MOLINA HEALTHCARE INC
Form 10-Q
November 04, 2010

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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, 2010

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: 001-31719

Molina Healthcare, Inc.
(Exact name of registrant as specified in its charter)

Delaware	**13-4204626**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
200 Oceangate, Suite 100 Long Beach, California	**90802**
(Address of principal executive offices)	*(Zip Code)*

(562) 435-3666
(Registrant s telephone number, including area code)

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company 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 of the issuer s Common Stock, par value $0.001 per share, outstanding as of October 29, 2010, was approximately 30,239,000.

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Part I Financial Information

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PART I FINANCIAL INFORMATION

Item 1: ***Financial Statements.***

MOLINA HEALTHCARE, INC.
CONSOLIDATED BALANCE SHEETS

	September 30, 2010	December 31, 2009
	(Amounts in thousands, except per-share data)	
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 426,455	$ 469,501
Investments	195,358	174,844
Receivables	225,547	136,654
Income and related taxes refundable	2,755	6,067
Deferred income taxes	7,580	8,757
Prepaid expenses and other current assets	25,185	15,583
Total current assets	882,880	811,406
Property and equipment, net	91,826	78,171
Deferred contract costs	20,255	
Intangible assets, net	115,270	80,846
Goodwill and indefinite-lived intangible assets	213,261	133,408
Investments	20,294	59,687
Restricted investments	45,047	36,274
Receivable for ceded life and annuity contracts	25,134	25,455
Other assets	17,463	19,988
	$ 1,431,430	$ 1,245,235
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Medical claims and benefits payable	$ 355,140	$ 316,516
Accounts payable and accrued liabilities	117,299	71,732
Deferred revenue	37,648	101,985
Total current liabilities	510,087	490,233
Long-term debt	162,700	158,900
Deferred income taxes	16,773	12,506
Liability for ceded life and annuity contracts	25,134	25,455
Other long-term liabilities	19,004	15,403
Total liabilities	733,698	702,497
Stockholders equity:		
	30	26

Common stock, $0.001 par value; 80,000 shares authorized; outstanding: 30,207 shares at September 30, 2010 and 25,607 shares at December 31, 2009		
Preferred stock, $0.001 par value; 20,000 shares authorized, no shares issued and outstanding		
Additional paid-in capital	247,845	129,902
Accumulated other comprehensive loss	(2,107)	(1,812)
Retained earnings	451,964	414,622
Total stockholders equity	697,732	542,738
	$ 1,431,430	$ 1,245,235

See accompanying notes.

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MOLINA HEALTHCARE, INC.
CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
	(Amounts in thousands, except net income per share) (Unaudited)			
Revenue:				
Premium revenue	$ 1,005,115	$ 914,805	$ 2,947,020	$ 2,697,796
Service revenue	32,271		53,325	
Investment income	1,760	1,707	4,880	7,336
Total revenue	1,039,146	916,512	3,005,225	2,705,132
Expenses:				
Medical care costs	845,937	792,771	2,508,366	2,333,865
Cost of service revenue	27,605		41,859	
General and administrative expenses	88,660	68,563	245,619	198,981
Premium tax expenses	35,037	30,257	104,578	87,612
Depreciation and amortization	11,954	9,832	33,234	28,468
Total expenses	1,009,193	901,423	2,933,656	2,648,926
Gain on retirement of convertible senior notes				1,532
Operating income	29,953	15,089	71,569	57,738
Interest expense	(4,600)	(3,279)	(12,056)	(9,917)
Income before income taxes	25,353	11,810	59,513	47,821
Provision for income taxes	9,180	3,246	22,171	12,481
Net income	$ 16,173	$ 8,564	$ 37,342	$ 35,340
Net income per share:				
Basic	$ 0.58	$ 0.34	$ 1.41	$ 1.36
Diluted	$ 0.57	$ 0.33	$ 1.39	$ 1.36
Weighted average shares outstanding:				
Basic	28,118	25,539	26,511	25,944
Diluted	28,363	25,630	26,802	26,058

See accompanying notes.

MOLINA HEALTHCARE, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
	(Amounts in thousands) (Unaudited)			
Net income	$ 16,173	$ 8,564	$ 37,342	$ 35,340
Other comprehensive income, net of tax:				
Unrealized (loss) gain on investments	(68)	37	(295)	645
Other comprehensive (loss) income	(68)	37	(295)	645
Comprehensive income	$ 16,105	$ 8,601	$ 37,047	$ 35,985

See accompanying notes.

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MOLINA HEALTHCARE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
	(Amounts in thousands) (Unaudited)	
Operating activities:		
Net income	$ 37,342	$ 35,340
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	40,485	28,468
Unrealized gain on trading securities	(4,170)	(3,509)
Loss on rights agreement	3,807	3,204
Deferred income taxes	4,463	2,322
Stock-based compensation	7,268	5,730
Non-cash interest on convertible senior notes	3,800	3,563
Gain on repurchase and retirement of convertible senior notes		(1,532)
Amortization of deferred financing costs	1,278	1,040
Tax deficiency from employee stock compensation recorded as additional paid-in capital	(676)	(704)
Changes in operating assets and liabilities:		
Receivables	(64,896)	(15,567)
Prepaid expenses and other current assets	(8,307)	454
Medical claims and benefits payable	33,947	10,672
Accounts payable and accrued liabilities	15,131	(6,140)
Deferred revenue	(64,337)	61,381
Income taxes	3,327	5,561
Net cash provided by operating activities	8,462	130,283
Investing activities:		
Purchases of equipment	(31,918)	(28,390)
Purchases of investments	(162,620)	(127,335)
Sales and maturities of investments	185,193	149,770
Net cash paid in business combinations	(127,231)	(10,900)
Increase in deferred contract costs	(20,616)	
Increase in restricted investments	(8,513)	(4,198)
Increase in other assets	(389)	(1,877)
Increase (decrease) in other long-term liabilities	2,729	(8,788)
Net cash used in investing activities	(163,365)	(31,718)
Financing activities:		
Amount borrowed under credit facility	105,000	
Proceeds from common stock offering, net of underwriting discount	111,578	
Repayment of amount borrowed under credit facility	(105,000)	

Treasury stock purchases		(27,712)
Purchase of convertible senior notes		(9,653)
Credit facility fees paid	(1,671)	
Equity offering costs paid	(332)	
Proceeds from employee stock plans	1,862	1,081
Excess tax benefits from employee stock compensation	420	26
Net cash provided by (used in) financing activities	111,857	(36,258)
Net (decrease) increase in cash and cash equivalents	(43,046)	62,307
Cash and cash equivalents at beginning of period	469,501	387,162
Cash and cash equivalents at end of period	$ 426,455	$ 449,469

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MOLINA HEALTHCARE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

	Nine Months Ended September 30, 2010		Nine Months Ended September 30, 2009	
	(Amounts in thousands) (Unaudited)			
Supplemental cash flow information:				
Cash paid during the period for:				
Income taxes	$	12,129	$	16,305
Interest	$	7,175	$	4,254
Schedule of non-cash investing and financing activities:				
Unrealized (loss) gain on investments	$	(476)	$	936
Deferred taxes		181		(291)
Net unrealized (loss) gain on investments	$	(295)	$	645
Accrued purchases of equipment	$	632	$	366
Retirement of common stock used for stock-based compensation	$	2,173	$	920
Retirement of treasury stock	$		$	48,102
Details of business combinations:				
Fair value of assets acquired	$	(161,862)	$	(30,600)
Fair value of liabilities assumed		25,880		
Release of deposit				9,000
Payable to seller		8,751		10,700
Net cash paid in business combinations	$	(127,231)	$	(10,900)

See accompanying notes.

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MOLINA HEALTHCARE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
September 30, 2010

1. Basis of Presentation

Organization and Operations

Molina Healthcare, Inc. provides quality and cost-effective Medicaid-related solutions to meet the health care needs of low-income families and individuals and to assist state agencies in their administration of the Medicaid program. Our licensed health plans in California, Florida, Michigan, Missouri, New Mexico, Ohio, Texas, Utah, Washington, and Wisconsin currently serve approximately 1.6 million members eligible for Medicaid, Medicare, and other government-sponsored health care programs for low-income families and individuals. The health plans are locally operated by our respective wholly owned subsidiaries in those states, each of which is licensed as a health maintenance organization, or HMO. Effective January 1, 2010, we terminated operations at our small Medicare health plan in Nevada. Our subsidiary, Molina Medicaid Solutions, provides business processing and information technology administrative services to Medicaid agencies in Idaho, Louisiana, Maine, New Jersey, and West Virginia, and drug rebate administration services in Florida.

On September 1, 2010, we acquired Abri Health Plan, a Medicaid managed care organization based in Milwaukee, Wisconsin. As of September 30, 2010, Abri Health Plan served approximately 28,000 Medicaid members. See Note 3, Business Combinations, for more information relating to this acquisition.

On May 1, 2010, we acquired a health information management business which now operates under the name, *Molina Medicaid Solutions*^{SM}. Molina Medicaid Solutions provides design, development, implementation, and business process outsourcing solutions to state governments for their Medicaid Management Information Systems, or MMIS. MMIS is a core tool used to support the administration of state Medicaid and other health care entitlement programs. See Note 3, Business Combinations, for more information relating to this acquisition.

Consolidation and Interim Financial Information

The consolidated financial statements include the accounts of Molina Healthcare, Inc. and all majority owned subsidiaries. In the opinion of management, all adjustments considered necessary for a fair presentation of the results as of the date and for the interim periods presented have been included. Except as described below under Reclassifications, such adjustments consist of normal recurring adjustments. All significant intercompany balances and transactions have been eliminated in consolidation. The consolidated results of operations for the current interim period are not necessarily indicative of the results for the entire year ending December 31, 2010. Financial information related to subsidiaries acquired during any year is included only for periods subsequent to their acquisition.

The unaudited consolidated interim financial statements have been prepared under the assumption that users of the interim financial data have either read or have access to our audited consolidated financial statements for the fiscal year ended December 31, 2009. Accordingly, certain disclosures that would substantially duplicate the disclosures contained in the December 31, 2009 audited consolidated financial statements have been omitted. These unaudited consolidated interim financial statements should be read in conjunction with our December 31, 2009 audited financial statements.

Reclassifications

Effective January 1, 2010, we have recorded the Michigan modified gross receipts tax as a premium tax and not as an income tax. For the three month and nine month periods ended September 30, 2009, amounts for premium tax expense and income tax expense have been reclassified to conform to this presentation. See Note 2, Significant Accounting Policies.

In prior periods, general and administrative expenses have included premium tax expenses. Beginning in the second quarter of 2010, we have reported premium tax expenses on a separate line in the accompanying consolidated statements of income. Prior periods have been reclassified to conform to this presentation.

2. Significant Accounting Policies

Molina Medicaid Solutions Segment Revenue Recognition and Deferred Contract Costs

As a result of our recent acquisition of Molina Medicaid Solutions, we report on the results of our operations using two business segments. The Molina Medicaid Solutions segment derives its revenue from service arrangements. This segment provides technology solutions to state Medicaid programs that include system development, system integration, and technology outsourcing services. In addition, this segment offers business process outsourcing to state Medicaid agencies that handle key administrative functions such as claims processing, provider enrollment, pharmacy drug rebate services, recipient eligibility management, and pre-authorization services. The following is an update of our accounting policies on revenue recognition, as included in our December 31, 2009 audited financial statements, which specifically addresses revenue recognition for service arrangements.

Under certain of the contracts we acquired, the development of the MMIS solution has already been completed. Under these contracts, we provide business process outsourcing and technology outsourcing services, and recognize outsourcing services revenue on a straight-line basis over the remaining term of the contract.

For fixed-price contracts where the system design and development phase was in process as of the acquisition date, we apply contract accounting because we will deliver significantly modified and customized MMIS software to the customer under the terms of the contract. Additionally, these contracts contain multiple deliverables; once the system design and development phase is complete, we provide technology outsourcing services and business process outsourcing. We do not have vendor specific objective evidence of the fair value of the technology outsourcing and business process outsourcing components of the contracts because we do not have history of offering these services on a stand-alone basis. As such, we account for these fixed-price service contracts as a single element.

Therefore, in general, we recognize contract revenues as a single element ratably over the performance period, or contract term, of the outsourcing services because these are the last elements to be delivered under the contract. Such contract terms typically range from five to 10 years. In those service arrangements where final acceptance of a system or solution by the customer is required, contract revenues and costs are deferred until all material acceptance criteria have been met. Performance will often extend over long periods, and our right to receive future payment depends on our future performance in accordance with the agreement. Revenues earned in excess of related billings are accrued, whereas billings in excess of revenues earned are deferred until the related services are provided.

Deferred contract costs include direct and incremental costs such as direct labor, hardware and software. We also defer and subsequently amortize certain transition costs related to activities that transition the contract from the design, development, and implementation phase to the operational, or business process outsourcing, phase. Deferred contract costs, including transition costs, are amortized on a straight-line basis over the remaining original contract term, consistent with the revenue recognition period. Indirect costs associated with MMIS service contracts are generally expensed as incurred.

The recoverability of deferred contract costs associated with a particular contract is analyzed on a periodic basis using the undiscounted estimated cash flows of the whole contract over its remaining contract term. If such undiscounted cash flows are insufficient to recover the long-lived assets and deferred contract costs, the deferred contract costs are written down by the amount of the cash flow deficiency. If a cash flow deficiency remains after reducing the balance of the deferred contract costs to zero, any remaining long-lived assets are evaluated for impairment. Any such impairment recognized would equal the amount by which the carrying value of the long-lived assets exceeds the fair value of those assets.

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Property and Equipment

Property and equipment are stated at historical cost. Replacements and major improvements are capitalized, and repairs and maintenance are charged to expense as incurred. Furniture and equipment are generally depreciated using the straight-line method over estimated useful lives ranging from three to seven years. Software developed for internal use is capitalized. Software is generally amortized over its estimated useful life of three years. Leasehold improvements are amortized over the term of the lease, or over their useful lives from five to 10 years, whichever is shorter. Buildings are depreciated over their estimated useful lives of 31.5 years.

As discussed in Molina Medicaid Solutions Segment Revenue Recognition and Deferred Contract Costs above, the costs associated with certain equipment and software, which may be ultimately transferred to our clients under fixed-price contracts, are capitalized and recorded as deferred contract costs. Such costs are amortized on a straight-line basis over the performance period, consistent with the revenue recognition period.

Goodwill and Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of net assets acquired. Identifiable intangible assets (consisting principally of purchased contract rights and provider contracts) are amortized on a straight-line basis over the expected period to be benefited (generally between one and 15 years).

Goodwill and indefinite-lived assets are not amortized, but are subject to impairment tests on an annual basis or more frequently if indicators of impairment exist. We use a discounted cash flow methodology to assess the fair values of our reporting units. If the carrying values of our reporting units exceed the fair values, we perform a hypothetical purchase price allocation. Impairment is measured by comparing the goodwill derived from the hypothetical purchase price allocation to the carrying value of the goodwill and indefinite-lived asset balance.

Identifiable intangible assets associated with Molina Medicaid Solutions are classified as either contract backlog or customer relationships.

The contract backlog intangible asset comprises all contractual cash flows anticipated to be received during the remaining contracted period for each specific contract relating to work that was performed prior to the acquisition. The contract backlog intangible has been developed on a contract-by-contract basis. The amortization of that portion of the contract backlog intangible associated with contracts for which revenue recognition has not yet commenced is deferred until revenue recognition has begun. Because each acquired contract constitutes a single revenue element, amortization of the contract backlog intangible is recorded to contra-service revenue so that amortization is matched to any revenues associated with contract performance that occurred prior to the acquisition date. The contract backlog intangible asset is amortized on a straight-line basis for each specific contract over periods generally ranging from one to six years.

The customer relationship intangible asset comprises all contractual cash flows that are anticipated to be received during the option periods of each specific contract as well as anticipated renewals of those contracts. The customer relationship intangible is amortized on a straight-line basis for each specific contract over periods generally ranging from four to nine years.

The determination of the value of identifiable intangible assets requires us to make estimates and assumptions about estimated asset lives, future business trends, and growth. In addition to annual impairment testing, we continually evaluate whether events and circumstances have occurred that indicate the balance of identifiable intangible assets may not be recoverable. In evaluating impairment, we compare the estimated fair value of the intangible asset to its underlying book value. Such evaluation is significantly impacted by estimates and assumptions of future revenues, costs and expenses, and other factors. If an event occurs that would cause us to revise our estimates and assumptions used in analyzing the value of our identifiable intangible assets, such revision could result in a non-cash impairment charge that could have a material impact on our financial results.

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Depreciation and Amortization

As noted above, the amortization of the contract backlog intangibles associated with the acquisition of Molina Medicaid Solutions is recorded as contra-service revenue, rather than as part of depreciation and amortization, to match revenues associated with contract performance that occurred prior to the acquisition date. Additionally, most of the depreciation associated with Molina Medicaid Solutions is recorded as cost of service revenue. The following table presents all depreciation and amortization recorded in our consolidated financial statements:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
	(In thousands)			
Depreciation and amortization	$ 11,954	$ 9,832	$ 33,234	$ 28,468
Amortization recorded as contra-service revenue	2,655		4,246	
Depreciation recorded as cost of service revenue	1,964		3,005	
Depreciation and amortization reported in our consolidated statements of cash flows	$ 16,573	$ 9,832	$ 40,485	$ 28,468

Income Taxes

The provision for income taxes is determined using an estimated annual effective tax rate, which is generally greater than the U.S. federal statutory rate primarily because of state taxes. The effective tax rate may be subject to fluctuations during the year as new information is obtained. Such information may affect the assumptions used to estimate the annual effective tax rate, including factors such as the mix of pretax earnings in the various tax jurisdictions in which we operate, valuation allowances against deferred tax assets, the recognition or derecognition of tax benefits related to uncertain tax positions, and changes in or the interpretation of tax laws in jurisdictions where we conduct business. We recognize deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of our assets and liabilities, along with net operating loss and tax credit carryovers.

The total amount of unrecognized tax benefits was $11.0 million and $4.1 million at September 30, 2010, and December 31, 2009, respectively. Approximately $8.4 million of the unrecognized tax benefits recorded at September 30, 2010, relates to a tax position claimed on a state refund claim that will not result in a cash payment for income taxes if our claim is denied. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate was $7.8 million and $3.4 million as of September 30, 2010 and December 31, 2009, respectively. We expect that during the next 12 months it is reasonably possible that unrecognized tax benefit liabilities will decrease by approximately $0.5 million due to the expiration of statute of limitations.

Our continuing practice is to recognize interest and/or penalties related to unrecognized tax benefits in income tax expense. Our accrual for the payment of interest relating to unrecognized tax benefits was $74,000 and $75,000 as of September 30, 2010 and December 31, 2009, respectively.

Through December 31, 2009, income tax expense included both the Michigan business income tax, or BIT, and Michigan modified gross receipts tax, or MGRT. Effective January 1, 2010, we have recorded the MGRT as a premium tax and not as an income tax. We will continue to record the BIT as an income tax. The MGRT amounted to $4.6 million and $3.4 million for the nine months ended September 30, 2010, and 2009, respectively.

Generally, the MGRT is a 0.976% tax (statutory rate of 0.8% plus 21.99% surtax) on modified gross receipts, which for most taxpayers is defined as receipts less purchases from other firms. Managed care organizations, however, are not currently allowed to deduct payments to providers in determining modified gross receipts. As a result, the MGRT is 0.976% of our Michigan plan s receipts and does not vary with levels of pretax income or margins. We believe that presentation of the MGRT as a premium tax produces financial statements that are more useful to the reader.

Recent Accounting Pronouncements

Revenue Recognition. In late 2009, the Financial Accounting Standards Board, or FASB, issued the following new accounting guidance which is first applicable for our January 1, 2011 reporting:

ASU No. 2009-14, Software (ASC Topic 985) *Certain Revenue Arrangements That Include Software Elements*, a consensus of the FASB Emerging Issues Task Force. This guidance modifies the scope of ASC Subtopic 985-605 *Software-Revenue Recognition* to exclude from its requirements (a) non-software components of tangible products and (b) software components of tangible products that are sold, licensed or leased with tangible products when the software components and non-software components of the tangible product function together to deliver the tangible product s essential functionality. We do not expect the update to impact our consolidated financial position, results of operations or cash flows.

ASU No. 2009-13, Revenue Recognition (ASC Topic 605) — *Multiple-Deliverable Revenue Arrangements*, a consensus of the FASB Emerging Issues Task Force. This guidance modifies previous requirements by allowing the use of the best estimate of selling price in the absence of vendor-specific objective evidence ("VSOE") or verifiable objective evidence (VOE) (now referred to as TPE or third-party evidence) for determining the selling price of a deliverable. A vendor is now required to use its best estimate of the selling price when more objective evidence of the selling price cannot be determined. In addition, the residual method of allocating arrangement consideration is no longer permitted. We do not expect the update to impact our consolidated financial position, results of operations or cash flows.

Fair Value Measurements. In January 2010, the FASB issued the following guidance which expanded the required disclosures about fair value measurements. Effective for interim and annual reporting beginning after December 15, 2009, with one new disclosure effective after December 15, 2010, we adopted this guidance in full during the interim period ended March 31, 2010.

ASU No. 2010-6, Fair Value Measurements and Disclosures (Topic 820) *Improving Disclosures about Fair Value Measurements*. This guidance requires (a) separate disclosure of the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements along with the reasons for such transfers, (b) information about purchases, sales, issuances and settlements to be presented separately in the reconciliation for Level 3 fair value measurements, (c) fair value measurement disclosures for each class of assets and liabilities and (d) disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for fair value measurements that fall in either Level 2 or Level 3. The adoption of this guidance did not impact our consolidated financial position, results of operations or cash flows.

3. Business Combinations

Wisconsin Health Plan

On September 1, 2010, Molina acquired 100% of the voting equity interests in Avatar Partners, LLC, which is the sole shareholder of Abri Health Plan, Inc. (Abri), a Medicaid managed care organization based in Milwaukee, Wisconsin. This acquisition is consistent with our stated strategy to enter markets with competitive provider communities, supportive regulatory environments, significant size and, where practicable, mandated Medicaid managed care enrollment.

We expect the final purchase price for the Abri acquisition to be approximately $16 million, subject to adjustments. As of September 30, 2010, we had paid $5 million of the total purchase price. There will be two subsequent measurement dates (November 1, 2010 and February 1, 2011) on which we will compute amounts due to the sellers based on the plan s membership on those dates. Following the final membership reconciliation on February 1, 2011, 10% of the final purchase price will be deposited to an escrow account payable at the later of 12 months or the resolution of all unresolved claims. In connection with this acquisition, we recorded $6.2 million in goodwill, and $3.9 million in various definite-lived identifiable intangible assets, with a weighted average useful life of 6.3 years. Accumulated amortization totaled approximately $135,000 as of September 30, 2010, which reflects amortization expense recorded since the acquisition date. We expect to record amortization relating to this acquisition in future years as follows 2011: $1.1 million, 2012: $432,000, 2013: $396,000, 2014: $325,000, and 2015: $281,000.

Molina Medicaid Solutions

On May 1, 2010, we acquired a health information management business that was previously an operating unit of Unisys Corporation. This business now operates under the name *Molina Medicaid Solutions*SM, or Molina Medicaid Solutions. Molina Medicaid Solutions provides design, development, implementation, and business process outsourcing solutions to state governments for their Medicaid Management Information Systems (MMIS). MMIS is a core tool used to support the administration of state Medicaid and other health care entitlement programs. Molina Medicaid Solutions currently holds MMIS contracts with the states of Idaho, Louisiana, Maine, New Jersey, and West Virginia, as well as a contract to provide drug rebate administration services for the Florida Medicaid program. As a result of this acquisition, we are diversifying our core health plan business, and we believe that the use of a common claims processing platform across our health plans and our new MMIS business will enable us to achieve synergies in the operations of both.

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We paid $131.3 million to acquire Molina Medicaid Solutions. The acquisition was funded with available cash of $26 million and $105 million drawn under our credit facility. In connection with the closing, both the fourth amendment and the fifth amendment to our credit facility became effective (see Note 11, Long-Term Debt).

Recording of assets acquired and liabilities assumed: The transaction has been accounted for using the acquisition method of accounting which requires, among other things, that most assets acquired and liabilities assumed be recognized at their fair values as of the acquisition date. Accounts receivable are based on gross contractual amounts receivable, substantially all of which we expect to collect because the creditors are state governments.

The following table summarizes the provisional acquisition-date fair values of the assets acquired and liabilities assumed:

	May 1, 2010 (In thousands)
Assets	
Accounts receivable	$ 17,128
Other current assets	3,884
Equipment and other long-term assets	783
Identifiable intangible assets	48,150
Goodwill	72,943
	142,888
Less: liabilities	
Accounts payable and accrued liabilities	11,153
Deferred tax liability	115
Other long-term liabilities	370
Net assets acquired	$ 131,250

The recorded amounts for assets and liabilities are provisional and subject to change. We will finalize the amounts recognized as we obtain the information necessary to complete the analyses, but by no later than December 31, 2010.

A single estimate of fair value results from a complex series of judgments about future events and uncertainties and relies heavily on estimates and assumptions. Results that differ from the estimates and judgments used to determine the estimated fair value assigned to each class of assets acquired and liabilities assumed, as well as asset lives, can materially impact our results of operations.

Accounts receivable: Accounts receivable are stated at fair value, based on the gross contractual amounts receivable. We expect to collect substantially all of the accounts receivable because the creditors are state governments.

Identifiable intangible assets: The following table is a summary of the fair value estimates of the identifiable intangible assets and their weighted-average useful lives:

	Estimated Fair Value (In thousands)	Weighted Average Useful Life (years)
Customer relationships	$ 24,550	5.2
Contract backlog	23,600	3.3
	$ 48,150	

Accumulated amortization totaled approximately $6.4 million as of September 30, 2010, which reflects total amortization recorded since the acquisition date. For identifiable intangible assets recorded as of September 30, 2010, we expect to record amortization in future years as follows 2011: $11.2 million, 2012: $10.6 million, 2013: $7.1 million, 2014: $5.3 million, and 2015: $1.7 million.

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Goodwill: Goodwill in the amount of $72.9 million was recognized for this acquisition, of which approximately $70.9 million is expected to be deductible for tax purposes. The total goodwill amount was calculated as the excess of the consideration transferred over the net assets recognized and represents the future economic benefits arising from other assets acquired that could not be individually identified and separately recognized. The goodwill recorded as part of the acquisition of Molina Medicaid Solutions includes:

- Expected synergies and other benefits that we believe will result from combining the operations of Molina Medicaid Solutions with the operations of Molina;
- Any intangible assets that do not qualify for separate recognition such as the assembled workforce; and
- The value of the going-concern element of Molina Medicaid Solutions existing businesses (the higher rate of return on the assembled collection of net assets versus acquiring all of the net assets separately).

Accounts payable and accrued liabilities: Accounts payable and accrued liabilities include $1.3 million payable to the seller of Molina Medicaid Solutions, which represented a working capital adjustment provided in the purchase agreement. The working capital adjustment provided that the net working capital, or current assets minus current liabilities, on Molina Medicaid Solutions opening balance sheet would equal $10 million. To the extent the final net working capital conveyed by the seller exceeded $10 million, the amount would be payable back to the seller; conversely, to the extent that net working capital conveyed by the seller was less than $10 million, the shortage would be a receivable from the seller. Thus, the $1.3 million amount described above represents the amount payable to the seller for net working capital in excess of $10 million on the opening balance sheet, and was paid to the seller in August 2010.

Pro-forma impact of the acquisition: The unaudited pro-forma results presented below include the effects of the acquisition as if it had been consummated as of January 1, 2010 and 2009. The pro-forma results include the amortization associated with the acquired intangible assets and interest expense associated with debt used to fund the acquisition. To better reflect the combined operating results, material non-recurring charges directly attributable to the transaction have been excluded. In addition, the pro-forma results do not include any anticipated synergies or other expected benefits of the acquisition. Accordingly, the unaudited pro forma financial information below is not necessarily indicative of either future results of operations or results that might have been achieved had the acquisition been consummated as of January 1, 2010 or January 1, 2009.

	Three Months Ended Sept. 30,	**Nine Months Ended Sept. 30,**	
	2009	**2010**	**2009**
Revenue	$ 942,846	$ 3,044,149	$ 2,781,356
Net income	$ 8,557	$ 40,645	$ 34,369
Diluted earnings per share	$ 0.33	$ 1.52	$ 1.32

4. Segment Reporting

Our reportable segments are consistent with how we manage the business and view the markets we serve. In the second quarter of 2010, we added a segment to our internal financial reporting structure as a result of the acquisition of Molina Medicaid Solutions described in Note 3, Business Combinations.

We now report our financial performance based on the following two reportable segments Health Plans and Molina Medicaid Solutions. The Health Plans segment represents our former single-segment health plan operations. The Molina Medicaid Solutions segment represents the operations of our new MMIS solutions business.

We rely on an internal management reporting process that provides segment information to the operating income level for purposes of making financial decisions and allocating resources. The accounting policies of the segments are the same as those described in Note 2, Significant Accounting Policies. The cost of services shared between the Health Plans and Molina Medicaid Solutions segments is charged to the Health Plans segment.

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Operating segment revenues and profitability for the three months and nine months ended September 30, 2010 and 2009 were as follows:

	Health Plans	Molina Medicaid Solutions	Total
		(In thousands)	
Three months ended September 30, 2010			
Premium revenue	$ 1,005,115	$	$ 1,005,115
Service revenue		32,271	32,271
Investment income	1,760		1,760
Total revenue	$ 1,006,875	$ 32,271	$ 1,039,146
Operating income	$ 28,796	$ 1,157	$ 29,953
Nine months ended September 30, 2010			
Premium revenue	$ 2,947,020	$	$ 2,947,020
Service revenue		53,325	53,325
Investment income	4,880		4,880
Total revenue	$ 2,951,900	$ 53,325	$ 3,005,225
Operating income	$ 65,407	$ 6,162	$ 71,569
Three months ended September 30, 2009			
Premium revenue	$ 914,805	$	$ 914,805
Service revenue			
Investment income	1,707		1,707
Total revenue	$ 916,512	$	$ 916,512
Operating income	$ 15,089	$	$ 15,089
Nine months ended September 30, 2009			
Premium revenue	$ 2,697,796	$	$ 2,697,796
Service revenue			
Investment income	7,336		7,336
Total revenue	$ 2,705,132	$	$ 2,705,132
Operating income	$ 57,738	$	$ 57,738

Reconciliation to Income before Income Taxes

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
	(In thousands)			
Segment operating income	$ 29,953	$ 15,089	$ 71,569	$ 57,738
Interest expense	(4,600)	(3,279)	(12,056)	(9,917)
Income before income taxes	$ 25,353	$ 11,810	$ 59,513	$ 47,821

Segment Assets

	Health Plans	Molina Medicaid Solutions	Total
	(In thousands)		
As of September 30, 2010	$ 1,261,967	$ 169,463	$ 1,431,430
As of December 31, 2009	$ 1,245,235	$	$ 1,245,235

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5. Earnings per Share

The denominators for the computation of basic and diluted earnings per share were calculated as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
	(In thousands)			
Shares outstanding at the beginning of the period	25,811	25,529	25,607	26,725
Weighted-average number of shares issued	2,279		768	
Weighted-average number of shares purchased				(865)
Weighted-average number of shares issued	28	10	136	84
Denominator for basic earnings per share	28,118	25,539	26,511	25,944
Dilutive effect of employee stock options and stock grants(1)	245	91	291	114
Denominator for diluted earnings per share(2)	28,363	25,630	26,802	26,058

(1) Options to purchase common shares are included in the calculation of diluted earnings per share when their exercise prices are below the average fair value of the common shares for each of the periods presented. For the three months ended September 30, 2010, and 2009, there were approximately 472,000 and 618,000 antidilutive weighted options, respectively. For the nine months ended

September 30, 2010, and 2009, there were approximately 492,000 and 622,000 antidilutive weighted options, respectively. Restricted shares are included in the calculation of diluted earnings per share when their grant date fair values are below the average fair value of the common shares for each of the periods presented. For the three months ended September 30, 2010, and 2009, there were approximately 6,000, and 232,000 antidilutive weighted restricted shares, respectively. For the nine months ended September 30, 2010, and 2009, there were approximately 6,000, and 28,000 antidilutive weighted restricted shares, respectively.

(2) Potentially dilutive shares issuable pursuant to our convertible senior notes were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive for the three month and nine month periods ended September 30, 2010 and 2009.

6. Share-Based Compensation

At September 30, 2010, we had employee equity incentives outstanding under two plans: (1) the 2002 Equity Incentive Plan; and (2) the 2000 Omnibus Stock and Incentive Plan (from which equity incentives are no longer awarded). Charged to general and administrative expenses, total stock-based compensation expense was as follows for the three month and nine month periods ended September 30, 2010 and 2009:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
	(In thousands)			
Restricted stock awards	$ 2,367	$ 1,787	$ 6,113	$ 4,661
Stock options (including shares issued under our employee stock purchase plan)	393	485	1,155	1,069
Total stock-based compensation expense	$ 2,760	$ 2,272	$ 7,268	$ 5,730

As of September 30, 2010, there was $14.4 million of total unrecognized compensation expense related to unvested restricted stock awards, which we expect to recognize over a remaining weighted-average period of 2.7 years. Also as of September 30, 2010, there was $352,000 of unrecognized compensation expense related to unvested stock options, which we expect to recognize over a remaining weighted-average period of 0.6 years.

The total fair value of restricted shares granted during the nine months ended September 30, 2010 and 2009 was $11.9 million and $7.8 million, respectively. The total fair value of restricted shares vested during the nine months ended September 30, 2010 and 2009 was $6.1 million and $3.0 million, respectively. Restricted stock activity for the nine months ended September 30, 2010 is summarized below:

	Shares	Weighted Average Grant Date Fair Value
Unvested balance as of December 31, 2009	687,630	$ 24.64
Granted	521,225	22.78
Vested	(257,781)	25.83
Forfeited	(87,875)	23.32
Unvested balance as of September 30, 2010	863,199	23.30

Stock option activity for the nine months ended September 30, 2010 is summarized below:

	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (In thousands)	Weighted Average Remaining Contractual Term (Years)
Stock options outstanding as of December 31, 2009	650,739	$ 30.25		
Exercised	(29,702)	25.58		
Forfeited	(11,513)	32.39		
Stock options outstanding as of September 30, 2010	609,524	30.44	$ 583	4.4
Stock options exercisable and expected to vest as of September 30, 2010	606,816	30.43	$ 582	4.4
Exercisable as of September 30, 2010	559,974	30.29	$ 580	4.2

7. Fair Value Measurements

Our consolidated balance sheets include the following financial instruments: cash and cash equivalents, investments, receivables, trade accounts payable, medical claims and benefits payable, long-term debt and other liabilities. We consider the carrying amounts of cash and cash equivalents, receivables, other current assets and current liabilities to approximate their fair value because of the relatively short period of time between the origination of these instruments and their expected realization or payment. For a comprehensive discussion of fair value measurements with regard to our current and non-current investments, see below.

Based on quoted market prices, the fair value of our convertible senior notes issued in October 2007 was $181.4 million at September 30, 2010, and $160.8 million at December 31, 2009. The carrying amount of the convertible senior notes was $162.7 million at September 30, 2010, and $158.9 million at December 31, 2009.

To prioritize the inputs we use in measuring fair value, we apply a three-tier fair value hierarchy. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

As of September 30, 2010, we held certain assets that are required to be measured at fair value on a recurring basis. These included investments as follows:

Balance Sheet Classification	**Description**
Current assets:	
Investments (see Note 8)	Investment grade debt securities; designated as available-for-sale; reported at fair value based on market prices that are readily available (Level 1).
Non-current assets:	
Investments (see Note 8)	Auction rate securities; designated as available-for-sale; reported at fair value based on discounted cash flow analysis or other type of valuation model (Level 3).

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As of September 30, 2010, $24.7 million par value ($20.3 million fair value) of our investments consisted of auction rate securities, all of which were collateralized by student loan portfolios guaranteed by the U.S. government. We continued to earn interest on substantially all of these auction rate securities as of September 30, 2010. Due to events in the credit markets, the auction rate securities held by us experienced failed auctions beginning in the first quarter of 2008. As such, quoted prices in active markets were not readily available during the majority of 2008, all of 2009, and continued to be unavailable as of September 30, 2010. To estimate the fair value of these securities, we used pricing models that included factors such as the collateral underlying the securities, the creditworthiness of the counterparty, the timing of expected future cash flows, and the expectation of the next time the security would have a successful auction. The estimated values of these securities were also compared, when possible, to valuation data with respect to similar securities held by other parties. We concluded that these estimates, given the lack of market available pricing, provided a reasonable basis for determining fair value of the auction rate securities as of September 30, 2010.

As of September 30, 2010, all of our auction rate securities were designated as available-for-sale securities. As a result of the decrease in fair value of auction rate securities designated as available-for-sale, we recorded pretax unrealized losses of $0.5 million to accumulated other comprehensive loss for the nine months ended September 30, 2010. We have deemed these unrealized losses to be temporary and attribute the decline in value to liquidity issues, as a result of the failed auction market, rather than to credit issues. Any future fluctuation in fair value related to these instruments that we deem to be temporary, including any recoveries of previous write-downs, would be recorded to accumulated other comprehensive loss. If we determine that any future valuation adjustment was other-than-temporary, we would record a charge to earnings as appropriate.

Until July 2, 2010, we held auction rate securities (designated as trading securities) with a certain investment securities firm. In the fourth quarter of 2008, we entered into a rights agreement with this firm that (1) allowed us to exercise rights (the Rights) to sell the eligible auction rate securities at par value to this firm between June 30, 2010 and July 2, 2012, and (2) gave the investment securities firm the right to purchase the auction rate securities from us any time after the agreement date as long as we received the par value. The remaining eligible auction rate securities, totaling $15.9 million as of June 30, 2010, were sold at par value on July 1, 2010. For the nine months ended September 30, 2010 and 2009, we recorded pretax gains of $4.2 million and $3.5 million, respectively, on the auction rate securities underlying the Rights.

We accounted for the Rights as a freestanding financial instrument and, until July 2, 2010, recorded the value of the Rights under the fair value option. When the remaining eligible auction rate securities were sold at par value on July 1, 2010, the value of the Rights was zero. For the nine months ended September 30, 2010 and 2009, we recorded pretax losses of $3.8 million and $3.2 million, respectively, on the Rights.

Our assets measured at fair value on a recurring basis at September 30, 2010, were as follows:

	Fair Value Measurements at Reporting Date Using			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Government -sponsored enterprise securities	$ 70,787	$ 70,787	$	$
Municipal securities	23,644	23,644		
Corporate debt securities	79,354	79,354		
U.S. treasury notes	18,296	18,296		
Certificates of deposit	3,277	3,277		
Auction rate securities (available-for-sale)	20,294			20,294
Total assets measured at fair value	$ 215,652	$ 195,358	$	$ 20,294

The following table presents a roll-forward of the balance of our assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3):

(Level 3)

		(In thousands)
Balance at December 31, 2009	$	63,494
Total gains (losses):		
Included in earnings:		
Auction rate securities designated as trading securities		4,170
Change in fair value of Rights		(3,807)
Included in other comprehensive income		(513)
Settlements		(43,050)
Balance at September 30, 2010	$	20,294
The amount of total losses for the period included in other comprehensive loss attributable to the change in unrealized losses relating to assets still held at September 30, 2010	$	(513)

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8. Investments

The following tables summarize our investments as of the dates indicated:

	September 30, 2010			
		Gross Unrealized		Estimated Fair
	Cost	Gains	Losses	Value
	(In thousands)			
Government-sponsored enterprise securities	$ 70,687	$ 426	$ 326	$ 70,787
Municipal securities (including non-current auction rate securities)	48,293	144	4,499	43,938
Corporate debt securities	79,892	163	701	79,354
U.S. treasury notes	18,169	137	10	18,296
Certificates of deposit	3,277			3,277
	$ 220,318	$ 870	$ 5,536	$ 215,652

	December 31, 2009			
		Gross Unrealized		Estimated Fair
	Cost	Gains	Losses	Value
	(In thousands)			
Government-sponsored enterprise securities	$ 89,451	$ 504	$ 281	$ 89,674
Municipal securities (including non-current auction rate securities)	82,009	3,120	4,154	80,975
Corporate debt securities	32,543	206	185	32,564
U.S. treasury notes	28,052	92	84	28,060
Certificates of deposit	3,258			3,258
	$ 235,313	$ 3,922	$ 4,704	$ 234,531

The contractual maturities of our investments as of September 30, 2010 are summarized below.

	Cost	Estimated Fair Value
	(In thousands)	
Due in one year or less	$ 100,109	$ 99,474
Due one year through five years	94,779	95,071
Due after five years through ten years	1,430	1,421
Due after ten years	24,000	19,686
	$ 220,318	$ 215,652

Gross realized gains and gross realized losses from sales of available-for-sale securities are calculated under the specific identification method and are included in investment income. Total proceeds from sales of available-for-sale securities were $35.4 million and $66.9 million for the three months ended September 30, 2010, and 2009, respectively. Total proceeds from sales of available-for-sale securities were $101.3 million and $148.8 million for the nine months ended September 30, 2010, and 2009, respectively. Net realized investment gains for the three months and nine months ended September 30, 2010, and 2009 were not significant.

We monitor our investments for other-than-temporary impairment. For investments other than our municipal securities, we have determined that unrealized gains and losses at September 30, 2010, and December 31, 2009, are temporary in nature, because the change in market value for these securities has resulted from fluctuating interest rates, rather than a deterioration of the credit worthiness of the issuers. So long as we hold these securities to maturity, we are unlikely to experience gains or losses. In the event that we dispose of these securities before maturity, we expect that realized gains or losses, if any, will be immaterial.

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Approximately half of our investment in municipal securities consists of auction rate securities. As described in Note 7, Fair Value Measurements, the unrealized losses on these investments were caused primarily by the illiquidity in the auction markets. Because the decline in market value is not due to the credit quality of the issuers, and because we do not intend to sell, nor is it more likely than not that we will be required to sell, these investments before recovery of their cost, we do not consider the auction rate securities that are designated as available-for-sale to be other-than-temporarily impaired at September 30, 2010.

The following table segregates those available-for-sale investments that have been in a continuous loss position for less than 12 months, and those that have been in a loss position for 12 months or more as of September 30, 2010.