Financial Statements

Magellan Complete Care of Arizona, Inc.
Year ended December 31, 2018
With Report of Independent Auditors

Magellan HEALTH SM

Magellan Complete Care of Arizona, Inc.

Financial Statements

Year Ended December 31, 2018

Contents

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Report of Independent Auditors

Board of Directors and Shareholders
Magellan Complete Care of Arizona, Inc.

We have audited the accompanying financial statements of Magellan Complete Care of Arizona, Inc., which comprise the balance sheet as of December 31, 2018, and the related statement of comprehensive loss, changes in stockholder's equity and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

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.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Magellan Complete Care of Arizona, Inc. at December 31, 2018, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

May 6, 2019

Magellan Complete Care of Arizona, Inc.

Balance Sheet

December 31, 2018

Assets	
Current assets:	
Cash and cash equivalents (restricted balance of $510,000)	$ 5,575,319
Short-term investments	9,938,386
Accounts receivable	861,973
Other current assets	39,730
Allocated corporate income taxes receivable	638,717
Total current assets	17,054,125
Long-term investments	510,618
Total assets	$ 17,564,743
Liabilities and stockholder's equity	
Current liabilities:	
Medical claims payable	$ 4,030,790
Unpaid claims adjustment expenses	26,274
Accounts payable and accrued expenses	227,051
Due to parent and affiliates, net	3,495,319
Total liabilities	7,779,434
Stockholder's equity:	
Common stock, $1.00 par value	
Authorized, issued and outstanding – 1,000 shares	1,000
Additional paid-in capital	12,109,350
Accumulated deficit	(2,318,696)
Accumulated other comprehensive loss	(6,345)
Total stockholder's equity	9,785,309
Total liabilities and stockholder's equity	$ 17,564,743

See accompanying notes to financial statements.

Magellan Complete Care of Arizona, Inc.

Statement of Comprehensive Loss

Year Ended December 31, 2018

Net revenues	$ 5,747,194
Operating expenses:	
Cost of care	5,469,804
Direct service costs	3,418,562
Total operating expenses	8,888,366
Operating loss	(3,141,172)
Other income:	
Net investment gain	181,543
Loss before allocated income tax benefit	(2,959,629)
Allocated income tax benefit	(638,717)
Net loss	(2,320,912)
Other comprehensive income:	
Unrealized gains on available-for-sale securities	2,793
Comprehensive loss	$ (2,318,119)

See accompanying notes to financial statements.

Magellan Complete Care of Arizona, Inc.

Statement of Changes in Stockholder's Equity

Year Ended December 31, 2018

	Common Stock										
	Shares		**Amount**		**Additional Paid-In Capital**		**Accumulated Deficit**		**Accumulated Other Comprehensive Loss**		**Total Stockholder's Equity**
January 1, 2018	1,000	$	1,000	$	1,509,350	$	2,216	$	(9,138)	$	1,503,428
Net loss	–		–		–		(2,320,912)		–		(2,320,912)
Capital contribution	–		–		10,600,000		–		–		10,600,000
Other comprehensive income – other	–		–		–		–		2,793		2,793
December 31, 2018	1,000	$	1,000	$	12,109,350	$	(2,318,696)	$	(6,345)	$	9,785,309

See accompanying notes to the financial statements.

Magellan Complete Care of Arizona, Inc.

Statement of Cash Flows

Year Ended December 31, 2018

Operating activities	
Net loss	$ (2,320,912)
Adjustments to reconcile net loss to net cash provided by operating activities:	
Amortization of investment premiums	(46,414)
Cash flows from changes in assets and liabilities:	
Account receivable	(861,973)
Other current assets	(37,770)
Medical claims payable	4,030,790
Unpaid claims adjustment expenses	26,274
Accounts payable and accrued expenses	220,504
Due to parent and affiliates, net	3,491,040
Allocated corporate income taxes receivable	(640,220)
Net cash provided by operating activities	3,861,319
Cash from investing activities	
Cost of investments acquired	(11,909,960)
Proceeds from maturities and investments	3,010,000
Net cash used in investing activities	(8,899,960)
Financing activities	
Capital contribution	10,600,000
Net cash provided by financing activities	10,600,000
Net increase in cash and equivalents	5,561,359
Cash and cash equivalents at beginning of year	13,960
Cash and cash equivalents at end of year	$ 5,575,319

See accompanying notes to financial statements.

1. Organization

Magellan Complete Care of Arizona, Inc. (the "Company") is a wholly owned subsidiary of Magellan Health Services of Arizona, Inc. ("MHS of AZ"). MHS of AZ is a wholly owned subsidiary of Magellan Healthcare, Inc. ("Magellan Healthcare"), which is a wholly owned subsidiary of Magellan Health, Inc. ("Magellan"). Magellan is engaged in the healthcare management business, and is focused on delivering innovative specialty solutions for the fastest growing, most complex areas of health including special populations, complete pharmacy benefits, and other specialty areas of healthcare.

The Company was incorporated in the State of Arizona on October 20, 2011 and on January 7, 2013 received a certificate of authority to transact health care services business in the State of Arizona.

The Company began providing healthcare services to Medicaid recipients in Arizona on October 1, 2018 under the Arizona Health Care Cost Containment System ("AHCCCS") Contract with the AHCCCS Administration. The initial term of the AHCCCS Contract is for a period of three years with the potential for up to two two-year extensions, not to exceed a total contracting period of seven years. The contract year is October 1 through September 30.

2. Summary of Significant Accounting Policies

Basis of Presentation

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

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities 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, accounts receivable realization and medical claims payable. Actual results could differ from those estimates.

2. Summary of Significant Accounting Policies (continued)

Fair Value Measurements

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

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

In accordance with the fair value hierarchy described above, the following table shows the fair value of the Company's financial assets and liabilities that are required to be measured at fair value as of December 31, 2018:

	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents[1]	$ –	$ 5,442,613	$ –	$ 5,442,613
Investments:				
U.S. Treasury securities	9,454,281	–	–	9,454,281
Obligations of U.S. government-sponsored agencies	–	994,723	–	994,723
Total assets held at fair value	$ 9,454,281	$ 6,437,336	$ –	$ 15,891,617

[1] Excludes $132,706 of cash held in bank accounts by the Company.

2. Summary of Significant Accounting Policies (continued)

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

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

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

As of December 31, 2018, there were no unrealized losses that the Company believed to be other-than-temporary.

2. Summary of Significant Accounting Policies (continued)

The following table is a summary of investment securities at December 31, 2018:

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Estimated Fair Value
U.S. Treasury securities	$ 9,455,568	$ 951	$ (2,238)	$ 9,454,281
Obligations of U.S. government-sponsored agencies	999,781	–	(5,058)	994,723
Total investments	$ 10,455,349	$ 951	$ (7,296)	$ 10,449,004

The maturity dates of the Company's investments as of December 31, 2018, are summarized below:

	Amortized Cost	Estimated Fair Value
2019	$ 9,945,683	$ 9,938,386
2020	509,666	510,618
Total investments	$ 10,455,349	$ 10,449,004

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

Cash and Cash Equivalents

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

Restricted Assets

At December 31, 2018, the Company held $510,000 in mutual funds that were pledged to the Department to comply with deposit requirements. This restricted asset was held in cash and cash equivalents in the accompanying balance sheet.

2. Summary of Significant Accounting Policies (continued)

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 commercial paper and corporate debt securities with a NAIC rating of "NAIC-1." The Company's receivables are comprised of investment income due and accrued, allocated federal income tax receivables due from Magellan and contract receivables associated with the AHCCCS Contract.

Revenue Recognition

The Company's revenues are derived from business in North America and are considered transferred over time.

Revenue is recognized over the applicable coverage period on a per member per month ("PMPM") basis for covered members at the rates established in the AHCCCS Contract. The AHCCCS Contract has a single performance obligation that constitutes a series for the provision of managed healthcare services for a population of enrolled members for the duration of the contract. The transaction price for PMPM contracts is entirely variable as it primarily includes per member per month fees associated with unspecified membership that fluctuates throughout the contract. The Company estimates the transaction price using an expected value methodology and amounts are only included in the net transaction price to the extent that it is probable that a significant reversal of cumulative revenue will not occur once any uncertainty is resolved. The majority of the Company's net PMPM transaction price relates specifically to its efforts to transfer the service for a distinct increment of the series (e.g., day or month) and is recognized as revenue in the month in which members are entitled to service. The remaining transaction price is recognized over the contract period (or portion of the series to which it specifically relates) based upon estimated membership as a measure of progress.

Accounts Receivable, Contract Assets and Contract Liabilities

The Company's accounts receivable at December 31, 2018, totaled $861,973 and were related to the AHCCCS Contract. The Company had no contract assets or contract liabilities at December 31, 2018.

2. Summary of Significant Accounting Policies (continued)

Cost of Care, Medical Claims Payable and Other Medical Liabilities

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

Since the AHCCCS contract is relatively new in duration, incurred medical expense estimates are recorded consistent with original underwriting estimates developed by Magellan based on historical cost data ("book rate") and related information provided by Arizona as part of the program's initial procurement process. Paid-to-date expenses are compared to the underwritten incurred estimates (at the geographic and member cohort specific rate cells) to compute the medical claims payable. Separately, paid-to-date claims detail and operational indicators (e.g., acute hospital authorization volumes, nursing home census data), as well as monthly claims completion rates by duration experienced in similar programs, are monitored to test the reasonability of the initial underwritten cost.

Deferred Income Taxes

Deferred tax assets and/or liabilities are determined by multiplying the temporary differences between financial reporting and tax reporting basis for assets and/or liabilities by the enacted tax rates expected to be in effect when such differences are recovered or settled. The Company's significant deferred tax assets consist of temporary differences related nondeductible accruals.

3. Medical Claims Payable

Medical claims payable 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 cost of care or a reduction of cost of care in the period an adjustment is made. Further, due to the considerable variability of health care costs, adjustments to claim liabilities occur each period and are sometimes significant as compared to the net income recorded in that period. Prior period development is recognized immediately upon the actuary's judgment that a portion of the prior period liability is no longer needed or that additional liability should have been accrued.

The following table presents the components of the change in medical claims payable for the year ended December 31, 2018:

Medical claims payable, beginning of year	$ –
Cost of care:	
Current year	5,469,804
Prior years	–
Total cost of care	5,469,804
Claims paid:	
Current year	1,439,014
Prior years	–
Total claims paid	1,439,014
Medical claims payable, end of year	$ 4,030,790

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 accrual for medical claims is adequate to cover its ultimate liability for unpaid claims as of December 31, 2018; however, actual claims payments may differ from established estimates.

3. Medical Claims Payable (continued)

The Company recorded claim adjustment expenses for the estimate of costs associated with processing the incurred but unpaid claims. As of December 31, 2018, accrued claim adjustment expenses were $26,274 and were included in unpaid claims adjustment expenses on the accompanying balance sheet.

4. Allocated Corporate Income Taxes

For federal and state income tax reporting purposes, the Company's operations are included in Magellan's consolidated federal and combined Arizona state income tax returns.

The Company participates in a federal and state tax allocation agreement with Magellan. Through this agreement, Magellan allocated benefits of $512,879 and $125,838 for its share of the federal and state tax provisions, respectively, for the year ended December 31, 2018.

The agreement calls for all parties to share the federal income tax rates, exclusions and other aspects of federal tax law proportionately, based on taxable income. These amounts are included in allocated income tax benefit in the accompanying statements of comprehensive loss.

In accordance with the federal and state tax allocation agreement, allocated federal and state income taxes payable or recoverable are required to be settled on a quarterly basis. If necessary, any final settlement under the agreement shall be due within thirty (30) days after the filing by Magellan of any annual income tax returns that includes the activities of the Company. The agreement calls for federal and state income taxes payable to be computed on the basis of pretax income adjusted for permanent book to tax differences with consideration of temporary items, if material.

On December 22, 2017, the President of the United States signed into law the Tax Cuts and Jobs Act (the "Tax Act"). The legislation includes a number of changes to existing U.S. tax laws that impact the Company, most notably a reduction of the U.S. corporate income tax rate from 35% to 21%, effective January 1, 2018.

4. Allocated Corporate Income Taxes (continued)

The significant components of the net deferred tax assets at December 31, 2018, are as follows:

Deferred tax assets:	
Medical claims payable	$ 81,088
Other liabilities	17,012
Total deferred tax assets	98,100
Valuation allowance	(95,604)
Deferred tax assets after valuation allowance	2,496
Deferred tax liabilities	(2,496)
Net deferred tax assets	$ –

5. Related-Party Transactions

Under a Master Services Agreement (the "Agreement") between Magellan Healthcare and the Company, Magellan Healthcare provides itself or through one or more of its affiliates, management information, legal, cash and asset management, financial, human resources, and other administrative services to the Company. Per the Agreement, the Company reimburses Magellan Healthcare for dedicated staffing and related expenses and pays to Magellan Healthcare a monthly administrative fee equal to 5% of all capitation received by the Company with an annual true-up to actual fees incurred each year.

For the year ended December 31, 2018, the amount charged to the Company in connection with the Agreement was $1,820,868. This charge is recorded as direct service costs in the accompanying statement of comprehensive income.

In April 2018, Magellan Healthcare contributed capital of $10,600,000 to the Company.

6. Stockholder's Equity

The Company is licensed in the State of Arizona and is subject to certain minimum statutory capital and surplus requirements as determined by the Department. Additionally, the terms of the Company's contract requires the Company to maintain a certain net worth at all times.

As of December 31, 2018, the Company was required to maintain a net worth of $6,000,000. The Company exceeded the contractual requirement with net worth of $9,785,309 as of December 31, 2018.

7. Commitments and Contingencies

Regulatory Issues

The managed healthcare industry is subject to extensive and evolving federal and state regulations. 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. Government investigations and allegations have become more frequent concerning possible violations of fraud and abuse and false claims statutes and regulations by healthcare organizations. Violators may be excluded from participating in government healthcare programs, subject to fines or penalties or required to repay amounts received from the government for previously billed services. A violation of such laws and regulations may have a material adverse effect on the Company.

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 one-year terms from June 17, 2018 through June 17, 2019. 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 claims-made basis.

8. Subsequent Events

The Company evaluated all events or transactions that occurred after December 31, 2018 and through May 6, 2019, the date the Company issued these financial statements, and noted no material subsequent events during this period.

Supplementary Information

Report of Independent Auditors on Supplementary Information

Board of Directors
Magellan Complete Care of Arizona, Inc.

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying detail of sub-capitated expenses are presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the information is fairly stated, in all material respects, in relation to the financial statements as a whole.

Ernst + Young LLP

May 6, 2019

Magellan Complete Care of Arizona, Inc.

Detail of Sub-Capitated Expenses

December 31, 2018

The Company had no sub-capitated expenses for the year ended December 31, 2018.

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