CORVEL CORP
Form 10-Q
November 09, 2006

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2006

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________

Commission file number 0-19291

CORVEL CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	33-0282651
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
2010 Main Street, Suite 600 Irvine, CA	92614
(Address of principal executive office)	(zip code)

Registrant s telephone number, including area code: (949) 851-1473

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accerlated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (check one)

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

The number of shares outstanding of the registrant s Common Stock, $0.0001 Par Value, as of September 30, 2006 was 9,369,332.

CORVEL CORPORATION
FORM 10-Q
TABLE OF CONTENTS

Table of Contents

Part I Financial Information
Item 1. Financial Statements
CORVEL CORPORATION
CONSOLIDATED BALANCE SHEETS

	March 31, 2006	September 30, 2006 (unaudited)
Assets		
Current Assets		
Cash and cash equivalents	$ 14,206,000	$ 21,988,000
Accounts receivable, net	39,521,000	40,027,000
Prepaid taxes and expenses	2,221,000	2,316,000
Deferred income taxes	4,521,000	5,041,000
Total current assets	60,469,000	69,372,000
Property and equipment, net	26,459,000	24,250,000
Goodwill and other assets	13,170,000	13,148,000
TOTAL ASSETS	$ 100,098,000	$ 106,770,000
Liabilities and Stockholders Equity		
Current Liabilities		
Accounts and taxes payable	$ 13,712,000	$ 14,581,000
Accrued liabilities	12,160,000	11,985,000
Total current liabilities	25,872,000	26,566,000
Deferred income taxes	6,190,000	5,551,000
Commitments and contingencies		
Stockholders Equity		
Common stock, $.0001 par value: 30,000,000 shares authorized; 16,517,387 shares (9,416,900, net of Treasury shares) and 16,584,005 shares (9,327,563, net of Treasury shares) issued and outstanding at March 31, 2006 and September 30, 2006, respectively	2,000	2,000
Paid-in-capital	61,084,000	63,649,000
Treasury Stock, (7,100,487 shares at March 31, 2006 and 7,256,442 shares at September 30, 2006)	(132,205,000)	(137,616,000)
Retained earnings	139,155,000	148,618,000

Total stockholders equity		68,036,000		74,653,000
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$	100,098,000	$	106,770,000

See accompanying notes to consolidated financial statements.

Table of Contents

CORVEL CORPORATION
CONSOLIDATED INCOME STATEMENTS UNAUDITED

	Three months ended September 30,	
	2005	2006
REVENUES	$ 66,343,000	$ 67,329,000
Cost of revenues	55,470,000	50,933,000
Gross profit	10,873,000	16,396,000
General and administrative expenses	7,280,000	8,489,000
Income before income tax provision	3,593,000	7,907,000
Income tax provision	1,382,000	3,084,000
NET INCOME	$ 2,211,000	$ 4,823,000
Net income per common and common equivalent share		
Basic	$ 0.22	$ 0.51
Diluted	$ 0.22	$ 0.51
Weighted average common and common equivalent shares		
Basic	9,858,000	9,415,000
Diluted	9,911,000	9,486,000

See accompanying notes to consolidated financial statements.

Table of Contents

CORVEL CORPORATION
CONSOLIDATED INCOME STATEMENTS UNAUDITED

	Six months ended September 30, 2005	2006
REVENUES	$ 137,010,000	$ 137,091,000
Cost of revenues	114,133,000	104,368,000
Gross profit	22,877,000	32,723,000
General and administrative expenses	14,714,000	17,209,000
Income before income tax provision	8,163,000	15,514,000
Income tax provision	3,142,000	6,051,000
NET INCOME	$ 5,021,000	$ 9,463,000
Net income per common and common equivalent share		
Basic	$ 0.51	$ 1.00
Diluted	$ 0.50	$ 1.00
Weighted average common and common equivalent shares		
Basic	9,909,000	9,416,000
Diluted	9,965,000	9,466,000

See accompanying notes to consolidated financial statements.

Page 5

Table of Contents

CORVEL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS UNAUDITED

	Six months ended September 30, 2005	2006
Cash flows from Operating Activities		
NET INCOME	$ 5,021,000	$ 9,463,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,701,000	5,146,000
Loss on disposal of assets	20,000	91,000
Tax benefits from stock options exercised	356,000	
Stock compensation expense		585,000
Write-off of uncollectible accounts	1,851,000	1,554,000
Provision for deferred income taxes	(1,080,000)	(1,069,000)
Changes in operating assets and liabilities		
Accounts receivable	818,000	(2,060,000)
Prepaid taxes and expenses	512,000	(34,000)
Accounts and taxes payable	1,348,000	1,360,000
Accrued liabilities	(1,448,000)	(175,000)
Other assets	59,000	10,000
Net cash provided by operating activities	13,158,000	14,871,000
Cash Flows from Investing Activities		
Additions to property and equipment	(4,925,000)	(3,016,000)
Net cash used in investing activities	(4,925,000)	(3,016,000)
Cash Flows from Financing Activities		
Purchase of treasury stock	(12,748,000)	(5,411,000)
Tax effect of stock compensation expense		(228,000)
Exercise of employee stock purchase options	421,000	192,000
Exercise of common stock options	2,237,000	1,374,000
Net cash used in financing activities	(10,090,000)	(4,073,000)
Increase (decrease) in cash and cash equivalents	(1,857,000)	7,782,000
Cash and cash equivalents at beginning	8,945,000	14,206,000
Cash and cash equivalents at end	$ 7,088,000	$ 21,988,000

Supplemental Cash Flow Information:		
Income taxes paid	$ 3,580,000	$ 6,154,000
Interest paid	1,000	
Non cash financing activity		642,000

See accompanying notes to consolidated financial statements.

Table of Contents

CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006 (Unaudited)

Note A Basis of Presentation and Summary of Significant Accounting Policies

The unaudited financial statements herein have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. The accompanying interim financial statements have been prepared under the presumption that users of the interim financial information have either read or have access to the audited financial statements for the latest fiscal year ended March 31, 2006. Accordingly, footnote disclosures which would substantially duplicate the disclosures contained in the March 31, 2006 audited financial statements have been omitted from these interim financial statements.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending March 31, 2007. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended March 31, 2006 included in the Company s Annual Report on Form 10-K.

Basis of Presentation: The consolidated financial statements include the accounts of CorVel and its subsidiaries. Significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates: The preparation of financial statements in conforming with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the accompanying financial statements. Actual results could differ from those estimates. Significant estimates include the allowance for doubtful accounts, accrual for bonuses, and accruals for self-insurance reserves.

Cash and Cash Equivalents: Cash and cash equivalents consists of short-term highly-liquid investments with maturities of 90 days or less when purchased. The carrying amounts of the Company s financial instruments approximate their fair values at March 31, 2006 and September 30, 2006.

Table of Contents

CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006 (Unaudited)

Note A Basis of Presentation and Summary of Significant Accounting Policies (continued)

Revenue Recognition: The Company s revenues are recognized primarily as services are rendered based on time and expenses incurred. A certain portion of the Company s revenues are derived from fee schedule auditing which is based on the number of provider charges audited and, to a limited extent, on a percentage of savings achieved for the Company s clients.

Accounts Receivable: The majority of the Company s accounts receivable are due from companies in the property and casualty insurance industries. Credit is extended based on evaluation of a customer s financial condition and, generally, collateral is not required. Accounts receivable are due within 30 days and are stated at amounts due from customers net of an allowance for doubtful accounts. Accounts outstanding longer than the contractual payment terms are considered past due. The Company determines its allowance by considering a number of factors, including the length of time trade accounts receivable are past due, the Company s previous loss history, the customer s current ability to pay its obligation to the Company and the condition of the general economy and the industry as a whole. The Company writes off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for doubtful accounts. No one customer accounted for 10% or more of accounts receivable during the three or six month periods ended September 30, 2005 and 2006. No customer accounted for 10% or more of revenue during either the six months ended September 30, 2005 or September 30, 2006.

Property and Equipment: Additions to property and equipment are recorded at cost. Depreciation and amortization are provided using the straight-line and accelerated methods over the estimated useful lives of the related assets, which range from three to seven years.

The Company capitalizes software development costs intended for internal use. The Company accounts for internally developed software costs in accordance with SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. These costs are included in computer software in property and equipment and are amortized over a period of five years.

Long-Lived Assets: The carrying amount of all long-lived assets is evaluated periodically to determine if adjustment to the depreciation and amortization period or to the unamortized balance is warranted. Such evaluation is based principally on the expected utilization of the long-lived assets and the projected, undiscounted cash flows of the operations in which the long-lived assets are deployed. No impairment of long-lived assets has been recognized in the financial statements.

Goodwill: Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*, became effective beginning in 2003, and, provides that goodwill, as well as identifiable intangible assets with indefinite lives, should not be amortized. Accordingly, with the adoption of SFAS 142 on April 1, 2002, the Company discontinued the amortization of goodwill and indefinite-lived intangibles. Impairments are recognized when the expected future undiscounted cash flows derived from such assets are less than their carrying value. The Company measures any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. A loss in the value of an investment will be recognized when it is determined that the decline in value is other than temporary. No impairment of goodwill has been recognized in the financial statements.

Table of Contents

CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006 (Unaudited)

Note A Basis of Presentation and Summary of Significant Accounting Policies (continued)

Income Taxes: The Company provides for income taxes under the liability method. Deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities as measured by the enacted tax rates which are expected to be in effect when these differences reverse. Income tax expense is the tax payable for the period and the change during the period in net deferred tax assets and liabilities.

Earnings Per Share: Earnings per common share-basic is based on the weighted average number of common shares outstanding during the period. Earnings per common shares-diluted is based on the weighted average number of common shares and common share equivalents outstanding during the period. In calculating earnings per share, earnings are the same for the basic and diluted calculations. Weighted average shares outstanding increased for diluted earnings per share due to the effect of stock options.

Table of Contents

CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006 (Unaudited)

Note B Stock Based Compensation and Stock Options

Prior to the quarter ended June 30, 2006, the first quarter of fiscal year ending March 31, 2007, the Company accounted for its stock-based compensation under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25). Under APB 25, no stock option expense was reflected in net income because the Company grants stock options with an exercise price equal to the market price of the underlying common stock on the date of grant.

Effective April 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. (SFAS) 123 (revised 2004), *Share-Based Payment* (SFAS 123R), which requires the measurement and recognition of compensation expense for all share-based payment stock options based on estimated fair values and eliminates the intrinsic value-based method prescribed by APB 25.

The Company adopted SFAS 123R using the modified prospective transition method. Under this transition method, compensation expense is recognized over the applicable vesting periods for all stock options granted prior to, but not yet vested, as of March 31, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123. In accordance with the modified prospective transition method, the Company s consolidated financial statements for prior periods have not been restated to reflect the impact of SFAS 123R.

The Company has historically issued new shares to satisfy option exercises as opposed to issuing shares from treasury stock.

The table below shows the amounts recognized in the financial statements for the six months ended September 30, 2006 for stock-based compensation.

	Three months ended September 30, 2006	Six months ended September 30, 2006
Cost of revenue	$ 225,000	$ 465,000
General and administrative	60,000	120,000
Total cost of stock-based compensation included in income, before income tax	285,000	585,000
Amount of income tax benefit recognized	111,000	228,000
Amount charged against net income	$ 174,000	$ 357,000
Effect on diluted income per share	($.02)	($.04)

Table of Contents

CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006 (Unaudited)

Note B Stock Based Compensation and Stock Options (continued)

For purposes of pro forma disclosures under SFAS 123 for the three and six months ended September 30, 2005, the estimated fair of share-based awards was assumed to be amortized to expense over the vesting period of the award. There is no pro forma presentation for the three and six months ended September 30, 2006 as the Company adopted SFAS 123R as of April 1, 2006, as discussed above. The following table illustrates the effect on net income had the Company applied the fair value recognition provisions of SFAS 123, *Accounting for Stock-Based Compensation* (SFAS 123), as amended by SFAS 148, *Accounting for Stock-Based Compensation Transition and Disclosure* (SFAS 148) for the three and six months ended September 30, 2005 (in thousands):

	Three months ended September 30, 2005	Six months ended September 30, 2005
Net income	$2,211,000	$ 5,021,000
Deduct: Stock-based compensation cost, net of income taxes	(168,000)	(352,000)
Pro forma net income	$2,043,000	$ 4,669,000
Net income per share basic		
As reported	$ 0.22	$ 0.51
Pro forma	$ 0.21	$ 0.47
Net income per share diluted		
As reported	$ 0.22	$ 0.50
Pro forma	$ 0.21	$ 0.47

Table of Contents

CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006 (Unaudited)

Note B Stock Based Compensation and Stock Options (continued)

The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model with the assumptions included in the table below. The Company uses historical data among other factors to estimate the expected volatility, the expected option life, and the expected forfeiture rate. The risk-free rate is based on the interest rate paid on a U.S. Treasury issue with a term similar to the estimated life of the option. The weighted average expected option term for 2006 reflects the application of the simplified method defined in the Securities and Exchange Commission Staff Accounting Bulletin No. 107, which defines the life as the average of the contractual term of the options and the weighted average vesting period for all option tranches. Based upon the historical experience of options cancellations, the Company has estimated an annualized forfeiture rate of 6.6% for the three months ended September 30, 2006. Forfeiture rates will be adjusted over the requsite service period when actual forfeitures differ, or are expected to differ, from the estimate. The following assumptions were used to estimate the fair value of options granted during the three months ended September 30, 2005 and 2006 using the Black-Scholes option-pricing model:

	Three Months Ended September 30,	
	2005	2006
Risk-free interest rate	3.8%	4.9%
Expected volatility	38%	38%
Expected dividend yield	0.0	0.0%
Expected forfeiture rate	6.6%	6.6%
Expected weighted average life of option in years	4.7 years	4.8 years

Under the Company s Restated 1988 Omnibus Incentive Plan (formerly the Restated Executive Stock Option Plan), (the Plan) as amended, options for up to 6,455,000 shares of the Company s common stock may be granted at prices not less than 100% of the fair value of the Company s common stock on date of grant. Options granted under the Plan are non-statutory stock options, and options granted generally have a maximum life of five years. Options will generally become exercisable for 25% of the options shares one year from the date of grant and then ratably over the following 36 months, respectively. All options granted in the three and six months ended September 30, 2005 and 2006 were granted at fair market value and are non-statutory stock options.

Table of Contents

CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006 (Unaudited)

Note B Stock Based Compensation and Stock Options (continued)

Summarized information for all stock options for the three and six months ended September 30, 2005 and 2006 follows:

	Three months ended September 30, 2005		Three months ended September 30, 2006	
	Shares	Average Price	Shares	Average Price
Options outstanding, beginning	886,227	$ 25.89	960,433	$ 25.52
Options granted	63,950	23.58	44,850	27.13
Options exercised	(25,080)	16.81	(69,003)	25.58
Options cancelled	(32,231)	28.41	(26,703)	26.38
Options outstanding, ending	892,866	$ 26.02	909,577	$ 25.57

	Six months ended September 30, 2005		Six months ended September 30, 2006	
	Shares	Average Price	Shares	Average Price
Options outstanding, beginning	969,200	$ 25.29	848,117	$ 25.92
Options granted	97,850	22.43	238,400	24.02
Options exercised	(123,895)	17.51	(69,128)	25.57
Options cancelled	(50,289)	25.94	(107,812)	24.91
Options outstanding, ending	892,866	$ 26.02	909,577	$ 25.57

The following table summarizes the status of stock options outstanding and exercisable at September 30, 2006:

Range of Exercise Price	Number of Outstanding Options	Weighted Average Remaining Contractual Life	Outstanding Options Weighted Average Exercise Price	Exercisable Options Number of Exercisable Options	Exercisable Options Weighted Average Exercise Price
$10.21 to $22.14	252,748	3.48	$ 17.99	101,253	$ 15.50
$23.33 to $25.00	229,562	4.86	23.73	33,095	24.35
$25.71 to $31.24	255,379	3.30	28.50	168,159	29.27
$33.22 to $38.74	171,888	1.97	34.83	146,458	34.60

Total	909,577	3.49	$ 25.57	448,965	$27.54

Table of Contents

CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006 (Unaudited)

Note B Stock Based Compensation and Stock Options (continued)

A summary of the status for all outstanding options at March 31, 2006 and September 30, 2006, and changes during the quarter then ended is presented in the table below:

	Number of Options	Weighted Average Exercise Per Share	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value as of September 30, 2006
Options outstanding at March 31, 2006	848,117	$ 25.92		
Granted	238,400	24.02		
Exercised	(69,128)	25.57		
Cancelled forfeited	(7,603)	22.89		
Cancelled expired	(100,209)	25.07		
Ending outstanding	909,577	$ 25.57	3.49	$ 8,757,275
Ending vested and expected to vest	848,663	$ 25.73	0.94	$ 8,044,512
Ending exercisable	448,965	$ 27.54	2.44	$ 3,455,586

As of September 30, 2006, unrecognized compensation expense related to unvested stock options totaled approximately $2.8 million, which will be recognized over a weighted period of 2.2 years.

The weighted-average grant-date fair value of options granted during the three months ended September 30, 2005 and September 30, 2006, was $7.62 and $8.87, respectively.

Prior to the adoption of SFAS 123R, the Company presented the tax benefit of all tax deductions resulting for the exercise of stock options and restricted stock awards as operating activities in the Consolidated Statements of Cash Flows. SFAS 123R requires the benefits of tax deductions in excess of grant-date fair value be reported as a financing activity, rather than an operating activity.

Table of Contents

CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006 (Unaudited)

Note C Treasury Stock

The Company s Board of Directors approved the commencement of a share repurchase program in the fall of 1996. In June 2006, the Company s Board of Directors approved a 1,000,000 share expansion to its existing share repurchase program, increasing the total number of shares approved for repurchase over the life of the program to 8,100,000 shares from 7,100,000 shares. Since the commencement of the share repurchase program, the Company has spent $138 million to repurchase 7,256,442 shares of its common stock, equal to 44% of the outstanding common stock had there been no repurchases. The average price of these repurchases is $18.96 per share. During the quarter ended September 30, 2006, the Company repurchased 155,955 shares for $5.4 million. These purchases have been funded primarily from the net earnings of the Company, along with the proceeds from the exercise of common stock options. CorVel has 9,327,563 shares of common stock outstanding as of September 30, 2006, after reduction for the 7,256,442 shares in treasury.

Note D Weighted Average Shares and Net Income Per Share

Weighted average basic common and common equivalent shares decreased from 9,858,000 for the quarter ended September 30, 2005 to 9,415,000 for the quarter ended September 30, 2006. Weighted average diluted common and common equivalent shares decreased from 9,911,000 for the quarter ended September 30, 2005 to 9,486,000 for the quarter ended September 30, 2006. The net decrease in both of these weighted share calculations is due to the repurchase of common stock as noted above offset by an increase in shares outstanding due to the exercise of stock options in the Company s employee stock option plan.

Net income per common and common equivalent shares was computed by dividing net income by the weighted average number of common and common stock equivalents outstanding during the quarter. The calculations of the basic and diluted weighted shares for the three and six months ended September 30, 2005 and 2006, are as follows:

	Three months ended September 30,	
	2005	2006
Basic Income Per Share:		
Weighted average common shares outstanding	9,858,000	9,415,000
Net Income	$ 2,211,000	$ 4,823,000
Net Income per share	$ .22	$ 0.51

	Three months ended September 30,	
	2005	2006
Diluted Income Per Share:		
Weighted average common shares outstanding	9,858,000	9,415,000
Net effect of dilutive common stock options	53,000	71,000
Total common and common equivalent shares	9,911,000	9,486,000
Net Income	$ 2,211,000	$ 4,823,000

Net Income per share	$	.22	$	0.51

Table of Contents

CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006 (Unaudited)

Note D Weighted Average Shares and Net Income Per Share (continued)

	Six months ended September 30,	
	2005	2006
Basic Income Per Share:		
Weighted average common shares outstanding	9,909,000	9,416,000
Net Income	$ 5,021,000	$ 9,463,000
Net Income per share	$ .51	$ 1.00

	Six months ended September 30,	
	2005	2006
Diluted Income Per Share:		
Weighted average common shares outstanding	9,909,000	9,416,000
Net effect of dilutive common stock options	56,000	50,000
Total common and common equivalent shares	9,965,000	9,466,000
Net Income	$ 5,021,000	$ 9,463,000
Net Income per share	$ .50	$ 1.00

For the quarters ended September 30, 2005 and September 30, 2006, 444,081 and 465,209 anti-dilutive shares, respectively, have been excluded from the diluted weighted shares outstanding calculation.

Table of Contents

CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006 (Unaudited)

Note E Shareholder Rights Plan

During fiscal 1997, the Company s Board of Directors approved the adoption of a Shareholder Rights Plan. The Shareholder Rights Plan provides for a dividend distribution to CorVel stockholders of one preferred stock purchase right for each outstanding share of CorVel s common stock under certain circumstances. In April 2002, the Board of Directors of CorVel approved an amendment to the Company s existing shareholder rights agreement to extend the expiration date of the rights to February 10, 2012, increase the initial exercise price of each right to $118 and enable Fidelity Management & Research Company and its affiliates to purchase up to 18% of the shares of common stock of the Company without triggering the stockholder rights. The limitations under the stockholder rights agreement remain in effect for all other stockholders of the Company. The rights are designed to assure that all shareholders receive fair and equal treatment in the event of any proposed takeover of the Company and to encourage a potential acquirer to negotiate with the Board of Directors prior to attempting a takeover. The rights have an exercise price of $118 per right, subject to subsequent adjustment. The rights trade with the Company s common stock and will not be exercisable until the occurrence of certain takeover-related events.

Generally, the Shareholder Rights Plan provides that if a person or group acquires 15% or more of the Company s common stock without the approval of the Board, subject to certain exception, the holders of the rights, other than the acquiring person or group, would, under certain circumstances, have the right to purchase additional shares of the Company s common stock having a market value equal to two times the then-current exercise price of the right.

In addition, if the Company is thereafter merged into another entity, or if 50% or more of the Company s consolidated assets or earning power are sold, then the right will entitle its holder to buy common shares of the acquiring entity having a market value equal to two times the then-current exercise price of the right. The Company s Board of Directors may exchange or redeem the rights under certain conditions.

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Management s Discussion and Analysis of Financial Condition and Results of Operations may include certain forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including (without limitation) statements with respect to anticipated future operating and financial performance, growth and acquisition opportunities and other similar forecasts and statements of expectation. Words such as expects, anticipates, intends, plans, believes, se estimates and should , and variations of these words and similar expressions, are intended to identify these forward-looking statements. Forward-looking statements made by the Company and its management are based on estimates, projections, beliefs and assumptions of management at the time of such statements and are not guarantees of future performance.

The Company disclaims any obligations to update or revise any forward-looking statement based on the occurrence of future events, the receipt of new information or otherwise. Actual future performance, outcomes and results may differ materially from those expressed in forward-looking statements made by the Company and its management as a result of a number of risks, uncertainties and assumptions. Representative examples of these factors include (without limitation) general industry and economic conditions; cost of capital and capital requirements; competition from other managed care companies; the ability to expand certain areas of the Company s business; shifts in customer demands; the ability of the Company to produce market-competitive software; changes in operating expenses including employee wages, benefits and medical inflation; governmental and public policy changes; dependence on key personnel; possible litigation and legal liability in the course of operations; and the continued availability of financing in the amounts and at the terms necessary to support the Company s future business.

Overview

CorVel Corporation is an independent nationwide provider of medical cost containment and managed care services designed to address the escalating medical costs of workers compensation and auto policies. The Company s services are provided to insurance companies, third-party administrators (TPA s), and self-administered employers to assist them in managing the medical costs and monitoring the quality of care associated with healthcare claims.

Network Solutions Services

The Company s network solutions services are designed to reduce the price paid by its customers for medical services rendered in workers compensation cases, auto policies and, to a lesser extent, group health policies. The network solutions offered by the Company include automated medical fee auditing, preferred provider services, retrospective utilization review, independent medical examinations, MRI examinations, and inpatient bill review.

Patient Management Services

In addition to its network solutions services, the Company offers a range of patient management services, which involve working on a one-on-one basis with injured employees and their various healthcare professionals, employers and insurance company adjusters. The services are designed to monitor the medical necessity and appropriateness of healthcare services provided to workers compensation and other healthcare claimants and to expedite return to work. The Company offers these services on a stand-alone basis, or as an integrated component of its medical cost containment services.

Organizational Structure

The Company s management is structured geographically with regional vice-presidents who report to the President of the Company. Each of these regional vice-presidents is responsible for all services provided by the Company in his or her particular region and for the operating results of the Company in multiple states. These regional vice presidents have area and district managers who are also responsible for all services provided by the Company in their given area and district.

Business Enterprise Segments

We operate in one reportable operating segment, managed care. The Company s services are delivered to its customers through its local offices in each region and financial information for the Company s operations follows this service delivery model. All regions provide the Company s patient management and network solutions services. Statement of Financial Accounting Standards, or SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, establishes standards for the way that public business enterprises report information about operating segments in annual consolidated financial statements. The Company s internal financial reporting is segmented geographically, as discussed above, and managed on a geographic rather than service line basis, with virtually all of the Company s operating revenue generated within the United States.

Under SFAS 131, two or more operating segments may be aggregated into a single operating segment for financial reporting purposes if aggregation is consistent with the objective and basic principles of SFAS 131, if the segments have similar economic characteristics, and if the segments are similar in each of the following areas: 1) the nature of products and services, 2) the nature of the production processes; 3) the type or class of customer for their products and services; and 4) the methods used to distribute their products or provide their services. We believe each of the Company s regions meet these criteria as they provide the similar services to similar customers using similar methods of productions and similar methods to distribute their services.

Summary of Quarterly Results

The Company generated revenues of $67.3 million for the quarter ended September 30, 2006, an increase of $1.0 million or 1.5%, compared to revenues of $66.3 million for the quarter ended September 30, 2005.

The slight revenue increase reflects the challenging market conditions and there is no guarantee that the Company will either post revenue growth similar to the period from 1991 to 2003 or generate revenue increases. The decrease in the nation s manufacturing employment levels, which has helped lead to a decline in national workers compensation claims, considerable price competition in a flat-to-declining overall market, an increase in competition from both larger and smaller competitors, changes and the potential changes in state workers compensation and auto managed care laws which can reduce demand for the Company s services, have created an environment where revenue and margin growth is more difficult to attain and where revenue growth is less certain than historically experienced. Additionally, the Company s technology and preferred provider network competes against other companies, some of which have more resources available. Also, some customers may handle their managed care services in-house and may reduce the amount of services which are outsourced to managed care companies such as CorVel Corporation.

The Company s cost of revenues decreased by $4.5 million, from $55.5 million in the September 2005 quarter to $50.9 million in the June 2006 quarter, a decrease of 8.2%. This decrease was primarily due to the decrease in the Company s headcount from 2,787 at September 30, 2005 to 2,573 at September 30, 2006 due to a decrease in the volume of business along with greater efficiencies in the Company s field operations, primarily Network Solutions. The Company benefited from a mix shift of revenue from the lower margin patient management revenue to the higher margin network solutions revenue. Within network solutions, the Company benefited from a mix shift from the lower margin CareIQ services to the higher margin bill review, PPO, out-of-network bill review, and checkwriting. As a result of these factors, the Company s cost of revenues decreased due to a lower volume of business while revenues increased by a nominal amount.

The Company s general and administrative costs increased by 16.6% from $7.3 million in the September 30 2005 quarter to $8.5 million in the September 2006 quarter. This increase was primarily due to the increase in corporate governance costs under the Sarbanes-Oxley Act of 2002 and an increase in systems costs.

The Company s income tax expense increased by 123.2%, from $1.4 million in the September 2005 quarter to $3.1 million in the September 2006 quarter. The increase in income tax expense was primarily due to the

Table of Contents

aforementioned decrease in cost of revenues although revenues increased which resulted in an increase in income before income taxes.

Weighted diluted shares decreased from 9.9 million shares in the September 2005 quarter to 9.49 million shares in the September 2006 quarter, a decrease of 425,000 shares or 4.3%. This decrease was primarily due to the Company s repurchase of common shares during the September 2005 and December 2005 quarters.

Diluted earnings per share increased from $0.22 in the September 2005 quarter to $0.51 in the September 2006 quarter, an increase of $0.29 per share or 132%. The increase in diluted earnings per share was primarily due to the increase in the income before income taxes and the decrease in the weighted diluted shares.

Results of Operations

The Company derives its revenues from providing patient management and network solutions services to payors of workers compensation benefits, auto insurance claims and health insurance benefits. Patient management services include utilization review, medical case management, and vocational rehabilitation. Network solutions revenues include fee schedule auditing, hospital bill auditing, independent medical examinations, diagnostic imaging review services and preferred provider referral services. Network solutions has shown to be the stronger business over the past year as revenues have increased while patient management revenues have decreased. The percentages of revenues attributable to patient management and network solutions services for the quarters ended September 30, 2005 and 2006:

	September 30, 2005	September 30, 2006
Patient management services	43.2%	39.0%
Network solutions revenues	56.8%	61.0%

The following table sets forth, for the periods indicated, the dollars and the percentage of revenues represented by certain items reflected in the Company s consolidated income statements for the quarters ended September 30, 2005 and September 30, 2006. The Company s past operating results are not necessarily indicative of future operating results.

	3 months ended September 30, 2005	3 months ended September 30, 2006	Dollar Change	Percentage Change
Revenue	$66,343,000	$ 67,329,000	$ 986,000	1.5%
Cost of revenues	55,470,000	50,933,000	(4,537,000)	(8.2%)
Gross profit	10,873,000	16,396,000	5,523,000	50.8%
Gross profit percentage	16.4%	24.4%		
General and administrative	7,280,000	8,489,000	1,209,000	16.6%
General and administrative percentage	11.0%	12.6%		
Income before income tax provision	3,593,000	7,907,000	4,314,000	120.1%
Income before income tax provision percentage	5.4%	11.7%		
Income tax provision	1,382,000	3,084,000	1,702,000	123.2%
Net income	$ 2,211,000	$ 4,823,000	$ 2,612,000	118.1%
Weighted Shares				
Basic	9,858,000	9,415,000	(443,000)	(4.5%)
Diluted	9,911,000	9,486,000	(425,000)	(4.3%)
Earnings Per Share				
Basic	$ 0.22	$ 0.51	$ 0.29	131.8%
Diluted	$ 0.22	$ 0.51	$ 0.29	131.8%

Revenues

Change in revenue from the quarter ended September 2005 to the quarter ended September 2006

Revenues increased from $66.3 million for the three months ended September 30, 2005 to $67.3 million for the three months ended September 30, 2006, a increase of $1.0 million or 1.5%. The continued softness in the national labor market, especially the manufacturing sector of the economy, has caused a reduction in the overall claims volume and a reduction in case management and bill review volume offset by an increase in the revenue per bill due to an increase in savings per bill for the Company s customers. The Company s patient management revenues decreased $2.3 million or 8.0% from $28.6 million in the September 2005 quarter to $26.3 million in the September 2006 quarter. This decrease was primarily due to a decrease in case referral volume offset by a nominal increase in price. The number of the Company s case managers decreased from just over 870 at September 30, 2005 to approximately 770 at September 30, 2006. The Company s network solutions revenues increased from $37.7 million in the September 2005 quarter to $41.0 million in the September 2006 quarter an increase of $3.3 million or 8.8%. This increase was primarily due to an increase in the volume of out of network bills reviewed which generate greater revenue per bill and an increase in revenue per provider bill reviewed due to increased savings per bills for the Company s customers.

Table of Contents

The Company believes that referral volume in the patient management services and bill review volume in network solutions will continue to reflect just nominal growth until there is a growth in the number of work related injuries and workers compensation related claims.

Cost of Revenues

The Company s cost of revenues consist of direct expenses, costs directly attributable to the generation of revenue, and field indirect costs which are incurred in the field offices of the Company. Direct costs are primarily case manager salaries, bill review analysts, related payroll taxes and fringe benefits, and costs for IME (independent medical examination) and MRI providers. Most of the Company s revenues are generated in offices which provide both patient management services and network solutions services. The largest of the field indirect costs are manager salaries and bonus, account executive base pay and commissions, administrative and clerical support, field systems personnel, PPO network developers, related payroll taxes and fringe benefits, office rent, and telephone expense. Approximately 42% of the costs incurred in the field are field indirect costs which support both the patient management services and network solutions operations of the Company s field operations.

Change in cost of revenue from the September 2005 quarter to the September 2006 quarter

The Company s costs of revenues decreased from $55.5 million in the quarter ended September 30, 2005 to $50.9 million in the quarter ended September 30, 2006, a decrease of $4.5 million or 8.2%. The Company s cost of revenues decreased while the revenue increased by 1.5% as compared to the same quarter of the prior year. Most of the decrease in cost of revenues was due to a shift in the mix of the business from the lower margin patient management business to the higher margin network solutions business. With the network solutions business, the Company benefited from a revenue mix shift from the lower margin CareIQ services to the higher margin bill review, and out of network bill review services. Most of the decrease in the cost of revenues was a decrease in professional salaries by $1.7 million, from $15.2 million in the September 2005 quarter to $13.5 million in the September 2006 quarter. This decrease was primarily attributable to a decrease in the number of case managers noted above. Additionally, the provider costs for the Company s CareIQ services decreased as the volume of activity decreased. The Company improved its operating productivity in both its patient management and network solutions lines of business.

General and Administrative Costs

Change in cost of general and administrative expense from the September 2005 quarter to the September 2006 quarter

For the quarter ended September 30, 2006, general and administrative costs consisted of approximately 53% of corporate systems costs which include the corporate systems support, implementation and training, amortization of software development costs, depreciation of the hardware costs in the Company s national systems, the Company s national wide area network and other systems related costs. The remaining 47% of the general and administrative costs consist of national marketing, national sales support, corporate legal, corporate insurance, human resources, accounting, product management, new business development and other general corporate matters. Approximately 30% of the non-systems portion of general and administrative costs during the September 2006 quarter pertained to the costs of corporate governance for compliance under the Sarbanes-Oxley Act of 2002.

General and administrative costs for the quarter increased from $7.3 million for the quarter ended September 30, 2005 to $8.5 million in the quarter ended September 30, 2006, an increase of $1.2 million or 16.6%. This increase is primarily due to the increase in the costs of managing the Company s systems efforts and an increase in corporate governance costs related to compliance with the Sarbanes Oxley Act.

Table of Contents

Results of Operations for the Six Months Ended September 30, 2005 and 2006

The following table sets forth, for the periods indicated, the dollars and the percentage of revenues represented by certain items reflected in the Company s consolidated income statements for the six months ended September 30, 2005 and September 30, 2006. The Company s past operating results are not necessarily indicative of future operating results.

	6 mo. ended Sept. 30, 2005	6 mo. ended Sept. 30, 2006	Dollar Change	Percentage Change
Revenue	$137,010,000	$137,091,000	$ 81,000	0.1%
Cost of revenues	114,133,000	104,368,000	(9,765,000)	(8.6%)
Gross profit	22,877,000	32,723,000	9,846,000	43.0%
Gross profit percentage	16.7%	23.9%		
General and administrative	14,714,000	17,209,000	2,495,000	17.0%
General and administrative percentage	10.7%	12.6%		
Income before income tax provision	8,163,000	15,514,000	7,351,000	90.1%
Income before income tax provision percentage	6.0%	11.3%		
Income tax provision	3,142,000	6,051,000	2,909,000	92.6%
Net income	$ 5,021,000	$ 9,463,000	$ 4,442,000	88.5%
Weighted Shares				
Basic	9,909,000	9,416,000	(493,000)	(5.0%)
Diluted	9,965,000	9,466,000	(499,000)	(5.0%)
Earnings Per Share				
Basic	$ 0.51	$ 1.00	$ 0.50	98.0%
Diluted	$ 0.50	$ 1.00	$ 0.50	100.0%

Revenues

Change in revenue from the six months ended September 2005 to the six months ended September 2006.

Revenues increased from $137.0 million for the six months ended September 30, 2005 to $137.1 million for the six months ended September 30, 2006, a increase of $0.1 million or 0.1%. As noted above in the revenue comparison for the three months ended September 30, 2005 as compared to the three months ended September 30, 2006, the continued softness in the national labor market, especially the manufacturing sector of the economy, has caused a reduction in the overall claims volume and a reduction case management and bill review volume offset by an increase in the revenue per bill due to an increase in savings per bill The Company s patient management revenues decreased $5.7 million or 9.7% from $59.4 million in the six months ended September 2005 to $53.6 million in the six months ended September 2006. This decrease was primarily due to a decrease in case referral volume offset by a nominal increase in price. The number of the Company s case managers decreased from just over 870 at September 30, 2005 to approximately 770 at September 30, 2006. The Company s network solutions revenues increased from $77.6 million in the six months ended September 2005 quarter to $83.5 million in the six months ended September 2006, an increase of $5.8 million or 7.5%. This increase was primarily due to an increase the volume of out of network bills reviewed which generate greater revenue per bill and an increase in revenue per provider bill reviewed due to increased savings per bills for the Company s customers offset by a decrease in the volume of CareIQ services performed (independent medical examinations and MRI s).

Table of Contents

Cost of Revenues

Change in cost of revenue from the six months ended September 2005 to the six months ended September 2006

The Company s costs of revenues decreased from $114.1 million in the six months ended September 30, 2005 to $104.4 million in the six months ended September 30, 2006, a decrease of $9.8 million or 8.6%. The Company s cost of revenues decreased while the revenue increased by 0.1% as compared to the same quarter of the prior year. Most of the decrease in cost of revenues was due to a shift in the mix of the business from the lower margin patient management business to the higher margin network solutions business. With the network solutions business, the Company benefited from a revenue mix shift from the lower margin CareIQ services to the higher margin bill review, and out-of-network bill review services. Most of the decrease in the cost of revenues was a decrease in professional salaries by $3.7 million, from $31.5 million for the six months ended September 2005 to $27.8 million for the six months ended September 2006. This decrease was primarily attributable to a decrease in the number of case managers noted above. Additionally, the provider costs for the Company s CareIQ services decreased as the volume of activity decreased.

General and Administrative Costs

Change in general and administrative expense from the six months ended September 2005 to the six months ended September 2006

General and administrative costs increased from $14.7 million for the six months ended September 30, 2005 to $17.2 million in the six months ended September 30, 2006, an increase of $2.5 million or 17.0%. This increase is primarily due to the increase in the cost of corporate governance and compliance with the Sarbanes Oxley act and the related internal controls documentation, testing and auditing. Additionally, the Company incurred greater costs to manage the computer systems.

Income Tax Provision

The Company s income tax expense increased from $1.4 million for the three months ended September 30, 2005 to $3.1 million for the three months ended September 30, 2006 due to the increase in income before income taxes from $3.6 million to $7.9 million for the same periods, respectively. The income tax expense as a percentage of income before income taxes was 38.5% for the three months ended September 30, 2005 and 39.0% for the three months ended September 30, 2006. The Company s income tax expense increased from $3.1 million for the six months ended September 30, 2005 to $6.1 million for the six months ended September 30, 2006 due to the increase in income before income taxes from $8.2 million to $15.5 million for the same periods, respectively. The income tax expense as a percentage of income before income taxes was 38.5% for the three months ended September 30, 2005 and 39.0% for the three months ended September 30, 2006. The income tax provision rates were based upon management s review of the Company s estimated annual income tax rate, including state taxes. This effective tax rate differed from the statutory federal tax rate of 35.0% primarily due to state income taxes and certain non-deductible expenses.

Table of Contents

Liquidity and Capital Resources

The Company has historically funded its operations and capital expenditures primarily from cash flow from operations, and to a lesser extent, option exercises. Net working capital increased from $35 million as of March 31, 2006 to $43 million as of September 30, 2006, primarily due to an increase in cash from $14 million as of March 31, 2006 to $22 million as of September 30, 2006. This increase in working capital is due primarily to the net income of $9.5 million during the six months ended September 2006.

The Company believes that cash from operations, and funds from exercise of stock options granted to employees are adequate to fund existing obligations, repurchase shares of the Company s common stock, introduce new services, and continue to develop healthcare related businesses. The Company regularly evaluates cash requirements for current operations and commitments, and for capital acquisitions and other strategic transactions. The Company may elect to raise additional funds for these purposes, either through debt or additional equity, the sale of investment securities or otherwise, as appropriate.

As of September 30, 2006 the Company had $22 million in cash and cash equivalents, invested primarily in short-term, highly liquid investments with maturities of 90 days or less in a federally regulated bank.

The Company has historically required substantial capital to fund the growth of its operations, particularly working capital to fund the growth in accounts receivable and capital expenditures. The Company believes, however, that the cash balance at September 30, 2006 along with anticipated internally generated funds and the available line of credit would be sufficient to meet the Company s expected cash requirements for at least the next twelve months.

Operating Cash Flows

Six months ended September 30, 2005 compared to six months ended September 30, 2006

Net cash provided by operating activities was $13.2 million in the six months ended September 30, 2005 compared to $14.9 million in the six months ended September 30, 2006. The increase in the cash flow from operating activities was primarily due to the increase in net income from $5.0 million for the six months ended September 30, 2005 to $9.5 million for the six months ended September 30, 2006. The increase in net income was offset by an increase in accounts receivable from March 31, 2006 to September 30, 2006.

Investing Activities

Six months ended September 30, 2005 compared to six months ended September 30, 2006

Net cash flow used in investing activities decreased from $4.9 million in the six months ended September 30, 2005 to $3.0 million in the six months ended September 30, 2006. This decrease in net cash used in investing activity is primarily due to the Company s reduction in capital expenditures due to lack of revenue growth, more centralization of the computer processing and greater efficiencies in operations which require less additional investment in capital assets.

Table of Contents

Financing Activities

Six months ended September 30, 2005 compared to six months ended September 30, 2006

Net cash flow used in financing activities decreased from $10.1 million for the six months ended September 30, 2005 to $4.1 million for the six months ended September 30, 2006. The primary reason for the decrease in cash flow used in financing activities was due to a decrease in the amount spent to repurchase shares of the Company s common stock from the six months ended September 30, 2005 to the six months ended September 30, 2006. During the six months ended September 2005, the Company spent $12.7 million in repurchases of 532,205 shares of its common stock. During the six months ended September 30, 2006, the Company spent $5.4 million to repurchase 155,955 shares of its common stock. The Company s Board of Directors had previously authorized the repurchase of 7,100,000 shares of its common stock which was attained in the December 2006 quarter. In June 2006, the Board of Directors increased the number of shares authorized to be repurchased over the life of the repurchase program by an additional 1,000,000 shares to 8,100,000 shares. The Company has historically used cash provided by operating activities and from the exercise of stock options to repurchase stock. The Company may use some of the $22 million of cash on the balance sheet at September 30, 2006 to repurchase additional shares of stock. The cost of the stock repurchases was offset by cash generated from the option proceeds on option exercises.

The following table summarizes the Company s contractual obligations outstanding as of September 30, 2006.

			Payments Due by Period		
	Total	Less Than One Year	Between Two and Three Years	Between Four and Five Years	More than Five Years
Operating leases	$27,463,000	$9,977,000	$12,950,000	$4,044,000	$492,000

Off-Balance Sheet Arrangements

As of September 30, 2006, we did not have any off-balance-sheet arrangements, as defined in Item 303(a)(4)(ii) of Regulation S-K promulgated by the SEC.

Critical Accounting Policies

The SEC defines critical accounting policies as those that require application of management s most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods.

The following is not intended to be a comprehensive list of our accounting policies. Our significant accounting policies are more fully described in Note A to the Consolidated Financial Statements. In many cases, the accounting treatment of a particular transaction is specifically dictated by accounting principles generally accepted in the United States of America, with no need for management s judgment in their application. There are also areas in which management s judgment in selecting an available alternative would not produce a materially different result.

We have identified the following accounting policies as critical to us: 1) revenue recognition, 2) allowance for uncollectible accounts, 3) valuation of long-lived assets, 4) accrual for self-insured costs, and 5) accounting for income taxes.

Revenue Recognition: The Company s revenues are recognized primarily as services are rendered based on time and expenses incurred. A certain portion of the Company s revenues are derived from fee schedule auditing which is based on the number of provider charges audited and, to a lesser extent, on a percentage of savings achieved for the Company s clients.

Table of Contents

Allowance for Uncollectible Accounts: The Company determines its allowance by considering a number of factors, including the length of time trade accounts receivable are past due, the Company s previous loss history, the customers current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. The Company writes off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for doubtful accounts. No one customer accounted for 10% or more of accounts receivable at any of the fiscal years ended March 31, 2004, 2005, and 2006 and September 30, 2006.

Valuation of Long-lived Assets: We assess the impairment of identifiable intangibles, property, plant and equipment, goodwill and investments whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

- significant underperformance relative to expected historical or projected future operating results;
- significant changes in the manner of our use of the acquired assets or the strategy for our overall business;
- significant negative industry or economic trends;
- significant decline in our stock price for a sustained period; and
- our market capitalization relative to net book value.

When we determine that the carrying value of intangibles, long-lived assets and related goodwill may not be recoverable based upon the existence of one or more of the above indicators of impairment, impairments are recognized when the expected future undiscounted cash flows derived from such assets are less than their carrying value, except for investments. We generally measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. A loss in the value of an investment will be recognized when it is determined that the decline in value is other than temporary. No impairment of long-lived assets has been recognized in the financial statements.

Accrual for Self-insurance Costs: The Company self-insures for the group medical costs and workers compensation costs of its employees. The Company purchases stop loss insurance for large claims. Management believes that the self-insurance reserves are appropriate; however, actual claims costs may differ from the original estimates requiring adjustments to the reserves. The Company determines its estimated self-insurance reserves based upon historical trends along with outstanding claims information provided by its claims paying agents.

Accounting for Income Taxes: As part of the process of preparing our consolidated financial statements we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves us estimating our actual current tax expense together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance. If the Company was to establish a valuation allowance or increase this allowance in a period, the Company must include an expense within the tax provision in the consolidated statement of income. Significant management judgment is required in determining our provision for income taxes and our deferred tax assets and liabilities.

Table of Contents

Recently Issued Accounting Standards

In May 2005, the Financial Accounting Standards Board (FASB) issued FAS No. 154, Accounting Changes and Error Corrections (FAS 154). SFAS No. 154 is a replacement of APB No. 20 and SFAS No. 3. SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application as the required method for reporting a change in accounting principle. SFAS No. 154 provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. SFAS No. 154 also addresses the reporting of a correction of an error by restating previously issued financial statements. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 did not have a material impact on the Company s financial statements.

In March 2005, the FASB issued FASB Interpretation No. (FIN) 47, Accounting for Conditional Asset Retirement Obligations, which is effective for fiscal years ending after December 15, 2005. The interpretation requires a conditional asset retirement obligation to be recognized when the fair value of the liability can be reasonably estimated. The interpretation did not have a material impact on the Company s financial statements.

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes, which defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. A tax position that meets the more-likely-than-not criterion shall be measured at the largest amount of benefit that is more than 50% likely of being realized upon ultimate settlement. Interpretation No. 48 applies to all tax positions accounted for under SFAS No. 109, Accounting for Income Taxes. Interpretation No. 48 is effective for fiscal years beginning after December 15, 2006. Upon adoption, we will adjust our financial statements to reflect only those tax positions that are more-likely-than-not to be sustained as of the adoption date. Any adjustment will be recorded directly to our beginning retained earnings balance in the period of adoption and reported as a change in accounting principle. The Company is currently analyzing the effects of adopting Interpretation No. 48.

Item 3 Quantitative and Qualitative Disclosures About Market Risk -

As of September 30, 2006, the Company held no market risk sensitive instruments for trading purposes, and the Company did not employ any derivative financial instruments, other financial instruments, or derivative commodity instruments to hedge any market risk. The Company had no debt outstanding as of September 30, 2006.

Item 4 Controls and Procedures -

Evaluation of Disclosure Controls and Procedures

CorVel s management, with the participation of CorVel s Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of CorVel s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were not effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported, within the time periods specified in the rules and forms of the Securities and Exchange Commission and (ii) accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Our management assessed the effectiveness of our internal control over financial reporting as of March 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control Integrated Framework (COSO). Based on our assessment, we believe that, as of March 31, 2006, our internal control over financial reporting was ineffective based on those criteria, in consideration of the material weaknesses described below.

Inadequate resources. CorVel did not maintain a sufficient complement of personnel with an appropriate level of accounting knowledge, experience and training to: (i) ensure the preparation of interim and annual financial statements in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP), (ii) effectively execute the principal control activities noted below, and (iii) remediate previously communicated deficiencies. The Company s finance and accounting structure also did not support appropriate lines of authority, reporting, and accountability to achieve desired reliable financial reporting controls. In addition, the Company placed substantial reliance on manual procedures and detective controls that lacked adequate management monitoring for compliance.

Control environment. We did not maintain an effective control environment. Specifically, we did not maintain: (i) a documented risk assessment process that adequately addresses COSO objectives, including strategic plans, budgets and clearly defined and communicated goals and objectives aligned with the assessment (ii) sufficient anti-fraud controls, such as the whistleblower program, communications, and training employees and the Board regarding fraud, (iii) adequate monitoring of existing controls over financial reporting and individual and corporate performance against expectations, (iv) appropriate human resource policies, such as background investigations and consistent performance reviews for key personnel, and (v) adequate documentation of actions taken by the Board regarding: fraud oversight, review and approval of external financial statements, actions supporting the Board independence and executive performance and compensation (including stock options, compliance with respective Board charters, and remediation of prior internal control weaknesses).

Revenue and receivables reporting. Effective controls related to revenue and receivables reporting were not maintained. Specifically, controls were not properly designed or operating effectively to ensure: (i) adequate documentation of customer agreements, (ii) proper cutoff of revenue at month end, (iii) consistent evaluation of customer credit worthiness, (iv) complete and timely reviews of revenue entries, write-offs, and sales adjustments, (v) all receivable and allowance accounts are appropriately analyzed, (vi) the timely posting of all cash receipts, (vii) completed transactions were appropriately offset or reclassified via journal entries in a timely manner.

Segregation of duties. Effective controls related to segregation of duties and restrictions on access to systems, financial applications and data were not maintained. The segregation of duties and systems access deficiencies affect financial reporting, payroll master and processing files, expenditure, fixed assets, revenue, and treasury controls. Specifically, management identified instances where various employees are responsible for custody, initiating, recording, and/or approving transactions thereby creating segregation of duties conflicts.

Inadequate controls over accounts payable and other accruals. We did not maintain adequate controls over expense recognition through accounts payable and accrual procedures and systems. Out-of-period invoices were not specifically identified and accrued through accounts payable and accrued expense processes to ensure an accurate cutoff and proper matching of revenues and expenses. Accruals related to salaries and wages, bonuses, workers compensation, rebates, professional fees, and PPO expenses were not properly identified and recorded. Specifically, there was no consistent verification of: (i) completeness of supporting documents, (ii) review and approval of supporting documents by appropriate personnel, and (iii) completeness and accuracy of month-end accruals.

Expenditure review and approval. Effective controls related to expenditure processing were not maintained. Specifically, controls were not properly designed or operating effectively to ensure: (i) payroll and benefit entries are reviewed and approved, (ii) accounts payable entries were reviewed and (iii) capital asset transactions are properly approved and recorded. In addition, controls over vendor master access and change monitoring were inadequate.

Period-end financial reporting processes. Effective controls over period-end financial reporting processes were not maintained to effectively ensure: (i) the security and validity of data transfers between financial applications, including consolidation and associated spreadsheets, (ii) key reconciliations, account analyses, and summaries are performed and approved with appropriate resolution of reconciling items, (iii) journal entries, both

Table of Contents

recurring and non-recurring, are approved, (iv) the resulting financial information, statements and disclosures are reviewed and appropriate checklists are used for compliance with U.S. GAAP, (v) monthly closing checklists were used consistently and thoroughly to ensure all financial reporting procedures and controls were performed, and (vi) documented reviews of financial results are compared to budgets and expectations. In some cases, inaccurate or incomplete account analyses, account summaries and account reconciliations were prepared during the financial close and reporting process in the areas of cash, accounts receivable, fixed assets, and accruals.

Accounting for income taxes. Effective controls over the accounting for income taxes were not maintained. Specifically, controls were not designed and in place to ensure that: (i) temporary and permanent book to tax differences are properly identified, (ii) deferred tax assets are recoverable, (iii) all tax-related accounts, including the income tax provision rate and pre-tax income, are properly reconciled to