CORVEL CORP
Form 10-Q
August 14, 2006

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

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

For the quarter ended June 30, 2006

or

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

For this transition period from __________ to __________

Commission file number O-19291

CORVEL CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	33-0282651
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
2010 Main Street, Suite 600 Irvine, CA	92614
(Address of principal executive office)	(zip code)

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yeso Noþ

The number of shares outstanding of the registrant s Common Stock, $0.0001 Par Value, as of June 30, 2006 was 9,417,025.

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Part I Financial Information
Item 1. Financial Statements
CORVEL CORPORATION
CONSOLIDATED BALANCE SHEETS UNAUDITED

	March 31, 2006	June 30, 2006
Assets		
Current Assets		
Cash and cash equivalents	$ 14,206,000	$ 21,365,000
Accounts receivable, net	39,521,000	39,155,000
Prepaid taxes and expenses	2,221,000	1,956,000
Deferred income taxes	4,521,000	5,426,000
Total current assets	60,469,000	67,902,000
Property and equipment, net	26,459,000	25,021,000
Goodwill and other assets	13,170,000	13,157,000
TOTAL ASSETS	$ 100,098,000	$ 106,080,000
Liabilities and Stockholders Equity		
Current Liabilities		
Accounts and taxes payable	$ 13,712,000	$ 16,837,000
Accrued liabilities	12,160,000	9,823,000
Total current liabilities	25,872,000	26,660,000
Deferred income taxes	6,190,000	5,925,000
Commitments and contingencies		
Stockholders Equity		
Common stock, $.0001 par value: 20,000,000 shares authorized; 16,517,387 shares (9,416,900, net of Treasury shares) and 16,517,512 shares (9,417,025, net of Treasury shares) issued and outstanding at March 31, 2006 and June 30, 2006, respectively	2,000	2,000
Paid-in-capital	61,084,000	61,903,000
Treasury Stock, (7,100,487 shares at March 31, 2006 and 7,100,487 shares at June 30, 2006)	(132,205,000)	(132,205,000)
Retained earnings	139,155,000	143,795,000
Total stockholders equity	68,036,000	73,495,000

TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 100,098,000	$ 106,080,000

See accompanying notes to consolidated financial statements.

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CORVEL CORPORATION
CONSOLIDATED INCOME STATEMENTS UNAUDITED

	Three months ended June 30, 2005	2006
REVENUES	$ 70,667,000	$ 69,762,000
Cost of revenues	58,663,000	53,435,000
Gross profit	12,004,000	16,327,000
General and administrative expenses	7,434,000	8,720,000
Income before income tax provision	4,570,000	7,607,000
Income tax provision	1,760,000	2,967,000
NET INCOME	$ 2,810,000	$ 4,640,000
Net income per common and common equivalent share		
Basic	$ 028	$ 0.49
Diluted	$ 0.28	$ 0.49
Weighted average common and common equivalent shares		
Basic	9,960,000	9,417,000
Diluted	10,020,000	9,446,000

See accompanying notes to consolidated financial statements.

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CORVEL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS UNAUDITED

	Three months ended June 30, 2005	2006
Cash flows from Operating Activities		
NET INCOME	$ 2,810,000	$ 4,640,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,855,000	2,587,000
Loss on disposal of assets	12,000	85,000
Tax benefit from stock options exercised	270,000	642,000
Stock compensation expense		285,000
Write-off of uncollectible accounts		667,000
Provision for deferred income taxes	(814,000)	(1,170,000)
Changes in operating assets and liabilities		
Accounts receivable	1,695,000	(301,000)
Prepaid taxes and expenses	926,000	265,000
Accounts and taxes payable	2,259,000	3,125,000
Accrued liabilities	(1,277,000)	(2,337,000)
Other assets	11,000	7,000
Net cash provided by operating activities	8,747,000	8,495,000
Cash Flows from Investing Activities		
Additions to property and equipment	(3,322,000)	(1,228,000)
Net cash used in investing activities	(3,322,000)	(1,228,000)
Cash Flows from Financing Activities		
Purchase of treasury stock	(6,212,000)	
Tax effect of stock compensation expense		(111,000)
Exercise of common stock options	1,812,000	3,000
Net cash used in financing activities	(4,400,000)	(108,000)
Increase in cash and cash equivalents	1,025,000	7,159,000
Cash and cash equivalents at beginning	8,945,000	14,206,000
Cash and cash equivalents at end	$ 9,970,000	$ 21,365,000

Supplemental Cash Flow Information:

Income taxes paid	$ 14,000	$ 116,000
Interest paid	1,000	

See accompanying notes to consolidated financial statements.

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2006 (Unaudited)

Note A Basis of Presentation

The unaudited financial statements herein have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. The accompanying interim financial statements have been prepared under the presumption that users of the interim financial information have either read or have access to the audited financial statements for the latest fiscal year ended March 31, 2006. Accordingly, footnote disclosures which would substantially duplicate the disclosures contained in the March 31, 2006 audited financial statements have been omitted from these interim financial statements. The consolidated financial statements include the accounts of CorVel and its wholly-owned subsidiaries. Significant intercompany accounts and transactions have been eliminated in consolidation.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending March 31, 2007. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended March 31, 2006 included in the Company s Annual Report on Form 10-K.

Note B Stock Based Compensation

Prior to the quarter ended June 30, 2006, the first quarter of fiscal year ending March 31, 2007, the Company accounted for its stock-based compensation under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25). Under APB 25, no stock option expense was reflected in net income because the Company grants stock options with an exercise price equal to the market price of the underlying common stock on the date of grant.

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

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

The Company has historically issued new shares to satisfy option exercises.

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note B Stock Based Compensation (continued)

The table below shows the amounts recognized in the financial statements for the three months ended June 30, 2006 for stock-based compensation.

		Three months Ended June 30, 2006
Cost of revenues	$	225,000
General and administrative		60,000
Total cost of stock-based compensation included in income, before income tax		285,000
Amount of income tax benefit recognized		111,000
Amount charged against income	$	174,000
Effect on diluted income per share	$	(.02)

For purposes of pro forma disclosures under SFAS 123 for the three months ended June 30, 2005, the estimated fair value of options was assumed to be amortized to expense over the vesting period of the award. There is not pro forma presentation for the three months ended June 30, 2006 as the Company adopted SFAS 123R as of April 1, 2006, as discussed above. The following table illustrates the effect on net income had the Company applied the fair value recognition provisions of SFAS 123, *Accounting for Stock-Based Compensation* (SFAS 123), as amended by SFAS 148, *Accounting for Stock-Based Compensation Transition and Disclosure* (SFAS 148) for the three months ended June 30, 2005 (in thousands):

		Three Months Ended June 30, 2005
Net income	$	2,810,000
Deduct: Stock-based compensation cost, net of income taxes		(183,000)
Pro forma net income	$	2,627,000
Net income per share basic		
As reported	$	0.28
Pro forma	$	0.26

Net income per share diluted		
As reported	$	0.28
Pro forma	$	0.26

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note B   Stock Based Compensation (continued)

The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model with the assumptions included in the table below. The Company uses historical data among other factors to estimate the expected volatility, the expected option life, and the expected forfeiture rate. The risk-free rate is based on the interest rate paid on a U.S. Treasury issue with a term similar to the estimated life of the option. The weighted average expected option term for 2006 reflects the application of the simplified method defined in the Securities and Exchange Commission Staff Accounting Bulletin No. 107, which defines the life as the average of the contractual term of the options and the weighted average vesting period for all option tranches. Based upon the historical experience of options cancellations, the Company has estimated an annualized forfeiture rate of 9.0%. Forfeiture rates will be adjusted over the requisite service period when actual forfeitures differ, or are expected to differ, from the estimate. The following assumptions were used to estimate the fair value of options granted during the three months ended June 30, 2005 and 2006 using the Black-Scholes option-pricing model:

	Three Months Ended June 30,	
	2005	2006
Risk-free interest rate	4.0%	4.9%
Expected volatility	37%	40%
Expected dividend yield	0.0	0.0
Expected forfeiture rate	9.0%	9.0%
Expected weighted average life of option in years	4.7 years	4.8 years

Under the Company s Restated 1988 Executive Stock Option Plan, (the Plan) as amended, options for up to 5,955,000 shares of the Company s common stock may be granted at prices not less than 85% of the fair value of the Company s common stock on date of grant, as determined by the Board. Options granted under the Plan may be either incentive stock options or non-statutory stock options, and options granted generally have a maximum life of five years. Options will generally become exercisable for 25% of the options shares one year from the date of grant and then ratably over the following 36 months, respectively. All options granted in the three months ended June 30, 2005 and 2006 were granted at fair market value and are non-statutory stock options. Summarized information for all stock options for the three months ended June 30, 2005 and 2006 follows:

	Three months ended June 30, 2005		Three months ended June 30, 2006	
	Shares	Average Price	Shares	Average Price
Options outstanding, beginning	969,887	$ 25.29	847,082	$ 25.92
Options granted	33,300	20.25	193,550	23.30
Options exercised	(98,815)	17.69	(125)	20.20
Options cancelled	(17,989)	27.92	(83,599)	24.63
Options outstanding, ending	886,383	$ 25.90	956,908	$ 25.50

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note B Stock Based Compensation (continued)

A summary of the status for all outstanding options at March 31, 2006 and June 30, 2006, and changes during the quarter then ended is presented in the table below:

	Number of Options	Weighted Average Exercise Per Share	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value as of June 30, 2006
Options outstanding at March 31, 2006	847,082	$ 25.92		
Granted	193,550	23.30		
Exercised	(125)	20.20		
Cancelled forfeited	(6,188)	22.07		
Cancelled expired	(77,411)	24.84		
Ending outstanding	956,908	$ 25.50	3.32	$ 2,218,036
Ending vested and expected to vest	875,597	$ 25.73	0.84	$ 2,031,549
Ending exercisable	492,214	$ 27.20	2.10	$ 1,089,344

As of June 30, 2006, unrecognized compensation expense related to unvested stock options totaled approximately $1.1 million, which will be recognized over a weighted period of 2.2 years.

The weighted-average grant-date fair value of options granted during the three months ended June 30, 2005 and June 30, 2006, was $6.34 and $8.08, respectively. The total intrinsic value for options exercised (i.e., the difference between the market price at exercise and the price paid by the employee to exercise the options) during the three months ended June 30, 2005 and 2006 was $702,000 and $1,000, respectively.

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

Note C Treasury Stock

The Company s Board of Directors approved the commencement of a share repurchase program in the fall of 1996. In June 2006, the Company s Board of Directors approved a 1,000,000 share expansion to its existing stock repurchase plan, increasing the total number of shares approved for repurchase to 8,100,000 shares from 7,100,000 shares. Since the commencement of the share repurchase program, the Company has spent $132 million to repurchase 7,100,487 shares of its common stock, equal to 43% of the outstanding common stock had there been no repurchases. The average price of these repurchases is $18.62 per share. During the quarter ended June 30, 2006, the Company did not repurchase any shares of its common stock. These purchases have been funded primarily from the net earnings of the Company, along with the proceeds from the exercise of common stock options, the employee stock purchase plan and related income tax benefits from the exercise of these options. CorVel has 9,417,025 shares of common stock outstanding as of June 30, 2006, after reduction for the 7,100,487 shares in treasury.

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note D Weighted Average Shares and Net Income Per Share

Weighted average basic common and common equivalent shares decreased from 9,960,000 for the quarter ended June 30, 2005 to 9,417,000 for the quarter ended June 30, 2006. Weighted average diluted common and common equivalent shares decreased from 10,020,000 for the quarter ended June 30, 2005 to 9,446,000 for the quarter ended June 30, 2006. The net decrease in both of these weighted share calculations is due to the repurchase of common stock as noted above offset by an increase in shares outstanding due to the exercise of stock options in the Company s employee stock option plan.

Net income per common and common equivalent shares was computed by dividing net income by the weighted average number of common and common stock equivalents outstanding during the quarter. The calculations of the basic and diluted weighted shares for the three months ended June 30, 2005 and 2006, are as follows:

	Three months ended June 30,	
Basic Income Per Share:	2005	2006
Weighted average common shares outstanding	9,960,000	9,417,000
Net Income	$ 2,810,000	$ 4,640,000
Net Income per share	$ .28	$ 0.49

	Three months ended June 30,	
Diluted Income Per Share:	2005	2006
Weighted average common shares outstanding	9,960,000	9,417,000
Treasury stock impact of stock options	60,000	29,000
Total common and common equivalent shares	10,020,000	9,446,000
Net Income	$ 2,810,000	$ 4,640,000
Net Income per share	$ .28	$ 0.49

For the quarters ended June 30, 2005 and June 30, 2006, 531,039 and 770,253 anti-dilutive shares, respectively, have been excluded from the diluted weighted shares outstanding calculation.

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note E Shareholder Rights Plan

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

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

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

Note F Components of the Balance Sheet

	March 31, 2006	June 30, 2006 (Unaudited)
Accrued liabilities		
Payroll and related benefits	$ 6,859,000	$ 5,906,000
Self-insurance accruals	3,644,000	3,722,000
Other	1,657,000	195,000
	$ 12,160,000	$ 9,823,000

Note G Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board (FASB) issued FAS No. 154, Accounting Changes and Error Corrections (FAS 154). SFAS No. 154 is a replacement of APB No. 20 and SFAS No. 3. SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application as the required method for reporting a change in accounting principle. SFAS No. 154 provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. SFAS No. 154 also addresses the reporting of a correction of an error by restating previously issued financial statements. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 is not expected to have a material impact on the Company s financial statements.

In March 2005, the FASB issued FASB Interpretation No. (FIN) 47, Accounting for Conditional Asset Retirement Obligations, which is effective for fiscal years ending after December 15, 2005. The interpretation requires a conditional asset retirement obligation to be recognized when the fair value of the liability can be reasonably estimated. The interpretation is not expected to have a material impact on the Company s financial statements.

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes, which defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. A tax position that meets the more-likely-than-not criterion shall be measured at the largest amount of benefit that is more than 50% likely of being realized upon ultimate settlement. Interpretation No. 48 applies to all tax positions accounted for under SFAS No. 109, Accounting for Income Taxes. Interpretation No. 48 is effective for fiscal years beginning after December 15, 2006. Upon adoption, we will adjust our financial statements to reflect only those tax positions that are more-likely-than-not to be sustained as of the adoption date. Any adjustment will be recorded directly to our beginning retained earnings balance in the period of adoption and reported as a change in accounting principle. The Company is currently analyzing the effects of adopting Interpretation No. 48.

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CORVEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note H Business Enterprise Segments

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

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

Note I Employee Stock Purchase Plan

There were no shares issued under the Company s Employee Stock Purchase Plan during either the quarter ended June 30, 2005 or June 30, 2006.

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

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

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

Overview

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

Network Solutions Services

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

Patient Management Services

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

Organizational Structure

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

Business Enterprise Segments

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

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

Summary of Quarterly Results

The Company generated revenues of $69.8 million for the quarter ended June 30, 2006, a decrease of $0.9 million or 1.3%, compared to revenues of $70.7 million for the quarter ended June 30, 2005.

The slight revenue decrease reflects the challenging market conditions and there is no guarantee that the Company will either post revenue growth similar to the period from 1991 to 2003 or generate revenue increases. The decrease in the nation s manufacturing employment levels, which has helped lead to a decline in national workers compensation claims, considerable price competition in a flat-to-declining overall market, an increase in competition from both larger and smaller competitors, changes and the potential changes in state workers compensation and auto managed care laws which can reduce demand for the Company s services, have created an environment where revenue and margin growth is more difficult to attain and where revenue growth is less certain than historically experienced. Additionally, the Company s technology and preferred provider network competes against other companies, some of which have more resources available. Also, some customers may handle their managed care services in-house and may reduce the amount of services which are outsourced to managed care companies such as CorVel Corporation.

The Company s cost of revenues decreased by $5.3 million, from $58.7 million in the June 2005 quarter to $53.4 million in the June 2006 quarter, a decrease of 9.0%. This decrease was primarily due to the decrease in the Company s headcount from 2,877 at June 30, 2005 to 2,587 at June 30, 2006 due to a decrease in the volume of business along with greater efficiencies in the Company s field operations, primarily Network Solutions.

The Company s general and administrative costs increased by 17.3% from $7.4 million in the June 2005 quarter to $8.7 million in the June 2006 quarter. This increase was primarily due to the increase in corporate governance costs under the Sarbanes-Oxley Act of 2002.

The Company s income before income taxes increased by 66.5%, from $4.6 million in the June 2005 quarter to $7.6 million in the June 2006 quarter. The increase in income before income taxes was primarily due to the aforementioned decrease in cost of revenues although revenues decreased by just a nominal amount.

Weighted diluted shares decreased from 10.02 million shares in the June 2005 quarter to 9.45 million shares in the June 2006 quarter, a decrease of 0.57 million shares or 5.7%. This decrease was primarily due to the Company s repurchase of common shares during the September 2005 and December 2005 quarters.

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Diluted earnings per share increased from $0.28 in the June 2005 quarter to $0.49 in the June 2006 quarter, an increase of $0.21 per share or 75.0%. The increase in diluted earnings per share was primarily due to the increase in the income before income taxes and the decrease in the weighted diluted shares.

Results of Operations

The Company derives its revenues from providing patient management and network solutions services to payors of workers compensation benefits, auto insurance claims and health insurance benefits. Patient management services include utilization review, medical case management, and vocational rehabilitation. Network solutions revenues include fee schedule auditing, hospital bill auditing, independent medical examinations, diagnostic imaging review services and preferred provider referral services. Network solutions has shown to be the stronger business over the past year as revenues have increased while patient management revenues have decreased. The percentages of revenues attributable to patient management and network solutions services for the quarters ended June 30, 2005 and June 2006:

	June 30, 2005	June 30, 2006
Patient management services	43.5%	39.2%
Network solutions revenues	56.5%	60.8%

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

	Quarter Ended June 30, 2005	Quarter Ended June 30, 2006	Dollar Change	Percentage Change
Revenue	$70,667,000	$69,762,000	($905,000)	(1.3%)
Cost of revenues	58,663,000	53,435,000	(5,228,000)	(8.9%)
Gross profit	12,004,000	16,327,000	4,323,000	36.0%
Gross profit percentage	17.0%	23.4%		
General and administrative	7,434,000	8,720,000	1,286,000	17.3%
General and administrative percentage	10.5%	12.4%		
Income before income tax provision	4,570,000	7,607,000	3,037,000	66.5%
Income before income tax provision percentage	6.5%	10.9%		
Income tax provision	1,760,000	2,967,000	1,207,000	68.6%
Net income	$ 2,810,000	$ 4,640,000	$ 1,830,000	65.1%
Weighted Shares				
Basic	9,960,000	9,417,000	(543,000)	(5.5%)
Diluted	10,020,000	9,446,000	(574,000)	(5.7%)

Earnings Per Share							
Basic	$	0.28	$	0.49	$	0.21	75.0%
Diluted	$	0.28	$	0.49	$	0.21	75.0%

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Revenues

As noted above, revenues decreased from $70.7 million for the three months ended June 30, 2005 to $69.8 million for the three months ended June 30, 2006, a decrease of $.9 million or 1.3%. The continued softness in the national labor market, especially the manufacturing sector of the economy, has caused a reduction in the overall claims volume. The Company s patient management revenues decreased $3.4 million or 11.1% from $30.7 million in the June 2005 quarter to $27.3 million in the June 2006 quarter. This decrease was primarily due to a decrease in case referral volume offset by a nominal increase in price. The number of the Company s case managers decreased from just over 900 at June 30, 2005 to approximately 800 at June 30, 2006. The Company s network solutions revenues increased from $39.9 million in the June 2005 quarter to $42.4 million, an increase of $2.5 million or 6.3%. This increase was primarily due to an increase the volume of out of network bills reviewed and an increase in revenue per provider bill reviewed due to increased savings per bills for the Company s customers.

Management believes that referral volume in the patient management services and bill review volume in the network solutions will continue to remain relatively flat until there is a growth in the number work related injuries and workers compensation related claims.

Cost of Revenues

The Company s cost of revenues consist of direct expenses, costs directly attributable to the generation of revenue, and field indirect costs which are incurred in the field offices of the Company. Direct costs are primarily case manager salaries, bill review analysts, related payroll taxes and fringe benefits, and costs for IME (independent medical examination) and MRI providers. Most of the Company s revenues are generated in offices which provide both patient management services and network solutions services. The largest of the field indirect costs are manager salaries and bonus, account executive base pay and commissions, administrative and clerical support, field systems personnel, PPO network developers, related payroll taxes and fringe benefits, office rent, and telephone expense. Approximately 44% of the costs incurred in the field are field indirect costs which support both the patient management services and network solutions operations of the Company s field operations.

Change in Cost of Revenues

The Company s cost of revenues decreased by 9.0% from $58.7 million for the three months ended June 30, 2005 to $53.4 million for the three months ended June 30, 2006, due to the reduction in revenues in the patient management business and the increased efficiencies in the network solutions business. Direct salaries in the field decreased from $17.1 million in the three months ended June 30, 2005 to $15.1 million for the three months ended June 30, 2006, a decrease of approximately $2 million. Total direct costs, including direct salaries, decreased from $34.4 million for the three months ended June 30, 2005 to $30.8 million for the three months ended June 30, 2006, a decrease of approximately $3.6 million. $1.1 million of the decrease was due to a decrease in provider costs due to decreases in revenues from the provision of IME s (independent medical examinations) MRI s (medical resonance imaging) and CorCareRX (pharmacy). Additionally, field management salaries decreased from $4.0 million for the three months ended June 30, 2005, to $3.7 million for the three months ended June 30, 2006, a decrease of approximately $0.3 million and field clerical salaries decreased from $4.3 million in the three months ended June 30, 2005 to $3.8 million for the three months ended June 30, 2006, a decrease of approximately $0.5 million. These reductions in field direct and field indirect salaries are primarily due to the reduction in the Company s headcount, which was caused by several factors including a decrease in the number of patient management referrals, the scope of work for these referrals, the numbers of bills processed, and a reduction of IME and MRI referrals in network solutions. The cost of revenues percentage for the three months ended June 30, 2005 was 83.0% compared to 76.6% for the three months ended June 30, 2006 primarily due to the revenue mix shift from the lower margin patient management revenues to the high margin network solutions revenues, the revenue mix shift within network solutions from the lower margin IME and MRI referral revenues to the higher margin bill review revenues and due to greater revenues per bill in the bill review revenues.

Because of the higher margins associated with the network solutions margins, the Company is actively emphasizing these services in its market and business development activities and believes the greatest opportunities for the Company is in the further development of these services.

General and Administrative Costs

For the quarter ended June 30, 2006, general and administrative costs consisted of approximately 53% of corporate systems costs which include the corporate systems support, implementation and training, amortization of software development costs, depreciation of the hardware costs in the Company s national systems, the Company s national wide area network and other systems related costs. The remaining 47% of the general and administrative costs consist of national marketing, national sales support, corporate legal, corporate insurance, human resources, accounting, product management, new business development and other general corporate matters. Approximately 30% of the non-systems portion of general and administrative costs during the June 2006 quarter pertained to the costs of corporate governance for compliance under the Sarbanes-Oxley Act of 2002.

Change in General and Administrative Costs

General and administrative expenses increased from $7.4 million or 10.5% of revenue in the June 2005 quarter to $8.7 million or 12.4% of revenue in the June 2006 quarter. A majority of the $1.3 million increase in general and administrative costs from the June 2005 quarter to the June 2006 quarter is due to the increase in the costs of corporate governance for compliance under the Sarbanes-Oxley Act of 2002.

Income Tax Provision

The Company s income tax expense increased from $1.8 million in the June 2005 quarter to $3.0 million in the June 2006 quarter primarily due to the increase in income before income taxes from $4.6 million in the June 2005 quarter to $7.6 million in the June 2006 quarter. The income tax provision rate in the June 2005 quarter was 38.5% of income before income taxes and the income tax provision rate in the June 2006 quarter was 39.0% of income before income taxes. This increase was based upon the Company s review of the components of the income tax provision for fiscal 2007.

Liquidity and Capital Resources

The Company has historically funded its operations and capital expenditures primarily from cash flow from operations, and to a lesser extent, option exercises. Net working capital increased from $34.6 million as of March 31, 2006 to $41.2 million as of June 30, 2006, primarily due to an increase in cash from $14.2 million as of March 31, 2006 to $21.4 million as of June 30, 2006. This increase in working capital is due primarily to the income before income taxes of $7.6 million during the June 2006 quarter.

The Company believes that cash from operations, and funds from exercise of stock options granted to employees are adequate to fund existing obligations, repurchase shares of the Company s common stock, introduce new services, and continue to develop healthcare related businesses. The Company regularly evaluates cash requirements for current operations and commitments, and for capital acquisitions and other strategic transactions. The Company may elect to raise additional funds for these purposes, either through debt or additional equity, the sale of investment securities or otherwise, as appropriate.

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As of June 30, 2006 the Company had $21.4 million in cash and cash equivalents, invested primarily in short-term, highly liquid investments with maturities of 90 days or less in a federally regulated bank.

The Company has historically required substantial capital to fund the growth of its operations, particularly working capital to fund the growth in accounts receivable and capital expenditures. Management believes, however, that the cash balance at June 30, 2006 along with anticipated internally generated funds and the available line of credit would be sufficient to meet the Company s expected cash requirements for at least the next twelve months.

Operating Cash Flows

Quarter ended June 30, 2005 compared to quarter ended June 30, 2006

Net cash provided by operating activities was $8.7 million in the three months ended June 30, 2005 compared to $8.5 million in the three months ended June 30, 2006. Although the Company s net income for the June 2005 was lower than the June 2006 quarter, the Company generated $1.7 million of cash flow from a decrease in receivables from March 31, 2005 to June 30, 2005 due to a decrease in revenues and days sales outstanding to 51 days at June 30, 2006 while during the current quarter, the Company had a slight increase in accounts receivable. The Company s historical net days sales outstanding (DSO) has ranged between 50 and 60 days and it is presently expected that the DSO will continue in this range. The Company s DSO was just under 51 days at June 30, 2006.

Investing Activities

Quarter ended June 30, 2005 compared to quarter ended June 30, 2006

Net cash flow used in investing activities decreased from $3.3 million in the three months ended June 30, 2005 to $1.2 million in the three months ended June 30, 2006. This decrease was primarily due to the reduction in the volume of the Company s business which required less capital additions during the June 2006 quarter as compared to the same quarter of the prior year. The Company s capital expenditures may remain below historical standards if the volume of business does not increase.

Financing Activities

Quarter ended June 30, 2005 compared to quarter ended June 30, 2006

Net cash flow used in financing activities decreased from $4.4 million for the three months ended June 30, 2005 to a nominal amount in the June 2006 quarter. During the June 2005 quarter, the Company spent $6.2 million in repurchases of its common stock and there were no repurchases of common stock during the June 2006 quarter. The June 2005 quarter stock repurchases were offset by $1.8 million of cash flow generated from the exercise of stock options. The exercise of stock options generated a nominal amount of cash flow during the June 2006 quarter.

The following table summarizes the Company s contractual obligations outstanding as of June 30, 2006.

	Payments Due by Period				
	Total	Within One Year	Between Two and Three Years	Between Four and Five Years	Thereafter
Operating leases	$30,563,000	$10,358,000	$14,484,000	$5,054,000	$667,000

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Critical Accounting Policies

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

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

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

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

Allowance for Uncollectible Accounts: The Company determines its allowance by considering a number of factors, including the length of time trade accounts receivable are past due, the Company s previous loss history, the customers current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. The Company writes off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for doubtful accounts. No one customer accounted for 10% or more of accounts receivable at any of the fiscal years ended March 31, 2003, 2004, and 2005.

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

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

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

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

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

Recently Issued Accounting Standards

In May 2005, the Financial Accounting Standards Board (FASB) issued FAS No. 154, Accounting Changes and Error Corrections (FAS 154). SFAS No. 154 is a replacement of APB No. 20 and SFAS No. 3. SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application as the required method for reporting a change in accounting principle. SFAS No. 154 provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. SFAS No. 154 also addresses the reporting of a correction of an error by restating previously issued financial statements. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 is not expected to have a material impact on the Company s financial statements.

In March 2005, the FASB issued FASB Interpretation No. (FIN) 47, Accounting for Conditional Asset Retirement Obligations, which is effective for fiscal years ending after December 15, 2005. The interpretation requires a conditional asset retirement obligation to be recognized when the fair value of the liability can be reasonably estimated. The interpretation is not expected to have a material impact on the Company s financial statements.

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes, which defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. A tax position that meets the more-likely-than-not criterion shall be measured at the largest amount of benefit that is more than 50% likely of being realized upon ultimate settlement. Interpretation No. 48 applies to all tax positions accounted for under SFAS No. 109, Accounting for Income Taxes. Interpretation No. 48 is effective for fiscal years beginning after December 15, 2006. Upon adoption, we will adjust our financial statements to reflect only those tax positions that are more-likely-than-not to be sustained as of the adoption date. Any adjustment will be recorded directly to our beginning retained earnings balance in the period of adoption and reported as a change in accounting principle. The Company is currently analyzing the effects of adopting Interpretation No. 48.

Item 3 Quantitative and Qualitative Disclosures About Market Risk -

As of June 30, 2006, the Company held no market risk sensitive instruments for trading purposes and the Company did not employ any derivative financial instruments, other financial instruments, or derivative commodity instruments to hedge any market risk. The Company had no debt outstanding as of June 30, 2006.

Item 4 Controls and Procedures

Evaluation of Disclosure Controls and Procedures

CorVel s management, with the participation of CorVel s Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of CorVel s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report.

Our management assessed the effectiveness of our internal control over financial reporting as of March 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control Integrated Framework (COSO). Based on our assessment, we believe that, as of June 30, 2006, our internal control over financial reporting was ineffective based on those criteria, in consideration of the material weaknesses described below. Based upon that evaluation, CorVel s Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, CorVel s disclosure controls and procedures were ineffective.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The Company is presently in the process of reviewing the weaknesses and developing a plan to remediate these weaknesses.

The certifications of the Company s Chief Executive Officer and Chief Financial Officer attached as Exhibits 31.1 and 31.2 to this Report include, in paragraph 4 of such certifications, information concerning the Company s procedures and internal control over financial reporting.

Changes in Internal Control over Financial Reporting

During the most recent fiscal quarter covered by this report, there has been no change in CorVel s internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) that has materially affected, or is reasonably likely to materially affect, CorVel s internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1 Legal Proceedings

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

Item 1A. Risk Factors

A restated description of the risk factors associated with our business is set forth below. This description includes any changes (whether or not material) to, and supercedes, the description of the risk factors associated with our business previously disclosed in Part 1, Item 1A of our Annual Report on Form 10-K for the fiscal year ended March 31, 2006.

Certain statements contained in the Company s Annual Report on Form 10-K for the year ended March 31, 2006, and Quarterly Report on Form 10-Q for the quarter ended June 30, 2006, such as statements concerning the development of new services, possible legislative changes, and other statements contained herein regarding matters that are not historical facts, are forward-looking statements (as such term is defined in the Securities Act of 1933, as amended). Because such statements involve risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements.

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

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

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

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

In addition, changes in workers compensation, auto and managed health care laws or regulations may reduce demand for the Company s services, require the Company to develop new or modified services to meet the demands of the marketplace or reduce the fees that the Company may charge for its services. One proposal which has been considered by Congress and certain state legislatures is 24-hour health coverage, in which the coverage of traditional employer-sponsored health plans is combined with workers compensation coverage to provide a single

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insurance plan for work-related and non-work-related health problems. Incorporating workers compensation coverage into conventional health plans may adversely affect the market for the Company s services because some employers would purchase 24 hour coverage from group health plans which could reduce the demand for CorVel s workers compensation customers.

The Company s quarterly revenue may continue to be flat or decrease as compared to the same quarter for the prior year. As a result, the Company may fail to meet or exceed the expectations of investors or securities analysts which could cause the Company s stock price to decline.

The Company s quarterly revenue may continue to be flat or decrease as compared to the same quarter of the prior year as a result of a variety of factors, many of which are outside of the Company s control. If the Company s quarterly sequential revenue growth falls below the expectations of investors or securities analysts, the price of the Company s common stock could decline substantially. Fluctuations or declines in quarterly sequential revenue growth may be due to a number of factors, including, but not limited to, those listed below and identified throughout this Risk Factors section the decline in the manufacturing employment, the decline in workers compensation claims, the considerable price competition given the flat-to-declining market, the increase in competition, and the changes and the potential changes in state workers compensation and auto managed care laws which can reduce demand for the Company s services. These factors create an environment where revenue and margin growth is more difficult to attain and where revenue growth is less certain than historically experienced. Additionally, the Company s technology and preferred provider network face competition from companies that have more resources available to them than the Company does. Also, some customers may handle their managed care services in-house and may reduce the amount of services which are outsourced to managed care companies such as CorVel Corporation.

These factors could cause the market price of the Company s Common Stock to fluctuate substantially. The Company s decrease in revenues in the most recent fiscal year was partially attributable to a reduction in the growth rate of healthcare expenditures nationally, contributing to a reduction in the growth of claims processed by the Company. There can be no assurance that the Company s growth rate in the future, if any will be at or near historical levels.

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

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

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

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

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

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

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

Healthcare providers are becoming increasingly resistant to the application of certain healthcare cost containment techniques, which could cause the Company s revenue to decrease.

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

A change in market dynamics may harm the Company s results of operations.

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

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

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

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

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

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

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

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

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

The Company is dependent to a substantial extent upon the continuing efforts and abilities of certain key management personnel. In addition, the Company faces competition for experienced employees with professional expertise in the workers compensation managed care area. The loss of, or the inability to attract, qualified employees, especially V. Gordon Clemons, Chairman and President, could have a material unfavorable effect on the Company s business and results of operations.

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

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

an acquisition may negatively impact the Company s results of operations because it may require incurring large one-time charges, substantial debt or liabilities; it may require the amortization or write down of amounts related to deferred compensation, goodwill and other intangible assets; or it may cause adverse tax consequences, substantial depreciation or deferred compensation charges;

the Company may encounter difficulties in assimilating and integrating the business, technologies, products, services, personnel or operations of companies that are acquired, particularly if key personnel of the acquired company decide not to work for the Company;

an acquisition may disrupt ongoing business, divert resources, increase expenses and distract management;

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the acquired businesses, products, services or technologies may not generate sufficient revenue to offset acquisition costs;

the Company may have to issue equity securities to complete an acquisition, which would dilute stockholders and could adversely affect the market price of the Company s common stock; and

acquisitions may involve the entry into a geographic or business market in which the Company has little or no prior experience.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Our business strategy and future success depend in part on our ability to capture market share with our cost containment services as national and regional insurance carriers and large, self-funded employers look for ways to achieve cost savings. We cannot assure you that we will successfully market our services to these insurance carriers and employers or that they will not resort to other means to achieve cost savings. Additionally, our ability to capture

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additional market share may be adversely affected by the decision of potential customers to perform services internally instead of outsourcing the provision of such services to us. Furthermore, we may not be able to demonstrate sufficient cost savings to potential or current customers to induce them not to provide comparable services internally or to accelerate efforts to provide such services internally.

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

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

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

Our acquisition of other businesses may result in significant increases in our intangible assets relating to goodwill. We regularly evaluate whether events and circumstances have occurred indicating that any portion of our goodwill may not be recoverable. When factors indicate that goodwill should be evaluated for possible impairment, we may be required to reduce the carrying value of these assets. We cannot currently estimate the timing and amount of any such charges.

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

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

If competition increases, our growth and profits may decline.

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

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

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

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

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

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

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

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

We have experienced a decline in the referrals for our Patient Management services.

We have experienced a general decline in the revenue and operating performance of Patient Management Services. We believe that the performance decline has been due to the following factors: the lingering effects of the downturn in the national economy and its corresponding effect on the number of workplace injuries that have become longer-term disability cases; increased regional and local competition from providers of managed care services; a possible reduction by insurers on the types of services provided by our Patient Management business; the closure of offices and continuing consolidation of our Patient Management operations; and employee turnover, including management personnel, in our Patient Management business. In the past, these factors have all contributed to the lowering of our long-term outlook for our Patient Management Services. If some or all of these conditions continue, we believe that the performance of our Patient Management revenues could decrease.

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

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

Our management has determined that there were material weaknesses in our system of internal control over financial reporting and as a result concluded that our internal control over financial reporting was not effective as of March 31, 2006 and June 30, 2006. If we are unable to correct the deficiencies that resulted in these material weaknesses, we may not be able to accurately report our future financial results, which could cause

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investors to lose confidence in our reported financial information and result in a decline in the market price of our common stock.

Our management assessed the effectiveness of our internal control over financial reporting as of March 31, 2006 and June 30, 2006, and this assessment identified material weaknesses in our internal control over financial reporting. As a result our management concluded that our internal control over financial reporting was not effective as of March 31, 2006. For a discussion of this material weakness and our responsive measures, please see Item 9A. Controls and Procedures of the Annual Report on Form 10-K for the year ended March 31, 2006 and Item 4. Controls and Procedures of this report. Although we are in the process of taking steps to correct the internal control deficiencies that resulted in these material weaknesses, the efficacy of the steps we are planning to take are subject to continuing management review supported by confirmation and testing. We cannot be certain that these measures will ensure that we will be able to implement and maintain adequate internal control over our financial reporting processes in the future. Any failure to implement required new or improved controls, or difficulties encountered in their implementation could prevent us from accurately reporting our financial results or cause us to fail to meet our reporting obligations in the future. Also, internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. As a result, insufficient internal control over financial reporting could cause investors to lose confidence in our reported financial information, which could result in a decline in the market price of our common stock.

Item 2 Unregistered Sales of Equity Securities and Use of Proceeds

There were no sales of unregistered securities during the period covered by this report.

In 1996, the Company s Board of Directors authorized a stock purchase plan for up to 100,000 shares of the Company s common stock. The Company s Board of Directors has periodically increased the number of shares authorized for repurchase under the plan. The most recent increase occurred in June 2006 and brought the number of shares authorized for repurchase to 8,100,000 shares. There is no expiration date for the plan. The Company did not repurchase any common shares during the June 2006 quarter.

Item 3 Defaults Upon Senior Securities - None.

Item 4 Submission of Matters to a Vote of Security Holders - None.

Item 5 Other Information None.

Item 6 Exhibits

3.1 Certificate of Incorporation of the Company Incorporated herein by reference to Exhibit 3.1 to the Company s Registration Statement on Form S-1 Registration No. 33-40629.

3.2 Amended and Restated Bylaws of the Company Filed herewith.

31.1 Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Filed herewith.

31.2 Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Filed herewith

32.1 Certification of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 Furnished herewith.

32.2 Certification of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 Furnished herewith.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

CORVEL CORPORATION

By: /s/ V. Gordon Clemons

V. Gordon Clemons, Chairman of the Board, and Chief Executive Officer

By: /s/ Scott McCloud

Scott McCloud,
Chief Financial Officer

August 11, 2006

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