

CORVEL CORP
Form 10-Q
February 08, 2008

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**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 December 31, 2007

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

33-0282651

(State or other jurisdiction
of incorporation or organization)

(IRS Employer Identification No.)

2010 Main Street, Suite 600
Irvine, CA

92614

(Address of principal executive office)

(zip code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes 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):

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 definition 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
(Do not check if a 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 Per Share, as of January 22, 2008 was 13,728,077.

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Part I Financial Information

Item 1. Financial Statements

CORVEL CORPORATION**CONSOLIDATED BALANCE SHEETS**

	March 31, 2007	December 31, 2007 (Unaudited)
Assets		
Current Assets		
Cash and cash equivalents	\$ 15,020,000	\$ 11,320,000
Accounts receivable, net	41,027,000	40,452,000
Prepaid taxes and expenses	3,090,000	3,508,000
Deferred income taxes	5,150,000	5,139,000
Total current assets	64,287,000	60,419,000
Property and equipment, net	24,864,000	30,844,000
Goodwill	22,341,000	35,407,000
Other intangibles, net	1,970,000	3,588,000
Other assets	306,000	123,000
TOTAL ASSETS	\$ 113,768,000	\$ 130,381,000
Liabilities and Stockholders Equity		
Current Liabilities		
Accounts and taxes payable	\$ 13,418,000	\$ 14,243,000
Accrued liabilities	15,851,000	18,447,000
Total current liabilities	29,269,000	32,690,000
Deferred income taxes	5,302,000	6,113,000
Commitments and contingencies		
Stockholders Equity		
Common stock, \$.0001 par value: 60,000,000 shares authorized; 25,320,089 shares (13,960,692, net of Treasury shares) and 25,414,491 shares (13,730,695, net of Treasury shares) issued and outstanding at March 31, 2007 and December 31, 2007, respectively	3,000	3,000
Paid-in-capital	75,554,000	78,880,000
Treasury Stock, (11,359,397 shares at March 31, 2007 and 11,683,796 shares at December 31, 2007)	(154,091,000)	(162,216,000)

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Retained earnings	157,731,000	174,911,000
Total stockholders' equity	79,197,000	91,578,000
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 113,768,000	\$ 130,381,000

See accompanying notes to consolidated financial statements.

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CONSOLIDATED INCOME STATEMENTS UNAUDITED**

	Three Months Ended December 31,	
	2006	2007
REVENUES	\$ 66,580,000	\$ 76,679,000
Cost of revenues	51,048,000	56,279,000
Gross profit	15,532,000	20,400,000
General and administrative expenses	9,263,000	10,584,000
Income before income tax provision	6,269,000	9,816,000
Income tax provision	2,444,000	3,829,000
NET INCOME	\$ 3,825,000	\$ 5,987,000
Net income per common and common equivalent share		
Basic	\$ 0.27	\$ 0.43
Diluted	\$ 0.27	\$ 0.43
Weighted average common and common equivalent		
Basic	14,026,000	13,813,000
Diluted	14,368,000	13,964,000

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

	Nine Months Ended December 31,	
	2006	2007
REVENUES	\$ 203,671,000	\$ 224,526,000
Cost of revenues	155,416,000	167,291,000
Gross profit	48,255,000	57,235,000
General and administrative expenses	26,472,000	29,059,000
Income before income tax provision	21,783,000	28,176,000
Income tax provision	8,495,000	10,996,000
 NET INCOME	 \$ 13,288,000	 \$ 17,180,000
 Net income per common and common equivalent share		
Basic	\$ 0.94	\$ 1.24
Diluted	\$ 0.93	\$ 1.22
 Weighted average common and common equivalent		
Basic	14,091,000	13,889,000
Diluted	14,255,000	14,062,000
See accompanying notes to consolidated financial statements.		

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CONSOLIDATED INCOME STATEMENTS OF CASH FLOWS UNAUDITED**

	Nine Months Ended December 31,	
	2006	2007
<i>Cash flows from Operating Activities</i>		
NET INCOME	\$ 13,288,000	\$ 17,180,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,615,000	8,686,000
Loss on disposal of assets	279,000	130,000
Tax benefits from stock options exercised	2,256,000	271,000
Stock compensation expense	921,000	1,156,000
Write-off of uncollectible accounts	2,387,000	2,195,000
Changes in operating assets and liabilities		
Accounts receivable	(1,435,000)	(258,000)
Prepaid taxes and expenses	(654,000)	(418,000)
Accounts and taxes payable	(355,000)	(252,000)
Accrued liabilities	777,000	(1,199,000)
Provision for deferred income taxes	(1,469,000)	149,000
Other assets	82,000	36,000
Net cash provided by operating activities	23,692,000	27,676,000
<i>Cash Flows from Investing Activities</i>		
Assets purchased in acquisition		(12,300,000)
Purchase of Property & Equipment	(5,516,000)	(12,201,000)
Net cash used in investing activities	(5,516,000)	(24,501,000)
<i>Cash Flows from Financing Activities</i>		
Purchase of Treasury Stock	(16,631,000)	(8,125,000)
Tax effect of stock compensation expense	(359,000)	(451,000)
Exercise of employee stock purchase options	194,000	172,000
Exercise of common stock options	8,417,000	1,529,000
Net cash used in financing activities	(8,379,000)	(6,875,000)
<i>Increase/(Decrease) in cash and cash equivalents</i>	9,797,000	(3,700,000)
Cash and cash equivalents at beginning of period	14,206,000	15,020,000
Cash and cash equivalents at end of period	\$ 24,003,000	\$ 11,320,000

Supplemental Cash Flow Information:

Income taxes paid	9,221,000	12,019,000
Interest paid		2,000
Non cash financing activity related to tax benefits	642,000	
Accrual of earnout related to acquisition		2,500,000
Software License		1,727,000
See accompanying notes to consolidated financial statements.		

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007 (Unaudited)

Note A Basis of Presentation and Summary of Significant Accounting Policies

The unaudited financial statements herein have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. The accompanying interim financial statements have been prepared under the presumption that users of the interim financial information have either read or have access to the audited financial statements for the latest fiscal year ended March 31, 2007. Accordingly, footnote disclosures which would substantially duplicate the disclosures contained in the March 31, 2007 audited financial statements have been omitted from these interim financial statements.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended December 31, 2007 are not necessarily indicative of the results that may be expected for the fiscal year ending March 31, 2008. For further information, refer to the consolidated financial statements and footnotes for the year ended March 31, 2007 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 conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the accompanying financial statements. Actual results could differ from those estimates. Significant estimates include the allowance for doubtful accounts, accrual for bonuses, and accruals for self-insurance reserves.

Cash and Cash Equivalents: Cash and cash equivalents consists of short-term, highly-liquid 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, 2007 and December 31, 2007.

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007 (Unaudited)

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

Revenue Recognition: The Company's revenues are recognized primarily as services are rendered based on time and expenses incurred or units of production processed. 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 on a percentage of savings achieved for the Company's customers. We generally recognize 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. We reduce revenue for estimated contractual allowances and record any amounts invoiced to the customer in advance of service performance as deferred revenue.

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. No one customer accounted for 10% or more of accounts receivable at either March 31, 2007 or December 31, 2007. No customer accounted for 10% or more of revenue during the fiscal year ended March 31, 2007 or either three or nine month period ended December 31, 2006 or 2007.

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

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

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

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

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007 (Unaudited)

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

Income Taxes: The Company provides for income taxes under the liability method. Deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities as measured by the enacted tax rates which are expected to be in effect when these differences reverse. Income tax expense is the tax payable for the period and the change during the period in net deferred tax assets and liabilities. The Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an *Interpretation of FASB Statement No. 109* (FIN 48) on April 1, 2007. As a result of the implementation of FIN 48, the Company recognized no material adjustment in the liability for unrecognized income tax benefits.

Earnings Per Share: Earnings per common share-basic is based on the weighted average number of common shares outstanding during the period. Earnings per common shares-diluted is based on the weighted average number of common shares and common share equivalents outstanding during the period. In calculating earnings per share, earnings are the same for the basic and diluted calculations. Weighted average shares outstanding decreased for diluted earnings per share due to the share repurchase program and a reduction in the treasury impact of stock options.

Stock Split: During the quarter ended December 31, 2006, the Company's Board of Directors declared a three-for-two stock split in the form of a 50% stock dividend with a record date of November 20, 2006 and a distribution date of December 8, 2006.

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007 (Unaudited)

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 December 31, 2007, options for up to 9,682,500 shares (adjusted for the three-for-two stock split in the form of a 50% stock dividend distributed on December 8, 2006 to shareholders of record on November 20, 2006) of the Company's common stock may be granted to 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 non-employee members of the board of directors expire at the end of five years and ten years from the date of grant, respectively. Prior to fiscal year 2007, the Company had not granted any performance-based stock options under the Plan. In May 2006, however, the Company granted options for 149,000 shares whose exercise price equaled the fair market value of the Company's common stock at the date of grant, which will only vest if the Company attains certain earnings per share targets, as established by the Company's Board of Directors, for calendar years 2008, 2009, and 2010. The Company's current operating results for the calendar year 2007 are tracking towards the targets established by the Board of Directors. The Company included the performance based options in the stock compensation expense for the quarter ended December 31, 2007 due to the determination that it is probable that the targets will be achieved for the calendar year 2008. The Company has historically issued new shares to satisfy option exercises as opposed to issuing shares from treasury stock. Prior to the quarter ended June 30, 2006, the first quarter of fiscal year ending March 31, 2007, the Company accounted for its stock-based compensation under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25). Under APB 25, no stock option expense was reflected in net income because the Company grants stock options with an exercise price equal to the market price of the underlying common stock on the date of grant.

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007 (Unaudited)

Note B Stock Based Compensation and Stock Options (continued)

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

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

The table below shows the amounts recognized in the financial statements for the three and nine months ended December 31, 2006 and 2007, respectively.

	Three Months Ended	
	December 31, 2006	December 31, 2007
Cost of revenues	\$ 95,000	\$ 146,000
General and administrative	241,000	279,000
Total cost of stock-based compensation included in income, before income tax	336,000	425,000
Amount of income tax benefit recognized	(131,000)	(166,000)
Amount charged against income	\$ 205,000	\$ 259,000
Effect on diluted income per share	(\$0.01)	(\$0.02)

	Nine Months Ended	
	December 31, 2006	December 31, 2007
Cost of revenues	\$ 560,000	\$ 373,000
General and administrative	361,000	783,000
Total cost of stock-based compensation included in income, before income tax	921,000	1,156,000
Amount of income tax benefit recognized	(359,000)	(451,000)
Amount charged against income	\$ 562,000	\$ 705,000
Effect on diluted income per share	(\$0.04)	(\$0.05)

As the Company achieves the earnings per share targets in calendar years 2008, 2009, and 2010, the Company will recognize the performance based related expense, based upon the fair values on the date of grant, during the period

when it is determined that it is probable that the performance based options will be earned. The Company determined it is probable that the targets will be achieved for calendar year 2008 and the expense was recognized.

Table of Contents**CORVEL CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****December 31, 2007 (Unaudited)****Note B Stock Based Compensation and Stock Options (continued)**

The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model with the assumptions included in the table below. The Company uses historical data among other factors to estimate the expected volatility, the expected option life, and the expected forfeiture rate. The risk-free rate is based on the interest rate paid on a U.S. Treasury issue with a term similar to the estimated life of the option. Based upon the historical experience of options cancellations, the Company has estimated an annualized forfeiture rate of 6.3% and 6.9% for the three months ended December 31, 2006 and 2007, 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 December 31, 2006 and 2007 using the Black-Scholes option-pricing model:

	Three Months Ended December 31,	
	2006	2007
Risk-free interest rate	4.60%	4.05%
Expected volatility	39%	40%
Expected dividend yield	0.00%	0.00%
Expected forfeiture rate	6.30%	6.85%
Expected weighted average life of option in years	4.9 years	4.7 years

Under the Company's Restated Omnibus Incentive Plan (formerly the Restated 1988 Executive Stock Option Plan), (the Plan) as in effect at December 31, 2007, options for up to 9,682,500 shares of the Company's common stock may be granted at exercise prices not less than 100% of the fair value of the Company's common stock on date of grant. Of this amount, 1,294,134 shares of the Company's common stock remain available for future grant or issuance under the Plan. Options granted under the Plan are non-statutory stock options, and options granted generally have a maximum life of five years for employees and 10 years for non-employee directors. Options will generally become exercisable for 25% of the options shares one year from the date of grant and then, for the remaining 75% of the options, ratably over the following 36 months, respectively. All options granted in the nine months ended December 31, 2006 and 2007 had exercise prices that equaled the fair value of the Company's common stock on the date of grant and are non-statutory stock options.

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007 (Unaudited)

Note B Stock Based Compensation and Stock Options (continued)

Summarized information for all stock options for the three and nine months ended December 31, 2006 and 2007 follows:

	Three Months Ended December 31, 2006		Three Months Ended December 31, 2007	
	Shares	Average Price	Shares	Average Price
Options outstanding, beginning	1,364,057	\$ 17.05	1,026,466	\$ 18.57
Options granted	111,675	29.79	31,100	25.30
Options exercised	(358,790)	18.27	(41,330)	20.03
Options cancelled	(4,275)	18.66	(3,279)	21.37
Options outstanding, ending	1,112,667	\$ 17.93	1,012,957	\$ 18.71

	Nine Months Ended December 31, 2006		Nine Months Ended December 31, 2007	
	Shares	Average Price	Shares	Average Price
Options outstanding, beginning	1,271,883	\$ 17.28	1,021,141	\$ 17.84
Options granted	469,275	19.29	104,900	26.47
Options exercised	(462,507)	18.00	(88,048)	17.89
Options cancelled	(165,984)	16.66	(25,036)	18.88
Options outstanding, ending	1,112,667	\$ 17.93	1,012,957	\$ 18.71

The following table summarizes the status of stock options outstanding and exercisable at December 31, 2007:

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
\$8.08 to \$15.55	271,767	3.00	\$ 12.91	147,250	\$12.45
\$15.76 to \$15.79	272,553	3.26	\$ 15.77	53,978	\$15.77
\$16.67 to \$25.30	267,555	3.35	\$ 19.98	176,352	\$19.77
\$25.83 to \$47.70	201,082	4.07	\$ 28.84	45,295	\$27.72
Total	1,012,957	3.38	\$ 18.71	422,875	\$17.56

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007 (Unaudited)

Note B Stock Based Compensation and Stock Options (continued)

A summary of the status for all outstanding options at March 31, 2007 and December 31, 2007, and changes during the nine months then ended is presented in the table below:

	Number of Options	Weighted Average Exercise Per Share	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value as of December 31, 2007
Options outstanding at March 31, 2007	1,021,141	\$ 17.84		
Granted	104,900	26.47		
Exercised	(88,048)	17.89		
Cancelled forfeited	(24,015)	18.74		
Cancelled expired	(1,021)	22.26		
Ending outstanding	1,012,957	\$ 18.71	3.38	\$ 5,629,322
Ending vested and expected to vest	919,128	\$ 18.68	3.33	\$ 5,118,134
Ending exercisable	422,875	\$ 17.56	2.68	\$ 2,539,917

The weighted-average grant-date fair value of options granted during the three months ended December 31, 2006 and December 31, 2007, was \$5.39 and \$10.01, respectively.

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

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007 (Unaudited)

Note C Treasury Stock

The Company's Board of Directors approved the commencement of a share repurchase program in the fall of 1996. In June 2006, the Company's Board of Directors approved a 1,500,000 share expansion to its existing share repurchase program, increasing the total number of shares approved for repurchase over the life of the program to 12,150,000 shares from 10,650,000 shares. Since the commencement of the share repurchase program, the Company has spent \$162 million to repurchase 11,683,796 shares of its common stock, equal to 46% of the outstanding common stock had there been no repurchases. The average price of these repurchases is \$13.88 per share. These purchases have been funded primarily from the net earnings of the Company, along with the proceeds from the exercise of common stock options. During the quarter ended December 31, 2007, the Company repurchased 171,473 shares for \$4.0 million. During the nine months ended December 31, 2007, the Company repurchased 324,400 shares for \$8.1 million. The Company had 13,730,695 shares of common stock outstanding as of December 31, 2007, after reduction for the 11,683,796 shares in treasury.

Note D Weighted Average Shares and Net Income Per Share

Weighted average basic common stock and common stock equivalent shares decreased from 14,026,000 for the quarter ended December 31, 2006 to 13,813,000 for the quarter ended December 31, 2007. Weighted average diluted common stock and common stock equivalent shares decreased from 14,368,000 for the quarter ended December 31, 2006 to 13,964,000 for the quarter ended December 31, 2007. The net decrease in both of these weighted share calculations is due to the repurchase of common stock as noted above, partially offset by an increase in shares outstanding due to the exercise of stock options in the Company's employee stock option plan.

Net income per common stock and common stock equivalent shares was computed by dividing net income by the weighted average number of common stock and common stock equivalent shares outstanding during the quarter. The calculations of the basic and diluted weighted shares for the three and nine months ended December 31, 2006 and 2007, are as follows:

Income per Share	Three Months Ended December	
	31,	
	2006	2007
Net Income	\$ 3,825,000	\$ 5,987,000
 Basic:		
Weighted average common shares outstanding	14,026,000	13,813,000
Net Income per share	\$ 0.27	\$ 0.43
 Diluted:		
Weighted average common shares outstanding	14,026,000	13,813,000
Treasury stock impact of stock options	342,000	151,000
Total common and common equivalent shares	14,368,000	13,964,000
Net Income per share	\$ 0.27	\$ 0.43

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007 (Unaudited)

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

	Nine Months Ended December 31,	
	2006	2007
Net Income	\$ 13,288,000	\$ 17,180,000
 Basic:		
Weighted average common shares outstanding	14,091,000	13,889,000
Net Income per share	\$ 0.94	\$ 1.24
 Diluted:		
Weighted average common shares outstanding	14,091,000	13,889,000
Treasury stock impact of stock options	164,000	173,000
Total common and common equivalent shares	14,255,000	14,062,000
Net Income per share	\$ 0.93	\$ 1.22

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007 (Unaudited)

Note E Shareholder Rights Plan

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

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

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

Note F Acquisitions

In December 2006, the Company's wholly owned subsidiary, CorVel Enterprise Comp, Inc., entered into an Asset Purchase Agreement with Hazelrigg Risk Management Services, Inc., a California based provider of integrated medical management, claims processing and technology services for workers' compensation clients, and its affiliated companies (Hazelrigg) to acquire certain assets and liabilities of Hazelrigg, for an initial cash payment of \$12 million. The acquisition closed in January 2007 and represented an expansion of CorVel's Enterprise Comp service offering in the Southern California marketplace. The seller of Hazelrigg also has the potential to receive up to an additional \$2.5 million in a cash earnout based upon the revenue collected by the Hazelrigg business during the one-year period after consummation of the acquisition, which may be accelerated based upon the occurrence of certain post-acquisition events. During the quarter ended September 30, 2007, the Company accrued the \$2.5 million under this obligation. During the quarter ended December 31, 2007 the earnout target was achieved.

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007 (Unaudited)

Note F Acquisitions (continued)

The following table summarizes the recorded value of the Hazelrigg assets acquired and liabilities assumed at the date of acquisition as adjusted to reflect the amount recognized on the earnout:

	Life	Amount
Accounts receivable, net		\$ 1,100,000
Property and equipment, net		321,000
Covenant not to compete	5 years	250,000
	10	
Customer contracts	years	500,000
	10	
Customer relationships	years	500,000
	15	
Servicemark	years	250,000
	15	
TPA license	years	500,000
Goodwill		12,720,000
Subtotal		16,141,000
Less: Accounts payable and deferred income		1,348,000
Total		\$ 14,793,000

In June 2007, the Company's wholly owned subsidiary, CorVel Enterprise Comp, Inc., acquired 100% of the stock of the The Schaffer Companies Ltd. (Schaffer) for \$12.3 million in cash. Schaffer is a third party administrator headquartered in Maryland. The acquisition is expected to allow the Company to expand its service capabilities as a third-party administrator and provide claims processing services along with patient management services and network solutions services to an increased customer base. The sellers of Schaffer have the potential to receive up to an additional \$3 million in a cash earnout based upon the revenue collected by the Schaffer business during the one-year period after completion of the acquisition. The Company will accrue the earnout when it is determinable beyond a reasonable doubt that the earnout target will be achieved. The results of Schaffer have been included in the Company's results for the seven month period ended December 31, 2007.

The following table summarizes the fair value of the Schaffer assets acquired and liabilities assumed at the date of acquisition:

	Life	Amount
Accounts receivable, net		\$ 1,362,000
Property and equipment, net		586,000
Other assets		104,000
Covenant not to compete	5 years	500,000
	10	
Customer contracts	years	400,000
	10	
Customer relationships	years	400,000
Servicemark		200,000

	15	
	years	
	15	
TPA license	years	400,000
Goodwill		10,316,000
Subtotal		14,268,000
Less: Accounts payable and deferred income		1,968,000
Total		\$ 12,300,000

The following supplemental unaudited pro forma information presents the combined operating results of the Company and the acquired businesses during the nine months ended December 31, 2006 and 2007, as if the acquisition had occurred at the beginning of each of the periods presented. The pro forma information is based on the historical financial statements of the Company and that of the acquired businesses. Amounts are not necessarily indicative of the results that may have been attained had the combinations been in effect at the beginning of the periods presented or that may be achieved in the future.

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007 (Unaudited)

Note F Acquisitions (continued)

	Nine Months Ended December 31,	
	2006	2007
Pro forma revenue	\$224,420,000	\$226,463,000
Pro forma income before income taxes	\$ 22,734,000	\$ 28,201,000
Pro forma net income	\$ 13,868,000	\$ 17,196,000
Pro forma basic earnings per share	\$ 0.98	\$ 1.24
Pro forma diluted earnings per share	\$ 0.97	\$ 1.22

Note G Other Intangible Assets

Other intangible assets consist of the following at December 31, 2007:

Item	Life	Schaffer Acquisition Cost	Hazelrigg Acquisition Cost	Combined Intangible Cost	Amortization	Accumulated
					Expense-Nine Months Ended December 31, 2007	Amortization as of December 17 December 31, 2007
Covenant not to compete	5 years	\$ 500,000	\$ 250,000	\$ 750,000	\$ 98,000	\$ 105,000
Customer contracts	10 years	400,000	500,000	900,000	62,000	69,000
Customer relationships	10 years	400,000	500,000	900,000	62,000	69,000
Servicemark	15 years	200,000	250,000	450,000	20,000	23,000
TPA license	15 years	400,000	500,000	900,000	40,000	46,000
Total		\$1,900,000	\$2,000,000	\$3,900,000	\$282,000	\$312,000

Note H Line of Credit

In August 2007, the Company, upon authorization by its Board of Directors, entered into a credit agreement with a financial institution to provide a revolving credit facility with borrowing capacity of up to \$10 million. This agreement expires in September 2008. Borrowings under this agreement bear interest, at the Company's option, at a fixed LIBOR-based rate plus 1.25% or at the financial institution's fluctuating prime lending rate. The loan covenants require the Company to maintain the current assets to liabilities ratio of at least 1.25:1, debt to tangible net worth not greater than 1:1 and have positive net income. There are no outstanding revolving loans as of the date hereof, but letters of credit in the aggregate amount of \$5.8 million have been issued under a letter of credit sub-limit that does not reduce the amount of borrowings available under the revolving credit facility.

Note I Paid-in-capital

In August 2007, the shareholders of CorVel Corporation approved an amendment to the Company's certificate of incorporation to increase the number of authorized shares from 30,000,000 to 60,000,000.

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Item 2.

**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, estimates and should, and variations of these words and similar expressions, are intended to identify these forward-looking statements. Forward-looking statements made by the Company and its management are based on estimates, projections, beliefs and assumptions of management at the time of such statements and are not guarantees of future performance.

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

Overview

CorVel Corporation is an independent nationwide provider of medical cost containment and managed care services designed to address the escalating medical costs of workers' compensation and auto policies. The Company's services are provided to insurance companies, third-party administrators (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, auto policies and, to a lesser extent, group health policies. The network solutions offered by the Company include automated medical fee auditing, preferred provider services, retrospective utilization review, independent medical examinations, MRI examinations, and inpatient bill review.

Patient Management Services

In addition to its network solutions services, the Company offers a range of patient management services, which involve working on a one-on-one basis with injured employees and their various healthcare professionals, employers and insurance company adjusters. The services are designed to monitor the medical necessity and appropriateness of healthcare services provided to workers' compensation and other healthcare claimants and to expedite return to work. The Company offers these services on a stand-alone basis, or as an integrated component of its medical cost containment services. The Company expanded its patient management services to include the processing of claims for self-insured payors to property and casualty insurance with the January 2007 acquisition of the assets of Hazelrigg Risk Management Services and the June 2007 acquisition of the outstanding capital stock of The Schaffer Companies, Ltd.

Table of Contents**Organizational Structure**

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

Business Enterprise Segments

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

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

Summary of Quarterly Results

The Company generated revenues of \$76.7 million for the quarter ended December 31, 2007, an increase of \$10.1 million, or 15.2%, compared to revenues of \$66.6 million for the quarter December 31, 2006.

The increase in revenues was due to the acquisitions of the assets of Hazelrigg Risk Management Services in January 2007 and the stock of Schaffer Companies in June 2007. These businesses both provide claims processing services to the property and casualty industry and are discussed further below. Excluding these acquisitions, the Company's revenues would have increased by approximately 4% for quarter ended December 31, 2007 compared to the quarter ended December 31, 2006. This increase was primarily due to improved pricing in the Company's network solutions line of business.

The Company's cost of revenues increased by \$5.2 million, from \$51.0 million in the December 2006 quarter to \$56.3 million in the December 2007 quarter, an increase of 10.2%. This increase was due to the January and June 2007 acquisitions of Hazelrigg and Schaffer. Excluding the acquisitions, the Company's cost of revenues would have decreased by approximately 1% for quarter ended December 31, 2007 compared to the quarter ended December 31, 2006. The cost of revenues as a percentage of revenues decreased from 77% for the quarter December 31, 2006 to 73% for the quarter ended December 31, 2007. This decrease was primarily due to reduced operating costs in the patient management line of business on a similar revenue base and moving field IT functions to the corporate offices.

The Company's general and administrative costs increased by \$1.3 million, or 14.3%, from \$9.3 million in the December 2006 quarter to \$10.6 million in the December 2007 quarter. This increase was primarily due to improvements and expansion to the Company's proprietary software infrastructure and operations.

The Company's income tax expense increased by \$1.4 million, or 56.7%, from \$2.4 million in the December 2006 quarter to \$3.8 million in the December 2007 quarter. The increase in income tax expense was primarily due to the increase in the Company's profits.

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Weighted average diluted shares decreased from 14.4 million shares in the December 2006 quarter to 14.0 million shares in the December 2007 quarter, a decrease of 404,000 shares or 2.8%. This decrease was due to the Company's repurchase of common shares during the March 2007, September 2007 and December 2007 quarters.

Diluted earnings per share increased from \$0.27 in the December 2006 quarter to \$0.43 in the December 2007 quarter, an increase of \$0.16 per share or 59.3%. The increase in diluted earnings per share was primarily due to the increase in the income before income taxes and the decrease in the weighted average diluted shares.

Results of Operations the three months ended December 31, 2006 and 2007

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, vocational rehabilitation, claims management and related claim services. 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 total revenues attributable to patient management and network solutions services for the quarters ended December 31, 2006 and December 31, 2007 are as follows:

	December 31, 2006	December 31, 2007
Patient Management services	38.7%	43.5%
Network solutions	61.3%	56.5%

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The following table sets forth, for the periods indicated, the dollars and the percentage of revenues represented by certain items reflected in the Company's consolidated income statements for the quarters ended December 31, 2006 and December 31, 2007. The Company's past operating results are not necessarily indicative of future operating results.

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2007	Dollar Change	Percentage Change
Revenue	\$66,580,000	\$ 76,679,000	\$ 10,099,000	15.2%
Cost of revenues	51,048,000	56,279,000	5,231,000	10.2%
Gross profit	15,532,000	20,400,000	4,868,000	31.3%
Gross profit as percentage of revenue	23.3%	26.6%		
General and administrative	9,263,000	10,584,000	1,321,000	14.3%
General and administrative as percentage of revenue	13.9%	13.8%		
Income before income tax provision	6,269,000	9,816,000	3,547,000	56.6%
Income before income tax provision as percentage of revenue	9.4%	12.8%		
Income tax provision	2,444,000	3,829,000	1,385,000	56.7%
Net income	\$ 3,825,000	\$ 5,987,000	\$ 2,162,000	56.5%
Weighted Shares				
Basic	14,026,000	13,813,000	(213,000)	-1.5%
Diluted	14,368,000	13,964,000	(404,000)	-2.8%
Earnings Per Share				
Basic	\$ 0.27	\$ 0.43	\$ 0.16	59.3%
Diluted	\$ 0.27	\$ 0.43	\$ 0.16	59.3%

Revenues**Change in revenue from the three months ended December 2006 to the three months ended December 2007**

Revenues increased from \$66.6 million for the three months ended December 31, 2006 to \$76.7 million for the three months ended December 31, 2007, an increase of \$10.1 million or 15.2%. The Company's patient management revenues increased \$7.6 million or 29% from \$25.8 million in the December 2006 quarter to \$33.4 million in the December 2007 quarter. This increase was primarily due to the January and June 2007 acquisitions of Hazelrigg and Schaffer. Excluding the acquisitions, patient management revenues increased by \$0.3 million, or 1%, from \$25.8 million to \$26.1 million, due to softness in referrals in the workers compensation market. The Company's network solutions revenues increased from \$40.8 million in the December 2006 quarter to \$43.3 million in the December 2007 quarter an increase of \$2.5 million or 6.2%. This increase was primarily due to an increase in out-of-network bills reviewed, which generate greater revenue per bill, and an increase in revenue per provider bill

reviewed due to increased savings per bills for the Company's customers.

The Company's revenue increase excluding the aforementioned acquisitions reflects the challenging market conditions the Company has experienced during the past few years. The decrease in the nation's manufacturing employment levels, which has helped lead to a decline in national workers' compensation claims, considerable price competition in a flat-to-declining overall market, an increase in competition from both larger and smaller competitors, changes and the potential changes in state workers' compensation and auto managed care laws which can reduce demand for the Company's services, have created an environment where revenue and margin growth is more difficult to attain and where revenue growth is less certain than historically experienced.

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Additionally, the Company's technology and preferred provider network competes against other companies, some of which have more resources available. Also, some customers may handle their managed care services in-house and may reduce the amount of services which are outsourced to managed care companies such as CorVel Corporation.

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

Cost of Revenues

The Company's cost of revenues consist of direct expenses, costs directly attributable to the generation of revenue, and field indirect costs which are incurred in the field offices of the Company. Direct costs are primarily case manager salaries, bill review analysts, related payroll taxes and fringe benefits, and costs for IME (independent medical examination) and MRI providers. Most of the Company's revenues are generated in offices which provide both patient management services and network solutions services. The largest of the field indirect costs are manager salaries and bonus, account executive base pay and commissions, administrative and clerical support, field systems personnel, PPO network developers, related payroll taxes and fringe benefits, office rent, and telephone expense. Approximately 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 from the three months ended December 2006 to the three months ended December 2007

The Company's costs of revenues increased from \$51.0 million in the quarter ended December 31, 2006 to \$56.3 million in the quarter ended December 31, 2007, an increase of \$5.2 million or 10.2%. This increase was due to the January and June 2007 acquisitions of Hazelrigg and Schaffer. Excluding the acquisitions, the Company's cost of revenues would have decreased by approximately 1%, primarily due to a decrease in professional salaries by \$0.3 million, from \$14.5 million in the December 2006 quarter to \$14.2 million in the December 2007 quarter. This decrease was primarily attributable to a decrease in the number of case managers. The Company improved its operating productivity in both its patient management and network solutions lines of business through improvements in technology and processes. Additionally, the Company reduced the allowance for doubtful accounts due to improvements in the Company's collection of accounts receivable.

General and Administrative Costs

Change in cost of general and administrative expense from the three months ended December 2006 to the three months ended December 2007 quarter

For the quarter ended December 31, 2007, general and administrative costs consisted of approximately 64% 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 36% of the general and administrative costs consisted of national marketing, national sales support, corporate legal, corporate insurance, human resources, accounting, product management, new business development and other general corporate matters. The largest portion of the non-systems portion of general and administrative costs during the December 2007 quarter pertained to accounting, financial reporting and corporate governance for compliance under the Sarbanes-Oxley Act of 2002.

General and administrative costs increased from \$9.3 million in the quarter ended December 31, 2006 to \$10.6 million in the quarter ended December 31, 2007, an increase of \$1.3 million or 14.3%. This increase was primarily due to an increase in the Company's systems and data interface costs and capabilities.

Table of Contents**Income Tax Provision**

The Company's income tax expense increased by \$1.4 million or, 56.7%, from \$2.4 million for the three months ended December 31, 2006 to \$3.8 million for the nine months ended December 31, 2007 due to the increase in income before income taxes from \$6.3 million to \$9.8 million for the same periods, respectively. The income tax expense as a percentage of income before income taxes was 39.0% for the three months ended December 2006 and December 2007. The income tax provision rates were based upon management's review of the Company's estimated annual income tax rate, including state taxes. This effective tax rate differed from the statutory federal tax rate of 35.0% primarily due to state income taxes and certain non-deductible expenses.

Results of Operations for the Nine Months Ended December 31, 2006 and 2007

The following table sets forth, for the periods indicated, the dollars and the percentage of revenues represented by certain items reflected in the Company's consolidated income statements for the nine months ended December 31, 2006 and December 31, 2007. The Company's past operating results are not necessarily indicative of future operating results.

	Nine Months Ended December 31, 2006	Nine Months Ended December 31, 2007	Dollar Change	Percentage Change
Revenue	\$203,671,000	\$224,526,000	\$20,855,000	10.2%
Cost of revenues	155,416,000	167,291,000	11,875,000	7.6%
Gross profit	48,255,000	57,235,000	8,980,000	18.6%
Gross profit as percentage of revenue	23.7%	25.5%		
General and administrative	26,472,000	29,059,000	2,587,000	9.8%
General and administrative as percentage of revenue	13.0%	12.9%		
Income before income tax provision	21,783,000	28,176,000	6,393,000	29.3%
Income before income tax provision as percentage of revenue	10.7%	12.5%		
Income tax provision	8,495,000	10,996,000	2,501,000	29.4%
Net income	\$ 13,288,000	\$ 17,180,000	\$ 3,892,000	29.3%
Weighted Shares				
Basic	14,091,000	13,889,000	(202,000)	-1.4%
Diluted	14,255,000	14,062,000	(193,000)	-1.4%
Earnings Per Share				
Basic	\$ 0.94	\$ 1.24	\$ 0.30	31.9%
Diluted	\$ 0.93	\$ 1.22	\$ 0.29	31.2%

Revenues**Change in revenue from the nine months ended December 2006 to the nine months ended December 2007**

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Revenues increased from \$203.7 million for the nine months ended December 31, 2006 to \$224.5 million for the nine months ended December 31, 2007, an increase of \$20.9 million or 10.2%. This increase in revenue was primarily due to the January and June 2007 acquisitions of Hazelrigg and Schaffer. The Company's patient management revenues increased \$15.8 million or 19.8% from \$79.4 million in the nine months ended December 31, 2006 to \$95.2 million in the nine months ended December 31, 2007. This increase was due to the January and June

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2007 acquisitions of Hazelrigg and Schaffer, offset by a decrease in case management services. The Company's network solutions revenues increased from \$124.3 million in nine months ended December 31, 2006 to \$129.4 million in the nine months ended December 31, 2007, an increase of \$5.1 million or 4.1%. This increase was primarily due an increase in revenue per provider bill reviewed due to an increase in large out of network bills reviewed by the Company that tend to generate higher revenue per bill.

The Company's revenue increase excluding the aforementioned acquisitions reflects the challenging market conditions the Company has experienced during the past few years. The decrease in the nation's manufacturing employment levels, which has helped lead to a decline in national workers' compensation claims, considerable price competition in a flat-to-declining overall market, an increase in competition from both larger and smaller competitors, changes and the potential changes in state workers' compensation and auto managed care laws which can reduce demand for the Company's services, have created an environment where revenue and margin growth is more difficult to attain and where revenue growth is less certain than historically experienced. Additionally, the Company's technology and preferred provider network competes against other companies, some of which have more resources available. Also, some customers may handle their managed care services in-house and may reduce the amount of services which are outsourced to managed care companies such as CorVel Corporation.

The continued softness in the national labor market, especially the manufacturing sector of the economy, has caused a reduction in the overall claims volume and a reduction in case management and bill review volume. The Company believes that referral volume in patient management services and bill review volume in network solutions will continue to reflect just nominal growth until there is growth in the number of work related injuries and workers compensation related claims.

Cost of Revenues

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

Change in cost of revenue from the nine months ended December 2006 to the nine months ended December 2007

The Company's cost of revenues increased from \$155.4 million for the **nine months ended** December 31, 2006 to \$167.3 million for the nine months ended December 31, 2007, an increase of \$11.9 million or 7.6%. The increase in cost of revenues was primarily due to the January and June 2007 acquisitions of Hazelrigg and Schaffer and the costs associated with operating those businesses. This was partially offset by the Company improving its operating productivity in both its patient management and network solutions lines of business through improvements in technology and processes. Additionally, the Company reduced the allowance for doubtful accounts due to improvements in the Company's collection of accounts receivable.

General and Administrative Costs**Change in cost of general and administrative expense from the nine months ended December 2006 to the nine months ended December 2007**

For the nine months ended December 31, 2007, general and administrative costs consisted of approximately 62% 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 38% of the

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general and administrative costs consisted of national marketing, national sales support, corporate legal, corporate insurance, human resources, accounting, product management, new business development and other general corporate matters.

General and administrative costs increased from \$26.5 million for the nine months ended December 31, 2006 to \$29.1 million for the nine months ended December 31, 2007, an increase of \$2.6 million or 9.8%. This increase was primarily due to the increase in the costs of managing the Company's information systems, an increase in sales meetings and salaries, and an increase in corporate staffing requirements.

Income Tax Provision

The Company's income tax expense increased by \$2.5 million or, 29.4%, from \$8.5 million for the nine months ended December 31, 2006 to \$11.0 million for the nine months ended December 31, 2007 due to the increase in income before income taxes from \$21.8 million to \$28.2 million for the same periods, respectively. The income tax expense as a percentage of income before income taxes was 39.0% for the nine months ended December 2006 and December 2007. The income tax provision rates were based upon management's review of the Company's estimated annual income tax rate, including state taxes. This effective tax rate differed from the statutory federal tax rate of 35.0% primarily due to state income taxes and certain non-deductible expenses.

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. Net working capital decreased \$7 million, or 20%, from \$35 million as of March 31, 2007 to \$28 million as of December 31, 2007, primarily due to a decrease in cash from \$15 million as of March 31, 2007 to \$11 million as of December 31, 2007. The decrease in cash is primarily due to the acquisition of Schaffer during the June 2007 quarter.

The Company believes that cash from operations, available funds under its line of credit, and funds from exercise of stock options granted to employees are adequate to fund existing obligations, repurchase shares of the Company's common stock under its current share repurchase program, introduce new services, and continue to develop healthcare related businesses for at least the next twelve months. 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. Additional equity or debt financing may not be available on terms favorable to us or at all.

As of December 31, 2007, the Company had \$11 million in cash and cash equivalents, invested primarily in short-term, interest-bearing, highly liquid investment-grade securities with maturities of 90 days or less in a federally regulated bank. As noted previously, the Company paid \$12 million on May 31, 2007 to acquire Schaffer. This amount was paid from cash on hand.

In August 2007, the Company entered into a credit agreement with a financial institution to provide a revolving credit facility with borrowing capacity of up to \$10 million. This agreement expires in September 2008. Borrowings under this agreement bear interest, at the Company's option, at a fixed LIBOR-based rate (4.83% at December 31, 2007) plus 1.25% or at the financial institution's fluctuating prime lending rate (7.25% at December 31, 2007). The loan covenants require the Company to maintain the current assets to liabilities ratio of at least 1.25:1, debt to tangible net worth not greater than 1:1 and have positive net income. There are no outstanding revolving loans as of the date hereof, but letters of credit in the aggregate amount of \$5.8 million have been issued under a letter of credit sub-limit that does not reduce the amount of borrowings available under the revolving credit facility.

The Company has historically required substantial capital to fund the growth of its operations, particularly working capital to fund the growth in accounts receivable and capital expenditures. The Company believes, however, that the cash balance at December 31, 2007 along with anticipated internally generated funds, the credit facility and taking into account the cash used to acquire the Hazelrigg and Schaffer businesses, including the related

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earnout commitments, would be sufficient to meet the Company's expected cash requirements for at least the next twelve months.

Operating Cash Flows***Nine months ended December 31, 2006 compared to nine months ended December 31, 2007***

Net cash provided by operating activities increased \$4.0 million, or 16.8%, from \$23.7 million in the nine months ended December 31, 2006 to \$27.7 million in the nine months ended December 31, 2007. The increase in the cash flow from operating activities was primarily due to the increase in net income for the nine months ended December 31, 2007 compared to the nine months ended December 31, 2006.

Investing Activities***Nine months ended December 31, 2006 compared to nine months ended December 31, 2007***

Net cash flow used in investing activities increased \$19.0 million, or 344.2%, from \$5.5 million in the nine months ended December 31, 2006 to \$24.5 million in the nine months ended December 31, 2007. The increase in net cash used in investing activities is primarily due to the Company's acquisition of The Schaffer Companies, Ltd. Additionally, capital expenditures increased due to investment in IT infrastructure, especially a co-location data center.

Financing Activities***Nine months ended December 31, 2006 compared to nine months ended December 31, 2007***

Net cash flow used in financing activities decreased \$1.5 million, or 17.9%, from \$8.4 million for the nine months ended December 31, 2006 to \$6.9 million for the nine months ended December 31, 2007. The primary reason for the decrease in cash flow used in financing activities was due to a decrease in the purchase of common stock under the Company's stock repurchase program. During the nine months ended December 31, 2006, the Company spent \$16.6 million to repurchase 561,023 shares of its common stock. During the nine months ended December 31, 2007, the Company spent \$8.1 million to repurchase 324,400 shares of its common stock. In June 2006, the Board of Directors increased the number of shares authorized to be repurchased over the life of the repurchase program by an additional 1,500,000 shares to 12,150,000 shares. The Company has historically used cash provided by operating activities and from the exercise of stock options to repurchase stock. The Company expects that it may use some of the cash on the balance sheet at Decembthe Company. A copy of this document is available on our website at www.zixcorp.com under Corporate Governance. Any waiver or amendment of the Code of Ethics with respect to our chief executive officer and senior financial officers will be publicly disclosed as required by applicable law and regulation, including by posting the waiver on our website.

Item 11. Executive Compensation

The information required by this Item 11, including certain information pertaining to Company securities authorized for issuance under equity compensation plans, is incorporated by reference from our Proxy Statement related to the 2014 Annual Meeting of Stockholders under the section COMPENSATION OF DIRECTORS AND EXECUTIVE OFFICERS.

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

The information required by this Item 12 is incorporated by reference from our Proxy Statement related to the 2014 Annual Meeting of Stockholders under the section SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT and COMPENSATION OF DIRECTORS AND EXECUTIVE OFFICERS Equity Compensation Plan Information.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by this Item 13 is incorporated by reference from our Proxy Statement related to the 2014 Annual Meeting of Stockholders under the section COMPENSATION OF DIRECTORS AND EXECUTIVE

OFFICERS Certain Relationships and Related Transactions and CORPORATE GOVERNANCE Corporate Governance Requirements and Board Member Independence.

Item 14. *Principal Accountant Fees and Services*

The information required by this Item 14 is incorporated by reference from our Proxy Statement related to the 2014 Annual Meeting of Stockholders under the section INDEPENDENT REGISTERED PUBLIC ACCOUNTANTS.

PART IV

Item 15. *Exhibits and Financial Statement Schedules*

(a)(1) *Financial Statements*

See Index to Consolidated Financial Statements on page F-1 hereof.

(a)(2) *Financial Statement Schedules*

All schedules for which provision is made in the applicable accounting regulations of the SEC have been omitted because of the absence of the conditions under which they are required or because the information required is included in the consolidated financial statements or notes thereto.

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(a)(3) Exhibits

Exhibit**Number****Description**

3.1	Restated Articles of Incorporation of Zix Corporation, as filed with the Texas Secretary of State on November 10, 2005. Filed as Exhibit 3.1 to Zix Corporation's Annual Report on Form 10-K for the year ended December 31, 2005, and incorporated herein by reference.
3.2*	Amended and Restated Bylaws of Zix Corporation, dated March 12, 2014.
10.1	1995 Long-Term Incentive Plan of Zix Corporation (Amended and Restated as of September 20, 2000). Filed as Exhibit 10.3 to Zix Corporation's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2000, and incorporated herein by reference.
10.2	Zix Corporation 1999 Directors' Stock Option Plan (Amended and Restated as of August 1, 2002). Filed as Exhibit 10.1 to Zix Corporation's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2002, and incorporated herein by reference.
10.3	Zix Corporation 2001 Employee Stock Option Plan (Amended and Restated as of June 7, 2007). Filed as Exhibit 10.6 to Zix Corporation's Report on Form 8-K, filed June 12, 2007, and incorporated herein by reference.
10.4	Zix Corporation's 2001 Stock Option Plan (Amended and Restated as of June 7, 2007). Filed as Exhibit 10.5 to Zix Corporation's Report on Form 8-K, filed June 12, 2007, and incorporated herein by reference.
10.5	Zix Corporation's 2003 New Employee Stock Option Plan (Amended and Restated as of June 7, 2007). Filed as Exhibit 10.4 to Zix Corporation's Report on Form 8-K, filed June 12, 2007, and incorporated herein by reference.
10.6	Zix Corporation 2004 Stock Option Plan (Amended and Restated as of June 7, 2007). Filed as Exhibit 10.3 to Zix Corporation's Report on Form 8-K, filed June 12, 2007, and incorporated herein by reference.
10.7	Zix Corporation 2004 Stock Option Plan (Amended and Restated as of May 25, 2005). Filed as Exhibit 10.1 to Zix Corporation's Registration Statement on Form S-8 (Registration No. 333-126576), dated July 13, 2005, and incorporated herein by reference.
10.8	Zix Corporation 2004 Directors' Stock Option Plan, dated May 6, 2004. Filed as Exhibit 10.2 to Zix Corporation's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2004, and incorporated herein by reference.
10.9	Zix Corporation 2006 Directors' Stock Option Plan (Amended and Restated as of June 7, 2007) Filed as Exhibit 10.1 to Zix Corporation's Current Report on Form 8-K, filed June 12, 2007, and incorporated herein by reference.
10.10	Form of Stock Option Agreement (with no change in control provision) for Zix Corporation Stock Option Plans. Filed as Exhibit 10.2 to Zix Corporation's Registration Statement on Form S-8 (Registration No. 333-126576), dated July 13, 2005, and incorporated herein by reference.
10.11	

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Form of Stock Option Agreement (with change in control provision) for Zix Corporation Stock Option Plans. Filed as Exhibit 10.3 to Zix Corporation's Registration Statement on Form S-8 (Registration No. 333-126576), dated July 13, 2005, and incorporated herein by reference.

- 10.12 Form of Stock Option Agreement (with acceleration event provision) for Zix Corporation Stock Option Plans and applicable to option agreements held by the Company's chief executive officer and direct reports. Filed as Exhibit 10.17 to Zix Corporation's Annual Report on Form 10-K for the year ended December 31, 2007, and incorporated herein by reference.
- 10.13 Zix Corporation 401(k) Retirement Plan. Filed as Exhibit 10.10 to Zix Corporation's Annual Report on Form 10-K for the year ended December 31, 2003, and incorporated herein by reference.

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Number	Description
10.14	Adoption Agreement relating to Zix Corporation 401(k) Retirement Plan. Filed as Exhibit 10.11 to Zix Corporation's Annual Report on Form 10-K for the year ended December 31, 2003, and incorporated herein by reference.
10.15	Form of Zix Corporation Outside Director Stock Option Agreement. Filed as Exhibit 10.3 to Zix Corporation's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004, and incorporated herein by reference.
10.16	Form of Zix Corporation Outside Director Stock Option Agreement. Filed as Exhibit 10.1 to Zix Corporation's Quarterly Report on Form 10-Q for the period ended June 30, 2010, and incorporated herein by reference.
10.17	Form of Zix Corporation Employee Stock Option Agreement. Filed as Exhibit 10.2 to Zix Corporation's Quarterly Report on Form 10-Q for the period ended June 30, 2010, and incorporated herein by reference.
10.18	Form of Director Indemnification Agreement. Filed as Exhibit 10.1 to Zix Corporation's Current Report on Form 8-K dated December 20, 2010, and incorporated herein by reference.
10.19	Form of Executive Termination Benefits Agreement. Filed as Exhibit 10.1 to Zix Corporation's Quarterly Report on Form 10-Q for the period ended June 30, 2011, and incorporated herein by reference.
10.20	Zix Corporation 2012 Incentive Plan. Filed as Appendix A of Schedule 14A on April 27, 2012, and incorporated herein by reference.
10.21	Form of Executive Termination Benefits Agreement. Filed as Exhibit 10.1 to Zix Corporation's Quarterly Report on Form 10-Q for the period ended September 30, 2012, and incorporated herein by reference.
10.22	Shareholder's Agreement dated December 28, 2012, among Zix Corporation, and Rockall Emerging Markets Master Fund Limited, Meldrum Asset Management, LLC, Fulvio Dobrich, Con Egan, Conor O Driscoll, Michael E. Dailey, and Mark J. Bonney. Filed as Exhibit 10.1 to Zix Corporation's Current Report on Form 8-K dated December 31, 2012, and incorporated herein by reference.
21.1	Subsidiaries of Zix Corporation. Filed as Exhibit 21.1 to Zix Corporation's Annual Report on Form 10-K dated December 31, 2009, and incorporated herein by reference.
23.1*	Consent of Independent Registered Public Accounting Firm (Whitley Penn LLP).
31.1*	Certification of Richard D. Spurr, President and Chief Executive Officer of the Company, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of Michael W. English, Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer) of the Company, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1**	Certification of Richard D. Spurr and Michael W. English, pursuant to 18 U.S.C. Section 1350, as adopted, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.1*	101. INS (XBRL Instance Document)

101. SCH (XBRL Taxonomy Extension Schema Document)

101. CAL (XBRL Calculation Linkbase Document)

101. LAB (XBRL Taxonomy Label Linkbase Document)

101. DEF (XBRL Taxonomy Linkbase Document)

101. PRE (XBRL Taxonomy Presentation Linkbase Document)

* Filed herewith.

** Furnished herewith.

Management contract or compensatory plan or arrangement.

Table of Contents**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the city of Dallas, state of Texas, on March 12, 2014.

ZIX CORPORATION

By: /s/ MICHAEL W. ENGLISH
 Michael W. English
*Chief Financial Officer (Principal
 Financial Officer and Principal
 Accounting Officer)*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 12, 2014.

Signature	Title
/s/ RICHARD D. SPURR (Richard D. Spurr)	Chairman, Chief Executive Officer, President and Director (Principal Executive Officer)
/s/ MICHAEL W. ENGLISH (Michael W. English)	Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)
/s/ MARK J. BONNEY (Mark J. Bonney)	Director
/s/ MICHAEL E. DAILEY (Michael E. Dailey)	Director
/s/ TAHER A. ELGAMAL (Taher A. Elgamal)	Director
/s/ ROBERT C. HAUSMANN (Robert C. Hausmann)	Director
/s/ MARIBESS L. MILLER (Maribess L. Miller)	Director
/s/ ANTONIO R. SANCHEZ III (Antonio R. Sanchez III)	Director

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Zix Corporation

We have audited the accompanying consolidated balance sheets of Zix Corporation and subsidiaries (the Company), as of December 31, 2013 and 2012, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2013. The Company's management is responsible for these financial statements. 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 audit 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 financial position of the Company, as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2013 in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated March 12, 2014 expressed an unqualified opinion.

/s/ WHITLEY PENN LLP

Dallas, Texas

March 12, 2014

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ZIX CORPORATION
CONSOLIDATED BALANCE SHEETS

(In thousands, except share and par value data)	December 31,	
	2013	2012
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 27,518	\$ 22,988
Receivables, net	2,324	967
Prepaid and other current assets	2,038	1,697
Deferred tax assets	1,814	1,600
Total current assets	33,694	27,252
Property and equipment, net	2,608	2,384
Goodwill	2,161	2,161
Deferred tax assets	52,239	51,052
Total assets	\$ 90,702	\$ 82,849
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 495	\$ 501
Accrued expenses	1,992	2,655
Deferred revenue	19,080	17,470
Total current liabilities	21,567	20,626
Long-term liabilities:		
Deferred revenue	1,278	902
Deferred rent	1,623	76
Total long-term liabilities	2,901	978
Total liabilities	24,468	21,604
Commitments and contingencies (Note 13)		
Stockholders equity:		
Preferred stock, \$1 par value, 10,000,000 shares authorized; none issued and outstanding		
Common stock, \$0.01 par value, 175,000,000 shares authorized; 74,417,946 issued and 60,513,287 outstanding in 2013 and 73,165,433 issued and 61,264,533 outstanding in 2012	737	728
Additional paid-in capital	359,154	355,747
Treasury stock, at cost; 13,904,659 common shares in 2013 and 11,900,900 common shares in 2012	(50,386)	(41,506)
Accumulated deficit	(243,271)	(253,724)

Total stockholders' equity	66,234	61,245
Total liabilities and stockholders' equity	\$ 90,702	\$ 82,849

See notes to consolidated financial statements.

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ZIX CORPORATION
CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except share and per share data)	Year Ended December 31,		
	2013	2012	2011
Revenues	\$ 48,138	\$ 43,356	\$ 38,145
Cost of revenues	7,614	7,609	7,211
Gross margin	40,524	35,747	30,934
Research and development expenses	9,563	7,419	5,229
Selling, general and administrative expenses	21,646	19,385	15,128
Operating income	9,315	8,943	10,577
Other income (expense):			
Investment and other income	132	112	95
Interest expense		(1)	(7)
Total other income	132	111	88
Income before income taxes	9,447	9,054	10,665
Income tax benefit	1,006	1,949	11,889
Net income	\$ 10,453	\$ 11,003	\$ 22,554
Basic income per common share	\$ 0.17	\$ 0.18	\$ 0.34
Diluted income per common share	\$ 0.17	\$ 0.17	\$ 0.34
Weighted average shares outstanding			
Basic common shares outstanding	61,139,035	62,211,228	65,439,078
Diluted common shares outstanding	62,526,507	62,875,347	67,261,514

See notes to consolidated financial statements.

Table of Contents**ZIX CORPORATION****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

(In thousands, except share data)	Stockholders Equity					Total Stockholders Equity
	Common Stock Shares	Common Stock Amount	Paid-In Capital	Treasury Stock	Accumulated Deficit	
Balance, December 31, 2010	69,505,919	\$ 695	\$ 344,981	\$ (11,507)	\$ (287,282)	46,887
Issuance of common stock upon exercise of stock options	725,936	7	1,784			1,791
Issuance of common stock upon exercise of warrants	2,407,610	24	3,683			3,707
Employee stock-based compensation costs			569			569
Non-employee stock-based compensation			48			48
Stock option exercise excess tax benefit			3,200			3,200
Treasury repurchase program				(20,999)		(20,999)
Net income					22,554	22,554
Balance, December 31, 2011	72,639,465	726	354,265	(32,506)	(264,728)	57,757
Issuance of common stock upon exercise of stock options	174,968	2	306			308
Issuance of restricted common stock	351,000					
Employee stock-based compensation costs			1,166			1,166
Non-employee stock-based compensation			10			10
Treasury repurchase program				(9,000)		(9,000)
Net income					11,003	11,003
Balance, December 31, 2012	73,165,433	728	355,747	(41,506)	(253,724)	61,245
Issuance of common stock upon exercise of stock options	839,263	9	1,696			1,705
Issuance of common stock upon vesting of restricted stock units	28,250					
Issuance of restricted common stock	385,000					
Employee stock-based compensation costs			1,711	(120)		1,591
Treasury repurchase program				(8,760)		(8,760)
Net income					10,453	10,453
Balance, December 31, 2013	74,417,946	\$ 737	\$ 359,154	\$ (50,386)	\$ (243,271)	\$ 66,234

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See notes to consolidated financial statements.

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ZIX CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)	Year Ended December 31,		
	2013	2012	2011
Operating activities:			
Net income	\$ 10,453	\$ 11,003	\$ 22,554
Non-cash items in net income:			
Depreciation and amortization	1,466	1,343	1,373
Employee stock-based compensation expense	1,711	1,166	569
Non-employee stock-based compensation		10	48
Changes in deferred taxes	(1,401)	(2,295)	(11,796)
Changes in operating assets and liabilities:			
Receivables	(1,357)	(263)	640
Prepaid and other assets	(341)	(275)	(264)
Accounts payable	(103)	140	(87)
Deferred revenue	1,986	1,009	593
Accrued and other liabilities	884	695	(411)
Net cash provided by operating activities	13,298	12,533	13,219
Investing activities:			
Purchases of property and equipment	(1,593)	(1,533)	(1,471)
Net cash used in investing activities	(1,593)	(1,533)	(1,471)
Financing activities:			
Proceeds from exercise of stock options	1,705	308	1,791
Proceeds from exercise of warrants			3,707
Payment of license subscription note payable			(186)
Treasury stock	(8,880)	(9,000)	(20,999)
Net cash used in financing activities	(7,175)	(8,692)	(15,687)
Increase (decrease) in cash and cash equivalents	4,530	2,308	(3,939)
Cash and cash equivalents, beginning of year	22,988	20,680	24,619
Cash and cash equivalents, end of year	\$ 27,518	\$ 22,988	\$ 20,680

See notes to consolidated financial statements.

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ZIX CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Company Overview

Zix Corporation (ZixCorp, the Company, we, our, us) provides email encryption, data loss prevention (DLP) Bring-Your-Own-Device (BYOD) solutions to meet the data protection and compliance needs of organizations primarily in the healthcare, financial services, insurance and government sectors.

2. Summary of Significant Accounting Policies

Basis of Presentation The accompanying consolidated financial statements include the accounts of all our wholly-owned subsidiaries and are prepared in accordance with accounting principles generally accepted in the United States of America. All inter-company accounts and transactions have been eliminated in consolidation.

Use of Estimates The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reported period. Our significant estimates include primarily those required in the valuation or impairment analysis of goodwill and property and equipment, revenue recognition, allowances for doubtful accounts, stock-based compensation, litigation accruals, valuation allowances for deferred tax assets and tax accruals. Although we believe that adequate accruals have been made for unsettled issues, additional gains or losses could occur in future years from resolutions of outstanding matters. Actual results could differ materially from original estimates.

Cash Equivalents Cash investments with maturities of three months or less when purchased are considered cash equivalents.

Fair Value of Financial Instruments The Company does not measure the fair value of any financial instrument other than cash equivalents, options, restricted stock, restricted stock units, and warrants. The carrying values of other financial instruments (receivables and accounts payable) are not recorded at fair value but approximate fair values primarily due to their short-term nature. The carrying values of other current assets and accrued expenses are also not recorded at fair value, but approximate fair values primarily due to their short-term nature.

Valuation of Property and Equipment The accounting policies and estimates relating to property and equipment are considered significant because of the potential impact that impairment, obsolescence, or change in an asset's useful life could have on the Company's operating results.

We record an impairment charge on the assets to be held and used when we determine based upon certain triggering events that the carrying value of property and equipment may not be recoverable based on expected undiscounted cash flows attributable to such assets. The amount of a potential impairment is determined by comparing the carrying amount of the asset to either the value determined from a projected discounted cash flow method, using a discount rate that is considered to be commensurate with the risk inherent in the Company's current business model or the estimated fair market value. Assumptions are made with respect to future net cash flows expected to be generated by the related asset. An impairment charge would be recorded for an amount by which the carrying value of the asset exceeded the discounted projected net cash flows or estimated fair market value. Also, even where a current impairment charge is not necessary, the remaining useful lives are evaluated. No impairment was recorded for any of the periods presented.

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Property and equipment are recorded at cost and depreciated or amortized using the straight-line method over their estimated useful lives as follows: computer and office equipment and software three years; leasehold improvements the shorter of five years or the lease term; and furniture and fixtures five years.

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Goodwill We account for the valuation of goodwill and other intangible assets after classifying intangible assets into three categories: (1) intangible assets with finite lives subject to amortization; (2) intangible assets with indefinite lives not subject to amortization; and (3) goodwill. For intangible assets with finite lives, tests for impairment must be performed if conditions exist that indicate the carrying value may not be recoverable. For intangible assets with indefinite lives and goodwill, tests for impairment must be performed at least annually or more frequently if events or circumstances indicate that assets might be impaired.

Goodwill was \$2.2 million, or 2% and 3% of total assets for the years ended December 31, 2013 and 2012, respectively.

Our goodwill is not being amortized, but we do evaluate the goodwill for impairment annually in the fourth quarter, or when there is reason to believe that the value has been diminished or impaired. Evaluations for possible impairment are based upon a comparison of the estimated fair value of the reporting unit to which the goodwill has been assigned, versus the sum of the carrying value of the assets and liabilities of that unit including the assigned goodwill value. The fair values used in this evaluation are estimated based on the Company's market capitalization, which is based on the outstanding stock and market price of the stock. Impairment is deemed to exist if the net book value of the unit exceeds its estimated fair value. No impairment was recorded for any of the periods presented.

Deferred Tax Assets Deferred tax assets are recognized if it is more likely than not that the benefit of the deferred tax asset will be realized on future federal or state income tax returns. At December 31, 2013, we provided a valuation allowance against a significant portion, \$46.2 million, of our accumulated U.S. deferred tax assets, reflecting our historical losses and the uncertainty of future taxable income sufficient to utilize net operating loss carryforwards prior to their expiration. Our total deferred tax asset not subject to a valuation allowance is valued at \$54.1 million, and consists of \$45.3 million for federal net operating loss carryforwards, \$5.7 million relating to temporary timing differences between GAAP and tax-related expense, \$2.0 million relating to U.S. state income tax credits and \$1.1 million related to Alternative Minimum Tax credits. If U.S. taxable income increases from its current level in a future period or if the facts and circumstances on which our estimates and assumptions are based were to change, thereby impacting the likelihood of realizing the deferred tax assets, judgment would have to be applied in determining the amount of valuation allowance no longer required. Reversal of all or a part of this valuation allowance could have a significant positive impact on operating results in the period that it becomes more likely than not that certain of the Company's deferred tax assets will be realized. Alternatively, should our future income decrease from current levels, a resulting increase to all or a part of this valuation allowance could also have a significant negative impact on our operating results.

Leases A leased asset whose lease terms meet the criteria for capitalization is recorded as an asset and depreciated. If a lease does not meet the criteria for capitalization, it is classified as an operating lease and payments are recorded as rent expense. For 2013 and 2012 we had no leases that qualified as capital leases. Lease renewal options which we are reasonably assured of using and the related payments are taken into account when initially classifying and recording the lease as a capital lease obligation or as straight-line rent if an operating lease. Funds provided by the lessor for leasehold improvements are recorded as a deferred lease incentive and amortized as a reduction of rent expense over the lease term.

Revenue Recognition We develop, market, and support applications that connect, protect and deliver information in a secure manner. Our services can be placed into several key revenue categories where each category has similar revenue recognition traits: Email Encryption, DLP, and BYOD email subscription-based services, various transaction fees and related professional services. The majority of the revenues generated are through a combination of direct sales and a network of resellers and other distribution partners.

Under all product categories and distribution models, we recognize revenue after all of the following occur:

persuasive evidence of an arrangement exists,

delivery has occurred or services have been rendered,

the price is fixed and determinable, and

collectability is reasonably assured.

Discounts provided to customers are recorded as reductions in revenue.

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Our Email Encryption, DLP and BYOD services are subscription services. Providing these services includes delivering subscribed-for software and providing secure electronic communications and customer support throughout the subscription period. Our subscribers generally execute multiple-year contracts that are irrevocable and non-refundable in nature and require annual, up-front payments. Subscription fees received from customers are initially recorded as deferred revenue and then recognized as revenue ratably over the subscription period. We do not offer stand alone services. Further, our services primarily include manufacturer provided warranty provisions. We recorded no warranty expense in any of the presented periods.

Software Development Costs Costs incurred in the development and testing of software used in the Company's Email Encryption, DLP, and BYOD email services related to research, project planning, training, maintenance and general and administrative activities, and overhead costs are expensed as incurred. The costs of relatively minor upgrades and enhancements to the software are also expensed as incurred.

Costs for the development of new software solutions and substantial enhancements to existing software solutions are expensed as incurred until technological feasibility has been established, at which time any additional costs would be capitalized. No research and development costs have been capitalized because we believe that technological feasibility is established concurrent with general release to customers.

Advertising Expense Advertising costs are expensed as incurred. Our continuing operations include advertising expense of \$959 thousand, \$538 thousand, and \$544 thousand in 2013, 2012, and 2011, respectively.

Stock-Based Compensation We currently use the straight-line amortization method for recognizing stock option and restricted stock compensation costs. The measurement and recognition of compensation expense for all share-based payment awards made to our employees, directors or outside service providers are based on the estimated fair value of the awards on the grant dates. The grant date fair value is estimated using either an option-pricing model which is consistent with the terms of the award or a market observed price, if such a price exists. Such cost is recognized over the period during which an employee, director or outside service provider is required to provide service in exchange for the award, i.e., the requisite service period (which is usually the vesting period). We also estimate the number of instruments that will ultimately be earned, rather than accounting for forfeitures as they occur.

Earnings Per Share (EPS) Basic EPS is based on the weighted average number of common shares outstanding during each period. Diluted EPS adjusts Basic EPS for the effects of dilutive common stock equivalents outstanding during each period using the treasury stock method.

New Accounting Standards*Presentation of Other Comprehensive Income*

In February 2013, the FASB issued guidance that requires entities to provide information about the amounts reclassified out of accumulated other comprehensive income by component and to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective items of net income. This new guidance did not have an impact on our consolidated financial statements.

Unrecognized Tax Benefit

In July 2013, the FASB issued guidance that requires entities to present unrecognized tax benefits (UTB) in the financial statements as a reduction to a deferred tax asset (DTA) for a net operating loss (NOL) carryforward when

NOL s exist. Entities whose NOL carryforwards are not available to settle taxes that would result from the disallowance of the tax position, or who do not intend to use their DTA for that purpose, should present their UTB as a liability and should not net the UTB with the DTA. The guidance becomes effective for us fiscal year 2014. We do not anticipate that this new guidance will have an impact on our consolidated financial statements.

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Table of Contents**3. Stock Options and Stock-based Employee Compensation**

Below is a summary of common stock options outstanding at December 31, 2013:

	Authorized Shares	Options Outstanding	Options Vested	Available for Grant
Employee and Director Stock Option Plans:				
1995 Long-term Incentive Plan	1,825,000	680,000	680,000	
1999 Director's Stock Option Plan	975,000	83,292	83,292	
2001 Stock Option Plan	2,525,000	515,796	515,796	
2001 Employee Stock Option Plan	300,000	77,931	77,931	
2003 New Employee Stock Option Plan	500,000	16,400	14,399	
2004 Stock Option Plan	5,000,000	3,254,404	2,937,718	
2004 Director's Stock Option Plan	300,000	160,000	160,000	
2006 Director's Stock Option Plan	1,100,000	586,676	586,676	
2012 Incentive Plan	2,700,000	723,875	202,686	523,160
Total employee and director stock option plans	15,225,000	6,098,374	5,258,498	523,160
Executive Stock Option Agreements:				
Richard D. Spurr, Chairman, President and CEO	650,000	650,000	650,000	
Total	15,875,000	6,748,374	5,908,498	523,160

Under all of our stock option plans, new shares are issued when options are exercised.

Employee and Director Stock Option Plans

We have non-qualified stock options outstanding to employees and directors under various stock option plans. The plans require the exercise price of options granted under these plans to equal or exceed the fair market value of the Company's common stock on the date of grant. The options, subject to termination of employment, generally expire ten years from the date of grant. Historically, our employee options typically vested pro-rata and quarterly over three years. Option grants to employees, officers and directors frequently contain accelerated vesting provisions upon the occurrence of a change of control, as defined in the applicable option agreements.

Under the terms of the 2012 Incentive Plan adopted by the Company's Board of Directors on April 13, 2012 (the 2012 Plan), 2,700,000 shares are available for issuance, plus a number of additional shares (not to exceed 1,327,000) underlying options outstanding under certain of the Company's prior equity plans that thereafter terminate or expire unexercised, or are cancelled, forfeited, or lapse for any reason. Awards issued under the 2012 Plan typically vest pro-rata and quarterly over four years.

Executive Stock Option Agreements:

Richard D. Spurr In January 2004, Mr. Richard D. Spurr was appointed president and chief operating officer of the Company. Mr. Spurr received non-shareholder approved options to acquire 650,000 shares of ZixCorp common stock at an exercise price of \$10.80 per share. At December 31, 2013, all 650,000 options were vested and outstanding.

These options expired unexercised in February 2014. Mr. Spurr was appointed Chief Executive Officer in March 2005, and Chairman of the Board in February 2006.

Other Stock Option Agreements:

From time to time we may grant stock options to consultants, contractors and other third parties for services provided to the Company. These options are expensed based on their fair values as calculated by using the Black-Scholes Option Pricing Model (BSOPM). At December 31, 2013, options outstanding to non-employees were 55,000, which were granted from our stock option plans.

Accounting Treatment

We use the straight-line amortization method for recognizing stock option compensation costs. Our share-based awards include stock options, restricted stock and restricted stock units (RSU s).

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For the twelve months ended December 31, 2013, 2012, and 2011, respectively, the total stock-based compensation expense resulting from stock options, restricted stock, and RSU s was recorded to the following line items of our consolidated statement of income:

(In thousands)	Year Ended December 31,		
	2013	2012	2011
Cost of revenues	\$ 172	\$ 136	\$ 71
Research and development expenses	212	142	68
Selling, general and administrative expenses	1,327	888	430
Stock-based compensation expense	\$ 1,711	\$ 1,166	\$ 569

As of December 31, 2013, there was \$3.2 million of total unrecognized stock-based compensation related to non-vested share-based compensation awards granted under the stock option plans. This cost is expected to be recognized over a weighted average period of 1.6 years.

We used the BSOPM to determine the fair value of option grants made during 2013, 2012, and 2011. On January 1, 2006, we elected to use the simplified method to calculate the estimated life of options granted to employees. The use of the simplified method has been extended until such time when we have sufficient information to make more refined estimates on the estimated life of our options. The expected stock price volatility was calculated by averaging the historical volatility of the Company s common stock over a term equal to the expected life of the options.

The following weighted average assumptions were applied in determining the fair value of options granted during the respective periods:

	Year Ended December 31,		
	2013	2012	2011
Risk-free interest rate	1.05%	0.92%	1.81%
Expected option life (years)	5.8	6.0	5.8
Expected stock price volatility	69%	74%	75%
Expected dividend yield			
Fair value of options granted	\$ 1.99	\$ 1.72	\$ 2.48

The assumptions used in the BSOPM valuation are critical as a change in any given factor could have a material impact on the financial results of the Company. The weighted average grant-date fair value of awards of restricted stock and RSU s is based on quoted market price of the Company s common stock on the date of grant.

Stock Option Activity

There were 839,263 stock options exercised for the twelve months ended December 31, 2013. As a result of these stock option exercises, there was \$427 thousand in excess tax benefits recorded in 2013. For the comparative period in 2012, there were 174,968 stock option exercises. A deferred tax asset totaling \$321 thousand and \$306 thousand resulting from stock-based compensation expenses was recorded for the twelve months ended December 31, 2013 and 2012, respectively.

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The following is a summary of all stock option transactions for the three years ended December 31, 2013:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Yrs)
Outstanding at January 1, 2011	7,646,892	\$ 4.42	
Granted at market price	536,500	\$ 3.83	
Cancelled or expired	(310,006)	\$ 6.41	
Exercised	(725,936)	\$ 2.46	
Outstanding at December 31, 2011	7,147,450	\$ 4.48	
Granted at market price	1,099,000	\$ 2.69	
Cancelled or expired	(386,706)	\$ 4.69	
Exercised	(174,968)	\$ 1.76	
Outstanding at December 31, 2012	7,684,776	\$ 4.28	
Granted at market price	150,000	\$ 3.27	
Cancelled or expired	(247,139)	\$ 5.15	
Exercised	(839,263)	\$ 2.03	
Outstanding at December 31, 2013	6,748,374	\$ 4.50	3.67
Options exercisable at December 31, 2013	5,908,498	\$ 4.73	3.10

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At December 31, 2013, we had 4,110,030 options outstanding and 3,270,154 options exercisable in which the exercise price was lower than the market value of the Company's common stock. The aggregate intrinsic value of these options was \$6.6 million and \$5.2 million, respectively. At December 31, 2012, we had 2,267,052 options outstanding and 1,657,907 options exercisable in which the exercise price was lower than the market value of the Company's common stock. The aggregate intrinsic value of these options was \$2.0 million and \$1.8 million, respectively.

The total intrinsic value of options exercised during the years ended December 31, 2013 and 2012, was \$1.9 million and \$135 thousand, respectively.

Summarized information about stock options outstanding at December 31, 2013, is as follows:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$1.11 - \$1.99	711,697	3.01	\$ 1.52	711,697	\$ 1.52
\$2.00 - \$3.49	1,923,433	6.61	\$ 2.72	1,198,070	\$ 2.71
\$3.50 - \$4.99	2,578,652	3.59	\$ 4.34	2,464,139	\$ 4.36
\$5.00 - \$5.99	286,500	0.77	\$ 5.00	286,500	\$ 5.00
\$6.00 - \$8.99	455,300	0.76	\$ 6.45	455,300	\$ 6.45
\$9.00 - \$11.00	792,792	0.14	\$ 10.72	792,792	\$ 10.72
	6,748,374	3.67	\$ 4.50	5,908,498	\$ 4.73

There were 6,412,505 and 7,034,356 exercisable options at December 31, 2012 and 2011, respectively.

Restricted Stock Activity

The following is a summary of all restricted stock activity during the two years ended December 31, 2013:

	Restricted Shares	Weighted Average Fair Value
Outstanding at January 1, 2012		
Granted at market price	351,000	\$ 2.49
Vested		
Cancelled		
Unvested restricted stock at December 31, 2012	351,000	\$ 2.49
Granted at market price	385,000	\$ 3.45
Vested	(87,750)	2.49

Cancelled

Unvested restricted stock at December 31, 2013	648,250	\$	3.06
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Table of Contents***Restricted Stock Unit Activity***

The following is a summary of all RSU activity during the two years ended December 31, 2013:

	Restricted Stock Units	Weighted Average Fair Value
Non-vested at January 1, 2012		
Granted at market price	113,000	\$ 2.49
Vested		
Cancelled		
Unvested restricted stock units at December 31, 2012	113,000	\$ 2.49
Granted at market price	95,000	\$ 3.45
Vested	(28,250)	2.49
Cancelled		
Unvested restricted stock units at December 31, 2013	179,750	\$ 3.00

The weighted average grant-date fair value of awards of restricted stock and RSU s (collectively restricted stock) is based on the quoted market price of the Company s common stock on the date of grant.

Reserved Common Stock

At December 31, 2013, we held no shares of common stock in reserve for potential future grants in lieu of cash compensation to employees.

4. Supplemental Cash Flow Information

Supplemental information relating to interest, taxes, and noncash activities:

(In thousands)	Year Ended December 31,		
	2013	2012	2011
Cash interest paid	\$	\$	\$ 7
Income tax payments	\$ 217	\$ 350	\$ 225
Payables related to purchases of capitalized assets	\$ (97)	\$ 34	\$ 79
Excess tax benefit on exercise of employee stock options	\$ 427	\$ 10	\$ 3,200

5. Receivables, net

(In thousands)	December 31,	
	2013	2012
Gross accounts receivables	\$ 8,359	\$ 6,721
Allowance for returns and doubtful accounts	(46)	(28)
Unpaid portion of deferred revenue	(5,989)	(5,726)
Note receivable	458	458
Allowance for note receivable	(458)	(458)
Receivables, net	\$ 2,324	\$ 967

Our gross accounts receivables include \$863 thousand associated with a tenant improvement allowance received as an incentive when we renewed the lease for our Dallas headquarters in 2013.

The allowance for doubtful accounts includes all specific accounts receivable which we believe are likely not collectable based on known information. In addition, we record 2.5% of all accounts receivable greater than 90 days past due, net of those accounts specifically reserved, as a general allowance against accounts that could potentially become uncollectible.

The reduction for deferred revenue represents future customer service or maintenance obligations which have been billed to customers, but remain unpaid as of the respective balance sheet dates. Deferred revenue on our consolidated balance sheets represents future customer service or maintenance obligations which have been billed and collected as of the respective balance sheet dates.

The note receivable represents the remaining outstanding balance of an original note related to the sale of a product line in 2005 in the amount of \$540 thousand. This was fully reserved at the time of the sale as the note's collectability was not assured. The note receivable is fully reserved at December 31, 2013.

Table of Contents**6. Prepaid and other current assets**

(In thousands)	December 31,	
	2013	2012
Prepaid insurance, maintenance, software licenses and other	\$ 1,489	\$ 1,502
Deferred commissions	320	215
Deferred rent	261	
Tax-related	(32)	(20)
Prepaid and other current assets	\$ 2,038	\$ 1,697

7. Property and Equipment

(In thousands)	December 31,	
	2013	2012
Computer and office equipment and software	\$ 22,550	\$ 23,807
Leasehold improvements	5,276	5,221
Furniture and fixtures	1,520	1,504
	29,346	30,532
Less accumulated depreciation and amortization	(26,738)	(28,148)
	\$ 2,608	\$ 2,384

Our continuing operations include depreciation and amortization expense related to property and equipment of \$1.5 million, \$1.3 million, and \$1.4 million in 2013, 2012, and 2011, respectfully.

8. Goodwill

At December 31, 2013 and 2012, we had goodwill totaling \$2.2 million. We evaluate goodwill for impairment annually in the fourth quarter, or when there is reason to believe that the value has been diminished or impaired. There were no impairment indicators to the goodwill recorded as of December 31, 2013.

9. Accrued Expenses

(In thousands)	December 31,	
	2013	2012
Employee compensation and benefits	\$ 872	\$ 790
Professional fees	469	842
Taxes	350	409
Other	301	614

Total accrued expenses	\$ 1,992	\$ 2,655
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10. Fair Value Measurements

FASB guidance regarding fair value measurement establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets for identical assets or liabilities; Level 2, defined as inputs other than quoted prices for similar assets and liabilities in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions.

For certain of the Company's financial instruments, including cash and cash equivalents, trade receivables, and accounts payable, the fair values approximate carrying values due to the short-term maturities of these instruments. The carrying values of other current assets and accrued expenses are also not recorded at fair value, but approximate fair values primarily due to their short-term nature.

Table of Contents**11. Earnings Per Share and Potential Dilution**

Basic earnings per share are computed using the weighted average number of common shares outstanding for the period. The dilutive effect of potential common shares outstanding is included in diluted earnings per share. The computations for basic and diluted earnings per share for the years ended December 31, 2013, 2012, and 2011, are as follows:

	Year Ended December 31,		
	2013	2012	2011
Basic weighted average shares	61,139,035	62,211,228	65,439,078
Effect of dilutive securities:			
Employee and director stock options	1,095,227	637,676	943,634
Restricted Stock	225,741	20,003	
RSU s	66,504	6,440	
Warrants			878,802
Potential dilutive common shares	62,526,507	62,875,347	67,261,514

For the years ended December 31, 2013, 2012, and 2011, weighted average shares related to certain stock options of 4,054,261, 5,645,239, and 4,640,713 respectively, were excluded from the calculation of diluted earnings per share because the stock options were anti-dilutive. Anti-dilutive restricted stock and RSU s of 31,281, and 7,719, respectively, were also excluded from the calculation for the year ended December 31, 2013. Anti-dilutive warrants of 145,853 were excluded from the calculation for the year ended December 31, 2011. All warrants expired in January 2012.

12. Significant Customers

In 2013, 2012, and 2011, no single customer accounted for 10% or more of our revenues. Our accounts receivable balance at December 31, 2012, included receivables from one customer comprising 12% of the net total. These receivables were paid to the Company in the first quarter 2013.

13. Commitments and Contingencies**Leases**

We lease office facilities under non-cancelable operating lease agreements. Our continuing operations include rent expense for these operating leases of \$1.3 million in each of 2013, 2012, and 2011, respectively. The term of the lease of our headquarter facility in Dallas was extended to 2024.

A summary of our fixed contractual obligations and commitments at December 31, 2013, is as follows:

(In thousands)	2014	2015	2016	2017	2018	Thereafter	Total
Operating leases	\$ 1,009	\$ 1,261	\$ 1,163	\$ 1,058	\$ 1,014	\$ 6,190	\$ 11,695

Claims and Proceedings

We are subject to legal proceedings, claims, and litigation against our business. While the outcome of these matters is currently not determinable and the costs and expenses of defending these matters may be significant, we currently do not expect that the ultimate costs to resolve these matters will have a material adverse effect on our consolidated financial statements.

14. Income Taxes

Components of the income taxes are as follows:

(In thousands)	2013	2012	2011
Current:			
U.S.	\$ 124	\$ 116	\$ 163
State	148	164	122
Foreign	123	66	(378)
Deferred			
Federal	(1,400)	(2,300)	(9,800)
State			(2,000)
Foreign	(1)	5	4
Income tax (benefit) expense	\$ (1,006)	\$ (1,949)	\$ (11,889)

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A reconciliation of the expected U.S. tax (benefit) expense to income taxes is as follows:

(In thousands)	2013	2012	2011
Expected tax (benefit) expense at U.S. statutory rate	\$ 3,212	\$ 3,078	\$ 3,753
Decrease in valuations allowance- Operations	(2,650)	(2,912)	(3,357)
Decrease in valuations allowance- Other	(1,400)	(2,300)	(9,900)
Nondeductible expense and nontaxable income	(370)	21	(125)
State income taxes	98	108	(1,878)
Foreign income taxes	122	71	(374)
Other	(18)	(15)	(8)
Income tax (benefit) expense	\$ (1,006)	\$ (1,949)	\$ (11,889)

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Components of our deferred income taxes as of December 31, 2013 and 2012 are as follows:

(In thousands)	2013	2012
Deferred tax assets:		
Reserves- Other	\$ 251	\$ 218
U.S. net operating loss carryforwards	88,562	91,396
State net operating loss carryforwards	347	487
Tax credit carryforwards	5,619	5,374
Stock-based compensation	2,839	2,604
Intangible assets	978	1,421
Depreciable assets	1,430	1,451
Other assets	649	323
Total deferred tax assets	100,675	103,274
Deferred tax liabilities:		
Prepaid expenses	(418)	(410)
Total deferred tax assets	100,257	102,864
Less valuation allowance	(46,209)	(50,216)
Net deferred income taxes	\$ 54,048	\$ 52,648

The Company has partially reserved its U.S. net deferred tax assets in 2013 and 2012 due to the uncertainty of future taxable income. The Company has U.S. net operating loss carryforwards of approximately \$260 million which begin to expire in 2020. The Company has state credits that net of federal tax expense total \$1.9 million which can be utilized through 2027 and state net operating losses that have various expiration dates. The Company also has tax credit carryforwards of approximately \$3.8 million consisting of business tax credits which begin to expire in 2014 and alternative minimum tax credits which do not expire.

In 2010, the Company achieved positive earnings and successfully discontinued operations of its e-Prescribing segment. Based on the weight of available objective evidence, including the Company's history of positive earnings from continuing operations and successful exit from e-Prescribing, management believed that it was more likely than not that a portion of the deferred tax asset would be realized. Accordingly, the Company reduced its valuation allowance by \$4.1 million in 2013, \$5.2 million in 2012, and \$15 million in 2011. The benefit from the 2011 reduction was recorded in part as an \$11.8 million income tax benefit and in part as a \$3.2 million increase to our additional paid in capital. The segregation of the release was due to the reduction related to historical employee stock option exercises.

We have determined that utilization of existing net operating losses against future taxable income is not limited by Section 382 of the Internal Revenue Code. Future ownership changes, however, may limit the company's ability to fully utilize its existing net operating loss carryforwards against any future taxable income.

The Company previously recorded a \$327 thousand tax contingency liability related to tax year 2004, and that amount and the specifics therein remained unchanged except for currency translation adjustments. As of December 31, 2010, the gross amount of our unrecognized tax benefits, inclusive of the \$327 thousand tax liability and \$50 thousand in other uncertain positions in 2008, was approximately \$461 thousand. Included in this balance were tax positions which, if recognized, would impact our effective tax rate. Because the statute of limitations expired on the returns associated with these uncertain tax positions, this contingency was reversed in 2011, resulting in the recognition of an income tax benefit and positive impact on our 2011 operating results.

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The Company or one of our subsidiaries files income tax returns in the U.S. federal jurisdiction and various states and in the Canadian federal and provincial jurisdictions. We have not taken a tax position that, if challenged, would have a material effect on the financial statements or the effective tax rate for the twelve-months ended December 31, 2013, or during the prior three years. We have determined it is not reasonably possible for the amounts of unrecognized tax benefits to significantly increase or decrease within the next twelve months. We are currently subject to a three-year statute of limitations by major tax jurisdictions.

15. Employee Benefit Plan

401(k) Plan We have a retirement savings plan structured under Section 401(k) of the Internal Revenue Code covering substantially all of our U.S. employees. Under the plan, contributions are voluntarily made by employees, and we may provide contributions based on the employees' contributions. Our operating income includes \$297 thousand, \$221 thousand and \$185 thousand, in 2013, 2012 and 2011, respectively, for net contributions from continuing operations to this plan.

16. ZixCorp Repurchase Program

On November 6, 2013, the Company's board of directors approved a share repurchase program that enables the Company to purchase up to \$15 million of its shares from time to time in the open market. The amount and timing of specific repurchases are subject to market conditions, applicable legal requirements, and other factors. The share purchases will be funded from existing cash resources and may be suspended or discontinued at any time, however, the share repurchase program will expire on June 30, 2014. The Company repurchased 1,976,900 shares at an aggregate cost of \$8.8 million under this program during the year ended December 31, 2013.

During the year ended December 31, 2012, we repurchased 3,080,966 shares valued at approximately \$9 million. This completed a \$15 million share repurchase program authorized by our board of directors announced November 9, 2011. During the year ended December 31, 2011, we repurchased a total of 6,492,753 shares valued at approximately \$21 million as authorized by our board of directors under a \$15 million share repurchase program announced on March 7, 2011, and the \$15 million repurchase program announced November 2011.

17. Quarterly Results of Operations (Unaudited)

The following is a summary of the quarterly results of operations for the years ended December 31, 2013 and 2012:

(In thousands except per share data)	Quarter Ended			
	March 31	June 30	September 30	December 31
2013				
Revenues	\$ 11,764	\$ 11,838	\$ 12,225	\$ 12,311
Gross margin	9,828	9,935	10,321	10,440
Net income	567	1,871	3,175	4,840
Basic net income per common share*	0.01	0.03	0.05	0.08
Diluted net income per common share*	0.01	0.03	0.05	0.08
2012				
Revenues	\$ 10,301	\$ 10,343	\$ 11,023	\$ 11,689
Gross margin	8,446	8,531	9,136	9,634
Net income	2,426	2,643	1,943	3,991

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Basic net income per common share*	0.04	0.04	0.03	0.07
Diluted net income per common share*	0.04	0.04	0.03	0.06

* Net income per share is calculated independently for each quarter. The sum of Net income per share for each quarter may not equal the total Net income per share for the year due to rounding differences.

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