SIERRA HEALTH SERVICES INC
Form 10-Q
November 14, 2002

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

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2002

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 1-8865

SIERRA HEALTH SERVICES, INC.
(Exact name of registrant as specified in its charter)

NEVADA	88-0200415
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2724 NORTH TENAYA WAY LAS VEGAS, NV	89128
(Address of principal executive offices)	(Zip Code)

(702) 242-7000
(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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 _X_ No___

As of November 11, 2002, there were 29,546,000 shares of common stock outstanding.

SIERRA HEALTH SERVICES, INC. AND SUBSIDIARIES

FORM 10-Q FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2002

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SIERRA HEALTH SERVICES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)
(Unaudited)

ASSETS

	September 2002
Current Assets:	
Cash and Cash Equivalents	$ 93,7
Investments	394,5
Accounts Receivable(Less Allowance for Doubtful Accounts; 2002 - $10,912; 2001 - $12,655)	23,0
Military Accounts Receivable	41,7
Current Portion of Deferred Tax Asset	49,9
Current Portion of Reinsurance Recoverable	81,6
Prepaid Expenses and Other Current Assets	26,4
Assets of Discontinued Operations	20,7
Total Current Assets	731,9
Property and Equipment, Net	62,8
Long-Term Investments	2,7
Restricted Cash and Investments	34,8
Reinsurance Recoverable, Net of Current Portion	103,9
Deferred Tax Asset, Net of Current Portion	36,0
Goodwill	14,7
Other Assets	42,4
TOTAL ASSETS	$1,029,5

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities:	
Accrued Liabilities	$ 72,2
Trade Accounts Payable	19,1
Accrued Payroll and Taxes	27,6
Medical Claims Payable	101,3
Current Portion of Reserve for Losses and Loss Adjustment Expense	167,2
Unearned Premium Revenue	30,1
Military Health Care Payable	76,1
Current Portion of Long-Term Debt	51,6
Liabilities of Discontinued Operations	43,8
Total Current Liabilities	589,4
Reserve For Losses and Loss Adjustment Expense, Net of Current Portion	231,4
Long-Term Debt, Net of Current Portion	16,2
Other Liabilities	38,9
TOTAL LIABILITIES	876,0
Stockholders' Equity:	
Preferred Stock, $.01 Par Value, 1,000 Shares Authorized; None Issued or Outstanding	
Common Stock, $.005 Par Value, 60,000 Shares Authorized; Shares Issued: 30,703 and 29,648 issued as of 2002 and 2001, respectively	1
Additional Paid-in Capital	196,6
Deferred Compensation for Restricted Stock	(6
Treasury Stock: 2002 - 1,163; 2001 - 1,523 Common Stock Shares	(17,1
Accumulated Other Comprehensive Gain (Loss)	2,0
Accumulated Deficit	(27,5

Total Stockholders' Equity..	153,5
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY................................	$1,029,5

See accompanying notes to condensed consolidated financial statements.

SIERRA HEALTH SERVICES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

	Three Months Ended September 30,	
	2002	**2001**
Operating Revenues:		
Medical Premiums..................................	$217,995	$184,402
Military Contract Revenues.........................	100,366	85,499
Specialty Product Revenues.........................	50,057	49,447
Professional Fees..................................	7,819	6,981
Investment and Other Revenues......................	5,087	4,525
Total..	381,324	330,854
Operating Expenses:		
Medical Expenses..................................	178,958	156,307
Military Contract Expenses.........................	96,629	83,561
Specialty Product Expenses.........................	52,843	50,144
General, Administrative and Marketing Expenses......	33,333	30,084
Total	361,763	320,096
Operating Income from Continuing Operations...........	19,561	10,758
Interest Expense and Other, Net.......................	(1,312)	(3,888)
Income from Continuing Operations Before Taxes.........	18,249	6,870
Income Tax Provision.................................	(6,114)	(2,298)
Net Income from Continuing Operations.................	12,135	4,572
Income (Loss) from Discontinued Operations (Note 3)....	1,928	(12,126)
Net Income (Loss)....................................	$ 14,063	$ (7,554)

Earnings per Common Share:

Net Income from Continuing Operations..................	$.42	$ .16
Income (Loss) from Discontinued Operations.............	.06	(.43)
Net Income (Loss)..................................	$.48	$(.27)

Earnings per Common Share Assuming Dilution:

Net Income from Continuing Operations..................	$.38	$ .16
Income (Loss) from Discontinued Operations.............	.06	(.42)
Net Income (Loss)..................................	$.44	$(.26)
Weighted Average Common Shares Outstanding.............	29,166	27,851
Weighted Average Common Shares Outstanding Assuming Dilution..................................	31,756	29,270

See accompanying notes to condensed consolidated financial statements.

SIERRA HEALTH SERVICES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Mont
	2002
Cash Flows From Operating Activities:	
Net Income (Loss)...	$ 31,967
Adjustments to Reconcile Net Income (Loss) to Net Cash Provided by Operating Activities:	
(Gain) Loss from Discontinued Operations........................	(1,928
Depreciation and Amortization..................................	15,205
Provision for Doubtful Accounts................................	2,321
Deferred Compensation Expense..................................	438
(Gain) Loss on Property and Equipment Dispositions..............	(80
Changes in Assets and Liabilities	
Deferred Tax Asset...	29,653
Reinsurance Recoverable..	34,575
Accrued Payroll and Taxes......................................	12,095
Medical Claims Payable...	19,653
Reserve for Losses and Loss Adjustment Expense..................	13,071
Unearned Premium Revenue.......................................	(22,781
Other Assets and Liabilities...................................	5,752
Net Cash Provided by Operating Activities	139,941
Cash Flows From Investing Activities:	
Capital Expenditures, Net of Dispositions..............................	(5,588
Changes in Investments..	(110,281
Net Cash Used for Investing Activities............................	(115,869

Cash Flows From Financing Activities:	
Payments on Debt and Capital Leases	(42,630
Proceeds on Sale-Leaseback Deposit	16,862
Issuance of Stock in Connection with Stock Plans	10,193
Net Cash Used for Financing Activities	(15,575
Net Cash Used for Discontinued Operations	(30,472
Net Decrease In Cash and Cash Equivalents	(21,975
Cash and Cash Equivalents at Beginning of Period	115,754
Cash and Cash Equivalents at End Of Period	$ 93,779

Supplemental Condensed Consolidated Continuing Operations Statements of Cash Flows Information:	**Nine Mon** **2002**
Cash Paid During the Period for Interest (Net of Amount Capitalized)	$ 5,224
Net Cash Received During the Period for Income Taxes	13,019
Non-cash Investing and Financing Activities:	
Retired Sale-Leaseback Assets, Liabilities and Financing Obligations (Note 6)	89,751
Debentures Exchanged	

See accompanying notes to condensed consolidated financial statements.

SIERRA HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

The accompanying unaudited financial statements include the consolidated accounts of Sierra Health Services, Inc. ("Sierra", a holding company, together with its subsidiaries, collectively referred to herein as the "Company"). All material intercompany balances and transactions have been eliminated. These statements have been prepared in conformity with accounting principles generally accepted in the United States of America and used in preparing the Company's annual audited consolidated financial statements but do not contain all of the information and disclosures that would be required in a complete set of audited financial statements. They should, therefore, be read in conjunction with the Company's annual audited consolidated financial statements and related notes thereto for the years ended December 31, 2001 and 2000. In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all material adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the financial results for the interim periods presented.

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 reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates and assumptions could change in the future as more information becomes available, which could impact the amounts reported and disclosed herein. Actual results may materially differ from estimates.

Certain amounts in the Condensed Consolidated Financial Statements for the three and nine months ended September 30, 2001 have been reclassified to conform with the current year presentation.

2. Asset Impairment, Restructuring, Reorganization and Other Costs

The table below presents a summary of asset impairment, restructuring, reorganization and other cost activity for the periods indicated that are included in general, administrative and marketing expenses. Discontinued Texas HMO health care operations are excluded from this table and are discussed in Note 3.

	Restructuring and Reorganization	**Other**
(In thousands)		
Balance, January 1, 2001	$ 594	$4,447
Charges recorded		
Cash used	(594)	
Noncash activity		
Changes in estimate		
Balance, December 31, 2001	-	4,447
Charges recorded		
Cash used		
Noncash activity		(500)
Changes in estimate		
Balance, September 30, 2002	$ -	$3,947

The remaining other costs of $3.9 million are related to legal claims. Management believes that the remaining reserves, as of September 30, 2002, are appropriate and that no revisions to the estimates are necessary at this time.

3. Discontinued Operations

In conjunction with the Company's plan to exit the Texas healthcare market, during the third quarter of 2001, the Company recorded charges of $10.6 million for premium deficiency medical costs, $1.6 million to write down certain Texas furniture and equipment, $2.0 million in lease and other termination costs, $1.8 million in legal and related costs, $500,000 in various other exit related costs and $570,000 in premium deficiency maintenance.

As part of the Company's continual evaluation of its remaining liabilities, it was determined during the second quarter of 2002, that the medical claims run out had been favorable compared with the Company's original projection and that legal and other costs were estimated to be higher than originally anticipated. As a result, during the second quarter, we reduced our medical claims payable and medical expenses by $5.0 million and increased our estimate of accounts payable and other liabilities and related expenses by $5.0 million. During the third quarter we continued to have favorable medical claims development and reduced our medical claims payable estimate by $2.0 million. The adjustment resulted in income, net of tax, from discontinued operations of $1.3 million. See the discussion below for a description of the $628,000 gain, net of tax, related to the Kaiser-Texas mortgage loan.

The following are the unaudited condensed statements of operations of the discontinued Texas HMO health care operations:

	Three Months Ended September 30, 2002	Three Months Ended September 30, 2001
(In thousands)		
Operating Revenues..	$ 84	$ 45,474
Medical Expenses..	(2,165)	49,042
General, Administrative and Marketing Expenses............	705	8,184
Asset Impairment, Restructuring, Reorganization and Other Costs.....................................		6,550
Interest Expense and Other, Net (including rental income).	(1,423)	(74)
Income (Loss) from Discontinued Operations Before Taxes...	2,967	(18,228)
Income Tax (Expense) Benefit............................	(1,039)	6,102
Net Income (Loss) from Discontinued Operations...........	$ 1,928	$(12,126)

The table below presents a summary of discontinued Texas HMO health care operations' asset impairment, restructuring, reorganization and other cost activity for the periods indicated.

	Asset Impairment	Restructuring and Reorganization	Premium Deficiency Maintenance	Ot
(In thousands)				
Balance, January 1, 2001.......	-	$ 3,755	$ 9,278	$
Charges recorded..............	$ 1,600	4,380	570	
Cash used......................		(3,716)	(1,478)	(
Noncash activity..............	(1,600)	(125)		
Changes in estimate............			(7,800)	
Balance, December 31, 2001.....	-	4,294	570	
Charges recorded..............				

Cash used......................		(1,707)	(570)	
Noncash activity...............				
Changes in estimate............		5,000		
Balance, September 30, 2002....	$ -	$ 7,587	$ -	$

The remaining restructuring and reorganization costs of $7.6 million are primarily due to legal and related costs, lease and other termination costs, the cost to provide malpractice insurance on our discontinued affiliated medical groups and various other exit related costs. Management believes that the remaining reserves, as of September 30, 2002, are appropriate and that no further revisions to the estimates are necessary at this time. Based on the current estimated Texas HMO healthcare run-out costs and recorded reserves, we believe we have adequate funds available and the ability to fund the anticipated obligations.

The following are the unaudited assets and liabilities of the discontinued Texas health care operations:

(In thousands)	September 30, 2002	De
ASSETS		
Cash and Cash Equivalents............................	$ -	
Accounts Receivable, Net.............................	31	
Other Assets...	4,593	
Property and Equipment, Net..........................	16,143	
ASSETS OF DISCONTINUED OPERATIONS......................	20,767	
LIABILITIES		
Accounts Payable and Other Liabilities................	13,846	
Medical Claims Payable...............................	5,411	
Unearned Premium Revenue.............................	-	
Premium Deficiency Reserve...........................	-	
Mortgage Loan Payable................................	24,638	
LIABILITIES OF DISCONTINUED OPERATIONS.................	43,895	
NET LIABILITIES OF DISCONTINUED OPERATIONS.............	$(23,128)	

The assets and liabilities above do not include an intercompany liability of $30.5 million from Texas Health Choice, L.C., ("TXHC") to Sierra at September 30, 2002. The liability is secured by certain of the TXHC land and buildings and has been eliminated upon consolidation.

Property and equipment consists mainly of real estate properties located in the Dallas/Fort Worth metroplex areas. TXHC acquired these properties from Kaiser Foundation Health Plan of Texas ("Kaiser-Texas"), for $44.0 million as part of the acquisition of certain assets of Kaiser-Texas in October 1998. In June 2000, as part of its restructuring and reorganization of the Texas HMO health care operations, the Company announced its intention to sell these properties. The real estate was written down to its estimated fair value and the Company took an asset impairment charge of $27.0 million. The real estate is encumbered by a mortgage loan to Kaiser-Texas, which is guaranteed by Sierra.

During 2001, Sierra participated in negotiations with Kaiser-Texas relating to the real estate properties and associated mortgage loan to Kaiser-Texas along with other matters. Sierra reached an agreement with Kaiser-Texas, effective December 31, 2001, whereby Kaiser-Texas forgave $8.5 million of the outstanding principal balance of the mortgage loan and extended the maturity from November 1, 2003 to November 1, 2006. In exchange for the consideration by Kaiser-Texas, Sierra agreed to an unconditional guaranty of the mortgage loan. In conjunction with the agreement, Sierra applied a $2.5 million outstanding receivable from Kaiser-Texas to the outstanding balance of the mortgage loan on December 31, 2001.

In accordance with accounting principles generally accepted in the United States of America, the agreement was accounted for as a restructuring of debt. In the transaction, total future cash payments (interest and principal) were less than the balance of the mortgage loan at the time of the agreement. Accordingly, a gain on restructuring was recognized for the difference and the carrying amount of the mortgage loan is equal to the total future cash payments. Costs incurred in connection with the agreement were offset against the gain on restructuring. Effective January 1, 2002, all future cash payments, including interest, related to the mortgage loan are reductions of the carrying amount; therefore, no future interest expense will be recognized.

During the third quarter of 2002, TXHC sold two of the real estate properties for net proceeds of $3.6 million. As required under the terms of the mortgage loan agreement, the proceeds of the sale went directly to Kaiser-Texas as payment on the mortgage loan. Since the principal payment resulted in a reduction of future interest, future accrued interest was reduced and a gain, net of tax, of $628,000 was recorded. At September 30, 2002, the mortgage loan has a carrying value of $24.6 million, which consists of a principal balance of $20.1 million and $4.5 million in future accrued interest.

4. Earnings Per Share:

The following table provides a reconciliation of basic and diluted earnings per share ("EPS") for continuing operations:

(In thousands, except per share data)	Basic	Diluti Stock Op
For the Three Months ended September 30, 2002:		
Income from Continuing Operations	$12,135	
Weighted Average Common Shares Outstanding	29,166	2,59
Per Share Amount	$.42	
For the Three Months ended September 30, 2001:		
Income from Continuing Operations	$ 4,572	
Weighted Average Common Shares Outstanding	27,851	1,41
Per Share Amount	$.16	
For the Nine Months ended September 30, 2002:		
Income from Continuing Operations	$30,039	
Weighted Average Common Shares Outstanding	28,489	2,50
Per Share Amount	$1.05	
For the Nine Months ended September 30, 2001:		

Income from Continuing Operations	$11,815	
Weighted Average Common Shares Outstanding	27,619	69
Per Share Amount	$.43	

5. The following table presents comprehensive income for the periods indicated:

	Three Months Ended September 30, 2002	2001	
(In thousands)			
Net Income (Loss)..........................	$14,063	$(7,554)	$31
Change in Accumulated Other Comprehensive Income, Net.................	6,555	4,779	7
Comprehensive Income (Loss)................	$20,618	$(2,775)	$39

The change in accumulated other comprehensive income is all due to unrealized gains in the available for sale investment portfolio.

6. Sale-Leaseback

On December 28, 2000, the Company sold the majority of its Las Vegas, Nevada, administrative and medical clinic real estate holdings in a sale-leaseback transaction. Due to continuing involvement as defined in Statement of Financial Accounting Standards No. 98, "Accounting for Leases" ("SFAS No. 98"), the transaction did not qualify as a sale. The Company recorded the transaction as a financing obligation offset by the mortgage notes receivable.

During 2001, the Company received full payment on the outstanding mortgage notes receivable associated with three of the medical clinics. During the first two quarters of 2002, the Company received the deposit back on the three administrative buildings and full payment of the outstanding mortgage obligation on one of the remaining medical clinics.

During the third quarter of 2002, the Company received full payment on the remaining outstanding mortgage obligations on the four remaining clinics. The payment cured the continuing involvement criteria from SFAS No. 98 and the transaction then qualified as a sale. To record the sale, the Company retired the assets and their associated accumulated depreciation and financing obligation and recorded a deferred gain to be recognized over the remaining 13 year term of the lease. The impact of the sale of the buildings recorded during 2002 was a net reduction of $68.8 million in property and equipment, a net reduction of $89.8 million in the associated financing obligation and a deferred gain of $21.0 million. As of September 30, 2002, the entire transaction has qualified as a sale. The total deferred gain recorded on the transaction in 2001 and 2002 was $25.7 million; $1.9 million will be recognized annually over the remaining term of the lease.

7. Segment Reporting

The Company has three reportable segments based on the products and services offered: managed care and corporate operations, military health services operations and workers' compensation operations. The managed care and corporate segment includes managed health care services provided through HMOs, managed indemnity plans, third-party administrative services programs for employer-funded health benefit plans, multi-specialty medical groups, other ancillary services and corporate operations. Discontinued Texas health care operations are excluded. The military health services segment administers a managed care federal contract for the Department of Defense's TRICARE program in Region 1. The workers' compensation segment assumes workers' compensation claims risk in return for premium revenues and also provides third party administrative services.

The Company evaluates each segment's performance based on segment operating profit. Information concerning reportable segments for continuing operations is as follows:

(In thousands)	**Managed Care and Corporate Operations**	**Military Health Services Operations**	**Worker Compensa Operat**
Three Months Ended September 30, 2002			
Medical Premiums.........................	$217,995		
Military Contract Revenues................		$100,366	
Specialty Product Revenues................	2,491		$ 47,5
Professional Fees.........................	7,819		
Investment and Other Revenues.............	744	624	3,7
Total Revenue.........................	$229,049	$100,990	$ 51,2
Segment Operating Profit (Loss)...........	$ 15,824	$ 4,361	$ (6
Interest Expense and Other, Net...........	(1,080)	91	(3
Income (Loss) Before Income Taxes.........	$ 14,744	$ 4,452	$ (9
Three Months Ended September 30, 2001			
Medical Premiums.........................	$184,402		
Military Contract Revenues................		$ 85,499	
Specialty Product Revenues................	1,908		$ 47,5
Professional Fees.........................	6,981		
Investment and Other Revenues.............	296	659	3,5
Total Revenue.........................	$193,587	$ 86,158	$ 51,1
Segment Operating Profit..................	$ 6,888	$ 2,597	$ 1,2
Interest Expense and Other, Net...........	(3,412)	31	(5
Income Before Income Taxes................	$ 3,476	$ 2,628	$ 7
Nine Months Ended September 30, 2002			
Medical Premiums.........................	$636,047		
Military Contract Revenues................		$279,560	
Specialty Product Revenues................	6,454		$133,9
Professional Fees.........................	23,045		
Investment and Other Revenues.............	1,813	1,709	11,2
Total Revenue.........................	$667,359	$281,269	$145,2

Segment Operating Profit..................	$ 37,758	$ 12,424	$ 1,1
Interest Expense and Other, Net...........	(5,196)	76	(1,0
Income Before Income Taxes................	$ 32,562	$ 12,500	$ 1
Nine Months Ended September 30, 2001			
Medical Premiums..........................	$522,806		
Military Contract Revenues................		$255,497	
Specialty Product Revenues................	5,813		$129,9
Professional Fees.........................	22,056		
Investment and Other Revenues.............	2,508	1,821	11,9
Total Revenue.........................	$553,183	$257,318	$141,9
Segment Operating Profit..................	$ 20,249	$ 6,986	$ 4,9
Interest Expense and Other, Net...........	(13,194)	14	(1,2
Income Before Income Taxes................	$ 7,055	$ 7,000	$ 3,7

Goodwill amortization of $201,000 and $606,000 is included as part of the managed care and corporate operations segment for the three and nine months ended September 30, 2001, respectively.

8. CII Financial Debentures

In December 2000, CII Financial, our wholly-owned workers' compensation subsidiary, commenced an offer to exchange its outstanding subordinated debentures for cash and/or new debentures. On May 7, 2001, CII Financial closed its exchange offer on $42.1 million of its outstanding subordinated debentures. CII Financial purchased $27.1 million in principal amount of subordinated debentures for $20.0 million in cash and issued $15.0 million in new 9 1/2% senior debentures, due September 15, 2004, in exchange for $15.0 million in subordinated debentures. The remaining $5.0 million in subordinated debentures were paid at maturity. Since the time of the exchange, Sierra has purchased $1.0 million in outstanding 9 1/2% senior debentures which are eliminated upon consolidation.

The transaction was accounted for as a restructuring of debt, therefore all future cash payments, including interest, related to the debentures will be reductions of the carrying amount of the debentures and no future interest expense will be recognized. Accordingly, the 9 1/2% senior debentures have a carrying amount of $16.8 million, which consists of principal amount of $14.0 million and $2.8 million in future accrued interest.

The 9 1/2% senior debentures pay interest, which is due semi-annually on March 15 and September 15, commencing on September 15, 2001. The 9 1/2% senior debentures rank senior to outstanding notes payable from CII Financial to Sierra and CII Financial's guarantee of Sierra's revolving credit facility. The 9 1/2% senior debentures may be redeemed by CII Financial at any time at premiums currently at 105% and declining to 100% for redemptions after April 1, 2004. In the event of a change in control of CII Financial (as defined), the holders of the 9 1/2% senior debentures may require that CII Financial repurchase them at the then applicable redemption price, plus accrued and unpaid interest.

9. Goodwill

On January 1, 2002, the Company adopted Statement of Financial Accounting

Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"). SFAS No. 142 requires, among other things, the discontinuance of goodwill amortization. In addition, the pronouncement includes provisions for the reclassification of certain existing recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the identification of reporting units for purposes of assessing potential future impairments of goodwill. SFAS No. 142 also required the Company to complete a transitional goodwill impairment test six months from the date of adoption and at least annually thereafter. The net amortized goodwill balance at December 31, 2001, was $14.8 million. The Company has completed its transitional goodwill test and determined that the recorded goodwill was not impaired under the guidelines of the pronouncement.

SIERRA HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the results of our operations as though the adoption of SFAS No. 142 occurred as of January 1, 2001:

	Three Months Ended Septemb	
	As Reported	Adjustments
(In thousands, except per share data)		
Net Income from Continuing Operations..................	$ 4,572	$131
Loss from Discontinued Operations......................	(12,126)	-
Net (Loss) Income..............................	$ (7,554)	$131
Earnings per Common Share:		
Net Income from Continuing Operations..................	$ .16	$.01
Loss from Discontinued Operations......................	(.43)	-
Net (Loss) Income..............................	$(.27)	$.01
Earnings per Common Share Assuming Dilution:		
Net Income from Continuing Operations..................	$ .16	-
Loss from Discontinued Operations......................	(.42)	-
Net Loss.......................................	$(.26)	-

	Nine Months Ended Septembe	
	As Reported	Adjustments
(In thousands, except per share data)		
Net Income from Continuing Operations..................	$ 11,815	$394
Loss from Discontinued Operations......................	(13,369)	-
Net (Loss) Income..............................	$ (1,554)	$394

Earnings per Common Share:		
Net Income from Continuing Operations..................	$ .43	$.01
Loss from Discontinued Operations......................	(.49)	-
Net (Loss) Income..............................	$(.06)	$.01
Earnings per Common Share Assuming Dilution:		
Net Income from Continuing Operations..................	$ .42	$.01
Loss from Discontinued Operations......................	(.47)	-
Net (Loss) Income..............................	$(.05)	$.01

10. Investments

Investments consist principally of U.S. Government and its agencies' securities and municipal bonds, as well as corporate and mortgage-backed securities. At September 30, 2002, over 85% of our portfolio is invested in U.S. Government and its agencies' securities and municipal bonds. All non-restricted investments that are designated as available-for-sale are classified as current assets. These investments are available for use in the current operations regardless of contractual maturity dates. Non-restricted investments designated as held-to-maturity are classified as current assets if expected maturity is within one year of the balance sheet date. Otherwise, they are classified as long-term investments. Realized gains and losses are calculated using the specific identification method and are included in net income. Unrealized holding gains and losses on available-for-sale securities are included as a separate component of stockholders' equity until realized.

Investments that the Company has the intention and ability to hold to maturity are stated at amortized cost and categorized as held-to-maturity. The remaining investments have been categorized as available-for-sale and are stated at their fair value. Fair value is estimated primarily from published market values as of the balance sheet date. The Company does not have any other than temporary investment impairments.

11. Recent Accounting Pronouncements

In April 2002, the FASB issued Statement of Financial Accounting Standard No. 145, "Recission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections" ("SFAS No. 145"). SFAS No. 145 requires that gains and losses from extinguishment of debt be classified as extraordinary items only if they meet the criteria in Accounting Principles Board Opinion No. 30 ("Opinion No. 30"). Applying the provisions of Opinion No. 30 will distinguish transactions that are part of an entity's recurring operations from those that are unusual and infrequent that meet the criteria for classification as an extraordinary item. SFAS No. 145 is effective for the Company beginning January 1, 2003, but the Company may adopt the provisions of SFAS No. 145 prior to this date. The Company has not yet completed is evaluation of the impact from SFAS No. 145 on its financial position and results of operations.

In June 2002, the FASB issued Statement of Financial Accounting Standard No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" ("SFAS No. 146"). SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)". SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. A fundamental conclusion reached by the FASB in this statement is that an entity's commitment to a plan, by itself, does not create a present obligation to others that meets the definition of a liability. SFAS No. 146 also establishes that fair value is the objective for initial measurement of the liability. The provisions of this statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early adoption encouraged. The Company has not completed its evaluation of the impact from SFAS No. 146 on its financial position and results of operations.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis provides information which management believes is relevant for an assessment and understanding of our consolidated financial condition and results of operations. The discussion should be read in conjunction with our audited Consolidated Financial Statements and accompanying notes for the year ended December 31, 2001, and "Management Discussion and Analysis of Financial Condition and Results of Operations" included in our 2001 annual report on Form 10-K filed with the Securities and Exchange Commission on March 29, 2002, and in conjunction with our unaudited Condensed Consolidated Financial Statements and accompanying notes for the three and nine month periods ended September 30, 2002 and 2001, included in this Form 10-Q. The information contained below is subject to risk factors. We urge you to review carefully the section "Risk Factors" in our 2001 Form 10-K for a more complete discussion of the risks associated with an investment in our securities. See "Note on Forward-Looking Statements and Risk Factors" under Item 1 of our 2001 Form 10-K.

This report contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, both as amended. All statements other than statements of historical fact are forward-looking statements for purposes of federal and state securities laws. The cautionary statements are made pursuant to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, as amended, and identify important factors that could cause our actual results to differ materially from those expressed in any projected, estimated or forward-looking statements relating to us. These forward-looking statements are identified by their use of terms and phrases such as "anticipate," "believe," "continue," "could," "estimate," "expect," "intend," "may," "plan," "project," "will" and other similar terms and phrases, including references to assumptions.

Although we believe that the expectations reflected in any of our forward-looking statements are reasonable, actual results could differ materially from those projected or assumed in any of our forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements that speak only as of the date hereof. We undertake no obligation to republish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Critical Accounting Policies and Estimates

In preparing our consolidated financial statements, we are required to make judgments, assumptions and estimates which affect certain of our revenues and expenses, their related balance sheet accounts and our disclosure of our contingent assets and liabilities. Our most significant accounting estimates are the liability for medical claims payable, reserve for losses and loss adjustment expense, or LAE, and reinsurance recoverables. Due to the inherent uncertainty in projecting these estimates, it is not only possible but probable that there will be differences between the projections and the actual results. Claims we incur in excess of our projections generally are not recovered in the current contract year. Any subsequent change in an estimate for a prior period would be reflected in the current period's operating results. For a description of our other critical accounting policies and estimates, see Item 7 of our 2001 Form 10-K and for a more extensive discussion of our accounting policies, see Note 2, Summary of Significant Accounting Policies, in the Notes to the Consolidated Financial Statements in our 2001 Form 10-K filed on March 29, 2002.

Our medical claims payable liability includes an estimate for pending claims and claims incurred but not reported to us. We use a variety of actuarial projection methods to make this estimate including historical trends and projected future trends. Our assumptions could be affected by unanticipated legal and regulatory changes or disputed contract provisions with either providers or members.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

We review the adequacy of our workers' compensation insurance reserves for losses and LAE with our independent actuary periodically. We consider external forces such as changes in the rate of inflation, the regulatory environment, state laws, changes in legal decisions that affect the administration or amount of payment on claims, medical costs and other factors that could cause actual losses and LAE to change. The actuarial projections include a range of estimates reflecting the uncertainty of projections over long periods of time and are based on the anticipated ultimate cost of losses. We evaluate the reserves in the aggregate and make adjustments where appropriate.

Reinsurance recoverable primarily represents the estimated amount of unpaid workers' compensation loss and LAE reserves that would be recovered from our reinsurers and, to a lesser extent, amounts billed to the reinsurers for their portion of paid losses and LAE and health care claims. Reinsurance receivable for ceded paid claims is recorded in accordance with the terms of the agreements and reinsurance recoverable for unpaid losses and LAE and medical claims payable is estimated in a manner consistent with the claim liability associated with the reinsurance policy. Any significant changes in the underlying claim liability could directly affect the amount of reinsurance recoverable. Reinsurance recoverable, including amounts related to paid and unpaid losses, are reported as assets rather than as a reduction of the related liabilities. Reinsurance contracts do not relieve us from our obligations to enrollees, injured workers or policyholders. If our reinsurers were to fail to honor their obligations because of insolvency or disputed contract provisions, we could incur significant losses. Prior to entering into reinsurance agreements, we evaluate the financial condition of our reinsurers to minimize our exposure to significant losses from reinsurer insolvencies.

RESULTS OF OPERATIONS, THREE MONTHS ENDED SEPTEMBER 30, 2002, COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2001.

Total Operating Revenues increased approximately 15.3% to $381.3 million from $330.9 million for 2001.

Medical Premiums from our HMO and managed indemnity insurance subsidiaries increased $33.6 million or 18.2%. The $33.6 million increase in premium revenue reflects a 4.2% increase in Medicare member months (the number of months individuals are enrolled in a plan), a 49.4% increase in Medicaid member months and a 21.9% increase in commercial member months. The growth in Medicare member months contributes significantly to the increase in premium revenues as the Medicare per member premium rates are more than three times higher than the average commercial premium rate.

HMO premium rates for renewing commercial groups increased on average 9% to 12% while the overall rate increase, including continuing business and new members, resulted in an approximate 7.8% increase. Managed indemnity rates increased approximately 17.8%. We do not anticipate a rate increase for Medicaid in 2002 or 2003. The basic Medicare rate increase received for the Las Vegas area was approximately 2%. Our overall Medicare rate increase was approximately 7.4% due primarily to the following:

- An increase in the Social HMO membership as a percentage of our total Medicare membership. The Social HMO members have a higher average rate than our other Medicare members. Over 97% of our Las Vegas, Nevada Medicare members are enrolled in the Social HMO Medicare program.
- We experienced increased risk factors in our Social HMO membership which contributes to higher rates and corresponding medical expenses.
- We received rate increases in excess of 2% for membership outside of the Las Vegas area.

The Centers for Medicare and Medicaid Services, or CMS, formerly known as the Health Care Financing Administration, or HCFA, may consider adjusting the reimbursement factor or changing the program for the Social HMO members in the future. At this time, however, the final reimbursement per member for 2004 has not been determined and there is no guaranty that the Social HMO contract will be renewed beyond 2003. It should be noted that Congress has in the past agreed to extend the contract. If the reimbursement for these members decreases significantly and related benefit changes are not made timely, there could be a materially adverse effect on our business. Continued medical premium revenue growth is principally dependent upon continued enrollment in our products and upon competitive and regulatory factors.

Military Contract Revenues increased $14.9 million or 17.4%. The increase in revenue is primarily the result of additive change order work and is significantly offset by increased military contract expenses associated with those change orders. The Congressionally approved Department of Defense, or DoD, fiscal year 2001 budget included several sweeping changes to the TRICARE program. In April 2001, Sierra Military Health Services, Inc., or SMHS, began implementation of a prescription drug program for beneficiaries over age 65. Likewise, in October 2001, SMHS implemented TRICARE for Life which is a comprehensive health care benefit to those retired military beneficiaries over age 65. Both of these program modifications resulted from Congressional changes to the program. SMHS administers the expanded benefits only to the over age 65 retiree military population. SMHS does not directly fund claims payment or bear any risk on these program modifications for the actual level of health care service utilization and does not record any claim payments or related revenue on these program modifications.

In June 2002, SMHS began the fifth year of a five year contract with the DoD. In October 2002, the DoD extended SMHS's contract. The new contract extension is renewable annually at the DoD's option for up to four additional years. However, on August 1, 2002, the DoD released a request for proposal for the procurement and subsequent award of three TRICARE managed care support contracts in place of the current seven contracts. SMHS expects to submit a bid proposal for one of the three new regions within the coming months. An announcement of the awarding of these new contracts under the TRICARE Next Generation program, or T-Nex, is not expected until the middle of 2003, with a transition period expected into mid to late 2004. If the DoD continues with its current plan to reduce the number of contracts from seven to three and we were not able to obtain one of the three new contracts, there would be a material adverse effect on our business.

SMHS incurred $1.3 million in bid proposal costs during the quarter which was partially offset by a change order adjustment. We expect to incur additional bid proposal costs in the fourth quarter and in 2003.

Specialty Product Revenues increased $610,000 or 1.2%. The revenue increase was from administrative services revenue as workers' compensation insurance revenue remained consistent between the quarters.

Workers' compensation net earned premiums are the end result of direct written premiums, plus the change in unearned premiums, plus premiums assumed from mandatory reinsurance pools, less premiums ceded to reinsurers. Direct written premiums decreased from $47.6 million in 2001 to $46.1 million in 2002 or 3.2% due primarily to a 30.4% decrease in premium production that was offset by a 37.5% increase in composite premium rates. Ceded reinsurance premiums decreased by $1.2 million due to the expiration of our low level reinsurance agreement on June 30, 2000 and a new reinsurance agreement with lower ceded premiums.

Professional Fees increased by $840,000 or 12.0% as a result of increased visits and activity at our provider subsidiaries.

Investment and Other Revenues increased $560,000 or 12.4% due primarily to an increase in the average invested balance offset by a decrease in the average investment yield during the period.

Medical Expenses increased $22.7 million or 14.5% due primarily to our increased membership. Medical expenses as a percentage of medical premiums and professional fees decreased to 79.3% from 81.7%. The decrease is primarily due to premium yields in excess of cost and utilization increases. Our medical claims payable liability requires us to make significant estimates. See the discussion of our medical claims payable liability under critical accounting policies and estimates for a further explanation.

During the third quarter of 2002, the Company entered into a new hospital contract. With this new contract, which begins October 1, 2002, the Company holds some form of contracted provider relationship with every hospital in the Las Vegas area.

Military Contract Expenses increased $13.1 million or 15.6%. The increase is consistent with the increase in revenues discussed previously and includes $1.3 million in bid proposal costs offset by a change order adjustment. Health care delivery expense consists primarily of costs to provide managed health care services to eligible beneficiaries in accordance with Sierra's TRICARE contract. Under the contract, SMHS provides health care services to approximately 662,000 dependents of active duty military personnel and military retirees under the age of 65 and their dependents through a network of approximately 50,000 health care providers and certain other subcontractor partnerships. Also included in military contract expenses are costs incurred to perform specific administrative services, such as health care appointment scheduling, enrollment, medical and network management services as well as health care advice line services, and other administrative functions of the military health care subsidiary. These administrative services are performed for active duty personnel and family members as well as retired military families.

Specialty Product Expenses increased $2.7 million or 5.4%. Expenses increased in the workers' compensation operations by $2.1 million and by $600,000 in the administrative services operations.

The increase in workers' compensation insurance segment expenses is primarily due to the following:

- In 2002, we recorded $5.5 million of net adverse loss development for prior accident years compared to net adverse loss development of $1.5 million recorded in 2001. Of the $5.5 million recorded, $1.3 million is related to our mandatory participation in assumed reinsurance pools. The remaining net adverse loss development recorded was largely attributable to higher costs per claim, or claim severity, in California. Higher claim severity has had a negative impact on the entire California workers' compensation industry in the past few periods and this trend may continue.
- The loss and LAE ratio for the 2002 accident year was lower due to significant premium increases offset partly by the termination of the low level reinsurance agreement. The lower loss and LAE ratio resulted in a decrease in expense of approximately $2.1 million. The low level reinsurance agreement terminated on June 30, 2000, which resulted in a higher risk exposure on policies effective after that date and a higher amount of net incurred loss and LAE.
- A net increase in underwriting expenses, policyholders' dividends and other operating expenses of approximately $200,000.

Since 1999, we have experienced adverse loss development on prior accident years. Loss reserves are evaluated periodically and due to the inherent uncertainty in projecting loss reserves, it is possible that we may continue to experience adverse development in the foreseeable future. Our reserve for losses and LAE requires us to make significant estimates. See the discussion of our reserves for losses and LAE under critical accounting policies and estimates for a further explanation.

The net adverse loss development on prior accident years included those years that were covered by our low level reinsurance agreement. This resulted in an increase in the reinsurance recoverable balance which is then reduced by amounts collected from reinsurers. During the quarter, we increased our ceded reserves by $7.5 million and received payments from our reinsurers totaling $23.6 million. Our net reinsurance recoverable decreased by $16.1 million in the third quarter of 2002, compared to a $2.0 million decrease in the third quarter of 2001.

In February 2002, California enacted Assembly Bill 749. This new legislation will increase benefits paid to injured workers starting January 1, 2003. Increased loss costs, such as benefit increases, are normally built into the rate making process so that premiums are increased to cover the increase in costs. On October 18, 2002, the California Insurance Commission approved an increase of 10.5% in pure premium rates for new and renewal policies effective in 2003. In addition, the Commission approved a 4.9% increase in pure premium rates to the unexpired terms of policies in force at January 1, 2003. Although we intend to increase our premiums, there is no assurance that our increase will be sufficient enough to cover the ultimate cost increases or that the WCIRB's estimate is accurate. Assembly Bill 749 is effective for claims occurring on and after January 1, 2003. However, due to other statutes, certain temporary total disability claims with dates of injury prior to 2003 will automatically increase to the new benefit levels effective January 1, 2003.

Reinsurance contracts do not relieve us from our obligations to insured workers or policyholders. At September 30, 2002, we had over $183 million in reinsurance recoverable. Prior to entering into reinsurance agreements, we evaluate the financial condition of our reinsurers to minimize our exposure to significant losses from reinsurer insolvencies. At September 30, 2002, all of our reinsurers were rated A+ or better by Fitch Ratings and the A.M. Best Company. Should these companies be unable to perform their obligations to reimburse us for ceded losses, we would experience significant losses and it could have a material adverse effect on our business.

The combined ratio is a measurement of the workers' compensation underwriting profit or loss and is the sum of the loss and LAE ratio, underwriting expense ratio and policyholders' dividend ratio. A combined ratio of less than 100% indicates an underwriting profit. Our combined ratio was 109.4% compared to 105.5% for 2001. The increase was primarily due to increased net adverse loss development for prior accident years.

General, Administrative and Marketing Expenses, or G&A, increased $3.2 million or 10.8%. The primary increases in G&A expenses were brokers fees and facility lease expense. The increase in brokers fees is primarily due to the growth in premium revenues. The increase in facility lease expense is due to the rent payments associated with the sale-leaseback transaction for our administrative buildings now being recorded as an operating expense instead of depreciation and interest expense. As a percentage of revenues, G&A expenses were 8.7% for 2002, compared to 9.1% in 2001. As a percentage of medical premium revenue, G&A expenses were 15.3% for 2002, compared to 16.3% for 2001. Our office buildings associated with the sale-leaseback transaction qualified as a sale at the end of the first quarter of 2002. This resulted in a quarterly increase in G&A expenses of approximately $1.1 million and a corresponding decrease in interest expense. See Note 6 of the Notes to Condensed Consolidated Financial Statements for a further explanation of the sale-leaseback transaction.

Interest Expense and Other, Net decreased $2.6 million or 66.3%. Interest expense related to the revolving credit facility decreased $500,000 due to a decrease in the average balance of outstanding debt during the period and a decrease in the weighted average cost of borrowing. Our average interest rate on the revolving credit facility, excluding the amortization of deferred financing fees, our interest rate swap agreement and fees on the unused portion of the credit facility was 4.4% in 2002, compared to 7.7% in 2001. We incur a fee of 0.5% on the unused portion of the revolving credit facility. In addition, we are amortizing $300,000 per quarter of deferred financing fees.

Interest expense related to the sale-leaseback transaction decreased by $1.5 million as the remaining eight buildings have qualified as a sale since the end of the third quarter of 2001. The quarterly impact of the entire sale-leaseback transaction qualifying as a sale compared to the treatment prior to qualifying for a sale is a decrease in interest expense of $2.4 million and a decrease in depreciation expense of $900,000 offset by an increase in facility rent on office buildings of $1.3 million and $1.6 million in facility rent on medical buildings. See Note 6 of the Notes to Condensed Consolidated Financial Statements for a further explanation of the sale-leaseback transaction.

In addition, we had a net gain on the sale of assets of $240,000 in 2002.

Provision for Income Taxes was recorded at $6.1 million for 2002 compared to $2.3 million for 2001. The effective tax rate for both periods was 33.5% and is expected to increase slightly in 2003. Our ongoing effective tax rate is less than the statutory rate due primarily to tax preferred investments. The State of Nevada is considering several alternatives to increase tax revenues for the state including imposing a gross receipts tax or corporate state income tax that may begin in 2003. It is not anticipated that our results of operations would be significantly impacted by this tax.

Discontinued Operations consist entirely of our Texas HMO health care operations. We elected to adopt early Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", or SFAS No. 144, effective January 1, 2001. In the third quarter of 2001, we decided to exit the Texas HMO health care market and received approval from the Texas Department of Insurance in mid-October 2001. We ceased providing HMO health care coverage on April 17, 2002. In accordance with SFAS No. 144, our Texas HMO health care operations are now reclassified as a discontinued operation. Net income from discontinued operations in the third quarter of 2002 was $1.9 million compared to a loss of $12.1 million for the third quarter of 2001. The utilization of prior premium deficiency reserves were $124,000 in 2002 and $7.1 million in 2001. The net income from discontinued operations in 2002 of $1.9 million was the result of a gain on a debt payment to Kaiser-Texas of $628,000, net of tax, and the reduction of our medical claims payable reserve, which resulted in a gain of $1.3 million, net of tax. See Note 3 of the Notes to Condensed Consolidated Financial Statements.

RESULTS OF OPERATIONS, NINE MONTHS ENDED SEPTEMBER 30, 2002, COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2001.

Total Operating Revenues, increased approximately 14.9% to $1.09 billion from $952.4 million for 2001.

Medical Premiums from our HMO and managed indemnity insurance subsidiaries increased $113.2 million or 21.7%. The $113.2 million increase in premium revenue reflects a 5.1% increase in Medicare member months (the number of months individuals are enrolled in a plan), a 60.5% increase in Medicaid member months and a 27.1% increase in commercial member months. The growth in Medicare member months contributes significantly to the increase in premium revenues as the Medicare per member premium rates are more than three times higher than the average commercial premium rate.

HMO premium rates for renewing commercial groups increased on average 9% to 12% while the overall rate increase, including continuing business and new members, resulted in an approximate 7.5% increase. Managed indemnity rates increased approximately 13.6%. We do not anticipate a rate increase for Medicaid in 2002 or 2003. The basic Medicare rate increase received for the Las Vegas area was approximately 2%. Our overall Medicare rate increase was approximately 6.7% due primarily to the following:

- An increase in the Social HMO membership as a percentage of our total Medicare membership. The Social HMO members have a higher average rate than our other Medicare members. Over 97% of our Las Vegas, Nevada Medicare members are enrolled in the Social HMO Medicare program.
- We experienced increased risk factors in our Social HMO membership which contributes to higher rates and corresponding medical expenses.
- We received rate increases in excess of 2% for membership outside of the Las Vegas area.

The Centers for Medicare and Medicaid Services, or CMS, formerly known as the Health Care Financing Administration, or HCFA, may consider adjusting the reimbursement factor or changing the program for the Social HMO members in the future. At this time, however, the final reimbursement per member for 2004 has not been determined and there is no guaranty that the Social HMO contract will be renewed beyond 2003. It should be noted that Congress has in the past agreed to extend the contract. If the reimbursement for these members decreases significantly and related benefit changes are not made timely, there could be a materially adverse effect on our business. Continued medical premium revenue growth is principally dependent upon continued enrollment in our products and upon competitive and regulatory factors.

Military Contract Revenues increased $24.1 million or 9.4%. The increase in revenue is primarily the result of additive change order work and is significantly offset by increased military contract expenses associated with those change orders. The Congressionally approved Department of Defense, or DoD, fiscal year 2001 budget included several sweeping changes to the TRICARE program. In April 2001, SMHS began implementation of a prescription drug program for beneficiaries over age 65. Likewise, in October 2001, SMHS implemented TRICARE for Life which is a comprehensive health care benefit to those retired military beneficiaries over age 65. Both of these modifications resulted from Congressional changes to the program. SMHS administers the expanded benefits only to the over age 65 retiree military population. SMHS does not directly fund claims payment or bear any risk on these program modifications for the actual level of health care service utilization and does not record any claim payments or related revenue on these program modifications.

Specialty Product Revenues increased $4.7 million or 3.4%. The revenue increase was from the workers' compensation insurance segment as administrative services revenue remained consistent between the periods.

Workers' compensation net earned premiums are the end result of direct written premiums, plus the change in unearned premiums, plus premiums assumed from mandatory reinsurance pools, less premiums ceded to reinsurers. Direct written premiums decreased from $143.0 million in 2001 to $132.4 million in 2002 or 7.4% due primarily to a 26.7% decrease in premium production that was partially offset by a 26.3% increase in composite premium rates. Ceded reinsurance premiums decreased by 107.9% due to the expiration of our low level reinsurance agreement on June 30, 2000, and a new reinsurance agreement with lower ceded premiums. In addition, during the second quarter of 2002, we recorded an adjustment of our estimate of historical ceded premiums related to the low level agreement which further reduced our ceded reinsurance by $2.0 million.

Professional Fees increased $1.0 million or 4.5% as a result of increased visits and activity at our provider subsidiaries.

Investment and Other Revenues decreased $1.5 million or 9.2% due primarily to a decrease in the average investment yield during the period offset by an increase in the average invested balance.

Medical Expenses increased $86.8 million or 19.6% due primarily to our increased membership. Medical expenses as a percentage of medical premiums and professional fees decreased to 80.5% from 81.4%. The decrease is primarily due to premium yields in excess of cost and utilization increases which were partially offset by higher bed days in 2002. Our medical claims payable liability requires us to make significant estimates. See the discussion of our medical claims payable liability under critical accounting policies and estimates for a further explanation.

During the third quarter of 2002, the Company entered into a new hospital contract. With this new contract, which begins October 1, 2002, the Company holds some form of contracted provider relationship with every hospital in the Las Vegas area.

Military Contract Expenses increased $18.5 million or 7.4%. The increase is consistent with the increase in revenues discussed previously. Health care delivery expense consists primarily of costs to provide managed health care services to eligible beneficiaries in accordance with Sierra's TRICARE contract. Under the contract, SMHS provides health care services to approximately 662,000 dependents of active duty military personnel and military retirees under the age of 65 and their dependents through a network of approximately 50,000 health care providers and certain other subcontractor partnerships. Also included in military contract expenses are costs incurred to perform specific administrative services, such as health care appointment scheduling, enrollment, medical and network management services as well as health care advice line services, and other administrative functions of the military health care subsidiary. These administrative services are performed for active duty personnel and family members as well as retired military families.

Specialty Product Expenses increased $7.7 million or 5.5%. Expenses increased in the workers' compensation operations by approximately $7.2 million and by $500,000 in administrative services operations.

The increase in workers' compensation insurance segment expenses is primarily due to the following:

- Approximately $3.0 million in additional loss and LAE related to the increase in net earned premiums in 2002 compared to 2001.
- In 2002, we recorded $10.8 million of net adverse loss development for prior accident years compared to net adverse loss development of $7.3 million recorded in 2001. Of the $10.8 million recorded, $1.3 million is related to our mandatory participation in assumed reinsurance pools. The net adverse loss development recorded was largely attributable to higher costs per claim, or claim severity, in California. Higher claim severity has had a negative impact on the entire California workers' compensation industry in the past few periods and this trend may continue.
- The loss and LAE ratio for the 2002 accident year was lower by 1.6% due to significant premium increases offset by the termination of the low level reinsurance agreement. The lower loss and LAE ratio resulted in a decrease in expense of approximately $2.1 million. The low level reinsurance agreement terminated on June 30, 2000, which resulted in a higher risk exposure on policies effective after that date and a higher amount of net incurred loss and LAE.
- A net increase in underwriting expenses, policyholders' dividends and other operating expenses of $2.8 million related primarily to the increase in net earned premiums.

Since 1999, we have experienced adverse loss development on prior accident years. Loss reserves are evaluated periodically and due to the inherent uncertainty in projecting loss reserves, it is possible that we may continue to experience adverse development in the foreseeable future. Our reserve for losses and LAE requires us to make significant estimates. See the discussion of our reserves for losses and LAE under critical accounting policies and estimates for a further explanation.

The net adverse loss development on prior accident years included those years that were covered by our low level reinsurance agreement. This resulted in an increase in the reinsurance recoverable balance which is then reduced by amounts collected from reinsurers. During the nine months ended September 30, 2002, we increased our ceded reserves by $28.2 million and received payments from our reinsurers totaling $62.3 million. Our net reinsurance recoverable decreased by $34.1 million for the nine months ended September 30, 2002, compared to an $8.6 million decrease for the nine months ended September 30, 2001.

The combined ratio is a measurement of the workers' compensation underwriting profit or loss and is the sum of the loss and LAE ratio, underwriting expense ratio and policyholders' dividend ratio. A combined ratio of less than 100% indicates an underwriting profit. Our combined ratio was 107.9% compared to 106.0% for 2001. The increase was primarily due to increased net adverse loss development for prior accident years. Excluding adverse loss development, the combined ratio would have been 99.8% for 2002 and 100.3% for 2001.

General, Administrative and Marketing Expenses, or G&A, increased approximately $9.4 million or 10.8%. The primary increases in G&A expenses were payroll and benefits, brokers fees, which were primarily due to increased premium revenues, and facility lease expense. The increase in facility lease expense is due to the rent payments associated with the sale-leaseback transaction for our administrative buildings now being recorded as an operating expense instead of depreciation and interest expense. Our office buildings associated with the sale-leaseback transaction qualified as a sale at the end of the first quarter of 2002. This resulted in a quarterly increase in G&A expenses of approximately $1.1 million and a corresponding decrease in interest expense. See Note 6 of the Notes to Condensed Consolidated Financial Statements for a further explanation of the sale-leaseback transaction. As a percentage of revenues, G&A expenses were 8.8% for 2002, compared to 9.1% in 2001. As a percentage of medical premium revenue, G&A expenses were 15.1% for 2002, compared to 16.6% for 2001.

Interest Expense and Other, Net decreased $8.3 million or 57.5%. Interest expense related to the revolving credit facility decreased $2.6 million due to a decrease in the average balance of outstanding debt during the period and a decrease in the weighted average cost of borrowing. Our average interest rate on the revolving credit facility, excluding the amortization of deferred financing fees, our interest rate swap agreement and fees on the unused portion of the credit facility was 6.0% in 2002, compared to 8.8% in 2001. We incur a fee of 0.5% on the unused portion of the revolving credit facility. In addition, we are amortizing $300,000 per quarter of deferred financing fees.

Interest expense related to the sale-leaseback transaction decreased by $3.1 million as the remaining eight buildings have qualified as a sale since the end of the third quarter of 2001. See Note 6 of the Notes to Condensed Consolidated Financial Statements for a further explanation of the sale-leaseback transaction.

CII Financial debenture interest decreased by $1.2 million in 2002, as a result of the restructuring of the debentures, which occurred during the second quarter of 2001 when we recorded a net gain of $700,000 on the transaction.

We had a net gain on sale of assets of $100,000 in 2002, compared to a loss of $2.4 million in 2001. In addition, we had various other increases in interest and other expense totaling $400,000.

Provision for Income Taxes was recorded at $15.1 million for 2002, compared to $5.9 million for 2001. The effective tax rate for both periods was 33.5%. Our ongoing effective tax rate is less than the statutory rate due primarily to tax preferred investments. The State of Nevada is considering imposing a gross receipts tax or corporate state income tax that may begin in 2003. It is not anticipated that our results of operations would be significantly impacted by this tax.

Discontinued Operationss consist entirely of our Texas HMO health care operations. Net income from discontinued operations in 2002 was $1.9 million compared to a loss of $13.4 million in 2001. The utilization of prior premium deficiency reserves were $1.7 million in 2002, and $15.6 million in 2001. The net income from discontinued operations in 2002 was the result of a gain on a debt payment to Kaiser-Texas of $628,000, net of tax, and the reduction of our medical claims payable reserve, which resulted in a gain of $1.3 million, net of tax. See Note 3 of the Notes to Condensed Consolidated Financial Statements.

LIQUIDITY AND CAPITAL RESOURCES

For continuing operations, we had cash in-flows from operating activities of $139.9 million in 2002, compared to $89.0 million in 2001. After adjusting for the timing of our Medicare payment received October 1, 2002, cash in-flows for 2002 would have been $168.6 million. The improvement over 2001 is primarily attributable to increased cash from earnings, reinsurance recoveries, an income tax refund and an increase in medical premiums.

SMHS receives monthly cash payments equivalent to one-twelfth of its annual contractual price with the DoD. SMHS accrues health care revenue on a monthly basis for any monies owed above its monthly cash receipt based on the number of at-risk eligible beneficiaries and the level of military direct care system utilization. The contractual bid price adjustment, or BPA, process serves to adjust the DoD's monthly payments to SMHS, because the payments are based in part on 1996 DoD estimates for beneficiary population and beneficiary population baseline health care cost, inflation and military direct care system utilization. As actual information becomes available for the above items, quarterly adjustments are made to SMHS' monthly health care payment in addition to lump sum adjustments for past months. In addition, SMHS accrues change order revenue for DoD directed contract changes. Our business and cash flows could be adversely affected if the timing or amount of the BPA and change order reimbursements vary significantly from our expectations.

To further enhance SMHS' funding resources, on November 16, 2001, SMHS entered into a securitization arrangement with General Electric Capital Corporation. The arrangement provides for the sale of SMHS' Federal Government accounts receivable to SMHS Funding, LLC. SMHS Funding is a special purpose limited liability company owned by SMHS and was formed for the purpose of purchasing all receivables of SMHS. This entity is fully consolidated into SMHS. SMHS Funding, LLC may sell an undivided interest in certain of the receivables to a subsidiary of General Electric Capital Corporation in the event that additional financing by SMHS is warranted. This securitization arrangement has not yet been utilized and we do not anticipate utilizing it in 2002.

For continuing operations, cash used in investing activities during 2002 was $115.9 million, compared to $3.3 million in 2001. The 2002 amount included $5.6 million in net capital expenditures compared to $2.5 million in 2001. The net change in investments for the period was an increase in investments of $110.3 million for 2002 and $840,000 for 2001 as investments were purchased with cash from operations.

For continuing operations, cash used in financing activities during 2002 was $15.6 million, compared to $69.2 million in 2001. The 2002 amount included net payments of $39.0 million on the revolving credit facility, compared to net payments of $41.0 million in 2001. Additional payments of $3.6 million and $6.0 million were made on other outstanding debt and capital leases for 2002 and 2001, respectively. Proceeds from the sale-leaseback notes were $16.9 million and $2.9 million for 2002 and 2001, respectively. Additionally, $27.3 million was used in 2001 for the purchase of CII Financial's 7 1/2% convertible subordinated debentures. In 2001, we have purchased $1.0 million in outstanding CII Financial 9 1/2% senior debentures. Proceeds from the issuance of stock in connection with stock plans were $10.2 million in 2002, compared to $2.2 million in 2001.

Discontinued Texas HMO health care operations used cash of $30.5 million in 2002, compared to $26.4 million in 2001. The cash used in 2002 was primarily for the run out of claims offset in part by premiums collected. Based on the current estimated Texas HMO healthcare run-out costs and recorded reserves, we believe we have adequate funds available and the ability to invest, should we be required to do so, adequate funds in Texas to meet the anticipated obligations for our members' claims.

Revolving Credit Facility

Our revolving credit facility balance decreased from $89 million to $50 million during the nine month period ended September 30, 2002. The balance is reflected as current since the credit facility matures on September 30, 2003. The availability under the credit facility has been reduced to $101 million at September 30, 2002, leaving $51 million available under the credit facility. The total availability, however, will be reduced by $6.0 million on December 31, 2002 and by $10.0 million on June 30, 2003. Interest under the revolving credit facility is variable and is based on Bank of America's "prime rate" adjusted by a margin. The rate as of September 30, 2002, is 4.375%, which is a combination of the prime rate of 4.75%, less a credit of .375%. We received .5% drop in the prime rate as of November 7, 2002, which makes our new rate 3.875%. The margin can fluctuate based on our completing certain transactions or if we fail to exceed certain financial ratios. The margin was reduced by 1.0% on April 1, 2002, since we exceeded certain ratio requirements as of December 31, 2001. Of the outstanding balance, $25 million is covered by an interest-rate swap agreement. In accordance with Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities", or SFAS No. 133, we increased our recorded liability of the interest-rate swap agreement during 2002 by $115,000.

Debentures

In December 2000, CII Financial commenced an offer to exchange its outstanding subordinated debentures for cash and/or new debentures. On May 7, 2001, CII Financial closed its exchange offer on $42.1 million of its outstanding subordinated debentures. CII Financial purchased $27.1 million in principal amount of subordinated debentures for $20.0 million in cash and issued $15.0 million in new 9 1/2% senior debentures, due September 15, 2004, in exchange for $15.0 million in subordinated debentures. The remaining $5.0 million in subordinated debentures were paid at maturity. Since the time of the exchange, Sierra has purchased $1.0 million in outstanding 9 1/2% senior debentures which are eliminated upon consolidation.

The transaction was accounted for as a restructuring of debt; therefore, all future cash payments, including interest, related to the debentures will be reductions of the carrying amount of the debentures and no future interest expense will be recognized. Accordingly, the 9 1/2% senior debentures have a carrying amount of $16.8 million, which consists of principal amount of $14.0 million and $2.8 million in future accrued interest.

The 9 1/2% senior debentures pay interest, which is due semi-annually on March 15 and September 15 of each year, commencing on September 15, 2001. The 9 1/2% senior debentures rank senior to outstanding notes payable from CII Financial to Sierra and CII Financial's guarantee of Sierra's revolving credit facility. The 9 1/2% senior debentures may be redeemed by CII Financial at any time at premiums currently at 105% and declining to 100% for redemptions after April 1, 2004. In the event of a change in control of CII Financial, the holders of the 9 1/2% senior debentures may require that CII Financial repurchase them at the then applicable redemption price, plus accrued and unpaid interest.

CII Financial is a holding company and its only significant asset is its investment in California Indemnity. Of the $27.3 million in cash and cash equivalents held at September 30, 2002, approximately $26.7 million was designated for use only by the regulated insurance companies. CII Financial has limited sources of cash and is dependent upon dividends paid by California Indemnity. California Indemnity may pay a dividend, without the prior approval of the state insurance commissioner, only to the extent the cumulative amount of dividends or distributions paid or proposed to be paid in any year does not exceed the amount shown as unassigned funds (reduced by any unrealized gains or losses included in any such amount) on its statutory statement as of the previous December 31. In 2002, California Indemnity can pay dividends of up to $2.1 million without the prior approval of the state insurance commissioner. In 2002, California Indemnity paid a dividend of $750,000 and in 2001, California Indemnity received prior approval to pay an aggregate of $10.0 million in dividends. We are not in a position to assess the likelihood of obtaining future approval for the payment of dividends other than those specifically allowed by law without prior approval in each of our subsidiaries' state of domicile.

Statutory Capital and Deposit Requirements

Our HMO and insurance subsidiaries are required by state regulatory agencies to maintain certain deposits and must also meet certain net worth and reserve requirements. The HMO and insurance subsidiaries had restricted assets on deposit in various states totaling $33.3 million at September 30, 2002. The HMO and insurance subsidiaries must also meet requirements to maintain minimum stockholders' equity, on a statutory basis, as well as minimum risk-based capital requirements, which are determined annually. Additionally, in conjunction with the exit from the Texas HMO health care market, the Texas Department of Insurance approved a plan of withdrawal and TXHC is now required to maintain deposits and net worth of at least $3.5 million. We believe we are in compliance with our regulatory requirements. We are limited by our credit facility in the amount of funds we can invest in our Texas operations.

Of the $93.8 million in cash and cash equivalents held at September 30, 2002, $48.8 million was designated for use only by the regulated subsidiaries. Amounts are available for transfer to the holding company from the HMO and insurance subsidiaries only to the extent that they can be remitted in accordance with the terms of existing management agreements and by dividends. The holding company will not receive dividends from its regulated subsidiaries if such dividend payment would cause violation of statutory net worth and reserve requirements.

In California, workers' compensation insurers are required to place qualified securities on deposit with the state to cover potential workers' compensation claims. The amount of the deposit is calculated annually and is largely based on the amount of workers' compensation insurance premiums earned during the preceding three years. A credit for ceded reinsurance to companies authorized as reinsurers by the California Department of Insurance can reduce the amount of deposit that a workers' compensation insurer must place. However, any reduction in the deposit for ceded reinsurance must then be made up by the reinsurer so that 100% of the deposit requirements are met. Failure of the reinsurer to make the required deposit can result in a disallowance of the ceded reinsurance credit by the ceding insurance company. The ceding insurance company will then either have to place the required deposit or show the ceded reinsurance as unauthorized reinsurance, which in turn reduces its total statutory surplus.

Sierra's workers' compensation insurance companies were notified by the California Department of Insurance in August of 2002, that some of its reinsurers had failed to make the required deposit. We have notified our reinsurers of this and they are in the process of making the required deposit. If the reinsurers were to fail to make the required deposit, this could have a material adverse effect on our workers' compensation insurance subsidiaries' ability to write business.

Obligations and Commitments

The following schedule represents our obligations and commitments for long-term debt, capital leases and operating leases at September 30, 2002. With the exception of our revolving credit facility, the amounts below represent the entire payment, principal and interest, on our outstanding obligations.

	Long-Term Debt	Capital Leases	Operatin Leases
(In thousands)			
Continuing Operations			
Payments due within 12 months..................	$51,541	$121	$ 17,808
Payments due in 13 to 36 months................	15,414	130	33,432
Payments due in 37 to 60 months................	71	61	32,209
Payments due in more than 60 months............	521	187	123,648
Total Continuing Operations...............	$67,547	$499	$207,097

Discontinued Operations		
Payments due within 12 months..................	$ 1,899	$235
Payments due in 13 to 36 months................	5,065	
Payments due in 37 to 60 months................	17,674	
Payments due in more than 60 months............		
Total Discontinued Operations.............	$24,638	$235

The amount included in long-term debt payments for discontinued operations is for a mortgage loan secured by certain underlying real estate assets of the discontinued operations. We are actively seeking a buyer for the real estate assets and anticipate selling them within the next 12 months. As the real estate assets are sold, we are required to make reductions on the mortgage note and completely satisfy the obligation once all of the assets have been sold.

Recent Accounting Pronouncements

In April 2002, the FASB issued Statement of Financial Accounting Standard No. 145, "Recission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections", or SFAS No. 145. SFAS No. 145 requires that gains and losses from extinguishment of debt be classified as extraordinary items only if they meet the criteria in Accounting Principles Board Opinion No. 30 ("Opinion No. 30"). Applying the provisions of Opinion No. 30 will distinguish transactions that are part of an entity's recurring operations from those that are unusual and infrequent that meet the criteria for classification as an extraordinary item. SFAS No. 145 is effective for us beginning January 1, 2003, but we may adopt the provisions of SFAS No. 145 prior to this date. We have not yet completed our evaluation of the impact from SFAS No. 145 on our financial position and results of operations.

In June 2002, the FASB issued Statement of Financial Accounting Standard No. 146, "Accounting for Costs Associated with Exit or Disposal Activities", or SFAS No. 146. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)". SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. A fundamental conclusion reached by the FASB in this statement is that an entity's commitment to a plan, by itself, does not create a present obligation to others that meets the definition of a liability. SFAS No. 146 also establishes that fair value is the objective for initial measurement of the liability. The provisions of this statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early adoption encouraged. We have not yet completed our evaluation of the impact from SFAS No. 146 on our financial position and results of operations.

Other

Under our current revolving credit facility, which expires September 30, 2003, we are limited to $20.2 million in capital expenditures for 2003. Our planned expenditures include a new provider clinic, digital radiology equipment, upgrades to our disaster recovery systems, various computer hardware and software, furniture and equipment and other normal capital requirements. Our liquidity needs over the next 12 months will primarily be for the capital items noted above, debt service and funds required to exit the Texas HMO health care market. We believe that our existing working capital, operating cash flow and, if necessary, equipment leasing, divestitures of certain non-core assets and amounts available under our credit facility and securitization arrangement should be sufficient to fund our capital expenditures and debt service.

Additionally, subject to unanticipated cash requirements, we believe that our existing working capital and operating cash flow should enable us to meet our liquidity needs on a long-term basis.

In the second quarter of 1997, our Board of Directors authorized a $3.0 million loan from us to our Chief Executive Officer, or CEO. In April 2000, our Board of Directors authorized an additional $2.5 million loan from us to the CEO. In the second quarter of 2001, our Board of Directors approved a loan amendment which extended the maturity of the principal balance along with accrued interest to December 31, 2003. During 2001, the CEO made payments of $898,000. No additional payments have been made during 2002 and as of September 30, 2002 the aggregate principal balance outstanding and accrued interest for both instruments was $5.2 million. All amounts borrowed bear interest at a rate equal to our current rate on our revolving credit facility plus 10 basis points. The amounts outstanding are collateralized by certain of the CEO's assets and rights to compensation from us. The loan is pledged as collateral under our revolving credit facility.

We have a $25 million interest-rate swap agreement, which expires on September 29, 2003, that allows us to mitigate the risk of interest rate fluctuation on our credit facility. The intent of the agreement was to keep our interest rate on $25 million of the credit facility relatively fixed. In accordance with SFAS No. 133, we recorded the interest-rate swap agreement to fair market value as of September 30, 2002. The fair market value indicated that we would need to pay $800,000 to terminate the swap agreement compared to an indicated fair market value of $685,000 at December 31, 2001. If the prime rate were to decrease by 1%, we estimate our maximum increase in annual expense associated with the swap to be approximately $250,000.

Membership

	Number of Members at S 2002
Continuing Operations:	
HMO	
Commercial	185,800
Medicare	47,100
Medicaid	34,900
Managed Indemnity	26,700
Medicare Supplement	19,900
Administrative Services (1)	219,600
TRICARE Eligibles	662,300
Total Members, Continuing Operations	1,196,300
Discontinued Texas Operations:	
HMO	
Commercial	-
Medicare (2)	-
Total Members, Discontinued Operations	-

(1) Restated to exclude the workers' compensation ASO membership which was 93,000 at September 30, 2001.

(2) The 2001 Medicare membership does not include 5,400 Houston members that the Company ceded to AmCare Health Plans of Texas, Inc., under a reinsurance agreement on December 1, 2000.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As of September 30, 2002, we had unrealized holding gains on available for sale investments of $2.0 million compared to unrealized holding losses of $5.6 million at December 31, 2001. This fluctuation is due primarily to a decrease in the yield on Government obligations and a decrease in mortgage rates. We believe that changes in market interest rates, resulting in unrealized holding gains or losses, should not have a material impact on future earnings or cash flows, as it is unlikely that we would need or choose to substantially liquidate our investment portfolio.

ITEM 4. CONTROLS AND PROCEDURES

Based on the evaluation by the Chief Executive Officer and Chief Financial Officer of the Company as of a date within 90 days of the filing date of this quarterly report, those officers believe that the Company's disclosure controls and procedures are reasonably effective to ensure that the information required to be included in this report has been recorded, processed, summarized and reported on a timely basis. There have not been any significant changes in the Company's internal controls or in other factors that could significantly affect these controls and there have been no corrective actions taken with regard to significant deficiencies and material weaknesses subsequent to the date of such officers' evaluation.

SIERRA HEALTH SERVICES, INC. AND SUBSIDIARIES

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are subject to various claims and other litigation in the ordinary course of business. Such litigation includes, for example, claims of medical malpractice, claims for coverage or payment for medical services rendered to HMO members and claims by providers for payment for medical services rendered to HMO and other members. Some litigation may also include claims for punitive damages that are not covered by insurance. Also included in such litigation are claims for workers' compensation and claims by providers for payment for medical services rendered to injured workers. These actions are in various stages of litigation and some may ultimately be brought to trial. With respect to certain pending actions, the Company maintains commercial insurance coverage with varying deductibles for which the Company maintains reserves for its self-insured portion based upon its current assessment of such litigation. Due to recent unfavorable changes in the commercial insurance market, the Company has, for certain risks, purchased coverage with higher deductibles and lower limits of coverage. In the opinion of management, based on information presently available, the ultimate resolution of these pending legal proceedings should not have a material adverse effect on our financial condition.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

(99.1) Certification pursuant to 18 U.S.C. as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of Principal Executive Officer dated November 14, 2002.

(99.2) Certification pursuant to 18 U.S.C. as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of Principal Financial Officer dated November 14, 2002.

(b) Reports on Form 8-K

Current Report on Form 8-K, dated August 14, 2002, with the Securities and Exchange Commission in connection with the Company's Principal Executive Officer and Principal Financial Officer submitting sworn statements pursuant to the Securities and Exchange Commission Order No. 4-460.

Current Report on Form 8-K, dated September 5, 2002, with the Securities and Exchange Commission in connection with the announcement of the Company's participation in a health care conference on September 18, 2002.

SIGNATURES

Pursuant to the requirements 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.

SIERRA HEALTH SERVICES, INC.

(Registrant)

Date: November 14, 2002

/s/ Paul H. Palmer

Paul H. Palmer
Senior Vice President of Finance,
Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)

CERTIFICATION

I, Anthony M. Marlon, M.D., Chief Executive Officer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Sierra Health Services, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b. any fraud, whether or not material, that involves management or other employees who have significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including my corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 14, 2002

/s/ Anthony M. Marlon

Anthony M. Marlon
Chief Executive Officer

CERTIFICATION

I, Paul H. Palmer, Chief Financial Officer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Sierra Health Services, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b. any fraud, whether or not material, that involves management or other employees who have significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including my corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 14, 2002

/s/ Paul H. Palmer

Paul H. Palmer
Chief Financial Officer