

NightHawk Radiology Holdings Inc  
Form 10-Q  
November 06, 2007  
Table of Contents

---

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

---

**FORM 10-Q**

---

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007**

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**  
(State or other jurisdiction of  
incorporation or organization)

**250 Northwest Boulevard, #202, Coeur d'Alene, Idaho**  
(Address of principal executive offices)

**(208) 676-8321**

(Registrant's telephone number, including area code)

**87-0722777**  
(IRS Employer

Identification No.)

**83814**  
(Zip code)

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

---

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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

Non-accelerated filer

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

As of October 26, 2007, 30,187,902 shares of the Registrant's common stock were outstanding.

---

**Table of Contents**

**TABLE OF CONTENTS**

**Part I**

Item 1.	<u>Financial Statements</u>	
	<u>Condensed Consolidated Balance Sheets</u>	3
	<u>Condensed Consolidated Statements of Operations</u>	4
	<u>Condensed Consolidated Statements of Cash Flows</u>	5
	<u>Condensed Consolidated Statements of Comprehensive Income</u>	7
	<u>Notes to Condensed Consolidated Financial Statements</u>	8
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	21
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	42
Item 4.	<u>Controls and Procedures</u>	42

**Part II**

Item 1.	<u>Legal Proceedings</u>	43
Item 1A.	<u>Risk Factors</u>	43
Item 2.	<u>Unregistered Sales of Equity Securities</u>	53
Item 6.	<u>Exhibits</u>	54
	<u>Signatures</u>	55

**Table of Contents****PART 1 FINANCIAL INFORMATION****Item 1. Financial Statements****NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)**

	September 30, 2007	December 31, 2006
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 29,712,634	\$ 46,500,818
Marketable securities	28,459,865	37,810,963
Trade accounts receivable, net	25,049,566	12,706,146
Deferred income taxes	469,793	365,930
Prepaid expenses and other current assets	2,630,770	2,076,037
Total current assets	86,322,628	99,459,894
Property and equipment, net	10,295,792	6,192,541
Goodwill	66,530,956	4,913,844
Intangible assets, net	88,943,523	2,922,543
Deferred income taxes		2,480,972
Other assets, net	5,095,297	96,572
Total	\$ 257,188,196	\$ 116,066,366
<b>LIABILITIES</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 19,407,803	\$ 9,052,634
Accrued payroll and related benefits	4,495,448	2,383,998
Current portion of notes payable	1,000,000	
Total current liabilities	24,903,251	11,436,632
Insurance reserves	3,448,924	2,000,000
Notes payable, less current portion	98,750,000	
Deferred income taxes	576,409	
Other liabilities	898,635	
Total liabilities	128,577,219	13,436,632
Commitments and contingencies (Note 7)		
<b>STOCKHOLDERS EQUITY:</b>		
Common stock 150,000,000 shares authorized; \$.001 par value; 30,187,902 and 29,944,069 shares issued and outstanding at September 30, 2007 and December 31, 2006, respectively	30,188	29,944
Additional paid-in capital	245,147,219	230,116,635
Retained earnings (deficit)	(116,017,948)	(127,516,845)
Accumulated other comprehensive income	(548,482)	
Total stockholders equity	128,610,977	102,629,734
Total	\$ 257,188,196	\$ 116,066,366

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)**

	Three Months Ended		Nine Months Ended	
	September 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
Service revenue	\$ 45,151,201	\$ 25,158,889	\$ 108,955,957	\$ 68,074,661
Operating costs and expenses:				
Professional services (includes non-cash compensation expense of \$1,536,432, \$1,086,747, \$3,567,030 and \$3,333,430)	19,069,295	9,552,784	46,844,263	26,500,833
Sales, general, and administrative (includes non-cash compensation expense of \$3,159,734, \$309,068, \$5,842,797 and \$660,512)	15,753,703	6,871,138	36,860,609	19,224,442
Depreciation and amortization	2,608,472	527,192	5,250,807	1,580,439
Total operating costs and expenses	37,431,470	16,951,114	88,955,679	47,305,714
Operating income	7,719,731	8,207,775	20,000,278	20,768,947
Other income (expense):				
Interest expense	(2,388,529)	(599)	(3,664,742)	(560,270)
Interest income	745,719	875,391	2,468,150	2,026,675
Other, net	(27,259)	(19,801)	(59,595)	(64,136)
Change in fair value of redeemable preferred stock conversion feature				(44,183,770)
Total other income (expense)	(1,670,069)	854,991	(1,256,187)	(42,781,501)
Income (loss) before income taxes	6,049,662	9,062,766	18,744,091	(22,012,554)
Income tax expense	2,261,818	3,480,615	7,110,594	8,595,532
Net income (loss)	3,787,844	5,582,151	11,633,497	(30,608,086)
Redeemable preferred stock accretion				(117,534)
Net income (loss) applicable to common stockholders	\$ 3,787,844	\$ 5,582,151	\$ 11,633,497	\$ (30,725,620)
Earnings (loss) per common share:				
Basic	\$ 0.13	\$ 0.19	\$ 0.39	\$ (1.09)
Diluted	\$ 0.12	\$ 0.18	\$ 0.38	\$ (1.09)
Weighted averages of common shares outstanding:				
Basic	30,111,156	29,836,960	30,023,122	28,061,658
Diluted	31,170,449	30,760,414	31,012,036	28,061,658

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)**

	Nine Months Ended	
	September 30, 2007	2006
Cash flows from operating activities:		
Net income (loss)	\$ 11,633,497	\$ (30,608,086)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	5,250,807	1,580,439
Amortization of debt issuance costs	234,051	
Accretion of discounts on marketable securities	(285,369)	(507,652)
Loss on disposal of property and equipment		346,423
Other loss (income)	(23,706)	
Deferred income taxes	(4,794,505)	(1,805,569)
Change in fair value of redeemable preferred stock conversion feature		44,183,770
Non-cash stock compensation expense	9,409,828	3,993,942
Excess tax benefit from exercise of stock options	(1,324,855)	(312,188)
Provision for doubtful accounts and sales credits	347,233	65,369
Changes in operating assets and liabilities (excluding effects of acquisitions):		
Trade accounts receivable	(7,572,921)	(1,707,471)
Prepaid expenses and other assets	(94,524)	(966,881)
Accounts payable and accrued expenses	3,328,335	682,871
Accrued payroll and related benefits	1,343,287	69,933
Accrued interest payable	6,192	(424,601)
Net cash provided by operating activities	17,457,350	14,590,299
Cash flows from investing activities:		
Purchase of marketable securities	(26,491,533)	(54,791,614)
Proceeds from maturities of marketable securities	36,128,000	25,987,000
Purchase of property and equipment	(3,498,660)	(2,068,148)
Cash and cash equivalents from acquisitions	339,085	
Cash paid for acquisitions	(125,735,643)	
Net cash used in investing activities	(119,258,751)	(30,872,762)
Cash flows from financing activities:		
Proceeds from note payable and debt	100,000,000	7,000,000
Repayment of notes payable and debt	(11,116,094)	(31,003,429)
Payment on line of credit	(1,678,953)	
Deferred financing costs	(4,478,527)	
Proceeds from issuance of common stock, net of issuance costs		84,893,905
Proceeds from exercise of stock options	961,936	182,724
Excess tax benefit from exercise of stock options	1,324,855	312,188
Dividends paid		(7,000,000)
Net cash provided by financing activities	85,013,217	54,358,388
Net increase (decrease) in cash and cash equivalents	(16,788,184)	38,102,925
Cash and cash equivalents beginning of period	46,500,818	12,610,487

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

Cash and cash equivalents end of period	\$ 29,712,634	\$ 50,713,412
---	---------------	---------------

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents**

**NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**

(unaudited)

	<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>Supplemental disclosures of cash flow information:</b>		
Cash paid for interest	\$ 3,355,817	\$ 646,585
Cash paid for income taxes	9,064,574	10,043,423
<b>Non-cash investing and financing activities:</b>		
Debt issuance costs included in accounts payable and accrued expenses	40,919	
Acquisition costs included in accounts payable and accrued expenses	700,000	
Purchases of equipment included in accounts payable	(6,146)	49,856
Accretion of redeemable preferred stock		117,534
Accretion of redeemable common stock		11,386,608
Conversion of redeemable convertible preferred stock		13,274,450
Conversion of redeemable common stock		26,742,861
Conversion of preferred stock conversion feature		89,440,020
Stock issuance costs included in accounts payable and accrued expenses		160,000
Stock issuance costs paid in 2005 reclassified to additional paid-in capital		532,686

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (unaudited)**

	Three Months Ended		Nine Months Ended	
	September 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
Net income (loss)	\$ 3,787,844	\$ 5,582,151	\$ 11,633,497	\$ (30,608,086)
Other comprehensive income:				
Change in fair value of interest rate swaps	(898,635)		(898,635)	
Less deferred income taxes	350,153		350,153	
Net other comprehensive income (loss)	(548,482)		(548,482)	
Comprehensive income (loss)	\$ 3,239,362	\$ 5,582,151	\$ 11,085,015	\$ (30,608,086)

See Notes to Condensed Consolidated Financial Statements.

---

**Table of Contents**

**NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**1. GENERAL**

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

In the opinion of Company management, the accompanying unaudited condensed consolidated financial statements include all adjustments necessary to present fairly, in all material respects, results for the periods presented. These condensed consolidated financial statements have been prepared by management pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ) for interim financial information. 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. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and accompanying notes included in our 2006 Annual Report on Form 10-K filed with the SEC on March 6, 2007. The results of operations for the three and nine months ended September 30, 2007 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, 2006 has been derived from the audited consolidated balance sheet as of that date.

**Use of Estimates** The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires 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 ) professional liability claims and estimates used for the purpose of determining stock-based compensation.

**Trade Accounts Receivable** Trade accounts receivable represent receivables for radiology services and are recorded at the invoiced amount and are non-interest bearing. The Company has a history of minimal uncollectible receivables. Management reviews past due accounts receivable to identify specific customers with known disputes or collectibility issues. As of September 30, 2007 and December 31, 2006, the Company had reserved approximately \$570,000 and \$380,000, 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 of marketable debt and equity securities at the time of purchase and reevaluates such designation at each balance sheet date. Marketable debt and equity securities have been classified and accounted for as available for sale. The Company may or may not hold securities with stated maturities greater than twelve 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. 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 are recorded as interest 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 interest income or expense.

**Medical Liability Insurance** The Company is exposed to various risks of loss related to litigation that may arise related to 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 on behalf of the Company.

---

**Table of Contents**

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. IBNR amounts are estimated using historical claims information and industry indices. This reserve is intended to cover potential medical claims that might arise related to the radiological interpretations performed by the Company's affiliated radiologists.

***Derivative Financial Instruments*** Accounting for derivative instruments and hedging activities requires the Company to recognize all derivatives on the consolidated balance sheet at fair value in accordance with Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133). If the derivative is a qualifying cash flow hedge, changes in its fair value are recognized in other comprehensive income until the hedged item is recognized in earnings. The Company does not engage in speculative transactions, nor does it hold or issue financial instruments for trading purposes.

The Company formally documents hedging instruments, as well as its risk management objective and strategy for undertaking hedged items. This process includes linking all derivatives that are cash flow hedges to specific liabilities on the consolidated balance sheet. The Company also formally assesses, both at inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair value or cash flows of hedged items. If it is determined that a derivative is not highly effective, the Company discontinues hedge accounting prospectively for that specific hedge instrument.

***Revenue Recognition and Presentation*** Service revenue is recognized when all significant contractual obligations have been satisfied and collection of the resulting receivable is reasonably assured. Service revenue consists of fees for radiological interpretations and is recognized in the fiscal month when the radiological interpretation is complete and delivered to the customer.

***Stock-Based Compensation*** The Company records stock-based compensation expense in connection with any grant of stock options or restricted stock units to affiliated radiologists. The Company calculates the stock-based compensation expense associated with the issuance of stock-based compensation to affiliated radiologists in accordance with SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123 (R)), and Emerging Issues Task Force Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* (EITF 96-18). The Company calculates the stock-based compensation expense related to the issuance of common stock or restricted stock units to affiliated radiologists based on the fair value of common stock at the date the shares or restricted stock units were earned. Stock-based compensation related to affiliated radiologists is included in professional services expenses.

The Company also records stock-based compensation expense in connection with any grant of stock options or restricted stock units to employees and directors. The Company calculates the stock-based compensation expense associated with the issuance of options or restricted stock units to its employees and directors in accordance with SFAS 123 (R). Stock-based compensation related to employees and directors is included in sales, general and administrative expenses.

***Concentration of Credit Risk*** Financial instruments that potentially expose the Company to concentration of credit risk consist primarily of cash and cash equivalents and accounts receivable. The Company maintains its cash and cash equivalents with high quality credit institutions. At times, such amounts may be in excess of insured amounts. As of September 30, 2007 and December 31, 2006, a total of approximately \$8,556,000 and \$10,690,000, respectively, of cash and cash equivalents was in excess of insured amounts.

***Recently Adopted Accounting Standards*** In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109* (FIN 48), which clarifies the accounting for uncertainty in tax positions. FIN 48 requires that the impact of a tax position be recognized in the financial statements if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The Company adopted the provisions of FIN 48 on January 1, 2007. As a result, the Company recorded \$660,800 of unrecognized tax benefits. Final recognition of those benefits would result in corresponding unrecognized tax obligations of \$601,100. Accordingly, the net impact on retained earnings for the cumulative effect of adopting FIN 48 was \$59,700. All of the unrecognized tax benefits would affect the Company's effective tax rate if recognized.

There was no change to the amount of unrecognized tax benefits in the quarter ended September 30, 2007, and the Company does not anticipate a material change to the total amount of unrecognized tax benefits within the next twelve months.

---

## **Table of Contents**

Interest and penalties related to income tax liabilities are included in Other Expense. As a result of the implementation of FIN 48, the Company recorded a cumulative effect adjustment to retained earnings of \$74,900 for accrued interest and penalties on unrecognized tax benefits. During the quarter ended September 30, 2007, the Company recorded \$7,200 of additional interest and penalties on unrecognized tax benefits.

Prior to 2004, the Company was not subject to significant income tax due to its status as a limited liability company. The Company's tax returns since 2004 are subject to examination in its significant jurisdictions, consisting of U.S. Federal, Australia, and Idaho.

**Recently Issued Accounting Standards** 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 will be effective for the Company on January 1, 2008. The Company is currently evaluating the impact of adopting SFAS 159 on its financial statements and footnotes.

In September 2006, the FASB issued 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, 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 are effective as of January 1, 2008. The Company is currently evaluating the impact of adopting SFAS 157 on its financial statements and footnotes.

## **2. ACQUISITIONS**

### ***Midwest Physicians Services, LLC and Emergency Radiology Services, LLC.***

On July 16, 2007, the Company entered into a Membership Interest Purchase Agreement (the Purchase Agreement ) with SPR Holdings II, LLC, ( SPR Holdings ) a privately held company located in St. Paul, Minnesota, Midwest Physicians Services, LLC ( MPS ), and Emergency Radiology Services, LLC ( ERS ), pursuant to which the Company acquired all of the outstanding equity interests of MPS and ERS from SPR Holdings. MPS was formed by St. Paul Radiology, P.A. ( St. Paul Radiology ) to provide a suite of business process services to support its radiology practice. This suite of business process services includes 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.

In accordance with the terms of the Purchase Agreement, the Company acquired all of the outstanding equity interests of MPS and ERS for aggregate consideration of (i) \$62,920,875 in cash, including certain costs associated with the acquisition totaling \$460,875 and (ii) a warrant that was issued to St. Paul Radiology. This warrant entitles St. Paul Radiology to purchase 300,000 shares of common stock of the Company at any time after July 16, 2010 and before July 16, 2017 at a price equal to the market price of a share of the Company's common stock at closing on July 16, 2007 (\$18.75). The fair value of the warrant of \$3,334,210 was calculated using a Black-Scholes model. \$57,460,000 of the cash portion of the purchase price was paid to SPR Holdings at closing and the remaining \$5,000,000 was placed into an escrow account to serve as a source of funds to satisfy the indemnification obligations of SPR Holdings under the Purchase Agreement.

In connection with the acquisition of MPS and ERS by the Company, MPS entered into a long-term administrative support services agreement with each of St. Paul Radiology and Midwest Radiology LLC ( MWR ), an affiliate of St. Paul Radiology and provider of imaging services. Under these long term services agreements, MPS will provide business process services to each of St. Paul Radiology and MWR in exchange for a percentage of the revenue generated by each of those companies.

**Table of Contents**

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

Current assets	\$ 809,460
Fixed assets	1,758,582
Intangible assets	57,590,000
Goodwill	7,235,693
<b>Assets acquired</b>	<b>67,393,735</b>
Current liabilities	827,802
Long-term liabilities	310,848
<b>Liabilities assumed</b>	<b>1,138,650</b>
<b>Purchase Price</b>	<b>\$ 66,255,085</b>

The acquisition of MPS and ERS resulted in the assets acquired and liabilities assumed being recorded based on their estimated fair values on the acquisition date. Goodwill of \$7,235,693, 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 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 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	Estimated Useful Life
Customer contracts	\$ 57,180,000	20 years
Tradename and trademarks	130,000	5 years
Noncompete agreements	280,000	5 years
	<b>\$ 57,590,000</b>	

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

The following unaudited pro forma information assumes the MPS and ERS acquisitions occurred as of January 1, 2006. The unaudited pro forma financial information summarizes the results of operations for the nine months ended September 30, 2007 and 2006. The unaudited pro forma results are not necessarily indicative of what would have occurred had the acquisition actually occurred as of January 1, 2006 or of future operations of the combined companies. Additionally, the unaudited pro forma results do not give effect to any potential cost savings or other synergies that could result from the combination of NightHawk, MPS and ERS or take in to account the restructuring of service agreements and other contracts renegotiated as part of the combination.

<b>Nine Months Ended</b>	<b>Nine Months Ended</b>
	<b>September 30, 2006</b>

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

	September 30, 2007	
	(unaudited)	
Service revenue	\$ 121,878,000	\$ 83,798,000
Net income (loss)	\$ 14,786,000	\$ (27,982,000)
Net income (loss) applicable to common shareholders	\$ 14,786,000	\$ (28,100,000)
Earnings (loss) per common share, basic and diluted	\$ 0.49	\$ (1.00)
Earnings (loss) per common share, basic and diluted	\$ 0.47	\$ (1.00)

**Table of Contents*****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 a total consideration consisting of \$53,000,000 in cash at closing. The consideration includes the assumption of \$12,608,070 in liabilities which were paid in full immediately following the acquisition and cash payments of \$40,673,804, including \$281,874 of costs associated with the acquisition.

Additional cash consideration will be paid as an earnout within 45 days of the one-year anniversary of the closing. This contingent consideration will be equal to 25% of the revenues generated by certain identified customers during that one-year period. As of September 30, 2007, the Company has recorded an additional liability of \$3,406,432 for this contingent consideration. The Company has also accrued \$369,724 for additional acquisition costs increasing the total consideration to \$44,449,960.

The following table summarizes the preliminary estimated fair value of the assets acquired and liabilities assumed at the date of acquisition. The preliminary purchase price allocations are based on a combination of third-party valuations and internal analyses and may be adjusted during the allocation period as defined in SFAS 141.

Current assets	\$ 3,640,963
Fixed assets	663,174
Intangible assets	19,400,000
Goodwill	38,833,227
<b>Assets acquired</b>	<b>62,537,364</b>
Current liabilities	5,416,510
Long-term liabilities	12,670,894
<b>Liabilities assumed</b>	<b>18,047,704</b>
<b>Purchase Price</b>	<b>\$ 44,449,960</b>

The acquisition of Radlinx resulted in the assets acquired and liabilities assumed being recorded based on their estimated fair values on the acquisition date. Goodwill of \$38,833,227, 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 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 management to make significant estimates and assumptions. These assumptions included future expected cash flows from customer contracts, certain noncompete agreements, customer lists, and 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	Estimated Useful Life
Customer lists and relationships	\$ 16,800,000	10 years
Tradenname and trademarks	1,500,000	5 years
Noncompete agreements	1,100,000	2 years
	<b>\$ 19,400,000</b>	

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



**Table of Contents**

The following unaudited pro forma information assumes the Radlinx acquisition occurred as of January 1, 2006. The unaudited pro forma financial information summarizes the results of operations for the nine months ended September 30, 2007 and 2006. The unaudited pro forma results are not necessarily indicative of what would have occurred had the acquisition actually occurred as of January 1, 2006 or of future operations of the combined companies.

	Nine Months Ended	
	September 30, 2007	Nine Months Ended September 30, 2006 (unaudited)
Service revenue	\$ 113,550,000	\$ 81,616,000
Net income (loss)	\$ 12,136,000	\$ (28,780,000)
Net income (loss) applicable to common shareholders	\$ 12,136,000	\$ (28,898,000)
Earnings (loss) per common share, basic and diluted	\$ 0.40	\$ (1.06)
Earnings (loss) per common share, basic and diluted	\$ 0.39	\$ (1.06)

***Teleradiology Diagnostic Service, Inc.***

On February 9, 2007, the Company entered into a Share Purchase Agreement with Teleradiology Diagnostic Service, Inc. ( TDS ), each of the shareholders of TDS and certain other related parties, pursuant to which the Company acquired all of the outstanding stock of TDS. The execution of the Share Purchase Agreement and the closing of the transaction occurred simultaneously. Under the terms of the Share Purchase Agreement, the Company acquired all of the outstanding stock of TDS, a privately held company, for an aggregate cash consideration of \$23,290,963 in cash, including certain costs associated with the acquisition and \$1,150,000 to be paid out at the conclusion of the eighteen month escrow period.

The following table summarizes the preliminary estimated fair value of the assets acquired and liabilities assumed at the date of acquisition. The preliminary purchase price allocations are based on a combination of third-party valuations and internal analyses and may be adjusted during the allocation period as defined in SFAS 141. The results of operations of TDS have been included in the Company's condensed consolidated statements of operations and cash flows since the date of acquisition.

Current assets	\$ 1,505,742
Fixed assets	197,062
Intangible assets	12,250,000
Goodwill	15,548,193
<b>Assets acquired</b>	<b>29,500,997</b>
Current liabilities	1,393,825
Long-term liabilities	4,816,209
<b>Liabilities assumed</b>	<b>6,210,034</b>
<b>Purchase Price</b>	<b>\$ 23,290,963</b>

***American Teleradiology Nighthawks, Inc.***

On September 30, 2005, the Company completed the purchase of American Teleradiology Nighthawks, Inc. ( ATN ). The ATN purchase agreement provides for two contingent purchase price adjustments based upon the achievement of specified financial goals. The adjustments are to be paid in shares of the Company's stock to stockholders of ATN at the acquisition date. During the three months ended September 30, 2006, \$3,511,025 was recorded for the first component of the contingent consideration, representing approximately 183,000 shares of the Company's stock. During the three months ended March 31, 2007, the Company determined that no amount was earned for the second component of the contingent consideration. Both components of the contingent consideration amount are currently being reviewed by the former stockholders of ATN and Company management. The contingent consideration ultimately due is subject to agreement by these parties.



**Table of Contents****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. Gross unrealized gains and losses on marketable securities were not significant at September 30, 2007 and December 31, 2006.

Below are the Company's marketable securities at fair value:

	September 30, 2007	December 31, 2006
Due in one year or less:		
U.S. Government and Federal Agency securities	\$ 11,129,865	\$ 19,931,536
Municipal securities		7,049,427
Due after three years:		
Municipal securities	17,330,000	10,830,000
Total marketable securities	\$ 28,459,865	\$ 37,810,963

**4. INTANGIBLE ASSETS**

A summary of intangible assets is as follows:

	Estimated Useful Life	September 30, 2007		December 31, 2006	
		Historical Amount	Accumulated Amortization	Historical Amount	Accumulated Amortization
Amortized intangible assets:					
Customer lists and relationships	6-10 years	\$ 30,770,000	\$ 2,390,392	\$ 2,620,000	\$ 548,915
Tradenname and trademarks	5 years	2,820,000	386,095	790,000	31,875
Customer contracts	1-20 years	57,280,000	695,625	100,000	100,000
Noncompete agreements	2-5 years	2,090,000	544,365	210,000	116,667
		\$ 92,960,000	\$ 4,016,477	\$ 3,720,000	\$ 797,457

Amortization expense was approximately \$1,740,000 and \$120,000 for the three months ended September 30, 2007 and 2006, respectively and approximately \$3,219,000 and \$392,000 for the nine months ended September 30, 2007 and 2006, respectively.

The following table shows the Company's estimated amortization expense as of September 30, 2007:

Estimated Amortization Expense:	Amount
Three months ending December 31, 2007	\$ 1,395,458
Year ending December 31, 2008	7,438,000
Year ending December 31, 2009	6,987,528
Year ending December 31, 2010	6,669,190
Year ending December 31, 2011	6,573,000
Thereafter	59,880,347
Total	\$ 88,943,523



**Table of Contents****5. PROPERTY AND EQUIPMENT**

Property and equipment consists of the following:

	September 30, 2007	December 31, 2006
Computers, diagnostic workstations, and telecommunications systems	\$ 8,377,480	\$ 4,353,715
Office furniture and equipment	1,869,606	813,614
Software	4,405,929	3,162,586
Leasehold improvements	2,760,625	1,286,507
	17,413,640	9,616,422
Less accumulated depreciation	(7,117,848)	(3,423,881)
	\$ 10,295,792	\$ 6,192,541

Depreciation expense for the three months ended September 30, 2007 and 2006 was approximately \$868,000 and \$407,000 respectively and approximately \$2,032,000 and \$1,189,000 for the nine months ended September 30, 2007 and 2006, respectively.

**6. LONG-TERM DEBT**

On April 5, 2007, the Company entered into a credit agreement with Morgan Stanley Senior Funding ( Credit Agreement ) relating to a term loan in an amount of \$53,000,000, with an option for the Company to request that the lenders advance up to an additional \$97,000,000 in term loans for a total credit facility of up to \$150,000,000 ( Credit Facility ). The Company used proceeds 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 LIBOR plus a margin of 2.25%. The Credit Facility was guaranteed by substantially all of the Company's assets as collateral for the amounts borrowed by the Company and contains normal restrictive covenants.

On July 10, 2007, the Company entered into the Amended and Restated Credit Agreement (the Amended Credit Facility ) with Morgan Stanley which amends and replaces the Company's Credit Agreement, dated as of April 5, 2007. The Amended Credit Facility provides for term loans up to \$150,000,000 in aggregate. Further, under the Amended Credit Facility, the Company may request that the lenders advance up to an additional \$75,000,000 in term loans, although this additional amount and the terms under which such loans would be made have not been committed. Under the Amended Credit Facility, the Company increased the loan to \$100,000,000 and used the proceeds for the MPS and ERS acquisitions and to pay the fees and expenses incurred in connection with the Amended Credit Facility. 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% (7.70% at September 30, 2007). The Company also entered into two interest rate swap contracts during the three months ended September 30, 2007 which, while in place for the next three years, will lower our effective rate to approximately 7.4%. See additional discussion in Note 12.

The term loan will be repaid in quarterly installments, with principal being amortized at an annual rate of 1%, 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 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.



---

## **Table of Contents**

On February 9, 2006, the Company borrowed \$7,000,000 under its then existing term loan facility with Comerica Bank and distributed the full amount as a special dividend to the holders of its common stock and its then-outstanding redeemable convertible preferred stock. See Dividend discussion in Note 11. On January 2, 2006, the Company paid a regularly scheduled debt payment to Comerica in the amount of approximately \$1,100,000. On February 14, 2006, the Company repaid in full the debt and interest outstanding with Comerica Bank in the amount of approximately \$30,100,000 with proceeds from the Company's initial public offering. Subsequent to repaying this outstanding debt, the Company terminated its term and revolving loan facilities with Comerica Bank in the first quarter of 2006.

## **7. COMMITMENTS AND CONTINGENCIES**

**Leases** In July 2007, the Company signed an operating lease for office facilities in St. Paul, Minnesota as part of the MPS and ERS acquisitions. The lease expires in 2016 and resulted in an additional total lease commitment of approximately \$3,900,000. Subsequent to September 30, 2007, the Company signed an operating lease for office facilities in Ann Arbor, Michigan. The lease commences January 1, 2008 and expires after five years. The total additional lease commitment for this office is approximately \$490,000.

**Litigation** The Company is involved in litigation in the normal course of business. After consultation with legal counsel, management estimates that at September 30, 2007 and December 31, 2006 these matters are 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 various risks of loss related to litigation that may arise related to 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 on behalf of 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 and totaled \$460,000 at September 30, 2007 and \$700,000 at December 31, 2006. The Company also accrues IBNR amounts using actuarial calculations, models and assumptions based on historical claims experience and industry indices. During the three and nine months ended September 30, 2007, the Company recorded approximately \$454,000 and \$1,449,000, respectively, of expense for estimated IBNR amounts. The increase in the third quarter IBNR expense is a result of the increased volumes of radiological interpretations. IBNR amounts, recorded as an insurance reserve on the balance sheet at September 30, 2007 and December 31, 2006, totaled approximately \$3,449,000 and \$2,000,000, respectively.

## **8. 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 September 30, 2007, the Company had an aggregate of 3,957,796 shares of its common stock reserved for issuance under the 2004 Plan and 2006 Plan, of which 305,655 shares were available for future grants and 3,652,141 shares were subject to outstanding stock awards.

Awards are subject to terms and conditions as determined by the Board of Directors. All stock options have an exercise price equal to or greater than the fair value of our common stock on the date the option is granted. Stock options generally have a contractual term of ten years and vest over three years.

**Table of Contents**

**Stock Options.** The Company granted stock options covering 450,000 and 2,126,461 shares during the three and nine months ended September 30, 2007 at weighted-average exercise prices of \$20.48 and \$20.61, respectively. The weighted-average grant-date fair values per share granted during the three and nine months ended September 30, 2007 were \$7.63 and \$7.13, respectively. A summary of our stock-based award activity for employees and non-employees under the 2004 Plan and 2006 Plan are as follows:

	Number of	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Yrs)	Aggregate Intrinsic Value
<b>Stock Options</b>	<b>Stock Options</b>	<b>Price</b>	<b>Contractual Life (Yrs)</b>	<b>Intrinsic Value</b>
Outstanding as of July 1, 2007	3,261,253	\$ 12.77		
Granted	450,000	20.48		
Exercised	(159,076)	3.95		
Cancelled	(83,073)	18.69		
Outstanding as of September 30, 2007	3,469,104	\$ 14.03	8.65	\$ 36,352,672

	Number of	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Yrs)	Aggregate Intrinsic Value
<b>Stock Options</b>	<b>Stock Options</b>	<b>Price</b>	<b>Contractual Life (Yrs)</b>	<b>Intrinsic Value</b>
Outstanding as of January 1, 2007	1,679,563	\$ 4.58		
Granted	2,126,461	20.61		
Exercised	(227,762)	4.22		
Cancelled	(109,158)	17.23		
Outstanding as of September 30, 2007	3,469,104	\$ 14.03	8.65	\$ 36,352,672
Exercisable as of September 30, 2007	370,260	\$ 3.71	7.37	\$ 7,702,331
Vested and expected to vest as of September 30, 2007	3,270,738	\$ 14.10	8.66	\$ 34,058,421

Intrinsic value represents the amount by which the fair market value of the underlying stock exceeds the exercise price of the options.

**Restricted Stock Units.** During the three and nine months ended September 30, 2007, the Company granted 32,750 and 117,881 restricted stock unit awards at a fair value of \$20.48 and \$21.04 per share, respectively. Activity related to these restricted stock unit awards is as follows:

	Number of	Weighted Average Remaining Contractual Life (Yrs)	Aggregate Intrinsic Value
<b>Restricted Stock Unit Awards</b>	<b>Awards</b>	<b>Contractual Life (Yrs)</b>	<b>Intrinsic Value</b>
Outstanding as of July 1, 2007	158,053		
Granted	32,750		
Released	(6,010)		
Cancelled	(1,756)		
Outstanding as of September 30, 2007	183,037	2.06	\$ 4,486,237

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

	Number of	Weighted Average		Aggregate
		Awards	Remaining	
Restricted Stock Unit Awards			Contractual Life (Yrs)	Value
Outstanding as of January 1, 2007	95,352			
Granted	117,881			
Released	(16,071)			
Cancelled	(14,125)			
Outstanding as of September 30, 2007	183,037		2.06	\$ 4,486,237
Vested as of September 30, 2007				
Vested and expected to vest as of September 30, 2007	166,185		2.04	\$ 4,073,187

**Table of Contents**

Intrinsic value represents the amount by which the fair market value of the underlying restricted stock unit exceeds the purchase price of the award. The purchase price for all of the Company's restricted stock unit awards is zero.

**Recognition of Compensation Expense.** The Company calculates the stock-based compensation expense related to the issuance of restricted stock units based on the fair value of our common stock on the date the restricted stock units are granted. The compensation expense associated with stock options is measured 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 values of the stock options granted. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by the persons 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:

	Three Months Ended	Three Months Ended
	September 30, 2007	September 30, 2006
Dividend yield		
Expected volatility	39%	N/A
Risk-free interest rates	4.16%	N/A
Expected term for employees (years)	4.2	N/A
Expected/remaining term for non-employee (years)	10	10

	Nine Months Ended	Nine Months Ended
	September 30, 2007	September 30, 2006
Dividend yield		
Expected volatility	36%	39%
Risk-free interest rates	4.66%	4.84%
Expected term for employees (years)	4.1	4.7
Expected/remaining term for non-employee (years)	10	10

Expected volatility is estimated based primarily on evaluating similar companies' volatility rates, due to the Company's limited trading history. The Company started incorporating its trading history into the estimates starting January 1, 2007. The risk-free interest rate is based on the U.S. Treasury yields in effect at the time of grant corresponding with the expected term of the options. The expected option term for employees is the number of years estimated that options will be outstanding prior to exercise considering vesting schedules, historical exercise experience and other relevant factors.

As of September 30, 2007, the total remaining unrecognized compensation cost related to all unvested stock-based employee/director arrangements, net of an estimated forfeiture rate of 6%, was approximately \$11,200,000 and is expected to be recognized over a weighted average period of 1.2 years.

**Table of Contents****9. COMPUTATION OF EARNINGS PER SHARE**

The following table presents a reconciliation of the numerators and denominators used in the basic and diluted earnings per common share computations:

	Three Months Ended		Nine Months Ended	
	September 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
<b>Numerator:</b>				
Net income (loss) available in basic calculation	\$ 3,787,844	\$ 5,582,151	\$ 11,633,497	\$ (30,725,620)
Plus: Income impact of assumed conversions of preferred stock dividends				(a)
Net income (loss) applicable to common stockholders-dilutive	\$ 3,787,844	\$ 5,582,151	\$ 11,633,497	\$ (30,725,620)
<b>Denominator:</b>				
Weighted average common shares outstanding-basic	30,111,156	29,836,960	30,023,122	28,061,658
Effect of dilutive stock options and restricted stock units	847,266	739,919	795,777	(b)
Effect of convertible preferred stock				(a)
Effect of contingently issuable shares	183,535	183,535	183,535	(c)
Effect of warrants issued	28,492		9,602	
Weighted average common shares outstanding-dilutive	31,170,449	30,760,414	31,012,036	28,061,658
Earnings (loss) per common share basic	\$ 0.13	\$ 0.19	\$ 0.39	\$ (1.09)
Earnings (loss) per common share diluted	\$ 0.12	\$ 0.18	\$ 0.38	\$ (1.09)
Anti-dilutive shares excluded from calculation	1,981,439	108,468	1,378,190	81,336

- (a) The income impact of assumed conversions of the preferred stock dividends and the effect of the convertible preferred stock in the denominator are anti-dilutive.
- (b) The effects of the shares which would be issued upon exercise of these options and restricted stock units have been excluded from the calculation of diluted earnings (loss) per common share because they are anti-dilutive.
- (c) The effects of the shares which would be issued upon finalization of our ATN purchase have been excluded from the calculation of diluted earnings (loss) per common share because they are anti-dilutive.

**10. INCOME TAXES**

In accordance with interim reporting requirements, the Company uses an estimated annual effective tax rate for computing its provision for income taxes. The effective rates for the three months ended September 30, 2007 and 2006 were 37.4% and 38.4%, respectively. The effective rate for the nine months ended September 30, 2007 and 2006 were 37.9% and (39.1%). The difference in effective tax rates is primarily due to the non-deductible increase in the fair market value of the redeemable preferred stock conversion feature which terminated in connection with the Company's initial public offering.

**Table of Contents**

**11. STOCKHOLDERS EQUITY**

On January 23, 2006, the Company completed a reverse stock split, 1 for 1.25, of its common and preferred stock and correspondingly adjusted the number of options issued and available for issuance under the 2004 Plan. All numbers of common stock, preferred stock and per share data in the accompanying condensed consolidated financial statements and related notes have been retroactively restated to give effect to the reverse stock split and the changes to the 2004 Plan.

On February 9, 2006, the Company completed an IPO of 5,800,000 shares of its common stock, from which the Company received net proceeds of approximately \$86,300,000 (after deducting the underwriting discounts and commissions). The Company had incurred \$2,200,000 in stock issuance costs. Subsequent to the IPO, these costs were charged against additional paid in capital on the consolidated balance sheet. In addition, at the closing of the IPO, all outstanding shares of the Company's redeemable convertible preferred stock converted into common stock and, as a result, the Company did not record any additional charge associated with the change in fair value of the conversion feature of the redeemable convertible preferred stock after such date. Prior to the IPO, this redeemable convertible preferred stock was classified as mezzanine equity on the consolidated balance sheet and the fair value of the related conversion feature was classified as a liability on the consolidated balance sheet. Also as a result of the conversion of all outstanding shares of redeemable convertible preferred stock into shares of common stock, all rights of the holders of such shares to receive accrued dividends or to exercise redemption rights terminated. As a result, the accretion relating to the Company's redeemable convertible preferred stock also terminated.

Finally, as a result of the Company's IPO, the rights of certain holders of the Company's common stock to have their shares redeemed by the Company terminated. Prior to the Company's IPO, this redeemable common stock was classified as mezzanine equity on the consolidated balance sheet and the Company recorded periodic accretions of the redemption value of such shares at each balance sheet date. Because this redemption right expired upon the IPO, the Company no longer records the periodic accretions related to these redemption rights, and these shares of common stock no longer are required to be recorded as mezzanine equity on the Company's balance sheet but, instead, as shares of common stock within stockholders' equity.

**Dividend** On February 9, 2006, the Company paid a dividend in the amount of \$7,000,000 or \$0.295 per share for each share of common stock and redeemable preferred stock outstanding as of September 9, 2005, the record date. This dividend was initially declared in September 2005 and was funded by a loan from Comerica Bank (see Note 6).

**12. DERIVATIVE FINANCIAL INSTRUMENTS**

The Company recognizes all derivatives on the Condensed Consolidated Balance Sheet at fair value. The Company designates at inception whether the derivative contract is considered hedging or non-hedging in accordance with SFAS 133. During the three months ended September 30, 2007, the Company entered into two interest rate swap contracts with a combined notional amount of \$100,000,000 in connection with its outstanding debt. The contracts expire on September 30, 2009 and 2010, respectively. These contracts, while in effect, will lower our effective interest rate to approximately 7.4%. The contracts were initiated to maintain compliance with debt requirements and to protect the Company against changes in the interest payments associated with its variable-rate long-term debt, and therefore are considered cash flow hedges. As a result, as long as the swap is deemed 100% effective, changes in the fair value of the swaps are recorded as either an asset (a gain position), or a liability (a loss position) on the balance sheet, with the offset recorded in accumulated other comprehensive income, a separate component of shareholders' equity. At September 30, 2007, the fair value of the interest rate swap contracts resulted in a net unrealized loss of \$898,635.

---

**Table of Contents**

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**Cautionary Statement for Purposes of Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995**

*THIS QUARTERLY REPORT CONTAINS FORWARD-LOOKING STATEMENTS THAT INVOLVE RISKS AND UNCERTAINTIES. THE STATEMENTS CONTAINED IN THIS QUARTERLY REPORT THAT ARE NOT PURELY HISTORICAL ARE 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. THESE FORWARD-LOOKING STATEMENTS INCLUDE, WITHOUT LIMITATION, STATEMENTS RELATING TO FUTURE ECONOMIC CONDITIONS IN GENERAL AND STATEMENTS ABOUT OUR FUTURE:*

*STRATEGY AND BUSINESS PROSPECTS;*

*DEVELOPMENT AND EXPANSION OF SERVICES, AND THE SIZE, GROWTH, AND LEADERSHIP OF THE POTENTIAL MARKETS FOR THESE SERVICES;*

*DEVELOPMENT OF NEW CUSTOMER RELATIONSHIPS AND PRODUCTS;*

*SALES, EARNINGS, INCOME, EXPENSES, OPERATING RESULTS, TAX RATES, OPERATING AND GROSS PROFIT AND PROFIT MARGINS, VALUATIONS, RECEIVABLES, RESERVES, LIQUIDITY, INVESTMENT INCOME, CURRENCY RATES, STOCK OPTION EXERCISES, CAPITAL RESOURCE NEEDS, CUSTOMERS, AND COMPETITION;*

*ABILITY TO OBTAIN AND PROTECT OUR INTELLECTUAL PROPERTY AND PROPRIETARY RIGHTS; AND*

*ACQUISITIONS AND TRANSACTION COSTS AND ADJUSTMENTS.*

*ALL OF THESE FORWARD-LOOKING STATEMENTS ARE BASED ON INFORMATION AVAILABLE TO US ON THE DATE OF THIS QUARTERLY REPORT. OUR ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THOSE DISCUSSED IN THIS QUARTERLY REPORT. THE FORWARD-LOOKING STATEMENTS CONTAINED IN THIS QUARTERLY REPORT, AND OTHER WRITTEN AND ORAL FORWARD-LOOKING STATEMENTS MADE BY US FROM TIME TO TIME, ARE SUBJECT TO CERTAIN RISKS AND UNCERTAINTIES THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE ANTICIPATED IN THE FORWARD-LOOKING STATEMENTS. FACTORS THAT MIGHT CAUSE SUCH A DIFFERENCE INCLUDE, BUT ARE NOT LIMITED TO, THOSE DISCUSSED IN ITEM 1A OF THIS REPORT ENTITLED RISK FACTORS.*

**Overview**

NightHawk Radiology is leading the transformation of the practice of radiology by providing high-quality, cost-effective services to radiology groups and hospitals throughout the United States. We provide the most complete suite of solutions, including professional services, business services, and our advanced, proprietary clinical workflow technology, all designed to increase efficiencies and improve the quality of patient care and the lives of physicians who provide it. Our team of U.S. board-certified, state-licensed, and hospital-privileged physicians located in the United States, Australia, and Switzerland, provides services 24 hours a day, seven days a week, for more than 750 radiology group customers and approximately 26% of all U.S. hospitals they serve. For more information, visit [www.nighthawkrad.net](http://www.nighthawkrad.net).

NightHawk Radiology Services, LLC, an Idaho limited liability company, is our wholly-owned subsidiary and was formed in Coeur d'Alene, Idaho in 2001 to serve as the entity through which we conduct our primary operations. In March 2004, NightHawk Radiology Holdings, Inc. was formed to facilitate a recapitalization of Nighthawk Radiology Services, LLC.

**Recent Acquisitions**

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

On July 16, 2007, we acquired all of the outstanding equity interests of Midwest Physicians Services, LLC ( MPS ) and Emergency Radiology Services ( ERS ) from SPR Holdings II, LLC. MPS was formed by St. Paul Radiology, P.A. ( St. Paul Radiology ) to provide a complete suite of business process services to support its radiology practice. This suite of business process services includes revenue cycle management, administrative, information technology and other services critical to the operation of a radiology group. With this acquisition, we now provide a more complete suite of radiology solutions, including professional services, our proprietary workflow technology, and business process solutions.

---

## **Table of Contents**

We acquired all of the outstanding equity interests of MPS and ERS for an aggregate consideration of (i) \$62.9 million in cash including certain costs associated with the acquisition and (ii) a warrant that was issued to St. Paul Radiology. This warrant entitles St. Paul Radiology to purchase 300,000 shares of our common stock at any time after July 16, 2010 and before July 16, 2017 at a price equal to the market price of our stock at closing on July 16, 2007 (\$18.75). The fair value of the warrant of \$3.3 million was calculated using a Black-Scholes model. \$57.5 million of the cash portion of the purchase price was paid to SPR Holdings at closing and the remaining \$5.0 million was placed into an escrow account to serve as a source of funds to satisfy the indemnification obligations of SPR Holdings under the Purchase Agreement.

On April 5, 2007, we completed the acquisition of The Radlinx Group, Ltd., a privately held radiology services company ( Radlinx ). The acquisition expands our core off-hours business and helps grow our final interpretation and sub-specialty business, while increasing our domestic presence and capabilities. We acquired Radlinx for total consideration consisting of \$53.0 million in cash at closing plus additional cash consideration to be paid as an earnout within 45 days of the one-year anniversary of the closing, which amount will be calculated as 25% of the revenues generated by certain Radlinx customers during that period. As of September 30, 2007, we have recorded an additional liability of \$3.4 million for this contingent consideration.

On February 9, 2007, we acquired Teleradiology Diagnostic Service, Inc. ( TDS ). We regard the acquisition of TDS as a strategic acquisition of an off-hours professional radiology services business that is supplemental to our current business and that expands our presence in California. We purchased TDS for an aggregate price of \$23.0 million dollars, of which approximately \$21.8 million was paid in cash at the closing of the acquisition.

On September 30, 2005, we completed the purchase of American Teleradiology Nighthawks, Inc. ( ATN ). The ATN purchase agreement provides for two contingent purchase price adjustments based upon the achievement of specified financial goals. The adjustments are to be paid in shares of our stock to stockholders of ATN at the acquisition date. During the three months ended September 30, 2006, \$3.5 million was recorded for the first component of the contingent consideration, representing approximately 0.2 million shares of our stock. During the three months ended March 31, 2007, we determined that no amount was earned for the second component of the contingent consideration. Both components of the contingent consideration amount are currently being reviewed by the former stockholders of ATN and our management. The contingent consideration ultimately due is subject to agreement by these parties.

## **Critical Accounting Policies**

The discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America, or U.S. GAAP. The preparation of these financial statements in accordance with U.S. GAAP requires us to utilize accounting policies and make certain estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingencies as of the date of the financial statements and the reported amounts of revenue and expenses during a fiscal period. The SEC considers an accounting policy to be critical if it is important to a company's financial condition and results of operations, and if it requires the exercise of significant judgment and the use of estimates on the part of management in its application. We have discussed the selection and development of the critical accounting policies with the audit committee of our board of directors, and the audit committee has reviewed our related disclosures in this report. Although we believe that our judgments and estimates are appropriate, actual results may differ from those estimates.

We believe the following to be our critical accounting policies because they are both important to the portrayal of our financial condition and results of operations and they require critical management judgment and estimates about matters that are uncertain:

revenue recognition and allowance for doubtful accounts,

stock-based compensation,

use of estimates,

long-lived assets including goodwill and other acquired intangible assets,

income taxes, and

accounting for redeemable preferred stock.

## **Table of Contents**

If actual results or events differ materially from those contemplated by us in making these estimates, our reported financial condition and results of operations for future periods could be materially affected. See **Risk Factors** for certain matters that may affect our future results of operations or financial condition.

### ***Revenue Recognition and Allowance for Doubtful Accounts***

We enter into services contracts with our customers that typically have a one year term, and automatically renew for each successive year unless terminated by the customer or by us. The amount we charge for our radiology services varies by customer based on a number of factors, including the hours of coverage we provide for the customer, the number of reads we provide to the customer and the technical and administrative services we provide to the customer. We recognize revenue when we have satisfied all of our significant contractual obligations to our customers and we determine that the collection of the resulting receivable is reasonably assured. Revenue from services is recognized in the fiscal month in which the radiological interpretation is complete and forwarded to the customer. We review our historical collection experience on a quarterly basis to determine the required amount necessary for our provision for doubtful accounts. As of September 30, 2007, we had reserved approximately \$0.6 million for doubtful accounts based on our estimate of the collectibility of outstanding receivables as of that date.

### ***Stock-Based Compensation***

***Physician Stock-Based Compensation.*** We record share-based compensation expense in connection with any grant of stock options, restricted stock units, or other issuance of shares of common stock to our affiliated radiologists. We calculate the share-based compensation expense associated with the issuance of stock options to our affiliated radiologists in accordance with SFAS No. 123 (revised 2004), *Share-Based Payment* ( SFAS 123 (R) ) and Emerging Issues Task Force Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* ( EITF 96-18 ), by determining the fair value using a Black-Scholes model. We calculate the stock-based compensation expense related to the issuance of restricted stock units or shares of our common stock to our affiliated radiologists based on the fair value of our common stock on the date the restricted stock units or shares are issued. In accordance with EITF 96-18, because our radiologists are treated as independent contractors and not as employees, we calculate the fair value of the share-based compensation expense in each period. The expense amount is determined by calculating the fair value of the shares earned in each period and recording that amount as expense during such period. If the price of our common stock increases over a given period, this accounting treatment results in compensation expense that exceeds the expense we would have recorded if these individuals were employees. Stock-based compensation to our affiliated radiologists is included in professional services expense.

***Non-Physician Stock-Based Compensation.*** We also record stock-based compensation expense in connection with any grant of stock options, restricted stock units, warrants or other issuance of shares of common stock to employees and directors. We calculate the stock-based compensation expense associated with the issuance of stock options and warrants to our employees and directors in accordance with SFAS 123 (R) by determining the fair value using a Black-Scholes model. We calculate the stock-based compensation expense related to the issuance of restricted stock units or shares of our common stock to our employees and directors based on the fair value of our common stock on the date the restricted stock units or shares are issued. Stock-based compensation to employees and directors is included in sales, general and administrative expense.

***Determination of Fair Value of our Stock Options.*** As indicated above, we record stock-based compensation expense associated with our stock options in accordance with SFAS 123 (R) and EITF 96-18, as applicable, which require us to calculate the expense associated with our stock options by determining the fair value of the options. To determine the fair value of our stock options, we use a Black-Scholes model which takes into account the exercise price of the stock option, the fair value of the common stock underlying the stock option, as measured on the date of grant (or at each reporting date for grants to non-employees that require future service), and an estimation of the volatility of the common stock underlying the stock option.

### ***Use of Estimates***

On an ongoing basis, we evaluate our estimates relating to the items described below. We generally base our estimates on our historical experience (which is limited) and on various other assumptions that we believe to be reasonable along with the guidance provided by Statement of Financial Accounting Standard, or SFAS, No. 5, *Accounting for Contingencies*, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

---

## **Table of Contents**

*Accounts Receivable Allowance.* We monitor customer payments and maintain a reserve for estimated losses resulting from our customers inability to make required payments. In estimating the reserve, we evaluate the collectibility of our accounts receivable from a specific customer when we become aware of circumstances that may impair the customer's ability to meet its financial obligations and record an allowance against amounts due. To date, we have not had any significant difficulty in collecting payments from our customers. We believe that the potential aggregate amount of nonpayment by our customers is limited in part by the frequency of our billing cycle and the ease with which we may discontinue service to customers during periods of nonpayment. However, actual future losses from uncollectible accounts may differ from our estimates due to our limited experience in establishing reserves for nonpayment, our limited history of non-collection, and the difficulty in predicting the future payment practices of a large number of customers.

*Loss Contingency for Medical Liability Claims.* We record a loss contingency for a medical liability claim in the month in which we deem such liability to be probable. Our determination of the probability of the liability is based upon a review of the claim by our executive staff, legal counsel and insurance carrier. Upon the determination that the liability is probable, we record a loss contingency for the claim up to the amount of the deductible specified in our medical liability insurance policy. Actual future losses from medical liability claims may differ from our estimates to the extent that we suffer an adverse determination for a claim that we did not deem the liability probable, did not record a loss contingency up to the maximum amount of our insurance deductible, or for which we do not have insurance coverage.

*Incurred But Not Reported Claims.* Starting in 2006, we started using actuarial assumptions to estimate and record a liability for incurred but not reported (IBNR) professional liability claims. Our estimated IBNR liability is based on long-term industry trends and averages, and considers a number of factors, including changes in claim reporting patterns, claim settlement patterns, judicial and legislative decisions, and economic conditions. Our estimated IBNR liability will fluctuate if claims experience changes over time.

*Fair Value of Redeemable Preferred Stock Conversion Feature.* Prior to the date of our initial public offering, our estimates of the fair value of our redeemable preferred stock conversion feature were determined by management with the assistance of an independent valuation specialist. However, because our outstanding redeemable preferred stock converted into common stock at the closing of our initial public offering, since such date we have not and will not in the future record any additional charges associated with the change in fair value of the conversion feature. As a result, since the closing of our initial public offering, we are no longer required to make these estimates.

### ***Long-Lived Assets Including Goodwill and Other Acquired Intangible Assets***

The value of goodwill and intangible assets is stated at the lower of cost or fair value. Goodwill is not subject to amortization; however it is subject to periodic impairment assessments. Under the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets*, we are required to perform at least annually an impairment test and to consider other indicators that may arise throughout the year to re-evaluate carrying value. Some factors we consider important, which could trigger an interim impairment review, include:

significant underperformance relative to historical or projected future operating results,

significant changes in the manner of our use of acquired assets or the strategy for our overall business, and

significant negative industry or economic trends.

If we determine through the impairment review process that goodwill or intangible assets have been impaired, we reduce goodwill and intangible assets by recording an impairment charge in our consolidated statement of operations in an amount equal to the amount that book value exceeds fair value at the date impairment is determined. We perform our annual impairment test in the last quarter of each fiscal year. SFAS 142 also requires that intangible assets with definite lives be amortized over their estimated useful lives. We amortize our acquired intangible assets with definite lives over periods ranging from seven months to ten years.

SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, requires impairment losses to be recognized for long-lived assets through operations when indicators of impairment exist and the underlying cash flows are not sufficient to support the asset's carrying value. In addition, SFAS 144 requires that a long-lived asset (disposal group) to be sold that meets certain recognition criteria be classified as held for sale and measured at the lower of carrying amount or fair value less cost to sell. SFAS 144 also requires that a long-lived asset subject to closure (abandonment) before the end of its previously estimated useful life continue to be classified as held and used until disposal, with depreciation estimates revised to reflect the use of the asset over its shortened useful life.



## **Table of Contents**

We regularly evaluate the carrying value of intangible and long-lived assets for events or changes in circumstances that indicate that the carrying amount may not be recoverable or that the remaining estimated useful life should be changed. Potential indicators of impairment can include, but are not limited to (1) history of operating losses or expected future losses, (2) significant adverse change in legal factors, (3) changes in the extent or manner in which the assets are used, (4) current expectations to dispose of the assets by sale or other means, and (5) reductions or expected reductions of cash flow. If we determine there is an indication of impairment, we compare undiscounted net cash flows to the carrying value of the respective asset. If the carrying value exceeds the undiscounted net cash flows, we perform an impairment calculation using discounted cash flows, valuation analyses from independent valuation specialists or comparisons to recent sales or purchase transactions to determine estimated fair value.

### ***Income Taxes***

As a limited liability company, or LLC, for all periods from inception through March 31, 2004, we were not subject to federal income taxes directly. Rather, the LLC members were subject to federal income taxation based on their respective allocation of the LLC's net taxable income or loss.

Since our recapitalization, we have recognized income taxes under the asset and liability method. This approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities.

Developing our provision for income taxes, including our effective tax rate and analysis of potential tax exposure items, if any, requires significant judgment and expertise in federal and state income tax laws, regulations and strategies, including the determination of deferred tax assets and liabilities and any estimated valuation allowances we deem necessary to value deferred tax assets. Our judgments and tax strategies are subject to audit by various taxing authorities. While we believe we have provided adequately for our income tax liabilities in our consolidated financial statements, adverse determinations by these taxing authorities could have a material adverse effect on our consolidated financial condition, results of operations or cash flows.

### ***Accounting for Redeemable Preferred Stock***

We account for derivative financial instruments in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. We record derivative financial instruments as assets or liabilities in our consolidated balance sheets, measured at fair value. We record the change in fair value of such instruments as non-cash gains or losses in our consolidated statements of operations. We do not enter into derivative contracts for trading purposes.

On March 31, 2004, in connection with the organization and capitalization of NightHawk Radiology Holdings, Inc., we issued 6,500,003 shares of redeemable preferred stock for a total consideration of \$13.0 million. Each share of redeemable preferred stock was convertible, at the option of the holder, into one share of common stock. The conversion feature of the redeemable preferred stock was considered an embedded derivative under the provisions of SFAS 133, and accordingly was accounted for separately from the redeemable preferred stock. We determined the fair value of the redeemable preferred stock conversion feature based upon the fair value of the underlying common stock. On the date of issuance, the estimated fair value of the conversion feature was approximately \$1.7 million which was recorded as a liability on the date of issuance, thus reducing the recorded value of the redeemable preferred stock to approximately \$11.3 million. At each balance sheet date, we adjusted the carrying value of the embedded derivative to estimated fair value and recognized the change in such estimated value in our consolidated statements of operations.

We also classified the redeemable preferred stock as mezzanine equity. As such, we accreted the carrying value of such stock to its redemption value using the effective interest method through the redemption period. In addition, the redeemable preferred stock accrued dividends since the date of issuance. We recognized these two types of accretion of redeemable preferred stock in our consolidated statement of operations as a decrease in net income available to common stockholders.

At the closing of our initial public offering, all outstanding shares of redeemable preferred stock converted into common stock. As a result, beginning at the closing of the initial public offering we have not recorded any additional charge associated with the change in fair value of the conversion feature. Effective February 9, 2006, the amount reported as fair value of the redeemable preferred stock conversion feature was reclassified to additional paid-in capital in the equity section of the balance sheet. Also, the rights of the holders of redeemable preferred stock to receive accrued dividends or to exercise redemption rights terminated. As a result, the accretion of redeemable preferred stock also terminated. These amounts were reclassified to stockholders' equity.



## **Table of Contents**

### **How We Generate Revenue**

Historically, we have generated substantially all of our revenue from the professional radiology services that we provide our customers. We typically provide these services pursuant to one-year services contracts that automatically renew for each successive year unless terminated by the customer or by us. The amount we charge for our radiology services varies by customer based upon a number of factors, including the hours of coverage we provide for the customer, the number of interpretations we perform for the customer and the technical and administrative services we provide to the customer.

More recently through our acquisition of MPS and ERS announced on July 16, 2007, we have expanded our service offerings for radiology groups to include business services such as revenue cycle management, human resources services, facilities management, accounting and financial services, transcription services, records management, operational support, and quality assurance program support.

We also license the use of our proprietary clinical workflow technology to customers which includes both hosted applications and wrap-around services.

We recognize revenue generated by our professional and business services during the month in which services are provided and we bill our customers at the beginning of the following month. Because the invoices are typically paid directly by our customers, we do not currently depend upon any material payments by third-party payors or patients.

Since our first full year of operations, we have experienced significant revenue growth, from \$4.7 million in 2002 to \$92.2 million in 2006, to \$109.0 million for the first nine months of 2007. This growth in service revenue resulted primarily from:

an increase in our customer base,

an increase in utilization of our service by our customers,

acquisitions,

an expansion of services offered,

an expansion of our service hours,

a high customer retention rate, and

growth in the use of diagnostic imaging technologies and procedures in the healthcare industry.

Through September 30, 2007, our exam volumes were 2,003,568 and our affiliated radiologists were providing services to 753 customers serving 1,469 hospitals. The total number of hospitals we cover represents approximately 26% of all hospitals in the United States. The revenue we generate is largely a function of the number of radiological interpretations performed by our affiliated radiologists.

### **Our Operating Expenses**

Our operating expenses consist primarily of professional services expense, sales, general and administrative expense, interest expense and income tax expense. We record stock compensation expense in connection with equity issuances to our affiliated radiologists (which we refer to as physician stock-based compensation) and in connection with equity issuances to our employees and directors (which we refer to as non-physician stock-based compensation). In our consolidated statements of operations, we present our physician stock-based compensation expense as part of our professional services expenses and our non-physician stock-based compensation as part of our sales, general and

administrative expense.

*Professional Services Expense.* Our professional services expense consists primarily of the fees we pay to our affiliated radiologists for their services (which we refer to as professional service fees), physician stock-based compensation, the premiums we pay for medical liability insurance and medical liability loss contingency expense. Our affiliated radiologists are highly trained professionals and we compensate them accordingly. As a result, our professional service fees are our most significant expense. We structure our relationships with our affiliated radiologists such that they have control over the number of hours that they work. We pay our affiliated radiologists using a formula that is generally based upon the number of hours worked and the workload completed, and we also provide discretionary bonuses. We recognize professional service fee expense in the month in which the professional services are performed.

## **Table of Contents**

*Malpractice Expense.* We recognize expenses associated with medical liability premiums in the month in which the expense is incurred. We record reserves for both reported and incurred but not reported (IBNR) professional liability claims. Reported amounts are reserved based upon our best estimate of future probable costs. IBNR claims are estimated using historical claims information and industry indices. This reserve is intended to cover potential medical claims that might arise related to the radiological interpretations performed by our affiliated radiologists.

*Physician Stock-Based Compensation Expense.* As described previously, we record physician stock-based compensation expense in connection with any stock options, restricted stock units or other issuance of shares of our common stock to our affiliated radiologists and present this expense in our consolidated statements of operations as part of our professional services expense. We calculate the stock-based compensation expense associated with the issuance of stock options and warrants to affiliated radiologists in accordance with SFAS 123 (R) and EITF 96-18.

*Sales, General and Administrative Expense.* Sales, general and administrative expense consists primarily of salaries and related expenses for all employees and non-physician contractors, non-physician stock-based compensation, information technology and telecommunications expenses, costs associated with licensing and privileging our affiliated radiologists, facilities and office-related expenses, sales and marketing expenses and other general and administrative expenses.

*Non-Physician Stock-Based Compensation Expense.* As described previously, we record non-physician stock-based compensation expense in connection with any grant of stock options, restricted stock units, warrants or other issuance of shares of our common stock to our employees and directors and present this expense in our consolidated statement of income as part of our sales, general and administrative expense. We calculate the stock-based compensation expense associated with the issuance of stock options and warrants to our employees and directors in accordance with SFAS 123(R).

## **Our Non-Operating Expenses**

In addition to our operating expenses, we record the following non-operating expenses.

*Interest Expense.* The interest expense we incur in a given period is directly attributable to the principal amount of debt we have outstanding during such period.

*Change in Fair Value of Redeemable Preferred Stock Conversion Feature.* In March 2004, we entered into a stockholders agreement with the holders of our Series A preferred stock pursuant to which we agreed to repurchase all or any portion of the shares of redeemable preferred stock then held by such holders at any time after seven years from the date of issuance. The redemption provision in the stockholders agreement, which terminated upon the closing of our initial public offering, provided that the repurchase price for such shares of redeemable preferred stock would be the greater of (i) the market value of the common stock issuable upon conversion of the redeemable preferred stock or (ii) the liquidation value of such shares of redeemable preferred stock (including all accrued and unpaid dividends). The conversion feature of the redeemable preferred stock was considered an embedded derivative under the provisions of SFAS 133, and accordingly was accounted for separately from the redeemable preferred stock. On the date of issuance, the estimated fair value of the conversion feature was \$1.7 million which was recorded as a liability on the balance sheet date on the date of issue thus reducing the recorded value of the redeemable preferred stock to \$11.3 million. While these shares remained outstanding, on each balance sheet date subsequent to the execution of that agreement, we adjusted the carrying value of the embedded derivative to estimated fair value and recognized the change in such estimated value in our consolidated statements of operations.

At the closing of our initial public offering, all outstanding shares of redeemable preferred stock converted into shares of common stock, and, as a result, we have not recorded any additional expenses associated with the change in fair value of the conversion feature of our redeemable preferred stock after such date.

*Income Tax Expense.* We recognize income taxes under the asset and liability method. This approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities.

## **Table of Contents**

*Redeemable Preferred Stock Accretion.* Shares of our redeemable preferred stock accrued dividends from the date of issuance until their conversion into shares of common stock at the closing of our initial public offering. The redeemable preferred stock dividends were cumulative and accrued at a rate of 6% per annum based on the sum of the liquidation value of each share of redeemable preferred stock, \$2.00, plus all accumulated and unpaid dividends. Dividends accumulated at the end of each calendar quarter. In addition to accruing dividends, we also accrued the carrying amount of the redeemable preferred stock to its redemption value using the effective interest method through the redemption period. We recognized these two types of accretion of redeemable preferred stock in our consolidated statements of operations as a decrease in net income available to common stockholders. At the closing of our initial public offering, all outstanding shares of redeemable preferred stock converted into shares of common stock and the rights of the holders of redeemable preferred stock to receive accrued dividends or to exercise redemption rights terminated. As a result, the accretion relating to our redeemable preferred stock also terminated. These amounts are now reported within stockholders' equity.

## **Trends in our Business and Results of Operations**

*Revenue Trends.* Our business has grown rapidly since inception. This growth has been driven by an increase in our customer base, an increase in utilization of our service by our customers, acquisitions, an expansion of services offered, an expansion of our service hours, a high customer retention rate and the growth in the use of diagnostic imaging technologies and procedures in the healthcare industry. Our strategy is to expand on our position as the leading provider of radiology services by:

continuing to expand our service offerings in final and sub-specialty interpretations, cardiac imaging services and business process services,

expanding our radiology group customers' utilization of our services as they implement coverage of additional hospitals,

targeting new customers,

pursuing both strategic and tactical acquisitions, and

developing markets for our data and technology solutions.

Our revenue has increased in absolute dollars each year since inception and our revenue growth rate has been strong year over year. Our third quarter revenue grew 79% and our year to date revenue grew 60%. We expect that a number of our customers will implement our new service offerings, continue to implement coverage for additional hospitals as well as continue to use additional hours of our service, resulting in an overall increase in the utilization of our service by those customers.

**Table of Contents**

Volume and revenue trends are driven by continuing growth in imaging demand, strong customer retention and recurring revenue streams, and expanded service offerings. Historically, we have seen an increase in exam volumes during the second and third quarters of each fiscal year, when weather conditions tend to be warmer in much of the United States and our customers take greater advantage of our coverage. During the first and fourth quarters of each fiscal year, when weather conditions are colder for a large portion of the United States, we have historically experienced relatively lower exam volumes than those experienced during the second and third quarters. We expect this seasonality to continue. A summary of our historical volumes is as follows:

Quarter	Year	Total Volumes	Growth Rates		Acquisition Contribution - First 12 months			
			Sequential	Year over Year	DayHawk	ATN	TDS	Radlinx
Q1	2004	120,554	36%	210%				
Q2	2004	152,640	27%	178%				
Q3	2004	182,737	20%	133%				
Q4	2004	193,883	6%	119%	8,316			
<b>FY</b>	<b>2004</b>	<b>649,814</b>	<b>149%</b>	<b>149%</b>				
Q1	2005	222,341	15%	84%	15,850			
Q2	2005	266,023	20%	74%	17,355			
Q3	2005	298,759	12%	63%	18,905			
Q4	2005	328,815	10%	70%	8,480	29,640		
<b>FY</b>	<b>2005</b>	<b>1,115,938</b>	<b>72%</b>	<b>72%</b>				
Q1	2006	364,155	11%	64%		32,130		
Q2	2006	417,269	15%	57%		32,622		
Q3	2006	463,028	11%	55%		32,086		
Q4	2006	448,084	(3%)	36%				
<b>FY</b>	<b>2006</b>	<b>1,692,536</b>	<b>52%</b>	<b>52%</b>				
<b>Q3 YTD</b>	<b>2006</b>	<b>1,244,452</b>	<b>n/a</b>	<b>n/a</b>				
Q1	2007	484,477	8%	33%			27,089	
Q2	2007	731,418	51%	75%			51,095	137,611
Q3	2007	787,673	8%	70%			52,708	143,339
<b>Q3 YTD</b>	<b>2007</b>	<b>2,003,568</b>	<b>61%</b>	<b>61%</b>				

*Trends in Professional Service Fees.* Since inception, our professional service fees have increased in absolute dollars each year, primarily due to the addition of new radiologists to perform an increased workload as our business has grown. We expect that our professional service fees will continue to increase in absolute dollars as we contract with additional radiologists to meet the increasing demand for our services, as we begin to offer additional services, and as a result of scheduled increases in hourly fees under our existing agreements with our affiliated radiologists. We expect our gross margins to improve and professional services expense to decline as a percentage of revenue compared to current levels as we integrate our recent acquisitions and as our physicians' productivity improves.

*Trends in Medical Liability Expense.* Our medical liability expense has also increased in absolute dollars each year since inception, primarily due to increases in our medical liability premiums as our business has grown and our reporting of IBNR. We expect our medical liability premiums and our IBNR expense to continue to increase in absolute dollars in future periods as our business continues to grow. In addition, if we have claims in future periods for which we deem a liability to be probable, our medical liability expense may increase.

*Trends in Physician Stock-Based Compensation Expense.* The amount of physician stock-based compensation expense we record in a given period depends primarily on the number of shares subject to outstanding options held by our affiliated radiologists, the number of hours worked, and the change in the value of our common stock in that period. Because of the accounting treatment required by EITF 96-18, if the value of our common stock increases over a given period, we will record a compensation expense that generally exceeds the expense we would have recorded if these individuals were employees because EITF 96-18 requires us to record the increase in the value of the option during such period as an expense. Our expense in future periods for physician stock-based compensation will be driven primarily by new equity-based grants we make to our affiliated radiologists, the rate at which those equity awards and the currently outstanding options are earned over such periods, as well as changes, if any, in our stock price during such periods.

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

*Trends in Sales, General and Administrative Expense.* Our sales, general and administrative expense has increased in absolute dollars each year since inception primarily as a result of increased payroll expenses in connection with the addition of key management personnel and general headcount necessary to support future growth. Our employee headcount increased from 208 at September 30, 2006 to 444 at September 30, 2007. We expect that these payroll expenses will continue to rise as we increase headcount at all levels of our business as we continue to grow. In addition to rising payroll

**Table of Contents**

expense, we expect that our general and administrative expenses will increase in absolute dollars due to increases in telecommunications and information technology costs, licensing and privileging costs and increased accounting, legal and consulting costs associated with Sarbanes-Oxley compliance. Also, we expect that our general and administrative expense will increase in absolute dollars with the additions of our offices in San Francisco, California, Austin, Texas, Dallas, Texas, St. Paul, Minnesota and Ann Arbor, Michigan, and the anticipated expansion of our Coeur d'Alene office in 2008. Accordingly, we expect sales, general and administrative expense to increase in absolute dollars in future periods.

*Trends in Non-Physician Stock-Based Compensation Expense.* The amount of non-physician stock-based compensation expense we record in a given period depends primarily on the number of shares subject to outstanding options. As we continue to grant options and restricted stock units to our employees and directors, we expect our non-physician stock-based compensation expense to continue to increase in future periods.

*Trends in Interest Expense.* On April 5, 2007, we entered into a Credit Agreement relating to a term loan in an amount of \$53.0 million to acquire The Radlinx Group, Ltd. On July 10, 2007, we entered into an Amended and Restated Credit Agreement and increased our borrowings to \$100.0 million to assist in funding the MPS and ERS acquisitions and associated fees. During the quarter ended September 30, 2007, we entered into two interest rate swap contracts to cover the full \$100.0 million in borrowing and to provide a hedge for us against changes in the interest payments during the next three years associated with this variable-rate long-term debt. While these swaps are in place, our effective rate should be approximately 7.4%. We expect our interest expense to remain consistent in future periods unless we change out debt position.

*Trends in Interest Income.* In February 2006, we completed an initial public offering of our common stock from which we received net proceeds of \$84.2 million after deducting underwriter discounts and commissions and approximately \$2.1 million in offering costs. Of this amount, we invested approximately \$63.0 million in a mix of highly-liquid, investment-grade securities and cash, primarily consisting of securities issued by U.S. government and federal agencies along with money market accounts and municipal securities. We utilized a portion of these securities in our acquisitions of TDS, Radlinx, MPS and ERS in the first nine months of 2007. We expect this amount to change based on our future needs.

*Trends and Treatment of Redeemable Preferred Stock.* Upon the closing of our initial public offering, all outstanding shares of redeemable preferred stock converted into shares of common stock and the rights of the holders of redeemable preferred stock to receive accrued dividends or to exercise redemption rights terminated. As a result, since the date of the closing of our initial public offering, we have not recorded any additional expenses associated with the change in fair value of the conversion feature of our redeemable preferred stock, and the accretion relating to our redeemable preferred stock has terminated.

**Table of Contents****Results of Operations**

The following table sets forth selected consolidated statements of operations data for each of the periods indicated as a percentage of service revenue.

	Three Months Ended		Nine Months Ended	
	September 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
Service revenue	100%	100%	100%	100%
Operating costs and expenses:				
Professional services (1)	42	38	43	39
Sales, general and administrative (2)	35	27	34	28
Depreciation and amortization	6	2	5	2
Total operating costs and expenses	83	67	82	69
Operating income	17	33	18	31
Other income (expense):				
Interest expense	(5)		(3)	(1)
Interest income	2	3	2	3
Other, net				
Change in fair value of redeemable preferred stock conversion feature				(65)
Total other income (expense)	(3)	3	(1)	(63)
Income (loss) before income taxes	14	36	17	(32)
Income tax expense	5	14	7	13
Net income (loss)	9	22	10	(45)
Redeemable preferred stock accretion				
Net income (loss) applicable to common stockholders	9%	22%	10%	(45)%

(1) Includes non-cash stock-based compensation expense of \$1.5 million, \$1.1 million, \$3.6 million and \$3.3 million for the three and nine months ended September 30, 2007 and 2006, respectively.

(2) Includes non-cash stock-based compensation expense of \$3.2 million, \$0.3 million, \$5.8 million and \$0.7 million for the three and nine months ended September 30, 2007 and 2006, respectively.

**Comparison of the Three Months Ended September 30, 2007 and September 30, 2006***Service Revenue*

	Three Months Ended September 30,		Change	
	2007	2006	In Dollars	Percentage
Service revenue	\$ 45,151,201	\$ 25,158,889	\$ 19,992,312	79%

The increase in service revenue from the three months ended September 30, 2006 to the three months ended September 30, 2007 resulted primarily from a 24% or \$5.9 million increase in organic revenue and \$14.1 million from acquisitions. The organic growth is driven by a 28%

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

increase in read volumes due to an increase in utilization by our customers of our hours of service, an increase in the number of our radiology group customers and their affiliated hospitals, new services and the growth in the use of diagnostic imaging technologies and procedures in the healthcare industry. The number of radiology group and hospital customers to which we provided service increased from 549 as of September 30, 2006 to 753 as of September 30, 2007, a 37% increase, and the number of hospital sites to which we provided service increased from 975 as of September 30, 2006 to 1,469 as of September 30, 2007, a 51% increase. The organic increase in the number of our customers and hospitals served resulted primarily from increased usage of our services, including new services, with additional increases from increased market acceptance of professional radiology services as a solution, an increase in the recognition by the marketplace of the quality of our service offerings, the success by our sales professionals in generating new customers, and an improvement in our ability to meet the increased demand for our services, primarily through the addition of affiliated radiologists, the expansion of our hours of service and acquisitions.

**Table of Contents***Operating Costs and Expenses**Professional Services*

	Three Months Ended			
	September 30,		In Dollars	Change Percentage
	2007	2006		
Professional services (1)	\$ 19,069,295	\$ 9,552,785	\$ 9,516,510	100%
<i>Percentage of service revenue</i>	42%	38%		

(1) Includes non-cash stock-based compensation expense of \$1.5 million for the three months ended September 30, 2007 and \$1.1 million for the three months ended September 30, 2006.

The increase in professional services expense for the three months ended September 30, 2007 compared to the three months ended September 30, 2006 resulted primarily from an increase in the number of our affiliated radiologists providing service and an increase in our 2007 medical liability expense due to our IBNR reserve. From September 30, 2006 to September 30, 2007, we increased the number of our affiliated radiologists from 57 to 116. This increase was driven primarily by the addition of radiologists in connection with our acquisitions of TDS and Radlinx as well as the increased demand for our services and our ability to effectively recruit additional radiologists to meet such demand. The following expenses comprise our professional services expense:

*Professional Service Fees.* Our professional service fees increased from approximately \$8.2 million for the three months ended September 30, 2006 to approximately \$16.6 million for the same period in 2007, a 103% increase. The increase in total expense was largely due to the increased volume of radiological interpretations performed by our affiliated radiologists due to our continued growth. As a percentage of sales, professional service fees increased from 32% for the three months ended September 30, 2006 to 37% for the three months ended September 30, 2007. This increase is driven by the acquisitions of TDS and Radlinx and the absorption of their professional service fee structures. We expect that our gross margins will improve and our professional services expense to decline as a percentage of revenue as the integrations progress and our new affiliated radiologists' productivity improves.

*Physician Stock-Based Compensation Expense.* Non-cash physician stock-based compensation expense for the three months ended September 30, 2007 increased 41% or approximately \$0.5 million. The increase for the three months ended September 30, 2007 is related to the increased number of affiliated radiologists and hours worked based on increasing volumes. The increase is also impacted by the stock price over the three month period. As a percentage of service revenue, physician stock-based compensation expense decreased from 4% for the three months ended September 30, 2006 to 3% for the same period in 2007.

*Medical Liability Expense.* Our medical liability expense increased from approximately \$0.3 million for the three months ended September 30, 2006 to approximately \$1.0 million for the three months ended September 30, 2007. The expense recorded in 2006 was solely related to medical liability premiums. The 2007 expense represents approximately \$0.5 million of medical liability premiums and the remaining \$0.5 million was attributable to the increase in our estimated IBNR reserve for exposure related to potential medical liability claims that have not yet been reported. We accrue IBNR amounts using actuarial calculations, models and assumptions based on historical loss experience and industry indices. The increased IBNR costs were partially driven by the acquisitions of TDS and Radlinx. The addition of the IBNR reserve increased the expense from 1% of service revenue for the three months ended September 30, 2006 to 2% for the three months ended September 30, 2007.

*Sales, General and Administrative***Three Months Ended**

September 30,

Change

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

	2007	2006	In Dollars	Percentage
Sales, general and administrative (1)	\$ 15,753,703	\$ 6,871,138	\$ 8,882,565	129%
<i>Percentage of service revenue</i>	<i>35%</i>	<i>27%</i>		

- (1) Includes non-cash stock-based compensation expense of \$3.2 million for the three months ended September 30, 2007 and \$0.3 million for the three months ended September 30, 2006.

**Table of Contents**

The increase in our sales, general and administrative expense from the three months ended September 30, 2006 to the three months ended September 30, 2007 resulted primarily from increases in payroll expense due to additional hiring and increased costs associated with our growing operations and increased non-physician stock-based compensation. As a percentage of service revenue, sales, general and administrative expense increased from 27% for the three months ended September 30, 2006 to 35% for the three months ended September 30, 2007. Higher absolute spending was driven primarily by investments in new service offerings and infrastructure, as well as the expansion of our management team along with temporary duplicative costs related to the recent acquisitions that have not yet been fully eliminated.

The following expenses comprise our sales, general and administrative expense:

*Payroll and Related Expense.* Our sales, general and administrative headcount increased from 208 at September 30, 2006 to 444 at September 30, 2007, a 121% increase, and resulted in an increase in non-stock-based payroll expense from \$4.1 million for the three months ended September 30, 2006 to \$8.3 million for the three months ended September 30, 2007, a 103% increase. This increase in payroll expense primarily resulted from acquisitions, additions due to new business offerings, and personnel additions in our senior management, quality control, and information technology departments.

*Information Technology and Telecommunications Expense.* Our non-payroll information technology and telecommunications expense increased from approximately \$0.5 million for the three months ended September 30, 2006 to approximately \$1.0 million for the three months ended September 30, 2007, an 83% increase. The increase in expense is due to our acquisitions and organic growth as we have expanded our operations to include centralized facilities in locations in the United States to support our service offerings.

*Facilities Expense.* Our facilities and office-based expense increased from approximately \$0.5 million for the three months ended September 30, 2006 to \$1.0 million for the three months ended September 30, 2007, a 93% increase. The increase in facilities and office-based expense was driven primarily by increased facilities and occupancy expenses associated with the acquisitions as well as our facilities in Sydney, Australia, Zurich, Switzerland, Milwaukee, Wisconsin, Coeur d'Alene, Idaho, Austin and Dallas, Texas, San Francisco and Arcadia, California, and St. Paul, Minnesota.

*Other General and Administrative Expense.* Our other general and administrative expense consists primarily of professional accounting, legal and consulting services, general liability insurance and employee-related expenses such as recruiting and travel. As a percentage of service revenue, other general and administrative expense remained constant at 4%. Other general and administrative expense increased from approximately \$1.0 million for the third quarter of 2006 to approximately \$1.7 million for the third quarter of 2007, a 59% increase. The increase in other general and administrative expense was driven primarily by higher accounting, consulting and legal costs, as well as higher travel costs associated with business development and marketing. We anticipate higher expenses in the current year due to costs related to our Sarbanes-Oxley compliance work.

*Non-Physician Stock-Based Compensation Expense.* Our non-physician stock-based compensation expense increased from approximately \$0.3 million for the three months ended September 30, 2006 to approximately \$3.2 million for the three months ended September 30, 2007 primarily due to additional equity grants made during this period.

*Depreciation and Amortization*

	Three Months Ended		Change	
	September 30, 2007	2006	In Dollars	Percentage
Depreciation and amortization	\$ 2,608,472	\$ 527,192	\$ 2,081,280	395%
Percentage of service revenue	6%	2%		

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

Depreciation and amortization for the three months ended September 30, 2007 increased 395% or \$2.1 million from the same period in 2006. The non-cash expense increased primarily as a result of additional amortization expense relating to the TDS, Radlinx, MPS and ERS acquisitions. As part of the acquisitions, we have increased our intangible asset balances from approximately \$3.0 million at September 30, 2006 to approximately \$88.9 million at September 30, 2007. These assets are amortized over their estimated useful lives, ranging from 1-20 years.

**Table of Contents***Other Income (Expense)**Interest Expense*

	Three Months Ended			
	September 30,		Change In Dollars	Percentage
	2007	2006		
Interest expense	\$ (2,388,529)	\$ (599)	\$ (2,387,930)	%
<i>Percentage of service revenue</i>	(5)%	%		

Our interest expense for the three months ended September 30, 2007 consists of the interest payable under our Credit Facility. On April 5, 2007 we borrowed \$53.0 million in connection with the Radlinx acquisition and an additional \$47.0 million on July 10, 2007 in connection with the MPS and ERS acquisitions. Also included in interest expense for the three months ended September 30, 2007 is \$0.2 million of amortized deferred loan fees.

*Interest Income*

	Three Months Ended			
	September 30,		Change In Dollars	Percentage
	2007	2006		
Interest Income	\$ 745,719	\$ 875,392	\$ (129,673)	(15)%
<i>Percentage of service revenue</i>	2%	3%		

Interest income for the three months ended September 30, 2007 and 2006 consists primarily of interest income on cash balances and investments of the cash we received in connection with our initial public offering and from operations. We invested in a mix of highly-liquid, investment-grade securities and cash, primarily consisting of securities issued by U.S. government and federal agencies along with money market accounts and municipal securities. The reduction in the marketable securities balance is partially offset by better returns in 2007.

*Income Tax Expense*

	Three Months Ended			
	September 30,		Change In Dollars	Percentage
	2007	2006		
Income tax expense	\$ 2,261,818	\$ 3,480,615	\$ (1,218,797)	(35)%
<i>Percentage of service revenue</i>	5%	14%		

We recorded an income tax expense of approximately \$2.3 million for the three months ended September 30, 2007 and approximately \$3.5 million for the three months ended September 30, 2006. The decrease in our income tax expense was due primarily to the decrease in income before taxes. The decrease in effective rate is primarily due to an increase in tax exempt interest as compared to prior period

**Comparison of the Nine Months Ended September 30, 2007 and September 30, 2006***Service Revenue*

	Nine Months Ended			
	September 30,		Change In Dollars	Percentage
	2007	2006		

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

Service revenue	\$ 108,955,957	\$ 68,074,661	\$ 40,881,296	60%
-----------------	----------------	---------------	---------------	-----

The increase in service revenue from the nine months ended September 30, 2006 to the nine months ended September 30, 2007 resulted primarily from a 25% or \$16.8 million increase in organic revenue and \$24.1 million from acquisitions. The organic growth is driven by a 28% increase in read volumes due to an increase in utilization by our customers of our hours of service, and increase in the number of our radiology group customers and their affiliated hospitals, new services and the growth in the use of diagnostic imaging technologies and procedures in the healthcare industry. The TDS, Radlinx, MPS and ERS acquisitions created the additional increases.

**Table of Contents***Operating Costs and Expenses**Professional Services*

	Nine Months Ended September 30,		Change	
	2007	2006	In Dollars	Percentage
Professional services (1)	\$ 46,844,263	\$ 26,500,833	\$ 20,343,430	77%
<i>Percentage of service revenue</i>	<i>43%</i>	<i>39%</i>		

(1) Includes non-cash stock-based compensation expense of \$3.6 million for the nine months ended September 30, 2007 and \$3.3 million for the nine months ended September 30, 2006.

The increase in professional services expense for the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006 resulted primarily from an increase in the number of our affiliated radiologists providing service and an increase in our 2007 medical liability expense due to our IBNR reserve. From September 30, 2006 to September 30, 2007, we increased the number of our affiliated radiologists from 57 to 116. This increase was driven primarily by the addition of radiologists in connection with our acquisition of TDS and Radlinx as well as the increased demand for our services and our ability to effectively recruit additional radiologists to meet such demand. The following expenses comprise our professional services expense:

*Professional Service Fees.* Our professional service fees increased from approximately \$22.2 million for the nine months ended September 30, 2006 to approximately \$40.4 million for the same period in 2007, an 82% increase. The increase in total expense was largely due to the increased volume of radiological interpretations performed by our affiliated radiologists due to our continued growth. As a percentage of sales, professional service fees increased from 33% for the nine months ended September 30, 2006 to 37% for the nine months ended September 30, 2007. This increase is driven by the acquisitions of TDS and Radlinx and the absorption of their professional service fee structures. We expect the gross margins to improve and professional services expense to decline as a percentage of revenue as the integrations progress and our new affiliated radiologists' productivity improves.

*Physician Stock-Based Compensation Expense.* The increase for the nine months ended September 30, 2007 is related to the increased number of affiliated radiologists and hours worked based on increasing volumes. The increase is also impacted by the stock price over the nine month period. As a percentage of service revenue, physician stock-based compensation expense decreased from 5% for the nine months ended September 30, 2006 to 3% for the same period in 2007.

*Medical Liability Expense.* Our medical liability expense increased from approximately \$0.9 million for the nine months ended September 30, 2006 to approximately \$2.9 million for the nine months ended September 30, 2007. The expense recorded in 2006 was solely related to medical liability premiums. The 2007 expense represents approximately \$1.4 million of medical liability premiums and the remaining \$1.5 million was attributable to the increase in our estimated IBNR reserve for exposure related to potential medical liability claims that have not yet been reported. We accrue IBNR amounts using actuarial calculations, models and assumptions based on historical loss experience and industry indices. The increased IBNR costs were partially driven by the acquisitions of TDS and Radlinx. The addition of the IBNR reserve increased the expense from 1% of service revenue for the nine months ended September 30, 2006 to 3% for the nine months ended September 30, 2007.

*Sales, General and Administrative*

	Nine Months Ended September 30,		Change	
	2007	2006	In Dollars	Percentage
Sales, general and administrative (1)	\$ 36,860,609	\$ 19,224,442	\$ 17,636,167	92%
<i>Percentage of service revenue</i>	<i>34%</i>	<i>28%</i>		

---

(1) Includes non-cash stock-based compensation expense of \$5.8 million for the nine months ended September 30, 2007 and \$0.7 million for the nine months ended September 30, 2006.

The increase in our sales, general and administrative expense from the nine months ended September 30, 2006 compared to the nine months ended September 30, 2007 resulted primarily from increases in payroll expense due to additional hiring and increased costs associated with our growing operations and increased non-physician stock-based compensation. As a percentage of service revenue, sales, general and administrative expense increased from 28% for the

**Table of Contents**

nine months ended September 30, 2006 to 34% for the nine months ended September 30, 2007. Higher absolute spending was driven primarily by investments in new service offerings and infrastructure, as well as the expansion of our management team along with temporary duplicative costs related to the recent acquisitions that have not yet been eliminated.

The following expenses comprise our sales, general and administrative expense:

*Payroll and Related Expense.* Our sales, general and administrative headcount increased from 208 at September 30, 2006 to 444 at September 30, 2007, a 121% increase, and resulted in an increase in non-stock-based payroll expense from \$11.9 million for the first nine months of 2006 to \$20.3 million for the first nine months of 2007, a 71% increase. This increase in payroll expense resulted from acquisitions, additions due to new business offerings, and personnel additions in our quality control and information technology departments.

*Information Technology and Telecommunications Expense.* Our non-payroll information technology and telecommunications expense increased from approximately \$1.5 million for the nine months ended September 30, 2006 to approximately \$2.2 million for the nine months ended September 30, 2007, a 50% increase. The increase in expense is due to our acquisitions and organic growth as we have expanded our operations to include centralized facilities in locations in the United States to support our service offerings.

*Facilities Expense.* Our facilities and office-based expense increased from approximately \$1.5 million for the first nine months of 2006 to \$2.3 million for the first nine months of 2007, a 57% increase. The increase in facilities and office-based expense was driven primarily by increased facilities and occupancy expenses associated with the acquisitions as well as our facilities in Sydney, Australia, Zurich, Switzerland, Milwaukee, Wisconsin, Coeur d Alene, Idaho, Austin and Dallas, Texas, San Francisco and Arcadia, California, and St. Paul, Minnesota.

*Other General and Administrative Expense.* Our other general and administrative expense consists primarily of professional accounting, legal and consulting services, general liability insurance and employee-related expenses such as recruiting, travel and entertainment. As a percentage of service revenue, other general and administrative expense remained consistent at 4%. Other general and administrative expense increased from approximately \$2.6 million for the first nine months of 2006 to approximately \$4.3 million for the first nine months of 2007, a 67% increase. The increase in other general and administrative expense was driven primarily by higher accounting, consulting and legal costs, as well as higher travel costs associated with business development and marketing. We anticipate higher expenses in the current year due to costs we will likely continue to incur related to our Sarbanes-Oxley compliance work.

*Non-Physician Stock-Based Compensation Expense.* Our non-physician stock-based compensation expense increased from approximately \$0.7 million for the first nine months of 2006 to approximately \$5.8 million for the first nine months of 2007 primarily due additional equity grants made during this period.

*Depreciation and Amortization*

	Nine Months Ended September 30,		Change	
	2007	2006	In Dollars	Percentage
Depreciation and amortization	\$ 5,250,807	\$ 1,580,439	\$ 3,670,368	232%
<i>Percentage of service revenue</i>	5%	2%		

Depreciation and amortization for the nine months ended September 30, 2007 increased 232% or \$3.7 million dollars from the same period in 2006. The non-cash expense increased primarily as a result of additional amortization expense relating to the TDS, Radlinx, MPS and ERS acquisitions. As part of the acquisitions, we have increased our intangible asset balances from approximately \$3.0 million at September 30, 2006 to approximately \$88.9 million at September 30, 2007. These assets are amortized over their estimated useful lives, ranging from 1-20 years.



**Table of Contents***Other Income (Expense)**Interest Expense*

	Nine Months Ended September 30,		Change	
	2007	2006	In Dollars	Percentage
Interest expense	\$ (3,664,742)	\$ (560,270)	\$ 3,104,472	554%
<i>Percentage of service revenue</i>	(3)%	(1)%		

Our interest expense for the nine months ended September 30, 2006 consisted primarily of interest payable under our credit facility with Comerica Bank. Additionally, in the first quarter of 2006 we incurred an expense of approximately \$326,000 related to unamortized deferred loan fees as a result of terminating our credit facilities with Comerica Bank. Upon the initial public offering in first quarter of 2006, we repaid the balance of the term loan with Comerica Bank and terminated the loan facility. Our interest expense for the nine months ended September 30, 2007 consists of the interest expense incurred on term loans under our current Credit Facility. On April 5, 2007 we borrowed \$53.0 million in connection with the Radlinx acquisition and an additional \$47.0 million on July 10, 2007 in connection with the MPS and ERS acquisitions. Also included in interest expense for the three months ended September 30, 2007 is \$0.2 million of amortized deferred loan fees.

*Interest Income*

	Nine Months Ended September 30,		Change	
	2007	2006	In Dollars	Percentage
Interest Income	\$ 2,468,149	\$ 2,026,676	\$ 441,473	22%
<i>Percentage of service revenue</i>	2%	3%		

Interest income for the nine months ended September 30, 2006 consisted primarily of interest income on cash balances and investments of the cash we received in connection with our initial public offering. We received cash proceeds of \$86.3 million, of which approximately \$30.1 million was used to repay all outstanding indebtedness to Comerica Bank. We invested the remaining balance in a mix of highly-liquid, investment-grade securities and cash, primarily consisting of securities issued by U.S. government and federal agencies along with money market accounts and municipal securities. The increase in the nine months ended September 30, 2007 is primarily due to a full nine months of interest and better market returns, partially offset by the use of cash for acquisitions.

*Change in Fair Value of Redeemable Preferred Stock Conversion Feature*

	Nine Months Ended September 30,		Change	
	2007	2006	In Dollars	Percentage
Change in fair value of redeemable preferred stock conversion feature	\$	\$ 44,183,770	\$ (44,183,770)	(100)%
<i>Percentage of service revenue</i>	%	65%		

In the first quarter of 2006 through the closing of our initial public offering, the fair value of the redeemable preferred stock conversion feature increased by a total of \$44.2 million, resulting in a non-cash expense of \$44.2 million for the first quarter of 2006. At the time of the closing of our initial public offering, all outstanding shares of redeemable preferred stock converted into common stock, and, as a result, after such date we will not record any additional expenses associated with the change in fair value of the conversion feature of our redeemable preferred stock.

*Income Tax Expense*

	Nine Months Ended September 30,		Change	
	2007	2006	In Dollars	Percentage

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

Income tax expense	\$ 7,110,594	\$ 8,595,532	\$ (1,484,938)	(17)%
<i>Percentage of service revenue</i>	<i>7%</i>	<i>13%</i>		

**Table of Contents**

We recorded an income tax expense of approximately \$7.1 million for the first nine months of 2007 and approximately \$8.6 million for the first nine months of 2006. The increase in the effective rate over the prior period is primarily due to the non-deductible increase in the fair market value of the redeemable preferred stock conversion feature which terminated in connection with our initial public offering. The decrease in our income tax expense was also driven by the decrease in income before taxes after adjusting for the impact of the change in fair value of the redeemable preferred stock conversion.

**Liquidity and Capital Resources****Cash, Cash Equivalents and Marketable Securities**

Our financial position includes cash, cash equivalents and marketable securities of \$58.2 million at September 30, 2007 and \$84.3 million at December 31, 2006.

Capital resources	September 30, 2007	December 31, 2006
Cash and cash equivalents	\$ 29,712,634	\$ 46,500,818
Marketable Securities	28,459,865	37,810,963
<b>Total</b>	<b>\$ 58,172,499</b>	<b>\$ 84,311,781</b>

**Cash Flows**

Cash flow activities (in millions)	Nine Months Ended	
	September 30, 2007	September 30, 2006
Net cash provided (used) by:		
Operating activities	\$ 17.5	\$ 14.6
Investing activities	(119.3)	(30.9)
Financing activities	85.0	54.4
<b>Increase in cash and cash equivalents</b>	<b>\$ (16.8)</b>	<b>\$ 38.1</b>

The discussion below highlights significant aspects of our cash flows.

**Operating Activities**

Net cash from operations was approximately \$17.5 million in the nine months ended September 30, 2007 and approximately \$14.6 million for the nine months ended September 30, 2006, a 20% increase.

For the nine months ended September 30, 2007, we generated net cash from operations of approximately \$17.5 million from net income of approximately \$11.6 million. Significant non-cash charges included in net income that did not impact our net cash from operations during this period include depreciation and amortization of approximately \$5.3 million and stock compensation expense of approximately \$9.4 million.

For the nine months ended September 30, 2006, we generated net cash from operations of approximately \$14.6 million from a net loss of approximately \$30.6 million. Significant non-cash charges included in the net loss that did not impact our net cash from operations during this period include depreciation and amortization of \$1.6 million, stock compensation expense of approximately \$4.0 million and \$44.2 million from the change in fair value of our redeemable preferred stock conversion feature.

The changes in our operating assets and liabilities, net of acquired assets, and the associated impacts on our net cash from operations during the nine months ended September 30, 2007 as compared to the changes during the nine months ended September 30, 2006 are primarily due to the following factors:

*Accounts Receivable.* Accounts receivable increased by approximately \$7.6 million during the nine months ended September 30, 2007, excluding acquired accounts receivable. This growth is primarily driven by the increased demand for our services and accounts receivable billed by our acquisitions. Days Sales Outstanding ( DSO ) has also increased from 45 days at September 30, 2006 to 46 at September 30, 2007 due mostly to acquisition integration and the need to develop relationships with the acquired customers and longer terms in acquired entities. Monthly billings have also increased by approximately 54% in the first nine months of 2007 compared to the same period in 2006.

**Table of Contents**

*Accounts Payable and Accrued Expenses.* Accounts payable and accrued expenses increased by \$3.3 million during the nine months ended September 30, 2007. This increase was primarily due to the expansion of our operations and acquisitions. The most significant area of growth during the first nine months of 2007 is \$2.5 million for professional service fees due to timing and the increase in the number of affiliated radiologists.

*Accrued Payroll and Related Benefits.* Accrued payroll and related benefits expenses increased \$1.3 million during the nine months ended September 30, 2007. The increase was driven by increased bonus and vacation accruals related to the increased number of employees.

***Net Cash Used in Investing Activities***

Net cash used in investing activities was \$119.3 million for the nine months ended September 30, 2007 compared to \$30.9 million for the nine months ended September 30, 2006. Net cash used by investing activities was primarily attributable to the use of approximately \$21.8 million for the acquisition of TDS, approximately \$41.0 million for the acquisition of Radlinx and approximately \$62.9 million for the acquisitions of MPS and ERS.

Investments in marketable securities with maturities greater than ninety days are classified as investing activities on the Consolidated Statement of Cash Flows. Investment activity during the nine months ended September 30, 2007 included the purchase of \$26.5 million in marketable securities, offset by cash receipts of \$36.1 million as a result of certain investments reaching maturity during the period. We also invested approximately \$3.5 million in property and equipment during this nine month period. The majority of these capital expenditures were associated with computer equipment and the continued investment in our information technology infrastructure.

In 2006, the increase in net cash used in investing activities resulted primarily from the purchase of \$54.8 million in marketable securities from part of the net cash proceeds received from our initial public offering. We also received \$26.0 million for maturities of investments during the nine month period ended September 30, 2006. We also invested approximately \$2.1 million in property and equipment during the nine-months ended September 30, 2006.

***Net Cash Provided By Financing Activities***

Net cash provided by financing activities was \$85.0 million for the nine months ended September 30, 2007. On April 5, 2007, we entered into a term loan in the amount of \$53.0 million to acquire Radlinx. Immediately following the acquisition of Radlinx, we paid in full \$12.6 million in assumed debt. In July 2007, we amended the credit facility and increased the loan to \$100.0 million as part of the financing for the MPS and ERS acquisitions. We also incurred approximately \$4.5 million in deferred financing costs. The remaining financing activities represent the cash proceeds to us from the exercise of stock options.

Net cash provided by financing activities was \$54.4 million for the nine months ended September 30, 2006. During that period, we completed our initial public offering from which we received net proceeds of \$84.9 million after deducting discounts and commissions paid to our underwriters. On January 2, 2006, we paid a regularly scheduled debt payment to Comerica Bank in the amount of approximately \$1.1 million. On February 8, 2006, we borrowed an additional \$7.0 million under our term loan facility and distributed the full amount as a special dividend to the holders of our common stock and our then-outstanding redeemable convertible preferred stock. On February 14, 2006, we repaid in full the outstanding principal with Comerica Bank in the amount of \$29.9 million with proceeds from our initial public offering. After repaying this outstanding debt, we terminated our term and revolving loan facilities with Comerica Bank.

***Liquidity, Sources and Uses of Capital***

We expect our long-term liquidity needs to consist primarily of working capital, capital expenditure requirements and future acquisitions. We intend to fund these liquidity needs from cash generated from operations and through credit agreements. We entered in to a credit agreement on April 5, 2007 and amended it July 10, 2007. We borrowed \$100.0 million under the Amended Credit Facility. Interest under the credit agreement is based on a floating per annum rate (based upon one, two, three or six-month interest periods) based on LIBOR plus a margin of 2.50% (7.70% at September 30, 2007). During the quarter ended September 30, 2007, we entered into two interest rate swap contracts to cover the full \$100.0 million in borrowings and to provide a hedge for us against changes in the interest payments in the next three years associated with this variable-rate long-term debt. While these swaps are in place, our effective rate should be approximately 7.4%. The Amended Credit Facility is guaranteed by substantially all of our assets as collateral. As discussed above, we used the proceeds to purchase Radlinx, MPS and ERS. For more information on our financing activities, see Note 6 Long-Term Debt, of the Notes to Condensed Consolidated Financial Statements in Item 1. Our outstanding balance on this agreement at September 30, 2007 was \$99.8 million. We believe our capital resources will be sufficient to meet our anticipated cash needs, including interest and principal payments on our outstanding debt, for at least the next twelve

months.

**Table of Contents****Off-Balance Sheet Arrangements and Contractual Obligations****Off-Balance Sheet Arrangements**

Our Sydney and San Francisco offices leases are collateralized by separate letters of credit in the amounts of approximately \$0.2 million and \$0.1 million, respectively, as of September 30, 2007. Our medical liability insurance policy is also collateralized by a separate letter of credit in the amount of \$0.4 million as of September 30, 2007.

**Contractual Obligations**

The following table presents a summary of our contractual obligations as of September 30, 2007:

	Payments Due Within				Total
	1-3	3-5	More than 5		
	Less than 1 Year	Years	Years	Years	
Long-term debt obligations (a)	\$ 1,000,000	\$ 2,000,000	\$ 2,000,000	\$ 94,750,000	\$ 99,750,000
Operating lease obligations (b)	\$ 2,336,554	\$ 3,440,872	\$ 2,813,241	\$ 3,785,987	\$ 12,376,654
<b>Total contractual obligations</b>	<b>\$ 3,336,554</b>	<b>\$ 5,440,872</b>	<b>\$ 4,813,241</b>	<b>\$ 98,535,987</b>	<b>\$ 112,126,654</b>

(a) See above information on Credit Agreement.

(b) In July 2007, we signed an operating lease for office facilities in St. Paul, Minnesota as part of the MPS and ERS acquisitions. The lease expires in 2016 and resulted in an additional total lease commitment of approximately \$3.9 million. In May 2007, we signed an operating lease for a new office facility in Dallas, Texas. The lease expires in 2012 and resulted in an additional total lease commitment of approximately \$1.1 million. In January 2007, we signed a lease for a new reading facility in San Francisco, California. The lease expires in 2012 and resulted in an additional total lease commitment of approximately \$1.3 million.

**ACCOUNTING STANDARDS****Recently adopted accounting standards**

In July 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109* ( FIN 48 ), which clarifies the accounting for uncertainty in tax positions. FIN 48 requires that the impact of a tax position be recognized in the financial statements if that position is more likely than not of being sustained on audit, based on the technical merits of the position. We adopted the provisions of FIN 48 on January 1, 2007. As a result, we recorded \$660,800 of unrecognized tax benefits. Final recognition of those benefits would result in corresponding unrecognized tax obligations of \$601,100. Accordingly, the net impact on retained earnings for the cumulative effect of adopting FIN 48 was \$59,700. All of the unrecognized tax benefits would affect our effective tax rate if recognized.

There was no change to the amount of unrecognized tax benefits in the quarter ended September 30, 2007, and we do not anticipate a material change to the total amount of unrecognized tax benefits within the next twelve months.

Interest and penalties related to income tax liabilities are included in Other Expense. As a result of the implementation of FIN 48, we recorded a cumulative effect adjustment to retained earnings of \$74,900 for accrued interest and penalties on unrecognized tax benefits. During the quarter ended September 30, 2007, we recorded \$7,200 of additional interest and penalties on unrecognized tax benefits.

Prior to 2004, we were not subject to significant income tax due to its status as a limited liability company. Our tax returns since 2004 are subject to examination in its significant jurisdictions, consisting of U.S. Federal, Australia, and Idaho.

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

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 will be effective for us on January 1, 2008. We are currently evaluating the impact of adopting SFAS 159 on its financial statements and footnotes.

**Table of Contents**

In September 2006, the FASB issued 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, 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 are effective as of January 1, 2008. We are currently evaluating the impact of adopting SFAS 157 on its financial statements and footnotes.

---

**Table of Contents****ITEM 3. Quantitative and Qualitative Disclosures About Market Risk*****Foreign Currency Exchange Risk***

Although a large number of our affiliated radiologists work from our centralized reading facilities in Australia and Switzerland, the professional service fees we pay to our affiliated radiologists are denominated primarily in U.S. dollars. As a result, only our operating leases in those countries present foreign currency exchange risks. Because we are not currently subject to material foreign currency exchange risk, we have not, to date, entered into any hedging contracts. If a weakening U.S. dollar requires us to increase the amounts we pay to our affiliated radiologists in the future in order to maintain a constant level of compensation denominated in U.S. dollars, our results of operations and cash flows could be affected. Any foreign exchange risks are related to the foreign currency exchange rates between the U.S. dollar and the Australian dollar and between the U.S. dollar and the Swiss franc.

***Interest Rate Sensitivity***

We had cash and cash equivalents totaling \$29.7 million at September 30, 2007. These amounts were invested primarily in interest-bearing money market accounts. Additionally, we had marketable securities totaling \$28.5 million at September 30, 2007 invested primarily in U.S. government agency securities and municipal securities. The cash and cash equivalents are held for working capital purposes. We do not enter into investments for trading or speculative purposes. We believe that we do not have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates. However, any declines in interest rates will reduce future investment income.

As of September 30, 2007, we had \$99.8 million in variable rate debt. Because of the two interest rate swap contracts entered in to during the three months ended September 30, 2007, these debt amounts are not subject to interest rate risk during the terms of such contracts. For more information on our hedging activities, see Note 12 Derivative Financial Instruments, of the Notes to Condensed Consolidated Financial Statements in Item 1.

**ITEM 4. Controls and Procedures*****Evaluation of disclosure controls and procedures.***

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (the Exchange Act). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that as of September 30, 2007, the end of the period covered by this report, our disclosure controls and procedures were effective at the reasonable assurance level in timely alerting them to material information relating to us required to be included in our Exchange Act filings and to ensure that information required to be disclosed by us in the report it files under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms.

***Changes in internal control over financial reporting.***

During the quarter ended September 30, 2007, there were no changes in our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

***Limitations on effectiveness of controls and procedures.***

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. These inherent limitations include, but are not limited to, the fact that judgments in decision making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, a control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost effective control system, misstatements due to error or fraud may occur and not be detected.



**Table of Contents**

**PART II OTHER INFORMATION**

**ITEM 1. Legal Proceedings**

We are involved in various legal proceedings arising in the ordinary course of our business activities. We maintain insurance policies with coverages that we believe are appropriate in light of the risks attendant to our business, and believe that the resolution of the current claims will not have a material adverse impact on our consolidated results of operations, cash flows or our financial position. However, depending on the amount of damages resulting from a current or future claim, an unfavorable resolution of a claim could materially affect our future results of operations, cash flows or financial position.

**ITEM 1A. Risk Factors**

*YOU SHOULD CAREFULLY CONSIDER THE RISKS DESCRIBED BELOW BEFORE MAKING AN INVESTMENT DECISION. OUR BUSINESS, PROSPECTS, FINANCIAL CONDITION OR OPERATING RESULTS COULD BE MATERIALLY ADVERSELY AFFECTED BY ANY OF THESE RISKS, AS WELL AS OTHER RISKS NOT CURRENTLY KNOWN TO US OR THAT WE CURRENTLY DEEM IMMATERIAL. THE TRADING PRICE OF OUR COMMON STOCK COULD DECLINE DUE TO ANY OF THESE RISKS AND YOU MAY LOSE ALL OR PART OF YOUR INVESTMENT. IN ASSESSING THE RISKS DESCRIBED BELOW, YOU SHOULD ALSO REFER TO THE OTHER INFORMATION CONTAINED IN THIS REPORT, INCLUDING OUR CONSOLIDATED FINANCIAL STATEMENTS AND THE RELATED NOTES, BEFORE DECIDING TO PURCHASE ANY SHARES OF OUR COMMON STOCK.*

*We have a short operating history in an emerging market, which makes it difficult to evaluate our business and prospects.*

We have a short operating history in an emerging market. As a result, our current business and future prospects are difficult to evaluate. You must consider our business and prospects in light of the risks and difficulties we encounter as an early-stage company in a rapidly evolving market. Some of these risks relate to our potential inability to:

effectively manage our business and technology,

effectively manage the integration of companies that we have acquired, or in the future may acquire,

develop new services that complement our existing business,

market our services to our customers due to regulatory rules governing reassignment of payments, which could affect our customers ability to collect fees for services provided by our affiliated radiologists,

acquire additional customers,

successfully provide high levels of service quality as we expand the scale of our business,

manage rapid growth in personnel and operations,

effectively manage our medical liability risk, and

recruit and retain radiologists and other key personnel.

We may not be able to successfully address these and the other risks described in this report. Failure to adequately do so would harm our business and cause our operating results to suffer. Furthermore, our limited operating history has resulted in revenue growth rates that we may not be able to sustain, and therefore may not be indicative of our future results of operations. As a result, the price of our common stock could decline.

***The market in which we participate is competitive and we expect competition to increase in the future, which will make it more difficult for us to sell our services and may result in pricing pressure, reduced revenue and reduced market share.***

The market for professional radiology services and business process services is competitive and rapidly changing, barriers to entry are relatively low, and with the introduction of new technologies and market entrants, we expect competition to intensify in the future. If we fail to compete effectively, our operating results will be harmed. Some of our principal

## **Table of Contents**

competitors offer their services at a lower price, which has resulted and will continue to result in pricing pressure. If we are unable to maintain our current pricing, our operating results could be negatively impacted. In addition, pricing pressures and increased competition could result in reduced revenue, reduced profits or the failure of our services to achieve or maintain more widespread market acceptance, any of which could harm our business.

In addition, if companies larger than we are enter the market through internal expansion or acquisition of one of our competitors, the change in the competitive landscape could adversely affect our ability to compete effectively. These competitors could have established customer relationships and greater financial, technical, sales, marketing and other resources than we do, and could be able to respond more quickly to new or emerging technologies or devote greater resources to the development, promotion and sale of their services. This competition could harm our ability to sell our services, which may lead to lower prices, reduced revenue and, ultimately, reduced market share.

***If we acquire any companies or technologies in the future, they could prove difficult to integrate, disrupt our business, dilute stockholder value and adversely affect our operating results.***

A key element of our strategy is to pursue strategic acquisitions that are complementary to our business or offer us other strategic benefits. Acquisitions in which we may engage involve numerous risks, including:

difficulties in integrating operations, technologies, services and personnel,

diversion of financial and management resources from existing operations,

risk of entering new markets,

potential write-offs of acquired assets,

potential loss of key employees, and

inability to generate sufficient revenue to offset acquisition costs.

We may experience these difficulties as we integrate the operations of future companies we acquire with our operations.

In addition, if we finance acquisitions by issuing convertible debt or equity securities, our existing stockholders may be diluted which could affect the market price of our stock. Including the July acquisition of Midwest Physicians Services, LLC and Emergency Radiology Services, LLC and the recently-closed acquisitions of Teleradiology Diagnostic Service, Inc. and the Radlinx Group, Ltd., we have made six acquisitions to date, and our management has limited experience in completing acquisitions and integrating acquired businesses with our operations. If we fail to properly evaluate and execute acquisitions, our business and prospects may be harmed.

***If our arrangements with our affiliated radiologists or our customers are found to violate state laws prohibiting the corporate practice of medicine or fee splitting, our business, financial condition and our ability to operate in those states could be adversely impacted.***

The laws of many states, including states in which our customers are located, prohibit us from exercising control over the medical judgments or decisions of physicians and from engaging in certain financial arrangements, such as splitting professional fees with physicians. These laws and their interpretations vary from state to state and are enforced by state courts and regulatory authorities, each with broad discretion. We enter into agreements with our affiliated radiologists pursuant to which the radiologists render professional medical services. In addition, we enter into agreements with our customers to deliver professional radiology interpretation services in exchange for a service fee. We structure our relationships with our affiliated radiologists and our customers in a manner that we believe is in compliance with prohibitions against the corporate practice of medicine and fee splitting. While we have not received notification from any state regulatory or similar authorities asserting that we are engaged in the corporate practice of medicine or that the payment of service fees to us by our customers constitutes fee

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

splitting, if such a claim were successful, we could be subject to civil and criminal penalties and could be required to restructure or terminate the applicable contractual arrangements. A determination that these arrangements violate state statutes, or our inability to successfully restructure our relationships with our affiliated radiologists to comply with these statutes, could eliminate customers located in certain states from the market for our services, which would have a materially adverse effect on our business, financial condition and operations.

***We may be unable to successfully expand our services beyond the off-hours emergency radiology market.***

We have historically focused our business on providing emergency radiology services during the hours of 5:00 p.m. to 8:00 a.m. and 24-hours per day on weekends and holidays. In 2006, we expanded our hours of service to 24-hours per day, seven days a week and began offering final reads and sub-specialty services, including cardiac imaging services, to enhance

## **Table of Contents**

our service offerings to our customers. In addition, our acquisitions of MPS and ERS will permit us to provide a more complete suite of radiology solutions. However, our efforts to provide these final reads and sub-specialty services, or any other services beyond our current services offerings and radiology solutions, may not result in significant revenue growth for us. In addition, efforts to expand our services into these new markets may divert management resources from existing operations and require us to commit significant financial resources to an unproven business. To support these service offerings, we have recently opened two additional centralized reading centers in San Francisco, California and Austin, Texas, similar to our facilities in Sydney, Australia and Zurich, Switzerland. If we are unable to effectively and profitably expand our offerings in these areas, our business, financial condition and results of operations could be adversely affected.

***If our affiliated radiologists are characterized as employees, we would be subject to employment and withholding liabilities and may be subject to prohibitions against the corporate practice of medicine.***

We structure our relationships with our affiliated radiologists in a manner that we believe results in an independent contractor relationship, not an employee relationship. An independent contractor is generally distinguished from an employee by his or her degree of autonomy and independence in providing services. A high degree of autonomy and independence is generally indicative of a contractor relationship, while a high degree of control is generally indicative of an employment relationship. Although we believe that our affiliated radiologists are properly characterized as independent contractors, tax or other regulatory authorities may in the future challenge our characterization of these relationships. If such regulatory authorities or state, federal or foreign courts were to determine that our affiliated radiologists are employees, and not independent contractors, we would be required to withhold income taxes, to withhold and pay social security, Medicare and similar taxes and to pay unemployment and other related payroll taxes. We would also be liable for unpaid past taxes and subject to penalties. In addition, such a determination may also result in a finding that we are engaged in the corporate practice of medicine in violation of the laws of many states. As a result, any determination that our affiliated radiologists are our employees would materially harm our business and operating results.

***Our growth strategy depends on our ability to recruit and retain qualified radiologists and other skilled personnel. If we are unable to do so, our future growth would be limited and our business and operating results would be harmed.***

Our success is dependent upon our continuing ability to recruit and retain qualified radiologists. An inability to recruit and retain radiologists would have a material adverse effect on our ability to grow and would adversely affect our results of operations. We face competition for radiologists from other healthcare providers, including radiology groups, research and academic institutions, government entities and other organizations. In addition, our affiliated radiologists are typically U.S. citizens who must obtain visas to work in Australia or Switzerland. We have worked with the government of Australia to establish a visa program and have assisted our affiliated radiologists in the visa application process with the government of Switzerland, and to date all of our professionals have successfully obtained work visas in a timely manner. However, any future inability to obtain or difficulty in obtaining work visas for our affiliated radiologists, due to changing immigration regulations or otherwise, would jeopardize our business and harm our results.

In addition to recruiting radiologists, we must identify, recruit and retain skilled executive, technical, administrative, sales, marketing and operations personnel for our headquarters in Coeur d'Alene, Idaho. Competition for highly qualified and experienced personnel is intense due to the limited number of people available with the necessary skills. In addition, Coeur d'Alene has a relatively small pool of potential employees with the skills that we require, and is a small city in a relatively rural part of the country, making it difficult for us to recruit employees from larger metropolitan areas of the country. Failure to attract and retain the necessary personnel would inhibit our growth and harm our business.

***We have been subject to medical liability claims and may become subject to additional claims, which could cause us to incur significant expenses and may require us to pay significant damages if not covered by insurance.***

Our business entails the risk of medical liability claims against our affiliated radiologists and us. We or our affiliated radiologists are subject to ongoing medical liability claims in the ordinary course of business. We have been subject to medical liability claims for which a settlement was paid by our insurance carrier and we are likely to be subject to future claims which will involve payment or settlement. Although we maintain medical liability insurance for ourselves and our affiliated radiologists with coverage that we believe is appropriate in light of the risks attendant to our business, successful medical liability claims could result in substantial damage awards which exceed the limits of our insurance coverage. In addition, medical liability insurance is expensive and insurance premiums may increase significantly in the future, particularly as we expand our services to include final and sub-specialty reads and cardiac imaging services. As a result, adequate medical liability insurance may not be available to our affiliated radiologists or us in the future at acceptable costs or at all.

## **Table of Contents**

Any claims made against us that are not fully covered by insurance could be costly to defend against, result in substantial damage awards against us and divert the attention of our management and our affiliated radiologists from our operations, which could adversely affect our operations and financial performance. In addition, any claims might adversely affect our business or reputation.

We indemnify our radiology group and hospital customers against damages or liabilities that they may incur as a result of the actions of our affiliated radiologists or us. We also indemnify some of our affiliated radiologists against medical liability claims. Our indemnification obligations are typically payable only to the extent that damages incurred are not covered by insurance.

We have also assumed and succeeded to substantially all of the obligations of the businesses that we have acquired. Medical liability claims may be asserted against us for events that occurred prior to these acquisitions. In connection with our acquisitions, the sellers of the businesses that we have acquired have agreed to indemnify us for certain claims. However, we may not be able to collect payment under these indemnity agreements, which could affect us adversely.

***Our customers may terminate their agreements with us, or their agreements with the hospitals that they serve may be terminated, either of which could adversely affect our financial condition and operating results.***

Our revenue is derived primarily from fee-for-service billings to our radiology group customers. Our agreements with our customers generally provide for one-year terms and automatically renew for successive one-year terms unless terminated by our customers or us upon 30 days' prior notice. Following the first anniversary of the agreements, the agreements typically may be terminated at any time by our customers or us upon 60 days' prior notice. Our customers may elect not to renew their contracts with us, they may seek to renegotiate the terms of their contracts or they may choose to reduce or eliminate our services in the future. If our arrangements with our customers are canceled, or are not renewed or replaced with other arrangements having at least as favorable terms, our business, financial condition and results of operations could be adversely affected. In addition, to the extent that our radiology group customers' agreements with the hospitals that they serve are terminated, our business, financial condition and results of operations could be adversely affected.

***If our security measures are breached and unauthorized access is obtained to patient or customer data, we may face liabilities and our system may be perceived as not being secure, causing customers to curtail or stop using our services, which could lead to a decline in revenues.***

We are required to implement administrative, physical and technological safeguards to ensure the security of the patient data that we create, process or store. These safeguards may fail to ensure the security of patient or customer data, thereby subjecting us to liability, including civil monetary penalties and possible criminal penalties. If our security measures are breached, whether as a result of third party action, employee error, malfeasance or otherwise, and, as a result, someone obtains unauthorized access to patient or customer data, our reputation will be damaged, our business may suffer and we could incur significant liability. Because techniques used to obtain unauthorized access to systems change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventive measures.

***Enforcement of federal and state laws regarding privacy and security of patient information may adversely affect our business, financial condition or operations.***

The use and disclosure of certain healthcare information by healthcare providers and their business associates have come under increasing public scrutiny. Federal standards under the Health Insurance Portability and Accountability Act of 1996, or HIPAA, establish rules concerning how individually-identifiable health information may be used, disclosed and protected. Historically, state law has governed confidentiality issues and HIPAA preserves these laws to the extent they are more protective of a patient's privacy or provide the patient with more access to his or her health information. As a result of the implementation of the HIPAA regulations, many states are considering revisions to their existing laws and regulations that may or may not be more stringent or burdensome than the federal HIPAA provisions. We must operate our business in a manner that complies with all applicable laws, both federal and state and that does not jeopardize the ability of our customers to comply with all applicable laws to which they are subject. We believe that our operations are consistent with these legal standards. Nevertheless, these laws and regulations present risks for healthcare providers and their business associates that provide services to patients in multiple states. Because few of these laws and regulations have been interpreted by government regulators or courts, our interpretations and activities may be challenged. If a challenge to our activities is successful, it could have an adverse effect on our operations, may require us to forgo relationships with customers in certain states, and may restrict the territory available to us to expand our business. In addition, even if our interpretations of HIPAA and other federal and state laws and regulations are correct, we could be held liable for unauthorized uses or disclosures of patient information as a result of inadequate systems and controls to protect this information or due to the theft of information by unauthorized computer programmers who penetrate our network security.



## **Table of Contents**

***Future changes in healthcare regulation are difficult to predict and may constrain or require us to restructure our operations, which could negatively impact our business and operating results.***

The healthcare industry is heavily regulated and subject to frequent changes in governing laws and regulations as well as to evolving administrative interpretations. Our business could be adversely affected by regulatory changes at the federal or state level that impose new requirements for licensing, new restrictions on reimbursement for medical services by government programs, new pretreatment certification requirements for patients seeking radiology procedures, or new limitations on services that can be performed by us. In addition, federal, state and local legislative bodies have adopted and continue to consider medical cost-containment legislation and regulations that have restricted or may restrict reimbursement to entities providing services in the healthcare industry and referrals by physicians to entities in which the physicians have a direct or indirect financial interest or other relationship. For example, Medicare recently adopted a regulation that limits the technical component of the reimbursement for multiple diagnostic tests performed during a single session at medical facilities other than hospitals. Any of these or future reimbursement regulations or policies could limit the number of diagnostic tests our customers order and could have a material adverse effect on our business.

Although we monitor legal and regulatory developments and modify our operations from time to time as the regulatory environment changes, we may not be able to adapt our operations to address every new regulation, and such regulations may adversely affect our business. In addition, although we believe that we are operating in compliance with applicable federal and state laws, our business operations have not been scrutinized or assessed by judicial or regulatory agencies. We cannot assure you that a review of our business by courts or regulatory authorities would not result in a determination that adversely affects our operations or that the healthcare regulatory environment will not change in a way that will restrict our operations.

***Our growth and our continued operations as a publicly-traded company could strain our personnel, management and infrastructure resources, which may harm our business.***

We are currently experiencing a period of rapid growth in our headcount and operations, including, in particular, the opening of our first U.S.-based centralized facilities in the first quarter of 2007, which has placed, and will continue to place, a significant strain on our management, administrative, operational and financial infrastructure. We also anticipate that further growth will be required to address increases in the scope of our operations and size of our customer base. Our success will depend in part upon the ability of our current senior management team to manage this growth, as well as to manage our operations as a publicly-traded company effectively.

To effectively manage our anticipated growth, we will need to continue to improve our operational, financial and management processes and controls and our reporting systems and procedures. In addition, the additional headcount we are adding and capital investments we are making will increase our costs, which will make it more difficult for us to offset any future revenue shortfalls by offsetting expense reductions in the short term. If we fail to successfully manage our growth and our operations as a publicly-traded company, our business and operating results will be harmed.

***Our operating results are subject to seasonal fluctuation, which makes our results difficult to predict and could cause our performance to fall short of quarterly expectations.***

We have experienced increased demand for and revenues from our services during the second and third fiscal quarters of each year. We believe that these increases are a result of increased outdoor and transportation activities during summer months. During the first and fourth quarters of each fiscal year, when weather conditions are colder for a large portion of the United States, we have historically experienced relatively lower revenues than those experienced during the second and third quarters. We may continue to experience this or other seasonality in the future. These seasonal factors may lead to unpredictable variations in our quarterly operating results and cause the trading price of our common stock to decline. Additionally, our ability to schedule adequate radiologist coverage during the seasonal period of increased demand for our services may affect our ability to provide appropriate turnaround times in our services to clients.

***Interruptions or delays in our information systems or in network or related services provided by third-party suppliers could impair the delivery of our services and harm our business.***

Our operations depend on the uninterrupted performance of our information systems, which are substantially dependent on systems provided by third parties over which we have little control. Failure to maintain reliable information systems, or disruptions in our information systems could cause disruptions and delays in our business operations which could have a material adverse effect on our business, financial condition and results of operations.



---

**Table of Contents**

We rely on broadband connections provided by third party suppliers to route digital images from hospitals in the United States to our facilities in Australia, Switzerland and the United States. Any interruption in the availability of the network connections between the hospitals and our reading facilities would reduce our revenue and profits. Frequent or persistent interruptions in our services could cause permanent harm to our reputation and brand and could cause current or potential customers to believe that our systems are unreliable, leading them to switch to our competitors. Because our customers may use our services for critical healthcare services, any system failures could result in damage to our customers' businesses and reputation. These customers could seek significant compensation from us for their losses, and our agreements with our customers do not limit the amount of compensation that they may receive. Any claim for compensation, even if unsuccessful, would likely be time consuming and costly for us to resolve.

Although our systems have been designed around industry-standard architectures to reduce downtime in the event of outages or catastrophic occurrences, they remain vulnerable to damage or interruption from earthquakes, floods, fires, power loss, telecommunication failures, terrorist attacks, computer viruses, break-ins, sabotage, and acts of vandalism. In addition, the connections from hospitals to our reading facility in Australia rely on two cables that link the west coast of the United States with Australia. Despite any precautions that we may take, the occurrence of a natural disaster or other unanticipated problems at our reading facilities or in the networks that connect our reading facilities with our hospitals could result in lengthy interruptions in our services. We do not carry business interruption insurance to protect us against losses that may result from interruptions in our service as a result of system failures.

***Hospital privileging requirements or physician licensure laws may limit our market, and the loss of hospital privileges or state medical licenses held by our affiliated radiologists could have a material adverse affect on our business, financial condition and results of operations.***

Each of our affiliated radiologists must be granted privileges to practice at each hospital from which the radiologist receives radiological images and must hold a license in good standing to practice medicine in the state in which the hospital is located. The requirements for obtaining and maintaining hospital privileges and state medical licenses vary significantly among hospitals and states. If a hospital or state restricts or impedes the ability of physicians located outside of the United States to obtain privileges or a license to practice medicine at that hospital or in that state, the market for our services could be reduced. In addition, any loss of existing privileges or medical licenses held by our affiliated radiologists could impair our ability to serve our existing customers and have a material adverse affect on our business, financial condition and results of operations.

***Medicare and Medicaid rules governing reassignment of payments could affect our customers' ability to collect fees for services provided by our affiliated radiologists and our ability to market our services to our customers.***

The majority of our customers are radiology practices. These customers, and not us, bill and receive payments from Medicare and/or Medicaid for the professional services provided by our affiliated radiologists. Medicare and Medicaid generally prohibit a physician who performs a covered medical service from reassigning to anyone else (including to other physicians) the performing physician's right to receive payment directly from Medicare or Medicaid, except in certain circumstances. We believe that the services provided by our affiliated radiologists satisfy one or more of the exceptions to this prohibition, but the various Medicare carriers and state Medicaid authorities may interpret these exceptions differently than we do. Because Medicare and Medicaid payments may comprise a significant portion of the total payments received by our customers for the services of our affiliated radiologists, if it were determined that we do not qualify for an exception, our customers could be prohibited from billing Medicare and/or Medicaid for the services of our affiliated radiologists and this would cause a material adverse effect on our ability to market our services and on our business and results of operations. Future laws or regulations, moreover, may require that we bill Medicare or Medicaid directly for new services we provide to our customers. Should this occur, we would either be required to forgo business with such customers or be required to design, develop and implement an appropriate recordkeeping and billing system to bill Medicare and Medicaid.

Medicare reimbursement rules currently provide that the proper Medicare carrier to pay physician claims is the Medicare carrier for the region in which the physician or practice providing the service is located, rather than the Medicare carrier for the region in which the patient receiving the services is located. Many of our affiliated radiologists are located in a Medicare region that is different from the Medicare region in which the patient and treating hospital are located. Since it is incumbent on our customers to file with the proper Medicare carrier in order to receive payment, it may be necessary for our customers to enroll with additional Medicare carriers in order to properly submit claims for reimbursement. To the extent that our customers are unwilling or unable to do so, they may be unwilling to use our services unless we were to submit the claims. Should this occur, we would either be required to forgo business with such customers or be required to design,

## **Table of Contents**

develop and implement an appropriate recordkeeping and billing system to bill Medicare and Medicaid. The Center for Medicare and Medicaid Services, or CMS, recently proposed amending the reimbursement rules to provide for reimbursement by the Medicare carrier for the region in which the patient and hospital are located regardless of the location of the physician. If adopted, the amended reimbursement rules would eliminate the need for our customers to enroll with additional Medicare carriers.

***Changes in the rules and regulations governing Medicare's and Medicaid's payment for medical services could affect our revenues, particularly with respect to final reads.***

Although most reads we provide are preliminary reads rather than final reads, we are providing an increasing number of final and sub-specialty reads and cardiac imaging services. Cost-containment pressures on Medicare and Medicaid could result in a reduction in the amount that the government will pay for these reads, which could cause pricing pressure on our services. Should that occur, we could be required to lower our prices, or our customers could elect to provide the reads themselves or obtain such services from one of our competitors, and not utilize the services of our affiliated radiologists, which would have a material adverse effect on our business, results of operations and financial condition.

***We may be subject to less favorable levels of payment based upon third party payor fee schedules.***

Many patients are covered by some form of private or government health insurance or other third party payment program. Third party payors generally establish fee schedules or other payment authorization methods for various procedures that govern which procedures will be reimbursed by the third party payors and the amount of reimbursement. To the extent that such schedules impact the rates at which third party payors are willing to pay the healthcare providers with whom we contract to provide imaging services, we are indirectly impacted by such fee schedules. However, if we were to negotiate direct payment arrangements with third party payors in the future, we would be directly impacted by such schedules. In addition, there is no guarantee that Medicare, state Medicaid programs, or commercial third party payors will continue to cover professional radiology services. Any reduction or elimination in coverage for our services could adversely impact our business.

***Our business could be materially affected if a U.S. Department of Health & Human Services Office of Inspector General study results in a recommendation that Medicare only pay for reads performed contemporaneously in an emergency room setting.***

In its Fiscal Year 2008 Work Plan, the U.S. Department of Health & Human Services Office of Inspector General, or HHS-OIG, indicated that it would conduct a study and issue a report assessing the appropriateness of Medicare billings for diagnostic tests performed in hospital emergency rooms. Part of the assessment will include a determination as to whether the tests were read contemporaneously with the patient's treatment. It is possible that, in the final report, the HHS-OIG could recommend to CMS that it change its reimbursement rules to clearly indicate that CMS will only pay for reads performed contemporaneously with a patient's treatment by a physician located within the United States. If CMS were to adopt this recommendation, final reads would no longer be eligible for reimbursement if performed by a physician other than the one who performed the preliminary read. In turn, if our customers were no longer able to be reimbursed for certain final reads, our customers may seek alternative arrangements for the performance of their preliminary reads, which could adversely impact our business.

***Changes in the healthcare industry or litigation reform could reduce the number of diagnostic radiology procedures ordered by physicians, which could result in a decline in the demand for our services, pricing pressure and decreased revenue.***

Changes in the healthcare industry directed at controlling healthcare costs and perceived over-utilization of diagnostic radiology procedures could reduce the volume of radiological procedures performed. For example, in an effort to contain increasing imaging costs, some managed care organizations and private insurers are instituting pre-authorization policies which require physicians to pre-clear orders for diagnostic radiology procedures before those procedures can be performed. If pre-clearance protocols are broadly instituted throughout the healthcare industry, the volume of radiological procedures could decrease, resulting in pricing pressure and declining demand for our services. In addition, it is often alleged that many physicians order diagnostic procedures even when the procedures may have limited clinical utility in large part to establish a record for defense in the event of a medical liability claim. Changes in tort law could reduce the number of radiological procedures ordered for this purpose and therefore reduce the total number of radiological procedures performed each year, which could harm our operating results.

## **Table of Contents**

***We may not have adequate intellectual property rights in our brand, which could limit our ability to enforce such rights.***

Our success depends in part upon our ability to market our services under the NightHawk brand. However, we believe that the term NightHawk cannot be afforded trademark protection as it is a generic term used to describe the provision of off-hours radiology services. Other than

DayHawk, we have not secured registrations of our other marks. Other businesses may have prior rights in the brand names that we market under or in similar names, which could limit or prevent our ability to use these marks, or to prevent others from using similar marks. If we are unable to prevent others from using our brand names, or if others prohibit us from using them, our revenue could be adversely affected. Even if we are able to protect our intellectual property rights in such brands, we could incur significant costs in doing so.

***Any failure to protect our intellectual property rights in our workflow technology could impair its value and our competitive advantage.***

We rely heavily on our proprietary workflow technology to distribute radiological images to the appropriately licensed and privileged radiologist best able to provide the necessary clinical insight in the least amount of turnaround time. If we fail to protect our intellectual property rights adequately, our competitors may gain access to our technology, and our business may be harmed. We currently do not hold any patents with respect to our technology. Although we have filed an application for a patent covering our workflow technology, we may be unable to obtain patent protection for this technology. In addition, any patents we may obtain may be challenged by third parties. Accordingly, despite our efforts, we may be unable to prevent third parties from using or misappropriating our intellectual property.

***We may in the future become subject to intellectual property rights claims, which could harm our business and operating results.***

The information technology industry is characterized by the existence of a large number of patents, trademarks and copyrights and by frequent litigation based on allegations of infringement or other violations of intellectual property rights. As an example, we are aware that on July 31, 2007, Merge eMed, Inc., or Merge, filed a complaint against another teleradiology provider, Virtual Radiologic Corporation, or VRC, alleging that VRC has infringed on certain of Merge's patents relating to teleradiology. In connection with that litigation, VRC has filed a Request for Reexamination with the U.S. Patent and Trademark Office, or US PTO, which asks the US PTO to reexamine the validity of the patents at issue. While we are not currently a party to any litigation, if Merge or another third party asserts that our technology violates that third-party's proprietary rights, or if a court holds that our technology violates such rights, we may be required to re-engineer our technology, obtain licenses from third parties to continue using our technology without substantial re-engineering or remove the infringing functionality or feature. In addition, we may incur substantial costs defending any such claim. We may also become subject to damage awards, which could cause us to incur additional losses and harm our financial position.

Monitoring potential infringement of and defending or asserting our intellectual property rights may entail significant expense. We may initiate claims or litigation against third parties for infringement of our proprietary rights or to establish the validity of our proprietary rights. Any litigation, whether or not it is resolved in our favor, could result in significant expense to us and divert the efforts of our technical and management personnel.

***We are dependent on our management team, and the loss of any key member of this team may prevent us from implementing our business plan in a timely manner.***

Our success depends largely upon the continued services of our executive officers, particularly Dr. Paul Berger, our Chief Executive Officer and Chairman of the Board. The loss of Dr. Berger, Jon D. Berger, our Senior Vice President of Strategy and Business Development, or Tim Mayleben, our President and Chief Operating Officer could have a material adverse effect on our business, financial condition, results of operations and the trading price of our common stock. Each of these named executives is employed on an at-will basis. In addition, the search for replacements could be time consuming and could distract our management team from the day-to-day operations of our business.

***If we fail to implement and maintain an effective system of internal controls, we may not be able to report our financial results in an accurate or timely manner, prevent fraud or comply with Section 404 of the Sarbanes-Oxley Act of 2002, which may harm our business and affect the trading price of our stock.***

Effective internal controls are necessary for us to provide reliable financial reports in a timely manner and to prevent fraud. Historically, we have had limited accounting personnel and other resources with which to design and implement our internal controls and procedures. As a result, in their audit of our fiscal 2004 financial statements, our auditors identified in their report to our audit committee material weaknesses relating to the adequacy and competency of our financial reporting personnel. Following receipt of our auditor's report, we consulted with our audit committee and undertook remedial steps to address these deficiencies, including hiring additional staff and training our new and existing staff. Although our auditors did not identify material weaknesses in our internal controls in connection with their audit of our financial statements as of and



---

**Table of Contents**

for the year ended December 31, 2006 or 2005, we cannot assure you that we will maintain an effective system of internal controls in the future. Beginning with our annual report on Form 10-K for our fiscal year ending December 31, 2007, we will be required to comply with the requirement of Section 404 of the Sarbanes-Oxley Act of 2002 to include in each of our annual reports an assessment by our management of the effectiveness of our internal controls over financial reporting and a report of our independent registered public accounting firm addressing these assessments. If we fail to adequately staff and train our accounting and finance personnel to meet the demands of operating as a public company, including the requirements of the Sarbanes-Oxley Act of 2002, or fail to maintain adequate internal controls, any resulting material weakness in internal controls could prevent our management from concluding the internal controls are effective and impair our ability to prevent material misstatements in our financial statements, which could cause our business to suffer. In addition, investors' perceptions that our internal controls are inadequate or that we are unable to produce accurate financial statements in a timely manner or prevent fraud may negatively affect the trading price of our stock or result in stockholder litigation.

***We may be unable to enforce non-compete agreements with our affiliated radiologists.***

Our independent contractor agreements with our affiliated radiologists typically provide that the radiologists may not compete with us for a period of time, typically one year, after the agreements terminate. These covenants not to compete are enforceable to varying degrees from jurisdiction to jurisdiction. In most jurisdictions, a covenant not to compete will be enforced only to the extent that it is necessary to protect the legitimate business interest of the party seeking enforcement, that it does not unreasonably restrain the party against whom enforcement is sought and that it is not contrary to the public interest. This determination is made based upon all the facts and circumstances of the specific case at the time enforcement is sought. It is unclear whether our interests will be viewed by courts as the type of protected business interest that would permit us to enforce a non-competition covenant against the radiologists. A determination that these provisions are not enforceable could have a material adverse effect on us.

***Enforcement of state and federal anti-kickback laws may adversely affect our business, financial condition or operations.***

Various federal and state laws govern financial arrangements among healthcare providers. The federal anti-kickback law prohibits the knowing and willful offer, payment, solicitation or receipt of any form of remuneration in return for, or with the purpose to induce, the referral of Medicare, Medicaid, or other federal healthcare program patients, or in return for, or with the purpose to induce, the purchase, lease or order of items or services that are covered by Medicare, Medicaid, or other federal healthcare programs. Similarly, many state laws prohibit the solicitation, payment or receipt of remuneration in return for, or to induce the referral of patients in private as well as government programs. Violation of these anti-kickback laws may result in substantial civil or criminal penalties for individuals or entities and/or exclusion from participating in federal or state healthcare programs. If we are excluded from federal or state healthcare programs, our customers who participate in those programs would not be permitted to continue doing business with us. We believe that we are operating in compliance with applicable law and believe that our arrangements with providers would not be found to violate the anti-kickback laws. However, these laws could be interpreted in a manner inconsistent with our operations.

***Because our customers submit claims to the Medicare program based on the services we provide, it is possible that a lawsuit could be brought against us or our customers under the federal False Claims Act, and the outcome of any such lawsuit could have a material adverse effect on our business, financial condition and operations.***

The Federal False Claims Act provides, in part, that the federal government may bring a lawsuit against any person whom it believes has knowingly presented, or caused to be presented, a false or fraudulent request for payment from the federal government, or who has made a false statement or used a false record to get a claim approved. The government has taken the position that claims presented in violation of the federal anti-kickback law may be considered a violation of the Federal False Claims Act. The Federal False Claims Act further provides that a lawsuit brought under that act may be initiated in the name of the United States by an individual who was the original source of the allegations, known as the relator. Actions brought under the Federal False Claims Act are sealed by the court at the time of filing. The only parties privy to the information contained in the complaint are the relator, the federal government and the court. Therefore, it is possible that lawsuits have been filed against us that we are unaware of or which we have been ordered by the court not to discuss until the court lifts the seal from the case. Penalties include fines ranging from \$5,500 to \$11,000 for each false claim, plus three times the amount of damages that the federal government sustained because of the act of that person. We believe that we are operating in compliance with the Medicare rules and regulations, and thus, the Federal False Claims Act. However, if we were found to have violated certain rules and regulations and, as a result, submitted or caused our customers to submit allegedly false claims, any sanctions imposed under the Federal False Claims Act could result in substantial fines and penalties or exclusion from participation in federal and state healthcare programs which could have a material adverse effect on our business and financial condition.

## **Table of Contents**

Federal regulatory and law enforcement authorities have recently increased enforcement activities with respect to Medicare and Medicaid fraud and abuse regulations and other reimbursement laws and regulations, including laws and regulations that govern our activities and the activities of teleradiologists. These increased enforcement activities may have a direct or indirect adverse affect on our business, financial condition and results of operations.

Additionally, some state statutes contain prohibitions similar to and possibly even more restrictive than the Federal False Claims Act. These state laws may also empower state administrators to adopt regulations restricting financial relationships or payment arrangements involving healthcare providers under which a person benefits financially by referring a patient to another person. We believe that we are operating in compliance with these laws. However, if we are found to have violated such laws, our business, results of operations and financial condition would be harmed.

***Changes in the governmental interpretation or enforcement of the federal prohibition on physician self-referral may adversely affect our business, financial conditions or operations.***

The federal Stark Law prohibits a physician from referring Medicare or Medicaid patients for the provision of designated health services by an entity in which the physician has an investment interest or with which the physician has entered into a compensation arrangement. Designated health services include both the professional and technical components of diagnostic tests using X-rays, ultrasound or other imaging services, CT, MRI, radiation therapy and diagnostic mammography services. Violation of the Stark Law may result in substantial civil penalties and/or exclusion from participation in federal health care programs for both the referring physicians and any entities that submit technical and/or professional component claims for any diagnostic tests ordered by those referring physicians. We believe that we have structured our arrangements between our affiliated radiologists and our customers in a manner that complies with applicable law. However, this law could be interpreted in a manner inconsistent with our arrangements.

***The trading price of our common stock has been volatile and will likely remain volatile.***

The trading prices of many newly publicly-traded companies are highly volatile, particularly companies such as ours that have limited operating histories. Since our initial public offering in February 2006, the trading price of our common stock has been subject to wide fluctuations. Factors that will continue to affect the trading price of our common stock include:

variations in our operating results,

announcements of new services, strategic alliances or significant agreements by us or by our competitors,

recruitment or departure of key personnel,

changes in the estimates of our operating results or changes in recommendations by any securities analysts that follow our common stock, and

market conditions in our industry, the industries of our customers and the economy as a whole.

In addition, if the market for healthcare stocks or healthcare services or the stock market in general experiences loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, operating results or financial condition. The trading price of our common stock might also decline in reaction to events that affect other companies in our industry even if these events do not directly affect us.

***If securities analysts do not publish research or reports about our business, or if they downgrade our stock, the price of our stock could decline.***

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

The trading market for our common stock will rely in part on the availability of research and reports that third-party industry or financial analysts publish about us. There are many large, publicly-traded companies active in the healthcare services industry, which may mean it will be less likely that we receive widespread analyst coverage. Furthermore, if one or more of the analysts who do cover us downgrade our stock, our stock price would likely decline. If one or more of these analysts cease coverage of our company, we could lose visibility in the market, which in turn could cause our stock price to decline.

## **Table of Contents**

*The concentration of our capital stock ownership with insiders will likely limit your ability to influence corporate matters.*

Our executive officers, directors, current five percent or greater stockholders and affiliated entities collectively own a relatively large percentage of the outstanding shares of our common stock. As a result, these stockholders, acting together, will have control over most matters that require approval by our stockholders, including the election of directors and approval of significant corporate transactions. Corporate action might be taken even if other stockholders oppose them. This concentration of ownership might also have the effect of delaying or preventing a change of control of our company that other stockholders may view as beneficial.

*We are exposed to foreign currency exchange risks, which could harm our business and operating results.*

We maintain significant operations in Australia and Switzerland, and are exposed to adverse changes in exchange rates associated with the expenses of our operations in these countries. However, we do not currently engage in any hedging transactions to mitigate these risks. Although from time to time we review our foreign currency exposure and evaluate whether we should enter into hedging transactions, we may not adequately hedge against any future volatility in currency exchange rates and, if we engage in hedging transactions, the transactions will be based on forecasts which later may prove to be inaccurate. Any failure to hedge successfully or anticipate currency risks properly could adversely affect our operating results.

In addition, half of our affiliated radiologists live in Australia and Switzerland, but receive compensation from us in U.S. dollars. Any relative weakness in the U.S. dollar compared to the Australian dollar or Swiss franc may increase the cost of living for our affiliated radiologists and make it less attractive for our affiliated radiologists to sign or renew their service contracts with us.

*Provisions in our certificate of incorporation and bylaws and Delaware law might discourage, delay or prevent a change of control of our company or changes in our management and, therefore, depress the trading price of our common stock.*

Our certificate of incorporation and bylaws contain provisions that could depress the trading price of our common stock by acting to discourage, delay or prevent a change in control of our company or changes in our management that the stockholders of our company may deem advantageous. These provisions:

establish a classified board of directors so that not all members of our board are elected at one time,

provide that directors may only be removed for cause,

authorize the issuance of blank check preferred stock that our board could issue to increase the number of outstanding shares and to discourage a takeover attempt,

eliminate the ability of our stockholders to call special meetings of stockholders,

prohibit stockholder action by written consent, which has the effect of requiring all stockholder actions to be taken at a meeting of stockholders,

provide that the board of directors is expressly authorized to make, alter or repeal our bylaws, and

establish advance notice requirements for nominations for election to our board or for proposing matters that can be acted upon by stockholders at stockholder meetings.

In addition, Section 203 of the Delaware General Corporation Law may discourage, delay or prevent a change in control of our company.

**Item 2. Unregistered Sales of Equity Securities**

In connection with our acquisition of Midwest Physician Services, LLC and Emergency Radiology Services, LLC, we issued a warrant to St. Paul Radiology, P.A. dated July 16, 2007 that entitles St. Paul Radiology, P.A. to purchase 300,000 shares of our common stock at any time after July 16, 2010 and before July 16, 2017 at a price equal to the market price of a share of our common stock at closing on July 16, 2007 (\$18.75). The issuance of the warrant to St. Paul Radiology, P.A. was made in reliance upon the exemption afforded by the provisions of Section 4(2) of the Securities Act of 1933, as amended. The warrant contains a provision that restricts the sale or transfer of the warrant.

**Table of Contents**

**ITEM 6. Exhibits**

<b>Exhibit Number</b>	<b>Description</b>
10.37(1)	Membership Interest Purchase Agreement dated July 16, 2007 between the Company, SPR Holdings II, LLC, Midwest Physicians Services, LLC and Emergency Radiology Services, LLC
10.38(2)	Amended and Restated Credit Agreement dated July 10, 2007 between the Company, Morgan Stanley Service Funding, Inc. and the Lenders thereto
10.39(2)	Amended and Restated Guaranty and Collateral Agreement dated July 10, 2007 between the Company and Morgan Stanley & Co. Incorporated, as Collateral Agent
10.40(2)*	Administrative Support Services Agreement dated July 16, 2007 between Midwest Physician Services, LLC (a wholly-owned subsidiary of the Company) and St. Paul Radiology P.A.
10.41(2)*	Administrative Support Services Agreement dated July 16, 2007 between Midwest Physician Services, LLC (a wholly-owned subsidiary of the Company) and Midwest Radiology, LLC.
31.1	Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(1) Incorporated by reference to Form 8-K (No. 000-51786) filed by the registrant on July 17, 2007.

(2) Incorporated by reference to Form 10-Q (No. 000-51786) filed by the registrant on August 1, 2007.

\* Registrant has omitted portions of the referenced exhibit and filed such exhibit separately with the Securities and Exchange Commission pursuant to a request for confidential treatment.

**Table of Contents**

**SIGNATURES**

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

**NIGHTHAWK RADIOLOGY HOLDINGS, INC.**

Date: November 5, 2007

By: **/s/ GLENN R. COLE**  
**Glenn R. Cole**

*Senior Vice President and Chief Financial Officer*