NightHawk Radiology Holdings Inc
Form 10-Q
July 31, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2008

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
Commission File Number 000-51786

NightHawk Radiology Holdings, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**87-0722777**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**
601 Front Street, #502, C ur d Alene, Idaho	**83814**
(Address of principal executive offices))	**(Zip code)**

(208) 676-8321

(Registrant s telephone number, including area code)

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

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 ¨ Accelerated filer x Non-accelerated filer ¨ Small reporting company ¨

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

As of July 25, 2008, 28,541,983 shares of the Registrant s common stock were outstanding.

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PART 1 FINANCIAL INFORMATION

Item 1. Financial Statements

NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)

(In thousands, except share data)

	June 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 38,245	$ 31,956
Marketable securities	10,000	30,625
Trade accounts receivable, net	26,553	25,665
Deferred income taxes	294	655
Prepaid expenses and other current assets	4,300	2,812
Total current assets	79,392	91,713
Property and equipment, net	11,669	10,555
Goodwill	69,012	68,601
Intangible assets, net	83,368	87,133
Deferred income taxes	1,656	1,251
Other assets, net	3,907	4,213
Total	$ 249,004	$ 263,466
LIABILITIES		
Current liabilities:		
Accounts payable	$ 6,895	$ 6,071
Accrued expenses and other liabilities	4,923	12,881
Accrued payroll and related benefits	3,554	4,570
Long-term debt, due within one year	1,000	1,000
Total current liabilities	16,372	24,522
Insurance reserve	3,734	3,038
Long-term debt	98,000	98,500
Other liabilities	2,860	2,717
Total liabilities	120,966	128,777
Commitments and contingencies (Note 6)		
STOCKHOLDERS EQUITY		
Common stock 150,000,000 shares authorized; $.001 par value; 28,533,983 and 30,312,322 shares issued and outstanding at June 30, 2008 and December 31, 2007, respectively	29	30
Additional paid-in capital	239,157	249,274
Retained earnings (deficit)	(109,456)	(112,957)
Accumulated other comprehensive income (deficit)	(1,692)	(1,658)

Total stockholders equity	128,038	134,689
Total	$ 249,004	$ 263,466

See Notes to Condensed Consolidated Financial Statements.

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NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)

(In thousands, except share data)

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Service revenue	$ 42,758	$ 37,923	$ 84,446	$ 63,805
Operating costs and expenses:				
Professional services (includes non-cash compensation expense of $386, $1,071, $976 and $2,031)	17,036	17,402	34,903	27,775
Sales, general, and administrative (includes non-cash compensation expense of $1,832, $1,845, $4,188 and $2,683)	16,463	12,643	34,634	21,107
Depreciation and amortization	2,959	1,792	5,757	2,642
Total operating costs and expenses	36,458	31,837	75,294	51,524
Operating income	6,300	6,086	9,152	12,281
Other income (expense):				
Interest expense	(2,189)	(1,275)	(4,376)	(1,276)
Interest income	376	834	903	1,722
Other, net	(41)	(30)	(13)	(32)
Total other income (expense)	(1,854)	(471)	(3,486)	414
Income before income taxes	4,446	5,615	5,666	12,695
Income tax expense	1,675	2,101	2,165	4,849
Net income	$ 2,771	$ 3,514	$ 3,501	$ 7,846
Earnings per common share:				
Basic	$ 0.09	$ 0.12	$ 0.12	$ 0.26
Diluted	$ 0.09	$ 0.11	$ 0.11	$ 0.25
Weighted averages of common shares outstanding:				
Basic	30,426,531	29,996,297	30,435,363	29,978,376
Diluted	31,442,818	30,993,033	31,411,253	30,903,332

See Notes to Condensed Consolidated Financial Statements.

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NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

(In thousands)

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Cash flows from operating activities:		
Net income	$ 3,501	$ 7,846
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,757	2,642
Accretion of discounts on marketable securities	(21)	(217)
Amortization of debt issuance costs	324	72
Loss (gain) on disposal of fixed assets and other, net	344	(24)
Deferred income taxes	(11)	(2,034)
Non-cash stock compensation expense	5,164	4,714
Excess tax benefit from exercise of stock options	(238)	(340)
Provision for doubtful accounts	199	136
Changes in operating assets and liabilities (excluding effects of acquisitions):		
Trade accounts receivable, net	(1,155)	(3,406)
Prepaid expenses and other assets	(1,507)	(537)
Accounts payable	615	2,307
Accrued expenses and other liabilities	(597)	728
Accrued payroll and related benefits	943	772
Net cash provided by operating activities	13,318	12,659
Cash flows from investing activities:		
Purchase of marketable securities	(26,390)	(13,871)
Proceeds from maturities of marketable securities	33,755	27,178
Proceeds from the sale of marketable securities	13,303	
Purchase of property and equipment	(3,296)	(2,375)
Cash and cash equivalents from acquisitions, net		87
Cash paid for acquisitions	(6,500)	(62,493)
Net cash provided by (used in) investing activities	10,872	(51,474)
Cash flows from financing activities:		
Repayment of debt	(500)	(10,866)
Proceeds from exercise of stock options	400	333
Excess tax benefit from exercise of stock options	238	340
Purchase of common stock shares	(18,039)	
Proceeds from debt		53,000
Payment on line of credit		(1,679)
Debt issuance costs paid		(1,827)
Net cash (used in) provided by financing activities	(17,901)	39,301
Net increase in cash and cash equivalents	6,289	486
Cash and cash equivalents beginning of period	31,956	46,501
Cash and cash equivalents end of period	$ 38,245	$ 46,987

See Notes to Condensed Consolidated Financial Statements.

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NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(unaudited)

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Supplemental disclosures of cash flow information:		
Cash paid for interest	$ 3,488	$ 1,174
Cash paid for income taxes	2,740	5,157
Non-cash investing and financing activities:		
Purchases of equipment included in accounts payable	176	210
Earnout liability included in accrued expenses settled in stock	2,078	
Tender offer costs included in accounts payable and accrued expenses	464	
Debt issuance costs included in accounts payable and accrued expenses		262
Acquisition costs included in accounts payable and accrued expenses		272

See Notes to Condensed Consolidated Financial Statements.

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NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (unaudited)

(In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Net income	$ 2,771	$ 3,514	$ 3,501	$ 7,846
Other comprehensive income:				
Change in fair value of interest rate swaps	2,611		(66)	
Less: deferred income taxes	(1,019)		33	
Net other comprehensive income	1,592		(33)	
Comprehensive income	$ 4,363	$ 3,514	$ 3,468	$ 7,846

See Notes to Condensed Consolidated Financial Statements.

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NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation The accompanying unaudited condensed consolidated financial statements include the results of operations, financial position and cash flows of Nighthawk Radiology Holdings, Inc and its subsidiaries (the Company). All material intercompany balances have been eliminated.

In the opinion of the Company s management, the accompanying unaudited condensed consolidated financial statements include all adjustments necessary to present fairly, in all material respects, the Company s results for the periods presented. These condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the SEC. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such SEC rules and regulations. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and accompanying notes included in Item 8 of the Company s 2007 Annual Report on Form 10-K filed with the SEC on February 19, 2008. The results of operations for the three months and six months ended June 30, 2008 are not necessarily indicative of results to be expected for the entire fiscal year.

The Company s unaudited condensed consolidated balance sheet as of December 31, 2007 has been derived from the audited consolidated balance sheet as of that date.

Use of Estimates The preparation of condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires the Company s management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of these estimates require difficult, subjective or complex judgments about matters that are inherently uncertain. Actual results could differ from those estimates.

On an ongoing basis, the Company evaluates its estimates, including those related to the accounts receivable allowance, fair value of acquired intangible assets and goodwill, useful lives of intangible assets and property and equipment, income taxes, the loss contingency for medical liability claims, reserves for incurred but not reported (IBNR) medical liability claims, estimates used for the purpose of determining stock-based compensation and the Company s business services customers expected net collections.

Trade Accounts Receivable Trade accounts receivable represent receivables for services and are recorded at the invoiced amount and are non-interest bearing. The Company has a history of minimal uncollectible receivables. Company management reviews past due accounts receivable to identify specific customers with known disputes or collectibility issues. As of June 30, 2008 and December 31, 2007, the Company had reserved $0.7 million and $0.6 million, respectively, for doubtful accounts based on its estimate of the collectibility of outstanding receivables as of those dates.

Marketable Securities The Company determines the appropriate classification of investments in marketable securities at the time of purchase and reevaluates such designation at each balance sheet date. Marketable securities have been classified and accounted for as available for sale. The Company may or may not hold securities with stated maturities greater than 12 months until maturity. In response to changes in the availability of and the yield on alternative investments as well as liquidity requirements, the Company occasionally sells these securities prior to their stated maturities. The Company expects that the majority of marketable securities will be sold within one year, regardless of maturity date. The Company primarily invests in high-credit-quality debt instruments with an active resale market and money market funds to ensure liquidity and the ability to readily convert these investments into cash to fund current operations, or satisfy other cash requirements as needed. The Company does not invest in auction rate securities. Accordingly, all marketable securities have been classified as current assets in the accompanying balance sheets. These securities are carried at fair value, with the unrealized gains and losses, net of taxes, reported as a component of stockholders equity, except for unrealized losses determined to be other than temporary which would be recorded as other income or expense. Any realized gains or losses on the sale of marketable securities are determined on a specific identification method, and such gains and losses are reflected as a component of other income or expense.

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Property and Equipment Property and equipment are stated at cost. Depreciation is provided using the straight-line method over the estimated useful lives of each asset, which range as follows:

Computers, diagnostic workstations and telecommunications systems	3 5 years
Office furniture and equipment	7 10 years
Software	3 7 years
Leasehold improvements	Term of lease or asset life, whichever is shorter

Expenditures for maintenance and repairs are charged to operating expense as incurred and expenditures for renewals and betterments are capitalized. Upon sale or retirement of depreciable assets, the related cost and accumulated depreciation are removed from the records and any gain or loss is reflected in operating expenses.

Cost of computer software for internal use is capitalized and accounted for in accordance with Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Capitalized costs are amortized based on their expected useful lives.

Depreciation expense for the three months ended June 30, 2008 and 2007 was $1.1 million and $0.7 million, respectively, and $2.0 million and $1.2 million for the six months ended June 30, 2008 and 2007, respectively.

Medical Liability Insurance The Company is exposed to risk of loss related to litigation that may arise from alleged malpractice and accordingly maintains insurance for medical liabilities in amounts considered adequate by Company management. The Company s claims-made policy provides coverage up to the policy limits for claims filed within the period of the policy term, subject to deductible requirements. Coverage for affiliated radiologists is initiated when they begin providing services on behalf of the Company.

The Company records reserves for both asserted and IBNR amounts. Asserted claims are reserved based upon the Company s best estimate of future probable costs. The IBNR reserve is intended to cover potential medical claims that might arise related to past medical services performed by the Company s affiliated radiologists. IBNR amounts are estimated using historical claims information and industry indices.

Concentration of Credit Risk Financial instruments that potentially expose the Company to concentration of credit risk consist primarily of cash, cash equivalents, marketable securities, and accounts receivable. The Company maintains its cash, cash equivalents, and marketable securities with high quality credit institutions and limits the amounts invested with any one financial institution or in any type of financial instrument. As of June 30, 2008 and December 31, 2007, a total of $17.8 million and $12.0 million, respectively, of cash and cash equivalents exceeded insured amounts.

Recent Accounting Standards In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value according to accounting principles generally accepted in the United States of America, and expands disclosure requirements regarding fair value measurements. This statement emphasizes that fair value should be determined based on assumptions market participants would use to price the asset or liability. The provisions of SFAS 157 were effective for fiscal years beginning after November 15, 2007. The Company adopted this new accounting pronouncement as of January 1, 2008 and the impact of adoption was not significant. See Note 11 for disclosures regarding fair value measurements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159) which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 was effective for the Company on January 1, 2008. The Company has assessed this option and decided against electing the fair value option for any items eligible at January 1, 2008.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* (SFAS 141(R)) which establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effect of the business combination.

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SFAS 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after an entity s fiscal year that begins after December 15, 2008. SFAS 141(R) will be effective for the Company on January 1, 2009. The Company does not expect the adoption of SFAS No. 141(R) to have a significant impact on its financial position or results of operations.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51* (SFAS 160). SFAS 160 requires that all entities in which its parent has a controlling financial interest be consolidated into the parent at 100 percent of fair value and the parent s consolidated net income include amounts attributable to both the parent and noncontrolling interest. SFAS 160 clarifies that non-controlling interests in subsidiaries be presented as equity and any changes to the ownership interest are considered equity transactions providing the parent maintains its controlling financial interest in the subsidiary. SFAS 160 will be effective for the Company on January 1, 2009. The Company does not expect the adoption of SFAS 160 to have a significant impact on its financial position or results of operations.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS 161) which amends and expands the disclosure requirements of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. SFAS 161 will be effective for the Company on January 1, 2009. *The Company is currently evaluating the impact of adopting SFAS 161 on its financial statements and footnotes.*

In April 2008, the FASB issued FASB Staff Position (FSP) SFAS 142-3, *Determination of Useful Life of Intangible Assets* (FSP SFAS 142-3). FSP SFAS 142-3 amends the factors that should be considered in developing the renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets*. FSP SFAS 142-3 also requires expanded disclosure related to the determination of intangible asset useful lives. FSP SFAS 142-3 is effective for fiscal years beginning after December 15, 2008. Earlier adoption is not permitted. The Company is currently evaluating the potential impact the adoption of FSP SFAS 142-3 on its consolidated financial statements and footnotes.

2. ACQUISITIONS

MIDWEST PHYSICIANS SERVICES, LLC AND EMERGENCY RADIOLOGY SERVICES, LLC.

On July 16, 2007, the Company acquired all of the outstanding equity interests of Midwest Physicians Services, LLC (MPS) and Emergency Radiology Services, LLC (ERS) from SPR Holdings II, LLC (SPR Holdings), a privately held company located in St. Paul, Minnesota. ERS is an off-hours teleradiology services company. MPS was formed by St. Paul Radiology, P.A. (SPR) to provide a suite of business process services including revenue cycle management, administrative, information technology and other services critical to the operation of a radiology group. The Company intends to combine these services with its proprietary workflow technology to offer its customers a more complete suite of professional and business process solutions.

The consideration for this acquisition consisted of (i) $62.9 million in cash, including $0.5 million in costs associated with the acquisition, and (ii) a warrant, issued to SPR, entitling SPR to purchase 300,000 shares of common stock of the Company at any time after July 16, 2010 and before July 16, 2017 at an exercise price of $18.75 per share. The fair value of the warrant was calculated using a Black-Scholes model as $3.3 million. Of the purchase price, $57.5 million of the cash portion was paid to SPR Holdings at closing and the remaining $5.0 million was placed into a third-party escrow account to secure SPR Holdings indemnification obligations under the terms of the acquisition agreement. The funds placed in the escrow account, net of any indemnification obligations, will be released to SPR Holdings on the second anniversary of the acquisition.

In connection with the acquisition, MPS entered into a long-term administrative support services agreement, under which MPS will provide business process services to each of SPR and Midwest Radiology LLC, an affiliate of SPR and provider of imaging services, in exchange for a percentage of the net revenue generated by each of those companies.

Prior to January 1, 2008, the Company recognized revenue associated with ERS on a net basis due to the structure of the services agreement with SPR. As part of the Company s goal to align all of its professional radiology service entities under the same business model, effective January 1, 2008 the Company and SPR amended the services agreement which resulted in ERS recognizing revenue on a gross basis. This amendment resulted in the Company recording (i) $1.4 million and $2.4 million in revenue for the three and six months ended June 30, 2008, respectively and (ii) $1.0 million and $1.7 million for professional fees related to these services for the three and six months ended June 30, 2008, respectively. The combined impact to net income was equal to what would have been reported under the contract prior to the amendment.

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The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition. The preliminary purchase price allocations are based on internal analyses and may be adjusted during the allocation period as defined in SFAS No. 141, *Business Combinations* (SFAS 141.).

	(In thousands)
Current assets	$ 809
Fixed assets	1,814
Intangible assets	57,590
Goodwill	7,055
Assets acquired	67,268
Current liabilities	676
Long-term liabilities	311
Liabilities assumed	987
Purchase price	$ 66,281

The Company recorded the assets acquired and liabilities assumed in the acquisition of MPS and ERS based on their estimated fair values on the acquisition date. Goodwill of $7.1 million, representing the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired and liabilities assumed, will not be amortized, consistent with the guidance in SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). The total goodwill balance is deductible for tax purposes over 15 years. The results of operations of MPS and ERS have been included in the Company s consolidated statements of operations and cash flows starting on July 17, 2007.

The determination of the estimated fair value of the intangible assets acquired required the Company s management to make significant estimates and assumptions. These assumptions included future expected cash flows from customer contracts, certain noncompete agreements and tradenames, and the useful lives of the intangible assets.

The amount allocated to intangible assets was attributed to the following categories:

	Acquired Value (In thousands)	Estimated Useful Life
Customer contracts	$ 57,180	20 years
Tradename and trademarks	130	5 years
Noncompete agreements	280	5 years
	$ 57,590	

All intangible assets are being amortized on a straight-line basis over their expected useful lives. See Note 4.

THE RADLINX GROUP, LTD.

On April 5, 2007, the Company completed the acquisition of all of the outstanding equity interests of The Radlinx Group, Ltd., a privately held radiology services company (Radlinx) for consideration consisting of (i) $53.0 million in cash at closing, including the assumption of $12.6 million in liabilities which were paid in full immediately following the acquisition and $0.3 million of certain costs associated with the acquisition, (ii) an additional $0.4 million paid in the fourth quarter of 2007 as settlement of a contractual working capital adjustment and (iii) $6.5 million in cash, equal to 25% of the revenues generated by certain identified customers during the one-year period following the closing, paid in May 2008 pursuant to an earnout.

Of the purchase price, $5.3 million was paid at closing and placed into a third party escrow account to secure Radlinx s indemnification obligations under the terms of the acquisition agreement. In the first quarter 2008, as a result of the settlement of a medical malpractice claim that originated prior to the Company s acquisition of Radlinx, the previous owners of Radlinx utilized the entire $5.3 million in the escrow account to satisfy their portion of the settlement arrangement. The Company also participated in the settlement arrangement; however, its total payment to the plaintiff was limited to $0.2 million which was recorded to goodwill.

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The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition. The following table presents the allocation of the purchase price to the acquired assets and liabilities:

	(In thousands)
Current assets	$ 3,572
Fixed assets	663
Intangible assets	19,400
Goodwill	42,293
Assets acquired	65,928
Current liabilities	2,371
Long-term debt (current and long-term portion)	12,608
Deferred income tax payable	3,308
Liabilities assumed	18,287
Purchase price	$ 47,641

The Company recorded the assets acquired and liabilities assumed in the Radlinx acquisition based on their estimated fair values on the acquisition date. Goodwill of $42.3 million, representing the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired and liabilities assumed, will not be amortized, consistent with the guidance in SFAS 142. The Company estimates that $30.0 million of the goodwill balance is deductible for tax purposes. The results of operations of Radlinx have been included in the Company s consolidated statements of operations and cash flows starting on April 6, 2007.

The determination of the estimated fair value of the intangible assets acquired required the Company s management to make significant estimates and assumptions. These assumptions included future expected cash flows from customer contracts, certain noncompete agreements, customer lists, the Radlinx tradename, and the useful lives of the intangible assets.

The amount allocated to intangible assets was attributed to the following categories:

	Acquired Value (In thousands)	Estimated Useful Life
Customer lists and relationships	$ 16,800	10 years
Tradename and trademarks	1,500	5 years
Noncompete agreements	1,100	2 years
	$ 19,400	

All intangible assets are being amortized on a straight-line basis over their expected useful lives, See Note 4.

TELERADIOLOGY DIAGNOSTIC SERVICE, INC.

On February 9, 2007, the Company acquired all of the outstanding stock of Teleradiology Diagnostic Service, Inc. (TDS), for $23.8 million in cash, including certain costs associated with the acquisition. Of the $23.8 million paid, $1.2 million was held by the Company as escrow to secure the indemnification obligations of TDS under the terms of the acquisition agreement. The funds, net of any indemnification obligations, will be released to the former owners of TDS on the 18 month anniversary of the acquisition.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition. The following table presents the allocation of the purchase price to the acquired assets and liabilities:

	(In thousands)
Current assets	$ 1,506
Fixed assets	197
Intangible assets	12,250
Goodwill	16,078
Assets acquired	30,031
Current liabilities	1,394
Deferred income tax payable	4,816
Liabilities assumed	6,210
Purchase price	$ 23,821

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The Company recorded the assets acquired and liabilities assumed in the acquisition of TDS based on their estimated fair values on the acquisition date. Goodwill of $16.1 million, representing the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired and liabilities assumed, will not be amortized, consistent with the guidance in SFAS 142. None of the goodwill balance is deductible for tax purposes. The results of operations of TDS have been included in the Company s consolidated statements of operations and cash flows starting on February 9, 2007.

The determination of the estimated fair value of the intangible assets acquired required the Company s management to make significant estimates and assumptions. These assumptions included future expected cash flows from customer contracts, certain noncompete agreements, customer lists, the TDS tradename, and the useful lives of the intangible assets.

The amount allocated to intangible assets was attributed to the following categories:

	Acquired Value (In thousands)	Estimated Useful Life
Customer lists and relationships	$ 11,350	10 years
Tradename and trademarks	400	5 years
Noncompete agreements	500	3 years
	$ 12,250	

All intangible assets are being amortized on a straight-line basis over their expected useful lives, see Note 4.

AMERICAN TELERADIOLOGY NIGHTHAWKS, INC.

On September 30, 2005, the Company acquired American Teleradiology Nighthawks, Inc. (ATN). The acquisition of ATN was considered by the Company as an acquisition of two distinct businesses: (i) an off-hours teleradiology business that was supplemental to the Company s off-hours business and (ii) a nascent hospital business that focused on partnering with radiologists in order to supplement the services they provide to their hospitals. The acquisition agreement provided that if the hospital business proved to be profitable as established under the terms of the agreement in the 18 months following the acquisition, additional shares of Company common stock would be issued. During the quarter ended March 31, 2007, the Company determined that the hospital business did not meet the profitability metrics set forth in the acquisition agreement and that no amount was earned as contingent consideration. This contingent consideration amount is currently subject to dispute. Although the Company does not believe that additional shares will be issued, the contingent consideration ultimately due is subject to resolution of this dispute by the parties.

3. MARKETABLE SECURITIES

Marketable securities include various available-for-sale securities. These securities are carried at fair value, with the unrealized gains and losses, net of taxes, reported as a component of stockholders equity. There were no unrealized gains or losses on marketable securities at June 30, 2008. Gross unrealized gains and losses on marketable securities were not significant at December 31, 2007.

Below are the Company s marketable securities at fair value:

	June 30, 2008	December 31, 2007
	(In thousands)	
Due in one year or less:		
U.S. Government and Federal Agency Securities	$	$ 13,430
Municipal Securities	10,000	17,195
Total Marketable Securities	$ 10,000	$ 30,625

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4. INTANGIBLE ASSETS SUBJECT TO AMORTIZATION

A summary of intangible assets is as follows:

		June 30, 2008			December 31, 2007		
	Estimated Useful Life	Historical Amount	Accumulated Amortization	Net Amount	Historical Amount	Accumulated Amortization	Net Amount
		(In thousands)					
Customer lists and relationships	6-10 years	$ 30,770	$ 4,762	$ 26,008	$ 30,770	$ 3,156	$ 27,614
Tradename and trademarks	5 years	2,820	826	1,994	2,820	510	2,310
Customer contracts	1-20 years	57,280	2,840	54,440	57,280	1,410	55,870
Noncompete agreements	2-5 years	2,090	1,164	926	2,090	751	1,339
		$ 92,960	$ 9,592	$ 83,368	$ 92,960	$ 5,827	$ 87,133

Amortization expense was $1.9 million and $1.1 million for the three months ended June 30, 2008 and 2007, respectively and $3.8 million and $1.5 million for the six months ended June 30, 2008 and 2007, respectively.

Estimated Amortization Expense:	Amount (In thousands)
Six months ending December 31, 2008	$ 3,752
Year ending December 31, 2009	7,064
Year ending December 31, 2010	6,687
Year ending December 31, 2011	6,452
Year ending December 31, 2012	5,879
Thereafter	53,534
Total	$ 83,368

5. LONG-TERM DEBT

On April 5, 2007, the Company entered into a credit facility with Morgan Stanley Senior Funding (the Credit Facility), pursuant to which the Company (i) incurred a term loan of $53.0 million and (ii) had an option to request that the lenders advance up to an additional $97.0 million in term loans for a total credit facility of up to $150.0 million. The Company used the $53.0 million of term loan borrowings from the Credit Facility to fund the acquisition of Radlinx. Interest under the Credit Facility was based on either: (i) a floating per annum rate based on the administrative agent s prime rate plus a margin of 1.25% or (ii) upon syndication, and at the option of the Company, a floating per annum rate (based upon one, two, three or six-month interest periods) based on prime plus a margin of 1.25%. The Company s obligations under the Credit Facility were secured by substantially all of the Company s assets as collateral and are guaranteed by the Company s subsidiaries. The Credit Facility contained customary covenants.

On July 10, 2007, the Company and Morgan Stanly Senior Funding amended and restated the Credit Facility (the Amended Credit Facility). The Amended Credit Facility provides for term loans up to $150.0 million in aggregate, $50 million of which was a delayed draw, which expired on July 10, 2008. Under the Amended Credit Facility, the Company increased its borrowings by $47.0 million to $100.0 million and used the proceeds from the additional borrowings to fund the MPS and ERS acquisitions and to pay the fees and expenses incurred in connection with the Amended Credit Facility. Further, under the Amended Credit Facility, the Company may request that the lenders advance up to an additional $75.0 million in term loans, although the lenders have not committed to lend this additional amount and the terms under which such loans would be made have not been agreed. The additional funds available under the Amended Credit Facility may be used by the Company for financing certain acquisitions and for general corporate purposes. Interest under the Amended Credit Facility is based, at the option of the Company, on either: (i) a floating per annum rate based on the administrative agent s prime rate plus a margin of 1.50% or (ii) a floating per annum rate (based upon one, two, three or six-month interest periods) based on LIBOR plus a margin of 2.50% (5.31% at June 30, 2008). The Company also entered into two interest rate swap contracts during 2007 which, while in place, will maintain an effective interest rate of approximately 7.40%. See additional discussion of the interest rate swap contracts in Note 10.

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The term loan will be repaid in quarterly installments, with principal being amortized at an annual rate of 1.00%, and the balance payable on the maturity date of July 10, 2014. The term loan is subject to mandatory prepayment under certain circumstances, including in connection with the Company s receipt of proceeds from certain issuances of equity or debt, sales of assets and casualty events and beginning eighteen months from closing, from the Company s excess cash flow. The term loan may be voluntarily prepaid without premium or penalty.

The Amended Credit Facility contains customary affirmative, negative and financial covenants, including, among other requirements, negative covenants that restrict the Company s ability to create liens, enter into mergers and acquisitions, pay dividends, repurchase stock, incur indebtedness, make investments and make capital expenditures, and financial covenants that establish applicable interest coverage ratios and limit the maximum leverage the Company can maintain at any one time.

The Amended Credit Facility contains events of default that include, among others, non-payment of principal, interest or fees, inaccuracy of representations and warranties, violation of covenants, cross defaults to certain other indebtedness, bankruptcy and insolvency events, material judgments, and events constituting a change of control. The occurrence of an event of default could result in an increased interest rate, the acceleration of the Company s obligations under the Amended Credit Facility and an obligation of the Company or any guarantor to repay the full amount of the Company s borrowings under the Amended Credit Facility.

6. COMMITMENTS AND CONTINGENCIES

Letters of Credit The Company s Sydney and San Francisco office leases and the Company s malpractice insurance were collateralized by separate letters of credit in the amounts of $0.2 million, $0.1 million and $0.4 million, respectively, as of June 30, 2008 and December 31, 2007.

Litigation The Company is involved in litigation in the normal course of business. After consultation with legal counsel, Company management estimates that at June 30, 2008 these matters were expected to be resolved without material adverse effect on the Company s financial position, results of operations, or cash flows.

Medical Liability Insurance The Company is exposed to risk of loss related to litigation that may arise from malpractice and maintains insurance for medical liabilities in amounts considered adequate by Company management. The Company s claims-made policy provides coverage up to the policy limits for claims filed within the period of the policy term, subject to deductible requirements. Coverage for affiliated radiologists is initiated when they begin providing services to the Company.

The Company records reserves for both reported and IBNR amounts. Reported amounts are reserved based upon the Company s best estimate of future probable costs. In instances where the Company may not be able to estimate the loss or range of loss that may be reasonably possible, the Company records no reserve. The Company had no specific reserves as of June 30, 2008 and $0.5 million of reserves at December 31, 2007 which were paid out during the three months ended June 30, 2008. During the three and six months ended June 30, 2008, the Company recorded $0.2 million of benefit and $0.7 million of expense, respectively, for estimated IBNR amounts. The increase in the six month period is primarily due to the termination of an indemnification clause related to the acquisition of Radlinx. As a result, the Company recorded $0.5 million of additional costs in the period ended March 31, 2008.

7. STOCK COMPENSATION PLANS

Share-Based Award Plans. The Company has two stock-based award plans, the 2004 Stock Plan (the 2004 Plan) and the 2006 Equity Incentive Plan (the 2006 Plan). In February 2006, all shares available for grant under the 2004 Plan were rolled over and became available for grant under the 2006 Plan. As of June 30, 2008, the Company had an aggregate of 4,446,962 shares of its common stock reserved for issuance under the 2004 Plan and 2006 Plan, of which 324,988 shares were available for future grants and 4,121,974 shares were subject to outstanding stock awards.

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The Company s Board of Directors administers the plans and establishes to whom the awards are granted, and the terms and conditions, including the exercise period, of such awards. All stock options granted have an exercise price equal to or greater than the fair value of the Company s common stock on the date the option is granted. All restricted stock units (RSUs) are granted with an exercise price of zero. Both stock options and RSUs granted generally have contractual terms of ten years and vest over three years. Options and RSUs granted to employees and directors are valued using the multiple valuation approach, and the resulting expense is recognized using the accelerated method over the service period for the entire award.

Stock Options. The Company granted stock options covering 639,915 and 892,915 shares during the three and six months ended June 30, 2008, respectively at a weighted-average exercise price of $7.62 and $8.92, respectively. The weighted-average grant-date fair value per share granted during the three and six months ended June 30, 2008 was $3.11 and $3.58, respectively. A summary of stock-based award activity for employees and non-employees under the 2004 Plan and 2006 Plan are as follows:

Stock Options	**Number of Stock Options**	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Life (Yrs)**	**Aggregate Intrinsic Value (in thousands)**
Outstanding as of April 1, 2008	3,426,145	$ 14.86		
Granted	639,915	7.62		
Exercised	(38,238)	1.65		
Cancelled	(487,472)	19.89		
Outstanding as of June 30, 2008	3,540,350	$ 13.00	8.19	$ 3,671

Stock Options	**Number of Stock Options**	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Life (Yrs)**	**Aggregate Intrinsic Value (in thousands)**
Outstanding as of January 1, 2008	3,497,210	$ 14.85		
Granted	892,915	8.92		
Exercised	(172,868)	2.31		
Cancelled	(676,907)	19.91		
Outstanding as of June 30, 2008	3,540,350	$ 13.00	8.19	$ 3,671
Exercisable as of June 30, 2008	1,116,053	$ 10.78	6.75	$ 2,732
Vested and expected to vest as of June 30, 2008	3,422,076	$ 12.97	8.16	$ 3,658

Restricted Stock Units. During the three and six months ended June 30, 2008, the Company granted 96,500 and 469,171 restricted stock unit awards, respectively, at a fair value of $7.60 and $11.28 per share, respectively. Activity related to these restricted stock unit awards is as follows:

Restricted Stock Unit Awards	**Number of Awards**	**Weighted Average Remaining Contractual Life (Yrs)**	**Aggregate Intrinsic Value (in thousands)**
Outstanding as of April 1, 2008	521,804		

Granted	96,500		
Released	(26,357)		
Cancelled	(10,323)		
Outstanding as of June 30, 2008	581,624	1.93	$ 4,118

Restricted Stock Unit Awards	**Number of Awards**	**Weighted Average Remaining Contractual Life (Yrs)**	**Aggregate Intrinsic Value (in thousands)**
Outstanding as of January 1, 2008	254,574		
Granted	469,171		
Released	(122,916)		
Cancelled	(19,205)		
Outstanding as of June 30, 2008	581,624	1.93	$ 4,118
Vested and expected to vest as of June 30, 2008	530,470	1.90	$ 3,756

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Intrinsic value represents the amount by which the fair market value of the underlying stock exceeds the exercise price of the options. For all RSU awards, the exercise price is zero.

Recognition of Compensation Expense. As of June 30, 2008, the total remaining unrecognized compensation cost related to unvested stock-based employee/director arrangements, net of an estimated forfeiture rate of 8.9%, was $7.9 million and is expected to be recognized over a weighted average period of 1.16 years.

The Company measures the compensation cost associated with stock-based payments by estimating the fair value of stock options as of the grant date using the Black-Scholes option pricing model. The Company believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair value of the stock options granted. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by the employees who receive equity awards.

The weighted average fair values of stock-based arrangements on the date of grant and the assumptions used to estimate the fair value of the stock-based arrangements were as follows: