value; 1,000 shares authorized, issued and outstanding	20,000	20,000
Unassigned funds	18,989,130	17,201,224
Total capital and surplus	<u>19,009,130</u>	<u>17,221,224</u>
Total liabilities, capital and surplus	<u>\$ 58,637,526</u>	<u>\$ 59,287,001</u>

See accompanying notes to the financial statements.

Magellan Behavioral Care of Iowa, Inc.

Statements of Income and Changes in Capital and Surplus—Statutory-Basis

	Year Ended December 31	
	2006	2007
Revenues	\$ 120,817,252	\$ 124,741,887
Claims costs and expenses:		
Claims costs	102,019,345	105,980,806
Claims adjustment expenses	2,188,759	1,436,189
General administrative expenses	15,673,462	16,319,555
Total claims costs and expenses	<u>119,881,566</u>	<u>123,736,550</u>
Underwriting gain	935,686	1,005,337
Net investment gains	2,819,239	2,397,885
Gain before allocated federal income taxes	<u>3,754,925</u>	<u>3,403,222</u>
Allocated federal income taxes	1,314,224	1,191,128
Net income	<u>\$ 2,440,701</u>	<u>\$ 2,212,094</u>
Capital and surplus at beginning of year	\$ 20,768,429	\$ 19,009,130
Net income	2,440,701	2,212,094
Dividends to stockholder	(4,200,000)	(4,000,000)
Capital and surplus at end of year	<u>\$ 19,009,130</u>	<u>\$ 17,221,224</u>

See accompanying notes to the financial statements.

Magellan Behavioral Care of Iowa, Inc.

Statements of Cash Flows—Statutory-Basis

	Year Ended December 31	
	2006	2007
Cash from operations		
Premiums collected	\$ 119,787,889	\$ 122,685,870
Net investment income collected	2,804,918	2,313,011
Performance-based revenue collected	1,750,000	1,000,000
Claims paid	(98,109,223)	(112,940,971)
Expenses paid	(37,670,941)	(9,354,070)
Allocated federal income taxes paid	(1,025,055)	(1,314,224)
Net cash from operations	<u>(12,462,412)</u>	<u>2,389,616</u>
Cash from investments		
Proceeds from long-term investments matured	10,700,000	—
Net (increase) decrease in receivables for securities	(2,000,000)	2,000,000
Net cash from investments	<u>8,700,000</u>	<u>2,000,000</u>
Cash from financing and miscellaneous sources		
Net transfers (to) from affiliates	(2,828,279)	1,118,968
Dividends to stockholders	(4,200,000)	(4,000,000)
Net cash from financing and miscellaneous sources	<u>(7,028,279)</u>	<u>(2,881,032)</u>
Net change in cash, cash equivalents and short-term investments	(10,790,691)	1,508,584
Cash, cash equivalents and short-term investments:		
Beginning of year	64,431,880	53,641,189
End of year	<u>\$ 53,641,189</u>	<u>\$ 55,149,773</u>

See accompanying notes to the financial statements.

Magellan Behavioral Care of Iowa, Inc.

Notes to Financial Statements—Statutory-Basis

December 31, 2007

1. Organization

Magellan Behavioral Care of Iowa, Inc. (the “Company”) is a wholly owned subsidiary of Merit Behavioral Care Corporation (“Merit”). Merit is a wholly owned subsidiary of Magellan Behavioral Health, Inc. (“MBH”), which is a wholly owned subsidiary of Magellan Health Services, Inc. (“Magellan”). Magellan is engaged in the specialty managed healthcare business, and provides managed behavioral healthcare services, radiology benefits management and specialty pharmaceutical management.

The Company was incorporated in November 1995, the same time it was initially capitalized by Merit. On December 31, 2001, the Company became licensed as a limited services organization, with the license requiring the Company to file annual statutory-basis financial statements.

The Company provides managed mental health and substance abuse services to Iowa Plan enrollees through a contract (the “Contract”) with the Iowa Department of Human Services and the Iowa Department of Public Health (the “State”). The current Contract consists of the Iowa Medicaid, Non-Medicaid, and State Payment Programs, and was for an initial term of July 1, 2004 through June 30, 2006, with a provision for three, one-year extensions at the State’s option. The Medicaid and Non-Medicaid components of the Contract have been extended through June 30, 2008 at the State’s option, with the State Payment Program component of the Contract terminated as of September 30, 2006.

2. Summary of Significant Accounting Policies

Basis of Presentation

The Company prepares its statutory-basis financial statements in conformity with accounting practices prescribed or permitted by the State of Iowa Insurance Division (the “Division”), which represents a comprehensive basis of accounting other than accounting principles generally accepted in the United States. The Division requires that insurance companies licensed in Iowa prepare their statutory financial statements in accordance with the Codified National Association of Insurance Commissioners’ (“NAIC”) Statements of Statutory Accounting Principles, subject to any deviations prescribed or permitted by the Division. The Company is not aware of any differences between the NAIC and the Division in regards to accounting practices.

Magellan Behavioral Care of Iowa, Inc.

Notes to Financial Statements—Statutory-Basis (continued)

2. Summary of Significant Accounting Policies (continued)

Basis of Presentation (continued)

Statutory accounting practices differ from accounting principles generally accepted in the United States. Variances between statutory accounting practices and generally accepted accounting principles (“GAAP”) could occur from the following:

- Certain assets designated as “non-admitted,” principally receivables over 90 days past due, certain property and equipment, prepaid expenses, and other assets not specifically identified as an admitted asset within the NAIC *Accounting Practices and Procedures Manual*, are excluded from the accompanying statements of admitted assets, liabilities, capital and surplus—statutory basis and are charged directly to capital and surplus. Under GAAP, such assets are included in the balance sheets.
- Investments in bonds and mandatory redeemable preferred stocks are reported at amortized cost, except in cases where NAIC designation requires them to be carried at the lower of amortized cost or fair value; for GAAP, such fixed maturity investments would be designated at purchase as held-to-maturity, available-for-sale or trading. Held-to-maturity fixed maturity investments would be reported at amortized cost, with the remaining fixed maturity investments reported at fair value with unrealized holding gains and losses reported as a separate component of stockholder’s equity for those designated as available-for-sale and in operations for those designated as trading.
- Cash, cash equivalents and short-term investments in the statements of cash flows—statutory-basis represent cash balances and investments with initial maturities at the time of acquisition of one year or less. Under GAAP, the corresponding caption of cash and cash equivalents includes cash balances and investments with maturities of three months or less when acquired.

Based on GAAP, the Company’s total stockholder’s equity was \$19,016,370 and \$17,224,125 as of December 31, 2006 and 2007 respectively. The difference between GAAP stockholder’s equity and statutory capital and surplus is attributable to unrealized gains and losses on available-for-sale investments. Net income for the years ended December 31, 2006 and 2007 based on GAAP was the same as those presented in the accompanying statutory-basis financial statements.

Magellan Behavioral Care of Iowa, Inc.

Notes to Financial Statements—Statutory-Basis (continued)

2. Summary of Significant Accounting Policies (continued)

Use of Estimates

The preparation of financial statements in conformity with statutory accounting practices requires management to make estimates and assumptions that affect the reported amounts of admitted assets and liabilities and the 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, contract receivables realization and the liability for claims unpaid. Actual results could differ from those estimates.

Fair Value of Financial Instruments

Statement of Statutory Accounting Principles (“SSAP”) No. 27, “*Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments*” requires disclosure of fair value information about financial instruments for which it is practicable to estimate fair value. The carrying value for the Company’s financial instruments classified as current assets (other than cash equivalents and short-term investments) and current liabilities approximate fair value due to their short maturities. The estimated fair values of the Company’s cash equivalents and short-term investments are disclosed in Note 3 – Investment Securities.

Cash, Cash Equivalents and Short-term Investments

Cash consists of cash on hand and in financial institutions, along with certificates of deposit with maturity dates at the time of acquisition of one year or less. Cash equivalents are short-term, highly liquid interest-bearing investments with maturity dates of three months or less when purchased, consisting of U.S government and agency securities and obligations of government-sponsored enterprises, which includes investments in notes issued by the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association and the Federal Home Loan Bank. Short-term investments have maturities of one year or less at the time of acquisition (excluding those investments classified as cash equivalents) and are recorded at amortized cost using the straight line basis, except in cases where the NAIC designation requires them to be carried at the lower of amortized cost or fair value. Short-term investments consist of U.S. government and agency securities, obligations of government-sponsored entities and class one money market mutual funds that are included on the mutual funds lists published by the NAIC.

Magellan Behavioral Care of Iowa, Inc.

Notes to Financial Statements—Statutory-Basis (continued)

2. Summary of Significant Accounting Policies (continued)

Investment Securities

The Company periodically evaluates whether any declines in the fair value of investment securities are other-than-temporary. This evaluation consists of a review of several factors, including but not limited to: the length of time and extent that a security has been in an unrealized loss position; the existence of an event that would impair the issuer's future earnings potential; the near-term prospects for recovery of the market value of a security; and the intent and ability of the Company to hold the security until the market value recovers. Declines in value below cost for investments where it is considered probable that all contractual terms of the investment will be satisfied, the decline in value is due primarily to changes in interest rates (and not because of increased credit risk), and where the Company intends and has the ability to hold the investment for a period of time sufficient to allow a market recovery, are not assumed to be other-than-temporary. The Company periodically reviews those investment securities whose unrealized losses have remained unrealized for more than six months to determine if such unrealized losses are other-than-temporary.

Restricted Assets

The Company has certain assets that are considered restricted to satisfy the Contract requirement for the Company to maintain a restricted insolvency protection account based on a percentage of revenue for the purpose of settling claims in the event of insolvency, and also specifies working capital and surplus fund requirements based on a multiple of monthly paid claims. The restricted assets of the Company as of December 31, 2006 and 2007 were as follows:

	<u>2006</u>	<u>2007</u>
Restricted cash	\$ 20,169	\$ 2,083,663
Restricted cash equivalents	2,983,755	17,547,899
Restricted short-term investments	13,805,155	—
Restricted receivables for securities	2,000,000	—
Total restricted assets	<u>\$ 18,809,079</u>	<u>\$ 19,631,562</u>

Magellan Behavioral Care of Iowa, Inc.

Notes to Financial Statements—Statutory-Basis (continued)

2. Summary of Significant Accounting Policies (continued)

Contract Receivables

Contract receivables consist of amounts due from customers for capitated services. Collateral is generally not required. The Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends and other information.

Concentration of Credit Risk

Certain financial instruments potentially subject the Company to concentrations of credit risk. These financial instruments consist primarily of cash, investments and receivables. The Company maintains its cash and investments with what it believes to be high-quality financial institutions, and invests in class one money market mutual funds, U.S. government and agency securities and obligations of government-sponsored enterprises. The Company's receivables are primarily comprised of contract receivables due from the State related to the Medicaid and Non-Medicaid Programs. The Company's contract receivables have been admitted in the accompanying statutory-basis financial statements pursuant to the provisions of SSAP No. 84, "*Certain Health Care Receivables and Receivables Under Government Insured Plans*".

Revenue Recognition

Medicaid revenue is derived from a monthly capitation fee based on contracted rates for specific categories of Medicaid eligibility for each beneficiary enrolled in the managed mental health and substance abuse plan. The capitation fee is generally received and recognized in the month of coverage. Amounts due from the State in arrears are included in contract receivables in the accompanying statements of admitted assets, liabilities, capital and surplus – statutory basis.

Non-Medicaid revenue is recognized in the month coverage is provided, and is usually paid by the State to the Company the following month. The amount included in the contract receivables balance associated with the Non-Medicaid Program is generally one month of revenue.

Performance-Based Revenue

The Company has the ability to earn performance-based revenue. Performance-based revenue generally is based on either the ability of the Company to manage care for its clients below specified targets, or on other operating metrics. The Company estimates and records performance-based revenue after considering the relevant contractual terms and the data available for the performance-based revenue calculation. Pro rata performance-based revenue is recognized during the term of the contract pursuant to the rights and obligations of each party

Magellan Behavioral Care of Iowa, Inc.

Notes to Financial Statements—Statutory-Basis (continued)

2. Summary of Significant Accounting Policies (continued)

Performance-Based Revenue (continued)

upon termination of the contract. The Company recorded performance-based revenue of \$875,000 and \$958,333 for the years ended December 31, 2006 and 2007, respectively. Performance-based receivables of \$197,917 and \$156,250 as of December 31, 2006 and 2007, respectively, are included in contract receivables in the accompanying statements of admitted assets, liabilities, capital and surplus – statutory-basis.

Administrative Service Contracts

Under the provisions of the State Payment Program, which terminated as of September 30, 2006, the Company provided administrative services only to a small division of the Contract membership, under which the Company earned fees for processing and paying medical claims and was reimbursed for the cost of such claims. The State’s self-insured division retained the liability risk for all such claims.

The results from operations of the uninsured administrative service only contract plan were as follows:

	Year Ended December 31	
	2006	2007
Gross reimbursement for medical claims incurred	\$ 4,856,314	\$ 124,882
Gross administrative fees earned	763,896	4,758
Gross medical claims accrued	(393,937)	(25,935)
Gross administrative expenses incurred	(703,826)	(5,815)
Gross medical claims paid	(4,462,377)	(98,947)
Net income (loss)	<u>\$ 60,070</u>	<u>\$ (1,057)</u>

Claims Costs and Claims Unpaid

Claims costs are recognized in the period in which covered members receive managed healthcare services. In addition to actual benefits paid, claims costs include the impact of accruals for estimates of claims unpaid.

Magellan Behavioral Care of Iowa, Inc.

Notes to Financial Statements—Statutory-Basis (continued)

2. Summary of Significant Accounting Policies (continued)

Claims Costs and Claims Unpaid (continued)

Claims unpaid represents the liability for healthcare claims reported but not yet paid and claims incurred but not yet reported (“IBNR”) related to the Company’s managed healthcare business. Such liabilities are determined employing actuarial methods that are commonly used by health insurance actuaries and meet actuarial standards of practice. The liability for claims unpaid also includes certain potential community reinvestment payable amounts (see Note 5).

The IBNR portion of claims unpaid is estimated based on past claims payment experience for member groups, enrollment data, utilization statistics, authorized healthcare 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 claims unpaid 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 percent 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.”

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation.

Magellan Behavioral Care of Iowa, Inc.

Notes to Financial Statements—Statutory-Basis (continued)

3. Investment Securities

Investment securities at December 31, 2006 and 2007 were as follows:

	Amortized Cost	Gross Unrealized Gain	Estimated Fair Value
December 31, 2006			
Obligations of government-sponsored enterprises	\$ 2,983,755	\$ 1,245	\$ 2,985,000
Total cash equivalents	<u>\$ 2,983,755</u>	<u>\$ 1,245</u>	<u>\$ 2,985,000</u>
Obligations of government-sponsored enterprises	\$ 13,805,155	\$ 5,995	\$ 13,811,150
Total short-term investments	<u>\$ 13,805,155</u>	<u>\$ 5,995</u>	<u>\$ 13,811,150</u>
December 31, 2007			
Obligations of government-sponsored enterprises	\$ 17,547,899	\$ 2,901	\$ 17,550,800
Total cash equivalents	<u>\$ 17,547,899</u>	<u>\$ 2,901</u>	<u>\$ 17,550,800</u>
Money market funds	\$ 15,001,842	\$ –	\$ 15,001,842
Total short-term investments	<u>\$ 15,001,842</u>	<u>\$ –</u>	<u>\$ 15,001,842</u>

All investment securities at December 31, 2007 mature in one year or less, and have a NAIC rating of “NAIC-1”. The Company’s cash balance totaled \$36,852,279 and \$22,600,032 as of December 31, 2006 and 2007, respectively.

4. 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 considerable variability of healthcare 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

Magellan Behavioral Care of Iowa, Inc.

Notes to Financial Statements—Statutory-Basis (continued)

4. Claims Unpaid (continued)

no longer needed or that additional liability should have been accrued. The following table presents the components of the change in claims unpaid for the years ended December 31, 2006 and 2007:

	<u>2006</u>	<u>2007</u>
Claims unpaid, beginning of year	\$ 26,906,268	\$ 30,816,390
Claims incurred:		
Current year	102,007,415	105,771,122
Prior years	11,930	209,684
Total claims incurred	<u>102,019,345</u>	<u>105,980,806</u>
Claims paid:		
Current year	(84,920,175)	(92,986,621)
Prior years	(8,846,976)	(11,605,475)
Total claims paid	<u>(93,767,151)</u>	<u>(104,592,096)</u>
Net transfers to community reinvestment account	(4,342,072)	(8,348,875)
Claims unpaid, end of year	<u>\$ 30,816,390</u>	<u>\$ 23,856,225</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.

The Company believes that the amount of claims unpaid is adequate to cover its ultimate liability for unpaid claims as of December 31, 2007; however, actual claims payments may differ from established estimates.

5. Reinvestment Requirements

Under the terms of the Contract, 2.5% of the Medicaid capitation payment is set aside for reinvestment in community projects and programs. In addition, any excess in the contract-year claims fund, determined 12 months after the contract-year ends, will be reclassified from the liability for claims unpaid into the community reinvestment account. The amounts held for

Magellan Behavioral Care of Iowa, Inc.

Notes to Financial Statements—Statutory-Basis (continued)

5. Reinvestment Requirements (continued)

community reinvestment as of December 31, 2006 and 2007 were \$3,074,116 and \$11,957,002, respectively, which is net of reinvestment projects already funded and amounts returned to the State. These amounts are included in the amounts retained for others in the accompanying statements of admitted assets, liabilities, capital and surplus – statutory basis.

During the year ended December 31, 2006, \$7,868,012 was reclassified to the community reinvestment account from the liability for claims unpaid based on a claims audit of the 12-month claim period from January 1, 2004 through December 31, 2004. During the year ended December 31, 2007, \$8,669,415 was reclassified to the community reinvestment account from the liability for claims unpaid based on a claims audit of the 12-month claim period from January 1, 2005 through December 31, 2005. In addition, community reinvestments funds of \$3,525,940 and \$320,540 were reclassified to the liability for claims unpaid from the community reinvestment account during the years ended December 31, 2006 and 2007, respectively, to cover provider rate increases. No reinvestment payable has been specifically agreed upon by the Company and the State for services performed from January 1, 2006 through December 31, 2007. Any amounts related to this period that will be subject to reinvestment upon final settlement of the claims fund are included in the liability for claims unpaid as of December 31, 2007.

6. Allocated Corporate Income Taxes

For federal and state income tax reporting purposes, the Company's operations are included in Magellan's consolidated federal income tax returns and Magellan's combined state income tax returns for the State of Iowa, respectively. The Company has a tax allocation agreement with Magellan. The current agreement calls for an allocation based on Magellan's effective tax rate before reflecting the allocation and after affecting permanent differences. Through the tax allocation agreement, Magellan has allocated \$1,817,737 and \$1,646,681 to the Company for its share of the state and federal income tax provisions for the years ended December 31, 2006 and 2007, respectively. Allocated income taxes were as follows:

	Year Ended December 31	
	2006	2007
State income taxes	\$ 503,513	\$ 455,553
Federal income taxes	1,314,224	1,191,128
Allocated corporate income taxes	<u>\$ 1,817,737</u>	<u>\$ 1,646,681</u>

Magellan Behavioral Care of Iowa, Inc.

Notes to Financial Statements—Statutory-Basis (continued)

6. Allocated Corporate Income Taxes (continued)

Allocated state income taxes are included as a component of general administrative expenses in the accompanying statements of income and changes in capital and surplus – statutory basis and general administrative expenses due or accrued in the accompanying statements of admitted assets, liabilities, capital and surplus – statutory basis. In accordance with the tax allocation agreement, allocated federal income taxes and state income taxes payable or recoverable are required to be settled within 30 days after the filing by Magellan of any annual federal or state income tax return that includes the activities of the Company. The Company does not have any deferred income tax assets or liabilities.

7. Related Party Transactions

Under an administrative services agreement between MBH and the Company, MBH performs all of the Company's administrative and operational functions, which includes the processing and payment of claims and the staffing of personnel. MBH also provides cash management, communication, financial record keeping, management information, participating provider, reporting and other administrative services for the Company. The amount charged to the Company in connection with these services for the years ended December 31, 2006 and 2007 was \$14,118,630 and \$13,816,164, respectively. Of the administrative fees charged for the years ended December 31, 2006 and 2007, \$2,188,759 and \$1,436,189, respectively, are reported as claims adjustment expenses in the accompanying statements of income and changes in capital and surplus – statutory basis, with the remaining administrative fees reported as general administrative expenses.

Amounts payable to parent, subsidiaries and affiliates are non-interest bearing and are settled on a monthly basis.

8. Capital and Surplus

The Company is subject to statutory risk-based capital (“RBC”) requirements. RBC, as defined by the NAIC, is a method of measuring the minimum amount of capital appropriate for a company to support its overall business operations in consideration of its size and risk profile. RBC is calculated by applying factors to various asset, premium and reserve items. The factor is higher for those items with greater underlying risk and lower for less risky items. As of December 31, 2006 and 2007, management believes the Company's RBC exceeded the Company Action Level, which is defined as 200% of authorized control level.

Magellan Behavioral Care of Iowa, Inc.

Notes to Financial Statements—Statutory-Basis (continued)

8. Capital and Surplus (continued)

No restrictions have been placed on the portion of Company profits that may be paid as ordinary dividends to stockholders. State of Iowa insurance regulations provide the authority for a domestic insurer to pay extraordinary dividends upon the approval of the Insurance Commissioner. The Company paid extraordinary dividends to Merit of \$4,200,000 and \$4,000,000 on July 18, 2006 and September 28, 2007, respectively, after approval was obtained from the Insurance Commissioner.

9. Commitments and Contingencies

Regulatory Issues

The specialty managed healthcare 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 healthcare 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 and/or allegations concerning possible violations of fraud and abuse and false claims statutes and/or regulations by healthcare organizations and insurers. Entities that are found to have violated these laws and regulations may be excluded from participating in government healthcare 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, professional and managed care liability insurance policies with unaffiliated insurers for a one year period from June 17, 2007 through June 17, 2008. The general liability policies are written on an "occurrence" basis, with the professional liability and managed care errors and omissions liability policies written on a "claim-made" basis.

Other Financial Information

Report of Independent Auditors on Other Financial Information

Magellan Behavioral Care of Iowa, Inc.

Our audit was conducted for the purpose of forming an opinion on the December 31, 2007 statutory-basis financial statements of Magellan Behavioral Care of Iowa, Inc. (the “Company”) taken as a whole. The accompanying supplemental schedule of investment risks interrogatories supplemental summary investment schedule and other supplemental schedules as listed in the table of contents are presented to comply with the National Association of Insurance Commissioners’ Annual Statement Instructions and the National Association of Insurance Commissioners’ *Accounting Practices and Procedures Manual*, and are not a required part of the statutory-basis financial statements. Such information has been subjected to the auditing procedures applied in our audit of the December 31, 2007 statutory-basis financial statements, and, in our opinion, is fairly stated in all material respects in relation to the statutory-basis financial statements taken as a whole.



May 22, 2008

Magellan Behavioral Care of Iowa, Inc.

Supplemental Schedule of Investment Risks Interrogatories

December 31, 2007

1. The Company's total admitted assets as reported per the accompanying statutory-basis financial statements are \$59,287,001.
2. The Company had no exposures to a single issuer/borrower/investment, excluding (i) U.S. government, U.S. government agency securities, and those U.S. government money market funds listed in the Appendix to the Practices and Procedures Manual of the NAIC Securities Valuation Office (SVO) as exempt; (ii) property occupied by the Company; and (iii) policy loans.
3. The amounts and percentages of the reporting entity's total admitted assets held in bonds and preferred stocks by NAIC rating are as follows:

Bonds	Amount	Percentage of Total Admitted Assets
NAIC-1	\$ 32,549,741	54.9%

- 4.–10. Assets held in foreign investments are less than 2.5% of the Company's total admitted assets at December 31, 2007.
11. Assets held in Canadian investments are less than 2.5% of the Company's total admitted assets at December 31, 2007.
12. Assets held in investments with contractual sales restrictions are less than 2.5% of the Company's total admitted assets at December 31, 2007.
13. Assets held in equity interests are less than 2.5% of the Company's total admitted assets at December 31, 2007.
14. Assets held in nonaffiliated, privately placed equities are less than 2.5% of the Company's total admitted assets at December 31, 2007.
15. Assets held in general partnership interests are less than 2.5% of the Company's total admitted assets at December 31, 2007.
- 16.–17. Mortgage loans reported in Schedule B are less than 2.5% of the Company's total admitted assets at December 31, 2007.

Magellan Behavioral Care of Iowa, Inc.

Supplemental Schedule of Investment Risks Interrogatories (continued)

December 31, 2007

18. Assets held in each of the five largest investments in one parcel or group of contiguous parcels of real estate reported in Schedule A are less than 2.5% of the Company's total admitted assets at December 31, 2007.
19. Investments held in mezzanine real estate loans are less than 2.5% of the Company's total admitted assets at December 31, 2007.
20. The Company had no admitted assets subject to securities lending agreements, repurchase agreements, reverse repurchase agreements, dollar repurchase agreements, or dollar reverse repurchase agreements at March 31, 2007, June 30, 2007, September 30, 2007 or December 31, 2007.
21. The Company did not own any warrants not attached to other financial instruments, options, caps, and floors at March 31, 2007, June 30, 2007, September 30, 2007 or December 31, 2007.
22. The Company did not have any potential exposure for collars, swaps, and forwards at March 31, 2007, June 30, 2007, September 30, 2007 or December 31, 2007.
23. The Company did not have any potential exposure for futures contracts at March 31, 2007, June 30, 2007, September 30, 2007 or December 31, 2007.

Magellan Behavioral Care of Iowa, Inc.

Supplemental Summary Investment Schedule

December 31, 2007

Investment Categories	Gross Investment Holdings*		Admitted Assets as Reported in the Annual Statement	
	Amount	Percentage of Total Invested Assets	Amount	Percentage of Total Invested Assets
Bonds:				
U.S. Treasury securities	\$ —	—%	\$ —	—%
U.S. government agency and corporate obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies	—	—	—	—
Issued by U.S. government-sponsored agencies	—	—	—	—
Foreign government (including Canada, excluding mortgage-backed securities)	—	—	—	—
Securities issued by states, territories, and possessions and their political subdivisions in the U.S.:				
States, territories, and possessions—general obligations	—	—	—	—
Political subdivisions of states, territories, and possessions—general obligations	—	—	—	—
Revenue and assessment obligations	—	—	—	—
Industrial development and similar obligations	—	—	—	—
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Guaranteed by GNMA	—	—	—	—
Issued by FNMA and FHLMC	—	—	—	—
Privately issued	—	—	—	—
CMOs and REMICs:				
Issued by FNMA and FHLMC	—	—	—	—
Privately issued and collateralized by MBS; issued or guaranteed by GNMA, FNMA, or FHLMC	—	—	—	—
All other privately issued	—	—	—	—
Other debt and other fixed income securities (excluding short term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	—	—	—	—
Unaffiliated foreign securities	—	—	—	—
Affiliated securities	—	—	—	—
Equity interests:				
Investments in mutual funds	—	—	—	—
Preferred stocks:				
Affiliated	—	—	—	—

Magellan Behavioral Care of Iowa, Inc.

Supplemental Summary Investment Schedule (continued)

December 31, 2007

Investment Categories	Gross Investment Holdings*		Admitted Assets as Reported in the Annual Statement	
	Amount	Percentage of Total Invested Assets	Amount	Percentage of Total Invested Assets
Unaffiliated	\$ -	-%	\$ -	-%
Publicly traded equity securities (excluding preferred stocks):				
Affiliated	-	-	-	-
Unaffiliated	-	-	-	-
Other equity securities:				
Affiliated	-	-	-	-
Unaffiliated	-	-	-	-
Other equity interests including tangible personal property under lease:				
Affiliated	-	-	-	-
Unaffiliated	-	-	-	-
Mortgage loans:				
Construction and land development	-	-	-	-
Agricultural	-	-	-	-
Single-family residential properties	-	-	-	-
Multifamily residential properties	-	-	-	-
Commercial loans	-	-	-	-
Real estate investments:				
Property occupied by company	-	-	-	-
Property held for production of income	-	-	-	-
Property held for sale	-	-	-	-
Collateral loans	-	-	-	-
Policy loans	-	-	-	-
Receivables for securities	-	-	-	-
Cash, cash equivalents, and short-term investments ^	55,149,773	100.0	55,149,773	100.0
Write-ins for invested assets	-	-	-	-
Total invested assets	<u>\$ 55,149,773</u>	<u>100.0%</u>	<u>\$ 55,149,773</u>	<u>100.0%</u>

*Gross investment holdings as valued in compliance with *NAIC Accounting Practices and Procedures Manual*.

^Includes investments related to items listed above that are classified as cash equivalents and short-term investments due to their original maturity date of less than one year.

Magellan Behavioral Care of Iowa, Inc.

Supplemental Schedule of Operations by Funding Source

Year Ended December 31, 2007

	Medicaid	Non-Medicaid	State Payment Program	Total
Revenues	\$100,822,601	\$ 23,914,528	\$ 4,758	\$ 124,741,887
Claims costs and expenses:				
Claims costs	83,586,391	22,394,415	–	105,980,806
Claims adjustment expenses	1,436,189	–	–	1,436,189
General administrative expenses	14,622,231	1,690,940	6,384	16,319,555
Total claims costs and expenses	99,644,811	24,085,355	6,384	123,736,550
Underwriting gain (loss)	1,177,790	(170,827)	(1,626)	1,005,337
Net investment gains	2,397,885	–	–	2,397,885
Gain (loss) before allocated federal income taxes	3,575,675	(170,827)	(1,626)	3,403,222
Allocated federal income taxes	1,251,486	(59,789)	(569)	1,191,128
Net income (loss)	\$ 2,324,189	\$ (111,038)	\$ (1,057)	\$ 2,212,094

Magellan Behavioral Care of Iowa, Inc.

Supplemental Schedule of General Administrative Expenses

Year Ended December 31, 2007

Administrative services management fee	\$ 12,379,974
Community reinvestment expense	2,496,607
Provider incentives expense related to Non-Medicaid block grant	690,032
Allocated state income taxes	455,553
Other expense	297,389
Total general administrative expenses	<u>\$ 16,319,555</u>

Magellan Behavioral Care of Iowa, Inc.

Supplemental Schedule of Restricted Cash and Investments

December 31, 2007

Components of restricted cash and investments as defined in the Contract:	
Insolvency protection account	\$ 14,289,439
Working capital	3,449,441
Surplus fund*	<u> —</u>
	<u>17,738,880</u>
Restricted cash and investments per audited financial statements as of	
December 31, 2007:	
Restricted cash	2,083,663
Restricted cash equivalents (\$17,600,000 par value)	<u>17,547,899</u>
	<u>19,631,562</u>
Amount over-funded	<u><u>\$ 1,892,682</u></u>

*As defined per the Contract, funds in the insolvency protection account may be used to cover the surplus fund. Of the insolvency protection account funds, \$10,460,806 was utilized to satisfy the surplus fund requirement.

Magellan Behavioral Care of Iowa, Inc.

Notes to Other Financial Information

December 31, 2007

1. Basis of Presentation

The accompanying schedules and interrogatories present selected statutory-basis financial data as of December 31, 2007 and for the year then ended for purposes of complying with paragraph 9 of the Annual Audited Financial Reports in the Annual Audited Report section of the National Association of Insurance Commissioners' Annual Statement Instructions and the National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual*, and agrees to or is included in the amounts reported in the Company's December 31, 2007 Statutory Annual Statement as filed with the State of Iowa Insurance Division.

2. Supplemental Schedule of Restricted Cash and Investments

In accordance with the Contract, the Company must maintain in restricted cash and investments certain funding levels to cover insolvency protection, working capital and surplus fund requirements. As of December 31, 2007, the Company satisfied these financial requirements.