

MAGELLAN BEHAVIORAL CARE OF IOWA, INC.

Statutory-Basis Financial Statements and Other Financial Information

Years ended December 31, 2004 and 2005 with Report of Independent Auditors

Magellan Behavioral Care of Iowa, Inc.

Statutory-Basis Financial Statements and Other Financial Information

Years ended December 31, 2004 and 2005

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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, reserves and unassigned funds of Magellan Behavioral Care of Iowa, Inc. (the Company), a wholly owned subsidiary of Merit Behavioral Care Corporation, as of December 31, 2004 and 2005, and the related statutory-basis statements of income and changes in reserves and unassigned funds 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, 2004 or 2005, 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, 2004 and 2005, 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 4, 2006

Magellan Behavioral Care of Iowa, Inc.

Statements of Admitted Assets, Liabilities, Reserves, and  
Unassigned Funds—Statutory Basis

	<b>December 31</b>	
	<b>2004</b>	<b>2005</b>
<b>Admitted assets</b>		
Current assets:		
Cash (includes restricted cash of \$145,545 and \$490,013)	\$ 37,144,919	\$ 57,598,942
Short-term investments (restricted)	17,393,738	6,832,938
Contract receivables	3,541,859	3,673,665
Accrued interest income	17,396	79,104
Other receivables	331,583	—
Total current assets	<u>58,429,495</u>	<u>68,184,649</u>
Long-term investments (restricted)	—	10,649,884
Total admitted assets	<u>\$ 58,429,495</u>	<u>\$ 78,834,533</u>
<b>Liabilities, reserves, and unassigned funds</b>		
Current liabilities:		
Liability for unpaid claims	\$ 27,491,488	\$ 26,906,268
Amounts retained for others	17,788,391	24,665,927
Accounts payable and accrued expenses	62,413	422,811
Payable to parent, subsidiaries, and affiliates	—	4,639,041
Accrued federal income taxes	—	1,025,055
Other liabilities	—	407,002
Total liabilities	<u>45,342,292</u>	<u>58,066,104</u>
Reserves and unassigned funds:		
Common stock, no par value; 1,000 shares authorized, issued, and outstanding	20,000	20,000
Unassigned funds	13,067,203	20,748,429
Total reserves and unassigned funds	<u>13,087,203</u>	<u>20,768,429</u>
Total liabilities, reserves, and unassigned funds	<u>\$ 58,429,495</u>	<u>\$ 78,834,533</u>

*See accompanying notes to the financial statements.*

Magellan Behavioral Care of Iowa, Inc.

Statements of Income and Changes in Reserves and  
Unassigned Funds—Statutory Basis

	<b>Year ended December 31</b>	
	<b>2004</b>	<b>2005</b>
Revenues	\$ 114,796,252	\$ 119,010,864
Claims costs and expenses:		
Claims incurred	96,561,749	99,908,073
Claims adjustment expenses	1,949,427	2,004,863
General and administrative expenses	15,268,991	15,931,554
Total claims costs and expenses	<u>113,780,167</u>	<u>117,844,490</u>
Underwriting gain	1,016,085	1,166,374
Investment income, net	481,502	1,762,354
Income before allocated federal income taxes	<u>1,497,587</u>	<u>2,928,728</u>
Allocated federal income taxes	509,179	1,025,055
Net income	<u>\$ 988,408</u>	<u>\$ 1,903,673</u>
Reserves and unassigned funds at beginning of year	\$ 9,187,070	\$ 13,087,203
Net income	988,408	1,903,673
Dividends to stockholder	–	(3,800,000)
Decrease in non-admitted assets	2,911,725	9,577,553
Reserves and unassigned funds at end of year	<u>\$ 13,087,203</u>	<u>\$ 20,768,429</u>

*See accompanying notes to the financial statements.*

Magellan Behavioral Care of Iowa, Inc.

Statements of Cash Flows—Statutory Basis

	<b>Year ended December 31</b>	
	<b>2004</b>	<b>2005</b>
<b>Underwriting and operations</b>		
Premiums collected	\$ 115,094,285	\$ 118,879,057
Claims and claims adjustment expenses paid	(93,443,017)	(100,493,293)
General and administrative expenses paid	(8,861,482)	(9,959,897)
Interest income collected	464,106	1,630,739
Allocated federal income taxes paid	(509,179)	—
Net cash from underwriting and operations	<u>12,744,713</u>	<u>10,056,606</u>
<b>Investing activities</b>		
Cost of long-term investments acquired	—	(10,579,977)
Net cash from investing activities	<u>—</u>	<u>(10,579,977)</u>
<b>Financing and miscellaneous activities</b>		
Decrease in non-admitted assets	2,911,725	9,577,553
Net transfers from affiliates	—	4,639,041
Dividends paid to stockholders	—	(3,800,000)
Net cash from financing and miscellaneous activities	<u>2,911,725</u>	<u>10,416,594</u>
Net increase in cash and short-term investments	15,656,438	9,893,223
Cash and short-term investments:		
Beginning of year	38,882,219	54,538,657
End of year	<u>\$ 54,538,657</u>	<u>\$ 64,431,880</u>

*See accompanying notes to the financial statements.*

# Magellan Behavioral Care of Iowa, Inc.

## Notes to Statutory-Basis Financial Statements

December 31, 2005

### **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 manages behavioral health care programs for payors across various segments of the health care industry. Managed mental health care programs are designed to decrease psychiatric and chemical dependency claim dollars through individualized case management and in-person intervention.

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 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 is for an initial term from July 1, 2004 through June 30, 2006, with a provision for three, one-year extensions at the State of Iowa's option. The Company obtained notification from the State that they were exercising the option of extending the Medicaid and Non-Medicaid components of the Contract through June 30, 2007. The State Payment Program component of the Contract will terminate 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, reserves, and unassigned funds—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 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 purchased.

Based on GAAP, the Company’s total stockholder’s equity was \$22,632,003 and \$20,696,416 as of December 31, 2004 and 2005, respectively. At December 31, 2004 the difference between GAAP stockholder’s equity and statutory reserves and unassigned funds was attributable to non-admitted assets (see Note 8) and unrealized losses on available-for-sale investments, with the difference at December 31, 2005 solely attributable to unrealized losses on available-for-sale investments. Net income for the years ended December 31, 2004 and 2005 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 unpaid claims, 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 short-term investments) and current liabilities approximate fair value due to their short maturities. The estimated fair values of the Company's short-term and long-term investments are disclosed in Note 3 – Investments.

#### **Cash and Short-Term Investments**

Cash and short-term investments consist of cash on hand and in financial institutions, along with certificates of deposit, U.S. Treasury securities, and U.S. government and agency securities whose maturities at the time of acquisition were one year or less. The short-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.

#### **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. The 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.

## Magellan Behavioral Care of Iowa, Inc.

### Notes to Statutory-Basis Financial Statements (continued)

#### **2. Summary of Significant Accounting Policies (continued)**

##### **Long-Term Investments (continued)**

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, declines due primarily to changes in interest rates (and not because of increased credit risk), and declines 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 and investments of \$17,539,283 and \$17,972,835 as of December 31, 2004 and 2005, 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, investments, and receivables. The Company maintains its cash and investments with what it believes to be high-quality financial institutions. The fair value of the Company's 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.

All of the Company's contract receivables are due from the State, with the balance comprised of receivables related to the Medicaid, Non-Medicaid, and State Payment Programs and performance-based receivables.

## 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

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, reserves, and unassigned funds—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 \$587,500 and \$1,072,917 of performance-based revenue for the years ended December 31, 2004 and 2005, respectively. The entire amount recorded for the year ended December 31, 2004 related to the contract year ended June 30, 2004. 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. Performance-based receivables of \$780,000 and \$1,072,917 as of December 31, 2004 and 2005, respectively, are included in contract receivables in the accompanying statements of admitted assets, liabilities, reserves, and unassigned funds—statutory basis.

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (continued)

**2. Summary of Significant Accounting Policies (continued)**

**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, 2005, from operations of uninsured administrative service only contract plans, were as follows:

Gross reimbursement for medical claims incurred	\$ 6,484,716
Gross administrative fees earned	1,067,757
Gross medical claims accrued	(738,585)
Gross administrative expenses incurred	(1,050,310)
Gross medical claims paid	<u>(5,746,131)</u>
Net income	<u>\$ 17,447</u>

**Claims Costs and Liability for Unpaid Claims**

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.

The liability for unpaid claims represents the liability for health care claims reported but not yet paid and claims incurred but not yet reported (known as IBNR) related to the Company's managed health care business. The IBNR portion of unpaid claims is estimated based on past claims payment experience for member groups, enrollment data, utilization statistics, authorized health care services, and other factors. The data is incorporated into contract-specific actuarial reserve models. The liability for unpaid

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (continued)

**2. Summary of Significant Accounting Policies (continued)**

**Claims Costs and Liability for Unpaid Claims (continued)**

claims also includes certain potential community reinvestment payable amounts (see Note 4). Although considerable variability is inherent in such estimates, management believes the liability for unpaid claims is adequate. Unpaid claims balances are continually monitored and reviewed. Changes in assumptions for claims costs caused by changes in actual experience could cause these estimates to change in the near term.

**Reclassification**

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

**3. Investments**

Investments are recorded at amortized cost in accordance with procedures prescribed by the NAIC. Investment securities at December 31, 2004 and 2005 were as follows:

	<b>Amortized Cost</b>	<b>Gross Unrealized Loss</b>	<b>Estimated Fair Value</b>
<b>December 31, 2004</b>			
Federal Home Loan Bank Discount Notes	\$ 799,824	\$ (16)	\$ 799,808
Federal National Mortgage Association Discount Notes	7,822,024	(13,721)	7,808,303
United States Government Treasury Notes	8,771,890	(19,016)	8,752,874
Total short-term investments	<u>\$ 17,393,738</u>	<u>\$(32,753)</u>	<u>\$ 17,360,985</u>
<b>December 31, 2005</b>			
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	<u>\$ 10,649,884</u>	<u>\$(49,343)</u>	<u>\$ 10,600,541</u>
Total long-term investments	<u>\$ 10,649,884</u>	<u>\$(49,343)</u>	<u>\$ 10,600,541</u>

All investment securities at December 31, 2004 and 2005 mature in one year or less, and have an NAIC rating of "NAIC-1."

## Magellan Behavioral Care of Iowa, Inc.

### Notes to Statutory-Basis Financial Statements (continued)

#### **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 unpaid claims into the community reinvestment account. The amount held for community reinvestment as of December 31, 2004 and 2005 is \$16,571,864 and \$23,669,193, respectively, which is net of reinvestment projects already funded. These amounts are included in the amounts retained for others in the accompanying statements of admitted assets, liabilities, reserves, and unassigned funds—statutory basis.

During the year ended December 31, 2004, \$7,291,038 was reclassified to the community reinvestment account from the liability for unpaid claims based on a claims audit of the 18-month claim period from July 1, 2001 through December 31, 2002. During the year ended December 31, 2005, \$6,969,586 was reclassified to the community reinvestment account from the liability for unpaid claims based on a claims audit of the 12-month claim period from January 1, 2003 through December 31, 2003. No reinvestment payable has been specifically agreed upon by the Company and the State for services performed from January 1, 2004 through December 31, 2005. 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 unpaid claims as of December 31, 2005.

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (continued)

**5. Liability for Unpaid Claims**

The following table presents the components of the change in the liability for unpaid claims:

	<b>Year ended December 31</b>	
	<b>2004</b>	<b>2005</b>
Liability for unpaid claims, beginning of period	\$ 24,372,756	\$ 27,491,488
Claims incurred:		
Current year	96,542,476	99,982,757
Prior years	19,273	(74,684)
Total claims incurred	<u>96,561,749</u>	<u>99,908,073</u>
Claims paid:		
Current year	(76,522,171)	(81,781,445)
Prior years	(9,629,808)	(11,742,262)
Total claims paid	<u>(86,151,979)</u>	<u>(93,523,707)</u>
Transfers to community reinvestment account	<u>(7,291,038)</u>	<u>(6,969,586)</u>
Liability for unpaid claims, end of period	<u>\$ 27,491,488</u>	<u>\$ 26,906,268</u>

The Company believes that the amount of unpaid claims is adequate to cover its ultimate liability for unpaid claims as of December 31, 2005; however, actual claims payments and other items may differ from established estimates.

**6. Allocated Corporate Income Taxes**

For federal and state income tax reporting purposes, the Company's operations are included in Magellan's consolidated federal tax returns and Magellan's combined state tax returns for the State of Iowa, respectively.

The Company has a tax-sharing agreement with Magellan. Through this agreement, Magellan has allocated \$704,873 and \$1,415,904 to the Company for its share of the state and federal income tax provisions for the years ended December 31, 2004 and 2005, 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

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (continued)

**6. Allocated Corporate Income Taxes (continued)**

expenses in the accompanying statements of income and changes in reserves and unassigned funds—statutory and accounts payable and accrued expenses in the accompanying statements of admitted assets, liabilities, reserves, and unassigned funds—statutory-basis for 2005. For 2004, allocated state and federal income taxes were recorded as a reduction to the receivable from parent, subsidiaries, and affiliates. 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 income tax return, which includes the activities of the Company.

Allocated income taxes were as follows:

	<b>Year ended December 31</b>	
	<b>2004</b>	<b>2005</b>
State income taxes	\$ 195,694	\$ 390,849
Federal income taxes	509,179	1,025,055
Allocated income taxes	<u>\$ 704,873</u>	<u>\$ 1,415,904</u>

**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, 2004 and 2005 was \$13,722,454 and \$14,189,490, respectively. Of the administrative fees charged for the years ended December 31, 2004 and 2005, \$1,949,427 and \$2,004,863, respectively, are reported as claims adjustment expenses in the accompanying statements of income and changes in reserves and unassigned funds—statutory basis, with the remaining administrative fees reported as general and administrative expenses.

## Magellan Behavioral Care of Iowa, Inc.

### Notes to Statutory-Basis Financial Statements (continued)

#### **8. Reserves and Unassigned Funds**

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, 2004 and 2005, management believes the Company's RBC exceeded this requirement.

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. The Company declared no dividends in 2004. In 2005, an extraordinary dividend of \$3,800,000 was declared and paid to Merit. Approval from the Division was obtained prior to the payment of the extraordinary dividend.

As of December 31, 2004, the Company's reserves and unassigned funds were reduced by non-admitted assets of \$9,577,553 related to amounts due from parent, subsidiaries, and affiliates. There were no non-admitted assets as of December 31, 2005.

#### **9. Commitments and Contingencies**

##### **Regulatory Matters**

The health care industry is subject to numerous laws and regulations of federal, state, and local governments. 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 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 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

Magellan Behavioral Care of Iowa, Inc.

Notes to Statutory-Basis Financial Statements (continued)

**9. Commitments and Contingencies (continued)**

**Regulatory Matters (continued)**

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.

**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. The claims-made policy has been renewed through June 17, 2006.

# 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, 2005 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, 2005 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 4, 2006

Magellan Behavioral Care of Iowa, Inc.

Supplemental Schedule of Investment Risks Interrogatories

December 31, 2005

The Company's total admitted assets as reported per the accompanying financial statements is \$78,834,533.

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:

	<b>Bonds</b>	<b>Amount</b>	<b>Percentage of Total Admitted Assets</b>
NAIC-1		\$ 17,482,822	22.2%

3. Assets held in foreign investments are less than 2.5% of the Company's total admitted assets at December 31, 2005.
4. Assets held in Canadian investments are less than 2.5% of the Company's total admitted assets at December 31, 2005.
5. Assets held in investments with contractual sales restrictions are less than 2.5% of the Company's total admitted assets at December 31, 2005.
6. Assets held in equity interests are less than 2.5% of the Company's total admitted assets at December 31, 2005.
7. Assets held in nonaffiliated, privately placed equities are less than 2.5% of the Company's total admitted assets at December 31, 2005.
8. Assets held in general partnership interests are less than 2.5% of the Company's total admitted assets at December 31, 2005.
9. Mortgage loans reported in Schedule B are less than 2.5% of the Company's total admitted assets at December 31, 2005.

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Summary Investment Schedule (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, 2005.
11. The Company did not lend any securities during 2005. The Company did not hold any repurchase agreements, reverse repurchase agreements or dollar repurchase agreements during 2005.
12. The Company did not own any warrants not attached to other financial instruments, options, caps, and floors at December 31, 2005.
13. The Company did not have any potential exposure for collars, swaps, and forwards during 2005.
14. The Company did not have any potential exposure for futures contracts during 2005.
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, 2005.

Magellan Behavioral Care of Iowa, Inc.

Summary Investment Schedule

December 31, 2005

	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	\$ 10,649,884	14.2%	\$ 10,649,884	14.2%
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	—	—	—	—
Cash and short-term investments	64,431,880	85.8	64,431,880	85.8
Write-ins for invested assets	—	—	—	—
Total invested assets	\$ 75,081,764	100.0%	\$ 75,081,764	100.0%

\*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, 2005

	<b>Medicaid</b>	<b>Non-Medicaid</b>	<b>State Payment Program</b>	<b>Total</b>
Revenues	\$ 96,762,871	\$ 21,180,236	\$ 1,067,757	\$ 119,010,864
Claims costs and expenses:				
Claims incurred	80,097,842	19,810,231	–	99,908,073
Claims adjustment expenses	1,924,668	–	80,195	2,004,863
General and administrative expenses	13,436,176	1,534,657	960,721	15,931,554
Total claims costs and expenses	95,458,686	21,344,888	1,040,916	117,844,490
Underwriting gain	1,304,185	(164,652)	26,841	1,166,374
Investment income, net	1,762,354	–	–	1,762,354
Income before allocated federal income taxes	3,066,539	(164,652)	26,841	2,928,728
Allocated federal income taxes	1,073,289	(57,628)	9,394	1,025,055
Net income	<u>\$ 1,993,250</u>	<u>\$ (107,024)</u>	<u>\$ 17,447</u>	<u>\$ 1,903,673</u>

Magellan Behavioral Care of Iowa, Inc.

Supplemental Schedule of General and Administrative Expenses

Year ended December 31, 2005

Administrative services management fee	\$ 12,184,627
Community reinvestment expense	2,393,295
Provider incentives expense related to non-Medicaid block grant	628,700
State taxes	390,849
Other expense	<u>334,083</u>
Total general and administrative expenses	<u>\$ 15,931,554</u>

Magellan Behavioral Care of Iowa, Inc.

Supplemental Schedule of Restricted Cash and Investments

December 31, 2005

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

Insolvency protection account	\$ 14,289,439
Working capital	3,361,960
Surplus fund*	—
	<u>17,651,399</u>

Restricted cash and investments per audited financial statements as of December 31, 2005:

Restricted cash	490,013
Restricted investments par value (\$17,482,822 admitted value)	<u>17,600,000</u>
	<u>18,090,013</u>
Amount over-funded	<u>\$ 438,614</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, \$10,025,844 was utilized to satisfy the surplus fund requirement.

# Magellan Behavioral Care of Iowa, Inc.

## Notes to Other Financial Information

December 31, 2005

### **1. Basis of Presentation**

The accompanying schedules and interrogatories present selected statutory-basis financial data as of December 31, 2005 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 2005 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, 2005, the Company satisfied these financial requirements.