

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-K**

**FOR ANNUAL AND TRANSITION REPORTS PURSUANT TO SECTIONS 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

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

**For the fiscal year ended March 31, 2006**

**OR**

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

**For the transition period from            to**

**Commission File Number 0-19291**

**CorVel Corporation**

*(Exact name of registrant as specified in its charter)*

**Delaware**

*(State or other jurisdiction of  
incorporation or organization)*

**2010 Main Street, Suite 600,**

**Irvine, California**

*(Address of principal executive offices)*

**33-0282651**

*(I.R.S. Employer  
Identification Number)*

**92614**

*(Zip Code)*

**Registrant's telephone number, including area code:**

**(949) 851-1473**

**Securities registered pursuant to Section 12(b) of the Act: None**

**Securities registered pursuant to Section 12(g) of the Act: Common Stock**

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act Yes  No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act Yes  No

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  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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. Large accelerated filer  Accelerated filer  Non-accelerated filer

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the Registrant's most recently completed second fiscal quarter:

As of September 30, 2005, the aggregate market value of the Registrant's voting and non-voting common equity held by non-affiliates of the Registrant was approximately \$133,000,000 based on the closing price per share of \$23.96 for the Registrant's common stock as reported on the Nasdaq National Market on such date multiplied by 5,540,889 shares (total outstanding shares of 9,682,967 less 4,142,078 shares held by affiliates) of the Registrant's common stock which were outstanding on such date. For the purposes of the foregoing calculation only, all of the Registrant's directors, executive officers and persons known to the Registrant to hold ten percent or greater of the Registrant's outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

Indicate the number of shares outstanding of each of the Registrant's classes of common stock, as of the latest practicable date: As of June 10, 2006, there were 9,416,900 shares of the Registrant's common stock, par value \$0.0001 per share, outstanding.

#### DOCUMENTS INCORPORATED BY REFERENCE

Information required by Items 10 through 14 of Part III of this Form 10-K to the extent not set forth herein, is incorporated herein by reference to portions of the Registrant's definitive proxy statement for the Registrant's 2006 Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission not later than 120 days after the end of the fiscal year ended March 31, 2006. Except with respect to the information specifically incorporated by reference in this Form 10-K, the Registrant's definitive proxy statement is not deemed to be filed as a part of this Form 10-K.

**CORVEL CORPORATION**  
**2006 FORM 10-K ANNUAL REPORT**

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In this report, the terms “CorVel”, “Company”, “we”, “us”, and “our” refer to CorVel Corporation and its subsidiaries.

### **CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

This report contains forward-looking statements within the meaning of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, including, but not limited to, the statements about our plans, strategies and prospects under the headings “Business” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and elsewhere in this report. Words such as “anticipates”, “expects”, “intends”, “plans”, “predicts”, “believes”, “seeks”, “estimates”, “may”, “will”, “should”, “would”, “could”, “potential”, “continue”, “ongoing” and variations of these words or similar expressions are intended to identify forward-looking statements. These forward-looking statements are based on management’s current expectations, estimates and projections about our industry, management’s beliefs, and certain assumptions made by management, and we can give no assurance that we will achieve our plans, intentions or expectations. Certain important factors could cause actual results to differ materially from the forward-looking statements we make in this report. Representative examples of these factors include (without limitation):

- general industry and economic conditions;
- cost of capital and capital requirements;
- competition from other managed care companies;
- the Company’s ability to renew and/or maintain contracts with its customers on favorable terms,
- the ability to expand certain areas of the Company’s business;
- shifts in customer demands;
- the ability of the Company to produce market-competitive software;
- increases in operating expenses including employee wages and benefits,
- changes in regulations affecting the workers’ compensation, insurance and healthcare industries in general;
- the ability to attract and retain key personnel,
- delays in completing financial and internal control audits,
- possible litigation and legal liability in the course of operations; and
- the continued availability of financing in the amounts, at the times, and on the terms necessary to support the Company’s future business.

The section entitled “Risk Factors” set forth in this report discusses these and other important risk factors that may affect our business, results of operations and financial condition. The factors listed above and the factors described under the heading “Risk Factors” and similar discussions in our other filings with the Securities and Exchange Commission are not necessarily all of the important factors that could cause actual results to differ materially from those expressed in any of our forward-looking statements. Other unknown or unpredictable factors also could have material adverse effects on our future results. Investors should consider these factors before deciding to make or maintain an investment in our securities. The forward-looking statements included in this annual report on Form 10-K are based on information available to us as of the date of this annual report. We expressly disclaim any intent or obligation to update any forward-looking statements to reflect subsequent events or circumstances.

## **PART I**

### **Item 1. Business.**

#### **INTRODUCTION**

CorVel is an independent nationwide provider of medical cost containment and managed care services designed to manage the medical costs of workers' compensation and other healthcare benefits, primarily for coverage under group health and auto insurance policies. The Company's services are sold as separate services directed toward managing claims, care, networks, reimbursements and settlements. They include automated medical fee auditing, preferred provider networks, out-of-network/line-item bill negotiation and repricing, utilization review and management, medical case management, vocational rehabilitation services, early intervention, Medicare set-asides and life-care planning, and a variety of directed care services including independent medical examinations, diagnostic imaging, transportation and translation, and durable medical equipment. Some customers purchase just one service, while other customers purchase more than one service. Customers of the Company that do not purchase managed care services generally either purchase such services from other vendors, perform such services using their own resources or elect not to utilize such services for managing their costs.

Such services are provided to insurance companies, third-party administrators ("TPAs"), and self-administered employers to assist them in managing the medical costs and monitoring the quality of care associated with healthcare claims.

The Company was incorporated in Delaware in 1991, and its principal executive offices are located at 2010 Main Street, Suite 600, Irvine, California, 92614. The Company's telephone number is 949-851-1473.

#### **INDUSTRY OVERVIEW**

Workers' compensation is a federally mandated, state-legislated, comprehensive insurance program that requires employers to fund medical expenses, lost wages and other costs resulting from work-related injuries and illnesses. Workers' compensation benefits and arrangements vary extensively on a state-by-state basis and are often highly complex. State statutes and court decisions control many aspects of the compensation process, including claims handling, impairment or disability evaluation, dispute settlement, benefit amount guidelines and cost-control strategies.

Workers' compensation plans generally require employers to fund all of an employee's costs of medical treatment and a significant portion of lost wages, legal fees and other associated costs. In certain jurisdictions, provision of vocational rehabilitation is also mandatory. Typically, work-related injuries are broadly defined and injured or ill employees are entitled to extensive benefits. Employers generally are required to provide first-dollar coverage with no co-payment or deductible due from the injured or ill employee for medical coverage for employees, and are not subject to litigation by employees for benefits in excess of those provided by the relevant state statute. In most states, the extensive benefits coverage (for both medical costs and lost wages) is provided to employees through the employer's purchase of commercial insurance from private insurance companies, participation in state-run insurance funds or self-insurance.

Healthcare provider reimbursement methods vary on a state-by-state basis. As of March 1, 2006, forty states have adopted fee schedules pursuant to which all healthcare providers are uniformly reimbursed. The fee schedules are set individually by each state and generally prescribe the maximum amounts that may be reimbursed for a designated procedure. In states without fee schedules, healthcare providers generally are reimbursed based on usual, customary and reasonable fees charged in the particular state in which services are provided.

Many states do not permit employers to restrict a claimant's choice of provider, making it more difficult for employers to utilize managed care approaches such as health maintenance organizations ("HMOs") and preferred

provider organizations (“PPOs”). However, in many other states, employers have the right to direct employees to a specific primary healthcare provider during the onset of a workers’ compensation case, subject to the right of the employee to change physicians after a specific period. In addition, workers’ compensation programs vary from state to state, making it difficult for payors and multi-state employers to adopt uniform policies to administer, manage and control the costs of benefits. As a result, the Company believes that managing the cost of workers’ compensation requires approaches which are tailored to the specified regulatory environment in which the employer is operating. Because workers’ compensation benefits are mandated by law and are subject to extensive regulation, the Company believes that payors and employers do not have the same flexibility to alter benefits as they might have with other health benefits programs.

Managed care techniques are intended to control the cost of healthcare services and to measure the performance of providers through intervention and ongoing review of services proposed and those actually provided. Managed care techniques were originally developed to stem the rising costs of group medical care. Historically, employers were slow to apply managed care techniques to workers’ compensation costs primarily because the aggregate costs are relatively small compared to costs associated with group health benefits and because state-by-state regulations related to workers’ compensation are far more complex than those related to group health. However, in recent years, the Company believes that employers and insurance carriers have been increasing their focus on applying managed care techniques to control their workers’ compensation costs.

An increasing number of states have adopted legislation encouraging the use of workers’ compensation managed care organizations (“MCOs”) in an effort to allow employers to control their worker’s compensation costs. MCO laws generally provide employers an opportunity to channel injured employees into provider networks. In certain states, MCO laws require licensed MCOs to offer certain specified services, such as utilization management, case management, peer review and provider bill review. The Company believes that most of the MCO laws adopted to date establish a framework within which a company such as CorVel can provide its customers a full range of managed care services for greater cost control.

## **FISCAL 2006 DEVELOPMENTS**

### ***Company Stock Repurchase Program***

During fiscal 2006, the Company continued to repurchase shares of its common stock under a plan originally approved by the Company’s Board of Directors in 1996. In March 2005, the Company’s Board of Directors increased the number authorized to be repurchased to 7.1 million shares. During fiscal 2006, the Company spent \$18.7 million to repurchase 835,339 shares of its common stock. Since commencing this program in the fall of 1996, the Company has repurchased 7.1 million shares of its common stock through March 31, 2006, the full amount authorized by the Company’s Board of Directors, at a cost of \$132 million. These repurchases were funded from the Company’s operating cash flows. In June 2006, the Company’s Board of Directors authorized an increase in the number of shares to be repurchased by 1,000,000 shares to 8,100,000 shares.

### ***MedCheck Enhancements***

With the Company’s continual investment in technology, developments of MedCheck, the Company’s propriety bill review software, are ongoing. New enhancements include the expert review matrix (ERM), MedCheck operations dashboard (MOD), increased look-up functionality and the creation of a comprehensive data where house.

The development of the Expert Review Matrix bill search function capitalizes on advances in image processing and artificial intelligence (AI) to optimize medical review savings. ERM processing techniques allow specialists in each diagnosis category, regulatory jurisdiction or benefit category access to bills across the country through MedCheck's secure server. This access permits CorVel specialists to utilize their knowledge and provide optimum review for each bill.

The MOD is an internal MedCheck application used to provide key metrics on behalf of CorVel's customers to help facilitate timely bill review. These reports can be organized in the form of charts, graphs and spreadsheets. Currently, the MOD is in development for direct access to customer via the CareMC Web portal.

The Company offers a preferred provider look-up on both Websites: corvel.com and caremc.com. During the year, the Company increased the functionality of the look-up with application enhancements. Customers can now create and develop customized, network specific panels and directories in real time.

The Company continued the development and design of its Data Warehouse systems capabilities. The Data Warehouse was designed to assist the Company and customers with expedited access to analytical data and reports. The warehouse is updated on a nightly basis and is accessible via the CareMC Website. The Company will continue to invest in this technology in the coming years with focus on the timeliness of information for the Company's customers.

### ***Directed Care Network Expansions***

The Company accelerated investments in its directed care networks. CorVel is expanding both the breadth of care covered by its directed care networks, CareIQ, as well as the geographic coverage. Market reception for these second generation networks and their effectiveness are the driving forces for this expansion.

### ***Systems and Technology Enhancements***

CorVel moved from a 32-bit processing system to a 64-bit processing capability within its core production systems, MedCheck and CareMC. The new infrastructure integrates network storage and allows the Company to access more data threads simultaneously and at much faster speeds. This investment enhances the overall processing capabilities and will enable CorVel to process more records in a shorter amount time, which can lead to greater efficiencies in productivity. This new system is the foundation for future architectures planned over the next five years. Total processing time is decreased due to improved redundancies, scaled architecture, and reduced single points of failure.

### ***Network Solutions***

Through its network solutions services, the Company saved over \$2 billion for its clients during fiscal 2006. The Company generated a greater savings for their customers as a percentage of the medical dollars reviewed than in previous years primarily due to the enhanced rules engine in the Company's MedCheck software. The Company believes its processes are becoming more streamlined and efficient for the reasons discussed as noted below under "Systems and Technology."

### ***ePPO Sales***

The Company had record growth in the ePPO product line stemming primarily from growth with existing large carrier clients, new managed care organizations and employer clients. ePPO is the electronic solution to CorVel's PPO network and provides the electronic intake and transmission of provider bills as well as automated pricing to the CorCare PPO Network. ePPO customers process provider bills to state mandated fee schedule or usual and customary rates, but lease PPO access to gain additional discounts afforded by PPO contracts. The Company's technological capabilities allow for electronic claim repricing solutions that are attractive to buyers of managed care services and can be integrated with their existing eCommerce products. ePPO provides access to CorVel's PPO network of more than 400,000 quality healthcare providers through electronic interface solutions. PPO database management expenses, associated with download models and to optimize repricing results. Bills reviewed through payor systems can be electronically interfaced to the CorCare PPO database, and automatically adjusted to reflect current PPO pricing. In addition, CorCare can reimburse providers automatically, significantly reducing the expense of generating EOR's, payment to providers and year-end tax filings.

## **SYSTEMS AND TECHNOLOGY**

### ***Infrastructure Changes***

The Company is currently developing a processing system that will be accessible twenty-four hours a day, seven days a week. During the past year, a number of infrastructure improvements were made to reduce the amount of time spent maintaining and backing up the Company's transactional databases. Two years ago, these databases were unavailable for processing each weeknight for several hours. Currently, in the case of the Company's medical bill review application, this has been reduced to a single maintenance window each weekend. By providing continual access, the Company is positioned to conduct business within all time zones, therefore increasing the Company's ability to deliver processed bills faster.

### ***Adoption of Imaging Technologies and Paperless Workflow***

Utilizing scanning and automated data capture processes allows the Company to process incoming paper and electronic claims documents, including medical bills, with less manual handling and has improved the Company's workflow process.

Scanning is the process of taking a bill and transferring it to an electronic form. Optical character recognition ("OCR") involves the automated reading of words from a digital image, such as a scanned document. The characters are translated into a standard text format, which can then be digitally manipulated. Scanning technology, OCR and electronic data interchange ("EDI") enable the Company to significantly cut back on manual data entry as well as reduce the other traditional costs associated with handling paper. Through the Company's internet portal, Care<sup>MC</sup>, customers can review the bills currently being processed and approve a bill for processing, which also helps to avoid the costs of paper-handling as well as expedite the payment process.

### ***Redundancy Center***

The Company's national data center is located in Portland, Oregon. The Company also has a redundancy center located in Ft. Worth, Texas. The redundancy center is the Company's backup processing site in the event that the Portland data center is off-line for any length of time. Currently, all of the Company's data is continually replicated to Ft. Worth so that in the event the Portland data center is offline, the redundancy center can be activated with current information within several hours. The Ft. Worth data center also hosts duplicates of the Company's Websites and is the primary processing site for the Company's Enterprise Comp service line.

## **BUSINESS - PRODUCTS**

The Company offers services in two general categories, network solutions and patient management services, to assist its customers in managing the increasing medical costs of workers' compensation, group health and auto insurance, and monitoring the quality of care provided to claimants.

### **Network Solutions**

The Company's Network Solutions services are a combination of medical bill review, enhanced bill review and Preferred Provider Organization (PPO). This program provides additional assurance that customers are only charged and pay for services actually delivered. Bills are evaluated, profiled and directed for the appropriate service based on state regulation, bill type and opportunity for savings and success.

### ***Proprietary Bill Review System***

Many states have adopted fee schedules, which regulate the maximum allowable fees payable under workers' compensation for procedures performed by a variety of health treatment providers. Such schedules may

also include fees for hospital treatment. The purpose of a fee schedule is to standardize the billing process by using uniform procedure descriptions and to set maximum reimbursement levels for each covered service.

Certain other states permit payors to pay workers' compensation medical costs limited to usual and customary charges for the relevant community. The Company provides automated medical fee auditing to assist its customers in verifying that the fees charged by workers' compensation healthcare providers comply with state fee schedules, or are consistent with usual and customary charges.

The Company offers its fee schedule auditing through an automated medical bill review service called MedCheck, which combines automated data reporting and transmission capabilities. MedCheck consists of an online computer-based information system comprised of a proprietary software program which stores and accesses state-mandated fee schedules and usual and customary charge information.

MedCheck is also being utilized for the review of medical charges under certain non-workers' compensation insurance coverages. The MedCheck service provides the following capabilities:

- checking for provider charges which exceed charges allowable under fee schedules or usual and customary charges, in accordance with the requirements of the relevant jurisdiction;
- repricing provider bills to contractual PPO reimbursement levels;
- checking for billed services or procedures that are excessive, unnecessary or unrelated to treating the particular medical problem and duplicate billing;
- checking for "unbundled" billings where the medical services performed are billed in components, that result in higher total charges than would be the case if the services were billed in the aggregate;
- engaging in on-site processing of claims and Internet-based reporting tools;
- sending claims data directly to carriers' databases, thereby reducing costs due to repetitive or erroneous data entry;
- PPO management; and
- pharmacy review.

The MedCheck system can be accessed by insurers under an ASP agreement through the Company's eCommerce Website, Care<sup>MC</sup>, and through virtual private networks ("VPNs"). The MedCheck suite can accept electronic bills and bill images, and publish EDIs to customer claims payment systems. This system integrates into the client's own workflow, automates the reimbursement of providers, allows for the application of all MedCheck fees to the individual claim file and eliminates the need for manual redundant data entry of MedCheck results by the carriers' claims personnel. The system is designed for easy access by claims adjusters and includes functionality for such part-time users within the claims payment environment.

### ***Preferred Provider Organization***

PPOs are groups of hospitals, physicians and other healthcare providers that offer services at pre-negotiated rates to employee groups. The Company believes that PPO networks offer the employer an additional means of managing healthcare costs by reducing the per-unit price of medical services provided to employees. The Company launched its CorCare network in 1992 and provides its customers with access to its PPO network, including more than 400,000 healthcare providers nationwide.

PPO providers are selected based on criteria such as quality, range of services, price and location. Each one is evaluated and credentialed, and then re-credentialed bi-annually by the Company. Throughout this evaluation process, the CorCare networks are able to provide hospital, physician and special ancillary medical discounts while maintaining quality care.

CorVel has a long-term strategy of network development, providing comprehensive networks to our customers and customization of networks to meet the specific needs of our customers. The Company believes that the combination of its national PPO director's strength and presence and the local PPO developers' commitment and community involvement enables CorVel to build, support and strengthen its PPO in size, quality, depth of discount, and commitment to service.

Over 80% of the providers in our network are directly contracted. CorVel does maintain some leased network access agreements only to the extent to which they provide broader network access capabilities, such as size, demographics and discounts, and to the extent that they enable CorVel to provide prompt response to network expansion requests while maintaining quality assurance controls.

In total, the Company has more than 220 national, regional and local personnel supporting the CorCare network. This number includes our national PPO director, national PPO contracting manager and contracting staff, in addition to 70 locally based PPO developers who are responsible for local recruitment, contract negotiations, credentialing and re-credentialing of providers, and working with customers to develop customer specific provider networks. Each bill review unit has provider relations support staff to address provider grievances and other billing issues.

Bills submitted from preferred providers are identified through the MedCheck bill review process, and the submitted charges are then audited against the PPO schedule and against any applicable fee schedule or usual and customary charges. The fee approved for payment is the lower of the submitted charges or the lowest allowable fee identified. Some of the features of the Company's PPO network services include: national networks for all coverages, board certified physicians, automated provider credentialing, patient channeling, online provider look-up and printable directories.

The Company offers online provider look-up on its Website where users can locate providers in their area, see a map, get door-to-door driving directions or print a directory.

#### ***Enhanced Bill Review - Retrospective Utilization Review***

The Company offers a full line of retrospective utilization services for all medical bills including PPO management, medical bill repricing, line-item bill review, professional nurse review, diagnosis related group ("DRG") validation and expert fee negotiation. The service, named MedCheck Select, is designed to maximize savings opportunities and increase efficiencies for customers.

CorVel offers cost containment by examining medical bills to verify that payors are only charged for services actually delivered and that charges reflect current billing levels for comparable service.

CorVel uses a combination of industry standard usual and customary databases, as well as a proprietary nationwide database of usual and customary charges for inpatient care. The inpatient database provides usual and customary charges for detailed charges, which are specified on the itemized hospital bill.

MedCheck Select service is designed to:

- assure that billed charges are usual and customary;
- confirm services were medically necessary;
- reduce claim costs through negotiated agreements;
- substantiate, by report, charges over usual and customary;
- support the payor and patient in all appeals;
- review out-of-network bills;
- provide a proprietary hospital usual and customary database;
- review professional nurses;
- provide expert fee negotiations;
- validate diagnostic related groups; and
- be HIPAA, AB1455, California SB 288 and SB899 compliant.

#### ***Provider Reimbursement***

Through MedCheck, the Company has the capability to provide check writing or provider reimbursement services for its customers. The provider payment check can be added to the bill analysis to produce one combined document, which is mailed to the provider. MedCheck reviews bills and providers are reimbursed directly upon completion of customer approval of the EOR. This service is designed to help customers expedite claims closure.

### ***Medical Review Application Service Provider (ASP)***

CorVel customers can utilize MedCheck's capabilities to insource their bill review processing needs, process varying portions of their workload from their own sites, or utilize MedCheck on an ASP basis. Through the ASP model, the customer can access MedCheck software over the Internet and process all, or a portion of their claims, themselves. ASP processing provides payors with MedCheck capabilities without the need for payors to invest heavily in computer systems, software support, and maintenance or the administration of the many information databases critical to proper medical reimbursement adjudication.

### ***Pharmacy Program – CorCareRX***

CorCareRX is the Company's national workers' compensation pharmacy management system. The CorCareRX Average Wholesale Price ("AWP") pricing model provides clients the amount of savings they will receive below the cost of prescriptions associated with a workers' compensation claim.

CorCareRX has been specifically designed to:

- manage claimants' prescription expenses;
- monitor appropriate utilization; and
- ensure prescriptions are related to injury.

The CorCareRX program offers a patient identification card that limits dispensing of drugs to those specifically authorized by the physician for a specific workers' compensation injury. The program was designed to ensure that the medication an injured employee receives is appropriate for the injury and is dispensed in the appropriate quantity. CorCareRX utilizes an identification system that creates a unique number that is specific to the particular claim. The use of the CorCareRX program eliminates the handling of pharmacy bills by the employee completely. All the processing and repricing occurs electronically, so that the payor need only to approve the payment. The Company's reporting system allows the claims payor to manage and track prescription drug costs from the onset of the injury.

### ***Directed Care Networks - Care<sup>IQ</sup>***

CorVel has expanded its network solutions with a directed care network. Care<sup>IQ</sup>, CorVel's directed care service line, offers an automated service ordering and status management system online. The Company's network service offers timely appointments and preferred pricing. Orders are fulfilled using local, preferred providers and billing and reimbursement for each transaction is automatically processed. Services also include Web-based request for service, a call center, and online reporting. Care<sup>IQ</sup> has a relationship with over 50% of the nation's credentialed facilities, offering the most extensive network of directed care services in the nation.

The Company's networks cover directed care needs for: independent medical evaluations (IME), medical imaging (MRI, EMG, CT and Bone Scan) durable medical equipment (DME), physical therapy, chiropractics, and transportation and translation services.

### **Patient Management Services**

In addition to its network solutions, the Company offers CorCase, a range of patient management services, which involve working on a one-on-one basis with injured employees and their various healthcare professionals, employers and insurance company claims professionals. Patient management services are designed to monitor the medical necessity and appropriateness of healthcare services provided to workers' compensation claimants and to expedite their return-to-work. CorCase offers early intervention, utilization management and vocational rehabilitation through local branch offices and case managers in local communities. The Company's case managers work side-by-side with patients to assist them through their episode of care and return-to-work. CorCase offers early intervention, utilization management and vocational rehabilitation through local branch offices and case managers in local communities. The Company's case managers work together with patients to assist them through their episode of care and return-to-work. The Company offers these services on a stand-alone basis or as an integrated component of its medical cost containment services.

These services are performed to maximize results and minimize costs. CorCase services are provided by trained and certified professionals in nursing and vocational counseling. The central focus of CorCase is to leverage quality care in order to manage claim costs. With the use of early intervention, nurses are able to gather and analyze medical treatment information and discuss with the employer the current job requirements of the injured worker, accommodations for modified work and gather any further information, which may assist in caring for the injured worker. This service positively impacts patient cases by utilizing proactive measures throughout the episode of care.

CorCase utilizes CorVel's proprietary Advocacy software to help determine available indemnity payments from the employer and coordinate case management information and issues. Protocols regarding length of disability are incorporated to guide the management of cases. Management and operations reports, electronic data interchange and billing are additional features of the software.

### ***Medical Case Management***

The Company offers medical case management services where the injury is catastrophic or complex in nature or where prolonged recovery is anticipated. The medical management components of CorVel's program focuses on medical intervention, management and appropriateness. In these cases, the Company's case managers confer with the attending physician, other providers, the patient and the patient's family to identify the appropriate rehabilitative treatment and most cost-effective healthcare alternatives. The program is geared towards offering the injured party prompt access to appropriate medical providers who will provide quality cost-effective medical care. Case managers may coordinate the services or care required and may arrange for special pricing of the required services.

### ***Early Intervention***

The Company believes that the earlier it becomes involved in an episode of care, the greater the impact on the healthcare outcome. The Company's early intervention program begins a series of steps that are designed to promote an employee's timely return-to-work including immediate telephonic assessment to ensure that an appropriate course of treatment is established and adhered to through the entire episode of care. CorVel's early intervention program features: automated, immediate notification, immediate patient assessment, clinical protocols and guidelines, channeling to preferred providers, private labeling options and telephonic case management.

### ***Telephonic Case Management***

Telephonic case management is designed to facilitate and promote patient care and patient progression through the healthcare system. The case manager, through telephonic contact with the patient and/or family, facilitates communication between the patient, insurer and healthcare providers in order to accelerate return-to-work.

### ***Utilization Management***

Utilization Management programs review proposed ambulatory care to determine: appropriateness, frequency, duration and setting. These programs utilize experienced registered nurses, proprietary medical treatment protocols and computer systems technology in an effort to avoid unnecessary treatments and associated costs. Processes in Utilization Management include: review injury, diagnosis and treatment plan; contact and negotiate provider's treatment requirements; certify appropriateness of treatment parameters and/or additional treatment requests; and respond to provider requests for additional treatment.

### ***Pre-certification of Hospitalization***

The pre-admission certification program verifies the medical necessity of proposed hospital admissions and determines the appropriate length of stay. The CorVel staff of nurses and reviewers, assisted by an automated medical rules/protocols system and backed up by physician consultants, individually evaluates every hospital admissions request. Pre-certification objectives include the following: determine appropriateness of proposed or emergent hospitalization; determine the medical necessity for hospital admission/inpatient care; explore alternatives to inpatient treatment; if inpatient care is required, determine the appropriate length of stay and monitor the patient's

condition throughout the hospitalization to prevent unnecessary inpatient days; channel the patient to a CorVel PPO provider/facility; and develop and implement a timely discharge plan.

### ***Inpatient Utilization Review***

The Company offers pre-certification and concurrent utilization review services. The Company's pre-certification service is designed to be utilized prior to the injured employee's admission to the hospital. Upon notification by a claims manager or employer, a Company nurse reviews the appropriateness of the proposed plan of care, the need for inpatient hospitalization, and the appropriate length of stay. Under the Company's concurrent review service the nurse reviewers monitor the medical necessity and appropriateness of the patient's continued hospitalization through regular contact with the hospital and the patient's physician and may identify cases that lend themselves to alternate treatment settings or home care.

### ***Vocational Rehabilitation***

In certain states, vocational rehabilitation is a legislated benefit of workers' compensation, which assists the employee's return to former employment or another job function with similar economic value. The Company offers vocational services to reduce workers' compensation costs and expedite the injured employee's return-to-work.

CorVel offers vocational services to evaluate the claimant's education, training and experience. Vocational services include work capacity assessments, job analysis, transferable skill analysis, job modification, vocational testing, job placement assistance, labor market surveys and retraining. By working with the employer, the Company's case managers can provide job modification or light-duty alternatives until the physician lifts the claimant's physical restrictions. In addition, CorVel can evaluate partial payment claims if the claimant returns to work in a new position, working for less than their pre-injury wage. Services included by the Company's vocational case managers include:

- ergonomic assessments;
- rehabilitation plans;
- transferable skills analysis;
- labor market survey;
- job seeking skills training;
- resume development;
- vocational assessment;
- job analysis, development and placement;
- expert testimony; and
- ADA compliance.

### ***Life Care Planning***

Life Care Planning is a tool used to project long-term future needs, services and related costs associated with catastrophic injury. CorVel's Life Care Plans summarize extensive amounts of medical data and compile it into a comprehensive report for future care requirements, producing improved outcomes and timely resolution of claims.

### ***Medicare Set-Asides***

A Medicare Set-Aside Allocation (MSA) is a process used to demonstrate to Medicare that adequate funds are available to cover the cost of future medical care and Medicare will not be assigned as the primary payor.

### ***Critical Stress Incident Debrief***

Crisis Counseling is used to minimize the effects of stress on employees following a traumatic event and maintain employees on their jobs following a critically stressful incident. Examples of such events include: experiencing or witnessing a physical assault, observing or suffering a catastrophic injury, and violence in the workplace.

## **Care<sup>MC</sup>**

In April 2000, the Company launched its Care<sup>MC</sup> Website (<http://www.caremc.com>). Care<sup>MC</sup> has become the application platform for all of the Company's primary services line and delivers immediate access to customers. Care<sup>MC</sup> offers customers direct access to the Company's primary services, Network Solutions, Patient Management and Claims Management. Care<sup>MC</sup> allows for electronic communication and reporting between providers, payors, employers and patients. Features of the Website include: request for service, FNOL (first notice of loss), appointment scheduling, online bill review, claims information management, treatment calendar, medical bill adjudication and automated provider reimbursement. Through the Care<sup>MC</sup> Website, users can:

- request services online;
- manage files throughout the life of the claim;
- receive and relay case notes from case managers; and
- integrate information from multiple claims management sources into one database.

The Care<sup>MC</sup> Website facilitates healthcare transaction processing. Using artificial intelligence techniques, the Website provides situation alerts and event triggers, to facilitate prompt and effective decisions. Users of Care<sup>MC</sup> can quickly see where event outliers are occurring within the claims management process. If costs exceed pre-determined thresholds or activities fall outside expected timelines, decision-makers can be quickly notified. Large amounts of information are consolidated and summarized to help customers focus on the critical issues.

## **Scanning Services**

In June 2003, the Company acquired Portland, Oregon based ScanOne, a provider of scanning, optical character recognition and document management services. This acquisition expanded the Company's existing office automation service line and all offices are selling scanning and document management, the services previously sold by Scan One. The Company has added scanning operations to approximately 40 of the Company's larger offices around the country calling them "Capture Centers."

With the scanning capability, the Company is able to store claim documents and organize the information by document type with the documents readily available on-line. The benefits of scanning are threefold: the service reduces costs, saves time and increases productivity. On the front-end of the scanning process, which is scanning technology, optical character recognition and electronic data interchange, can enable organizations to significantly cut back on manual data entry and paper shuffling. It also increases reporting, sorting and indexing capabilities. With scanning, customers are able to electronically view documents and images, obtain information in real-time, reduce overhead, staffing, and paper storage costs.

Scan One also offers a Web interface ([www.onlinedocumentcenter.com](http://www.onlinedocumentcenter.com)) providing immediate access to documents and data called the Online Document Center (ODC). Secure document review, approval, transaction workflow and archival storage are available at subscription-based pricing.

Aside from ScanOne's services to CorVel, they actively pursue marketing initiatives to customers in the following fields: Accounting Department, Insurance Carrier, Hospital Administration, Clinics and Legal Field.

## **INDUSTRY, CUSTOMERS AND MARKETING**

The company focuses on four major industries around the country: workers' compensation, auto insurance, group health and municipalities.

The Company's customers primarily are workers' compensation insurers and, to a lesser extent, TPAs and self-administered employers. Many claims management decisions in workers' compensation are the responsibility of the local claims office of national or regional insurers. The Company's national branch office network has been

established to enable the Company to market and offer its services at both a local and national account level. The Company is placing increasing emphasis on national account marketing. The marketing activities of the Company are conducted by account executives located in key geographic areas. No single customer of the Company represented more than 10% of revenues in fiscal 2004, 2005 or 2006.

## **COMPETITION AND MARKET CONDITIONS**

The healthcare cost containment industry is highly fragmented and competitive and is subject to shifting customer requirements, frequent introductions of new products and services, increased marketing activities of other industry participants and legislative reforms. The Company expects intensity of competition to increase in the future as existing competitors continue to develop their products and services and as new companies enter the Company's market. The Company's primary competitors in the workers' compensation market include some large insurance carriers which offer one or more services similar to those offered by the Company, HMOs and numerous independent companies, typically on a local or regional basis. The Company also competes with national and local firms specializing in utilization review and with major insurance carriers and TPAs which have implemented their own internal utilization review services. Many of the Company's competitors are significantly larger and have greater financial and marketing resources than the Company. Moreover, the Company's customers may establish the in-house capability of performing services offered by the Company. If the Company is unable to compete effectively, it will be difficult for the Company to add and retain customers, and the Company's business, financial condition and results of operations will be seriously harmed.

Legislative reforms in some states permit employers to designate health plans such as HMOs and PPOs to cover workers' compensation claimants. Because many health plans have the capacity to manage healthcare for workers' compensation claimants, such legislation may intensify competition in the market served by the Company.

The Company believes that declines in workers' compensation costs in these states are due principally to intensified efforts by payors to manage and control claim costs, to improved risk management by employers and to legislative reforms. If declines in workers' compensation costs occur in many states and persist over the long-term, they may have an adverse impact on the Company's business, financial condition and results of operations.

The Company believes the principal factors that generally determine a company's competitive advantage in the Company's market include the following: specialization in workers' compensation, breadth of services, ability to offer local services on a nationwide basis, information management systems and independence from insurance carriers. There can be no assurance that the Company will be successful in all or any of these areas that the Company believes contribute to competitive advantage, that the Company will be able to compete successfully against current or potential competitors, or that competition will not have a material adverse effect on the Company's business, financial condition and results of operations.

## **GOVERNMENT REGULATIONS**

### ***General***

Managed healthcare programs for workers' compensation are subject to various laws and regulations. Both the nature and degree of applicable government regulation vary greatly depending upon the specific activities involved. Generally, parties that actually provide or arrange for the provision of healthcare services, assume financial risk related to the provision of those services or undertake direct responsibility for making payment or payment decisions for those services, are subject to a number of complex regulatory schemes that govern many aspects of their conduct and operations.

In contrast, the management and information services provided by the Company to its customers typically have not been the subject of regulation by the federal government or the states. Since the managed healthcare field is a rapidly expanding and changing industry and the cost of providing healthcare continues to increase, it is possible that the applicable state and federal regulatory frameworks will expand to have a greater impact upon the conduct and operation of the Company's business.

Under the current workers' compensation system, employer insurance or self-funded coverage is governed by individual laws in each of the 50 states and by certain federal laws. The management and information services that make up the Company's managed care program serve markets that have developed largely in response to needs of insurers, employers and large TPAs, and generally have not been mandated by legislation or other government action. On the other hand, the vocational rehabilitation case management marketplace within the workers' compensation system has been dependent upon the laws and regulations within those states that require the availability of specified rehabilitation services for injured workers. Similarly, the Company's fee schedule auditing services address market needs created by certain states' enactment of maximum permissible fee schedules for workers' compensation services. Changes in individual state regulation of workers' compensation may create a greater or lesser demand for some or all of the Company's services or require the Company to develop new or modified services in order to meet the needs of the marketplace and compete effectively in that marketplace.

### ***California's Medical Provider Networks***

In California, beginning January 1, 2005, an employer or insurer may establish a Medical Provider Network ("MPN") to provide care for injured workers. The recent California legislation was designed to allow employers more control over their workers' compensation claims by providing nearly 100% control over the life of a claim. Senate Bill 899 allows every California employer to require their employees to utilize an MPN. Senate Bill 228 mandates that each California employer conduct Utilization Review per the American College of Occupational and Environmental Medicine ("ACOEM") guidelines on all claims. Used in conjunction with SB 899 for the MPN, SB 228 will dramatically reduce the amount of medical payments on each individual claim.

### ***Health Insurance Portability and Accountability Act (HIPAA) of 1996***

The Health Insurance Portability and Accountability Act of 1996, or HIPAA, requires the adoption of standards for the exchange of health information in an effort to encourage overall administrative simplification and to enhance the effectiveness and efficiency of the healthcare industry. Pursuant to HIPAA, the Secretary of the Department of Health and Human Services has issued final rules concerning the privacy and security of health information, the establishment of standard transactions and code sets. The HIPAA requirements only apply to covered entities, which include health plans, healthcare clearinghouses, and healthcare providers that transmit any health information in electronic form. The Company's network solutions services may be subject to HIPAA obligations through business associate agreements with our customers. We are also indirectly regulated by HIPAA as a plan sponsor of a healthcare benefit plan for our own employees.

Of the HIPAA requirements, the privacy standards and the security standards have the most significant impact on our business operations. The privacy standards require covered entities to implement certain procedures to govern the use and disclosure of protected health information and to safeguard such information from inappropriate access, use or disclosure. Protected health information includes individually identifiable health information, such as an individual's medical records, transmitted or maintained in any format, including paper and electronic records. The privacy standards establish the different levels of individual permission that are required before a covered entity may use or disclose an individual's protected health information, and establish new rights for the individual with respect to his or her protected health information.

The security standards are designed to protect health information against reasonably anticipated threats or hazards to the security or integrity of the information, and to protect the information against unauthorized use or disclosure. The security standards establish a national standard for protecting the security and integrity of medical records when they are kept in electronic form. Compliance with the security standards was required on April 21, 2005.

### ***Medical Cost Containments Litigation***

Historically, governmental strategies to contain medical costs in the workers' compensation field have been generally limited to legislation on a state-by-state basis. For example, many states have implemented fee schedules that list maximum reimbursement levels for healthcare procedures. In certain states that have not authorized the use of a fee schedule, the Company adjusts bills to the usual and customary levels authorized by the payor.

Opportunities for the Company's services could increase if more states legislate additional cost containment strategies. Conversely, the Company would be adversely affected if states elect to reduce the extent of medical cost containment strategies available to insurance carriers and other payors, or adopt other strategies for cost containment that would not support a demand for the Company's services.

### ***Healthcare Reform***

There has been considerable discussion of healthcare reform at both the federal level and in numerous state legislatures in recent years. Due to uncertainties regarding the ultimate features of reform initiatives and the timing of their enactment, the Company cannot predict which, if any, reforms will be adopted, when they may be adopted, or what impact they may have on the Company.

### ***Vocational Rehabilitation Legislation***

During the early 1970s, the case management marketplace within workers' compensation was dominated by the provision of medical management services. Such services were purchased at the option of insurance carriers with little or no support from legislative efforts within any of the states. By the mid-1970s, it became popular for states to legislate either supportive programs for vocational rehabilitation or, in some cases, mandatory vocational rehabilitation statutes.

## **SHAREHOLDER RIGHTS PLAN**

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

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

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

## **EMPLOYEES**

As of March 31, 2006, CorVel had 2,623 employees, including nurses, therapists, counselors and other employees. No employees are represented by any collective bargaining unit. Management believes the Company's relationship with its employees to be good.

## **AVAILABLE INFORMATION**

Copies of our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Sections 13(a) or 15(d) of the Securities Exchange Act of 1934, and other filings made with the Securities and Exchange Commission, are available free of charge through our Website (<http://www.corvel.com>, under the Investor Relations section) as soon as reasonably practicable after such reports are electronically filed with, or furnished to, the Securities and Exchange Commission. The inclusion of our Web site address and the address of any of our portals such as [www.caremc.com](http://www.caremc.com) and [www.onlinedocumentcenter.com](http://www.onlinedocumentcenter.com), in this report does not include or incorporate by reference into this report any information contained on, or accessible through our Web sites.

#### **DATE OF ANNUAL MEETING OF STOCKHOLDERS**

The date of our 2006 annual meeting of stockholders (the “2006 Annual Meeting”) will be August 3, 2006, which is more than thirty days before the anniversary date of our 2005 annual meeting of stockholders. The deadlines, relating to stockholders proposals for the 2006 Annual Meeting, set forth in our definitive proxy statement filed on August 17, 2005 have not changed.

## **Item 1A. Risk Factors.**

### **Risk Factors**

Past financial performance is not necessarily a reliable indicator of future performance, and investors in the Company's common stock should not use historical performance to anticipate results or future period trends. Investing in the Company's common stock involves a high degree of risk. Investors should consider carefully the following risk factors, as well as the other information in this report and the Company's other filings with the Securities and Exchange Commission, including the Company's consolidated financial statements and the related notes, before deciding whether to invest or maintain an investment in shares of the Company's common stock. If any of the following risks actually occurs, the Company's business, financial condition and results of operations would suffer. In this case, the trading price of the Company's common stock would likely decline. The risks described below are not the only ones the Company faces. Additional risks that the Company currently does not know about or that the Company currently believes to be immaterial also may impair the Company's business operations.

#### **Changes in government regulations could increase the Company's cost of operations and/or reduce the demand for the Company's services.**

Many states, including a number of those in which the Company transacts business, have licensing and other regulatory requirements applicable to the Company's business. Approximately half of the states have enacted laws that require licensing of businesses which provide medical review services such as the Company. Some of these laws apply to medical review of care covered by workers' compensation. These laws typically establish minimum standards for qualifications of personnel, confidentiality, internal quality control and dispute resolution procedures. These regulatory programs may result in increased costs of operation for the Company, which may have an adverse impact upon the Company's ability to compete with other available alternatives for healthcare cost control. In addition, new laws regulating the operation of managed care provider networks have been adopted by a number of states. These laws may apply to managed care provider networks having contracts with the Company or to provider networks which the Company may organize. To the extent the Company is governed by these regulations, it may be subject to additional licensing requirements, financial and operational oversight and procedural standards for beneficiaries and providers.

Regulation in the healthcare and workers' compensation fields is constantly evolving. The Company is unable to predict what additional government initiatives, if any, affecting its business may be promulgated in the future. The Company's business may be adversely affected by failure to comply with existing laws and regulations, failure to obtain necessary licenses and government approvals or failure to adapt to new or modified regulatory requirements. Proposals for healthcare legislative reforms are regularly considered at the federal and state levels. To the extent that such proposals affect workers' compensation, such proposals may adversely affect the Company's business, financial condition and results of operations.

In addition, changes in workers' compensation, auto and managed health care laws or regulations may reduce demand for the Company's services, require the Company to develop new or modified services to meet the demands of the marketplace or reduce the fees that the Company may charge for its services. One proposal which has been considered by Congress and certain state legislatures is 24-hour health coverage, in which the coverage of traditional employer-sponsored health plans is combined with workers' compensation coverage to provide a single insurance plan for work-related and non-work-related health problems. Incorporating workers' compensation coverage into conventional health plans may adversely affect the market for the Company's services because some employers would purchase 24-hour coverage from group health plans, which would reduce the demand for CorVel's workers' compensation customers.

#### **The Company's quarterly sequential revenue may not increase and may decline. As a result, the Company may fail to meet or exceed the expectations of investors or analysts which could cause the Company's common stock price to decline.**

The Company's quarterly sequential revenue growth may not increase and may decline in the future as a result of a variety of factors, many of which are outside of the Company's control. If changes in the Company's

quarterly sequential revenue fall below the expectations of investors or analysts, the price of the Company's common stock could decline substantially. Fluctuations or declines in quarterly sequential revenue growth may be due to a number of factors, including, but not limited to, those listed below and identified throughout this "Risk Factors" section: the decline in manufacturing employment, the decline in workers' compensation claims, the decline in healthcare expenditures, the considerable price competition in a flat-to-declining workers' compensation market, the increase in competition, and the changes and the potential changes in state workers' compensation and automobile managed care laws which can reduce demand for the Company's services. These factors create an environment where revenue and margin growth is more difficult to attain and where revenue growth is less certain than historically experienced. Additionally, the Company's technology and preferred provider network face competition from companies that have more resources available to them than the Company does. Also, some customers may handle their managed care services in-house and may reduce the amount of services which are outsourced to managed care companies such as CorVel. These factors could cause the market price of the Company's common stock to fluctuate substantially. There can be no assurance that the Company's growth rate in the future, if any will be at or near historical levels.

In addition, the stock market has in the past experienced price and volume fluctuations that have particularly affected companies in the healthcare and managed care markets resulting in changes in the market price of the stock of many companies, which may not have been directly related to the operating performance of those companies.

Due to the foregoing factors, and the other risks discussed in this report, investors should not rely on quarter-to-quarter comparisons of the Company's results of operations as an indication of its future performance.

**Exposure to possible litigation and legal liability may adversely affect the Company's business, financial condition and results of operations.**

The Company, through its utilization management services, makes recommendations concerning the appropriateness of providers' medical treatment plans of patients throughout the country, and as a result, could be exposed to claims for adverse medical consequences. The Company does not grant or deny claims for payment of benefits and the Company does not believe that it engages in the practice of medicine or the delivery of medical services. There can be no assurance, however, that the Company will not be subject to claims or litigation related to the authorization or denial of claims for payment of benefits or allegations that the Company engages in the practice of medicine or the delivery of medical services.

In addition, there can be no assurance that the Company will not be subject to other litigation that may adversely affect the Company's business, financial condition or results of operations, including but not limited to being joined in litigation brought against the Company's customers in the managed care industry. The Company maintains professional liability insurance and such other coverages as the Company believes are reasonable in light of the Company's experience to date. If such insurance is insufficient or unavailable in the future at reasonable cost to protect the Company from liability, the Company's business, financial condition or results of operations could be adversely affected.

**The Company's failure to compete successfully could make it difficult for the Company to add and retain customers and could reduce or impede the growth of the Company's business.**

The Company faces competition from PPOs, TPAs and other managed healthcare companies. The Company believes that as managed care techniques continue to gain acceptance in the workers' compensation marketplace, CorVel's competitors will increasingly consist of nationally-focused workers' compensation managed care service companies, insurance companies, HMOs and other significant providers of managed care products. Legislative reforms in some states permit employers to designate health plans such as HMOs and PPOs to cover workers' compensation claimants. Because many health plans have the ability to manage medical costs for workers' compensation claimants, such legislation may intensify competition in the markets served by the Company. Many of the Company's current and potential competitors are significantly larger and have greater financial and marketing resources than those of the Company, and there can be no assurance that the Company will continue to maintain its existing clients, its past level of operating performance or be successful with any new products or in any new geographical markets it may enter.

**A change in workers' compensation market may harm the Company's results of operations.**

Within the past few years, several states have experienced a decline in the number of workers' compensation claims and the average cost per claim which have been reflected in workers' compensation insurance premium rate reductions in those states. The Company believes that declines in workers' compensation costs in these states are due principally to intensified efforts by payors to manage and control claim costs, and to a lesser extent, to improved risk management by employers and to legislative reforms. If declines in workers' compensation costs occur in many states and persist over the long-term, it would have an adverse impact on the Company's business, financial condition and results of operations.

The Company provides an outsource service to payors of workers' compensation and auto healthcare benefits. These payors include insurance companies, TPAs, municipalities, state funds, and self-insured, self-administered employers. If these payors reduce the amount of work they outsource, the Company's results of operations would be adversely affected.

**If the average annual growth in nationwide employment does not offset declines in the frequency of workplace injuries and illnesses, then the size of our market may decline, which may adversely affect our ability to grow.**

The rate of injuries that occur in the workplace has decreased over time. Although the overall number of people employed in the workplace has generally increased over time, this increase has only partially offset the declining rate of injuries and illnesses. Our business model is based, in part, on our ability to expand our relative share of the market for the treatment and review of claims for workplace injuries and illnesses. If nationwide employment does not increase or experiences periods of decline, or if workplace injuries and illnesses continue to decline at a greater rate than the increase in total employment, our ability to increase our revenue and earnings could be adversely impacted.

**If the utilization by healthcare payors of early intervention services continues to increase, the revenue from our later stage network and healthcare management services could be negatively affected.**

The performance of early intervention services, including injury occupational healthcare, first notice of loss, and telephonic case management services, often result in a decrease in the average length of, and the total costs associated with, a healthcare claim. By successfully intervening at an early stage in a claim, the need for additional cost containment services for that claim often can be reduced or even eliminated. As healthcare payors continue to increase their utilization of early intervention services, the revenue from our later stage network and healthcare management services will decrease.

**The Company faces competition for staffing, which may increase its labor costs and reduce profitability.**

The Company competes with other health-care providers in recruiting qualified management and staff personnel for the day-to-day operations of its business, including nurses and other case management professionals. In some markets, the scarcity of nurses and other medical support personnel has become a significant operating issue to health-care providers. This shortage may require the Company to enhance wages to recruit and retain qualified nurses and other health-care professionals. The failure of the Company to recruit and retain qualified management, nurses and other health-care professionals, or to control labor costs could have a material adverse effect on profitability.

**The failure to attract and retain qualified or key personnel may prevent the Company from effectively developing, marketing, selling, integrating and supporting its services.**

The Company is dependent to a substantial extent upon the continuing efforts and abilities of certain key management personnel. In addition, the Company faces competition for experienced employees with professional expertise in the workers' compensation managed care area. The loss of key employees, especially V. Gordon

Clemons, Chairman and Chief Executive Officer, and Dan Starck, President, or the inability to attract, qualified employees, could have a material unfavorable effect on the Company's business and results of operations.

**If the Company fails to increase revenue, it may be unable to execute its business plan, maintain high levels of service or adequately address competitive challenges.**

The Company's strategy is to continue its internal growth and, as strategic opportunities arise in the workers' compensation managed care industry, to consider acquisitions of, or relationships with, other companies in related lines of business. As a result, the Company is subject to certain growth-related risks, including the risk that it will be unable to retain personnel or acquire other resources necessary to service such growth adequately. Expenses arising from the Company's efforts to increase its market penetration may have a negative impact on operating results. In addition, there can be no assurance that any suitable opportunities for strategic acquisitions or relationships will arise or, if they do arise, that the transactions contemplated could be completed. If such a transaction does occur, there can be no assurance that the Company will be able to integrate effectively any acquired business into the Company. In addition, any such transaction would be subject to various risks associated with the acquisition of businesses, including, but not limited to, the following:

- an acquisition may negatively impact the Company's results of operations because it may require incurring large one-time charges, substantial debt or liabilities; it may require the amortization or write down of amounts related to deferred compensation, goodwill and other intangible assets; or it may cause adverse tax consequences, substantial depreciation or deferred compensation charges;
- the Company may encounter difficulties in assimilating and integrating the business, technologies, products, services, personnel or operations of companies that are acquired, particularly if key personnel of the acquired company decide not to work for the Company;
- an acquisition may disrupt ongoing business, divert resources, increase expenses and distract management;
- the acquired businesses, products, services or technologies may not generate sufficient revenue to offset acquisition costs;
- the Company may have to issue equity or debt securities to complete an acquisition, which would dilute stockholders and could adversely affect the market price of the Company's common stock; and
- acquisitions may involve the entry into a geographic or business market in which the Company has little or no prior experience.

There can be no assurance that the Company will be able to identify or consummate any future acquisitions or other strategic relationships on favorable terms, or at all, or that any future acquisition or other strategic relationship will not have an adverse impact on the Company's business or results of operations. If suitable opportunities arise, the Company may finance such transactions, as well as its internal growth, through debt or equity financing. There can be no assurance, however, that such debt or equity financing would be available to the Company on acceptable terms when, and if, suitable strategic opportunities arise.

**Our Internet-based services are dependent on the development and maintenance of the Internet infrastructure.**

We deploy our Care<sup>MC</sup> and, to a lesser extent, MedCheck services over the Internet. Our ability to deliver our Internet-based services is dependent on the development and maintenance of the infrastructure of the Internet by third parties. This includes maintenance of a reliable network backbone with the necessary speed, data capacity and security, as well as timely development of complementary products, such as high-speed modems, for providing reliable Internet access and services. The Internet has experienced, and is likely to continue to experience, significant growth in the number of users and the amount of traffic. If the Internet continues to experience increased usage, the Internet infrastructure may be unable to support the demands placed on it. In addition, the performance of the Internet may be harmed by increased usage.

The Internet has experienced a variety of outages and other delays as a result of damages to portions of its infrastructure, and it could face outages and delays in the future. These outages and delays could reduce the level of Internet usage, as well as the availability of the Internet to us for delivery of our Internet-based services. In addition, our customers who use our Web-based services depend on Internet service providers, online service providers and other Web site operators for access to our Web site. All of these providers have experienced significant outages in the past and could experience outages, delays and other difficulties in the future due to system failures unrelated to our systems. Any significant interruptions in our services or increases in response time could result in a loss of potential or existing users, and, if sustained or repeated, could reduce the attractiveness of our services.

**Demand for our services could be adversely affected if our prospective customers are unable to implement the transaction and security standards required under HIPAA.**

For some of our network services, we routinely implement electronic data interfaces (“EDIs”) to our customers’ locations that enable the exchange of information on a computerized basis. To the extent that our customers do not have sufficient personnel to implement the transactions and security standards required by HIPAA or to work with our information technology personnel in the implementation of our electronic interfaces, the demand for our network services could decline.

**An interruption in the Company’s ability to access critical data may cause customers to cancel their service and/or may reduce the Company’s ability to effectively compete.**

Certain aspects of the Company’s business are dependent upon its ability to store, retrieve, process and manage data and to maintain and upgrade its data processing capabilities. Interruption of data processing capabilities for any extended length of time, loss of stored data, programming errors or other system failures could cause customers to cancel their service and could have a material adverse effect on the Company’s business and results of operations.

In addition, the Company expects that a considerable amount of its future growth will depend on its ability to process and manage claims data more efficiently and to provide more meaningful healthcare information to customers and payors of healthcare. There can be no assurance that the Company’s current data processing capabilities will be adequate for its future growth, that it will be able to efficiently upgrade its systems to meet future demands, or that the Company will be able to develop, license or otherwise acquire software to address these market demands as well or as timely as its competitors.

**The introduction of software products incorporating new technologies and the emergence of new industry standards could render the Company’s existing software products less competitive, obsolete or unmarketable.**

There can be no assurance that the Company will be successful in developing and marketing new software products that respond to technological changes or evolving industry standards. If the Company is unable, for technological or other reasons, to develop and introduce new software products cost-effectively, in a timely manner and in response to changing market conditions or customer requirements, the Company’s business, results of operations and financial condition may be adversely affected.

Developing or implementing new or updated software products and services may take longer and cost more than expected. The Company relies on a combination of internal development, strategic relationships, licensing and acquisitions to develop its software products and services. The cost of developing new healthcare information services and technology solutions is inherently difficult to estimate. The Company’s development and implementation of proposed software products and services may take longer than originally expected, require more testing than originally anticipated and require the acquisition of additional personnel and other resources. If the Company is unable to develop new or updated software products and services cost-effectively on a timely basis and implement them without significant disruptions to the existing systems and processes of the Company’s customers, the Company may lose potential sales and harm its relationships with current or potential customers.

**A breach of security may cause the Company's customers to curtail or stop using the Company's services.**

The Company relies largely on its own security systems, confidentiality procedures and employee nondisclosure agreements to maintain the privacy and security of its and its customers proprietary information. Accidental or willful security breaches or other unauthorized access by third parties to the Company's information systems, the existence of computer viruses in the Company's data or software and misappropriation of the Company's proprietary information could expose the Company to a risk of information loss, litigation and other possible liabilities which may have a material adverse effect on the Company's business, financial condition and results of operations. If security measures are breached because of third-party action, employee error, malfeasance or otherwise, or if design flaws in the Company's software are exposed and exploited, and, as a result, a third party obtains unauthorized access to any customer data, the Company's relationships with its customers and its reputation will be damaged, the Company's business may suffer and the Company could incur significant liability. Because techniques used to obtain unauthorized access or to sabotage systems change frequently and generally are not recognized until launched against a target, the Company may be unable to anticipate these techniques or to implement adequate preventative measures.

**Changes in the accounting treatment of stock options could adversely affect the Company's results of operations.**

The Financial Accounting Standards Board has issued Statement of Financial Accounting Standards ("SFAS") No. 123R, *Accounting for Stock-Based Compensation*, which requires that stock-based compensation be accounted for at fair value and expensed over the service period for financial reporting purposes, is effective for the Company starting in the fiscal quarter ending June 30, 2006. Such stock option expensing would require the Company to value its employee stock option grants at fair value, and then amortize the estimated cost against the Company's reported earnings over the vesting period in effect for those options. The Company currently accounts for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, and has adopted the disclosure-only alternative of SFAS 123. This change in accounting treatment will materially and adversely affect the Company's reported results of operations as the stock-based compensation expense will be charged directly against the Company's reported earnings.

**If we are unable to increase our market share among national and regional insurance carriers and large, self-funded employers, our results may be adversely affected.**

Our business strategy and future success depend in part on our ability to capture market share with our cost containment services as national and regional insurance carriers and large, self-funded employers look for ways to achieve cost savings. We cannot assure you that we will successfully market our services to these insurance carriers and employers or that they will not resort to other means to achieve cost savings. Additionally, our ability to capture additional market share may be adversely affected by the decision of potential customers to perform services internally instead of outsourcing the provision of such services to us. Furthermore, we may not be able to demonstrate sufficient cost savings to potential or current customers to induce them not to provide comparable services internally or to accelerate efforts to provide such services internally.

**If we lose several customers in a short period, our results may be adversely affected.**

Our results may decline if we lose several customers during a short period. Most of our customer contracts permit either party to terminate without cause. If several customers terminate, or do not renew or extend their contracts with us, our results could be adversely affected. Many organizations in the insurance industry have consolidated and this could result in the loss of one or more of our significant customers through a merger or acquisition. Additionally, we could lose significant customers due to competitive pricing pressures or other reasons.

**We are subject to risks associated with acquisitions of intangible assets.**

Our acquisition of other businesses may result in significant increases in our intangible assets relating to goodwill. We regularly evaluate whether events and circumstances have occurred indicating that any portion of our goodwill may not be recoverable. When factors indicate that goodwill should be evaluated for possible impairment,

we may be required to reduce the carrying value of these assets. We cannot currently estimate the timing and amount of any such charges.

**If we are unable to leverage our information systems to enhance our outcome-driven service model, our results may be adversely affected.**

To leverage our knowledge of workplace injuries, treatment protocols, outcomes data, and complex regulatory provisions related to the workers' compensation market, we must continue to implement and enhance information systems that can analyze our data related to the workers' compensation industry. We frequently upgrade existing operating systems and are updating other information systems that we rely upon in our operating segments. We have detailed implementation schedules for these projects that require extensive involvement from our operational, technological and financial personnel. Delays or other problems we might encounter in implementing these projects could adversely affect our ability to deliver streamlined patient care and outcome reporting to our customers.

**If competition increases, our growth and profits may decline.**

The markets for our Network Services and Care Management Services segments are also fragmented and competitive. Our competitors include national managed care providers, preferred provider networks, smaller independent providers and insurance companies. Companies that offer one or more workers' compensation managed care services on a national basis are our primary competitors. We also compete with many smaller vendors who generally provide unbundled services on a local level, particularly companies with an established relationship with a local insurance company adjuster. In addition, several large workers' compensation insurance carriers offer managed care services for their customers, either by performance of the services in-house or by outsourcing to organizations like ours. If these carriers increase their performance of these services in-house, our business may be adversely affected. In addition, consolidation in the industry may result in carriers performing more of such services in-house.

**If lawsuits against us are successful, we may incur significant liabilities.**

We provide to insurers and other payors of health care costs managed care programs that utilize preferred provider organizations and computerized bill review programs. Health care providers have brought against the Company and its clients individual and class action lawsuits challenging such programs. If such lawsuits are successful, we may incur significant liabilities.

We make recommendations about the appropriateness of providers' proposed medical treatment plans for patients throughout the country. As a result, we could be subject to claims arising from any adverse medical consequences. Although plaintiffs have not to date subjected us to any claims or litigation relating to the grant or denial of claims for payment of benefits or allegations that we engage in the practice of medicine or the delivery of medical services, we cannot assure you that plaintiffs will not make such claims in future litigation. We also cannot assure you that our insurance will provide sufficient coverage or that insurance companies will make insurance available at a reasonable cost to protect us from significant future liability.

**The increased costs of professional and general liability insurance may have an adverse effect on our profitability.**

The cost of commercial professional and general liability insurance coverage has risen significantly in the past several years, and this trend may continue. In addition, if we were to suffer a material loss, our costs may increase over and above the general increases in the industry. If the costs associated with insuring our business continue to increase, it may adversely affect our business. We believe our current level of insurance coverage is adequate for a company of our size engaged in our business.

**We have experienced a decline in the referrals for our patient management services.**

We have experienced a general decline in the revenue and operating performance of patient management services. We believe that the performance decline has been due to the following factors: the lingering effects of the downturn in the national economy and its corresponding effect on the number of workplace injuries that have

become longer-term disability cases; increased regional and local competition from providers of managed care services; a possible reduction by insurers on the types of services provided by our patient management business; the closure of offices and continuing consolidation of our patient management operations; and employee turnover, including management personnel, in our patient management business. In the past, these factors have all contributed to the lowering of our long-term outlook for our patient management services. If some or all of these conditions continue, we believe that the performance of our patient management revenues could decrease.

**Healthcare providers are becoming increasingly resistant to the application of certain healthcare cost containment techniques; this may cause revenue from our cost containment operations to decrease.**

Healthcare providers have become more active in their efforts to minimize the use of certain cost containment techniques and are engaging in litigation to avoid application of certain cost containment practices. Recent litigation between healthcare providers and insurers has challenged certain insurers' claims adjudication and reimbursement decisions. Although these lawsuits do not directly involve us or any services we provide, these cases may affect the use by insurers of certain cost containment services that we provide and may result in a decrease in revenue from our cost containment business.

**Failure to achieve and maintain effective internal controls in accordance with Section 404 of the Sarbanes-Oxley Act of 2002, and delays in completing our internal controls and financial audits, could have a material adverse effect on our business and stock price.**

Our fiscal 2006 audit revealed material weaknesses in our internal controls over financial reporting related to the size of our accounting staff, lack of an effective control monitoring process and inadequate anti-fraud controls. We are attempting to cure these material weaknesses by taking the steps described in Item 9A of this report, but we have not yet completed such remediation and there can be no assurance that such remediation will be successful. During the course of our continued testing, we also may identify other significant deficiencies or material weaknesses, in addition to the ones already identified, which we may not be able to remediate in a timely manner or at all. If we continue to fail to achieve and maintain effective internal controls, we will not be able to conclude that we have effective internal controls over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act of 2002. In addition, since 2005, we have experienced delays in completing our internal controls and financial audits, which have resulted in the untimely filing of our Annual Report on Form 10-K for the fiscal year ended March 31, 2005 and the filing of several notifications of late filing on Form 12b-25. Failure to achieve and maintain an effective internal control environment, and delays in completing our internal controls and financial audits, could cause investors to lose confidence in our reported financial information and our company, which could result in a decline in the market price of our common stock, and cause us to fail to meet our reporting obligations in the future, which in turn could impact our ability to raise equity financing if needed in the future.

**Item 1B. *Unresolved Staff Comments.***

None.

**Item 2. *Properties.***

The Company's principal executive office is located in Irvine, California in approximately 6,600 square feet of leased space. The lease expires in September 2007. The Company leases 125 branch offices in 49 states, which range in size from 1,000 square feet up to approximately 16,000 square feet. The lease terms for the branch offices range from monthly to ten years and expire through 2014. The Company believes that its facilities are adequate for its current needs and that suitable additional space will be available as required.

**Item 3. *Legal Proceedings.***

The Company is involved in litigation arising in the normal course of business. Management believes that resolution of these matters will not result in any payment that, in the aggregate, would be material to the financial position or financial operations of the Company.

**Item 4. *Submission of Matters to a Vote of Security Holders.***

There were no matters submitted to a vote of stockholders during the quarter ended March 31, 2006.

## PART II

### Item 5. *Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.*

#### Market Information

The Company's common stock is traded on the NASDAQ National Market under the symbol CRVL. The quarterly high and low per share sales prices for the Company's common stock for fiscal years 2005 and 2006 as reported by NASDAQ are set forth below for the periods indicated. These prices represent prices among dealers, do not include retail markups, markdowns or commissions, and may not represent actual transactions.

	<u>High</u>	<u>Low</u>
<b>Fiscal Year Ended March 31, 2005:</b>		
Quarter Ended June 30, 2004:	\$ 36.75	\$ 22.65
Quarter Ended September 30, 2004:	31.50	23.81
Quarter Ended December 31, 2004:	32.35	25.99
Quarter Ended March 31, 2005:	27.85	18.40
<b>Fiscal Year Ended March 31, 2006:</b>		
Quarter Ended June 30, 2005:	\$ 28.47	\$ 19.90
Quarter Ended September 30, 2005:	29.00	22.73
Quarter Ended December 31, 2005:	23.96	15.90
Quarter Ended March 31, 2006:	22.02	16.87

*Holders.* As of May 15, 2006, there were approximately 1,161 holders of record of the Company's common stock according to the information provided by the Company's transfer agent.

*Dividends.* The Company has never paid any cash dividends on its common stock and has no current plans to do so in the foreseeable future. The Company intends to retain future earnings, if any, for use in the Company's business. The payment of any future dividends on its common stock will be determined by the Board of Directors in light of conditions then existing, including the Company's earnings, financial condition and requirements, restrictions in financing agreements, business conditions and other factors.

*Unregistered Sales of Equity Securities.* None.

*Issuer Purchases of Equity Securities.* There were no shares repurchased by the Company during the quarter ended March 31, 2006. During the fiscal year ended March 31, 2006 the Company repurchased 835,339 shares of its common stock.

#### Item 6. *Selected Financial Data.*

The selected consolidated financial data of the Company appears in a separate section of this Annual Report on Form 10-K on page 39 and is incorporated herein by this reference.

#### Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations.*

Management's Discussion and Analysis of Financial Condition and Results of Operations appears in a separate section of this Annual Report on Form 10-K beginning on page 40 and is incorporated herein by this reference.

**Item 7A. *Quantitative and Qualitative Disclosures About Market Risk.***

As of March 31, 2006, the Company held no market risk sensitive instruments for trading purposes and the Company did not employ any derivative financial instruments, other financial instruments, or derivative commodity instruments to hedge any market risk. The Company had no debt outstanding as of March 31, 2006, and therefore, had no market risk related to debt.

**Item 8. *Financial Statements and Supplementary Data.***

The Company's consolidated financial statements, as listed under Item 15, appear in a separate section of this Annual Report on Form 10-K beginning on page 51 and are incorporated herein by this reference. The financial statement schedule is included below under Item 15.

**Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.***

None.

## **Item 9A. Controls and Procedures .**

### **Evaluation of Disclosure Controls and Procedures**

Our management has evaluated, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report pursuant to Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Based on that evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were not effective due to the material weaknesses in our internal control over financial reporting as of March 31, 2006, described below.

### **Management’s Report on Internal Control over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control system is designed to provide reasonable assurance to our management, the Board of Directors and investors regarding reliable preparation and presentation of published financial statements. Nonetheless, all internal control systems, no matter how well designed, have inherent limitations. Even systems determined to be effective as of a particular date can only provide reasonable assurance with respect to reliable financial statement preparation and presentation.

A material weakness in internal control over financial reporting is a control deficiency (within the meaning of the Public Company Accounting Oversight Board (United States) Auditing Standard No. 2), or a combination of control deficiencies, that result in there being more than a remote likelihood of material misstatement in the annual or interim financial statements would not be prevented or detected.

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

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

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

***Revenue and receivables reporting.*** Effective controls related to revenue and receivables reporting were not maintained. Specifically, controls were not properly designed or operating effectively to ensure: (i) adequate documentation of customer agreements, (ii) proper cutoff of revenue at month end, (iii) consistent evaluation of customer credit worthiness, (iv) complete and timely reviews of revenue entries, write-offs, and sales adjustments,

(v) all receivable and allowance accounts are appropriately analyzed, (vi) the timely posting of all cash receipts, (vii) completed transactions were appropriately offset or reclassified via journal entries in a timely manner.

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

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

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

***Period-end financial reporting processes.*** Effective controls over period-end financial reporting processes were not maintained to effectively ensure: (i) the security and validity of data transfers between financial applications, including consolidation and associated spreadsheets, (ii) key reconciliations, account analyses, and summaries are performed and approved with appropriate resolution of reconciling items, (iii) journal entries, both recurring and non-recurring, are approved, (iv) the resulting financial information, statements and disclosures are reviewed and appropriate checklists are used for compliance with U.S. GAAP, (v) monthly closing checklists were used consistently and thoroughly to ensure all financial reporting procedures and controls were performed, and (vi) documented reviews of financial results are compared to budgets and expectations. In some cases, inaccurate or incomplete account analyses, account summaries and account reconciliations were prepared during the financial close and reporting process in the areas of cash, accounts receivable, fixed assets, and accruals.

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

***Accounting for fixed assets.*** Controls to ensure current, accurate and complete accounting for fixed assets were inadequate. The Company had no formal purchasing system or asset disposal system to help manage property and equipment. Additionally, there was insufficient formal, timely review of certain processes associated with the fixed asset management system. Specifically, there was: (i) no documented controls or monitoring of purchase orders for fixed assets, (ii) inadequate processes over the timely and complete receipt of receiving information and invoices for fixed asset additions to ensure timely recording of the fixed asset additions, (iii) limited review of the input of new acquisitions of property and equipment, (iv) no formal documented review of capital pending amounts to determine final categorization as capital or expense items, (v) no review of placed-in service dates, (vi) no review of system-generated depreciation expense, (vii) no documented periodic review of depreciable lives, and (viii) no formal approval of the fixed assets sub ledger reconciliation to the general ledger, with appropriate resolution of reconciling items.

**Treasury process.** Effective controls related to certain treasury processes were not maintained. Specifically, controls were not properly designed or operating effectively to ensure: (i) proper authorization, monitoring and segregation of duties over wire transfers and other banking activities, (ii) proper authorization of stock option transactions, and (iii) timely bank account reconciliations are performed.

**Review of third party controls.** Effective monitoring of third party controls supporting our financial reporting were not maintained. Specifically, controls were not properly designed or operating effectively to ensure adequate review of Independent Auditors' Reports on Controls Placed in Operation and Tests of Operating Effectiveness (SAS 70 Type II reports) or additional control evaluation of the third party controls that support the accounting of benefit accruals and payroll transactions.

**Accounting for leases.** Effective controls related to lease accounting were not maintained to ensure that lease transactions are adequately analyzed and the financial accounts properly reflect all lease agreements. Consequently, a restatement for lease activity in prior periods was required for the fiscal year 2004 and 2005 financial statements.

**Documentation of accounting policies and procedures.** Effective controls over the documentation of accounting policies and procedures were not maintained. Written documentation of accounting policies, procedures and authority limits for approving various transactions were considered inadequate for: (i) fixed asset disposals, impairment analysis and physical inventory of assets, (ii) corporate purchasing policies, including policies covering dollar limits of approval for various levels of management on expenditures, check signing, wire transfers and other banking transactions, (iii) internally developed software costs, (iv) cash receipts processing, (v) income taxes, (vi) various accrual and reserve calculations, (vii) vendor set-up, and (viii) the extension of customer credit.

**Payroll.** The Company does not maintain effective controls over payroll processing. There was inadequate segregation of duties relating to access to the payroll master files and processing files. In addition, there was insufficient review of the master file data for accuracy and completeness. There was no documented review of the comparison of the amounts paid for payroll, related taxes and payroll tax returns to the amounts recorded in the general ledger.

**Security Access over Consolidating Spreadsheets.** The Company did not maintain effective controls over spreadsheets used in the Company's financial reporting process. Specifically, controls were not designed and in place throughout the year to ensure that unauthorized modification of the data or formulas within spreadsheets was prevented.

These control deficiencies result in a more than remote likelihood of material misstatements to the annual or interim financial statements that would not be prevented or detected. Accordingly, management has determined that these control deficiencies constitute material weaknesses in these control activities.

## Report of Independent Registered Public Accounting Firm

Shareholders and Board of Directors  
CorVel Corporation

We have audited management's assessment, included in the accompanying CorVel Corporation Management's Report on Internal Control Over Financial Reporting, that CorVel Corporation did not maintain effective internal control over financial reporting as of March 31, 2006, because of the effect of the material weaknesses identified in management's assessment, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). CorVel Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weaknesses have been identified and included in management's assessment:

- The Company did not maintain an effective control environment. Specifically, the Company was lacking: (i) a robust risk assessment process that adequately addresses COSO objectives, including strategic plans, budgets and clearly defined and communicated goals and objectives aligned with the assessment, (ii) adequate monitoring of its existing control activities over financial reporting by management and individual and corporate performance against expectations, (iii) adequate anti-fraud controls in areas such as the whistleblower program, communication, and training of employees and the Board regarding fraud, (iv) adequate human resources policies and procedures, and (v) effective Audit Committee oversight, including adequate documentation of actions taken by the Board and remediation of prior internal control weaknesses.

- The Company did not maintain a sufficient number of personnel and appropriate depth of experience for its accounting and finance departments to (i) ensure the preparation of interim and annual financial statements in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP), (ii) effectively execute the principal control activities noted below, and (iii) remediate previously communicated deficiencies. The Company's finance and accounting structure also did not support appropriate lines of authority, reporting, and accountability to achieve desired reliable financial reporting controls. In addition, the Company placed heavy reliance on manual procedures and detective controls without quality control review and other monitoring controls in place to adequately identify and assess significant risks that may impact financial statements and related disclosures.
- The Company did not maintain effective controls over its period-end financial reporting processes. Specifically, the controls were not designed and in place to ensure that: (i) journal entries, both recurring and non-recurring, were reviewed and approved, (ii) a review of the chart of accounts was performed timely to ensure all accounts and balances were appropriately reconciled, reviewed, and approved, with appropriate resolution of reconciling items, (iii) monthly closing checklists were used consistently and thoroughly to ensure all financial reporting procedures and controls were performed, (iv) disclosure checklists were used to ensure compliance with U.S. GAAP, (v) internal reporting and analysis were completed in a timely manner, and (vi) data transfer between application systems was complete and accurate.
- The Company did not maintain adequate segregation of duties. The inadequate segregation of duties impacted the financial reporting processes, revenue controls, expenditure controls, fixed asset controls, payroll controls, and corporate treasury controls. Management did not provide adequate oversight and monitoring of finance personnel to compensate for the inadequate segregation of duties. We have identified deficiencies where the same individual had authority for activities that should be segregated, such as: (i) approval of vendors and payment processing transactions, (ii) employee master file maintenance and payroll transaction processing, (iii) journal entry creation and review and/or posting, (iv) application of cash receipts and account write-offs, and (v) information technology controls.
- The Company did not maintain effective controls over access to systems, financial applications and data. Specifically, users with financial, accounting and reporting responsibilities also had access to financial application programs and data. Such access was not in compliance with appropriate segregation of duties requirements and was not independently monitored.
- The Company did not maintain effective controls over the preparation of account analyses, account summaries and account reconciliations. In some cases, inaccurate or incomplete account analyses, account summaries and account reconciliations were prepared during the financial close and reporting process in the areas of cash, accounts receivable, fixed assets, and accruals.
- The Company did not maintain effective controls over the documentation of accounting policies and procedures. The following areas had inadequate written documentation of accounting policies, procedures and authority limits for approving various transactions: (i) capitalized software, (ii) income taxes, (iii) various accrual and reserve calculations, (iv) fixed assets, (v) cash receipts, (vi) the extension of customer credit, (vii) vendor set-up, and (viii) corporate purchasing policies, including policies covering dollar limits of approval for various levels of management on expenditures, check signing, wire transfers and other banking transactions,.
- The Company did not maintain effective controls over accounts payable and month-end accruals, including salaries and wages, bonuses, workers compensation, rebates, professional fees, and PPO expenses. There was no consistent verification of: (i) completeness of supporting documents, (ii) review and approval of supporting documents by appropriate personnel, and (iii) completeness and accuracy of month-end accruals.
- The Company did not maintain effective controls related to expenditure processing. Specifically, controls were not properly designed or operating effectively to ensure that: (i) payroll and benefit entries are reviewed and approved, (ii) accounts payable entries are reviewed and (iii) capital asset transactions are properly approved and recorded. Furthermore, there were inadequate controls over systems access to new vendor set-up files and no independent reviews of changes to the vendor master file.
- The Company did not maintain effective controls over the recording of, and accounting for, fixed assets. The Company had no formal purchasing system or asset disposal system to help manage property and equipment. Additionally, there was no formal, timely review of certain processes associated with the fixed asset management system. Specifically, there was: (i) no documented controls or monitoring of purchase

orders for fixed assets, (ii) no processes over the timely and complete receipt of receiving information and invoices for fixed asset additions to ensure timely recording of the fixed asset additions, (iii) no review of the input of new acquisitions of property and equipment, (iv) no formal review of capital pending amounts to determine final categorization as capital or expense items, (v) no review of placed-in service dates, (vi) no review of system-generated depreciation expense, (vii) no periodic review of depreciable lives, and (viii) no proper approval of the fixed assets sub ledger reconciliation to the general ledger, with appropriate resolution of reconciling items.

- The Company did not maintain effective control over the preparation and review of income taxes. Specifically, controls were not designed and in place to ensure that: (i) temporary and permanent book to tax differences are properly identified, (ii) deferred tax assets are recoverable, (iii) all tax-related accounts, including the income tax provision rate and pre-tax income, are properly reconciled to the trial balance or tax return, and (iv) all quarterly tax payments are accurately tracked and recorded.
- The Company did not maintain effective controls related to revenue and receivables reporting, including the complete and timely review of revenue entries and the collection and application of payments and credits to accounts receivable. Specifically, there was: (i) no formal process for evaluating and authorizing customer credit, (ii) no control to ensure timely posting of all cash receipts, (iii) no process to ensure completed transactions were appropriately offset or reclassified via journal entries in a timely manner, (iv) no process to ensure adequate documentation of customer agreements, (v) no process to properly analyze accounts receivable, allowances, write-offs and related revenue adjustments, and (vi) no controls to ensure proper cut-off of revenue at month-end.
- The Company does not maintain effective controls over payroll processing. There was inadequate segregation of duties relating to access to the payroll master files and processing files. In addition, there was no periodic review of the master file data for accuracy and completeness. There was no documented review of the comparison of the amounts paid for payroll, related taxes and payroll tax returns to the amounts recorded in the general ledger.
- The Company did not maintain effective monitoring controls over transaction authorities and limits, including authorized signers for bank accounts and stock option activity. In addition, appropriate month-end cash cutoff procedures were not consistently followed and bank reconciliations were not completed in a timely manner.
- The Company did not maintain effective controls over accounting for leases. Specifically, controls were not designed and in place to ensure that a proper and timely analysis of leases was performed. Consequently, the financial accounts did not reflect an accrual for leases with escalation lease clauses and resulted in a restatement to prior annual financial statements.
- The Company did not maintain effective controls over spreadsheets used in the Company's financial reporting process. Specifically, controls were not designed and in place throughout the year to ensure that unauthorized modification of the data or formulas within spreadsheets was prevented.
- The Company did not maintain effective monitoring of third party controls supporting financial reporting. Specifically, controls were not properly designed or operating effectively to ensure adequate review of Independent Auditors' Reports on Controls Placed in Operating and Tests of Operating Effectiveness (SAS 70 Type II reports) or related user control considerations that support the accounting of various accruals and payroll transactions.

These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2006 financial statements, and this report does not affect our report dated June 28, 2006, which expressed an unqualified opinion on those financial statements.

In our opinion, management's assessment that CorVel Corporation did not maintain effective internal control over financial reporting as of March 31, 2006, is fairly stated, in all material respects, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, CorVel Corporation has not maintained effective internal control over financial reporting as of March 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

/s/ Grant Thornton LLP

Portland, Oregon  
June 28, 2006

**Item 9B. *Other Information.***

None.

### **PART III**

#### **Item 10. *Directors and Executive Officers of the Registrant.***

(a) Identification of Directors.

The information under the captions “Proposal One: Election of Directors” and “Corporate Governance, Board Composition and Board Committees” appearing in the Company’s Definitive Proxy Statement for the 2006 Annual Meeting of Stockholders is incorporated herein by reference.

(b) Identification of Executive Officers and Certain Significant Employees.

The information under the caption “Directors and Executive Officers of the Company” appearing in the Company’s Definitive Proxy Statement for the 2006 Annual Meeting of Stockholders is incorporated herein by reference.

(c) Compliance with Section 16(a) of the Exchange Act.

The information under the caption “Section 16(a) Beneficial Ownership Reporting Compliance” appearing in the Company’s Definitive Proxy Statement for the 2006 Annual Meeting of Stockholders is incorporated herein by reference.

(d) Code of Ethics.

The Board of Directors has adopted a code of ethics and business conduct that applies to all of the Company’s employees, officers (including the Company’s principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions) and directors. The full text of the Company’s code of ethics and business conduct is posted on the Company’s Web site at <http://www.corvel.com> under the “Investor Relations” section. The Company intends to disclose future amendments to certain provisions of the Company’s code of ethics and business conduct, or waivers of such provisions, applicable to the Company’s directors and executive officers (including the Company’s principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions), at the same location on the Company’s Web site identified above. The inclusion of the Company’s Web site address in this report does not include or incorporate by reference the information on the Company’s Web site into this report.

#### **Item 11. *Executive Compensation.***

The information under the captions “Executive Compensation,” “Compensation of Directors” and “Compensation Committee Interlocks and Insider Participation” appearing in the Company’s Definitive Proxy Statement for the 2006 Annual Meeting of Stockholders is incorporated herein by reference.

#### **Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information under the caption “Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters” appearing in the Company’s Definitive Proxy Statement for the 2006 Annual Meeting of Stockholders is incorporated herein by reference.

#### **Item 13. *Certain Relationships and Related Transactions.***

The information under the caption “Certain Transactions” appearing in the Company’s Definitive Proxy Statement for the 2006 Annual Meeting of Stockholders is incorporated herein by reference.

Mr. Clemons has an adult son, V. Gordon Clemons, Jr., who is currently employed by the Company as its Vice President of Business Development. V. Gordon Clemons, Jr. became an employee of the Company in 2001 as

a Product Manager, served as Director of Business Development from June 2002 to March 2006, and was promoted to Vice President of Business Development in March 2006. V. Gordon Clemons, Jr. has received a salary of \$64,999, \$77,249, \$100,417, \$106,876 and \$120,681 for fiscal years 2002, 2003, 2004, 2005, and 2006, respectively. V. Gordon Clemons, Jr. also received a bonus of \$10,725, \$20,580, \$23,410, and \$23,603 for fiscal years 2003, 2004, 2005, and 2006, respectively. V. Gordon Clemons, Jr. also received option grants for 3,325 shares, 3,400 shares, 2,400 shares, 2,400 shares, and 2,750 shares for fiscal years 2002, 2003, 2004, 2005, and 2006, respectively. V. Gordon Clemons, Jr. received other compensation of annual premiums and matching 401(k) contributions in the aggregate amounts of \$127, \$251, \$35, \$68, and \$74 for fiscal years 2002, 2003, 2004, 2005, and 2006, respectively, paid by the Company for the purchase of group term life insurance in an amount equal to his annual salary and as matching contributions by the Company to the Company's Section 401(k) Plan.

**Item 14. *Principal Accountant Fees and Services***

The information under the caption "Principal Accountant Fees and Services" and in the second paragraph under the caption "Ratification of Appointment of Independent Auditors" appearing in the Company's Definitive Proxy Statement for the 2006 Annual Meeting of Stockholders is incorporated herein by reference.

**PART IV**

**Item 15. Exhibits and Financial Statement Schedules.**

**(a)(1) Financial Statements:**

The Company's financial statements appear in a separate section of this Annual Report on Form 10-K beginning on the pages referenced below:

	<u>Page</u>
Report of Independent Registered Public Accounting Firm .....	50
Consolidated Statements of Income for the Years Ended March 31, 2004, 2005, and 2006.....	51
Consolidated Balance Sheets as of March 31, 2005 and 2006 .....	52
Consolidated Statements of Stockholders' Equity for the Years Ended March 31, 2004, 2005, and 2006..	53
Consolidated Statements of Cash Flows for the Years Ended March 31, 2004, 2005, and 2006.....	54
Notes to Consolidated Financial Statements .....	55

**(2) Financial Statement Schedule:**

The Company's consolidated financial statements, as listed under Item 15(a)(1), appear in a separate section of this Annual Report on Form 10-K beginning on page 51. The Company's financial statement schedule is as follows:

**Schedule II — Valuation and Qualifying Accounts**

	<b>Balance at Beginning of Year</b>	<b>Additions Charged to Costs and Expenses</b>	<b>Deductions</b>	<b>Balance at End of Year</b>
<b>Allowance for doubtful accounts:</b>				
Year Ended March 31, 2006:	\$ 3,487,000	\$ 3,713,000	\$ (3,713,000)	\$ 3,487,000
Year Ended March 31, 2005:	3,470,000	2,355,000	(2,338,000)	3,487,000
Year Ended March 31, 2004:	3,473,000	2,100,000	(2,103,000)	3,470,000

(3) Exhibits:

**EXHIBITS**

<u>Exhibit No.</u>	<u>Title</u>	<u>Method of Filing</u>
3.1	Certificate of Incorporation of the Company	Incorporated herein by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2002.
3.2	Bylaws of the Company	Incorporated herein by reference to Exhibit 3.2 to the Company's Registration Statement on Form S-1 Registration No. 33-40629.
10.1*	Nonqualified Stock Option Agreement between V. Gordon Clemons, the Company and North Star together with all amendments and addendums thereto	Incorporated herein by reference to Exhibit 10.6 to the Company's Registration Statement on Form S-1 Registration No. 33-40629.
10.2*	Supplementary Agreement between V. Gordon Clemons, the Company and North Star	Incorporated herein by reference to Exhibit 10.7 to the Company's Registration Statement on Form S-1 Registration No. 33-40629.
10.3*	Amendment to Supplementary Agreement between Mr. Clemons, the Company and North Star	Incorporated herein by reference to Exhibit 10.5 to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 1992.
10.4*	Restated 1988 Executive Stock Option Plan, as amended	Incorporated herein by reference to Exhibit 10.6 to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 1995.
10.5*	Form of Notice of Grant of Stock Option Under the Restated 1988 Executive Stock Option	Incorporated herein by reference to Exhibit 10.7 to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 1994.
10.6*	Form of Stock Option Agreement under the Restated 1988 Executive Stock Option Plan	Incorporated herein by reference to Exhibit 10.8 to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 1994.
10.7*	Form of Notice of Exercise under the Restated 1988 Executive Stock Option Plan	Incorporated herein by reference to Exhibit 10.9 to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 1994.
10.8*	Employment Agreement of V. Gordon Clemons	Incorporated herein by reference to Exhibit 10.12 to the Company's Registration Statement on Form S-1 Registration No. 33-40629.
10.9*	Restated 1991 Employee Stock Purchase Plan, as amended	Incorporated herein by reference to Exhibit 10.11 in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 1995.
10.10	Fidelity Master Plan for Savings and Investment, and amendments	Incorporated herein by reference to Exhibits 10.16 and 10.16A to the Company's Registration Statement on Form S-1 Registration No. 33-40629.
10.15	Shareholder Rights Plan	Incorporated herein by reference to the Company's Form 8-K filed on February 28, 1997.
10.16	Amended Shareholder Rights Plan	Incorporated herein by reference to the Company's Form 8-K filed on May 24, 2002.
10.17	Employment Agreement of Dan Starck*	Incorporated herein by reference to the Company's Form 8-K filed on May 30, 2006.

<u>Exhibit No.</u>	<u>Title</u>	<u>Method of Filing</u>
21.1	Subsidiaries of the Company	Filed herewith.
23.1	Consent of Independent Registered Public Accounting Firm	Filed herewith.
31.1	Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed herewith.
31.2	Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed herewith.
32.1	Certification of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	Furnished herewith.
32.2	Certification of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	Furnished herewith.

\* - Denotes management contract or compensatory plan or arrangement.

**(b) Exhibits**

The exhibits filed as part of this report are listed under Item 15(a)(3) of this Annual Report on Form 10-K.

**(c) Financial Statement Schedule**

The Financial State Schedules required by Regulation S-X and Item 8 of this form are listed under Item 15(a)(2) of this Annual Report on Form 10-K.



## SELECTED CONSOLIDATED FINANCIAL DATA

The following selected financial data for each of the fiscal year for the five years ended March 31, 2006, have been derived from the Company's audited consolidated financial statements. The following data should be read in conjunction with the Company's Consolidated Financial Statements, the related notes thereto, and "Management's Discussion and Analysis of Financial Condition and Results of Operations." The following amounts are in thousands, except per share data.

	<u>Year Ended March 31,</u>				
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
<b>Statement of Income Data:</b>	(Restated)	(Restated)			
Revenues .....	\$ 235,912	\$ 282,776	\$ 305,279	\$ 291,000	\$ 266,504
Cost of revenues .....	<u>193,348</u>	<u>230,991</u>	<u>253,846</u>	<u>246,341</u>	<u>221,060</u>
Gross profit .....	<u>42,564</u>	<u>51,785</u>	<u>51,433</u>	<u>44,659</u>	<u>45,444</u>
General and administrative .....	<u>18,783</u>	<u>25,081</u>	<u>26,067</u>	<u>28,144</u>	<u>29,590</u>
Income before income taxes .....	23,781	26,704	25,366	16,515	15,854
Income tax provision .....	<u>9,036</u>	<u>10,147</u>	<u>9,353</u>	<u>6,358</u>	<u>6,101</u>
Net income .....	<u>\$ 14,745</u>	<u>\$ 16,557</u>	<u>\$ 16,013</u>	<u>\$ 10,157</u>	<u>\$ 9,753</u>
Net income per share:					
Basic .....	<u>\$ 1.34</u>	<u>\$ 1.54</u>	<u>\$ 1.51</u>	<u>\$ 0.97</u>	<u>\$ 1.01</u>
Diluted .....	<u>\$ 1.30</u>	<u>\$ 1.50</u>	<u>\$ 1.48</u>	<u>\$ 0.97</u>	<u>\$ 1.00</u>
Shares used in computing net income per share:					
Basic .....	11,043	10,735	10,585	10,419	9,689
Diluted .....	11,367	11,057	10,838	10,520	9,728
Return on beginning of year equity .....	25.3%	27.4%	24.1%	13.2%	13.3%
Return on beginning of year assets .....	18.9%	20.5%	16.6%	9.5%	9.2%
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
<b>Balance Sheet Data as of March 31,</b>	(Restated)	(Restated)	(Restated)	(Restated)	
Cash and cash equivalents .....	\$ 12,601	\$ 5,913	\$ 8,641	\$ 8,945	\$ 14,206
Accounts receivable, net .....	33,040	45,394	45,538	45,611	39,521
Working capital .....	34,918	36,865	40,598	38,599	34,597
Total assets .....	80,683	96,645	106,716	105,698	100,098
Retained earnings .....	86,675	103,232	119,245	129,402	139,155
Treasury stock .....	(69,140)	(84,127)	(96,281)	(113,481)	(132,205)
Total stockholders' equity .....	60,362	66,572	76,974	73,593	68,036

Certain numbers in fiscal 2002, 2003, 2004 and 2005 were restated. Please see additional discussion in the following Management's Discussion and Analysis and Footnote B to the financial statements.

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

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

The Company disclaims any obligations to update or revise any forward-looking statement based on the occurrence of future events, the receipt of new information or otherwise. Actual future performance, outcomes and results may differ materially from those expressed in forward-looking statements made by the Company and its management as a result of a number of risks, uncertainties and assumptions. Representative examples of these factors include (without limitation) general industry and economic conditions; cost of capital and capital requirements; competition from other managed care companies; the ability to expand certain areas of the Company's business; shifts in customer demands; the ability of the Company to produce market-competitive software; changes in operating expenses including employee wages, benefits and medical inflation; governmental and public policy changes, including but not limited to legislative and administrative law and rule implementation or change; dependence on key personnel; possible litigation and legal liability in the course of operations; and the continued availability of financing in the amounts and at the terms necessary to support the Company's future business.

### **Overview**

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

### **Network Solutions Services**

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

### **Patient Management Services**

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

### **Organizational Structure**

The Company's management is structured geographically with regional vice-presidents who report to the President of the Company. Each of these regional vice-presidents is responsible for all services provided by the Company in his or her particular region and responsible for the operating results of the Company in multiple states.

These regional vice presidents have area and district managers who are also responsible for all services provided by the Company in their given area and district.

### **Business Enterprise Segments**

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

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

Because we believe we meet each of the criteria set forth above and each of our regions have similar economic characteristics, we aggregate our results of operations in one reportable operating segment.

### **Summary of Fiscal 2006 Annual Results**

The Company reported revenues of \$267 million for fiscal year ended March 31, 2006, a decrease of \$24 million, or 8% compared to \$291 million in fiscal year ended March 31, 2005. The Company reported sequential declining quarterly revenues for the first three quarters of fiscal year 2006. Sequential revenue decreases for the first three quarters of fiscal 2006 were 3%, 6%, and 5% from the previous quarter. In the quarter ended March 31, 2006, the Company reported revenues of \$66.4 million, an increase in revenue of \$3.3 million, or 5.2% over the \$63.1 million reported in the previous quarter ended December 31, 2005. The revenue for the quarter ended March 31, 2006 also benefited from two extra business days in the quarter compared to the quarter ended December 31, 2005.

The continued decrease in the number of jobs in the manufacturing sector and its corresponding effect on the number of workplace injuries that have become longer-term disability cases, the considerable price competition given the flat-to-declining overall workers compensation market, the increase in competition from local and regional competition, changes and the potential changes in state workers' compensation and auto managed care laws, which can reduce demand for the Company's services, have created an environment where revenue and margin growth is more difficult to attain and where revenue growth is uncertain. Additionally, the Company's technology and preferred provider network competes against other companies, some of which have more resources available. Also, some customers may handle their managed care services in-house and may reduce the amount of services which are outsourced to managed care companies such as CorVel Corporation.

### **Results of Operations**

The Company derives its revenues from providing patient management and network solutions services to payors of workers' compensation benefits, auto insurance claims and health insurance benefits. Patient management services include utilization review, medical case management and vocational rehabilitation. Network solutions revenues include fee schedule auditing, hospital bill auditing, independent medical examinations, diagnostic imaging review services and preferred provider referral services. The percentages of revenues attributable to patient management and network solutions services for the fiscal years ended March 31, 2004, 2005, and 2006 are listed below.

	<u>2004</u>	<u>2005</u>	<u>2006</u>
Patient management services .....	45.2%	44.4%	42.7%
Network solutions services .....	54.8%	55.6%	57.3%
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

### **Income Statement Percentages**

The following table sets forth, for the periods indicated, the percentage of revenues represented by certain items reflected in the Company's consolidated statements of income. The Company's past operating results are not necessarily indicative of future operating results.

	<u>Year Ended March 31,</u>		
	<u>2004</u>	<u>2005</u>	<u>2006</u>
Revenues.....	100.0%	100.0%	100.0%
Cost of revenues.....	<u>83.2</u>	<u>84.6</u>	<u>82.9</u>
Gross profit .....	16.8	15.4	17.1
General and administrative .....	<u>8.5</u>	<u>9.7</u>	<u>11.1</u>
Income before income taxes .....	8.3	5.7	6.0
Income tax expense.....	<u>3.1</u>	<u>2.2</u>	<u>2.3</u>
Net income.....	<u>5.2%</u>	<u>3.5%</u>	<u>3.7%</u>

### **Revenue**

The Company derives its revenues from providing patient management and network solutions services to payors of workers' compensation benefits, auto insurance claims and health insurance benefits. Patient management services include utilization review, medical case management and vocational rehabilitation. Network solutions revenues include fee schedule auditing, hospital bill auditing, independent medical examinations, diagnostic imaging review services and preferred provider referral services.

#### ***Change in Revenue***

##### ***2006 Compared to 2005***

Revenues decreased by 8.2% to \$267 million in fiscal 2006, from \$291 million in fiscal year 2005, a decrease of \$24 million. Nearly two-thirds of this decrease was attributable to the decrease in revenue from the Company's patient management services primarily due to a decrease in the patient management referrals received by the Company. The decrease was primarily the result of a continued softness in the national labor market, especially the manufacturing sector of the economy. The Company has been negatively impacted by a reduction in the overall claims volume due to employers implementing workplace safety programs. Employers have also been more aggressive in seeking early intervention services which the Company and the Company's competitors offer, decreasing the length of a claim and decreasing the need for on-site case management services. The rest of the decrease in revenues was attributable to a decrease in demand for the Company's network solution services, primarily demand for the IME (independent medical examination) and MRI services.

##### ***2005 Compared to 2004***

Revenues for fiscal year 2005 decreased by 4.7% to \$291 million, from \$305 million in fiscal year 2004, a decrease of \$14 million. Nearly two-thirds of this decrease was attributable to the decrease in revenue from the

Company's patient management services primarily due to a decrease in the patient management referrals received by the Company. The decrease was primarily the result of a continued softness in the national labor market, especially the manufacturing sector of the economy. The Company has been negatively impacted by a reduction in the overall claims volume due to employers implementing workplace safety programs. Employers have also been more aggressive in seeking early intervention services which the Company and the Company's competitors offer, decreasing the length of a claim and decreasing the need for on-site case management services. The rest of the decrease in revenues was attributable to a decrease in demand for the Company's network solution services, primarily demand for the IME and MRI services.

### **Cost of Revenue**

The Company's cost of revenues consist of direct expenses, costs directly attributable to the generation of revenue, and field indirect costs which are incurred in the field to support the operations in the field offices which generate the revenue. Direct costs are primarily case manager salaries, bill review analysts, related payroll taxes and fringe benefits, and costs for IME (independent medical examination), prescription drugs, and MRI providers. Most of the Company's revenues are generated in offices which provide both patient management services and network solutions services. The largest of the field indirect costs are manager salaries and bonus, account executive base pay and commissions, administrative and clerical support, field systems personnel, PPO network developers, related payroll taxes and fringe benefits, office rent, and telephone expense. Approximately 40% of the costs incurred in the field are field indirect costs which support both the patient management services and network solutions operations of the Company's field operations.

#### ***Change in Cost of Revenue***

##### ***2006 Compared to 2005***

The Company's cost of revenues decreased from \$246 million in fiscal 2005 to \$221 million in fiscal 2006, a decrease of 10.2% or \$25 million. The decrease in cost of revenues is primarily attributable to the decrease in revenues noted above. The Company reduced their field employee headcount as revenue decreased. Approximately one quarter of the decrease is attributable to a decrease in direct labor costs of \$6.3 million. The Company has been working to decrease direct labor costs in response to the reduction in demand for the Company's services resulting from the soft national labor market. The Company also experienced lower direct costs for MRI, IME and prescription drug patient management services of \$2.7 million, \$2.8 million and \$1.3 million respectively. The decreases in these costs are directly attributable to related decreases in these respective services.

The largest components of the field indirect costs and changes from fiscal 2005 to fiscal 2006 are: manager salaries, which experienced a decrease of \$1.5 million; and clerical salaries, which decreased by \$2.5 million. The Company has been working to decrease indirect labor costs in response to the reduction in demand for the Company's services and corresponding decrease in direct labor, but there can be no assurance that the Company will be successful in doing so.

##### ***2005 Compared to 2004***

The Company's cost of revenues decreased from \$254 million in fiscal 2004 to \$246 million in fiscal 2005, a decrease of 3.3% or \$8 million. The decrease in cost of revenues is primarily attributable to the decrease in revenues noted above. The Company reduced their field employee headcount as revenue decreased. Approximately half of the decrease is attributable to a decrease in direct labor costs of \$3.4 million. The Company has been working to decrease direct labor costs in response to the reduction in demand for the Company's services resulting from the soft national labor market. The Company also experienced lower direct costs for MRI and prescription drug patient management services of \$2.4 million and \$1.4 million respectively. The decreases in these costs are directly attributable to related decreases in these respective services.

### **General and Administrative Costs**

During fiscals 2004, 2005 and 2006, approximately 62%, 62%, and 59%, respectively, of general and administrative costs consisted of corporate systems costs, which include the corporate systems support, implementation and training, amortization of software development costs, depreciation of the hardware costs in the Company's national systems, the Company's national wide area network, and other systems related costs. The remaining general and administrative costs consist of national marketing, national sales support, corporate legal, corporate insurance, human resources, accounting, product management, new business development, and other general corporate expenses.

### ***Change in General and Administrative Costs***

#### ***2006 Compared to 2005***

General and administrative expense increased \$2 million from \$28 million in fiscal 2005 to \$30 million in fiscal 2006. General and administrative expense increased as a percentage of revenue by 1.4% from 9.7% of revenue in fiscal 2005 to 11.1% of revenue in fiscal 2006. The increase was primarily related to increased expenditures in auditing and consulting fees attributable to the requirements of the Sarbanes-Oxley Act of 2002. The Company's accounting and legal costs increased by \$1.7 million. This increase was partially offset by a decrease of \$0.6 million in the Company's marketing costs. System costs, included in general and administrative costs, fell as a percentage of general and administrative costs even though their expense, in absolute dollars, remained similar to fiscal year 2005.

#### ***2005 Compared to 2004***

General and administrative expense increased \$2 million from \$26 million in fiscal 2004 to \$28 million in fiscal 2005. General and administrative expense increased as a percentage of revenue, by 1.2%, from 8.5% of revenue in fiscal 2004 to 9.7% of revenue in fiscal 2005. The increase was related to increased expenditures in systems and increases in depreciation and amortization from prior year capital investments in technology. Systems costs included in general and administrative costs increased by \$1.7 million, from \$15.6 million in fiscal 2004 to \$17.3 million in fiscal 2005. This increase was due to the Company's continued increase in investment in technology. The Company is continuing to invest in and advance its scanning and document management capabilities for their customers as well as for internal use. The Company also continued making improvements to its primary data center and its second data center as part of its business continuity planning.

### **Income Tax Provision**

The Company's income tax expense for fiscal 2004, 2005, and 2006 were \$9 million, \$6 million, and \$6 million respectively. The tax expense remained unchanged during fiscal 2006 from 2005 because the income before taxes and effective tax rate were both relatively unchanged. The effective income tax rates for fiscal 2004, 2005, and 2006 were 37%, 38%, and 38% respectively. These rates differed from the statutory federal tax rate of 35.0% primarily due to state income taxes and certain non-deductible expenses.

### **Restatement of prior year financial statements**

During fiscal year 2006, the Company determined that it should restate its financial statements as its accounting policy for leased properties was not in accordance with SFAS No. 13, "Accounting for Leases," as amended, and Financial Accounting Standards Board Technical Bulletin No. 88-1, "Issues Related to Accounting for Leases"; and its then-current method of accounting for rent on an actual basis rather than on a straight-line basis was not in accordance with Financial Accounting Standards Board Technical Bulletin No. 85-3 "Accounting for Operating Leases with Schedule Rent Increases." The Company determined that the impact on net income for fiscal year 2004 and 2005 was immaterial. The Company restated its consolidated balance sheet at March 31, 2005 and its consolidated statements of stockholders' equity for the fiscal years ended March 31, 2003, 2004 and 2005.

The above-noted correction resulted in increased rent in the years prior to fiscal 2004 and recognition of a deferred rent liability, including related tax effects. These adjustments had no effect on historical or future cash flows or the timing of payments under the related leases.

The following is a summary of the effects of these changes on the Company's consolidated balance sheet as of March 31, 2005 and the consolidated statements of stockholders' equity for the fiscal years ended March 31, 2003, 2004 and 2005.

For the audited financial statements, the adjustment noted above has the following impact:

Consolidated Balance Sheet as of March 31, 2005:

	<u>As previously reported</u>	<u>Adjustment</u>	<u>As Restated</u>
Fiscal year ended March 31, 2005			
Deferred income tax asset	\$ 4,152,000	\$ 405,000	\$ 4,557,000
Total assets	105,293,000	405,000	105,698,000
Accrued liabilities	11,059,000	1,053,000	12,112,000
Retained earnings	130,050,000	(648,000)	129,402,000
Total stockholders' equity	74,241,000	(648,000)	73,593,000

Consolidated Statements of Stockholders' Equity for fiscal years ended March 31, 2003, 2004, and 2005:

	<u>As previously reported</u>	<u>Adjustment</u>	<u>As Restated</u>
Retained earnings as of:			
March 31, 2003	\$103,880,000	\$ (648,000)	\$103,232,000
March 31, 2004	119,893,000	(648,000)	119,245,000
March 31, 2005	130,050,000	(648,000)	129,402,000
Stockholders' Equity as of:			
March 31, 2003	\$67,220,000	\$ (648,000)	\$66,572,000
March 31, 2004	77,622,000	(648,000)	76,974,000
March 31, 2005	74,241,000	(648,000)	73,593,000

The restatement had an insignificant impact on the consolidated statements of income and no impact on the consolidated statements of cash flows for the fiscal years ended March 31, 2004 and 2005 and therefore no changes have been reflected. The Company's historical income statement for the fiscal year ended March 31, 2005 properly reflected the Company's lease expense in accordance with FAS 13.

### **Liquidity and Capital Resources**

The Company has historically funded its operations and capital expenditures primarily from cash flow from operations, and to a lesser extent, stock option exercises. The Company's net accounts receivables have historically averaged below 60 days of average sales. Property, net of accumulated depreciation, has averaged approximately 10% or less of annual revenue. These historical ratios of investments in assets used in the business has allowed the Company to generate sufficient cash flow to repurchase \$132 million of its common stock during the past ten fiscal years, without incurring debt, on cumulative net earnings of \$140 million.

The Company believes that cash from operations, existing working capital, and funds from the exercise of stock options granted to employees are adequate to fund existing obligations, repurchase shares of the Company's common stock, introduce new services and continue to develop healthcare-related businesses. The Company regularly evaluates cash requirements for current operations and commitments, and for capital acquisitions and other strategic transactions. The Company may elect to raise additional funds for these purposes, either through debt or additional equity, the sale of investment securities or otherwise, as appropriate. There can be no assurance,

however, that such additional funds would be available in the amounts, at the times and on terms favorable to the Company, or at all.

Net working capital decreased from \$39 million to \$35 million, primarily due to an \$8 million decrease in accounts receivable primarily due to a reduction in revenue from \$291 million in fiscal year ended March 31, 2005 to \$267 million in fiscal year ended March 31, 2006 and a decrease in the net days sales outstanding. The net days sales outstanding in accounts receivable was 57 days at March 31, 2005 and was 54 days at March 31, 2006.

As of March 31, 2006, the Company had \$14 million in cash and cash equivalents, invested primarily in short-term, highly liquid investments with maturities of 90 days or less.

In April 2003, the Company entered into a credit agreement with a financial institution to provide borrowing capacity of up to \$5 million. In March 2005, the Company's Board of Directors authorized an increase in the credit agreement by \$5 million, to \$10 million. This agreement expired in September 2005. Borrowings under this agreement had bore interest, at the Company's option, at a fluctuating LIBOR-based rate plus 1.25% or at the financial institution's prime lending rate. There were no borrowings under the line of credit at March 31, 2005 or during the fiscal year ended March 31, 2006. The loan covenants had required the Company to maintain a quick ratio of at least 2:1, a tangible net equity of at least \$45 million, and have positive net income. The Company was in compliance with these covenants at all times during fiscal year ended March 31, 2005 and during fiscal 2006 during the periods when the line of credit was in effect.

Management believes that the cash balance at March 31, 2006 along with anticipated internally generated funds will be sufficient to meet the Company's expected cash requirements for at least the next twelve months.

## **Operating Cash Flows**

### ***2006 Compared to 2005***

Net cash provided by operating activities increased from \$26 million in fiscal 2005 to \$29 million in fiscal 2006. The increase in cash provided by operations was primarily due to the decrease in net accounts receivable from \$46 million at March 31, 2005 to \$40 million at March 31, 2006. This decrease in accounts receivable is primarily due to the decrease in revenues from \$291 million in fiscal 2005 to \$267 million in fiscal 2006. Additionally, the decrease in net accounts receivable is due to the decrease in net days sales outstanding from 57 days at March 31, 2005 to 54 days at March 31, 2006.

### ***2005 Compared to 2004***

Net cash provided by operating activities decreased from \$28 million in fiscal 2004 to \$26 million in fiscal 2005. The decrease in cash provided by operations was primarily due to the decrease in net income from \$16 million in fiscal 2004 to \$10 million in fiscal 2005. This decrease in cash provided by operating activities due to the decrease in net income was partially offset by decrease of \$1 million in prepaid expenses and taxes along with a \$2 million increase in accounts and taxes payable.

## **Investing Activities**

### ***2006 Compared to 2005***

Net cash flow used in investing activities decreased from \$12 million in fiscal 2005 to \$8 million in fiscal 2006. This decrease in investing activity is primarily due to the reduction in the volume of business and the investment in the prior years. The Company expects future expenditures for property and equipment to increase if revenues increase.

### ***2005 Compared to 2004***

Net cash flow used in investing activities decreased from \$17 million in fiscal 2004 to \$12 million in fiscal 2005. This reduction was due primarily to the reduction in the amount paid for business acquisitions from \$4 million in fiscal 2004 to \$80,000 in fiscal 2005. Purchases of property and equipment decreased from \$13 million in fiscal 2004 to \$11.5 million in fiscal 2005 partially due to the reduction in the Company's business volume.

### **Financing Activities**

#### ***2006 Compared to 2005***

Net cash flow used in financing activities increased from \$14 million in fiscal 2005 to \$16 million in fiscal 2006. The increase in cash flow used in financing activities was primarily due to the increased amount spent to repurchase shares of the Company's common stock. In fiscal 2005, the Company repurchased \$17 million of common stock (691,720 shares, at an average price of \$24.86 per share). In fiscal 2006, the Company repurchased \$19 million of common stock (835,339 shares, at an average price of \$22.42 per share). Cash proceeds from the Company's stock option and employee stock purchase plan were \$3 million in both fiscal 2005 and fiscal 2006. If the Company continues to generate cash flow from operating activities, the Company may continue to repurchase shares of its common stock on the open market, if authorized by the Company's Board of Directors, or seek to identify other businesses to acquire. In June 2006, the Company's Board of Directors approved an increase in the authorized number of shares to repurchase by 1,000,000 shares to 8,100,000 shares.

#### ***2005 Compared to 2004***

Net cash flow used in financing activities increased from \$8 million in 2004 to \$14 million in 2005. The increase in cash flow used in financing activities was primarily due to the increased amount spent to repurchase shares of the Company's common stock. In fiscal 2004, the Company repurchased \$12 million of common stock (342,121 shares, at an average price of \$35.53 per share). In fiscal 2005, the Company repurchased \$17 million of common stock (691,720 shares, at an average price of \$24.86 per share). Cash proceeds from the exercise of stock options decreased from \$3 million in fiscal 2004 to \$2 million in fiscal 2005.

### **Contractual Obligations**

The following table set forth our contractual obligations at March 31, 2006, which are future minimum lease payments due under noncancelable operating leases:

	<b>For the fiscal years ended March 31:</b>				
	<u>Total</u>	<u>2007</u>	<u>2008 - 2009</u>	<u>2010 - 2011</u>	<u>After 2011</u>
Operating Leases .....	<u>\$30,465,000</u>	<u>\$10,307,000</u>	<u>\$14,679,000</u>	<u>\$4,867,000</u>	<u>\$612,000</u>

### **Critical Accounting Policies**

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

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

in which management's judgment in selecting an available alternative would not produce a materially different result.

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

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

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

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

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

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

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

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

Significant management judgment is required in determining our provision for income taxes and our deferred tax assets and liabilities.

### **Recently Issued Accounting Standards**

In December 2004, the FASB issued Statement of Financial Accounting Standards No. (“SFAS”) 153, *Exchanges of Nonmonetary Assets – an amendment of APB Opinion No. 29* (“SFAS 153”), which is based on the principle that nonmonetary asset exchanges should be recorded and measured at the estimated fair value of the assets exchanged, with certain exceptions. SFAS 153 amends Accounting Principles Board (“APB”) Opinion No. 29, *Accounting for Nonmonetary Transactions*, to eliminate the fair-value exception for nonmonetary exchanges of similar productive assets and replace it with a general exception for nonmonetary exchanges that do not have commercial substance. This statement is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005 (fiscal year beginning April 1, 2006 for the Company). The Company does not anticipate any material impact on its financial statements upon adoption of this statement.

In December 2004, the FASB issued SFAS 123 (revised 2004), *Share-Based Payment* (“SFAS 123R”). This statement requires companies to recognize compensation expense in an amount equal to the fair value of share-based payments granted to employees. SFAS 123R eliminates the intrinsic value-based method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, that the Company currently uses. This statement is effective for the Company beginning in the first quarter of fiscal 2007. SFAS 123R offers alternate methods of adopting this standard. The Company plans to adopt SFAS 123R on a modified prospective basis in the first quarter of fiscal 2007 and will continue to use the Black-Scholes option pricing model to estimate the fair value of stock options granted. Based on current analyses and information, the Company expects that the combination of expensing stock options upon adoption of SFAS 123R and grants of other stock options will result in approximately \$900,000 of additional non-cash compensation expense, before income tax benefit, in fiscal 2007. The Company’s actual stock-based compensation expense could differ materially from this estimate depending upon the timing and magnitude of new awards, the number and mix of new awards, changes in the fair market value or volatility of the Company’s common stock, as well as unanticipated changes in the Company’s workforce.

In March 2005, the Securities and Exchange Commission (the “SEC”) issued Staff Accounting Bulletin 107 (“SAB 107”) that expresses the views of the SEC regarding the interaction between SFAS 123R and certain SEC rules and regulations and provides the SEC’s views regarding the valuation of share-based payment arrangements for public companies. In particular, SAB 107 provides guidance related to share-based payment transactions with non-employees, the transition from non-public to public entity status, valuation methods (including assumptions such as expected volatility and expected term), the accounting classification of compensation expense, non-GAAP financial measures, first-time adoption of SFAS 123R in an interim period, capitalization of compensation costs related to share-based payment arrangements, the accounting for income tax effects of share-based payment arrangements upon adoption of SFAS 123R, the modification of employee share options prior to adoption of SFAS 123R, and disclosures in Management’s Discussion and Analysis of Financial Condition and Results of Operations subsequent to adoption of SFAS 123R. The Company is currently evaluating the impact that SAB 107 will have on its consolidated financial position, results of operations, and cash flows upon its adoption in 2007. The Company does not anticipate any material impact on its financial statements upon adoption of this statement.

In May 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections – a replacement of APB Opinion No. 20 and FASB Statement No. 3* (“SFAS 154”). SFAS 154 requires retrospective application to prior periods’ financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company does not anticipate any material impact on its financial statements upon adoption of this statement.

Report of Independent Registered Public Accounting Firm

Shareholders and Board of Directors  
CorVel Corporation

We have audited the accompanying consolidated balance sheets of CorVel Corporation (the Company) as of March 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended March 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of CorVel Corporation as of March 31, 2006 and 2005, and the consolidated results of its operations and its consolidated cash flows for each of the three years in the period ended March 31, 2006 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note B, the Company has restated its 2005 and 2004 consolidated financial statements.

Our audits were conducted for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The accompanying Schedule II for each of the three years in the period ended March 31, 2006 of CorVel Corporation is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements. This schedule has been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic consolidated financial statements taken as a whole.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of CorVel Corporation's internal control over financial reporting as of March 31, 2006, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated June 28, 2006, expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an adverse opinion on the effectiveness of the Company's internal control over financial reporting because of material weaknesses.

/s/ GRANT THORNTON LLP

Portland, Oregon  
June 28, 2006

**CORVEL CORPORATION**

**CONSOLIDATED STATEMENTS OF INCOME**

	Years Ended March 31,		
	2004	2005	2006
REVENUES .....	\$ 305,279,000	\$ 291,000,000	\$ 266,504,000
Cost of revenues .....	<u>253,846,000</u>	<u>246,341,000</u>	<u>221,060,000</u>
Gross profit.....	51,433,000	44,659,000	45,444,000
General and administrative.....	<u>26,067,000</u>	<u>28,144,000</u>	<u>29,590,000</u>
Income before income tax provision .....	25,366,000	16,515,000	15,854,000
Income tax provision .....	<u>9,353,000</u>	<u>6,358,000</u>	<u>6,101,000</u>
NET INCOME.....	<u>\$ 16,013,000</u>	<u>\$ 10,157,000</u>	<u>\$ 9,753,000</u>
Net income per share:			
Basic .....	<u>\$ 1.51</u>	<u>\$ 0.97</u>	<u>\$ 1.01</u>
Diluted.....	<u>\$ 1.48</u>	<u>\$ 0.97</u>	<u>\$ 1.00</u>
Weighted average shares outstanding:			
Basic .....	10,585,000	10,419,000	9,689,000
Diluted.....	10,838,000	10,520,000	9,728,000

See accompanying notes to consolidated financial statements.

**CORVEL CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**

	March 31,	
	2005	2006
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents .....	\$ 8,945,000	\$ 14,206,000
Accounts receivable (less allowance for doubtful accounts of \$3,487,000 in 2005 and \$3,487,000 in 2006) .....	45,611,000	39,521,000
Prepaid expenses and taxes .....	3,891,000	2,221,000
Deferred income taxes .....	<u>4,557,000</u>	<u>4,521,000</u>
Total current assets .....	63,004,000	60,469,000
Property and equipment, net .....	29,649,000	26,459,000
Goodwill .....	12,642,000	12,620,000
Non-current deferred income taxes and other assets .....	<u>403,000</u>	<u>550,000</u>
	<u>\$ 105,698,000</u>	<u>\$ 100,098,000</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current Liabilities		
Accounts and taxes payable .....	\$ 12,293,000	\$ 13,712,000
Accrued liabilities .....	<u>12,112,000</u>	<u>12,160,000</u>
Total current liabilities .....	24,405,000	25,872,000
Deferred income taxes .....	7,700,000	6,190,000
Commitments and Contingencies .....	—	—
Stockholders' Equity		
Common Stock, \$.0001 par value: 20,000,000 shares authorized; 16,338,332 (10,073,184, net of Treasury shares) and 16,517,387 shares (9,416,900, net of the Treasury shares) issued and outstanding in 2005 and 2006, respectively .....	2,000	2,000
Paid-in Capital .....	57,670,000	61,084,000
Treasury Stock, at cost (6,265,148 shares in 2005 and 7,100,487 shares in 2006) .....	(113,481,000)	(132,205,000)
Retained Earnings .....	<u>129,402,000</u>	<u>139,155,000</u>
Total stockholders' equity .....	<u>73,593,000</u>	<u>68,036,000</u>
	<u>\$ 105,698,000</u>	<u>\$ 100,098,000</u>

See accompanying notes to consolidated financial statements.

**CORVEL CORPORATION**

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
**Years Ended March 31, 2004, 2005, and 2006**

	<u>Common Shares</u>	<u>Stock Amount</u>	<u>Paid-In- Capital</u>	<u>Treasury Shares</u>	<u>Treasury Stock</u>	<u>Retained Earnings (Restated)</u>	<u>Total Shareholders' Equity (Restated)</u>
Balance — March 31, 2003 as previously reported .....	15,857,676	\$ 2,000	\$ 47,465,000	(5,231,307)	\$ (84,127,000)	\$ 103,880,000	\$ 67,220,000
Restatement for lease liability .....	-	-	-	-	-	(648,000)	(648,000)
Balance – March 31, 2003, as restated .....	15,857,676	2,000	47,465,000	(5,231,307)	(84,127,000)	103,232,000	66,572,000
Stock issued under employee stock purchase plan .....	39,295	-	1,143,000	-	-	-	1,143,000
Stock issued under stock option plan, net of shares repurchased .....	266,133	-	3,365,000	-	-	-	3,365,000
Income tax benefits from stock option exercises .....	-	-	2,035,000	-	-	-	2,035,000
Purchase of treasury stock .....	-	-	-	(342,121)	(12,154,000)	-	(12,154,000)
Net income .....	-	-	-	-	-	16,013,000	16,013,000
Balance — March 31, 2004 .....	16,163,104	2,000	54,008,000	(5,573,428)	(96,281,000)	119,245,000	76,974,000
Stock issued under employee stock purchase plan .....	48,883	-	1,043,000	-	-	-	1,043,000
Stock issued under stock option plan, net of shares repurchased .....	126,345	-	1,746,000	-	-	-	1,746,000
Income tax benefits from stock option exercises .....	-	-	873,000	-	-	-	873,000
Purchase of treasury stock .....	-	-	-	(691,720)	(17,200,000)	-	(17,200,000)
Net income .....	-	-	-	-	-	10,157,000	10,157,000
Balance — March 31, 2005 .....	16,338,332	2,000	57,670,000	(6,265,148)	(113,481,000)	129,402,000	73,593,000
Stock issued under employee stock purchase plan .....	35,098	-	658,000	-	-	-	658,000
Stock issued under stock option plan, net of shares repurchased .....	143,957	-	2,337,000	-	-	-	2,337,000
Income tax benefits from stock option exercises .....	-	-	419,000	-	-	-	419,000
Purchase of treasury stock .....	-	-	-	(835,339)	(18,724,000)	-	(18,724,000)
Net income .....	-	-	-	-	-	9,753,000	9,753,000
Balance — March 31, 2006 .....	<u>16,517,387</u>	<u>\$ 2,000</u>	<u>\$ 61,084,000</u>	<u>(7,100,487)</u>	<u>\$ (132,205,000)</u>	<u>\$ 139,155,000</u>	<u>\$ 68,036,000</u>

See accompanying notes to consolidated financial statements.

**CORVEL CORPORATION**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<u>Years Ended March 31,</u>		
	<u>2004</u>	<u>2005</u>	<u>2006</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net income.....	\$ 16,013,000	\$ 10,157,000	\$ 9,753,000
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization .....	9,958,000	11,085,000	10,940,000
Loss on write down or disposal of property or capitalized software .....	—	238,000	26,000
Provision for doubtful accounts.....	2,100,000	2,355,000	3,713,000
Tax benefits from stock option exercises.....	2,035,000	873,000	419,000
Provision (benefit) for deferred income taxes .....	1,323,000	1,787,000	(1,474,000)
Changes in operating assets and liabilities:			
Accounts receivable.....	(1,941,000)	(2,428,000)	2,377,000
Prepaid expenses and taxes.....	(536,000)	1,472,000	1,670,000
Accounts and taxes payable.....	789,000	1,528,000	1,419,000
Accrued liabilities .....	(1,975,000)	(788,000)	48,000
Other assets.....	(42,000)	76,000	(147,000)
Net cash provided by operating activities .....	<u>27,724,000</u>	<u>26,355,000</u>	<u>28,744,000</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Acquisition of business, net of cash acquired .....	(4,228,000)	(80,000)	-
Purchases of property and equipment .....	(13,122,000)	(11,560,000)	(7,754,000)
Net cash used in investing activities .....	<u>(17,350,000)</u>	<u>(11,640,000)</u>	<u>(7,754,000)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Proceeds from employee stock purchase plan.....	1,143,000	1,043,000	658,000
Proceeds from exercise of stock options.....	3,365,000	1,746,000	2,337,000
Purchase of treasury stock .....	(12,154,000)	(17,200,000)	(18,724,000)
Net cash used in financing activities.....	<u>(7,646,000)</u>	<u>(14,411,000)</u>	<u>(15,729,000)</u>
Net increase in cash and cash equivalents.....	2,728,000	304,000	5,261,000
Cash and cash equivalents at beginning of year.....	<u>5,913,000</u>	<u>8,641,000</u>	<u>8,945,000</u>
<b>CASH AND CASH EQUIVALENTS AT END OF YEAR.....</b>	<b><u>\$ 8,641,000</u></b>	<b><u>\$ 8,945,000</u></b>	<b><u>\$ 14,206,000</u></b>

See accompanying notes to consolidated financial statements.

**CORVEL CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**March 31, 2005 and 2006**

**Note A — Summary of Significant Accounting Policies**

*Organization:* CorVel Corporation (CorVel or the Company) provides services and programs nationwide that are designed to enable insurance carriers, third party administrators and employers with self-insured programs to administer, manage and control the cost of workers' compensation and other healthcare benefits.

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

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

*Cash and Cash Equivalents:* Cash and cash equivalents consists of short-term highly-liquid investments with maturities of 90 days or less when purchased.

*Fair Value of Financial Instruments:* The carrying amounts of the Company's financial instruments (i.e. cash, accounts receivable, accounts payable, etc.) approximate their fair values at March 31, 2005 and 2006.

*Revenue Recognition:* The Company's revenues are recognized primarily as services are rendered based on time and expenses incurred. A certain portion of the Company's revenues are derived from fee schedule auditing which is based on the number of provider charges audited and, to a limited extent, on a percentage of savings achieved for the Company's clients. The revenue mix percentages shown below have been adjusted to include utilization review with the patient management services revenue. The percentages of revenues attributable to patient management and network solutions services for the fiscal years ended March 31, 2004, 2005, and 2006 are listed below.

	<u>2004</u>	<u>2005</u>	<u>2006</u>
Patient management services .....	45.2%	44.4%	42.7%
Network solutions services.....	54.8%	55.6%	57.3%
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

*Accounts Receivable:* The majority of the Company's accounts receivable are due from companies in the property and casualty insurance industries. Credit is extended based on evaluation of a customer's financial condition and, generally, collateral is not required. Accounts receivable are due within 30 days and are stated at amounts due from customers net of an allowance for doubtful accounts. Accounts outstanding longer than the contractual payment terms are considered past due. The Company determines its allowance by considering a number of factors, including the length of time trade accounts receivable are past due, the Company's previous loss history, the customer's current ability to pay its obligation to the Company and the condition of the general economy and the industry as a whole. There has been no change in the reserve balance during the past two years. The Company writes off accounts receivable, along with sales adjustments, to cost of sales when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for doubtful accounts. Accounts receivable includes \$3,561,000 and \$2,883,000 of unbilled receivables at March 31, 2005 and 2006, respectively. Unbilled receivables represent the revenue for the work performed for which has not yet been invoiced to the

customer. Unbilled receivables are generally invoiced within the following month. No one customer accounted for 10% or more of accounts receivable at any of the fiscal years ended March 31, 2005, and 2006.

## CORVEL CORPORATION

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### Note A — Summary of Significant Accounting Policies (continued)

*Property and Equipment:* Additions to property and equipment are recorded at cost. The Company provides for depreciation on property and equipment using the straight-line method by charges to operations in amounts that allocate the cost of depreciable assets over their estimated lives as follows:

<u>Asset Classification</u>	<u>Estimated Useful Life</u>
Leasehold Improvements	The shorter of five years or the life of lease
Furniture and equipment	Five to seven years
Computer hardware	Three to five years
Computer software	Three to five years

The Company capitalized software development costs intended for internal use. The Company accounts for internally developed software costs in accordance with SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Capitalized software development costs, intended for internal use, totaled \$9,956,000 (net of \$18,124,000 in accumulated amortization) and \$9,057,000, (net of \$21,999,000 in accumulated amortization) as of March 31, 2005 and 2006, respectively. These costs are included in computer software in property and equipment and are amortized over a period of five years.

*Long-Lived Assets:* The carrying amount of all long-lived assets is evaluated periodically to determine if adjustment to the depreciation and amortization period or to the unamortized balance is warranted. Such evaluation is based principally on the expected utilization of the long-lived assets and the projected, undiscounted cash flows of the operations in which the long-lived assets are deployed.

*Goodwill:* Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*, provides that goodwill, as well as identifiable intangible assets with indefinite lives, should not be amortized. Impairments are recognized when the expected future undiscounted cash flows derived from such assets are less than their carrying value. We measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. This most recent impairment test was performed as of December 31, 2005. No impairment of long-lived assets has been recognized in the financial statements. Goodwill amounted to \$12,642,000, (net of accumulated amortization of \$2,047,000) at March 31, 2005 and \$12,620,000, (net of accumulated amortization of \$2,069,000) at March 31, 2006.

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

*Concentrations of Credit Risk:* The Company performs periodic credit evaluations of its customers' financial condition and does not require collateral. No single customer accounted for more than 10% of accounts receivable in 2005 or 2006. Receivables are generally due within 30 days. Credit losses relating to customers in the workers' compensation insurance industry consistently have been within management's expectations. Substantially all of the Company's cash is invested in financial institutions in amounts which exceed the FDIC insurance levels but the Company has not experienced any losses from such concentrations.

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



## CORVEL CORPORATION

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### Note A — Summary of Significant Accounting Policies (continued)

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

The difference between the basic shares and the diluted shares for each of the three fiscal years ended March 31, 2004, 2005, and 2006 is as follows:

	March 31, 2004	March 31, 2005	March 31, 2006
Basic weighted shares	10,585,000	10,419,000	9,689,000
Treasury stock impact of stock options	253,000	101,000	39,000
Diluted weighted shares	10,838,000	10,520,000	9,728,000

734,332 anti-dilutive shares were excluded from the weighted shares calculation during the quarter ending March 31, 2006 because the option prices were below the average fair market value of the stock during the quarter.

*Stock Based Compensation Plans:* The Company has a stock-based employee compensation plan, which is described more fully in Note F. The Company applies the intrinsic value method provided by APB Opinion 25, *Accounting for Stock Issued to Employees*, and related Interpretations to account for its plans. In accordance with SFAS 148, the following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123, *Accounting for Stock-Based Compensation*, using the assumptions shown below, to its stock-based employee plans.

	2004	2005	2006
Net income as reported .....	\$ 16,013,000	\$ 10,157,000	\$ 9,753,000
Add back: stock-based compensation costs charged to expense.....	-	-	-
Deduct: Stock-based employee compensation cost, net of taxes	(1,075,000)	(1,022,000)	(764,000)
Pro forma net income .....	\$ 14,938,000	\$ 9,135,000	\$ 8,989,000
Earnings per share — basic As reported.....	\$ 1.51	\$ 0.97	\$ 1.01
Pro forma.....	\$ 1.41	\$ 0.88	\$ 0.93
Earnings per share — diluted As reported.....	\$ 1.48	\$ 0.97	\$ 1.00
Pro forma.....	\$ 1.38	\$ 0.87	\$ 0.92

**CORVEL CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note A — Summary of Significant Accounting Policies (continued)**

*Stock Based Compensation Plans: (continued)*

The weighted average fair values at date of grant for options granted during fiscal 2004, 2005, and 2006 were \$9.77, \$7.49, and \$6.60, respectively.

The fair value of each grant is estimated on the date of grant using the Black-Scholes option-pricing model. The following weighted average assumptions were used for fiscal years ending March 31, 2004, 2005 and 2006:

	<u>2004</u>	<u>2005</u>	<u>2006</u>
Expected volatility .....	33%	38%	38%
Risk free interest rate .....	3.9%	3.4%	4.0 %
Dividend yield.....	0.0%	0.0%	0.0%
Weighted average option life .....	4.6 years	4.7 years	4.7 years

*Recent Accounting Pronouncements:* In December 2004, the FASB issued Statement of Financial Accounting Standards No. (“SFAS”) 153, *Exchanges of Nonmonetary Assets – an amendment of APB Opinion No. 29* (“SFAS 153”), which is based on the principle that nonmonetary asset exchanges should be recorded and measured at the fair value of the assets exchanged, with certain exceptions. SFAS 153 amends Accounting Principles Board (“APB”) Opinion No. 29, *Accounting for Nonmonetary Transactions*, to eliminate the fair-value exception for nonmonetary exchanges of similar productive assets and replace it with a general exception for nonmonetary exchanges that do not have commercial substance. This statement is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005 (fiscal year beginning April 1, 2006 for the Company). The Company does not anticipate any material impact on its financial statements upon adoption of this statement.

## CORVEL CORPORATION

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### Note A — Summary of Significant Accounting Policies (continued)

##### *Recent Accounting Pronouncements:* (continued)

In December 2004, the FASB issued SFAS 123 (revised 2004), *Share-Based Payment* (“SFAS 123R”). This statement requires companies to recognize compensation expense in an amount equal to the fair value of share-based payments granted to employees. SFAS 123R eliminates the intrinsic value-based method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, that the Company currently uses. This statement is effective for the Company beginning in the first quarter of fiscal 2007. SFAS 123R offers alternate methods of adopting this standard. The Company is adopting SFAS 123R on a prospective basis in the first quarter of fiscal 2007 and will continue to use the Black-Scholes option pricing model to estimate the fair value of stock options granted. Based on current analyses and information, the Company expects that the combination of expensing stock options upon adoption of SFAS 123R and grants of other stock options will result in approximately \$900,000 of additional non-cash compensation expense before income tax benefit in fiscal 2007. The Company’s actual stock-based compensation expense could differ materially from this estimate depending upon the timing and magnitude of new awards, the number and mix of new awards, changes in the fair market value or volatility of the Company’s common stock, as well as unanticipated changes in the Company’s workforce.

In March 2005, the Securities and Exchange Commission (the “SEC”) issued Staff Accounting Bulletin 107 (“SAB 107”) that expresses the views of the SEC regarding the interaction between SFAS 123R and certain SEC rules and regulations and provides the SEC’s views regarding the valuation of share-based payment arrangements for public companies. In particular, SAB 107 provides guidance related to share-based payment transactions with non-employees, the transition from non-public to public entity status, valuation methods (including assumptions such as expected volatility and expected term), the accounting classification of compensation expense, non-GAAP financial measures, first-time adoption of SFAS 123R in an interim period, capitalization of compensation costs related to share-based payment arrangements, the accounting for income tax effects of share-based payment arrangements upon adoption of SFAS 123R, the modification of employee share options prior to adoption of SFAS 123R, and disclosures in Management’s Discussion and Analysis of Financial Condition and Results of Operations subsequent to adoption of SFAS 123R. The Company is currently evaluating the impact that SAB 107 will have on its consolidated financial position, results of operations, and cash flows upon its adoption in 2007. The Company does not anticipate any material impact on its financial statements upon adoption of this statement.

In May 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections – a replacement of APB Opinion No. 20 and FASB Statement No. 3* (“SFAS 154”). SFAS 154 requires retrospective application to prior periods’ financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company does not anticipate any material impact on its financial statements upon adoption of this statement.

## CORVEL CORPORATION

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### Note B -- Restatement

During fiscal year 2006, the Company determined that it should restate its financial statements as its accounting policy for leased properties was not in accordance with SFAS No. 13, "Accounting for Leases," as amended, and Financial Accounting Standards Board Technical Bulletin No. 88-1, "Issues Related to Accounting for Leases"; and its then-current method of accounting for rent on an actual basis rather than on a straight-line basis was not in accordance with Financial Accounting Standards Board Technical Bulletin No. 85-3 "Accounting for Operating Leases with Schedule Rent Increases." The Company determined that the impact on net income for fiscal year 2004 and 2005 was immaterial. The Company restated its consolidated balance sheet at March 31, 2005 and its consolidated statements of stockholders' equity for the fiscal years ended March 31, 2003, 2004 and 2005.

The following is a summary of the effects of these changes on the Company's consolidated balance sheet at March 31, 2005 and the consolidated statements of stockholders' equity as of and for the fiscal years ended March 31, 2003, 2004 and 2005.

For the audited financial statements, the adjustment noted above has the following impact:

Consolidated Balance Sheet as of March 31, 2005:

	<u>As previously reported</u>	<u>Adjustment</u>	<u>As Restated</u>
Fiscal year ended March 31, 2005			
Deferred income tax asset	\$ 4,152,000	\$ 405,000	\$ 4,557,000
Total assets	105,293,000	405,000	105,698,000
Accrued liabilities	11,059,000	1,053,000	12,112,000
Retained earnings	130,050,000	(648,000)	129,402,000
Total stockholders' equity	74,241,000	(648,000)	73,593,000

Consolidated Statements of Stockholders' Equity for fiscal years ended March 31, 2003, 2004, and 2005:

	<u>As previously reported</u>	<u>Adjustment</u>	<u>As Restated</u>
Retained earnings as of:			
March 31, 2003	\$103,880,000	\$ (648,000)	\$103,232,000
March 31, 2004	119,893,000	(648,000)	119,245,000
March 31, 2005	130,050,000	(648,000)	129,402,000
Stockholders' Equity as of:			
March 31, 2003	\$67,220,000	\$ (648,000)	\$66,572,000
March 31, 2004	77,622,000	(648,000)	76,974,000
March 31, 2005	74,241,000	(648,000)	73,593,000

The restatement had an insignificant impact on the consolidated statements of income and no impact on the consolidated statements of cash flows for the fiscal years ended March 31, 2004 and 2005 and therefore no changes have been reflected. The Company's historical income statement for the fiscal year ended March 31, 2005 properly reflected the Company's lease expense in accordance with FAS 13.

**CORVEL CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note C — Property and Equipment**

Property and equipment consists of the following at March 31, 2005 and 2006:

	<u>2005</u>	<u>2006</u>
Office equipment and computers .....	\$41,190,000	\$44,466,000
Computer software .....	34,585,000	37,565,000
Leasehold improvements .....	<u>3,702,000</u>	<u>3,832,000</u>
	79,477,000	85,863,000
Less: accumulated depreciation and amortization.....	<u>(49,828,000)</u>	<u>(59,404,000)</u>
	<u>\$ 29,649,000</u>	<u>\$ 26,459,000</u>

**Note D — Accrued Liabilities**

Accrued liabilities consist of the following at March 31, 2005 and 2006:

	<u>2005</u>	<u>2006</u>
	<u>(Restated)</u>	
Payroll and related benefits .....	\$ 7,038,000	\$ 6,859,000
Self-insurance accruals.....	3,239,000	3,644,000
Other .....	<u>1,835,000</u>	<u>1,657,000</u>
	<u>\$ 12,112,000</u>	<u>\$ 12,160,000</u>

See Footnote B for comments related to the restatement of the March 31, 2005 balance.

**CORVEL CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note E — Income Taxes**

The income tax provision consists of the following for the three years ended March 31, 2004, 2005 and 2006:

	<u>2004</u>	<u>2005</u>	<u>2006</u>
Current — Federal.....	\$ 7,548,000	\$ 4,155,000	\$ 6,822,000
Current — State .....	482,000	416,000	753,000
Subtotal .....	<u>8,030,000</u>	<u>4,571,000</u>	<u>7,575,000</u>
Deferred — Federal.....	1,208,000	1,624,000	(1,340,000)
Deferred — State.....	115,000	163,000	(134,000)
Subtotal .....	<u>1,323,000</u>	<u>1,787,000</u>	<u>(1,474,000)</u>
	<u>\$ 9,353,000</u>	<u>\$ 6,358,000</u>	<u>\$ 6,101,000</u>

The following is a reconciliation of the income tax provision from the statutory federal income tax rate to the effective rate for the three years ended March 31, 2004, 2005 and 2006:

	<u>2004</u>	<u>2005</u>	<u>2006</u>
Income taxes at federal statutory rate (35%) .....	\$ 8,878,000	\$ 5,780,000	\$ 5,549,000
State income taxes, net of federal benefit.....	809,000	662,000	552,000
Other .....	<u>(334,000)</u>	<u>(84,000)</u>	-
	<u>\$ 9,353,000</u>	<u>\$ 6,358,000</u>	<u>\$ 6,101,000</u>

Income taxes paid totaled \$6,455,000, \$2,711,000 and \$6,624,000 for the years ended March 31, 2004, 2005, and 2006, respectively.

**CORVEL CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note E — Income Taxes (continued)**

Deferred taxes at March 31, 2005 and 2006 are:

	<u>2005</u> (Restated)	<u>2006</u>
<i>Deferred tax assets:</i>		
Accrued liabilities not currently deductible .....	\$ 2,781,000	\$ 2,995,000
Allowance for doubtful accounts .....	1,342,000	1,343,000
Other .....	<u>405,000</u>	<u>183,000</u>
Deferred assets .....	<u>4,557,000</u>	<u>4,521,000</u>
<i>Deferred tax liabilities:</i>		
Excess of book over tax basis of fixed assets.....	(6,758,000)	(5,362,000)
Other .....	<u>(942,000)</u>	<u>(828,000)</u>
Deferred liabilities.....	<u>(7,700,000)</u>	<u>(6,190,000)</u>
Net deferred tax liability .....	<u>\$ (3,143,000)</u>	<u>\$ (1,669,000)</u>

Prepaid expenses and taxes include \$1,225,000 and \$1,162,000 at March 31, 2005 and March 31, 2006, respectively, for income taxes due in the first quarter of the succeeding fiscal year.

**Note F — Stock Options**

Under the Company's Restated 1988 Executive Stock Option Plan, ("the Plan") as in effect at March 31, 2006, options for up to 5,955,000 shares (adjusted for the two-for-one stock split in the form of a dividend in June 1999 and the three-for-two stock split in the form of the dividend in August 2001) of the Company's common stock may be granted to key employees, non-employee directors and consultants at prices not less than 85% of the fair value of the stock at the date of grant as determined by the Board. Options granted under the Plan may be either incentive stock options or non-statutory stock options and options granted generally vest 25% one year from date of grant and the remaining 75% vesting ratably each month for the next 36 months. The options generally expire at the end of five years from date of grant.

**CORVEL CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note F — Stock Options (continued)**

Summarized information for all stock options for the past three fiscal year follows:

	<u>2004</u>	<u>2005</u>	<u>2006</u>
Options outstanding at the beginning of the year	1,197,747	994,475	969,887
Options granted	138,871	145,750	155,400
Options exercised	(277,240)	(132,456)	(152,436)
Options cancelled/forfeited	<u>(64,903)</u>	<u>(37,882)</u>	<u>(126,369)</u>
Options outstanding at the end of the year	<u><u>994,475</u></u>	<u><u>969,887</u></u>	<u><u>846,482</u></u>

During the year, weighted average exercise price of:

Options granted	\$ 34.63	\$ 23.40	\$ 20.48
Options exercised	\$ 13.55	\$ 14.80	\$ 16.97
Options forfeited	\$ 14.75	\$ 31.88	\$ 25.17

At the end of the year:

Price range of outstanding options.....	\$ 6.13 - \$38.74	\$ 8.50-\$38.74	\$ 10.21-\$38.74
Weighted average exercise price per share .....	\$ 24.42	\$ 25.29	\$ 25.92
Options available for future grants .....	731,735	632,867	594,836
Exercisable options.....	585,529	640,351	538,204

The weighted average exercise price for exercisable options at March 31, 2004, 2005, and 2006, was \$20.47, \$23.57 and \$26.84, respectively.

**CORVEL CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note F — Stock Options (continued)**

The following table summarizes the status of stock options outstanding and exercisable at March 31, 2006:

<u>Range of Exercise Prices</u>	<u>Number of Outstanding Options</u>	<u>Weighted Average Remaining Contractual Life</u>	<u>Outstanding Options — Weighted Average Exercise Price</u>	<u>Exercisable Options — Number of Exercisable Options</u>	<u>Exercisable Options — Weighted Average Exercise Price</u>
\$10.21 to \$20.20 .....	194,100	3.56	\$16.39	97,524	\$14.40
20.21 to 25.00 .....	218,730	2.83	23.64	123,430	24.54
25.01 to 30.00 .....	209,144	2.65	28.35	155,427	29.04
30.01 to 38.74 .....	<u>224,508</u>	<u>2.65</u>	<u>34.13</u>	<u>161,823</u>	<u>33.96</u>
Total.....	<u>846,482</u>	<u>2.92</u>	<u>\$25.92</u>	<u>538,204</u>	<u>\$26.84</u>

**Note G — Employee Stock Purchase Plan**

The Company maintains an Employee Stock Purchase Plan (“ESPP”) which was amended by approval of the Company’s stockholders in September 2005 to allow employees of the Company and its subsidiaries to purchase shares of common stock on the last day of two six-month purchase periods (i.e. March 31 and September 30) at a purchase price which is 95% of the closing sale price of shares as quoted on NASDAQ on the last day of such purchase period. Prior to the purchase period beginning October 1, 2005, the purchase price was equal to 85% of the closing sale price of shares as quoted on NASDAQ on the first or last day of the purchase period, whichever was lower. In September 2005, the shareholders approved to amend the plan to the purchase price formula noted above. Employees are allowed to contribute up to 20% of their gross pay. A maximum of 950,000 shares has been authorized for issuance under the ESPP, as amended. As of March 31, 2006, 750,831 shares had been issued pursuant to the ESPP. Summarized ESPP information is as follows:

	<u>2004</u>	<u>2005</u>	<u>2006</u>
Employee contributions .....	\$1,143,000	\$1,043,000	\$ 658,000
Shares acquired .....	39,295	48,883	35,098
Average purchase price.....	\$ 29.09	\$ 21.34	\$ 18.75

In accordance with FASB Technical Bulletin 97-1, the fair value of this stock purchase plan has been included in the pro forma disclosures contained in Note A, Stock Based Compensation Plans.

**CORVEL CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note H — Treasury Stock and Subsequent Event**

During fiscals 2004, 2005, and 2006, the Company continued to repurchase shares of its common stock under a plan originally approved by the Company's Board of Directors in 1996. Including an expansion authorized in March 2005, the total number of shares authorized to be repurchased is 7,100,000 shares. Purchases may be made from time to time depending on market conditions and other relevant factors. The share repurchases for fiscal years ending March 31, 2004, 2005 and 2006 are as follows:

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>Cumulative</u>
Shares repurchased .....	342,121	691,720	835,339	7,100,487
Cost.....	\$ 12,154,000	\$ 17,200,000	\$ 18,724,000	\$ 132,205,000
Average price .....	\$ 35.53	\$ 24.86	\$ 22.42	\$ 18.62

The repurchased shares were recorded as treasury stock, at cost, and are available for general corporate purposes. The repurchases were financed from cash generated from operations.

In June 2006, the Company's Board of Directors authorized an increase in the number of shares to be repurchased by 1,000,000 shares to 8,100,000 shares.

**Note I — Commitments and Contingencies**

The Company leases office facilities under noncancelable operating leases. Some of these leases contain escalation clauses. Future minimum rental commitments under operating leases at March 31, 2006 are \$10,307,000 in fiscal 2007, \$8,595,000 in fiscal 2008, \$6,084,000 in fiscal 2009, \$3,397,000 in fiscal 2010, \$1,470,000 in fiscal 2011, and \$612,000 thereafter. Total rental expense of \$11,365,000, \$12,379,000 and \$12,312,000 was charged to operations for the years ended March 31, 2004, 2005, and 2006, respectively. The cost of leasehold improvements are capitalized as incurred and amortized over the life of the lease.

The Company is involved in litigation arising in the normal course of business. Management believes that resolution of these matters will not result in any payment that, in the aggregate, would be material to the financial position or results of the operations of the Company.

## CORVEL CORPORATION

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### **Note J — Savings Plan**

The Company maintains a retirement savings plan for its employees, which is a qualified plan under Section 401(k) of the Internal Revenue Code. Full-time employees that meet certain requirements are eligible to participate in the plan. Contributions are made annually, primarily at the discretion of the Company's Board of Directors. Contributions of \$150,000 were charged to operations for the years ended March 31, 2004. There was no employer contribution for the fiscal years ended March 31, 2005 and March 31, 2006.

#### **Note K — Shareholder Rights Plan**

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

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

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

#### **Note L — Line of Credit**

In April 2003, the Company entered into a credit agreement with a financial institution to provide borrowing capacity of up to \$5 million. In March 2005, the Company's Board of Directors authorized an increase in the credit agreement by \$5 million, to \$10 million. This agreement expired in September 2005. Borrowings under this agreement had bore interest, at the Company's option, at a fluctuating LIBOR-based rate plus 1.25% or at the financial institution's prime lending rate. There were no borrowings under the line of credit at March 31, 2005 or during the fiscal year ended March 31, 2006. The loan covenants had required the Company to maintain a quick ratio of at least 2:1, a tangible net equity of at least \$45 million, and have positive net income. The Company was in compliance with these covenants at all times during fiscal year ended March 31, 2005 and during fiscal 2006 during the periods when the line of credit was in place.

**CORVEL CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note M — Quarterly Results (Unaudited)**

The following is a summary of unaudited quarterly results of operations for the two years ended March 31, 2005 and 2006:

	<u>Revenues</u>	<u>Gross Profit</u>	<u>Net Income</u>	<u>Net Income per Basic Common Share</u>	<u>Net Income per Diluted Common Share</u>
<b>Fiscal Year Ended March 31, 2005:</b>					
First Quarter .....	\$ 76,256,000	\$ 12,909,000	\$ 3,411,000	\$.32	\$.32
Second Quarter .....	72,156,000	11,694,000	3,037,000	.29	.29
Third Quarter .....	69,788,000	8,904,000	1,261,000	.12	.12
Fourth Quarter .....	72,800,000	11,152,000	2,448,000	.24	.24
<b>Fiscal Year Ended March 31, 2006:</b>					
First Quarter .....	\$ 70,667,000	\$ 12,004,000	\$ 2,810,000	\$.28	\$.28
Second Quarter .....	66,343,000	10,873,000	2,211,000	.22	.22
Third Quarter .....	63,073,000	10,048,000	1,665,000	.17	.17
Fourth Quarter .....	66,421,000	12,519,000	3,067,000	.33	.33

**Note N — Segment Reporting**

The Company derives the majority of its revenues from providing patient management and network solutions services to payors of workers' compensation benefits, automobile insurance claims and health insurance benefits. Patient management services include utilization review, medical case management, and vocational rehabilitation. Network solutions revenues include fee schedule auditing, hospital bill auditing, independent medical examinations, diagnostic imaging review services and preferred provider referral services. In the prior fiscal years, the Company included the revenue from utilization review with network solutions revenues.

## CORVEL CORPORATION

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### **Note N — Segment Reporting (continued)**

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

Because the Company meets each of the criteria set forth above and each of our regions have similar economic characteristics, the Company aggregates its results of operations in one reportable operating segment.

## EXHIBIT INDEX

<b>Exhibit No.</b>	<b>Title - - Method of Filing</b>	<b>Page</b>
3.1	Certificate of Incorporation of the Company - - Incorporated herein by reference to Exhibit 3.1 to the Company's Registration Statement on Form S-1 Registration No. 33-40629.	
3.2	Bylaws of the Company - - Incorporated herein by reference to Exhibit 3.2 to the Company's Registration Statement on Form S-1 Registration No. 33-40629.	
10.1*	Nonqualified Stock Option Agreement between V. Gordon Clemons, the Company and North Star together with all amendments and addendums thereto - - Incorporated herein by reference to Exhibit 10.6 to the Company's Registration Statement on Form S-1 Registration No. 33-40629.	
10.2*	Supplementary Agreement between V. Gordon Clemons, the Company and North Star - - Incorporated herein by reference to Exhibit 10.7 to the Company's Registration Statement on Form S-1 Registration No. 33-40629.	
10.3*	Amendment to Supplementary Agreement between Mr. Clemons, the Company and North Star - - Incorporated herein by reference to Exhibit 10.5 to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 1992.	
10.4*	Restated 1988 Executive Stock Option Plan, as amended - - Incorporated herein by reference to Exhibit 10.5 to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 1995.	
10.5*	Form of Notice of Grant of Stock Option Under the Restated 1988 Executive Stock Option Plan - - Incorporated herein by reference to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 1994.	
10.6*	Form of Stock Option Agreement under the Restated 1988 Executive Stock Option Plan - - Incorporated herein by reference to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 1994.	
10.7*	Form of Notice of Exercise under the Restated 1988 Executive Stock Option Plan - - Incorporated herein by reference to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 1994.	
10.8*	Employment Agreement of V. Gordon Clemons - - Incorporated herein by reference to Exhibit 10.12 to the Company's Registration Statement on Form S-1 Registration No. 33-40629.	

\* - Denotes management contract or compensatory plan or arrangement.

## **EXHIBIT INDEX (continued)**

<b><u>Exhibit No.</u></b>	<b><u>Title - - Method of Filing</u></b>	<b><u>Page</u></b>
10.9*	Restated 1991 Employee Stock Purchase Plan, as amended - - Incorporated herein by reference to Exhibit 10.11 in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 1995.	
10.10	Fidelity Master Plan for Savings and Investments, and amendments - - Incorporated herein by reference to Exhibit 10.16 and 10.16A to the Company's Registration Statement on Form S-1 Registration No. 33-40629.	
10.12	Shareholder Rights Plan - - Incorporated herein by reference to the Company's 8-K filed on February 28, 1997.	
10.16	Amended Shareholder Rights Plan - - Incorporated herein by reference to the Company's 8-K filed on May 24, 2002.	
10.17	Employment Agreement of Dan Starck -- Incorporated herein by reference to the Company's Form 8-K filed on May 30, 2006.	
21.1	Subsidiaries of the Company - - Filed herewith	
23.1	Consent of Independent Registered Public Accounting Firm - - Filed herewith.	
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. - - Filed herewith.	
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. - - Filed herewith.	
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. - - Furnished herewith.	
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. - - Furnished herewith.	

\* - Denotes management contract or compensatory plan or arrangement.

**EXHIBIT 21.1 - - SUBSIDIARIES OF THE REGISTRANT**

<u>Name of Subsidiary</u>	<u>State of Incorporation</u>	<u>Relationship to Registrant</u>
CorVel Health Care Organization	California	wholly-owned subsidiary
CorVel Healthcare Corporation	California	wholly-owned subsidiary

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We have issued our reports dated June 28, 2006 accompanying the consolidated financial statements and management's assessment of the effectiveness of internal control over financial reporting included in the annual report of CorVel Corporation on Form 10-K for the year ended March 31, 2006. We hereby consent to the incorporation by reference of said reports in the Registration Statement of CorVel Corporation on Form S-8 (File No. 333-58455, effective July 2, 1998, File No. 333-16379, effective November 19, 1996, File No. 333-107428, effective July 29, 2003 and File No. 333-128739, effective September 30, 2005.

/s/ Grant Thornton LLP

Portland, Oregon  
June 28, 2006

**CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER  
UNDER SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, V. Gordon Clemons, Chief Executive Officer of CorVel Corporation, certify that:

1. I have reviewed this annual report on Form 10-K of CorVel Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: June 29, 2006

/s/ V. Gordon Clemons  
V. Gordon Clemons  
Chief Executive Officer (Principal Executive Officer)

**CERTIFICATION OF THE CHIEF FINANCIAL OFFICER  
UNDER SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Scott McCloud, Chief Financial Officer of CorVel Corporation, certify that:

1. I have reviewed this annual report on Form 10-K of CorVel Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: June 29, 2006

/s/ Scott McCloud  
Scott McCloud  
Chief Financial Officer (Principal Financial Officer)

**Exhibit 32.1**

**CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER  
UNDER SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of CorVel Corporation (the “Registrant”) on Form 10-K for the fiscal year ended March 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the “Annual Report”), I, V. Gordon Clemons, Chief Executive Officer of the Registrant, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(1) the Annual Report fully complies with the requirements of Section 13(a) or 15 (d) of the Securities Exchange Act of 1934; and

(2) the information contained in the Annual Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ V. Gordon Clemons  
V. Gordon Clemons  
Chief Executive Officer  
June 29, 2006

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to CorVel Corporation and will be retained by CorVel Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

This certification accompanies this Annual Report and is being furnished pursuant to Item 601(b)(32) of Regulation S-K promulgated under the Securities Act of 1933, as amended (the “Securities Act”) and the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This certification shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by the Registrant for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), or otherwise subject to the liability of that section, or incorporated by reference into any filing under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific incorporation by reference in such a filing.

**CERTIFICATION OF THE CHIEF FINANCIAL OFFICER  
UNDER SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of CorVel Corporation (the “Registrant”) on Form 10-K for the fiscal year ended March 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the “Annual Report”), I, Scott McCloud, Chief Financial Officer of the Registrant, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(1) the Annual Report fully complies with the requirements of Section 13(a) or 15 (d) of the Securities Exchange Act of 1934; and

(2) the information contained in the Annual Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ Scott McCloud  
Scott McCloud  
Chief Financial Officer  
June 29, 2006

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to CorVel Corporation and will be retained by CorVel Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

This certification accompanies this Annual Report and is being furnished pursuant to Item 601(b)(32) of Regulation S-K promulgated under the Securities Act of 1933, as amended (the “Securities Act”) and the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This certification shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by the Registrant for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), or otherwise subject to the liability of that section, or incorporated by reference into any filing under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific incorporation by reference in such a filing.