MAGELLAN HEALTH INC
Form 10-Q
October 24, 2014

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2014

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 No. 1-6639

MAGELLAN HEALTH, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**58-1076937** (IRS Employer Identification No.)
4800 Scottsdale Rd, Suite 4400 **Scottsdale, Arizona** (Address of principal executive offices)	**85251** (Zip code)

(602) 572-6050
(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 twelve 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 ý 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated 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 ý	Accelerated filer o	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 ý

The number of shares of the registrant's Ordinary Common Stock outstanding as of September 30, 2014 was 27,645,831.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

MAGELLAN HEALTH, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

	December 31, 2013	September 30, 2014 (unaudited)
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 203,187	$ 368,273
Restricted cash	236,696	165,166
Accounts receivable, less allowance for doubtful accounts of $5,447 and $4,763 at December 31, 2013 and September 30, 2014, respectively	238,185	302,682
Short-term investments (restricted investments of $117,674 and $128,043 at December 31, 2013 and September 30, 2014, respectively)	175,883	150,558
Deferred income taxes	37,530	36,090
Pharmaceutical inventory	49,609	40,899
Other current assets (restricted deposits of $25,009 and $32,692 at December 31, 2013 and September 30, 2014, respectively)	48,268	67,172
Total Current Assets	989,358	1,130,840
Property and equipment, net	172,333	175,521
Restricted long-term investments	32,430	50,866
Other long-term assets	7,197	11,601
Goodwill	488,206	566,106
Other intangible assets, net	69,694	140,313
Total Assets	$ 1,759,218	$ 2,075,247
LIABILITIES, REDEEMABLE NON-CONTROLLING INTEREST AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 42,853	$ 65,382
Accrued liabilities	134,652	121,408
Medical claims payable	228,341	281,133
Other medical liabilities	67,416	54,338
Current maturities of long-term debt and capital lease obligations	3,005	15,484
Total Current Liabilities	476,267	537,745
Long-term debt and capital lease obligations	23,720	258,868
Deferred income taxes	42,046	43,069
Tax contingencies	32,343	14,217
Contingent consideration		47,941
Deferred credits and other long-term liabilities	17,803	21,744

Total Liabilities		592,179		923,584
Redeemable non-controlling interest		10,554		7,200
Preferred stock, par value $.01 per share				
Authorized 10,000 shares at December 31, 2013 and September 30, 2014 Issued and outstanding none				
Ordinary common stock, par value $.01 per share				
Authorized 100,000 shares at December 31, 2013 and September 30, 2014 Issued and outstanding 47,351 shares and 27,616 shares at December 31, 2013, respectively, and 49,834 and 27,646 shares at September 30, 2014, respectively		474		498
Multi-Vote common stock, par value $.01 per share				
Authorized 40,000 shares at December 31, 2013 and September 30, 2014 Issued and outstanding none				
Other Stockholders' Equity:				
Additional paid-in capital		922,325		994,728
Retained earnings		1,100,493		1,158,332
Accumulated other comprehensive loss		(93)		(91)
Ordinary common stock in treasury, at cost, 19,735 shares and 22,188 shares at December 31, 2013 and September 30, 2014, respectively		(866,714)		(1,009,004)
Total Stockholders' Equity		1,156,485		1,144,463
Total Liabilities, Redeemable Non-Controlling Interest and Stockholders' Equity	$	1,759,218	$	2,075,247

See accompanying notes to consolidated financial statements.

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MAGELLAN HEALTH, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	**2014**	**2013**	**2014**
Net revenue:				
Managed care and other	$ 770,113	$ 703,020	$ 2,239,422	$ 2,214,885
PBM and dispensing	103,485	220,150	298,685	562,774
Total net revenue	873,598	923,170	2,538,107	2,777,659
Cost and expenses:				
Cost of care	564,537	495,180	1,627,194	1,582,505
Cost of goods sold	97,503	202,180	281,190	520,044
Direct service costs and other operating expenses(1)	156,834	176,928	440,958	520,684
Depreciation and amortization	17,654	23,956	50,770	66,665
Interest expense	789	2,879	2,191	5,719
Interest income	(291)	(241)	(1,002)	(827)
Total costs and expenses	837,026	900,882	2,401,301	2,694,790
Income before income taxes	36,572	22,288	136,806	82,869
(Benefit) provision for income taxes	(10,660)	(3,490)	30,036	28,384
Net income	47,232	25,778	106,770	54,485
Less: net income (loss) attributable to non-controlling interest		(1,355)		(3,354)
Net income attributable to Magellan Health, Inc.	$ 47,232	$ 27,133	$ 106,770	$ 57,839
Net income per common share attributable to Magellan Health, Inc.:				
Basic (See Note B)	$ 1.75	$ 1.02	$ 3.96	$ 2.14
Diluted (See Note B)	$ 1.70	$ 1.00	$ 3.87	$ 2.09

(1) Includes stock compensation expense of $4,524 and $11,961 for the three months ended September 30, 2013 and 2014, respectively, and $14,764 and $25,983 for the nine months ended September 30, 2013 and 2014, respectively.

See accompanying notes to consolidated financial statements.

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MAGELLAN HEALTH, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	**2014**	**2013**	**2014**
Net income	$ 47,232	$ 25,778	$ 106,770	$ 54,485
Other comprehensive income:				
Unrealized gains (losses) on available-for-sale securities(1)	110	(111)	(37)	2
Comprehensive income	47,342	25,667	106,733	54,487
Less: comprehensive income (loss) attributable to non-controlling interest		(1,355)		(3,354)
Comprehensive income attributable to Magellan Health, Inc.	$ 47,342	$ 27,022	$ 106,733	$ 57,841

(1) Net of income tax provision (benefit) of $74 and $(74) for the three months ended September 30, 2013 and 2014, respectively, and $(25) and $1 for the nine months ended September 30, 2013 and 2014, respectively.

See accompanying notes to consolidated financial statements.

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MAGELLAN HEALTH, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE NINE MONTHS ENDED SEPTEMBER 30,

(Unaudited)

(In thousands)

	2013	2014
Cash flows from operating activities:		
Net income	$ 106,770	$ 54,485
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	50,770	66,665
Non-cash interest expense	552	3,888
Non-cash stock compensation expense	14,764	25,983
Non-cash income tax (benefit) expense	(164)	813
Non-cash amortization on investments	7,273	3,620
Realized loss on sale of investments		40
Cash flows from changes in assets and liabilities, net of effects from acquisitions of businesses:		
Restricted cash	17,987	71,530
Accounts receivable, net	(19,231)	(19,492)
Pharmaceutical inventory	(1,680)	8,710
Other assets	(9,781)	(22,378)
Accounts payable and accrued liabilities	6,685	(28,461)
Medical claims payable and other medical liabilities	16,144	39,940
Tax contingencies	(22,981)	(15,179)
Deferred credits and other long-term liabilities	2,221	3,940
Other	1,953	138
Net cash provided by operating activities	171,282	194,242
Cash flows from investing activities:		
Capital expenditures	(42,091)	(50,597)
Acquisitions and investments in businesses, net of cash acquired		(132,210)
Purchase of investments	(235,946)	(216,958)
Maturity of investments	233,723	220,191
Other	(7,900)	
Net cash used in investing activities	(52,214)	(179,574)
Cash flows from financing activities:		
Proceeds from issuance of debt		250,000
Payments to acquire treasury stock	(49,462)	(139,316)
Proceeds from exercise of stock options and warrants	24,548	41,685
Payments on capital lease obligations	(2,310)	(2,606)
Other	484	655
Net cash (used in) provided by financing activities	(26,740)	150,418

Net increase in cash and cash equivalents		92,328		165,086
Cash and cash equivalents at beginning of period		189,464		203,187
Cash and cash equivalents at end of period	$	281,792	$	368,273

Supplemental cash flow data:				
Non-cash investing activites:				
Property and equipment acquired under capital leases	$	29,323	$	216

See accompanying notes to consolidated financial statements.

MAGELLAN HEALTH, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2014

(Unaudited)

NOTE A General

Basis of Presentation

The accompanying unaudited consolidated financial statements of Magellan Health, Inc., a Delaware corporation ("Magellan"), include the accounts of Magellan, its majority owned subsidiaries, and all variable interest entities ("VIEs") for which Magellan is the primary beneficiary (together with Magellan, the "Company"). The financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the Securities and Exchange Commission's (the "SEC") instructions to Form 10-Q. Accordingly, the financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments considered necessary for a fair presentation, have been included. The results of operations for the three and nine months ended September 30, 2014 are not necessarily indicative of the results to be expected for the full year. All significant intercompany accounts and transactions have been eliminated in consolidation.

The Company has evaluated subsequent events for recognition or disclosure in the consolidated financial statements filed on this Form 10-Q. Other than as described in Note F "Subsequent Events", the Company did not have any material recognizable events during the period.

These unaudited consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements for the year ended December 31, 2013 and the notes thereto, which are included in the Company's Annual Report on Form 10-K filed with the SEC on March 3, 2014.

Business Overview

The Company is engaged in the healthcare management business, and is focused on meeting needs in areas of healthcare that are fast growing, highly complex and high cost, with an emphasis on special population management. The Company provides services to health plans, managed care organizations ("MCOs"), insurance companies, employers, labor unions, various military and governmental agencies, third party administrators, consultants and brokers. The Company's business is divided into the following five segments, based on the services it provides and/or the customers that it serves, as described below.

Managed Healthcare

Two of the Company's segments are in the managed healthcare business. This line of business reflects the Company's: (i) management of behavioral healthcare services, and (ii) the integrated management of physical, behavioral and pharmaceutical healthcare for special populations, delivered through Magellan Complete Care ("MCC"). The Company's coordination and management of physical and behavioral healthcare includes services provided through its comprehensive network of medical and behavioral health professionals, clinics, hospitals and ancillary service providers. This network of credentialed and privileged providers is integrated with clinical and quality improvement programs to enhance the healthcare experience for individuals in need of care, while at the same time managing the cost of these services for our customers. The treatment services provided through the Company's

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MAGELLAN HEALTH, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2014

(Unaudited)

NOTE A General (Continued)

provider network include outpatient programs, intermediate care programs, inpatient treatment and crisis intervention services. The Company generally does not directly provide or own any provider of treatment services, although it does employ licensed behavioral health counselors to deliver non-medical counseling under certain government contracts.

The Company's integrated management of physical and behavioral healthcare includes its full service health plans which provide for the holistic management of special populations. These special populations include individuals with serious mental illness, dual eligibles, those eligible for long term care and other populations with unique and often complex healthcare needs.

The Company provides its management services primarily through: (i) risk-based products, where the Company assumes all or a substantial portion of the responsibility for the cost of providing treatment services in exchange for a fixed per member per month fee, (ii) administrative services only ("ASO") products, where the Company provides services such as utilization review, claims administration and/or provider network management, but does not assume responsibility for the cost of the treatment services, and (iii) employee assistance programs ("EAPs") where the Company provides short-term outpatient behavioral counseling services.

The managed healthcare business is managed based on the services provided and/or the customers served, through the following two segments:

Commercial. The Managed Healthcare Commercial segment ("Commercial") generally reflects managed behavioral healthcare services and EAP services provided under contracts with health plans, insurance companies and MCOs for some or all of their commercial, Medicaid and Medicare members, as well as with employers, including corporations, governmental agencies, military and labor unions. Commercial's contracts encompass risk-based, ASO and EAP arrangements.

Public Sector. The Managed Healthcare Public Sector segment ("Public Sector") generally reflects: (i) the management of behavioral health services provided to recipients under Medicaid and other state sponsored programs under contracts with state and local governmental agencies, and (ii) the integrated management of physical, behavioral and pharmaceutical care for special populations covered under Medicaid and other government sponsored programs. Public Sector contracts encompass either risk-based or ASO arrangements.

Specialty Solutions

The Specialty Solutions segment ("Specialty Solutions") generally reflects the management of the delivery of diagnostic imaging (radiology benefits management or "RBM") and a variety of other specialty areas such as radiation oncology, obstetrical ultrasound, cardiology and musculoskeletal management to ensure that such services are clinically appropriate and cost effective. The Company's Specialty Solutions services are currently provided under contracts with health plans and insurance companies for some or all of their commercial, Medicaid and Medicare members. The Company also contracts with state and local governmental agencies for the provision of such services to Medicaid recipients. The Company offers its Specialty Solutions services through risk-based contracts, where the Company assumes all or a substantial portion of the responsibility for the cost of providing services,

MAGELLAN HEALTH, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2014

(Unaudited)

NOTE A General (Continued)

and through ASO contracts, where the Company provides services such as utilization review and claims administration, but does not assume responsibility for the cost of the services.

Pharmacy Management

The Pharmacy Management segment ("Pharmacy Management") comprises products and solutions that provide clinical and financial management of drugs paid under medical and pharmacy benefit programs. Pharmacy Management's services include (i) traditional pharmacy benefit management ("PBM") services; (ii) pharmacy benefit administration ("PBA") for state Medicaid and other government sponsored programs; (iii) specialty pharmaceutical dispensing operations, contracting and formulary optimization programs; (iv) medical pharmacy management programs; and (v) programs for the integrated management of drugs that treat complex conditions, regardless of site of service, method of delivery, or benefit reimbursement. In addition, the Company had a subcontract arrangement to provide PBM services on a risk basis for one of Public Sector's customers, which terminated on March 31, 2014.

The Company's Pharmacy Management programs are provided under contracts with health plans, employers, Medicaid MCOs, state Medicaid programs, and other government agencies, and encompass risk-based and fee-for-service ("FFS") arrangements.

Corporate

This segment of the Company is comprised primarily of operational support functions such as sales and marketing and information technology, as well as corporate support functions such as executive, finance, human resources and legal.

Summary of Significant Accounting Policies

Recent Accounting Pronouncements

In July 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-06, "Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers (a consensus of the FASB Emerging Issues Task Force)" ("ASU 2011-06"), which addresses how fees mandated by the Patient Protection and the Affordable Care Act ("ACA"), as amended by the Health Care and Education Reconciliation Act of 2010 (collectively, the "Health Reform Law"), should be recognized and classified in the income statements of health insurers. The Health Reform Law imposes a mandatory annual fee on health insurers for each calendar year beginning on or after January 1, 2014. ASU 2011-06 stipulates that the liability incurred for that fee be amortized to expense over the calendar year in which it is payable. This ASU is effective for calendar years beginning after December 31, 2013, when the fee initially becomes effective. The Company is currently pursuing rate adjustments to cover the direct costs of these fees and the impact from non-deductibility of such fees for federal and state income tax purposes. To the extent the Company has a state public sector customer that does not renew, there may be some impact due to taxes paid where the timing and amount of recoupment of these additional costs is uncertain. In the event the Company is unable to obtain rate adjustments to cover the financial impact of the annual fee, the fee

MAGELLAN HEALTH, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2014

(Unaudited)

NOTE A General (Continued)

may have a material impact on the Company. As of September 30, 2014, the Company has obtained signed commitments from six of its customers to recover the economic impact of the ACA fees. For 2014, the projected ACA fee is currently estimated to be $21.4 million and is included in accrued liabilities in the consolidated balance sheets. Of this amount $5.4 million and $16.1 million was expensed in the three and nine months ended September 30, 2014, respectively, which is included in direct service costs and other operating expenses in the consolidated statements of income. The Company has recorded revenues of $8.8 million and $22.9 million in the three and nine months ended September 30, 2014, respectively, associated with the accrual for the reimbursement of the economic impact of the ACA fees from its customers.

In July 2013, the FASB issued ASU No. 2013-11, "Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Carryforward Exists" ("ASU 2013-11"). ASU 2013-11 provides guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. An unrecognized tax benefit should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward with certain exceptions, in which case such an unrecognized tax benefit should be presented in the financial statements as a liability. The amendments in this ASU do not require new recurring disclosures. The amendments in this ASU are effective for reporting periods beginning after December 15, 2013 and were adopted by the Company during the quarter ended March 31, 2014. The effect of the guidance is immaterial to the Company's consolidated results of operations, financial position, and cash flows.

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)" ("ASU 2014-09), which is a new comprehensive revenue recognition standard that will supersede virtually all existing revenue guidance under GAAP. This ASU is effective for calendar years beginning after December 15, 2016. The Company is currently assessing the potential impact this ASU will have on the Company's consolidated results of operations, financial position, and cash flows.

In June 2014, the FASB issued ASU No. 2014-12, "Compensation Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved After the Requisite Service Period" ("ASU 2014-12), which revises the accounting treatment for stock compensation tied to performance targets. This ASU is effective for calendar years beginning after December 15, 2015. The guidance is not expected to materially impact the Company's consolidated results of operations, financial position, or cash flows.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Significant estimates of the Company include, among other things, accounts receivable realization, valuation allowances for deferred tax assets, valuation of goodwill and intangible assets, medical claims

MAGELLAN HEALTH, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2014

(Unaudited)

NOTE A General (Continued)

payable, other medical liabilities, contingent consideration, stock compensation assumptions, tax contingencies and legal liabilities. Actual results could differ from those estimates.

Managed Care and Other Revenue

Managed Care Revenue. Managed care revenue, inclusive of revenue from the Company's risk, EAP and ASO contracts, is recognized over the applicable coverage period on a per member basis for covered members. The Company is paid a per member fee for all enrolled members, and this fee is recorded as revenue in the month in which members are entitled to service. The Company adjusts its revenue for retroactive membership terminations, additions and other changes, when such adjustments are identified, with the exception of retroactivity that can be reasonably estimated. The impact of retroactive rate amendments is generally recorded in the accounting period that terms to the amendment are finalized, and that the amendment is executed. Any fees paid prior to the month of service are recorded as deferred revenue. Managed care revenues approximated $673.6 million and $1,957.9 million for the three and nine months ended September 30, 2013, respectively, and $611.4 million and $1,935.0 million for the three and nine months ended September 30, 2014, respectively.

Fee-For-Service and Cost-Plus Contracts. The Company has certain fee-for-service contracts, including cost-plus contracts, with customers under which the Company recognizes revenue as services are performed and as costs are incurred. This includes revenues received in relation to ACA fees billed on a cost reimbursement basis. Revenues from these contracts approximated $52.6 million and $152.9 million for the three and nine months ended September 30, 2013, respectively, and $72.9 million and $205.6 million for the three and nine months ended September 30, 2014, respectively.

Block Grant Revenues. The Maricopa Contract (as defined below) was partially funded by federal, state and county block grant money, which represents annual appropriations. The Company recognizes revenue from block grant activity ratably over the period to which the block grant funding applies. Block grant revenues were approximately $32.3 million and $96.9 million for the three and nine months ended September 30, 2013, respectively, and $0.0 million and $33.3 million for the three and nine months ended September 30, 2014, respectively.

Performance-Based Revenue. The Company has the ability to earn performance-based revenue under certain risk and non-risk contracts. Performance-based revenue generally is based on either the ability of the Company to manage care for its clients below specified targets, or on other operating metrics. For each such contract, the Company estimates and records performance-based revenue after considering the relevant contractual terms and the data available for the performance-based revenue calculation. Pro-rata performance-based revenue may be recognized on an interim basis pursuant to the rights and obligations of each party upon termination of the contracts. Performance-based revenues were $2.7 million and $6.1 million for the three and nine months ended September 30, 2013, respectively, and $1.6 million and $7.0 million for the three and nine months ended September 30, 2014, respectively.

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MAGELLAN HEALTH, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2014

(Unaudited)

NOTE A General (Continued)

Rebate Revenue. The Company administers a rebate program for certain clients through which the Company coordinates the achievement, calculation and collection of rebates and administrative fees from pharmaceutical manufacturers on behalf of clients. Each period, the Company estimates the total rebates earned based on actual volumes of pharmaceutical purchases by the Company's clients, as well as historical and/or anticipated sharing percentages. The Company earns fees based upon the volume of rebates generated for its clients. The Company does not record as rebate revenue any rebates that are passed through to its clients. Total rebate revenues were $8.8 million and $25.6 million for the three and nine months ended September 30, 2013, respectively, and $14.3 million and $27.6 million for the three and nine months ended September 30, 2014, respectively.

In relation to the Company's PBM business, the Company administers rebate programs through which it receives rebates from pharmaceutical manufacturers that are shared with its customers. The Company recognizes rebates when the Company is entitled to them and when the amounts of the rebates are determinable. The amount recorded for rebates earned by the Company from the pharmaceutical manufacturers are recorded as a reduction of cost of goods sold.

PBM and Dispensing Revenue

Pharmacy Benefit Management Revenue. The Company recognizes PBM revenue, which consists of a negotiated prescription price (ingredient cost plus dispensing fee), co-payments collected by the pharmacy and any associated administrative fees, when claims are adjudicated. The Company recognizes PBM revenue on a gross basis (i.e. including drug costs and co-payments) as it is acting as the principal in the arrangement and is contractually obligated to its clients and network pharmacies, which is a primary indicator of gross reporting. In addition, the Company is solely responsible for the claims adjudication process, negotiating the prescription price for the pharmacy, collection of payments from the client for drugs dispensed by the pharmacy, and managing the total prescription drug relationship with the client's members. If the Company enters into a contract where it is only an administrator, and does not assume any of the risks previously noted, revenue will be recognized on a net basis. PBM revenues were $5.9 million and $16.4 million for the three and nine months ended September 30, 2013, respectively, and $155.7 million and $383.2 million for the three and nine months ended September 30, 2014, respectively. The increase mainly relates to the October 1, 2013 acquisition of Partners Rx Management, LLC ("Partners Rx").

Dispensing Revenue. The Company recognizes dispensing revenue, which includes the co-payments received from members of the health plans the Company serves, when the specialty pharmaceutical drugs are shipped. At the time of shipment, the earnings process is complete; the obligation of the Company's customer to pay for the specialty pharmaceutical drugs is fixed, and, due to the nature of the product, the member may neither return the specialty pharmaceutical drugs nor receive a refund. Revenues from the dispensing of specialty pharmaceutical drugs on behalf of health plans were $97.6 million and $282.4 million for the three and nine months ended September 30, 2013, respectively, and $64.5 million and $179.6 million for the three and nine months ended September 30, 2014, respectively.

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MAGELLAN HEALTH, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2014

(Unaudited)

NOTE A General (Continued)

Significant Customers

Consolidated Company

Through March 31, 2014, the Company provided behavioral healthcare management and other related services to approximately 680,000 members in Maricopa County, Arizona as the Regional Behavioral Health Authority ("RBHA") for GSA6 ("Maricopa County") pursuant to a contract with the State of Arizona (the "Maricopa Contract"). The Maricopa Contract was for the management of the publicly funded behavioral health system that delivered mental health, substance abuse and crisis services for adults, youth, and children. The Maricopa Contract terminated on March 31, 2014. The Maricopa Contract generated net revenues of $557.6 million and $213.3 million for the nine months ended September 30, 2013 and 2014, respectively.

By Segment

In addition to the Maricopa Contract previously discussed, the following customers generated in excess of ten percent of net revenues for the respective segment for the nine months ended September 30, 2013 and 2014 (in thousands):

Segment	Term Date	2013	2014
Commercial			
Customer A	June 30, 2014(1)	$ 156,269	$ 110,138
Customer B	December 31, 2019	106,433	138,944
Customer C	August 14, 2017	47,625*	76,863
Customer D	December 14, 2013(1)	58,246	
Public Sector			
Customer E	June 30, 2015 to July 1, 2016(2)	215,396	337,893
Specialty Solutions			
Customer F	December 31, 2015	96,402	109,138
Customer G	June 30, 2016(3)	43,490	28,046
Customer H	July 31, 2015	47,161	55,768
Customer A	November 30, 2016	1,623*	40,003
Customer I	January 31, 2016	34,338	38,282
Pharmacy Management			
Customer J	November 30, 2014 to December 31, 2014(2)	99,599	92,793
Customer K	December 31, 2013(4)	68,166	2,339*
Customer L	March 31, 2014(1)(5)	48,527	18,055*
Customer M	December 16, 2016		105,079

*

Revenue amount did not exceed ten percent of net revenues for the respective segment for the period presented. Amount is shown for comparative purposes only.

(1)

The contract has terminated.

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(2) The customer has more than one contract. The individual contracts are scheduled to terminate at various points during the time period indicated above.

(3) This contract transitioned from risk to ASO based services effective July 1, 2014.

(4) The contract has terminated, however, the Company continues to provide services as the contract is transitioned to the new vendor.

(5) This customer represented a subcontract with a Public Sector customer and was eliminated in consolidation.

Concentration of Business

The Company also has a significant concentration of business with various counties in the State of Pennsylvania (the "Pennsylvania Counties") which are part of the Pennsylvania Medicaid program. Net revenues from the Pennsylvania Counties in the aggregate totaled $269.1 million and $272.0 million for the nine months ended September 30, 2013 and 2014, respectively.

In addition, the Company has a significant concentration of business with the State of Florida. The Company currently has behavioral healthcare contracts with various areas in the State of Florida (the "Florida Areas") which are part of the Florida Medicaid program. The State of Florida implemented a new system of mandated managed care through which Medicaid enrollees will receive integrated healthcare services, and has phased out the behavioral healthcare programs under which the Florida Areas' contracts operated. The Company has a contract with the State of Florida to provide integrated healthcare services under the new program. Net revenues from the State of Florida in the aggregate totaled $98.0 million and $143.9 million for the nine months ended September 30, 2013 and 2014, respectively.

The Company's contracts with customers typically have terms of one to three years, and in certain cases contain renewal provisions (at the customer's option) for successive terms of between one and two years (unless terminated earlier). Substantially all of these contracts may be immediately terminated with cause and many of the Company's contracts are terminable without cause by the customer or the Company either upon the giving of requisite notice and the passage of a specified period of time (typically between 60 and 180 days) or upon the occurrence of other specified events. In addition, the Company's contracts with federal, state and local governmental agencies generally are conditioned on legislative appropriations. These contracts generally can be terminated or modified by the customer if such appropriations are not made.

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Fair Value Measurements

The Company has certain assets and liabilities that are required to be measured at fair value on a recurring basis. These assets and liabilities are to be measured using inputs from the three levels of the fair value hierarchy, which are as follows:

Level 1 Inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.

Level 2 Inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (i.e., interest rates, yield curves, etc.), and inputs that are derived principally from or corroborated by observable market data by correlation or other means (market corroborated inputs).

Level 3 Unobservable inputs that reflect the Company's assumptions about the assumptions that market participants would use in pricing the asset or liability. The Company develops these inputs based on the best information available, including the Company's data.

In accordance with the fair value hierarchy described above, the following table shows the fair value of the Company's assets and liabilities that are required to be measured at fair value as of December 31, 2013 and September 30, 2014 (in thousands):

	December 31, 2013			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets				
Cash and cash equivalents(1)	$	$ 101,028	$	$ 101,028
Restricted cash(2)		128,318		128,318
Investments:				
U.S. government and agency securities	1,129			1,129
Obligations of government-sponsored enterprises(3)		8,440		8,440
Corporate debt securities		198,594		198,594
Certificates of deposit		150		150
Total assets held at fair value	$ 1,129	$ 436,530	$	$ 437,659

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	September 30, 2014			
	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents(4)	$	$ 73,194	$	$ 73,194
Restricted cash(5)		76,428		76,428
Investments:				
U.S. government and agency securities	2,393			2,393
Obligations of government-sponsored enterprises(3)		15,222		15,222
Corporate debt securities		182,659		182,659
Certificates of deposit		1,150		1,150
Total assets held at fair value	$ 2,393	$ 348,653	$	$ 351,046
Liabilities				
Contingent consideration			51,981	51,981
Total liabilities held at fair value	$	$	$ 51,981	$ 51,981

(1) Excludes $102.2 million of cash held in bank accounts by the Company.

(2) Excludes $108.4 million of restricted cash held in bank accounts by the Company.

(3) Includes investments in notes issued by the Federal Home Loan Bank.

(4) Excludes $295.1 million of cash held in bank accounts by the Company.

(5)

Excludes $88.7 million of restricted cash held in bank accounts by the Company.

For the nine months ended September 30, 2014, the Company has not transferred any assets between fair value measurement levels.

The carrying values of financial instruments, including accounts receivable and accounts payable, approximate their fair values due to their short-term maturities. The estimated fair value of the Company's term loan of $250 million as of September 30, 2014 was based on current interest rates for similar types of borrowings and is in Level 2 of the fair value hierarchy. The estimated fair values may not represent actual values of the financial instruments that could be realized as of the balance sheet date or that will be realized in the future.

All of the Company's investments are classified as "available-for-sale" and are carried at fair value.

The contingent consideration liability reflects the fair value of potential future payments related to the CDMI, LLC ("CDMI") and Cobalt Technologies, LLC ("Cobalt") acquisitions. The CDMI purchase agreement provides for potential contingent payments up to a maximum aggregate amount of $165.0 million. The potential future payments are contingent upon CDMI meeting certain client retention, client conversion, and gross profit milestones through December 31, 2016. The Cobalt purchase agreement provides for potential contingent payments up to a maximum aggregate amount of

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$6.0 million. The potential future payments are contingent upon engagement of new members and new contract execution through June 30, 2017.

The fair value of contingent consideration is determined based on probabilities of payment, projected payment dates, discount rates, and projected revenues, gross profits, client base, member engagement, and new contract execution. The projected revenues, gross profits, client base, member engagement, and new contract execution are derived from the Company's latest internal operational forecasts. The Company used a probability weighted discounted cash flow method to arrive at the fair value of the contingent consideration. Changes in the operational forecasts, probabilities of payment, discount rates, or projected payment dates may result in a change in the fair value measurement. Any changes in the fair value measurement are reflected as income or expense in the consolidated statements of income. As the fair value measurement for the contingent consideration is based on inputs not observed in the market, these measurements are classified as Level 3 measurements as defined by fair value measurement guidance.

The following unobservable inputs were used in the fair value measurement of contingent consideration: (i) discount rate of 14.5 percent; (ii) probabilities of payment of 0.2 to 75.9 percent for CDMI and zero to 69.9 percent for Cobalt; and (iii) projected payment dates of 2015 to 2017. As of the acquisition date, the Company estimated undiscounted future contingent payments of $61.7 million and $4.2 million for CDMI and Cobalt, respectively. As of September 30, 2014, the fair value of the short term and long term contingent consideration was $4.0 million and $48.0 million, respectively, and is included in accrued liabilities and contingent liabilities, respectively, in the consolidated balance sheet. The change in the present value of the contingent consideration was $1.9 million and $3.1 million for the three months and nine months ended September 30, 2014 and was recorded as interest expense in the consolidated statements of income.

The following table summarizes the Company's liability for contingent consideration (in thousands):

	September 30, 2014
Balance as of beginning of period	$
Acquisition of CDMI	45,778
Acquisition of Cobalt	3,071
Interest accretion	3,132
Balance as of end of period	$ 51,981

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

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than-temporary impairment is recognized in other-than-temporary impairment losses recognized in income in the consolidated statements of income and the non-credit component of the other-than-temporary impairment is recognized in other comprehensive income.

As of December 31, 2013 and September 30, 2014, there were no unrealized losses that the Company believed to be other-than-temporary. No realized gains or losses were recorded for the nine months ended September 30, 2013. During the nine months ended September 30, 2014, the Company recognized a $0.1 million loss on the sale of investments. The following is a summary of short-term and long-term investments at December 31, 2013 and September 30, 2014 (in thousands):

	December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government and agency securities	$ 1,129	$	$	$ 1,129
Obligations of government-sponsored enterprises(1)	8,441	2	(3)	8,440
Corporate debt securities	198,748	18	(172)	198,594
Certificates of deposit	150			150
Total investments at December 31, 2013	$ 208,468	$ 20	$ (175)	$ 208,313

	September 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government and agency securities	$ 2,394	$	$ (1)	$ 2,393
Obligations of government-sponsored enterprises(1)	15,222	2	(2)	15,222
Corporate debt securities	182,809	27	(177)	182,659
Certificates of deposit	1,150			1,150
Total investments at September 30, 2014	$ 201,575	$ 29	$ (180)	$ 201,424

(1) Includes investments in notes issued by the Federal Home Loan Bank.

The maturity dates of the Company's investments as of September 30, 2014 are summarized below (in thousands):

	Amortized Cost	Estimated Fair Value
2014	$ 32,325	$ 32,297
2015	141,233	141,169
2016	28,017	27,958
Total investments at September 30, 2014	$ 201,575	$ 201,424

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Income Taxes

The Company's effective income tax rates were 22.0 percent and 34.3 percent for the nine months ended September 30, 2013 and 2014, respectively. These rates differ from the federal statutory income tax rate primarily due to state income taxes, permanent differences between book and tax income, and changes to recorded tax contingencies and valuation allowances. The Company also accrues interest and penalties related to unrecognized tax benefits in its provision for income taxes. The effective income tax rate for the nine months ended September 30, 2013 is lower than the effective rate for the nine months ended September 30, 2014 mainly due to the non-deductible ACA fees, lower reversals of tax contingencies in the current year from the closure of statutes of limitation, and increased valuation allowances in the current year for certain deferred tax assets.

The Company files a consolidated federal income tax return for the Company and its eighty percent or more owned subsidiaries, and the Company and its subsidiaries file income tax returns in various state and local jurisdictions. With few exceptions, the Company is no longer subject to state or local income tax assessments by tax authorities for years ended prior to 2010. Further, the statutes of limitation regarding the assessment of federal and certain state and local income taxes for 2010 closed during the current quarter. As a result, $18.7 million of unrecognized tax benefits (excluding interest costs) recorded as of December 31, 2013 were reversed in the current quarter, of which $15.6 million is reflected as a discrete reduction to income tax expense, $2.6 million as an increase to additional paid-in capital, and the remainder as a decrease to deferred tax assets. Additionally, $1.3 million of accrued interest was reversed in the current quarter and reflected as a reduction to income tax expense due to the closing of statutes of limitation on tax assessments.

Stock Compensation

At December 31, 2013 and September 30, 2014, the Company had equity-based employee incentive plans, which are described more fully in Note 6 in the Company's Annual Report on Form 10-K for the year ended December 31, 2013. The Company recorded stock compensation expense of $4.5 million and $14.8 million for the three and nine months ended September 30, 2013 and $11.9 million and $26.0 million for the three and nine months ended September 30, 2014, respectively. Stock compensation expense recognized in the consolidated statements of income for the nine months ended September 30, 2013 and 2014 has been reduced for forfeitures, estimated at four percent for both periods.

The weighted average grant date fair value of all stock options granted during the nine months ended September 30, 2014 was $13.55 as estimated using the Black-Scholes-Merton option pricing model, which also assumed an expected volatility of 26.20 percent based on the historical volatility of the Company's stock price.

The benefits of tax deductions in excess of recognized stock compensation expense are reported as a financing cash flow, rather than as an operating cash flow. In the nine months ended September 30, 2013 and 2014, $1.1 million and $2.8 million, respectively, of benefits of such tax deductions related to stock compensation expense were realized and as such were reported as financing cash flows. For the nine months ended September 30, 2013, the net change to additional paid in capital related to tax

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benefits (deficiencies) was $0.4 million, which includes the $1.1 million of excess tax benefits offset by $(0.7) million of excess tax deficiencies. For the nine months ended September 30, 2014, the net change to additional paid in capital related to tax benefits (deficiencies) was $2.5 million, which includes the $2.8 million of excess tax benefits offset by $(0.3) million of excess tax deficiencies.

Summarized information related to the Company's stock options for the nine months ended September 30, 2014 is as follows:

	Options	Weighted Average Exercise Price
Outstanding, beginning of period	4,010,146	$ 47.23
Granted	729,636	59.89
Forfeited	(232,948)	53.91
Exercised	(941,070)	44.27
Outstanding, end of period	3,565,764	$ 50.17
Vested and expected to vest at end of period	3,530,403	$ 50.11
Exercisable, end of period	1,911,740	$ 46.20

All of the Company's options granted during the nine months ended September 30, 2014 vest ratably on each anniversary date over the three years subsequent to grant. All options granted during the nine months ended September 30, 2014 have a ten year life.

Summarized information related to the Company's nonvested restricted stock awards ("RSAs") for the nine months ended September 30, 2014 is as follows:

	Shares	Weighted Average Grant Date Fair Value
Outstanding, beginning of period	192,165	$ 56.59
Awarded(1)	1,450,316	57.74
Vested	(16,569)	52.82

Forfeited			
Outstanding, ending of period	1,625,912	$	57.66

(1) Includes 1,433,946 shares associated with the CDMI acquisition.

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Summarized information related to the Company's nonvested restricted stock units ("RSUs") for the nine months ended September 30, 2014 is as follows:

	Shares	Weighted Average Grant Date Fair Value
Outstanding, beginning of period	194,913	$ 50.21
Awarded	76,306	60.39
Vested	(91,510)	49.53
Forfeited	(18,079)	54.77
Outstanding, ending of period	161,630	$ 54.89

The vesting period for RSAs ranges from 12 months to 42 months. In general, RSUs vest ratably on each anniversary over the three years subsequent to grant, assuming that the associated performance hurdle(s) for that vesting year are met.

Long Term Debt and Capital Lease Obligations

On December 9, 2011, the Company entered into a Senior Secured Revolving Credit Facility Credit Agreement with Citibank, N.A., Wells Fargo Bank, N.A., Bank of America, N.A., and U.S. Bank, N.A. that provides for up to $230.0 million of revolving loans with a sublimit of up to $70.0 million for the issuance of letters of credit for the account of the Company (the "2011 Credit Facility"). Citibank, N.A., has assigned a portion of its interest in the 2011 Credit Facility to Bank of Tokyo. The 2011 Credit Facility is guaranteed by substantially all of the non-regulated subsidiaries of the Company and is secured by substantially all of the assets of the Company and the subsidiary guarantors. The 2011 Credit Facility was scheduled to mature on December 9, 2014.

Under the 2011 Credit Facility, the annual interest rate on revolving loan borrowings is equal to (i) in the case of U.S. dollar denominated loans, the sum of a borrowing margin of 0.75 percent plus the higher of the prime rate, one-half of one percent in excess of the overnight "federal funds" rate, or the Eurodollar rate for one month plus 1.00 percent, or (ii) in the case of Eurodollar denominated loans, the sum of a borrowing margin of 1.75 percent plus the Eurodollar rate for the selected interest period. The Company has the option to borrow in U.S. dollar denominated loans or Eurodollar denominated loans at its discretion. Letters of credit issued under the Revolving Loan Commitment bear interest at the rate of 1.875 percent. The commitment commission on the 2011 Credit Facility is 0.375 percent of the unused Revolving Loan Commitment.

On July 23, 2014, the Company entered into a $500.0 million Credit Agreement with various lenders that provides for Magellan Rx Management, Inc. (a wholly owned subsidiary of Magellan Health, Inc.) to borrow up to $250.0 million of revolving loans, with a sublimit of up to $70.0 million for the issuance of letters of credit for the account of the Company, and a term loan in an original aggregate principal amount of $250.0 million (the "2014 Credit Facility"). At such point, the 2011 Credit Facility was terminated. The 2014 Credit Facility is guaranteed by substantially all of the

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non-regulated subsidiaries of the Company and will mature on July 23, 2019, but the Company holds an option to extend the 2014 Credit Facility for an additional one year period.

Under the 2014 Credit Facility, the annual interest rate on revolving and term loan borrowings is equal to (i) in the case of base rate loans, the sum of a borrowing margin of 0.50 percent plus the higher of the prime rate, one-half of one percent in excess of the overnight "federal funds" rate, or the Eurodollar rate for one month plus 1.00 percent, or (ii) in the case of Eurodollar rate loans, the sum of a borrowing margin of 1.50 percent plus the Eurodollar rate for the selected interest period, which rates shall be adjusted from time to time based on the Company's total leverage ratio. The Company has the option to borrow in base rate loans or Eurodollar rate loans at its discretion. Letters of credit issued bear interest at the rate of 1.625 percent. The commitment commission on the 2014 Credit Facility is 0.20 percent of the unused Revolving Loan Commitment, which rate shall be adjusted from time to time based on the Company's total leverage ratio.

On September 30, 2014, the Company completed a draw-down of the $250.0 million term loan. The borrowings will initially be maintained as a Eurodollar loan. The term loan is subject to certain quarterly amortization payments. As of September 30, 2014, the term loan bore interest at a rate of 1.50 percent plus the London Interbank Offered Rate ("LIBOR"). As of September 30, 2014, the one-month interest rate was 1.654 percent. As of September 30, 2014, the contractual maturities of the term loan were as follows: 2014 $3.1 million; 2015 $12.5 million; 2016-$15.6 million; 2017 $25.0 million; 2018 $25.0 million; and 2019 $168.8 million.

There were $26.7 million and $24.4 million of capital lease obligations at December 31, 2013 and September 30, 2014, respectively. The Company had $33.7 million and $32.9 million of letters of credit outstanding at December 31, 2013 and September 30, 2014, respectively, and no revolving loan borrowings at December 31, 2013 or September 30, 2014.

Goodwill

The Company is required to test its goodwill for impairment on at least an annual basis and more frequently if indicators of impairment exist. The Company has selected October 1 as the date of its annual impairment test. Goodwill for each of the Company's reporting units at December 31, 2013 and September 30, 2014 were as follows (in thousands):

	December 31, 2013	September 30, 2014
Health Plan	$ 120,485	$ 129,042
Public Sector	20,882	20,879
Specialty Solutions	104,549	104,549
Pharmacy Management	242,290	311,636
Total	$ 488,206	$ 566,106

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The changes in the carry amount of goodwill for the year ended December 31, 2013 and the nine months ended September 30, 2014 are reflected in the table below (in thousands):

	December 31, 2013	September 30, 2014
Balance as of beginning of period	$ 426,939	$ 488,206
Acquisition of Partners Rx(1)	40,385	254
Acquisition of AlphaCare Holdings(1)	20,882	(3)
Acquisition of CDMI		69,092
Acquisition of Cobalt		8,557
Balance as of end of period	$ 488,206	$ 566,106

(1) Activity for the period ended September 30, 2014 represents measurement period adjustments.

Intangible Assets

The following is a summary of intangible assets at December 31, 2013 and September 30, 2014, and the estimated useful lives for such assets (in thousands):

		December 31, 2013		
Asset	Estimated Useful Life	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer agreements and lists	2.5 to 18 years	$ 163,990	$ (100,482)	$ 63,508
Provider networks and other	1 to 16 years	11,593	(5,407)	6,186
		$ 175,583	$ (105,889)	$ 69,694

Asset	Estimated Useful Life		Gross Carrying Amount		Accumulated Amortization		Net Carrying Amount
Customer agreements and lists	2.5 to 18 years	$	249,390	$	(115,598)	$	133,792
Provider networks and other	1 to 16 years		13,013		(6,492)		6,521
		$	262,403	$	(122,090)	$	140,313

Amortization expense was $2.3 million and $6.9 million for the three and nine months ended September 30, 2013, respectively, and $6.6 million and $16.2 million for the three and nine months ended September 30, 2014, respectively. The Company estimates amortization expense will be $22.8 million, $25.0 million, $20.7 million, $16.9 million and $15.4 million for the years ended December 31, 2014, 2015, 2016, 2017, and 2018, respectively.

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Redeemable Non-Controlling Interest

On December 31, 2013, the Company acquired a 65% equity interest in AlphaCare Holdings, Inc. ("AlphaCare Holdings"). The other shareholders of AlphaCare Holdings have the right to exercise put options, requiring the Company to purchase up to 50% of the remaining shares prior to January 1, 2017 provided certain membership levels are attained. After December 31, 2016 the other shareholders of AlphaCare Holdings have the right to exercise put options requiring the Company to purchase all or any portion of the remaining shares. In addition, after December 31, 2016 the Company has the right to purchase all remaining shares. Non-controlling interests with redemption features, such as put options, that are not solely within the Company's control are considered redeemable non-controlling interest. Redeemable non-controlling interest is considered to be temporary and is therefore reported in a mezzanine level between liabilities and stockholders' equity on the Company's consolidated balance sheet at the greater of the initial carrying amount adjusted for the non-controlling interest's share of net income or loss or its redemption value. The Company recorded $10.6 million of redeemable non-controlling interest in relation to the acquisition. The carrying value of the non- controlling interest as of September 30, 2014 was $7.2 million. The $3.4 million reduction in carrying value for the nine months ended September 30, 2014 is a result of operating losses. The Company recognizes changes in the redemption value on a quarterly basis and adjusts the carrying amount of the non-controlling interest to equal the redemption value at the end of each reporting period. Under this method, this is viewed at the end of the reporting period as if it were also the redemption date for the non-controlling interest. The Company will reflect redemption value adjustments in the earnings per share calculation if redemption value is in excess of the carrying value of the non-controlling interest. As of September 30, 2014, the carrying value of the non-controlling interest exceeded the redemption value and therefore no adjustment to the carrying value was required.

Reclassifications

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

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NOTE B Net Income per Common Share Attributable to Magellan Health, Inc.

The following tables reconcile income attributable to common shareholders (numerator) and shares (denominator) used in the computations of net income per share attributable to common shareholders (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	**2014**	**2013**	**2014**
Numerator:				
Net income attributable to Magellan Health, Inc.	$ 47,232	$ 27,133	$ 106,770	$ 57,839
Denominator:				
Weighted average number of common shares outstanding basic	26,990	26,703	26,976	27,070
Common stock equivalents stock options	655	404	539	517
Common stock equivalents restricted stock	4	133	11	77
Common stock equivalents restricted stock units	54		35	18
Common stock equivalents employee stock purchase plan	1	2	2	2
Weighted average number of common shares outstanding diluted	27,704	27,242	27,563	27,684
Net income attributable to Magellan Health, Inc. per common share basic	$ 1.75	$ 1.02	$ 3.96	$ 2.14
Net income attributable to Magellan Health, Inc. per common share diluted	$ 1.70	$ 1.00	$ 3.87	$ 2.09

The weighted average number of common shares outstanding for the three and nine months ended September 30, 2013 and 2014 were calculated using outstanding shares of the Company's common stock. Common stock equivalents included in the calculation of diluted weighted average common shares outstanding for the three and nine months ended September 30, 2013 and 2014 represent stock options to purchase shares of the Company's common stock, restricted stock awards and restricted stock units, and stock purchased under the Employee Stock Purchase Plan.

The Company had additional potential dilutive securities outstanding representing 0.9 million and 0.9 million options for the three and nine months ended September 30, 2013, respectively, and 0.7 million and 0.6 million for the three and nine months ended September 30, 2014, respectively, that were not included in the computation of dilutive securities because they were anti-dilutive for the period. Had these shares not been anti-dilutive, all of these shares would not have been included in the net income attributable to common shareholder per common share calculation as the Company uses the treasury stock method of calculating diluted shares.

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NOTE C Business Segment Information

The accounting policies of the Company's segments are the same as those described in Note A "General." The Company evaluates performance of its segments based on segment profit attributable to Magellan shareholders, which is defined as income before taxes, excluding stock compensation expense, non-controlling interest segment profit (loss), depreciation and amortization, interest expense, interest income, gain on sale of assets, and special charges or benefits ("Segment Profit"). Management uses Segment Profit information for internal reporting and control purposes and considers it important in making decisions regarding the allocation of capital and other resources, risk assessment and employee compensation, among other matters. Public Sector subcontracts with Pharmacy Management to provide pharmacy benefits management services for certain of Public Sector's customers. In addition, Pharmacy Management provides pharmacy benefits management for the Company's employees covered under its medical plan. As such, revenue, cost of care, cost of goods sold and direct service costs and other related to these arrangements are eliminated. The Company's segments are defined above.

The following tables summarize, for the periods indicated, operating results by business segment (in thousands):

	Commercial	Public Sector	Specialty Solutions	Pharmacy Management	Corporate and Elimination	Consolidated
Three Months Ended September 30, 2013						
Managed care and other revenue	$ 190,655	$ 445,260	$ 94,125	$ 57,164	$ (17,091)	$ 770,113
PBM and dispensing revenue				103,485		103,485
Cost of care	(118,022)	(382,913)	(65,403)	(15,290)	17,091	(564,537)
Cost of goods sold				(97,503)		(97,503)
Direct service costs and other	(47,032)	(27,826)	(13,990)	(32,281)	(35,705)	(156,834)
Stock compensation expense(1)	124	259	384	198	3,559	4,524
Segment profit (loss)	$ 25,725	$ 34,780	$ 15,116	$ 15,773	$ (32,146)	$ 59,248

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SEPTEMBER 30, 2014

(Unaudited)

NOTE C Business Segment Information (Continued)

	Commercial	Public Sector	Specialty Solutions	Pharmacy Management	Corporate and Elimination	Consolidated
Three Months Ended September 30, 2014						
Managed care and other revenue	$ 144,257	$ 388,682	$ 120,808	$ 49,273	$	$ 703,020
PBM and dispensing revenue				241,226	(21,076)	220,150
Cost of care	(71,264)	(337,128)	(86,787)	(1)		(495,180)
Cost of goods sold				(223,251)	21,071	(202,180)
Direct service costs and other	(37,513)	(45,789)	(17,843)	(45,535)	(30,248)	(176,928)
Stock compensation expense(1)	164	225	269	8,122	3,181	11,961
Less: non-controlling interest segment profit (loss)(2)		(1,323)				(1,323)
Segment profit (loss)	$ 35,644	$ 7,313	$ 16,447	$ 29,834	$ (27,072)	$ 62,166

	Commercial	Public Sector	Specialty Solutions	Pharmacy Management	Corporate and Elimination	Consolidated
Nine Months Ended September 30, 2013						
Managed care and other revenue	$ 578,030	$ 1,266,739	$ 277,118	$ 166,092	$ (48,557)	$ 2,239,422
PBM and dispensing revenue				298,685		298,685
Cost of care	(354,520)	(1,095,694)	(182,212)	(43,325)	48,557	(1,627,194)
Cost of goods sold				(281,190)		(281,190)
Direct service costs and other	(129,823)	(82,403)	(41,224)	(93,216)	(94,292)	(440,958)
Stock compensation expense(1)	390	833	1,275	898	11,368	14,764
Segment profit (loss)	$ 94,077	$ 89,475	$ 54,957	$ 47,944	$ (82,924)	$ 203,529

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MAGELLAN HEALTH, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2014

(Unaudited)

NOTE C Business Segment Information (Continued)

	Commercial	Public Sector	Specialty Solutions	Pharmacy Management	Corporate and Elimination	Consolidated
Nine Months Ended September 30, 2014						
Managed care and other revenue	$ 531,173	$ 1,206,579	$ 345,568	$ 149,620	$ (18,055)	$ 2,214,885
PBM and dispensing revenue				590,115	(27,341)	562,774
Cost of care	(299,318)	(1,034,754)	(250,192)	(16,296)	18,055	(1,582,505)
Cost of goods sold				(547,362)	27,318	(520,044)
Direct service costs and other	(120,319)	(134,138)	(50,881)	(122,691)	(92,655)	(520,684)
Stock compensation expense(1)	476	729				