NightHawk Radiology Holdings Inc
Form 10-Q
November 06, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED 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	**87-0722777**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**
250 Northwest Boulevard, #202, C ur d Alene, Idaho	**83814**
(Address of principal executive offices)	**(Zip code)**

(208) 676-8321

(Registrant s telephone number, including area code)

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

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

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

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

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

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PART 1 FINANCIAL INFORMATION

Item 1. Financial Statements

NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)

	September 30, 2007	December 31, 2006
ASSETS		
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
LIABILITIES		
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)		
STOCKHOLDERS EQUITY:		
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

See Notes to Condensed Consolidated Financial Statements.

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NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**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.

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NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 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

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

See Notes to Condensed Consolidated Financial Statements.

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NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(unaudited)

	Nine Months Ended September 30, 2007	2006
Supplemental disclosures of cash flow information:		
Cash paid for interest	$ 3,355,817	$ 646,585
Cash paid for income taxes	9,064,574	10,043,423
Non-cash investing and financing activities:		
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.

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NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	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.

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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.

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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.

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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.

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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
Assets acquired	67,393,735
Current liabilities	827,802
Long-term liabilities	310,848
Liabilities assumed	1,138,650
Purchase Price	$ 66,255,085

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
	$ 57,590,000	

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.

	Nine Months Ended	Nine Months Ended September 30, 2006

	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)

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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
Assets acquired	62,537,364
Current liabilities	5,416,510
Long-term liabilities	12,670,894
Liabilities assumed	18,047,704
Purchase Price	$ 44,449,960

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
Tradename and trademarks	1,500,000	5 years
Noncompete agreements	1,100,000	2 years
	$ 19,400,000	

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

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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
Assets acquired	29,500,997
Current liabilities	1,393,825
Long-term liabilities	4,816,209
Liabilities assumed	6,210,034
Purchase Price	$ 23,290,963

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.

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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:

		September 30, 2007		December 31, 2006	
	Estimated Useful Life	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
Tradename 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

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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.

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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.

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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:

Stock Options	Number of Stock Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Yrs)	Aggregate Intrinsic Value
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

Stock Options	Number of Stock Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Yrs)	Aggregate Intrinsic Value
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:

Restricted Stock Unit Awards	Number of Awards	Weighted Average Remaining Contractual Life (Yrs)	Aggregate Intrinsic Value
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

Restricted Stock Unit Awards	Number of Awards	Weighted Average Remaining Contractual Life (Yrs)	Aggregate Intrinsic 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

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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 September 30, 2007	**Three Months Ended 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 September 30, 2007	**Nine Months Ended 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.

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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 September 30, 2007	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Numerator:				
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)
Denominator:				
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.

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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.

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.

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

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.

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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.

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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.

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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.

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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.

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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.

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.

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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.

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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:

			Growth Rates		Acquisition Contribution - First 12 months			
Quarter	**Year**	**Total Volumes**	**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			