SIERRA HEALTH SERVICES INC
Form 10-Q
July 28, 2004

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 June 30, 2004

OR

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

For the transition period from ________to _________

Commission file 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 Number)

2724 North Tenaya Way
Las Vegas, Nevada 89128

(Address of principal executive offices including zip code)

(702) 242-7000

(Registrant's telephone number, including area code)

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

x No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes x No

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As of July 26, 2004, there were 26,794,000 shares of common stock outstanding.

SIERRA HEALTH SERVICES, INC.
Quarterly Report on Form 10-Q
For the period ended June 30, 2004

PART I. FINANCIAL INFORMATION **Page No.**

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)

	June 30, 2004	December 31, 2003
ASSETS		
CURRENT ASSETS:		
Cash and Cash Equivalents	$ 177,310	$ 118,473
Investments	139,757	197,573
Accounts Receivable (Less Allowance for Doubtful Accounts; 2004 - $6,421; 2003 - $7,342)	18,091	12,080
Military Accounts Receivable (Less Allowance for Doubtful Accounts; 2004 and 2003 - $100)	37,460	47,389
Current Portion of Deferred Tax Asset	26,698	33,708
Prepaid Expenses and Other Current Assets	47,454	37,478
Assets of Discontinued Operations	2,605	533,756
Total Current Assets	449,375	980,457

PROPERTY AND EQUIPMENT, NET	64,422	63,109
RESTRICTED CASH AND INVESTMENTS	19,543	17,646
GOODWILL	14,782	14,782
DEFERRED TAX ASSET (Less Current Portion)	12,393	11,501
NOTE RECEIVABLE	62,000	--
OTHER ASSETS	59,337	46,626
TOTAL ASSETS	$ 681,852	$ 1,134,121
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accrued Liabilities	$ 82,416	$ 56,327
Trade Accounts Payable	20,221	37,787
Accrued Payroll and Taxes	29,758	15,879
Medical Claims Payable	113,101	103,749
Unearned Premium Revenue	20,202	45,888
Military Health Care Payable	65,366	76,605
Current Portion of Long-Term Debt	43	163
Liabilities of Discontinued Operations	733	472,407
Total Current Liabilities	331,840	808,805
LONG-TERM DEBT (Less Current Portion)	115,288	116,645
OTHER LIABILITIES	67,560	57,907
TOTAL LIABILITIES	514,688	983,357
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Preferred Stock, $.01 Par Value, 1,000 Shares Authorized; None Issued or Outstanding		
Common Stock, $.005 Par Value, 60,000 Shares Authorized; 2004 - 34,757; 2003 - 33,173 Shares Issued	174	166
Treasury Stock: 2004 - 8,064; 2003 - 6,221 Common Stock Shares	(187,877)	(112,737)
Additional Paid-in Capital	265,081	227,417
Deferred Compensation	(4,319)	(22)
Accumulated Other Comprehensive Loss	(831)	(479)
Retained Earnings	94,936	36,419
TOTAL STOCKHOLDERS' EQUITY	167,164	150,764
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 681,852	$ 1,134,121

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 June 30,		Six Months Ende
	2004	2003	2004
OPERATING REVENUES:			
Medical Premiums	$ 280,661	$ 239,142	$ 546,099
Military Contract Revenues	140,705	115,431	268,329
Professional Fees	8,085	9,715	17,563
Investment and Other Revenues	11,788	5,917	17,438
Total	441,239	370,205	849,429
OPERATING EXPENSES:			
Medical Expenses	218,421	189,775	426,486
Military Contract Expenses	116,420	113,347	237,217
General and Administrative Expenses	45,231	33,787	82,399
Total	380,072	336,909	746,102
OPERATING INCOME FROM CONTINUING OPERATIONS	61,167	33,296	103,327
Interest Expense	(1,175)	(1,530)	(2,340)
Other Income (Expense), Net	41	(332)	163
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	60,033	31,434	101,150
PROVISION FOR INCOME TAXES	(21,812)	(10,924)	(36,614)
INCOME FROM CONTINUING OPERATIONS	38,221	20,510	64,536
LOSS FROM DISCONTINUED OPERATIONS (net of income tax benefit of $0, $987, $761, and $1,322), respectively	--	(245)	(486)
NET INCOME	$ 38,221	$ 20,265	$ 64,050
EARNINGS PER COMMON SHARE:			
Income from Continuing Operations	$ 1.43	$ 0.75	$ 2.40
Loss from Discontinued Operations	--	(0.01)	(0.02)
Net Income	$ 1.43	$ 0.74	$ 2.38
EARNINGS PER COMMON SHARE ASSUMING DILUTION:			
Income from Continuing Operations	$ 1.10	$ 0.68	$ 1.85
Loss from Discontinued Operations	--	(0.01)	(0.01)
Net Income	$ 1.10	$ 0.67	$ 1.84

See accompanying notes to condensed consolidated financial statements.

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

Six Months Ended June 30,

	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Income	$ 64,050	$ 35,287
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Loss from Discontinued Operations	486	651
Depreciation	8,274	7,715
Deferred Compensation Expense	951	293
Provision for Doubtful Accounts	750	1,201
(Gain) Loss on Disposal of Assets	(13)	789
Changes in Assets and Liabilities:		
Other Assets	(2,027)	(5,335
Deferred Tax Asset	23,948	12,156
Other Liabilities	(11,562)	7,902
Other Current Assets	(441)	(10,872
Military Accounts Receivable	9,929	(28,639
Military Health Care Payable	(11,239)	9,053
Medical Claims Payable	9,352	5,912
Accrued Payroll and Taxes	13,879	10,044
Unearned Premium Revenue	(25,686)	(27,876
Net Cash Provided by Operating Activities of Continuing Operations	80,651	18,281
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital Expenditures, Net of Dispositions	(7,892)	(9,586
Change in Investments	50,057	34,687
Net Cash Provided by Investing Activities of Continuing Operations	42,165	25,101
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments on Debt and Capital Leases	(1,524)	(60,460
Purchase of Treasury Stock	(82,759)	(34,267
Exercise of Stock in Connection with Stock Plans	16,920	4,294
Proceeds from Senior Convertible Debentures	--	115,000
Debt Issue Costs	--	(5,137
Net Cash (Used for) Provided by Financing Activities of Continuing Operations	(67,363)	19,430
NET CASH PROVIDED BY (USED FOR) DISCONTINUED OPERATIONS	3,384	(29,785
NET INCREASE IN CASH AND CASH EQUIVALENTS	58,837	33,027
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	118,473	45,778
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 177,310	$ 78,805

Supplemental Condensed Consolidated Continuing Operations Statements of Cash Flows Information:	2004	2003
Cash Paid During the Period for Interest (Net of Amount Capitalized)	$ (1,463)	$ (1,125
Net Cash Paid During the Period for Income Taxes	(1,569)	(10,378
Non-Cash Investing and Financing Activities:		
Assets and Liabilities Recorded in Conjunction with the Sale of the Workers' Compensation Operations	54,060	--
Additions to Capital Leases	47	--

See accompanying notes to condensed consolidated financial statements.

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SIERRA HEALTH SERVICES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated 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 and the Company's annual audited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America; however, these statements 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 year ended December 31, 2003. 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 differ materially from estimates.

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2. EMPLOYEE STOCK PLANS

Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" requires prominent disclosures in interim as well as annual financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported net income. The Company has continued to account for its stock-based compensation using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," as amended. Accordingly, no compensation cost has been recognized for the Company's employee stock plans except for those expenses associated with restricted stock units and certain stock options in which vesting was or has been agreed to be accelerated. Had compensation cost for the Company's stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans, the Company's net income and earnings per share, would have been reduced to the pro forma amounts indicated below:

	Three Months Ended June 30,		Six Months End
	2004	2003	2004
(In thousands, except per share data)			

Net income, as reported	$ 38,221	$ 20,265	$ 64,050	$
Less: total stock-based employee compensation expense determined under fair value based methods for all awards, net of tax	(1,484)	(2,319)	(2,842)	
Pro forma net income	$ 36,737	$ 17,946	$ 61,208	$
Net income per share, as reported	$ 1.43	$ 0.74	$ 2.38	$
Pro forma net income, per share	1.37	0.65	2.28	
Net income per share assuming dilution, as reported	$ 1.10	$ 0.67	$ 1.84	$
Pro forma net income, per share	1.06	0.60	1.76	

3. LONG-TERM DEBT

Sierra Debentures

- In March 2003, the Company issued $115.0 million aggregate principal amount of its 2¼% senior convertible debentures due March 15, 2023. The debentures pay interest, which is due semi- annually on March 15 and September 15 of each year. Each $1,000 principal amount of debentures is convertible, at the option of the holders, into 54.6747 shares of Sierra Health Services, Inc., common stock prior to March 15, 2023 if (i) the market price of the Company's common stock for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of the preceding fiscal quarter exceeds 120% of the conversion price per share of the Company's common stock; (ii) the debentures are called for redemption; (iii) there is an event of default with respect to the debentures; or (iv) specified corporate transactions have occurred. The conversion rate is subject to certain adjustments. This conversion rate initially represents a conversion price of $18.29 per share. Holders of the debentures may require the Company to repurchase all or a portion of their debentures on March 15 in 2008, 2013 and 2018 or upon certain corporate events including a change in control. In either case, the Company may choose to pay the purchase price of such debentures in cash or common stock or a combination of cash and common stock. The debentures can be redeemed by the Company for cash

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beginning on or after March 20, 2008.

The Company evaluates the market price condition each quarter to determine whether the debentures will be convertible, at the option of the holder, during the subsequent quarter. For the quarters ended December 31, 2003, March 31, 2004 and June 30, 2004, the market price condition was satisfied. As a result, the debentures were convertible, at the option of the holder, at any time during the quarters ended March 31, 2004 and June 30, 2004 and are convertible at any time during the quarter ending September 30, 2004. Although no debentures were converted as of June 30, 2004, they are considered common stock equivalents and are included in the calculation of weighted average common shares outstanding assuming dilution for the three and six months ended June 30, 2004.

Revolving Credit Facility.

On March 3, 2003, the Company entered into a $65.0 million revolving credit facility, which replaced its amended and restated credit facility. The facility may be increased up to an aggregate amount of $125.0 million upon receipt of new commitments from existing or additional lenders. Interest on the facility was initially LIBOR plus 2.25% and is currently LIBOR plus 2.00%. The facility will expire on April 30, 2006 but can be extended, at the sole discretion of each of the lenders, until March 3, 2008. The facility is available for general corporate purposes. The Company has not yet drawn on this facility.

The credit facility is secured by guarantees by certain of the Company's subsidiaries and a first priority perfected security interest in (i) all the capital stock of each of the Company's unregulated, material domestic subsidiaries (direct or indirect) as well as all of the capital stock of certain regulated, material domestic subsidiaries; and (ii) all other present and future assets and properties of the Company and those of its subsidiaries that guarantee the credit agreement obligations (including, without limitation, accounts receivable, inventory, real property, equipment, contracts, trademarks, copyrights, patents, license rights and general intangibles) other than cash and cash equivalents, subject, in each case, to the exclusion of the capital stock of CII Financial, Inc. ("CII") and certain other exclusions.

The revolving credit facility has covenants that limit the Company's ability and the ability of the Company's subsidiaries to dispose of assets, incur indebtedness, incur other liens, make investments, loans or advances, make acquisitions, engage in mergers or consolidations, repurchase Company common stock or make capital expenditures and otherwise restricts certain corporate activities. In addition, the Company is required to comply with specified financial ratios as set forth in the credit agreement. The Company believes it is in compliance with all covenants of the credit agreement.

4. SHARE REPURCHASE PROGRAM

From January 1, 2004 through June 30, 2004, the Company purchased 2.2 million shares of its common stock, in the open market or negotiated transactions, for $82.8 million at an average cost of $37.38. In addition to the remaining 56,000 shares its Board of Directors has previously approved, the Company will then have available an additional $70.0 million to be used for share repurchases based on approval by its Board of Directors on May 20, 2004. The Company's revolving credit facility, as amended, allows for stock repurchases of up to $60.0 million from May 27, 2004 through December 31, 2004. The Company purchased 528,000 shares for $22.8 million from May 27, 2004 through June 30, 2004. From July 1, 2004 to July 21, 2004, the Company repurchased an additional 38,000 shares for $1.6 million at an average cost of $43.70.

Included in the repurchases for the first quarter of 2004 are 500,000 shares the Company purchased from its CEO, at $32.00 per share, for a total of $16.0 million. The closing price of the Company's common stock on the date of the transaction, February 11, 2004, was $32.35. Included in the repurchases for the second quarter of 2004 are an additional 500,000 shares the Company purchased from its CEO, at

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$43.20 per share, for a total of $21.6 million. The closing price of the Company's common stock on the date of the transaction, May 27, 2004, was $43.25. The Company's Board of Directors approved both of the purchases.

5. TEXAS DISCONTINUED OPERATIONS

During the third quarter of 2001, the Company announced its plan to exit the Texas HMO health care market and received formal approval from the Texas Department of Insurance to withdraw its HMO operations in mid-October 2001. The Company ceased providing HMO health care coverage in Texas on April 17, 2002.

The Company elected to early adopt Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"), effective January 1, 2001. In accordance with SFAS No. 144, the Company's Texas HMO health care operations were reclassified as discontinued operations.

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

	June 30, 2004	December 31, 2003
(In thousands)		

ASSETS		
Cash and Cash Equivalents	$ 396	$ 47
Investments	2,149	4,048
Other Assets	60	115
ASSETS OF DISCONTINUED OPERATIONS	2,605	4,210
LIABILITIES		
Accounts Payable and Other Liabilities	616	2,658
Medical Claims Payable	117	202
LIABILITIES OF DISCONTINUED OPERATIONS	733	2,860
NET ASSETS OF DISCONTINUED OPERATIONS	$ 1,872	$ 1,350

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

	Three Months Ended June 30,		Six Months
	2004	2003	2004
(In thousands)			
Operating Revenues	$ 50	$ 35	$ 86
Medical Expenses	(8)	(72)	(183
General and Administrative Expenses, Net	58	1,234	(78
Interest Expense and Other, Net (including rental income)	--	(2,418)	73
Total Expenses, Net	50	(1,256)	(188
Income from Discontinued Operations Before Taxes	--	1,291	274
Income Tax Provision	--	(450)	(78
Net Income from Discontinued Operations	$ --	$ 841	$ 196

The operating revenues are all related to investment income. All of the discontinued Texas HMO health care operations had previously been a component of the "managed care and corporate operations" segment.

In the first quarter of 2003, the Company made an adjustment due to continued favorable development. The Company's estimate for medical claims payable was reduced by $1.4 million and legal, restitution and other exit related costs and the related accruals were reduced by $1.9 million. Included in the $1.9 million reduction is $1.2 million that had been originally recorded as a charge in the third quarter of 2001.

In the second quarter of 2003, the Company determined that it needed to increase its legal and restitution accruals by approximately $500,000. Also in the second quarter of 2003, the remaining mortgage loan with Kaiser Foundation Health Plan of Texas was paid off, resulting in a gain, net of tax, of $1.3 million.

In the first quarter of 2004, the Company made an adjustment due to favorable development and reduced legal reserves and medical claims payable by a total of $300,000.

Management believes that the remaining liabilities, at June 30, 2004, are appropriate and that no further revisions to the estimates are necessary at this time. Based on the current estimated Texas HMO health care run-out costs and recorded reserves, the Company believes it has adequate funds available and the ability to fund the anticipated obligations.

6. CII FINANCIAL, INC. DISCONTINUED OPERATIONS

On January 15, 2003, the Company announced that it was exploring strategic alternatives to sell its workers' compensation company, CII. Sierra's Board of Directors authorized the plan to sell the operations on December 31, 2002. Accordingly, beginning in the fourth quarter of 2002, the Company reclassified its workers' compensation insurance business as discontinued operations. CII represented the majority of the Company's previous workers' compensation operations segment and specialty product income and expenses. See Note 10 for the recast segment presentation.

On March 31, 2004, the Company completed the sale of CII's subsidiary, California Indemnity Insurance Company ("Cal Indemnity"), which was CII's only significant asset. Cal Indemnity's subsidiaries, which were included in the sale, are Commercial Casualty Insurance Company, Sierra Insurance Company of Texas, and CII Insurance Company.

The Company received $14.2 million in cash at the closing, subject to potential post closing adjustments with regard to the closing date balance sheet. The transaction also includes a note receivable of $62.0 million, plus accrued interest, payable to the Company in January 2010. The note receivable can be increased or decreased depending on favorable or adverse claim and expense development from the date of closing through December 31, 2009, and other offsets and additions based on certain agreements between the parties. The note receivable can be increased on a dollar for dollar basis for the first $15 million in positive loss reserve development and $.50 per dollar on any positive development in excess of $15 million. The note receivable can also be decreased on a dollar for dollar basis for the first $58 million in adverse loss development. Certain other contractual assets and liabilities were recorded in conjunction with the sale including a current asset of $15.8 million and a non- current asset of $7.1 million that represent Cal Indemnity's unallocated loss adjustment expense ("ULAE") reserves to be paid to Sierra. Offsetting these assets is a current liability of $15.8 million and a non-current liability of $7.1 million, which represent the contractual services to be performed by Sierra. Including the cash proceeds, net assets of $68.3 million were recorded in conjunction with the sale of Cal Indemnity. Previously, CII had recorded valuation adjustments to reduce the business to its estimated net realizable value upon disposition. No further adjustments were required upon final disposition; therefore, no gain or loss on the sale was recorded.

A third-party claims administrator was engaged to administer claims for a period of 15 years. Under the terms of this agreement, the administrator will provide certain claims services for Cal Indemnity and its subsidiaries. Sierra will be responsible for this administrator's costs and for providing certain transition services for varying terms to Cal Indemnity. The purchaser of Cal Indemnity will pay Sierra for these costs from an account consisting of the ULAE reserves and accrued liabilities as of the closing, a percentage of premiums earned after the closing, plus accrued interest on the ULAE reserves. In addition, Sierra is providing workers' compensation managed care services at market rates to Cal Indemnity.

The Company's June 30, 2004 Condensed Consolidated Balance Sheet does not include the assets and liabilities of Cal Indemnity due to the disposal of those assets and liabilities at March 31, 2004. The Company's Condensed Consolidated Statement of Income for the six months ended June 30, 2004 reflects the activity of the discontinued operations through March 31, 2004, the disposal date. Any subsequent activity related to this disposal will be reflected in continuing operations.

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The following are the assets and liabilities of the discontinued operations of CII:

(In thousands)	December 31, 2003
ASSETS	
Cash and Cash Equivalents	$ 58,634
Investments	243,647
Reinsurance Recoverable	177,333
Property and Equipment, Net	1,612
Other Assets	48,320
TOTAL ASSETS	529,546
LIABILITIES	
Accounts Payable and Other Accrued Expenses	54,208
Reserve for Loss and Loss Adjustment Expenses	415,339
TOTAL LIABILITIES	469,547
NET ASSETS OF DISCONTINUED OPERATIONS	$ 59,999

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The following are the unaudited condensed statements of operations of the discontinued operations of CII:

(In thousands)	Three Months Ended June 30, 2003	Three Months Ended March 31, 2004	Six Months Ended June 30, 2003
OPERATING REVENUES:			
Specialty Product Revenues	$ 35,233	$ 19,015	$ 72,044
Investment and Other Revenues	2,820	1,290	7,300
Total Revenues	38,053	20,305	79,344
OPERATING EXPENSES:			
Specialty Product Expenses	41,362	21,917	86,747
Interest Expense and Other (Income) Expense, Net	(786)	(91)	(851)
Total Operating Expenses	40,576	21,826	85,896
Loss from Discontinued Operations Before Income Tax	(2,523)	(1,521)	(6,552)
Income Tax Benefit	1,437	839	2,922

Net Loss from Discontinued Operations	$ (1,086)	$ (682)	$ (3,630)

The activity for 2004 is through March 31, 2004, the disposal date. There is no activity for the operations beyond that date. Specialty product revenues consist of workers' compensation insurance net earned premiums. Specialty product expenses consist of loss and loss adjustment expenses incurred and general and administrative expenses.

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7. EARNINGS PER SHARE:

The following table provides a reconciliation of basic and diluted earnings per share:

(In thousands, except per share data)	Three Months Ended June 30, 2004	Three Months Ended June 30, 2003	Six Months End 2004
BASIC INCOME (LOSS) PER SHARE			
Income from continuing operations	$ 38,221	$ 20,510	$ 64,536 $
Loss from discontinued operations	--	(245)	(486)
Net income	$ 38,221	$ 20,265	$ 64,050 $
Weighted average common shares outstanding	26,766	27,451	26,903
Earnings per common share:			
Income from continuing operations	$ 1.43	$ 0.75	$ 2.40 $
Loss from discontinued operations	--	(0.01)	(0.02)
Net income	1.43	0.74	2.38
DILUTED INCOME (LOSS) PER SHARE			
Income from continuing operations	$ 38,221	$ 20,510	$ 64,536 $
Loss from discontinued operations	--	(245)	(486)
Net income	38,221	20,265	64,050
Interest expense on Sierra Debentures, net of tax	421	--	841
Income for purposes of computing diluted net income per share	$ 38,642	$ 20,265	$ 64,891 $
Weighted average common shares outstanding	26,766	27,451	26,903
Dilutive options and restricted shares outstanding	2,005	2,543	2,134
Dilutive impact of conversion of Sierra Debentures	6,288	--	6,288
Weighted average common shares outstanding assuming dilution	35,059	29,994	35,325
Earnings per common share assuming dilution:			
Income from continuing operations	$ 1.10	$ 0.68	$ 1.85 $
Loss from discontinued operations	--	(0.01)	(0.01)

Net income	$ 1.10	$ 0.67	$ 1.84	$

The Company evaluates the market price condition of its convertible debentures each quarter to determine whether they will be convertible, at the option of the holder, during the subsequent quarter. For the quarters ended December 31, 2003, March 31, 2004 and June 30, 2004, the market price condition was satisfied. As a result, the debentures were convertible, at the option of the holder, at any time during the quarters ended March 31, 2004 and June 30, 2004 and are convertible at any time during the quarter ending September 30, 2004. Although no debentures were converted as of June 30, 2004, they are

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considered common stock equivalents and are included in the calculation of weighted average common shares outstanding assuming dilution for the three and six months ended June 30, 2004.

The Company issued 125,000 restricted stock units ("units") to certain executives in the second quarter of 2004. For the three and six months ended June 30, 2004, the units were not dilutive and, therefore, were not included in the computation of diluted earnings per share. For the six months ended June 30, 2004, stock options to purchase 17,000 shares were not dilutive and, therefore, were also not included in the computation of diluted earnings per share.

For the three and six months ended June 30, 2003, stock options to purchase 259,000 and 281,000 shares, respectively, were not dilutive and, therefore, were not included in the computation of diluted earnings per share.

8. DEFINED BENEFIT PLAN

The Company previously disclosed that it expects to contribute approximately $800,000 to its defined benefit plan in 2004 to fund expected benefit payments. As of June 30, 2004, the Company has contributed $392,000 to the plan to fund benefit payments and anticipates making approximately $400,000 in additional contributions during 2004.

	Three Months Ended June 30,		**Six Months Ended Ju**	
	2004	**2003**	**2004**	**20**
(In thousands)				
Components of Net Periodic Benefit Cost:				
Service Cost	$ 106	$ 81	$ 212	$
Interest Cost	418	336	836	
Amortization of Prior Service Credits	303	232	606	
Recognized Actuarial Loss	109	172	218	
Net Periodic Benefit Cost	$ 936	$ 821	$ 1,872	$

9. COMPREHENSIVE INCOME

The following table presents comprehensive income for the periods indicated:

Three Months Ended June 30,	**Six Months**

(In thousands)	2004	2003	2004
Net Income	$ 38,221	$ 20,265	$ 64,050
Change in Unrealized Holding Gain on Available-for-Sale Investments, net of tax....	(1,134)	(708)	(352)
Change in Minimum Pension Liability, net of tax....	--	368	--
Comprehensive Income	$ 37,087	$ 19,925	$ 63,698

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10. SEGMENT REPORTING

The Company has two reportable segments based on the products and services offered: managed care and corporate operations, and military health services operations. The managed care segment includes managed health care services provided through an HMO, managed indemnity plans, third-party administrative services programs for employer-funded health benefit plans and self-insured workers' compensation plans, multi-specialty medical groups, workers' compensation administration services, other ancillary services and corporate operations. The military health services segment administers a managed care federal contract for the Department of Defense's ("DoD") TRICARE program in Region 1. The military health services segment includes an allocation for estimated corporate overhead of $1.0 million per quarter for direct and indirect services provided to Sierra Military Health Services LLC, ("SMHS").

SMHS completed the fifth year of a five-year contract in May 2003. SMHS is currently operating in a negotiated contract extension period which will end August 31, 2004. In August 2002, the DoD requested proposals for managed care services under the TRICARE Next Generation ("T-Nex") contract. The Company submitted its proposal in January 2003 for the T-Nex North Region contract, which includes Region 1, as well as Michigan, Ohio, Kentucky, Indiana, Illinois, Wisconsin, Virginia and North Carolina. In August 2003, the DoD awarded the T- Nex North Region contract to a competitor and the General Accounting Office denied the Company's protest of the award in December 2003. The new contractor is scheduled to be operational in Region 1 on September 1, 2004 and the new contract will supersede the remainder of the Company's current TRICARE Region 1 contract. After the new contractor is operational on September 1, 2004, SMHS will commence a six-month phase-out of operations at prices previously negotiated with the DoD. SMHS does not meet the definition of discontinued operations since the Company does not have plans to dispose of the operations before the phase-out is complete.

The Company evaluates each segment's performance based on segment operating profit. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies.

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(In thousands)	Managed Care and Corporate Operations	Military Health Services Operations	Total
Three Months Ended June 30, 2004			
Medical Premiums............................	$ 280,661	$ --	$ 280,661
Military Contract Revenues..................	--	140,705	140,705
Professional Fees...........................	8,085	--	8,085
Investment and Other Revenues...............	11,502	286	11,788

Total Revenue	$ 300,248	$ 140,991	$ 441,239
Segment Operating Profit	$ 36,596	$ 24,571	$ 61,167
Interest Expense	(1,150)	(25)	(1,175)
Other Income (Expense), Net	73	(32)	41
Income from Continuing Operations Before Income Taxes	$ 35,519	$ 24,514	$ 60,033
Three Months Ended June 30, 2003			
Medical Premiums	$ 239,142	$ --	$ 239,142
Military Contract Revenues	--	115,431	115,431
Professional Fees	9,715	--	9,715
Investment and Other Revenues	5,323	594	5,917
Total Revenue	$ 254,180	$ 116,025	$ 370,205
Segment Operating Profit	$ 30,618	$ 2,678	$ 33,296
Interest Expense	(1,446)	(84)	(1,530)
Other Income (Expense), Net	(712)	380	(332)
Income from Continuing Operations Before Income Taxes	$ 28,460	$ 2,974	$ 31,434
Six Months Ended June 30, 2004			
Medical Premiums	$ 546,099	$ --	$ 546,099
Military Contract Revenues	--	268,329	268,329
Professional Fees	17,563	--	17,563
Investment and Other Revenues	16,507	931	17,438
Total Revenue	$ 580,169	$ 269,260	$ 849,429
Segment Operating Profit	$ 71,284	$ 32,043	$ 103,327
Interest Expense	(2,297)	(43)	(2,340)
Other Income (Expense), Net	200	(37)	163
Income from Continuing Operations Before Income Taxes	$ 69,187	$ 31,963	$ 101,150
Six Months Ended June 30, 2003			
Medical Premiums	$ 474,222	$ --	$ 474,222
Military Contract Revenues	--	219,844	219,844
Professional Fees	18,419	--	18,419
Investment and Other Revenues	9,159	831	9,990
Total Revenue	$ 501,800	$ 220,675	$ 722,475
Segment Operating Profit	$ 53,039	$ 5,532	$ 58,571
Interest Expense	(3,020)	(130)	(3,150)
Other Income (Expense), Net	(705)	362	(343)
Income from Continuing Operations Before Income Taxes	$ 49,314	$ 5,764	$ 55,078

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11. INVESTMENTS

Of the cash and cash equivalents and current investments that total $317.1 million in the accompanying Consolidated Balance Sheet at June 30, 2004, $183.2 million is limited for use only by the Company's regulated subsidiaries. Such amounts are available for transfer to Sierra from the regulated subsidiaries only to the extent that they can be remitted in accordance with terms of existing management agreements and by dividends, which customarily must be approved by regulating state insurance departments. The remainder is available to Sierra on an unrestricted basis.

Investments consist primarily of U.S. Government and its agencies' securities, municipal bonds, corporate bonds, securities and first trust deed mortgage notes. At June 30, 2004, approximately 90% of the Company's investment 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. Restricted investments are classified as non-current assets. Realized gains and losses are calculated using the specific identification method and are included in investment and other revenues. Unrealized holding gains and losses on available-for-sale securities are included as a separate component of stockholders' equity, net of income tax effects, 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. All of the Company's held-to-maturity investments were part of the discontinued workers' compensation operations. At June 30, 2004, the Company does not have any held-to-maturity investments and all investments have been stated at their fair value. Fair value is estimated primarily from published market values at balance sheet date. The Company does not believe it has any other than temporary investment impairments.

12. COMMITMENTS AND CONTINGENCIES

On March 15, 2004, SMHS entered into a lease assignment agreement relative to one of its administrative locations. The agreement assigns the remainder of the lease term, which expires September 30, 2012. Under the assignment SMHS remains contingently liable should the new tenant not perform under its obligation. At June 30, 2004, the future lease payments due under the lease agreement total $5.5 million. SMHS did not record a liability for its obligation under this agreement as the likelihood of performance is considered remote at this time and SMHS would have the ability to sublease or enter into another assignment arrangement if required to perform on this obligation.

Although the Company is not a named defendant, the Company has been notified that it has been named as a co-conspirator in the class action lawsuit, In Re: Managed Care Litigation: MDL No. 1334. The following summary is based upon information obtained from certain publicly filed documents. Beginning in 1999, a series of class action lawsuits were filed against most other major entities in the health benefits business. A multi-district litigation panel has consolidated most of these cases in the Southern District Court of Florida, Miami division. The plaintiffs assert that the defendants improperly paid providers' claims and "downcoded" their claims by paying lesser amounts than they submitted. The complaint alleges, among other things, multiple violations under the Racketeer Influenced and Corrupt Organizations Act, or RICO, as well as various breaches of contract and violations of regulations governing the timeliness of claim payments. The consolidated suits seek injunctive, compensatory and equitable relief as well as restitution, costs, fees and interest payments. Discovery commenced on September 30, 2002. In November 2002, the Eleventh Circuit granted the industry defendants' petition to review the class certification order. That appeal is pending. On April 7, 2003, the United States Supreme Court determined that the RICO claims against certain defendants should be arbitrated. On September 15, 2003, the district court granted in part and denied in part the industry defendants' further motion to compel arbitration.

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Significantly, the court denied the industry defendants' motion with respect to plaintiffs' derivative RICO claims. On September 19, 2003, the industry defendants appealed the district court's arbitration order to the Eleventh Circuit. Discovery is ongoing and a trial date has been set for September 13, 2004. In the meantime, two of the defendants, Aetna Inc. and Cigna Corporation, have entered into settlement agreements which have been approved by the Court.

The Company is subject to other various claims and litigation in the ordinary course of business. Such litigation includes, but is not limited to, claims of medical malpractice, claims for coverage or payment for medical services rendered to HMO and other 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. 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 estimated 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 amount or range of any potential loss cannot be reasonably estimated but the ultimate resolution of these pending legal proceedings should not have a material adverse effect on the Company's financial condition.

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

ITEM 2.

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, 2003, and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in our 2003 annual report on Form 10-K filed with the Securities and Exchange Commission on March 5, 2004, and in conjunction with our unaudited condensed consolidated financial statements and accompanying notes for the three and six month periods ended June 30, 2004 and 2003, included in this Form 10-Q. The information contained below is subject to risk factors. We urge the reader to review carefully the section "Risk Factors" in Part 1, Item 1 of our 2003 annual report on 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 Part 1, Item 1 of our 2003 annual report on Form 10-K.

This report on Form 10-Q 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. The forward-looking statements regarding our business and results of operations should be considered by our stockholders or any reader of our business or financial information along with the risk factors discussed in our 2003 annual report on Form 10-K. 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 generally identified by their use of terms and phrases such as "anticipate," "believe," "could," "estimate," "expect," "hope," "intend," "may," "plan," "predict," "project," "seeks," "will," "continue," and other similar terms and phrases, including all 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 publish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Overview

Our continuing operations derive revenues from our health maintenance organization, or HMO, managed indemnity plans and military health care services. To a lesser extent, we also derive revenues from professional fees (consisting primarily of fees for providing health care services to non- members, co-payment fees received from members and ancillary products), and investment and other revenue (consisting of fees for workers' compensation third party administration, utilization management services and ancillary products).

Our principal expenses consist of medical expenses, military contract expenses, and general and administrative expenses. Medical expenses represent capitation fees and other fee-for-service payments paid to independent contracted physicians, hospitals and other health care providers to cover members, pharmacy costs, as well as the aggregate expenses to operate and manage our wholly-owned multi-specialty medical group and other provider subsidiaries. As a provider of health care management services, we seek to positively affect quality of care and expenses by contracting with physicians, hospitals and other health care providers at negotiated price levels, by adopting quality assurance programs, monitoring and managing utilization of physician and hospital services and providing incentives

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to use cost-effective providers. Military contract expenses represent payments to providers for health care services rendered under the TRICARE program, as well as administrative costs to pay claims and operate the military health care subsidiary. General and administrative expenses generally represent operational costs other than those directly associated with the delivery of health care services and military contract services.

Executive Summary

Continuing Operations. Our operating results for the six months ended June 30, 2004, were significantly improved over the six months ended June 30, 2003. Our income from continuing operations increased by 79.6% to $64.5 million. The improvement in the 2004 operating results was primarily driven by medical premium revenue growth from new members, rate increases, an expansion of our operating margin and contractual settlements and other adjustments at our Military operation. Our HMO membership increased by 13.2% from 281,600 at June 30, 2003 to 318,700 at June 30, 2004. Our aggregate 2004 premium rates increased by approximately 5.3% over 2003. The combination of these factors resulted in a 15.2% increase in our medical premium revenues to $546.1 million, which was partially offset by an increase in medical expenses, which increased by 12.0% to $426.5 million. Medical expenses, as a percentage of medical premiums and professional fees, decreased from 77.3% to 75.7%, or 160 basis points for the six months ended June 30, 2004. Our operating margin, which is the operating income from continuing operations divided by total revenues, improved by 410 basis points to 12.2%.

Our Military Health Services Operations segment represented 31.7% of our operating revenues and 31.0% of our operating income from continuing operations for the six months ended June 30, 2004. This segment had income before income taxes of $32.0 million for the six months ended June 30, 2004, compared to $5.8 million for the same period in 2003. For 2003, excluding TRICARE Next Generation, or T-Nex, bid related expenses, the Military Health Services Operations segment would have had income before income taxes of $10.1 million. The improvement over 2003 is primarily due to change orders and final bid price adjustments on option periods three and four of the TRICARE Region 1 contract. The impact on income before taxes of the change orders, final bid price adjustments for option periods three and four and other contractual settlements was an increase of $16.3 million.

We did not win the T-Nex North Region contract and our appeal to the United States General Accounting Office was denied in December 2003. Health care services under our current TRICARE contract for Region 1 will end on August 31, 2004. We will then have a six-month phase-out at substantially reduced revenues and earnings.

For the six months ended June 30, 2004 compared to June 30, 2003, investment and other revenues increased from $10.0 million to $17.4 million, an increase of $7.4 million or 74.6%. Of the increase, $5.9 million is related to the services we are providing relative to our sales agreement for the workers' compensation insurance operations, beginning April 1, 2004. For a further description of this agreement, see below in the discussion of Discontinued Operations.

For the six months ended June 30, 2004 compared to June 30, 2003, our general and administrative, or G&A, expenses increased from $68.0 million to $82.4 million, an increase of approximately $14.4 million or 21.2%. Of the increase, $5.9 million is for the cost to provide services related to the sale of the workers' compensation insurance operations referred to above. The remaining increase is due to increases in payroll and benefits, premium taxes and legal expenses. As a percentage of total operating revenues, G&A expenses were 9.7% for 2004, compared to 9.4% in 2003. As a percentage of medical premium revenue, G&A expenses were 15.1% for 2004, compared to 14.3% for 2003. Excluding the services relative to our sales agreement for the workers' compensation insurance opeations described above, our G&A expenses, as a percentage of total operating revenues and medical premium revenue for the six month period, were 9.1% and 14.0%, respectively.

We had cash flows from operating activities of continuing operations for the six months ended June 30, 2004, of $80.7 million compared to $18.3 million for 2003. We received five monthly payments from the Centers for Medicare and Medicaid Services during the first two quarters of 2004 and 2003 as the January payments were received at the end of December. When the first quarters are adjusted to reflect three monthly payments from CMS, the cash flow from continuing operations would be $113.6 million in 2004 and $48.2 million in 2003. We believe presenting this adjustment for the timing of the CMS payments is useful for making a six-month period-to-period comparison of our cash flow from continuing operations. The improvement in cash flows from continuing operations over 2003 is primarily attributable to cash from earnings and the decrease in cash related to the increase in the military accounts receivable balance that occurred from December 31, 2002 to June 30, 2003.

Discontinued Operations. On January 15, 2003, we announced that we were exploring strategic alternatives to dispose of CII Financial, Inc., or CII. Sierra's Board of Directors authorized the sale of the operations on December 31, 2002. Accordingly, beginning in the fourth quarter of 2002, we reclassified our workers' compensation insurance business as discontinued operations.

On November 25, 2003, we announced that we had reached an agreement to sell California Indemnity Insurance Company, or Cal Indemnity, and its subsidiaries. In the fourth quarter of 2003, we recorded a charge of $15.6 million, gross and net of tax, to write down the investment in Cal Indemnity to its estimated net sales proceeds.

On March 31, 2004, we completed the sale of CII's subsidiary, Cal Indemnity, which was CII's only significant asset. Cal Indemnity's subsidiaries, which were included in the sale, are Commercial Casualty Insurance Company, Sierra Insurance Company of Texas, and CII Insurance Company.

We received $14.2 million in cash at the closing, subject to potential post closing adjustments with regard to the closing date balance sheet. The transaction also includes a note receivable of $62.0 million, plus accrued interest, payable to us in January 2010. The note receivable can be increased or decreased depending on favorable or adverse claim and expense development from the date of closing through December 31, 2009, and other offsets and additions based on certain agreements between the parties. The note receivable can be increased on a dollar for dollar basis for the first $15 million in positive loss reserve development and $.50 per dollar on any positive development in excess of

$15 million. The note receivable can also be decreased on a dollar for dollar basis for the first $58 million in adverse loss development. Certain other contractual assets and liabilities were recorded in conjunction with the sale including a current asset of $15.8 million and a non-current asset of $7.1 million that represent Cal Indemnity's unallocated loss adjustment expense, or ULAE, reserves to be paid to Sierra. Offsetting these assets is a current liability of $15.8 million and a non-current liability of $7.1 million, which represent the contractual services to be performed by Sierra. Including the cash proceeds, net assets of $68.3 million were recorded in conjunction with the sale of Cal Indemnity.

A third-party claims administrator was engaged to administer claims for a period of 15 years. Under the terms of this agreement the administrator will provide certain claims services for Cal Indemnity and its subsidiaries. Sierra will be responsible for this administrator's costs and for providing certain transition services for varying terms to Cal Indemnity. The purchaser of Cal Indemnity will pay Sierra for these costs from an account consisting of the ULAE reserves and accrued liabilities as of the closing, a percentage of premiums earned after the closing, plus accrued interest on the ULAE reserves. In addition, Sierra is providing workers' compensation managed care services at market rates to Cal Indemnity.

RESULTS OF OPERATIONS, THREE MONTHS ENDED JUNE 30, 2004, COMPARED TO THREE MONTHS ENDED JUNE 30, 2003

Total Operating Revenues

increased approximately 19.2% from $370.2 million to $441.2 million.

The change in operating revenues was comprised of the following:

- An increase in medical premiums of $41.5 million

- An increase in military contract revenues of $25.3 million

- A decrease in professional fees of $1.6 million

- An increase in investment and other revenues of $5.9 million

Medical Premiums

from our HMO and managed indemnity insurance subsidiaries increased from $239.1 million to $280.7 million, an increase of $41.5 million or 17.4%. The increase in premium revenue reflects a 5.6% increase in Medicare member months (the number of months individuals are enrolled in a plan), a 32.9% increase in Medicaid member months and a 10.8% 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. Of the 32.9% increase in Medicaid member months, 19.0% is due to the expansion of our Medicaid service area to Reno beginning February 2004.

HMO and POS premium rates for renewing commercial groups increased approximately 6% while the overall recorded per member per month revenue increase, including new and continuing business, was approximately 3%, net of changes in benefits. We did not receive a Medicaid rate increase in 2004 or 2003. The basic Medicare rate increase received for 2004 was approximately 2.2%. In addition, we received a Medicare rate increase on March 1, 2004, of over 15% due to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, or MMA, as described below.

In December 2003, President Bush signed MMA into law, which, among other changes to Medicare, alters the Medicare+Choice program. Under the MMA, Medicare+Choice plans are renamed Medicare Advantage plans and received increased funding from CMS starting March 2004. Because of the way in which the increased funding was calculated, both our non-Social HMO Medicare Advantage benefit plans and our Social HMO benefit plans received the increased funding. MMA increased our Medicare premium rates by over 15% starting March 1, 2004. The increased funding must be used in one or more of the following ways: to reduce beneficiary premiums; to reduce beneficiary cost sharing; to enhance benefits; to be placed into a benefit stabilization fund; to retain providers or expand the provider network as long as the benefit stabilization fund or enhancement does not result in increased premiums, increased cost sharing or reduced benefits. We are using the additional funding to enhance various plan benefits, including a reduction in the amount of Medicare Part B premium that our members pay to the federal government, and to stabilize our provider network.

Effective January 2004, CMS adopted a new risk adjustment payment methodology for Medicare beneficiaries who are enrolled in managed care programs, including the Social HMO. In addition, CMS has revised the payment factors for the Social HMO members to include a frailty adjuster that uses measures of functional impairment to predict expenditures. Under the new payment methodology, we are being paid 90% based on the previous payment approach and 10% based on the new approach for 2004. For 2004, excluding the effects of MMA, the new payment methodology reduced our rate increase by 60 basis points. For 2005 we will be paid 70% based on the previous payment approach and 30% based on the new approach. The Social HMO program was due to expire at the end of 2003; however, CMS administratively extended the Social HMO program for one year, through 2004. If the Social HMO contract is not renewed beyond 2004, we would seek to transfer the members into one of our traditional Medicare plans. This transfer would allow for the continuity of care of our members but without the additional Social HMO specific benefits that are currently available to them and the associated higher

premiums we receive. There are activities taking place on a federal level to continue the program, but there is no guarantee at this time that the Social HMO contract will be renewed beyond 2004.

Continued medical premium revenue growth is principally dependent upon continued enrollment in our products and upon competitive and regulatory factors.

Our commercial membership increased from 194,100 at June 30, 2003 to 215,700 at June 30, 2004. Our commercial member retention was approximately 95% for our second quarter 2004 renewals, which represent approximately 7% of our total commercial membership. The increase in commercial membership during the second quarter of 2004 is primarily attributed to in-case growth, movement from self-insured plans to our commercial products and new accounts.

Military Contract Revenues

increased from $115.4 million to $140.7 million, an increase of $25.3 million or 21.9%. The increased revenue is primarily the result of increased health care bid revenue consistent with the terms of Sierra Military Health Services LLC, or SMHS' negotiated contract extension for the first year beyond the original five-year term. In addition, incremental change order revenues and final bid price adjustments on option periods three and four contributed to the higher revenue for 2004. The final bid price adjustments resulted in revenue increases of approximately $6.1 million for Option Period 3 (June 1, 2000 to May 31, 2001), which is 3.4% of the final revenue settlement amount for that period and $4.3 million for Option Period 4 (June 1, 2001 to May 31, 2002), which is 2.3% of the final revenue settlement amount for that period. The impact on income before taxes of the final bid price adjustments for option periods three and four was an increase of $6.6 million. The total impact on income before taxes of the change orders, bid price adjustments and other contractual settlements was an increase of $16.3 million.

SMHS completed the fifth year of a five-year contract in May 2003. SMHS is currently operating in a negotiated contract extension period, which will end August 31, 2004. In August 2002, the Department of Defense, or DoD, requested proposals for managed care services under the T-Nex contract. We submitted our proposal in January 2003 for the T-Nex North Region contract, which includes Region 1, as well as Michigan, Ohio, Kentucky, Indiana, Illinois, Wisconsin, Virginia and North Carolina. In August 2003, the DoD awarded the T-Nex North Region contract to a competitor and the General Accounting Office denied our protest of the award in December 2003. The new contractor is scheduled to be operational in Region 1 on September 1, 2004 and the new contract will supersede the remainder of our current TRICARE Region 1 contract. After the new contractor is operational on September 1, 2004, SMHS will commence a six-month phase-out of operations at prices previously negotiated with the DoD. SMHS does not meet the definition of discontinued operations since we do not have plans to dispose of the operations before the phase-out is complete.

In March 2004, SMHS entered into a definitive agreement with the new T-Nex North Region Contractor to provide certain transition services and to sell certain portions of its TRICARE business, including its provider network and certain other assets. The value of the transaction is up to $4 million with the final value contingent on SMHS' operational performance through August 2004. SMHS recorded revenue of approximately $200,000 pursuant to this agreement in the second quarter of 2004.

Professional Fees

decreased from $9.7 million to $8.1 million, a decrease of $1.6 million, or 16.8% primarily as a result of the outsourcing of our eye care unit in late 2003. The outsourcing of these services reduced both our revenue and corresponding expenses.

Investment and Other Revenues

increased from $5.9 million to $11.8 million, an increase of $5.9 million or 99.2%. The increase in administrative services revenue is due to the services we are providing relative to our sales agreement for the workers' compensation insurance operations, beginning April 1, 2004. On March 31, 2004, we completed the sale of the workers' compensation insurance operations and we have been engaged to administer claims for a period of fifteen years as well as perform certain transition and

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managed care services. Total revenue associated with these services for 2004 was $5.9 million. The cost to provide these services is reflected in our general and administrative expenses. In addition we recorded accrued interest of $620,000 on the $62.0 million note receivable.

Medical Expenses

increased from $189.8 million to $218.4 million, an increase of $28.6 million or 15.1%. The increase is due primarily to our increased membership, which is in part offset by a lower medical care ratio. This ratio, which is medical expenses as a percentage of medical premiums and professional fees, decreased from 76.3% to 75.6%. The favorable decrease in our medical care ratio is due primarily to premium increases in excess of cost increases. We incurred some favorable development on prior period claims during the quarter, which were more than offset by contractual allowances we recorded to cover ongoing provider disputes and negotiations. The number of days in claims payable, which is the medical claims payable balance divided by the average medical expense per day for the period, at June 30, 2004, was 47.1 compared to 49.8 at June 30, 2003. In an effort to further improve service and customer relations with our medical providers, we have enhanced several claims processes, including electronic data interchange and optical character recognition, to reduce the time required to make claim payments. The decrease in days in claims payable is primarily a result of these enhancements.

We contract with hospitals, physicians and other independent contracted providers of health care under capitated or discounted fee-for- service arrangements, including hospital per diems, to provide medical care services to members. Capitated providers are at risk for a portion of the cost of medical care services provided to our members in the relevant geographic areas; however, we are ultimately responsible for the provision of services to our members should the capitated provider be unable to provide the contracted services. We incurred capitation expenses with non-affiliated providers of $28.9 million and $25.0 million, or 13.2% and 13.2%, of our total medical expenses for 2004 and 2003, respectively.

Military Contract Expenses

increased from $113.3 million to $116.4 million, an increase of $3.1 million or 2.7%. The increase is consistent with the increase in revenues discussed previously and includes T-Nex bid related costs of $2.0 million in 2003. In addition, the 2004 contract expenses included final bid price adjustments on option periods three and four of the TRICARE Region 1 contract. The final adjustments resulted in a contract expense increase of approximately $1.9 million for Option Period 3, which is 0.9% of the final contract expense settlement amount for that period and a contract expense increase of $1.9 million for Option Period 4, which is 0.8 % of the final contract expense settlement amount for that period. There were no final settlements of bid price adjustments in 2003. Included in our military contract expenses is an allocation for estimated corporate overhead of $1.0 million per quarter for direct and indirect services provided to SMHS.

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 710,000 eligible individuals of active duty military personnel, military retirees under the age of 65 and dependents of military retirees through a network of approximately 50,300 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.

General and Administrative Expenses

increased from $33.8 million to $45.2 million, an increase of approximately $11.4 million or 33.9%. The primary increase in G&A expenses is the $5.9 million to provide services relative to our sales agreement for the workers' compensation insurance operations as

discussed above. The remaining increases in G&A expenses are primarily due to increases in payroll and benefits and legal expenses. As a percentage of revenues, G&A expenses were 10.3% for 2004, compared to 9.1% in 2003. As a percentage of medical premium revenue, G&A expenses were 16.1% for 2004, compared to 14.1% for 2003. Excluding the services relative to our sales agreement for the workers' compensation insurance operations described above, our G&A expenses, as a percentage of total operating revenues and medical premium revenue for the three month period, were 9.0% and 14.0%, respectively.

Interest Expense

decreased from $1.5 million to $1.2 million, a decrease of $355,000 or 23.2%. The decrease is due to costs incurred relative to the new senior convertible debentures in 2003. We continue to incur a fee of 0.375% on the unused portion of our revolving credit facility.

Other Income (Expense), Net

resulted in income of $41,000 for 2004 compared to expense of $332,000 for 2003. The expense in 2003 was primarily related to the loss on sale of certain assets.

Provision for Income Taxes

was recorded at $21.8 million for 2004 compared to $10.9 million for 2003. The effective tax rate for 2004 was 36.3% compared to 34.8% for 2003. Our effective tax rate is greater than the statutory rate due primarily to state income taxes and other non-deductible expenses.

Discontinued Operations

consist of our Texas HMO health care operations and the CII workers' compensation operations. The net loss from discontinued operations for 2003 was $245,000. We have discontinued paying Texas claims, as our evidence of coverage requires that all claims must be settled within 18 months of the time of service.

Discontinued Texas HMO health care operations.

There is very little activity remaining relative to our discontinued Texas operations and there was no income or loss for the current period.

Discontinued CII workers' compensation operations.

On March 31, 2004, we completed the sale of CII's subsidiary, Cal Indemnity. The activity related to this transaction, subsequent to the March 31, 2004 closing date, has been discussed above.

The sale of Cal Indemnity includes a note receivable of $62.0 million, plus accrued interest, payable in January 2010. The note receivable can be increased or decreased depending on favorable or adverse claim and expense development from the date of closing through December 31, 2009, and other offsets and additions based on certain agreements between the parties. Interest accrues quarterly on the note at 4.0%.

RESULTS OF OPERATIONS, SIX MONTHS ENDED JUNE 30, 2004, COMPARED TO SIX MONTHS ENDED JUNE 30, 2003

Total Operating Revenues

increased approximately 17.6% from $722.5 million to $849.4 million.

The change in operating revenues was comprised of the following:

- An increase in medical premiums of $71.9 million
- An increase in military contract revenues of $48.5 million
- A decrease in professional fees of $856,000
- An increase in investment and other revenues of $7.4 million

Medical Premiums

from our HMO and managed indemnity insurance subsidiaries increased from $474.2 million to $546.1 million, an increase of $71.9 million or 15.2%. The increase in premium revenue reflects a 5.9% increase in Medicare member months (the number of months individuals are enrolled in a plan), a

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27.5% increase in Medicaid member months and an 11.4% 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 and POS premium rates for renewing commercial groups increased approximately 6% while the overall recorded per member per month revenue increase, including new and continuing business, was approximately 4%, net of changes in benefits. We did not receive a Medicaid rate increase in 2004 or 2003. The basic Medicare rate increase received in 2004 was approximately 2.2%. Our overall Medicare rate increase was approximately 12.5% due primarily to the impact of the MMA, as previously described, which started in March 2004.

Our commercial membership increased from 194,100 at June 30, 2003 to 215,700 at June 30, 2004. Our commercial member retention was approximately 95% on renewals through June 30, 2004, which represents approximately 53% of our total commercial membership.

Military Contract Revenues

increased from $219.8 million to $268.3 million, an increase of $48.5 million or 22.1%. The increased revenue is primarily the result of increased health care bid revenue consistent with the terms of SMHS' negotiated contract extension for the first year beyond the original five-year term. In addition, incremental change order revenues and final bid price adjustments on option periods three and four contributed to the higher revenue for 2004. The final bid price adjustments resulted in revenue increases of approximately $6.1 million for Option Period 3 (June 1, 2000 to May 31, 2001), which is 3.4% of the final revenue settlement amount for that period and $4.3 million for Option Period 4 (June 1, 2001 to May 31, 2002), which is 2.3% of the final revenue settlement amount for that period. The impact on income before taxes of the final bid price adjustments for option periods three and four was an increase of $6.6 million. The total impact on income before taxes of the change orders, bid price adjustments and other contractual settlements was an increase of $16.3 million.

In March 2004, SMHS entered into a definitive agreement with the new T-Nex North Region Contractor to provide certain transition services and to sell certain portions of its TRICARE business, including its provider network and certain other assets. The value of the transaction is up to $4 million with the final value contingent on SMHS' operational performance through August 2004. SMHS has recorded revenue of approximately $700,000 pursuant to this agreement during 2004.

Professional Fees

decreased from $18.4 million to $17.6 million, a decrease of $856,000, or 4.6% primarily as a result of the outsourcing of our eye care unit in late 2003. The outsourcing of these services reduced both our revenue and corresponding expenses.

Investment and Other Revenues

increased from $10.0 million to $17.4 million, an increase of $7.4 million or 74.6%. The increase in administrative services revenue is due to the services we are providing relative to our sales agreement for the workers' compensation insurance operations, beginning April 1, 2004. On March 31, 2004, we completed the sale of the workers' compensation insurance operations and we have been engaged to administer claims for a period of fifteen years as well as perform certain transition and managed care services. Total revenue associated with these services for 2004 was $5.9 million. The cost to provide these services is reflected in our general and administrative expenses. The remaining increase in investment and other revenues is due to higher average invested balances, the accrued interest on our note receivable and an increase in net gains on the sale of investments.

Medical Expenses

increased from $380.8 million to $426.5 million, an increase of $45.7 million or 12.0%. The increase is due primarily to our increased membership, which is in part offset by a lower medical care ratio. This ratio, which is medical expenses as a percentage of medical premiums and professional fees, decreased from 77.3% to 75.7%. The favorable decrease in our medical care ratio is due primarily to premium increases in excess of cost increases. We incurred capitation expenses with

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non-affiliated providers of $55.8 million and $49.0 million, or 13.1% and 12.9%, of our total medical expenses for the six months ended June 20, 2004 and 2003, respectively.

Military Contract Expenses

increased from $215.1 million to $237.2 million, an increase of $22.1 million or 10.3%. The increase is consistent with the increase in revenues discussed previously and includes T- Nex related costs of $4.3 million in 2003. In addition, the 2004 contract expenses included final bid price adjustments on option periods three and four of the TRICARE Region 1 contract. The final adjustments resulted in a contract expense increase of approximately $1.9 million for Option Period 3, which is 0.9% of the final contract expense settlement amount for that period and a contract expense increase of $1.9 million for Option Period 4, which is 0.8 % of the final contract expense settlement amount for that period. There were no final settlements of bid price adjustments in 2003. Included in our military contract expenses is an allocation for estimated corporate overhead of $1.0 million per quarter for direct and indirect services provided to SMHS.

General and Administrative Expenses

increased from $68.0 million to $82.4 million, an increase of approximately $14.4 million or 21.2%. The primary increase in G&A expenses is the $5.9 million to provide services relative to our sales agreement for the workers' compensation insurance operations as discussed above. The remaining increases in G&A expenses are primarily due to increases in payroll and benefits, premium taxes and legal expenses. As a percentage of revenues, G&A expenses were 9.7% for 2004, compared to 9.4% in 2003. As a percentage of medical premium revenue, G&A expenses were 15.1% for 2004, compared to 14.3% for 2003. Excluding the services relative to our sales agreement for the workers' compensation insurance operations described above, our G&A expenses, as a percentage of total operating revenues and medical premium revenue for the six month period, were 9.1% and 14.0%, respectively.

Interest Expense

decreased from $3.2 million to $2.3 million, a decrease of approximately $800,000 or 25.7%. The decrease was primarily due to the write off of the remaining deferred financing fees on the amended and restated credit facility of approximately $800,000 in 2003.

Other Income (Expense), Net

resulted in income of $163,000 for 2004 compared to expense of $343,000 for 2003. The expense in 2003 was primarily related to the loss on sale of certain assets.

Provision for Income Taxes

was recorded at $36.6 million for 2004 compared to $19.1 million for 2003. The effective tax rate for 2004 was 36.2% compared to 34.8% for 2003. Our effective tax rate is greater than the statutory rate due primarily to state income taxes and other non-deductible expenses.

Discontinued Operations

consist of our Texas HMO health care operations and the CII workers' compensation operations. The net loss from discontinued operations for 2004 was $486,000 compared to $651,000 for 2003. The Texas HMO health care operations had net income of $196,000 for 2004, which was offset by a net loss on the CII workers' compensation operations of $682,000. We have discontinued paying Texas claims, as our evidence of coverage requires that all claims must be settled within 18 months of the time of service.

Discontinued Texas HMO health care operations.

The income from the Texas HMO health care operations for 2004 is the result of favorable development in the medical claim liabilities and legal reserves.

Discontinued CII workers' compensation operations.

On March 31, 2004, we completed the sale of CII's subsidiary, Cal Indemnity. Our Condensed Consolidated Statement of Income for the six months ended June 30, 2004 reflects the activity of the discontinued operations through March 31, 2004, the disposal date. Any future activity related to this disposal will be reflected in continuing operations as previously discussed.

The discontinued workers' compensation operations for 2004 had a net loss of $682,000 compared to a loss of $3.6 million for 2003. Net earned premiums decreased by $53.0 million or 73.6% and investment and other revenue decreased by $6.0 million or 82.3% as the 2004 results include activity through March 31, 2004. Expenses decreased in the CII workers' compensation operations by $64.1 million or 74.6% due to the overall decrease in premiums.

LIQUIDITY AND CAPITAL RESOURCES

We had cash flows from operating activities for continuing operations of $80.7 million for the six months ended June 30, 2004 compared to $18.3 million in 2003. We received five monthly CMS payments during the first six months of 2004 and 2003 as the January payments were received at the end of December. When the first quarters are adjusted to reflect three monthly payments from CMS, the cash flow from continuing operations would be $113.6 million in 2004 and $48.2 million in 2003. We believe presenting this adjustment for the timing of the CMS payments is useful for making a six-month period-to-period comparison of our cash flow from continuing operations. We used the majority of the cash flow for the repurchase of the Company's common stock. The improvement in cash flows from continuing operations over 2003 is primarily attributable to cash from earnings and the decrease in cash related to the increase in the military accounts receivable balance that occurred from December 31, 2002 to June 30, 2003.

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.

We expect that the loss of the T-Nex contract will adversely affect our cash flow from operations starting in the fourth quarter of 2004 through the first half of 2005. During the phase-out period, we expect that SMHS will use $35.0 million to $40.0 million of its cash, as the payout of the remaining liabilities will exceed SMHS' accounts receivable and other non-cash asset balances.

Net cash used for investing activities of continuing operations during 2004 included $9.2 million in capital expenditures associated with clinical expansion, continued implementation of new computer systems, leasehold improvements on facilities, furniture and equipment and other capital purchases to support our growth. The net cash change in investments for the year was a decrease in investments of $50.1 million as investments were converted to cash equivalents.

Net cash used for financing activities of continuing operations during 2004 included net payments of $1.5 million on debt related items. Proceeds from the issuance of stock in connection with stock plans were $16.9 million and cash of $82.8 million was used to repurchase Sierra stock.

Discontinued operations provided cash of $3.4 million in 2004, compared to cash used of $29.8 million in 2003. Cash provided in 2004 was primarily the result of the sale of Cal Indemnity.

Sierra Debentures

In March 2003, we issued $115.0 million aggregate principal amount of 2¼% senior convertible debentures due March 15, 2023. The debentures pay interest, which is due semi-annually on March 15 and September 15 of each year. Each $1,000 principal amount of debentures is convertible, at the option of the holders, into 54.6747 shares of Sierra Health Services, Inc., common stock prior to March 15, 2023 if (i) the market price of our common stock for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of the preceding fiscal quarter exceeds 120% of the conversion price per share of our common stock; (ii) the debentures are called for redemption; (iii) there is an event of default with respect to the debentures; or (iv) specified corporate transactions have occurred. The conversion rate is subject to certain adjustments. This conversion rate initially represents a conversion price of $18.29 per share. Holders of the debentures may require us to repurchase all or a portion of their debentures on March 15 in 2008, 2013 and 2018 or upon certain corporate events including a change in control. In either case, we may choose to pay the purchase price of such debentures in cash or common stock or a combination of cash and common stock. The debentures can be redeemed by us for cash beginning on or after March 20, 2008.

Sierra used the net proceeds of the offering to repay the $39.0 million outstanding under the then existing credit facility and to contribute $35.0 million to SMHS. The $35.0 million contribution to SMHS was subsequently repaid to Sierra in February 2004. Sierra also used $19.9 million of the proceeds to purchase 1.6 million shares of Sierra's common stock under our repurchase program. The remainder of the net proceeds were used for working capital and general corporate purposes including additional share repurchases.

Revolving Credit Facility

On March 3, 2003, we entered into a $65.0 million revolving credit facility, which replaced our amended and restated credit facility. The facility may be increased up to an aggregate amount of $125.0 million upon receipt of new commitments from existing or additional lenders. Interest on the facility was initially LIBOR plus 2.25% and is currently LIBOR plus 2.00%. The facility will expire on April 30, 2006, but can be extended, at the sole discretion of each of the lenders, until March 3, 2008. The facility is available for general corporate purposes. We have not yet drawn on this facility.

The credit facility is secured by guarantees by certain of our subsidiaries and a first priority perfected security interest in (i) all the capital stock of each of our unregulated, material domestic subsidiaries (direct or indirect) as well as all of the capital stock of certain regulated, material domestic subsidiaries; and (ii) all other present and future assets and properties of ours and those of our subsidiaries that guarantee our credit agreement obligations (including, without limitation, accounts receivable, inventory, real property, equipment, contracts, trademarks, copyrights, patents, license rights and general intangibles) subject, in each case, to the exclusion of the capital stock of CII and certain other exclusions.

The revolving credit facility has covenants that limit our ability and the ability of our subsidiaries to dispose of assets, incur indebtedness, incur other liens, make investments, loans or advances, make acquisitions, engage in mergers or consolidations, repurchase our common stock or make capital expenditures and otherwise restricts certain corporate activities. In addition, we are required to comply with specified financial ratios as set forth in the credit agreement. We believe that we are in compliance with all covenants of the credit agreement.

Sierra Share Repurchase Program

From January 1, 2004 through June 30, 2004, we purchased 2.2 million shares of our common stock, in the open market or negotiated transactions, for $82.8 million at an average cost of $37.38. In addition to

the remaining 56,000 shares that our Board of Directors has previously approved, we will then have available an additional $70.0 million to be used for share repurchases based on approval by our Board of Directors on May 20,

2004. Our revolving credit facility, as amended, allows for stock repurchases of up to $60.0 million from May 27, 2004 through December 31, 2004. We purchased 528,000 shares for $22.8 million from May 27, 2004 through June 30, 2004. From July 1, 2004 to July 21, 2004, we repurchased an additional 38,000 shares for $1.6 million at an average cost of $43.70.

Included in the repurchases for the first quarter of 2004 are 500,000 shares we purchased from our CEO, at $32.00 per share, for a total of $16.0 million. The closing price of our common stock on the date of the transaction, February 11, 2004, was $32.35. Included in the repurchases for the second quarter of 2004 are an additional 500,000 shares we purchased from our CEO, at $43.20 per share, for a total of $21.6 million. The closing price of our common stock on the date of the transaction, May 27, 2004, was $43.25. Our Board of Directors approved both of the purchases.

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, including the discontinued operations, had restricted assets on deposit in various states totaling $21.0 million at June 30, 2004. 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. In conjunction with the exit from the Texas HMO health care market, the Texas Department of Insurance approved a plan of withdrawal and Texas Health Choice, L.C., is now required to maintain deposits of $1.5 million and net worth of at least $3.5 million. We believe we are in material compliance with our regulatory requirements.

Of the $177.7 million in cash and cash equivalents held at June 30, 2004, including discontinued operations, $396,000 was held by discontinued operations and $86.8 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.

Obligations and Commitments

The following schedule represents our obligations and commitments for long-term debt, capital leases and operating leases at June 30, 2004. The amounts presented below include all future payments associated with each obligation including interest expense.

(In thousands)	Long-Term Debt	Capital Leases	Operating Leases	Total
Continuing Operations				
Payments due within 12 months............	$ 2,587	$ 83	$ 19,912	$ 22,582
Payments due in 13 to 36 months..........	5,175	165	39,327	44,667
Payments due in 37 to 60 months..........	5,175	99	36,106	41,380
Payments due in more than 60 months.......	151,225	107	106,381	257,713
Total Continuing Operations.........	$ 164,162	$ 454	$ 201,726	$ 366,342
Discontinued Operations				
Payments due within 12 months............	$ --	$ 235	$ --	$ 235
Payments due in 13 to 36 months..........	--	--	--	--

Payments due in 37 to 60 months...........	--	--	--	--
Payments due in more than 60 months.......	--	--	--	--
Total Discontinued Operations........	$ --	$ 235	$ --	$ 235

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Other

We have a 2004 capital budget of $16.9 million and are also limited in the amount of capital expenditures we can purchase by our revolving credit facility. The 2004 planned expenditures are primarily for a new medical clinic, the purchase of 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 and the phase-out of the Military operations. 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 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.

Inflation

Health care costs continue to rise at a rate faster than the Consumer Price Index. We use various strategies to mitigate the negative effects of health care cost inflation, including setting commercial premiums based on our anticipated health care costs, risk-sharing arrangements with our various health care providers and other health care cost containment measures including member co-payments. There can be no assurance, however, that in the future, our ability to manage medical costs will not be negatively impacted by items such as technological advances, competitive pressures, applicable regulations, increases in pharmacy costs, utilization changes and catastrophic items, which could, in turn, result in medical cost increases equaling or exceeding premium increases.

Government Regulation

Our business, offering health care coverage, health care management services and, to a lesser extent, the delivery of medical services, is heavily regulated at both the federal and state levels.

Government regulation of health care coverage products and services is a dynamic area of law that varies from jurisdiction to jurisdiction. Amendments to existing laws and regulations are continually being considered and interpretation of the existing laws and rules changes from time to time. Regulatory agencies generally exercise broad discretion in interpreting laws and promulgating regulations to enforce their interpretations.

While we are unable to predict what legislative or regulatory changes may occur or the impact of any particular change, our operations and financial results could be negatively affected by any legislative or regulatory requirements. For example, any proposals to eliminate or reduce the Employee Retirement Income Security Act, or ERISA, which regulates insured and self- insured health care coverage plans offered by employers, pre-emption of state laws that would increase litigation exposure, affect underwriting practices, limit rate increases, require new or additional benefits or affect contracting arrangements (including proposals to require HMOs and PPOs to accept any health care provider willing to abide by an HMO's or PPO's contract terms) may have a material adverse effect on our business. The continued consideration and enactment of "anti-managed care" laws and regulations by federal and state bodies may make it more difficult for us to manage medical costs and may adversely affect financial results.

In addition to changes in existing laws and regulations, we are subject to audits, investigations and enforcement actions. These include possible government actions relating to ERISA, the Federal Employees Health Benefit Plan, federal and state fraud and abuse laws and laws relating to utilization >management and the delivery and payment of health care. In addition, our Medicare business is subject to Medicare regulations promulgated by CMS. Violation of government laws and regulations may result in

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an assessment of damages, civil or criminal fines or penalties, or other sanctions, including exclusion from participation in government programs. In addition, disclosure of any adverse investigation or audit results or sanctions could negatively affect our reputation in various markets and make it more difficult for us to sell our products and services.

In addition to the items described above, we urge you to review carefully the section "Risk Factors" in Part 1, Item 1 of our 2003 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" in Part 1, Item 1.

Critical Accounting Policies and Estimates

Our consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America. In preparing these financial statements, we are required to make judgments, assumptions and estimates, which we believe are reasonable and prudent based on the available facts and circumstances. These judgments, assumptions and estimates affect certain of our revenues and expenses and their related balance sheet accounts and in disclosing our contingent assets and liabilities. Our most significant accounting estimates are for our premium allowance, the liability for medical claims payable, military contract revenues and expenses, investment impairment, litigation and legal accruals and deferred tax assets and liabilities. We base our assumptions and estimates primarily on historical experience and trends and factor in known and projected trends. On an on-going basis, we re-evaluate our selection of assumptions and the method of calculating our estimates. Actual future results, however, may materially differ from our calculated estimates and this difference would be reported in our then current operations.

For a more detailed description of our critical accounting policies and estimates, see Part II, Item 7 of our 2003 annual report on 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 2003 annual report on Form 10-K filed on March 5, 2004.

Membership

	Number of Members at June 30,	
	2004	**2003**
HMO		
Commercial................................	215,700	194,100
Medicare..................................	52,200	49,600
Medicaid..................................	50,800	37,900
Managed Indemnity..........................	24,800	25,000
Medicare Supplement........................	16,700	18,400
Administrative Services....................	173,700	186,500
TRICARE Eligibles..........................	710,400	672,200
Total Members..............................	1,244,300	1,183,700

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

At June 30, 2004, we had unrealized holding losses on available for sale investments of $831,000, net of tax, compared to unrealized holding losses of $479,000, net of tax, at December 31, 2003. 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.

At June 30, 2004, we had outstanding $115.0 million in aggregate principal amount of our 2¼% senior convertible debentures due March 15, 2023. The debentures are fixed rate, and therefore, the interest expense on the debentures will not be impacted by future interest rate fluctuations. The interest rate on our revolving credit facility was initially LIBOR plus 2.25% and is currently LIBOR plus 2.00%; we have not yet drawn on this facility.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures as of the end of the period covered by this report were designed and were functioning effectively to provide reasonable assurance that the information required to be disclosed by the Company in reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. The Company believes that a system of controls, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

Change in Internal Control over Financial Reporting

No change in the Company's internal control over financial reporting occurred during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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SIERRA HEALTH SERVICES, INC. AND SUBSIDIARIES

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Although Sierra is not a named defendant, we have been notified that we have been named as a co-conspirator in the class action lawsuit, In Re: Managed Care Litigation: MDL No. 1334. The following summary is based upon information obtained from certain publicly filed documents. Beginning in 1999, a series of class action lawsuits were filed against most other major entities in the health benefits business. A multi-district litigation panel has consolidated most of these cases in the Southern District Court of Florida, Miami division. The plaintiffs assert that the defendants improperly paid providers' claims and "downcoded" their claims by paying lesser amounts than they submitted. The complaint alleges, among other things, multiple violations under the Racketeer Influenced and Corrupt Organizations Act, or RICO, as well as various breaches of contract and violations of regulations governing the timeliness of claim payments. The consolidated suits seek injunctive, compensatory and equitable relief as well as restitution, costs, fees and interest payments. Discovery commenced on September 30, 2002. In November 2002, the Eleventh Circuit granted the industry defendants' petition to review the class certification order. That appeal is pending. On April 7, 2003, the United States Supreme Court determined that the RICO claims against certain defendants should be arbitrated. On September 15, 2003, the district court granted in part and denied in part the industry defendants' further motion to compel arbitration. Significantly, the court denied the industry defendants' motion with respect to plaintiffs' derivative RICO claims. On September 19, 2003, the industry defendants appealed the district court's arbitration order to the Eleventh Circuit. Discovery is ongoing and a trial date has been set for September 13, 2004. In the meantime, two of the defendants, Aetna Inc. and Cigna Corporation, have entered into settlement agreements which have been approved by the Court.

We are subject to other various claims and litigation in the ordinary course of business. Such litigation includes, but is not limited to, claims of medical malpractice, claims for coverage or payment for medical services rendered to HMO and other 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. These actions are in various stages of litigation and some may ultimately be brought to trial. With respect to certain pending actions, we maintain commercial insurance coverage with varying deductibles for which we maintain estimated reserves for our self-insured portion based upon our current assessment of such litigation. Due to recent unfavorable changes in the commercial insurance market, we have, for certain risks, purchased coverage with higher deductibles and lower limits of coverage. In the opinion of management, based on information presently available, the amount or range of any potential loss cannot be reasonably estimated but the ultimate resolution of these pending legal proceedings should not have a material adverse effect on our financial condition.

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ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

(e) Below, is a summary of stock repurchases for the six months ended June 30, 2004. See Note 4 of our Notes to Condensed Consolidated Financial Statements for information regarding our stock repurchase plan.

(In thousands, except per share data) Period	Total number of shares repurchased (1)	Average price paid per share	Total number of shares purchased as part of publicly announced plan or program
Beginning shares available to be purchased			
January 1, 2004 - January 31, 2004	--	--	--
February 1, 2004 - February 29, 2004 (4)	663	$31.86	663
March 1, 2004 - March 31, 2004	317	34.19	317
April 1, 2004 - April 30, 2004	16	34.91	16
May 1, 2004 - May 31, 2004	590	39.20	590
June 1, 2004 - June 30, 2004 (5)	628	43.20	628

(1) Certain repurchases were made pursuant to a 10b-5 plan.

(2) On October 28, 2003, the Company announced that its Board of Directors had authorized the Company to

purchase an additional 3.0 million shares of its common stock in addition to the 4.6 million shares that had previously been authorized. The repurchase program has no stated expiration date. Through December 31, 2003, the Company had purchased 5.3 million shares leaving 2.3 million shares authorized to be repurchased.

(3) On May 20, 2004, the Company's Board of Directors authorized the Company to purchase an additional $70.0 million of its common stock. The repurchase program has no stated expiration date, and will commence after the previously authorized share repurchase has been completed. Based on the July 22, 2004 closing price this would allow the Company to repurchase an additional 1.5 million shares.

(4) Includes 500,000 shares the Company purchased from its CEO at $32.00 per share.

(5) Includes 500,000 shares the Company purchased from its CEO at $43.20 per share.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

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

Sierra held its annual meeting of stockholders on May 20, 2004 in Las Vegas, Nevada.

The following persons were elected directors for two-year terms ending in 2006 based on the voting results below:

Name	For	Withheld
Albert L. Greene	23,811,591	1,409,960
Erin E. MacDonald	24,303,158	918,393
William J. Raggio	21,772,418	3,449,133
Charles L. Ruthe	23,165,586	2,055,965

The following persons' terms as directors continued after the meeting and end in 2005.

Name
Thomas Y. Hartley
Michael E. Luce
Anthony M. Marlon, M.D.
Anthony L. Watson

The stockholders also amended the Company's employee stock purchase plan to increase by 900,000 the number of shares of common stock reserved for issuance to participants. The voting results were as follows:

For	Against	Abstain	Broker Non-votes
18,890,157	2,404,306	43,668	0

The stockholders also ratified the appointment of Deloitte & Touche LLP as the Company's independent auditors for the year ending December 31, 2004. The voting results were as follows:

For	Against	Abstain	Broker Non-votes
24,876,208	329,083	16,260	0

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

(10.1) Employment Agreement with William R. Godfrey dated April 3, 2004.

(10.2) Employment Agreement with Laurence S. Howard dated April 3, 2004.

(10.3) Employment Agreement with Paul H. Palmer dated April 3, 2004.

(31.1) Rule 13a - 14(a) Certification of Chief Executive Officer.

(31.2) Rule 13a - 14(a) Certification of Chief Financial Officer.

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

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

(b) Reports on Form 8-K

Current Report on Form 8-K, dated April 15, 2004, with the Securities and Exchange Commission announcing the completion of the sale of the Company's workers' compensation subsidiary on March 31, 2004.

Current Report on Form 8-K, dated April 26, 2004, with the Securities and Exchange Commission announcing the Company's operating results for the quarter ended March 31, 2004.

Current Report on Form 8-K, dated May 3, 2004, with the Securities and Exchange Commission announcing the Company's participation in a small and mid-cap conference on May 5, 2005.

Current Report on Form 8-K, dated May 13, 2004, with the Securities and Exchange Commission announcing the Company's participation in a health care conference on May 19, 2004.

Current Report on Form 8-K, dated May 18, 2004, with the Securities and Exchange Commission announcing that its subsidiary Sierra Military Health Services, Inc. will experience higher than expected income for the second quarter of 2004.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned thereto duly authorized.

SIERRA HEALTH SERVICES, INC.
Registrant
By: /s/ Paul H. Palmer
Paul H. Palmer
Senior Vice President of Finance,
Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)

Date: July 27, 2004

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