

MAGELLAN BEHAVIORAL CARE OF IOWA, INC.

Statutory-Basis Financial Statements and Other Financial Information

Years ended December 31, 2005 and 2006 with Report of Independent Auditors

Magellan Behavioral Care of Iowa, Inc.

Statutory-Basis Financial Statements and Other Financial Information

Years ended December 31, 2005 and 2006

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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, 2005 and 2006, 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 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.

As discussed in Note 2 to the financial statements, the Company presents its financial statements in conformity with accounting practices prescribed 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, 2005 or 2006, 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, 2005 and 2006, 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 11, 2007

Magellan Behavioral Care of Iowa, Inc.

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

	December 31	
	2005	2006
Admitted assets		
Current assets:		
Cash (restricted cash of \$490,013 and \$20,169)	\$ 57,598,942	\$ 36,852,279
Cash equivalents (restricted)	–	2,983,755
Short-term investments (restricted)	6,832,938	13,805,155
Total cash, cash equivalents, and short-term investments	64,431,880	53,641,189
Receivables for securities (restricted)	–	2,000,000
Contract receivables	3,673,665	2,953,028
Accrued interest income	79,104	43,309
Total current assets	68,184,649	58,637,526
Long-term investments (restricted)	10,649,884	–
Total admitted assets	\$ 78,834,533	\$ 58,637,526
 Liabilities, capital and surplus		
Current liabilities:		
Claims unpaid	\$ 26,906,268	\$ 30,816,390
Amounts retained for others	24,665,927	4,440,811
Accounts payable and accrued expenses	422,811	528,140
Payable to parent, subsidiaries, and affiliates	4,639,041	1,810,762
Accrued federal income taxes	1,025,055	1,314,224
Other liabilities	407,002	718,069
Total liabilities	58,066,104	39,628,396
 Capital and surplus:		
Common stock, no par value; 1,000 shares authorized, issued, and outstanding	20,000	20,000
Unassigned funds	20,748,429	18,989,130
Total capital and surplus	20,768,429	19,009,130
Total liabilities, capital and surplus	\$ 78,834,533	\$ 58,637,526

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	
	2005	2006
Revenues	\$ 119,010,864	\$ 120,817,252
Claims costs and expenses:		
Claims incurred	99,908,073	102,019,345
Claims adjustment expenses	2,004,863	2,188,759
General administrative expenses	15,931,554	15,673,462
Total claims costs and expenses	117,844,490	119,881,566
Underwriting gain	1,166,374	935,686
Investment income, net	1,762,354	2,819,239
Income before allocated federal income taxes	2,928,728	3,754,925
Allocated federal income taxes	1,025,055	1,314,224
Net income	\$ 1,903,673	\$ 2,440,701
Capital and surplus at beginning of year	\$ 13,087,203	\$ 20,768,429
Net income	1,903,673	2,440,701
Dividends to stockholder	(3,800,000)	(4,200,000)
Decrease in non-admitted assets	9,577,553	—
Capital and surplus at end of year	\$ 20,768,429	\$ 19,009,130

See accompanying notes to the financial statements.

Magellan Behavioral Care of Iowa, Inc.

Statements of Cash Flows—Statutory-Basis

	Year ended December 31	
	2005	2006
Cash from operations		
Premiums collected	\$ 118,879,057	\$ 121,537,889
Claims paid	(100,493,293)	(98,109,223)
General administrative expenses and amounts retained for others paid	(9,959,897)	(37,953,176)
Interest income collected	1,630,739	3,087,153
Allocated federal income taxes paid	–	(1,025,055)
Net cash from operations	<u>10,056,606</u>	<u>(12,462,412)</u>
Cash from investments		
Proceeds from long-term investments matured	–	10,700,000
Cost of long-term investments acquired	(10,579,977)	–
Increase in receivables for securities	–	(2,000,000)
Net cash from investments	<u>(10,579,977)</u>	<u>8,700,000</u>
Cash from financing and miscellaneous sources		
Decrease in non-admitted assets	9,577,553	–
Net transfers from (to) affiliates	4,639,041	(2,828,279)
Dividends paid to stockholders	(3,800,000)	(4,200,000)
Net cash from financing and miscellaneous sources	<u>10,416,594</u>	<u>(7,028,279)</u>
Net change in cash, cash equivalents and short-term investments	9,893,223	(10,790,691)
Cash, cash equivalents and short-term investments:		
Beginning of year	54,538,657	64,431,880
End of year	<u>\$ 64,431,880</u>	<u>\$ 53,641,189</u>

See accompanying notes to the financial statements.

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements

December 31, 2006

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 healthcare management services 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 was 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 consisted 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 Company has obtained notification that the State has exercised its option to extend both the Medicaid and Non-Medicaid components of the Contract through June 30, 2008. 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 insurance companies domiciled in Iowa to prepare their statutory-basis financial statements in accordance with the Codified National Association of Insurance Commissioners’ Statements of Statutory Accounting Principles (“NAIC SAP”), subject to any deviations prescribed or permitted by the Division.

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (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 (“GAAP”). Variances between GAAP and statutory accounting practices 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 unassigned funds. 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, trading, or available-for-sale. Held-to-maturity fixed maturity investments would be reported at amortized cost, and the remaining fixed maturity investments would be reported at fair value with unrealized holding gains and losses reported in operations for those designated as trading and as a separate component of stockholder’s equity for those designated as available-for-sale.
- 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 \$20,696,416 and \$19,016,370 as of December 31, 2005 and 2006 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, 2005 and 2006 based on GAAP was the same as those presented in the accompanying statutory-basis financial statements.

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (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, liability for claims unpaid, and legal liabilities. Actual results could differ from those estimates.

Fair Value of Financial Instruments

Statement of Statutory Accounting Principles 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 amounts 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, short-term investments and long-term investments are disclosed in Note 3 – Investments.

Cash and Cash Equivalents

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 investments with maturity dates of three months or less when acquired.

Short-Term Investments

Short-term investments consist of U.S. Treasury securities and U.S. government and agency securities whose maturities at the time of acquisition were one year or less (excluding those investments classified as cash equivalents). Short-term investments are recorded at amortized cost, except in cases where the NAIC designation requires them to be carried at the lower of amortized cost or fair value.

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Long-Term Investments

Long-term investments consist of U.S. Treasury securities and U.S. government and agency securities that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition. Long-term investments are recorded at amortized cost, except in cases where NAIC designation requires them to be carried at the lower of amortized cost or fair value.

The Company periodically evaluates whether any declines in the fair value of investments 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, 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.

Restricted Cash and Investments

The Contract requires 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 Company held restricted cash, investments, and receivable for securities totaling \$17,972,835 and \$18,809,079 as of December 31, 2005 and 2006, respectively, to satisfy the financial solvency, working capital and surplus fund requirements specified in the Contract.

Concentration of Credit Risk

Certain financial instruments potentially subject the Company to concentrations of credit risk. These financial instruments consist primarily of cash, cash equivalents, investments and contract receivables. The Company maintains its cash, cash equivalents and investments with what it believes to be high-quality financial institutions. The fair value of these financial instruments is substantially equivalent to its carrying value and, although there is some credit risk associated with these instruments, the Company believes the risk to be minimal.

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Concentration of Credit Risk (continued)

As of December 31, 2005 and 2006, all of the Company's cash was held at one financial institution. As of December 31, 2005 and 2006, all of the Company's contract receivables are due from the State, with the balance primarily comprised of receivables related to the Medicaid and Non-Medicaid Programs and performance-based receivables associated with the Medicaid Program.

Revenue Recognition and Contract Receivables

The Company's contract receivables have been admitted in the accompanying statutory-basis financial statements pursuant to the provisions of Statement of Statutory Accounting Principles No. 84, *Certain Health Care Receivables and Receivables Under Government Insured Plans*. 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 reflected 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, therefore, generally one month of revenue.

The Company has the ability to earn performance-based revenue. 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 upon termination of the contract.

The Company recorded \$1,072,917 and \$875,000 of performance-based revenue for the years ended December 31, 2005 and 2006, respectively. Of the amount recorded for the year ended December 31, 2005, \$875,000 related to the contract year ended June 30, 2005, with \$197,917 recorded as management's estimate of the performance fees earned during the period from July 1, 2005 through December 31, 2005 related to the contract year ending June 30, 2006. Of the amount recorded for the year ended December 31, 2006, \$677,083 related to the contract year ended June 30, 2006, with \$197,917 recorded

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Revenue Recognition and Contract Receivables (continued)

as management's estimate of the performance fees earned during the period from July 1, 2006 through December 31, 2006 related to the contract year ending June 30, 2007. Performance-based receivables of \$1,072,917 and \$197,917 as of December 31, 2005 and 2006, 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, the Company provides administrative services only to a small division of the Contract membership, under which the Company earns fees for processing and paying medical claims and is reimbursed for the cost of such claims. The State's self-insured division retains the liability risk for all such claims.

The results for the year ended December 31, 2006, from operations of the uninsured administrative service only contract plan, were as follows:

Gross reimbursement for medical claims incurred	\$ 4,856,314
Gross administrative fees earned	763,896
Gross medical claims accrued	(393,937)
Gross administrative expenses incurred	(703,826)
Gross medical claims paid	<u>(4,462,377)</u>
Net income	<u>\$ 60,070</u>

Claims Costs and Claims Unpaid

The Company's claims costs are comprised principally of expenses associated with managing, supervising, and providing the Company's services, including third-party network provider charges, inpatient facility charges, and costs associated with members of management principally engaged in the Company's clinical operations and their support staff. Claims costs are recognized in the month in which services are rendered. The Company also records additional claims costs, where applicable, when estimated claims costs are less than prescribed minimum costs under the Contract. Prescribed minimum claims costs are determined based on contractual percentages of capitation revenue.

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (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. 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. The data is incorporated into contract-specific actuarial reserve models. The liability for claims unpaid also includes certain potential community reinvestment payable amounts (*see Note 4*). Although considerable variability is inherent in such estimates, management believes the liability for claims unpaid is adequate. Changes in assumptions for claims costs caused by changes in actual experience could cause these estimates to change in the near term. Such changes are reflected in current operations.

3. Investments

Investments are recorded at amortized cost in accordance with procedures prescribed by the NAIC. Investment securities at December 31, 2005 and 2006 were as follows:

	Amortized Cost	Gross Unrealized (Loss)	Estimated Fair Value
December 31, 2005			
Federal National Mortgage Association Discount Notes	\$ 1,655,179	\$ (6,383)	\$ 1,648,796
United States Government Treasury Notes	5,177,759	(16,288)	5,161,471
Total short-term investments	<u>\$ 6,832,938</u>	<u>\$ (22,671)</u>	<u>\$ 6,810,267</u>
United States Government Treasury Notes	\$ 10,649,884	\$ (49,343)	\$ 10,600,541
Total long-term investments	<u>\$ 10,649,884</u>	<u>\$ (49,343)</u>	<u>\$ 10,600,541</u>

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (continued)

3. Investments (continued)

	Amortized Cost	Gross Unrealized Gain	Estimated Fair Value
December 31, 2006			
Federal National Mortgage Association			
Discount Notes	\$ 2,983,755	\$ 1,245	\$ 2,985,000
Total cash equivalents	\$ 2,983,755	\$ 1,245	\$ 2,985,000
Federal National Mortgage Association			
Discount Notes	\$ 4,280,736	\$ 1,634	\$ 4,282,370
Federal Home Loan Bank Discount Notes	5,549,499	2,481	5,551,980
Federal Home Loan Mortgage Company			
Discount Notes	3,974,920	1,880	3,976,800
Total short-term investments	\$ 13,805,155	\$ 5,995	\$ 13,811,150

All investment securities at December 31, 2005 and 2006 mature in one year or less, and have an NAIC rating of NAIC-1.

4. 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 amount held for community reinvestment as of December 31, 2005 and 2006 is \$23,669,193 and \$3,074,116, 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, 2005, \$6,969,586 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, 2003 through December 31, 2003. 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. In addition, during the year ended December 31, 2006, community reinvestments funds of \$3,525,940 were reclassified to the liability for claims unpaid from the community reinvestment account to cover provider rate increases. No reinvestment payable has been specifically

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (continued)

4. Reinvestment Requirements (continued)

agreed upon by the Company and the State for services performed from January 1, 2005 through December 31, 2006. 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, 2006.

During the year ended December 31, 2006, community reinvestment funds of \$26,232,156 primarily associated with previously audited claims periods were returned to the State.

5. 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 incurred or a reduction in claims incurred in the period an adjustment is made. Prior period development is recognized immediately upon the determination that a portion of the prior period liability is 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, 2005 and 2006:

	<u>2005</u>	<u>2006</u>
Claims unpaid, beginning of period	\$ 27,491,488	\$ 26,906,268
Claims incurred:		
Current year	99,982,757	102,007,415
Prior years	(74,684)	11,930
Total claims incurred	<u>99,908,073</u>	<u>102,019,345</u>
Claims paid:		
Current year	(81,781,445)	(84,920,175)
Prior years	(11,742,262)	(8,846,976)
Total claims paid	<u>(93,523,707)</u>	<u>(93,767,151)</u>
Net transfers to community reinvestment account	<u>(6,969,586)</u>	<u>(4,342,072)</u>
Claims unpaid, end of period	<u>\$ 26,906,268</u>	<u>\$ 30,816,390</u>

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (continued)

5. Claims Unpaid (continued)

The Company believes that the claims unpaid balance is adequate to cover its ultimate liability for claims unpaid as of December 31, 2006; however, actual claims payments and other items may differ from established estimates. The methodology used in calculating the liability for claims unpaid as of December 31, 2006 is consistent with prior year.

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-sharing agreement with Magellan. Through this agreement, Magellan has allocated \$1,415,904 and \$1,817,737 to the Company for its share of the state and federal income tax provisions for the years ended December 31, 2005 and 2006, respectively. The current agreement calls for an allocation based on Magellan's effective tax rate before reflecting the allocation and after affecting for permanent differences. Allocated state income taxes are included as a component of general and administrative expenses in the accompanying statements of income and changes in capital and surplus—statutory-basis and accounts payable and accrued expenses in the accompanying statements of admitted assets, liabilities, capital and surplus—statutory-basis. In accordance with the tax allocation agreement, income taxes payable or recoverable are required to be settled within 30 days after the filing by Magellan of any annual income tax return that includes the activities of the Company.

Allocated income taxes for the years ended December 31, 2005 and 2006 were as follows:

	<u>2005</u>	<u>2006</u>
State income taxes	\$ 390,849	\$ 503,513
Federal income taxes	1,025,055	1,314,224
Allocated corporate income taxes	<u>\$ 1,415,904</u>	<u>\$ 1,817,737</u>

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (continued)

7. Related Party Transactions

Under an 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 participating provider, management information, communication, legal, cash management, and other administrative services to the Company. The amount charged to the Company in connection with these services for the years ended December 31, 2005 and 2006 was \$14,189,490 and \$14,118,630, respectively. Of the administrative fees charged for the years ended December 31, 2005 and 2006, \$2,004,863 and \$2,188,759, 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.

Activity in amounts payable to parent, subsidiaries, and affiliates is as follows for the years ended December 31, 2005 and 2006:

	<u>2005</u>	<u>2006</u>
Payment of claims by MBH for Non-Medicaid Program	\$ 19,810,231	\$ 20,849,427
Payment of claims by MBH for State Payment Program	5,746,131	4,462,377
Community reinvestment payments made by MBH	2,265,552	1,128,128
Allocated administrative management fees	14,189,490	14,118,630
Settlement of prior year payable to parent, subsidiaries and affiliates	–	(4,639,041)
Settlement of current year intercompany activity	(35,800,254)	(38,299,562)
Other activity, net	(1,572,109)	(448,238)
Change in payable to parent, subsidiaries, and affiliates	4,639,041	(2,828,279)
Payable to parent, subsidiaries and affiliates – beginning of year	–	4,639,041
Payable to parent, subsidiaries and affiliates – end of year	<u>\$ 4,639,041</u>	<u>\$ 1,810,762</u>

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (continued)

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 managed care organization to support its overall business operations in consideration of its size and risk profile. The managed care organization’s 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. State of Iowa Administrative Rules requires limited service organizations to maintain significant positive equity, which is defined as 200% of authorized control level. As of December 31, 2005 and 2006, management believes the Company’s capital and surplus exceeded the RBC requirement as specified by the State.

In addition, the State of Iowa insurance regulations provide the authority for a domestic insurer to pay dividends upon the approval of the Insurance Commissioner. For the years ended December 31, 2005 and 2006, extraordinary dividends of \$3,800,000 and \$4,200,000, respectively, were declared and paid to Merit.

9. Commitments and Contingencies

Regulatory Matters

The 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 and 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. Management believes that the Company is in compliance with fraud and abuse, as well as other applicable government laws and regulations.

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (continued)

9. Commitments and Contingencies (continued)

Legal

The Company is involved in certain legal actions arising in the ordinary course of business. After taking into consideration legal counsel's evaluation of such actions, management is of the opinion that the outcome will not have a significant effect on the accompanying statutory-basis financial statements.

Professional Liability Insurance

The Company is covered under Magellan's professional liability insurance. Coverage is limited to the period in which a claim is asserted, rather than when the incident giving rise to such claim occurred. Management has the intent to renew the insurance coverage, and historically has been able to renew such coverage. In the event that Magellan is unable to obtain professional liability insurance at the expiration of the current policy period, it is possible that the Company would be uninsured for claims asserted after the expiration of the current policy period. Magellan's "claims-made" policy has been renewed through June 17, 2007.

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, 2006 statutory-basis financial statements taken as a whole. The accompanying supplemental schedule of investment risks interrogatories and 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, the National Association of Insurance Commissioners' Accounting Practices and Procedures Manual, and the conditions of the Contract 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, 2006 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.

This report is intended solely for the information and use of the Company, the state insurance division to whose jurisdiction the Company is subject, the Iowa Department of Human Services, and the Iowa Department of Public Health and is not intended to be and should not be used by anyone other than these specified parties.

Ernst & Young LLP

May 11, 2007

Magellan Behavioral Care of Iowa, Inc.

Schedule of Investment Risks Interrogatories

December 31, 2006

The Company's total admitted assets as reported per the accompanying financial statements is \$58,637,526.

1. 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.
2. 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		\$ 16,788,910	28.6%

3. Assets held in foreign investments are less than 2.5% of the Company's total admitted assets at December 31, 2006.
4. Assets held in Canadian investments are less than 2.5% of the Company's total admitted assets at December 31, 2006.
5. Assets held in investments with contractual sales restrictions are less than 2.5% of the Company's total admitted assets at December 31, 2006.
6. Assets held in equity interests are less than 2.5% of the Company's total admitted assets at December 31, 2006.
7. Assets held in nonaffiliated, privately placed equities are less than 2.5% of the Company's total admitted assets at December 31, 2006.
8. Assets held in general partnership interests are less than 2.5% of the Company's total admitted assets at December 31, 2006.
9. Mortgage loans reported in Schedule B are less than 2.5% of the Company's total admitted assets at December 31, 2006.

Magellan Behavioral Care of Iowa, Inc.

Schedule of Investment Risks Interrogatories (continued)

10. 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, 2006.
11. The Company did not lend any securities during 2006. The Company did not hold any repurchase agreements, reverse repurchase agreements or dollar repurchase agreements during 2006.
12. The Company did not own any warrants not attached to other financial instruments, options, caps, and floors at December 31, 2006.
13. The Company did not have any potential exposure for collars, swaps, and forwards during 2006.
14. The Company did not have any potential exposure for futures contracts during 2006.
15. The Company did not own any investments included in the write-ins for invested assets category included on the Summary Investment Schedule at December 31, 2006.

Magellan Behavioral Care of Iowa, Inc.

Summary Investment Schedule

December 31, 2006

	Gross Investment Holdings*		Admitted Assets as Reported in the Annual Statement	
	Amount	Percentage of Gross Investment Holdings	Amount	Percentage of Total Admitted 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	—	—	—	—

Magellan Behavioral Care of Iowa, Inc.

Summary Investment Schedule (continued)

	Gross Investment Holdings*		Admitted Assets as Reported in the Annual Statement	
	Amount	Percentage of Gross Investment Holdings	Amount	Percentage of Total Admitted Invested Assets
Equity interests:				
Investments in mutual funds	\$ —	—%	\$ —	—%
Preferred stocks:				
Affiliated	—	—	—	—
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	2,000,000	3.6	2,000,000	3.6
Cash, cash equivalents and short-term investments	53,641,189	96.4	53,641,189	96.4
Write-ins for invested assets	—	—	—	—
Total invested assets	<u>\$ 55,641,189</u>	<u>100.0%</u>	<u>\$ 55,641,189</u>	<u>100.0%</u>

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

Magellan Behavioral Care of Iowa, Inc.

Supplemental Schedule of Operations by Funding Source

Year ended December 31, 2006

	Medicaid	Non-Medicaid	State Payment Program	Total
Revenues	\$ 97,800,533	\$ 22,252,823	\$ 763,896	\$ 120,817,252
Claims costs and expenses:				
Claims incurred	81,126,585	20,892,760	–	102,019,345
Claims adjustment expenses	2,123,096	–	65,663	2,188,759
General and administrative expenses	13,539,334	1,528,310	605,818	15,673,462
Total claims costs and expenses	96,789,015	22,421,070	671,481	119,881,566
Underwriting gain (loss)	1,011,518	(168,247)	92,415	935,686
Investment income, net	2,819,239	–	–	2,819,239
Income (loss) before allocated federal income taxes	3,830,757	(168,247)	92,415	3,754,925
Allocated federal income taxes	1,340,765	(58,886)	32,345	1,314,224
Net income (loss)	\$ 2,489,992	\$ (109,361)	\$ 60,070	\$ 2,440,701

Magellan Behavioral Care of Iowa, Inc.

Supplemental Schedule of General and Administrative Expenses

Year ended December 31, 2006

Administrative services management fee	\$ 11,929,871
Community reinvestment expense	2,423,135
Provider incentives expense related to Non-Medicaid block grant	582,728
Allocated state income taxes	503,513
Other expense	<u>234,215</u>
Total general and administrative expenses	<u>\$ 15,673,462</u>

Magellan Behavioral Care of Iowa, Inc.

Supplemental Schedule of Restricted Cash and Investments

December 31, 2006

Components of restricted cash and investments as defined in the Contract:

Insolvency protection account	\$ 14,289,439
Working capital	3,346,876
Surplus fund*	<u> —</u>
	<u>17,636,315</u>

Restricted cash and investments per audited financial statements as of December 31, 2006:

Restricted cash	20,169
Restricted investments par value (\$18,788,910 admitted value)	<u>18,900,000</u>
	<u>18,920,169</u>
Amount over-funded	<u><u>\$ 1,283,854</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, \$10,149,766 was utilized to satisfy the surplus fund requirement.

Magellan Behavioral Care of Iowa, Inc.

Notes to Other Financial Information

December 31, 2006

1. Basis of Presentation

The accompanying schedules and interrogatories present selected statutory-basis financial data as of December 31, 2006 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 2006 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, 2006, the Company satisfied these financial requirements.