

CORVEL CORP
Form 10-Q
August 05, 2014
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2014

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	33-0282651 (IRS Employer
incorporation or organization)	Identification No.)
2010 Main Street, Suite 600 Irvine, CA (Address of principal executive office)	92614 (zip code)
Registrant's telephone number, including area code: (949) 851-1473	

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller Reporting Company

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

The number of shares outstanding of the registrant's Common Stock, \$0.0001 par value per share, as of July 23, 2014 was 20,849,420.

Table of Contents

CORVEL CORPORATION

FORM 10-Q

TABLE OF CONTENTS

	Page
<u>PART I FINANCIAL INFORMATION</u>	
Item 1. <u>Financial Statements</u>	
<u>Consolidated Balance Sheets</u> March 31, 2014 and June 30, 2014 (unaudited)	3
<u>Consolidated Income Statements (unaudited)</u> Three months ended June 30, 2013 and 2014	4
<u>Consolidated Statements of Cash Flows (unaudited)</u> Three months ended June 30, 2013 and 2014	5
<u>Notes to Consolidated Financial Statements</u> June 30, 2014	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	15
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	24
Item 4. <u>Controls and Procedures</u>	24
<u>PART II. OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings</u>	24
Item 1A. <u>Risk Factors</u>	25
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	32
Item 3. <u>Defaults Upon Senior Securities</u>	32
Item 4. <u>Mine Safety Disclosures</u>	32
Item 5. <u>Other Information</u>	32
Item 6. <u>Exhibits</u>	33
<u>Signatures</u>	34

Table of Contents

Part I - Financial Information

Item 1. Financial Statements

CORVEL CORPORATION**CONSOLIDATED BALANCE SHEETS**

	March 31, 2014	June 30, 2014 (Unaudited)
Assets		
Current Assets		
Cash and cash equivalents (Note A)	\$ 34,866,000	\$ 34,134,000
Customer deposits	16,142,000	13,005,000
Accounts receivable, net	57,229,000	57,186,000
Prepaid taxes and expenses	5,862,000	4,933,000
Deferred income taxes	6,861,000	7,139,000
Total current assets	120,960,000	116,397,000
Property and equipment, net	51,253,000	51,832,000
Goodwill	36,814,000	36,814,000
Other intangibles, net (Note F)	5,193,000	5,079,000
Other assets	261,000	952,000
TOTAL ASSETS	\$ 214,481,000	\$ 211,074,000
Liabilities and Stockholders Equity		
Current Liabilities		
Accounts and taxes payable	\$ 18,465,000	\$ 19,439,000
Accrued liabilities	53,375,000	44,995,000
Total current liabilities	71,840,000	64,434,000
Deferred income taxes	16,119,000	16,119,000
Commitments and contingencies (Notes G and H)		
Stockholders Equity		
Common stock, \$.0001 par value: 120,000,000 shares authorized at March 31, 2014 and June 30, 2014; 53,126,866 shares issued (20,979,392 shares outstanding, net of Treasury shares) and 53,151,889 shares issued (20,880,969 shares outstanding, net of Treasury shares) at March 31, 2014 and June 30, 2014, respectively	3,000	3,000
Paid-in capital	118,831,000	120,255,000
Treasury Stock (32,147,474 shares at March 31, 2014 and 32,270,920 shares at June 30, 2014)	(328,480,000)	(334,204,000)
Retained earnings	336,168,000	344,467,000
Total stockholders equity	126,522,000	130,521,000

TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	\$ 214,481,000	\$ 211,074,000
--	----------------	----------------

See accompanying notes to consolidated financial statements.

Table of Contents**CORVEL CORPORATION****CONSOLIDATED INCOME STATEMENTS UNAUDITED**

	Three Months Ended June 30,	
	2013	2014
REVENUES	\$ 118,113,000	\$ 124,364,000
Cost of revenues	91,195,000	96,664,000
Gross profit	26,918,000	27,700,000
General and administrative expenses	12,842,000	14,205,000
Income before income tax provision	14,076,000	13,495,000
Income tax provision	5,467,000	5,196,000
NET INCOME	\$ 8,609,000	\$ 8,299,000
Net income per common and common equivalent share		
Basic	\$ 0.40	\$ 0.40
Diluted	\$ 0.40	\$ 0.39
Weighted average common and common equivalent shares		
Basic	21,396,000	20,935,000
Diluted	21,584,000	21,210,000

See accompanying notes to consolidated financial statements.

Table of Contents**CORVEL CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS UNAUDITED**

	Three Months Ended June 30,	
	2013	2014
<i>Cash flows from Operating Activities</i>		
NET INCOME	\$ 8,609,000	\$ 8,299,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,012,000	4,117,000
Loss on disposal of assets	1,000	5,000
Stock compensation expense	405,000	717,000
Write-off of uncollectible accounts	320,000	355,000
Deferred income tax	(162,000)	(278,000)
Changes in operating assets and liabilities		
Accounts receivable	(1,973,000)	(312,000)
Customer deposits	(1,220,000)	3,137,000
Prepaid taxes and expenses	2,879,000	929,000
Other assets	174,000	110,000
Accounts and taxes payable	3,580,000	975,000
Accrued liabilities	168,000	(8,380,000)
Net cash provided by operating activities	16,793,000	9,674,000
<i>Cash Flows from Investing Activities</i>		
Investment in private equity		(800,000)
Purchase of property and equipment	(5,477,000)	(4,588,000)
Net cash (used in) investing activities	(5,477,000)	(5,388,000)
<i>Cash Flows from Financing Activities</i>		
Purchase of treasury stock	(7,308,000)	(5,725,000)
Tax effect of stock option exercises	337,000	282,000
Exercise of common stock options	867,000	425,000
Net cash (used in) financing activities	(6,104,000)	(5,018,000)
<i>Increase (decrease) in cash and cash equivalents</i>	5,212,000	(732,000)
Cash and cash equivalents at beginning of period	19,822,000	34,866,000
Cash and cash equivalents at end of period	\$ 25,034,000	\$ 34,134,000
Supplemental Cash Flow Information:		
Income taxes paid	\$ 300,000	\$ 183,000
Purchase of software license under finance agreement	\$ 2,343,000	\$ 1,172,000

See accompanying notes to consolidated financial statements.

Table of Contents

CORVEL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2014

Note A Basis of Presentation and Summary of Significant Accounting Policies

The unaudited financial statements herein have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. The accompanying interim financial statements have been prepared under the presumption that users of the interim financial information have either read or have access to the audited financial statements for the latest fiscal year ended March 31, 2014. Accordingly, note disclosures which would substantially duplicate the disclosures contained in the March 31, 2014 audited financial statements have been omitted from these interim financial statements.

The Company evaluated all subsequent events or transactions through the date of filing this report. During the period subsequent to June 30, 2014, the Company repurchased 35,566 shares for \$1,599,000 for an average of \$44.97 per share. These shares were repurchased under the Company's ongoing share repurchase program described in Note C.

Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. Operating results for the three months ended June 30, 2014 are not necessarily indicative of the results that may be expected for the fiscal year ending March 31, 2015. For further information, refer to the consolidated financial statements and notes for the fiscal year ended March 31, 2014 included in the Company's Annual Report on Form 10-K.

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

Use of Estimates: The preparation of financial statements in compliance 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 values assigned to intangible assets, capitalized software development, the allowance for doubtful accounts, accrual for income taxes, share-based payments related to performance based awards, loss contingencies, estimated claims for claims administration revenue recognition, estimates used in stock options valuations, and accrual for self-insurance reserves.

Cash and Cash Equivalents: Cash and cash equivalents consist of short-term, highly-liquid, investment-grade, interest-bearing securities with maturities of 90 days or less when purchased. The carrying amounts of the Company's financial instruments approximate their fair values at March 31, 2014 and June 30, 2014.

Fair Value of Financial Instruments: The Company applies Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820, Fair Value Measurements and Disclosures, which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements with respect to fair value measurements of (a) nonfinancial assets and liabilities that are recognized or disclosed at fair value in the Company's Consolidated Financial Statements on a recurring basis (at least annually) and (b) all financial assets and liabilities. ASC 820 prioritizes the inputs used in measuring fair value into the following hierarchy:

Level 1- Quoted market prices in active markets for identical assets or liabilities;

Level 2- Observable inputs other than those included in Level 1 (for example, quoted prices for similar assets in active markets or quoted prices for identical assets in inactive markets); and

Level 3- Unobservable inputs reflecting management's own assumptions about the inputs used in estimating the value of the asset.

Table of Contents

CORVEL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2014

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

The carrying amount of the Company's financial instruments (i.e. cash, accounts receivable, accounts payable, etc.) are all Level 1 and approximate their fair values at March 31, 2014 and June 30, 2014. The Company has no Level 2 or Level 3 assets, other than an investment in a private equity group.

Investment in Private Equity: During the quarter ended June 30, 2014, the Company's board of directors approved an investment of \$2,000,000 into a private equity start-up limited partnership. The Company invested \$800,000 into the partnership during the quarter ended June 30, 2014 and expects to invest the remaining \$1,200,000 commitment within the next 12 months. The Company will account for the investment on the cost method and will periodically review the investment for possible impairment. There was no impairment on investment for the quarter ended June 30, 2014. The investment is recorded in other assets on the accompanying consolidated balance sheets.

Goodwill: The Company accounts for its business combinations in accordance with the FASB ASC 805-10 through ASC 805-50, Business Combinations, which requires that the purchase method of accounting be applied to all business combinations and addresses the criteria for initial recognition of intangible assets and goodwill. In accordance with FASB ASC 350-10 through ASC 350-30, goodwill and other intangible assets with indefinite lives are not amortized but are tested for impairment annually, or more frequently if circumstances indicate the possibility of impairment. If the carrying value of goodwill or an intangible asset exceeds its fair value, an impairment loss shall be recognized.

Revenue Recognition: The Company recognizes revenue when there is persuasive evidence of an arrangement, the services have been provided to the customer, the sales price is fixed or determinable, and collectability is reasonably assured. For the Company's services, as the Company's professional staff performs work, they are contractually permitted to bill for fees earned in fraction of an hour increments worked or by units of production. The Company recognizes revenue as the time is worked or as units of production are completed, which is when the revenue is earned and realized. Labor costs are recognized as the costs are incurred. The Company derives its revenue from the sale of Network Solutions and Patient Management services. Network Solutions and Patient Management services may be sold individually or combined. When a sale combines multiple elements, the Company accounts for multiple element arrangements in accordance with the guidance included in ASC 605-25.

Management evaluates agreements with customers in accordance with the provision of the revenue recognition topic ASC 605 that addresses multiple-deliverable revenue arrangements. The multiple-deliverable arrangements entered into consist of bundled managed care which includes various units of accounting such as network solutions, and patient management which includes claims administration. Such elements are considered separate units of accounting due to each element having value to the customer on a stand-alone basis. The selling price for each unit of accounting is determined using contract price and management estimates. When the Company's customers purchase several products the pricing of the products sold is generally the same as if the products were sold on an individual basis.

Revenue is recognized as the work is performed in accordance with the Company's customer contracts. Based upon the nature of the Company's products, bundled managed care elements are generally delivered in the same accounting period. The Company recognizes revenue for patient management claims administration services over the life of the customer contract. The Company estimates, based upon prior experience in managing claims, the deferral amount from when the claim is received to when the customer contract expires.

Table of Contents

CORVEL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2014

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

Recent Accounting Pronouncements: On May 28, 2014, the FASB issued ASU 2014-09 regarding ASC Topic 606, Revenue from Contracts with Customers. The standard provides principles for recognizing revenue for the transfer of promised goods or services to customers with the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance will be effective for our fiscal year beginning April 1, 2017. Early adoption is not permitted. We are currently evaluating the accounting, transition and disclosure requirements of the standard and cannot currently estimate the financial statement impact of adoption.

Accounts Receivable: The majority of the Company's accounts receivable are due from companies in the property and casualty insurance industries, self-insured employers, and government entities. Accounts receivable are generally due within 30 days and are stated as amounts due from customers net of an allowance for doubtful accounts. Those 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. No one customer accounted for 10% or more of accounts receivable at either March 31, 2014 or June 30, 2014. No one customer accounted for 10% or more of revenue during the three months ended June 30, 2013 or 2014.

Property and Equipment: Additions to property and equipment are recorded at cost. Depreciation and amortization are provided using the straight-line method over the estimated useful lives of the related assets, which range from one to seven years. The Company accounts for internally developed software costs in accordance with FASB ASC 350-40, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, which allows for the capitalization of software developed for internal use. These costs are included in computer software in property and equipment and are amortized over a period of five years.

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

Income Taxes: The Company provides for income taxes in accordance with provisions specified in ASC 740, Accounting for Income Taxes. Accordingly, deferred income tax assets and liabilities are computed for differences between the financial statement and tax bases of assets and liabilities. These differences will result in taxable or deductible amounts in the future, based on tax laws and rates applicable to the periods in which the differences are expected to affect taxable income. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which temporary differences become deductible. In making an assessment regarding the probability of realizing a benefit from these deductible differences, management considers the

Company's current and past performance, the market environment in which the Company operates, tax-planning strategies and the length of carry-forward periods for loss carry-forwards, if any. Valuation allowances are established when necessary to reduce deferred tax assets to amounts that are more likely than not to be realized. Further, the Company provides for income tax issues not yet resolved with federal, state and local tax authorities. The balance of the unrecognized tax benefits as of March 31, 2014 and June 30, 2014 was \$700,000 and \$707,000, respectively.

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 share-diluted is based on the weighted average number of common shares and common share equivalents outstanding during the period. In calculating earnings per share, earnings are the same for the basic and diluted calculations. Weighted average shares outstanding decreased in the June 2014 quarter compared to the same quarter of the prior year primarily due to repurchases of shares under the Company's share repurchase program. See also Note D.

Table of Contents

CORVEL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2014

Note B Stock Based Compensation and Stock Options

Under the Company's Restated Omnibus Incentive Plan (formerly the Restated 1988 Executive Stock Option Plan) (the Plan) as in effect at June 30, 2014, options for up to 19,365,000 shares of the Company's common stock may be granted over the life of the Plan to key employees, non-employee directors and consultants at exercise prices not less than the fair market value of the stock at the date of grant. Options granted under the Plan are non-statutory stock options and generally vest 25% one year from date of grant and the remaining 75% vesting ratably each month for the next 36 months. The options granted to employees and the board of directors expire at the end of five years and ten years from date of grant, respectively.

The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model with the assumptions included in the table below. The Company uses historical data among other factors to estimate the expected volatility, the expected option life, and the expected forfeiture rate. The risk-free rate is based on the interest rate paid on a U.S. Treasury issue with a term similar to the estimated life of the option. Based upon the historical experience of options cancellations, the Company has estimated an annualized forfeiture rate of 12.84% and 12.40% for the three months ended June 30, 2013 and 2014, respectively. Forfeiture rates will be adjusted over the requisite service period when actual forfeitures differ, or are expected to differ, from the estimate. The following assumptions were used to estimate the fair value of options granted during the three months ended June 30, 2013 and 2014 using the Black-Scholes option-pricing model:

	Three Months Ended June 30,	
	2013	2014
Risk-free interest rate	0.66%	1.62%
Expected volatility	47%	46%
Expected dividend yield	0.00%	0.00%
Expected forfeiture rate	12.84%	12.40%
Expected weighted average life of option in years	4.5 years	4.4 years

Table of Contents

CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2014

Note B Stock Options and Stock-Based Compensation (continued)

All options granted in the three months ended June 30, 2013 and 2014 were granted with an exercise price equal to the fair value of the Company's common stock on the grant date and are non-statutory stock options.

For the three months ended June 30, 2013 and 2014, the Company recorded share-based compensation expense of \$405,000 and \$717,000, respectively. The table below shows the amounts recognized in the financial statements for stock compensation expense for time based options and performance based options during the three months ended June 30, 2013 and 2014, respectively.

	Three Months Ended	
	June 30, 2013	June 30, 2014
Cost of revenues	\$ 136,000	\$ 239,000
General and administrative	269,000	478,000
Total cost of stock-based compensation included in income before income tax provision	405,000	717,000
Amount of income tax benefit recognized	(157,000)	(276,000)
Amount charged against net income	\$ 248,000	\$ 441,000
Effect on diluted net income per share	\$ (0.01)	\$ (0.02)

Summarized information for all stock options for the three months ended June 30, 2013 and 2014 follows:

	Three Months Ended June 30, 2013		Three Months Ended June 30, 2014	
	Shares	Average Price	Shares	Average Price
Options outstanding, beginning	1,100,952	\$ 18.65	1,115,984	\$ 24.80
Options granted	191,900	23.46	37,550	44.86
Options exercised	(64,976)	13.40	(25,993)	17.99
Options cancelled	(28,246)	23.36	(9,011)	29.32
Options outstanding, ending	1,199,630	\$ 19.60	1,118,530	\$ 25.60

Table of Contents

CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2014

Note B Stock Options and Stock-Based Compensation (continued)

The following table summarizes the status of stock options outstanding and exercisable at June 30, 2014:

Range of Exercise Price	Number of Outstanding Options	Weighted Average Remaining Contractual Life	Outstanding Options Weighted Average Exercise Price	Exercisable Options Number of Exercisable Options	Exercisable Options Weighted Average Exercise Price
\$7.78 to \$20.54	279,585	2.69	\$ 14.12	262,051	\$ 13.71
\$20.55 to \$23.10	336,048	4.10	\$ 22.72	125,460	\$ 22.72