

NightHawk Radiology Holdings Inc
Form 10-Q
August 11, 2006
Table of Contents

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

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission File Number 000-51786

NightHawk Radiology Holdings, Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

87-0722777
(IRS Employer

Identification No.)

250 Northwest Boulevard, #202, C ur d Alene, Idaho 83814

(Address of principal executive offices) (Zip code)

Registrant s telephone number, including area code:

(208) 676-8321

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

As of July 31, 2006, 29,811,955 shares of the registrant's Common Stock were outstanding.

Table of Contents

TABLE OF CONTENTS

Part I

| | | |
|---------|--|----|
| Item 1. | <u>Financial Statements</u> | 3 |
| | <u>Condensed Consolidated Balance Sheets</u> | 3 |
| | <u>Condensed Consolidated Statements of Operations</u> | 4 |
| | <u>Condensed Consolidated Statements of Cash Flows</u> | 5 |
| | <u>Notes to Condensed Consolidated Financial Statements</u> | 7 |
| Item 2. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 14 |
| Item 3. | <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 31 |
| Item 4. | <u>Controls and Procedures</u> | 32 |

Part II

| | | |
|----------|--------------------------|----|
| Item 1. | <u>Legal Proceedings</u> | 32 |
| Item 1A. | <u>Risk Factors</u> | 32 |
| Item 6. | <u>Exhibits</u> | 41 |

| | | |
|--|-------------------|----|
| | <u>Signatures</u> | 42 |
| | Exhibit Index | |

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

| | December 31, 2005 | June 30, 2006 |
|--|----------------------|------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 12,610,487 | \$ 36,061,564 |
| Short-term investments | | 37,191,604 |
| Trade accounts receivable, net | 10,485,571 | 11,342,695 |
| Deferred income taxes | 19,839 | |
| Prepaid expenses and other current assets | 2,164,126 | 2,039,971 |
| Total current assets | 25,280,023 | 86,635,834 |
| Property and equipment, net | 5,079,280 | 5,604,800 |
| Goodwill | 1,335,788 | 1,335,788 |
| Intangible assets, net | 3,431,418 | 3,159,751 |
| Deferred income taxes | | 792,553 |
| Other assets, net | 409,253 | 82,788 |
| Total | \$ 35,535,762 | \$ 97,611,514 |
| LIABILITIES | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | \$ 5,502,977 | \$ 5,103,473 |
| Dividends declared | 7,000,000 | |
| Accrued payroll and related benefits | 2,366,430 | 2,120,053 |
| Accrued interest payable | 424,601 | |
| Deferred income taxes | | 72,206 |
| Long-term debt, due within one year | 6,229,991 | |
| Total current liabilities | 21,523,999 | 7,295,732 |
| Long-term debt | 17,773,438 | |
| Fair value of redeemable preferred stock conversion feature | 45,256,250 | |
| Deferred income taxes | 630,303 | |
| Total liabilities | 85,183,990 | 7,295,732 |
| COMMITMENTS AND CONTINGENCIES | | |
| Redeemable common stock | 15,356,253 | |
| Redeemable convertible preferred stock | 13,156,916 | |
| STOCKHOLDERS EQUITY (DEFICIT): | | |
| Common stock 150,000,000 shares authorized; \$.001 par value; 15,838,139 and 29,809,571 shares issued and outstanding at December 31, 2005 and June 30, 2006 | 15,838 | 29,810 |
| Additional paid-in capital | 9,434,351 | 225,591,937 |
| Retained earnings (deficit) | (87,611,586) | (135,305,965) |

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

| | | |
|--------------------------------------|---------------|---------------|
| Total stockholders' equity (deficit) | (78,161,397) | 90,315,782 |
| Total | \$ 35,535,762 | \$ 97,611,514 |

See Notes to Condensed Consolidated Financial Statements.

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

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|---------------|------------------|-----------------|
| | June 30, | | June 30, | |
| | 2005 | 2006 | 2005 | 2006 |
| Service revenue | \$ 15,332,300 | \$ 22,876,569 | \$ 28,443,923 | \$ 42,915,772 |
| Operating costs and expenses: | | | | |
| Professional services (includes non-cash compensation expense of \$158,679, \$931,531, \$241,388 and \$2,246,683) | 5,132,472 | 8,553,972 | 9,514,299 | 16,948,047 |
| Sales, general, and administrative (includes non-cash compensation expense of \$2,901,034, \$165,807, \$3,030,503 and \$351,444) | 7,388,264 | 6,283,744 | 11,600,119 | 12,353,305 |
| Depreciation and amortization | 275,886 | 522,835 | 552,142 | 1,053,247 |
| Total operating costs and expenses | 12,796,622 | 15,360,551 | 21,666,560 | 30,354,599 |
| Operating income | 2,535,678 | 7,516,018 | 6,777,363 | 12,561,173 |
| Other income (expense): | | | | |
| Interest expense | (199,161) | (7,017) | (461,424) | (559,671) |
| Interest income | 11,164 | 764,559 | 32,131 | 1,151,284 |
| Other, net | (33,825) | (22,693) | (47,494) | (44,336) |
| Change in fair value of redeemable preferred stock conversion feature | (9,993,750) | | (11,372,221) | (44,183,770) |
| Total other income (expense) | (10,215,572) | 734,849 | (11,849,008) | (43,636,493) |
| Income (loss) before income taxes | (7,679,894) | 8,250,867 | (5,071,645) | (31,075,320) |
| Income tax expense | 904,949 | 3,214,631 | 2,464,155 | 5,114,917 |
| Net income (loss) | (8,584,843) | 5,036,236 | (7,535,800) | (36,190,237) |
| Redeemable preferred stock accretion | (263,288) | | (521,053) | (117,534) |
| Net income (loss) applicable to common stockholders | \$ (8,848,131) | \$ 5,036,236 | \$ (8,056,853) | \$ (36,307,771) |
| Earnings (loss) per common share: | | | | |
| Basic | \$ (0.51) | \$ 0.17 | \$ (0.47) | \$ (1.34) |
| Diluted | \$ (0.51) | \$ 0.17 | \$ (0.47) | \$ (1.34) |
| Weighted averages of common shares outstanding: | | | | |
| Basic | 17,194,286 | 29,809,571 | 17,194,286 | 27,159,294 |
| Diluted | 17,194,286 | 30,484,960 | 17,194,286 | 27,159,294 |

See Notes to Condensed Consolidated Financial Statements.

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

| | Six Months Ended June 30, | |
|---|----------------------------------|----------------------|
| | 2005 | 2006 |
| Cash flows from operating activities: | | |
| Net loss | \$ (7,535,800) | \$ (36,190,237) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 552,142 | 1,053,247 |
| Accretion of discounts on investments | | (233,765) |
| Other losses | | 346,423 |
| Deferred income taxes | (352,085) | (1,330,811) |
| Change in fair value of redeemable preferred stock conversion feature | 11,372,221 | 44,183,770 |
| Non-cash stock compensation expense | 3,271,891 | 2,598,127 |
| Provision for doubtful accounts and sales credits | 17,566 | 37,328 |
| Changes in operating assets and liabilities : | | |
| Trade accounts receivable | (3,953,835) | (894,452) |
| Prepaid expenses and other current assets | (1,263,511) | (1,309,188) |
| Accounts payable and accrued expenses | 523,862 | 14,206 |
| Accrued payroll and related benefits | (193,904) | (246,377) |
| Accrued interest payable | (248,219) | (424,601) |
| Net cash provided by operating activities | 2,190,328 | 7,603,670 |
| Cash flows from investing activities: | | |
| Purchase of short-term investments | | (41,457,839) |
| Proceeds from maturities of short-term investments | | 4,500,000 |
| Purchase of property and equipment | (1,113,401) | (1,300,230) |
| Payment of amount related to DayHawk acquisition | (500,000) | |
| Net cash used in investing activities | (1,613,401) | (38,258,069) |
| Cash flows from financing activities: | | |
| Repayments of line of credit | (3,000,000) | |
| Proceeds from note payable | 12,780,900 | 7,000,000 |
| Repayment of notes payable and debt | (10,134,046) | (31,003,429) |
| Proceeds from issuance of common stock, net of issuance costs | | 85,108,905 |
| Dividends paid | | (7,000,000) |
| Net cash provided by (used in) financing activities | (353,146) | 54,105,476 |
| Net increase in cash and cash equivalents | 223,781 | 23,451,077 |
| Cash and cash equivalents beginning of period | 5,813,861 | 12,610,487 |
| Cash and cash equivalents end of period | \$ 6,037,642 | \$ 36,061,564 |

Table of Contents

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

(unaudited)

| | Six Months Ended June 30, | |
|--|----------------------------------|---------------|
| | 2005 | 2006 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid for interest | \$ 710,260 | \$ 646,327 |
| Cash paid for income taxes | \$ 2,507,455 | \$ 6,213,702 |
| Non-cash investing and financing activities: | | |
| Accretion of redeemable preferred stock | \$ 521,053 | \$ 117,534 |
| Accretion of redeemable common stock | \$ 3,572,679 | \$ 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 | \$ 427,346 | \$ 460,118 |
| Stock issuance costs paid in 2005 reclassified to additional paid-in capital | | \$ 532,686 |
| Purchases of equipment included in accounts payable | \$ 12,016 | \$ 26,937 |

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. GENERAL

Background NightHawk Radiology Holdings, Inc., a Delaware corporation (the "Company"), is a provider of radiology services to radiology groups and hospitals across the United States. The Company's general offices are located in Coeur d'Alene, Idaho and its primary reading facilities are in Sydney, Australia and Zurich, Switzerland. The Company's functional currency is the U.S. dollar. The Company has a single reporting segment and reporting unit structure.

On February 8, 2006, a registration statement relating to our initial public offering of the Company's common stock was declared effective by the Securities and Exchange Commission. Under this registration statement, the Company registered the issuance of 5,800,000 shares of its common stock, and another 1,445,000 shares of its common stock sold by certain selling stockholders. All 7,245,000 shares of common stock issued pursuant to the registration statement, including the 1,445,000 shares sold by the selling stockholders, were sold at a price to the public of \$16.00 per share.

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 wholly-owned subsidiaries. All material intercompany balances and transactions have been eliminated.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements include all adjustments necessary to present fairly, in all material aspects, the results of operations for the periods presented. These condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company's 2005 Form 10-K previously filed with the Securities and Exchange Commission. The results of operations for the three months and six-months ended June 30, 2006 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, 2005 has been derived from the audited Consolidated Balance Sheet as of that date.

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

Cash and Cash Equivalents The Company considers all highly liquid investments with a remaining maturity of three months or less at the date of purchase to be cash equivalents.

Trade Accounts Receivables 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.

Investments The Company determines the appropriate classification of investment securities at the time of purchase. Held-to-maturity securities are those debt securities that the Company has the positive intent and ability to hold to maturity and are recorded at amortized cost. Assets in the held-to-maturity portfolio are initially recorded at cost, which includes any premiums and discounts. The Company amortizes premiums and discounts as an adjustment to interest income using the level interest yield method over the estimated life of the security.

Management evaluates investment securities for other than temporary declines in fair value on a quarterly basis. If the fair value of investment securities falls below their amortized cost and the decline is deemed to be other than temporary, the securities will be written down to current market value, resulting in a loss recorded in the statement of operations. There were no investment securities which management identified to be

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

other-than-temporarily impaired as of June 30, 2006, because the decline in fair value was attributable to changes in interest rates and not credit quality, and because the Company has the ability and intent to hold these investments until a recovery in market price occurs, or until maturity. Realized losses could

Table of Contents

occur in future periods due to a change in management's intent to hold the investments to maturity, a change in management's assessment of credit risk, or a change in regulatory or accounting requirements.

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, warrants or other issuance of shares of common stock to affiliated radiologists. Prior to January 1, 2006, the Company calculated the stock-based compensation expense associated with the issuance of stock-based compensation to affiliated radiologists in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure, an amendment of FASB Statement No. 123* (SFAS No. 148) 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 No. 96-18), by determining the fair value using a Black-Scholes model. The Company calculated the stock-based compensation expense related to issuance of common stock to affiliated radiologists based on the fair value of common stock at the date the shares were issued. 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, warrants or other issuance of shares of common stock to employees, directors and non-physician contractors. Prior to January 1, 2006, the Company calculated the stock-based compensation expense associated with the issuance of options to our employees, directors and non-physician contractors in accordance with SFAS No. 123 and SFAS No. 148 by determining the fair value using a Black-Scholes model. Stock-based compensation related to employees, directors and non-physician contractors is included in sales, general and administrative expenses.

Beginning on January 1, 2006, the Company adopted the provisions of SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123 (R)).

2. EFFECT OF RECENTLY ISSUED ACCOUNTING STANDARDS

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123(R)) which is a revision of SFAS No. 123. SFAS No. 123(R) supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. SFAS No. 123(R) requires all entities to recognize compensation expense in an amount equal to the fair value of share-based payments. In accordance with SFAS No. 123(R), the Company expenses the fair value of all employee stock option awards in the Company's statement of operations, typically, over the related vesting period of the options. SFAS No. 123(R) requires use of fair value to measure share-based awards issued to employees, computed at the date of grant. The Company adopted SFAS No. 123(R) as of January 1, 2006 and the adoption did not have a material effect on the Company's consolidated financial statements.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions*. SFAS No. 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29 and replaces it with an exception for exchanges that do not have commercial substance. SFAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for the fiscal periods beginning after June 15, 2005. The Company adopted SFAS No. 153 as of January 1, 2006 and the adoption did not have a material effect on the Company's consolidated financial statements.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and FASB Statement No. 3*. SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle and applies to all voluntary changes in accounting principles. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. The provisions of SFAS No. 154 are effective for fiscal years beginning after December 15, 2005. The Company adopted

Table of Contents

SFAS No. 154 as of January 1, 2006 and the adoption did not have a material effect on the Company's consolidated financial statements.

In July 2006, the 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 the recognition in the consolidated financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of January 1, 2007, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on the Company's consolidated financial statements.

3. SHORT-TERM INVESTMENTS

At June 30, 2006, short-term investments includes various held-to-maturity debt securities, which are carried at amortized cost. Due to the short-term nature of these investments, the amortized cost approximates fair market value. All of these securities mature during 2006 and consist of the following at June 30, 2006:

| | |
|---|----------------------|
| U.S. government and federal agency securities | \$ 35,189,432 |
| Municipal securities | 2,002,172 |
| | \$ 37,191,604 |

4. PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

| | December 31, | June 30, |
|--|---------------------|---------------------|
| | 2005 | 2006 |
| Computers, diagnostic workstations, and telecommunications systems | \$ 3,361,821 | \$ 3,930,031 |
| Office furniture and equipment | 530,544 | 643,262 |
| Software | 1,803,112 | 2,358,887 |
| Leasehold improvements | 1,208,020 | 1,268,520 |
| | 6,903,497 | 8,200,700 |
| Less accumulated depreciation | (1,824,217) | (2,595,900) |
| | \$ 5,079,280 | \$ 5,604,800 |

Depreciation expense for the three-months ended June 30, 2005 and 2006 was approximately \$207,000 and \$403,000, respectively, and \$412,000 and \$782,000 for the six months ended June 30, 2005 and 2006, respectively.

5. INTANGIBLE ASSETS

A summary of intangible assets at June 30, 2006 is as follows:

| | Estimated Useful Life | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
|------------------------------|--------------------------|-----------------------------|-----------------------------|---------------------------|
| Amortized intangible assets: | | | | |

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

| | | | | |
|----------------------------------|------------|--------------|--------------|--------------|
| Customer lists and relationships | 6-10 years | \$ 2,620,000 | \$ (355,249) | \$ 2,264,751 |
| Tradenname and trademarks | 10 years | 150,000 | (24,375) | 125,625 |
| Customer contracts | 7 months | 100,000 | (100,000) | |
| Noncompete agreements | 2-3 years | 210,000 | (80,625) | 129,375 |
| Total | | \$ 3,080,000 | \$ (560,249) | 2,519,751 |
| Unamortized intangible assets: | | | | |
| Tradenname and trademarks | | | | 640,000 |
| Total intangible assets | | | | \$ 3,159,751 |

Table of Contents

| Estimated Amortization Expense: | Amount |
|--|------------------|
| Year ending December 31, 2006 | \$ 477,583 |
| Year ending December 31, 2007 | 455,667 |
| Year ending December 31, 2008 | 442,333 |
| Year ending December 31, 2009 | 402,333 |
| Year ending December 31, 2010 | 402,333 |
| Total | \$ 2,180,249 |

Amortization expense for the three months ended June 30, 2005 and 2006 was approximately \$64,000 and \$120,000, respectively, and \$136,000 and \$272,000 for the six months ended June 30, 2005 and 2006, respectively.

6. LONG-TERM DEBT

On February 8, 2006, the Company borrowed an additional \$7,000,000 under its 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 Dividends discussion in Note 12. On January 2, 2006, the Company paid a regularly scheduled debt payment to Comerica in the amount of \$1,074,219. On February 14, 2006, the Company repaid in full the debt and interest outstanding with Comerica Bank in the amount of \$30,066,639 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. CONTINGENCIES

Litigation The Company is involved in litigation in the normal course of business. After consultation with legal counsel, management estimates that at December 31, 2005 and June 30, 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.

8. RELATED PARTY TRANSACTIONS

The Company provided radiology services to a former member of Nighthawk Radiology Services, LLC without charge. The former member provides radiology readings to a local hospital during business hours and the Company provided off-hours and emergency radiology readings to the hospital on the former member's behalf. The estimated value of the services provided by the Company, based on rates charged to unrelated third parties for the three months ended June 30, 2005 and 2006 was approximately \$35,000 and \$31,000, respectively, and \$63,000 and \$57,000 for the six months ended June 30, 2005 and 2006, respectively. These services are included in service revenue and professional services.

On May 28, 2004, the Company issued 638,876 shares of restricted common stock to a person who subsequently became a non-employee member of the Company's Board of Directors. These shares have been recorded in accordance with EITF No. 96-18. On June 9, 2005, the Company's Board of Directors accelerated vesting of these shares. As a result, the Company recognized non-cash stock compensation expense of \$2,861,574 for the three-months ended June 30, 2005 and \$2,926,255 for the six-months ended June 30, 2005. After June 9, 2005, the Company no longer records non-cash stock compensation associated with these shares.

Table of Contents**9. EMPLOYEE BENEFIT AND STOCK 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). On February 14, 2006, the 2006 Plan became effective, with a total of 1,600,000 shares of our common stock initially authorized for issuance thereunder. In addition, shares available for grant under the 2004 Plan as of such date were rolled over and became available for grant under the 2006 Plan, as will shares subject to options that expire or are cancelled or forfeited under the 2004 Plan. In addition, on the first day of each fiscal year beginning in 2007, the number of shares available for issuance under the 2006 Plan may be increased by an amount equal to the lesser of (i) 3% of the outstanding shares of our common stock on the first day of the fiscal year, and (ii) such other amount as our board of directors may determine.

On January 20, 2006 the Company's board of directors approved the grant of options to purchase an aggregate of 107,968 shares of the Company's common stock under the 2004 Plan at an exercise price of \$10.63. On February 15, 2006, the Company's board of directors approved the grant of options to purchase an aggregate of 62,352 shares of the Company's common stock under the 2006 Plan at an exercise price of \$23.05. No stock-based awards were issued during the second quarter of 2006.

At June 30, 2006, the Company had 1,849,124 options outstanding to purchase common stock (372,901 vested and exercisable) with a weighted average exercise price of \$4.49 and expiring at various dates through February 2016. At June 30, 2006, the Company had 1,651,033 stock-based awards available to be issued under its 2006 Plan.

Effective January 1, 2006, the Company adopted the provisions of SFAS No. 123(R) for its share-based compensation plans. SFAS No. 123(R) requires the measurement and recognition of compensation expense for all share-based awards made to employees and directors based on estimated fair values. SFAS No. 123(R) supersedes Accounting Principles Board (APB) Opinion 58, *Accounting for Stock Issued to Employees*. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin 107 (SAB 107) relating to SFAS No. 123(R). The Company has applied the provisions of SAB 107 in our adoption of SFAS No. 123(R).

The Company previously accounted for these plans under the recognition and measurement principals and disclosure requirements established by SFAS No. 123, as amended by SFAS No. 148. Under SFAS No. 123, compensation expense was recorded in operations for the Company's stock-based awards granted under the 2004 plan, so compensation expense related to all the Company's share-based compensation plans have been recorded in both the current and prior year comparative periods.

The Company adopted SFAS 123(R) using the modified prospective method, which requires the application of the accounting standard as of January 1, 2006, the first day of our fiscal year 2006. Our condensed consolidated financial statements for prior periods have not been restated to reflect, and do not include the impact of SFAS No. 123(R).

A summary of our stock option activity during the six months ended June 30, 2006 is as follows:

| | Shares | Weighted Average Exercise Price |
|--|-----------|------------------------------------|
| Options outstanding at January 1, 2006 | 1,723,590 | \$ 3.47 |
| Grants | 170,320 | \$ 15.17 |
| Cancellations | (44,786) | \$ 6.04 |
| Options outstanding at June 30, 2006 | 1,849,124 | \$ 4.49 |

The following table summarizes information about stock options outstanding at June 30, 2006:

| OPTIONS OUTSTANDING | | | | OPTIONS EXERCISABLE | | |
|-----------------------------|--------|-----------------------|---|------------------------------------|-----------------------|--|
| Range of Exercise Prices | | Number Outstanding | Weighted Average Remaining Contractual Life (in years) | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercisable Price |
| \$1.56 | \$2.81 | 991,200 | 8.34 | \$ 1.69 | 244,849 | \$ 1.59 |

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

| | | | | | | | | |
|---------|---------|-----------|------|----|-------|---------|----|------|
| \$2.82 | \$4.68 | 252,369 | 8.69 | \$ | 3.45 | 90,712 | \$ | 3.41 |
| \$4.69 | \$10.00 | 451,219 | 9.14 | \$ | 7.40 | 37,340 | \$ | 4.81 |
| \$10.01 | \$10.62 | 91,984 | 9.56 | \$ | 10.62 | | | |
| \$10.63 | \$23.05 | 62,352 | 9.63 | \$ | 23.05 | | | |
| | | 1,849,124 | 8.69 | \$ | 4.49 | 372,901 | \$ | 2.35 |

Table of Contents

The fair value of stock options issued during the three and six months ended June 30, 2005 and 2006 were estimated at the grant date using the Black-Scholes option pricing model with the following weighted average assumptions.

| | Three Months | Three Months |
|--------------------------|----------------------|----------------------|
| | Ended | Ended |
| | June 30, 2005 | June 30, 2006 |
| Dividend yield | | |
| Expected volatility | 54.0% | N/A |
| Risk-free interest rates | 3.67% | N/A |
| Expected life (years) | 3.67 | N/A |
| | Six Months | Six Months |
| | Ended | Ended |
| | June 30, 2005 | June 30, 2006 |
| Dividend yield | | |
| Expected volatility | 54.0% | 38.7% |
| Risk-free interest rates | 3.86% | 4.84% |
| Expected life (years) | 3.63 | 4.73 |

10. 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 | | Six-Months Ended | |
|---|---------------------------|----------------------|-------------------------|----------------------|
| | June 30, 2005 | June 30, 2006 | June 30, 2005 | June 30, 2006 |
| Numerator: | | | | |
| Net income (loss) available in basic calculation | \$ (8,848,131) | \$ 5,036,236 | \$ (8,056,853) | \$ (36,307,771) |
| Plus: Income impact of assumed conversions of preferred stock dividends | (a) | | (a) | (a) |
| Net income (loss) applicable to common stockholders-dilutive | \$ (8,848,131) | \$ 5,036,236 | \$ (8,056,853) | \$ (36,307,771) |
| Denominator: | | | | |
| Weighted-average common shares outstanding-basic | 17,194,286 | 29,809,571 | 17,194,286 | 27,159,294 |
| Effect of dilutive stock options | (b) | 675,389 | (b) | (b) |
| Effect of convertible preferred stock | (a) | | (a) | (a) |
| Weighted average common shares outstanding-dilutive | 17,194,286 | 30,484,960 | 17,194,286 | 27,159,294 |
| Earnings (loss) per common share basic | \$ (0.51) | \$ 0.17 | \$ (0.47) | \$ (1.34) |
| Earnings (loss) per common share diluted | \$ (0.51) | \$ 0.17 | \$ (0.47) | \$ (1.34) |

(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 have been excluded from the calculation of diluted earnings (loss) per common share because they are anti-dilutive.

Table of Contents

11. 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 rate for the three months ended June 30, 2005 and 2006 was (11.8%) and 39.0%, respectively. The effective rate for the six months ended June 30, 2005 and 2006 was (48.6%) and (16.5%), respectively. The difference in effective tax rates is primarily due to the increase in the fair market value of the redeemable preferred stock conversion feature which terminated in connection with the Company's initial public offering.

12. 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 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 initial public offering (IPO) of 5,800,000 shares of its common stock, from which the Company received net proceeds of approximately \$86.3 million (after deducting the underwriting discounts and commissions). The Company had incurred \$2.2 million 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 consolidated 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 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).

Table of Contents

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
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. ALL 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 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 PART II OF THIS REPORT ENTITLED RISK FACTORS.

Overview

We believe that we are the leading provider of radiology services to radiology groups and hospitals across the United States. Our team of American Board of Radiology-certified, U.S. state-licensed and hospital-privileged radiologists uses our proprietary workflow technology to provide radiological interpretations to our customers primarily from centralized reading facilities located in Sydney, Australia and Zurich, Switzerland.

Nighthawk Radiology Services, LLC, an Idaho limited liability company, was founded in August 2001 and began providing off-hours emergency radiology services in October 2001. On March 31, 2004, our management team, along with entities affiliated with Summit Partners, consummated a series of related transactions that resulted in the creation and capitalization of NightHawk Radiology Holdings, Inc., a Delaware corporation, and its acquisition of all the outstanding membership units of Nighthawk Radiology Services, LLC. These transactions resulted in Nighthawk Radiology Services, LLC becoming a wholly-owned subsidiary of NightHawk Radiology Holdings, Inc. NightHawk Radiology Holdings, Inc. conducts its operations primarily through Nighthawk Radiology Services, LLC.

On February 8, 2006, a registration statement relating to our initial public offering of our common stock was declared effective by the Securities and Exchange Commission. Under this registration statement, we registered the issuance of 5,800,000 shares of our common stock, and another 1,445,000 shares of our common stock sold by certain selling stockholders. All 7,245,000 shares of common stock issued pursuant to the registration statement, including the 1,445,000 shares sold by the selling stockholders, were sold at a price to the public of \$16.00 per share.

Executive Summary and Highlights

Recent Acquisition

On September 30, 2005, we acquired American Teleradiology Nighthawks, Inc., or ATN. We regard the ATN acquisition as an acquisition of an off-hours teleradiology business that is supplemental to our current business, and an early-stage teleradiology business that will focus on partnering with radiologists in order to supplement the services they provide to their hospitals. The consideration to the ATN stockholders in connection with the acquisition is based primarily upon the future financial performance of these two businesses. Specifically, the consideration to the stockholders of ATN consists of:

315,279 shares of our common stock issued on September 30, 2005.

additional shares of our common stock that may be issued in an amount equal to (a) the quotient obtained by dividing (i) revenue generated during the twelve month period ending September 30, 2006 from the off hours teleradiology contracts acquired from ATN by (ii) \$12.69, which was the value per share of our common stock on the date of completion of the acquisition (as agreed by the parties) minus (b) 315,279, which was the number of shares of our common stock issued to the stockholders of ATN at the completion of the acquisition, and

additional shares of our common stock that may be issued in an amount equal to the sum of (a) the quotient obtained by dividing (i) earnings before interest, taxes, depreciation and amortization, or EBITDA, generated by the group partnering business during the

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

twelve month period ending March 31, 2007 by (ii) \$12.69, which was the value per share of our common stock on the date of completion of the acquisition (as agreed by the parties), plus (b) the quotient obtained by dividing (A) three times (3x) the EBITDA amount described in clause (i) by (B) the fair market value of our common stock, determined on a per share basis, on March 31, 2007.

Table of Contents

The number of additional shares of our common stock which may be paid based on the future financial performance of ATN is currently not determinable, as the earnout formulas do not contain any minimum or maximum limitation with respect to the number of shares of common stock, if any, to be issued.

The 315,279 shares of common stock that were issued at the completion of the acquisition were recorded at par value as common stock with additional amounts up to fair value recorded as Additional Paid-In Capital. The shares that may be issued as a result of the future financial performance of ATN are considered contingent consideration and will be recorded in a similar manner upon resolution of the contingency.

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,

accounting for redeemable preferred stock,

stock-based compensation,

use of estimates,

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

income taxes.

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 necessity of a provision for doubtful accounts. As of June 30, 2006, we had reserved

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

approximately \$263,000 for doubtful accounts and sales credits based on our estimate of the collectibility of outstanding receivables as of that date.

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 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

Table of Contents

redeemable preferred stock was considered an embedded derivative under the provisions of SFAS No. 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 \$1,670,277 which was recorded as a liability on the date of issuance, thus reducing the recorded value of the redeemable preferred stock to \$11,329,723. 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.

Stock-Based Compensation

Physician Stock-Based Compensation. We 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 our affiliated radiologists. We calculate the stock-based compensation expense associated with the issuance of stock options and warrants to our affiliated radiologists in accordance with SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 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 No. 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 at the date the shares are issued. Stock-based compensation to our affiliated radiologists is included in professional services expense. In accordance with EITF No. 96-18, because our radiologists are treated as independent contractors and not as employees, we calculate the stock-based compensation expense related to the issuance of stock options or restricted stock units to our affiliated radiologists by determining the fair value of the equity grant at the end of each period and recording the change in value of the equity grant as an 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.

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, directors and non-physician contractors. We calculate the stock-based compensation expense associated with the issuance of stock options and warrants to our employees, directors and non-physician contractors in accordance with SFAS No. 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, directors and non-physician contractors 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 non-physician contractors 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 No. 123 (R) and EITF No. 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, the Company uses 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

Table of Contents

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.

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 experienced any material difficulties in collecting payments from our customers and only began maintaining a reserve for customer nonpayment during 2005. 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.

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, we will not record any additional charges associated with the change in fair value of the conversion feature after such date. As a result, since the closing of our initial public offering, we are no longer required to make these estimates.

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. To date, we have not experienced any liabilities for claims that were in excess of our prior loss contingency estimates for such claims. However, 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 do not have insurance coverage.

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 No. 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 assets' carrying value. In addition, SFAS No. 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 No. 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.

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

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

Table of Contents

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

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.

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.

How We Generate Revenue

We generate substantially all of our revenue from the 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 reads we provide to the customer and the technical and administrative services we provide to the customer.

We recognize revenue generated by our 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 paid directly by our customers, we do not currently depend upon payment 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 \$64.1 million in 2005 and to \$42.9 million in the first six-months of 2006. This growth in service revenue resulted primarily from:

an increase in our customer base,

an increase in utilization of our service by our customers,

an expansion of our service hours and product offerings,

a high customer retention rate, and

our acquisition of ATN in September 2005 and DayHawk in November 2004.

As of June 30, 2006, our affiliated radiologists provided services to 517 customers serving 933 hospitals. The total number of hospitals we cover represents approximately 17% of all hospitals in the United States. Most of our customers do not utilize all of the hours of coverage that we are able to provide.

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

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

as physician stock-based compensation) and in connection with equity issuances to our employees, directors and non-physician contractors (which we refer to as non-physician stock-based compensation). In our consolidated statement of income, 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 physician compensation), 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, physician compensation is our most

Table of Contents

significant expense. We structure our relationships with our affiliated radiologists such that they have control over the number of hours that they work. We compensate 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 physician compensation expense in the month in which the services are performed. We recognize expenses associated with medical liability premiums in the month in which the expense is incurred. We record medical liability loss contingency expense in the month in which we deem such liability to be probable.

Physician Stock-Based Compensation Expense. As described previously, we record 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 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 EITF No. 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, directors and non-physician contractors 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, directors and non-physician contractors in accordance with SFAS No. 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. 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 No. 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 \$1,670,277 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 \$11,329,723. 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 do not record 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.

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

Table of Contents

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 primarily by an increase in our customer base, an increase in utilization of our service by our customers, 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 market. Our strategy is to expand on our position as the leading provider of radiology services by:

targeting new customers,

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

marketing to our customers the additional available hours of coverage,

expanding our service offerings to include primary and subspecialty interpretations,

pursuing strategic acquisitions, and

developing a market for our software technology.

Our revenue has increased in absolute dollars each year since inception and our revenue growth rate has been strong. However, our revenue growth rate declined from the second quarter of 2005 to the second quarter of 2006 when compared with our growth rate from the second quarter of 2004 to the second quarter of 2005 and will likely continue to decline as a result of the increased revenue base against which future periods will be compared. We expect that a number of our customers will 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.

Historically, we have seen an increase in same-site volumes during the second and third quarters of each fiscal year, when weather conditions tend to be warmer in much of the United States. We believe these increases are a result of increased outdoor and transportation activities during summer months. During the first and fourth quarters of each fiscal year, when weather conditions are colder for a large portion of the United States, we have historically experienced relatively lower same-site volumes than those experienced during the second and third quarters. We expect this seasonality to continue.

Trends in Physician Compensation Expense. Since inception, our physician compensation expense has increased in absolute dollars each year, primarily due to the addition of new radiologists to perform an increased workload as our business has grown. We expect that our physician compensation will continue to increase in absolute dollars as we contract with additional radiologists to meet the increasing demand for our services, as we begin to offer services that we do not currently provide, and as a result of scheduled increases in hourly compensation under our existing professional services agreements with our affiliated radiologists.

Our medical liability expense has also increased in absolute dollars each year since inception, primarily due to increases in our medical liability premiums as our business has grown. We expect our medical liability premiums and, as a result, our medical liability expenses, to continue to increase in future periods as our business grows. In addition, if we have claims in future periods for which we deem a liability to be probable, our medical liability expense may increase.

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

Trends in Physician Stock-Based Compensation Expense. The amount of physician stock-based compensation expense we record in a given period depends primarily on the number of shares subject to outstanding options held by our affiliated radiologists and the amount of increase, if any, in the value of our common stock in that period. Because of the accounting treatment required by EITF 96-18, if the value of our common stock increases over a given period, we will record a compensation expense that generally exceeds the expense we would have recorded if these individuals were employees because EITF 96-18 requires us to record the increase in the value of the option during such period as an expense. As a result, because of the relatively significant increase in value of our common stock during the first quarter of 2006 primarily as a result of our initial public offering, we recorded significant physician stock-based compensation expense in the first half of 2006 as compared to the first half of 2005. Our expense in future periods for physician stock-based compensation will be driven primarily by new equity-based grants we make to our radiologists, the rate at which those equity awards and the currently outstanding options vest over such periods, as well as changes, if any, in our stock price during such periods.

Table of Contents

Trends in Sales, General and Administrative Expense. Our sales, general and administrative expense has increased in absolute dollars each year since inception primarily as a result of increased payroll expenses in connection with the addition of key management personnel, software development professionals and the implementation of executive and employee bonuses. We expect that these payroll expenses will continue to increase as we continue to increase headcount as our business grows. In addition to increased payroll expense, we expect that our general and administrative expense will increase in absolute dollars due to increases in telecommunications and information technology costs and licensing and privileging costs. Also, we expect that our general and administrative expense will increase in absolute dollars due to increases in legal, accounting, consulting, staffing and insurance costs associated with being a public company. Accordingly, we expect sales, general and administrative expense to increase in absolute dollars in future periods.

Trends in Non-Physician Stock-Based Compensation Expense. In June 2005, our board of directors agreed to accelerate the vesting of the 638,876 shares of common stock held by one of our directors which resulted in a non-physician stock-based compensation expense of approximately \$2.9 million, which contributed to a relatively significant non-physician stock-based compensation expense in the first half of 2005. However, we do not anticipate issuing any shares of our common stock related to non-physician stock-based compensation other than pursuant to the grant of options or shares of restricted stock or restricted stock units to our employees, directors and non-physician contractors in the ordinary course.

Trends in Interest Expense. For 2005 and first quarter of 2006 our interest expense was attributable to the principal amount of debt we had outstanding primarily as a result of a loan agreement with Comerica Bank. Pursuant to this loan agreement we borrowed an aggregate of \$35 million at various times throughout 2005 and the first quarter of 2006. We used the proceeds from this loan facility in part to repay previously existing debt and in part to fund a special distribution of \$20 million to the holders of our then-outstanding common stock and redeemable preferred stock. We repaid all of this indebtedness on February 14, 2006 with a portion of the proceeds from our initial public offering. We do not expect to incur material interest expense in future periods.

Trends in Interest Income. On February 14, 2006, we completed an initial public offering of our common stock from which we received net proceeds of \$85.1 million after deducting underwriter discounts and commissions and approximately \$1.2 million in offering costs paid during the six month period ended June 30, 2006. Of this amount, we invested approximately \$63 million in a mix of highly-liquid, investment-grade securities and cash, primarily consisting of securities issued by U.S. government and federal agencies along with money market accounts and municipal securities.

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

Results of Operations

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

| | Three Months Ended | | Six Months Ended | |
|---------------------------------------|--------------------|------|------------------|------|
| | June 30, | | June 30, | |
| | 2005 | 2006 | 2005 | 2006 |
| Service revenue | 100% | 100% | 100% | 100% |
| Operating costs and expenses: | | | | |
| Professional services (1) | 33 | 37 | 33 | 39 |
| Sales, general and administrative (2) | 48 | 28 | 41 | 29 |
| Depreciation and amortization | 2 | 2 | 2 | 3 |
| Total operating costs and expenses | 83 | 67 | 76 | 71 |
| Operating income | 17 | 33 | 24 | 29 |
| Other income (expense): | | | | |

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

| | | | | |
|---|-------|-----|-------|-------|
| Interest expense | (2) | | (2) | (1) |
| Interest income | | 3 | | 3 |
| Change in fair value of redeemable preferred stock conversion feature | (65) | | (40) | (103) |
| Total other income (expense) | (67) | 3 | (42) | (101) |
| Income (loss) before income taxes | (50) | 36 | (18) | (72) |
| Income tax expense | 6 | 14 | 9 | 12 |
| Net income (loss) | (56) | 22 | (27) | (84) |
| Redeemable preferred stock accretion | (2) | | (1) | (1) |
| Net income (loss) applicable to common stockholders | (58)% | 22% | (28)% | (85)% |

-
- (1) Includes non-cash stock-based compensation expense of \$158,679 and \$931,531 for the second quarter of 2005 and 2006, respectively and \$241,388 and \$2,246,683 for the six months ended June 30, 2005 and 2006, respectively.
- (2) Includes non-cash stock-based compensation expense of \$2,901,034 and \$165,807 for the second quarter of 2005 and 2006, respectively and \$3,030,503 and \$351,444 for the six months ended June 30, 2005 and 2006, respectively.

Table of Contents**Comparison of Fiscal Quarters Ended June 30, 2005 and June 30, 2006***Service Revenue*

| | Fiscal Quarter Ended June 30, | | Change | |
|-----------------|----------------------------------|---------------|--------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Service revenue | \$ 15,332,300 | \$ 22,876,569 | \$ 7,544,269 | 49% |

The increase in service revenue from the second quarter of 2005 to the second quarter of 2006 resulted primarily from a 57% increase in volume, which was primarily due to an increase in the number of our radiology group customers and their affiliated hospitals, an increase in utilization by our customers of our hours of service and the growth in the use of diagnostic imaging technologies and procedures in the healthcare market. The number of radiology group and hospital customers to which we provided service increased from 357 as of June 30, 2005 to 517 as of June 30, 2006, a 45% increase, and the number of hospital sites to which we provided service increased from 714 as of June 30, 2005 to 933 as of June 30, 2006, a 31% increase. The increase in the number of our customers and hospitals served resulted primarily from increased market acceptance of teleradiology as a solution, an increase in the recognition by the marketplace of the quality of our service offerings, the success by our sales professionals in generating new customers, and an improvement in our ability to meet the increased demand for our service, primarily through the addition of affiliated radiologists and the expansion of our hours of service. In addition, the ATN acquisition, completed on September 30, 2005, contributed 51 new customers. The increase in service revenue was offset partially by pricing declines.

*Operating Costs and Expenses**Professional Services*

| | Fiscal Quarter Ended June 30, | | Change | |
|--------------------------------------|----------------------------------|--------------|--------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Professional services (1) | \$ 5,132,472 | \$ 8,553,973 | \$ 3,421,501 | 67% |
| <i>Percentage of service revenue</i> | 33% | 37% | | |

- (1) Includes non-cash stock-based compensation expense of \$158,679 for the second quarter of 2005 and \$931,531 for the second quarter of 2006.

The increase in professional services expense from the second quarter of 2005 to the second quarter of 2006 resulted primarily from an increase in the number of our affiliated radiologists providing service, an increase in our physician stock-based compensation expense, as well as an increase in the service fees we paid to our affiliated radiologists as a result of increases in volume and scheduled increases in hourly compensation under the terms of the professional services agreements with our affiliated radiologists. From the second quarter of 2005 to the second quarter of 2006, we increased the number of our affiliated radiologists from 30 to 54. This increase was driven primarily by the increased demand for our services and was attributable to our ability to effectively recruit additional radiologists to meet such demand. While our professional services expense increased by 67% for the period, our professional services expense as a percentage of service revenue increased from 33% for the second quarter of 2005, to 37% for the second quarter of 2006 due to the expenses described below. The following expenses comprise our professional services expense:

Physician Compensation Expense. Our physician compensation expense increased from \$4.7 million for the second quarter of 2005 to \$7.3 million for the second quarter of 2006, a 55% increase, and as a percentage of service revenue from 31% to 32% during that same period. These increases were largely due to (i) the compensation structure for the physicians who were part of the ATN acquisition and (ii) a decrease in unit pricing which was largely driven by lower priced contracts assumed from the ATN acquisition and pricing pressure from increased competition.

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

Medical Liability Expense. Our medical liability expense increased from approximately \$258,000 for the second quarter of 2005 to approximately \$315,000 for the second quarter of 2006, a 22% increase. As a percentage of service revenue, medical liability expense decreased from 1.7% of service revenue for the second quarter of 2005 to 1.4% for the second quarter of 2006 due to lower premiums relative to the higher volume. We had no claims loss contingency expense for either period and expenses are solely related to medical liability premiums.

Table of Contents

Physician Stock-Based Compensation Expense. We experienced a significant increase in non-cash physician stock-based compensation expense from approximately \$159,000 for the second quarter of 2005 to approximately \$932,000 for the second quarter of 2006. As a percentage of revenue, physician stock-based compensation expense increased from 1% for the second quarter of 2005 to 4% for the second quarter of 2006. This increase, which resulted partially from the accounting treatment required by EITF 96-18, was driven primarily by the growth in the number of physicians, increased vesting in options held by independent contractors and the increase in our stock price as of June 30, 2006 as compared to the value of our common stock as of June 30, 2005, which was primarily due to the completion of our initial public offering.

Sales, General and Administrative

| | Fiscal Quarter Ended June 30, | | Change | |
|---------------------------------------|----------------------------------|--------------|----------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Sales, general and administrative (1) | \$ 7,388,264 | \$ 6,283,744 | \$ (1,104,521) | (15)% |
| <i>Percentage of service revenue</i> | 48% | 28% | | |

(1) Includes non-cash stock-based compensation expense of \$2.9 million for the second quarter of 2005 and \$166,000 for the second quarter of 2006.

The decrease in our sales, general and administrative expense from the second quarter of 2005 to the second quarter of 2006 resulted primarily from a one time non-cash stock compensation expense associated with a restricted stock grant to one of our former board members in the second quarter of 2005. As a result, as a percentage of service revenue, sales, general and administrative expense is down from 48% for the second quarter of 2005 to 28% for the second quarter of 2006. Excluding non-cash stock compensation, our sales, general and administrative expense increased in the second quarter of 2006 primarily due to increases in payroll expense due to additional hiring and costs associated with operating as a public company in 2006. Excluding non-cash stock compensation expense, expressed as a percentage of revenue, sales, general and administrative expense is down from 29% for the second quarter of 2005 to 27% for the second quarter of 2006. The following expenses comprise our sales, general and administrative expense:

Payroll and Related Expense. Our sales, general and administrative headcount increased from 132 at June 30, 2005 to 200 at June 30, 2006, a 52% increase, and resulted in an increase in payroll expense from \$2.5 million for the second quarter of 2005 to \$4.1 million for the second quarter of 2006, a 63% increase. This increase in payroll expense resulted primarily from personnel additions in our quality control, information technology, finance, sales, business development and licensing and privileging departments. Expressed as a percentage of service revenue, our sales, general and administrative payroll and related expenses increased from approximately 16% of service revenue for the second quarter of 2005 to 18% for the second quarter of 2006.

Information Technology and Telecommunications Expense. Our non-payroll information technology and telecommunications expense increased from approximately \$437,000 for the second quarter of 2005 to approximately \$489,000 for the second quarter of 2006, a 12% increase. As a percentage of service revenue, IT and telecommunications expense decreased from 3% for the second quarter of 2005 to 2% for the second quarter of 2006. These changes resulted primarily from lower telephone service costs as the company implemented cost reduction initiatives.

Facilities Expense. Our facilities and office-based expense increased from approximately \$378,000 for the second quarter of 2005 to \$483,000 for the second quarter of 2006, a 28% increase. As a percentage of service revenue, facilities expense decreased from 2.5% for the second quarter of 2005 to 2.1% for the second quarter of 2006. The increase in facilities and office-based expense was driven primarily by increased facilities and occupancy expenses associated with our facilities in Sydney, Australia, Zurich, Switzerland, Milwaukee, Wisconsin, Coeur d Alene, Idaho and Roanoke, Virginia.

Licensing and Privileging Expense. Our non-payroll licensing and privileging expense consists primarily of fees paid in connection with the state medical licenses and hospital privileges we obtain on behalf of our affiliated radiologists. Our affiliated radiologists are licensed to practice medicine in an average of 35 states and have been granted privileges at an average of 446 hospitals. As a result of our efforts to obtain these medical licenses and staff privileges for our affiliated radiologists, we incur administrative expenses as well

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

as fees payable to the states and hospitals. Each state typically requires a fee to be paid in connection with the issuance of a medical license as well as an additional annual fee that must be paid to maintain the medical license. In addition, many hospitals have annual fees associated with the granting of medical staff privileges. Non-payroll licensing and privileging expenses decreased from approximately \$286,000 for the second quarter of 2005 to approximately \$269,000 for the second quarter of 2006, a 6% decrease. As a percentage of service revenue, licensing and privileging costs

Table of Contents

decreased from 2% for the second quarter of 2005 to 1% for the second quarter of 2006. Licensing and privileging expense is driven by the timing of new contracted physicians and the timing of renewals for existing physicians' licenses and credentials.

Other General and Administrative Expense. Our other general and administrative expense consists primarily of professional accounting, legal and consulting services, general liability insurance and employee related expenses such as recruiting, travel and entertainment. Other general and administrative expense decreased from approximately \$789,000 for the second quarter of 2005 to approximately \$689,000 for the second quarter of 2006, a 13% decrease. The decrease in other general and administrative expense was driven primarily by lower accounting, legal, consulting and recruiting costs than prior year. Offsetting these savings were higher travel and entertainment expenses as well as costs associated with operating as a public company such as investor relations and higher premiums for Directors and Officers insurance. As a percentage of service revenue, other general and administrative expense decreased from 5% for the second quarter of 2005 to 3% for the second quarter of 2006.

Non-Physician Stock-Based Compensation Expense. Our non-physician stock-based compensation expense decreased from approximately \$2.9 million for the second quarter of 2005 to approximately \$166,000 for the second quarter of 2006 primarily due to the one time expense associated with a restricted stock grant to one of our board members in the second quarter of 2005. As a percentage of revenue, these costs were approximately 19% of revenue for the second quarter of 2005 and less than 1% for the second quarter of 2006.

*Other Income (Expense)**Interest Expense*

| | Fiscal Quarter Ended June 30, | | Change | |
|--------------------------------------|----------------------------------|----------|--------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Interest expense | \$ 199,161 | \$ 7,017 | \$ (192,144) | (96)% |
| <i>Percentage of service revenue</i> | 2% | % | | |

The interest expense for the second quarter of 2005 consisted primarily of interest payable under our term loan facility with Comerica Bank. The Company had outstanding promissory notes issued to certain affiliates of Summit Partners and interest payable under a \$3 million revolving line of credit with Silicon Valley Bank at the beginning of the second quarter of 2005. The aggregate principal balance of the outstanding promissory notes was approximately \$9 million through March 31, 2005. The aggregate principal balance of our revolving credit facility with Silicon Valley Bank was \$3 million through March 31, 2005. On April 20, 2005, we entered into a loan agreement with Comerica Bank that provided us a \$12 million term loan facility and a \$3 million revolving line of credit. We used the proceeds from the term loan facility to repay in full all outstanding indebtedness under the promissory notes held by the entities affiliated with Summit Partners and the revolving credit facility with Silicon Valley Bank. In September 2005, we borrowed an additional \$13 million under our term loan facility with Comerica Bank and distributed the full amount as a special distribution to the holders of our common stock and redeemable preferred stock. Prior to the initial public offering in February 2006, we borrowed an additional \$7 million under our term loan facility with Comerica Bank and distributed the full amount as a special distribution to the holders of our common stock and redeemable preferred stock. Upon the initial public offering in first quarter of 2006, the Company repaid the balance of the term loan with Comerica Bank and terminated the loan facility.

Interest Income

| | Fiscal Quarter Ended June 30, | | Change | |
|--------------------------------------|----------------------------------|------------|------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Interest Income | \$ 11,164 | \$ 764,559 | \$ 753,395 | 6,748% |
| <i>Percentage of service revenue</i> | 0% | 3% | | |

Interest income for the second quarter of 2006 consisted primarily of interest income on cash balances and short-term investments of the cash we received in connection with our initial public offering. We received cash proceeds of \$86.3 million, of which approximately \$30.1 million was used to repay all outstanding indebtedness to Comerica Bank. We invested the remaining balance in a mix of highly-liquid, investment-grade securities and cash, primarily consisting of securities issued by U.S. government and federal agencies along with money market accounts and

municipal securities. Interest income for the second quarter of 2005 was interest earned on a money market account.

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

| | Fiscal Quarter Ended June 30, | | Change | |
|---|----------------------------------|------|----------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Change in fair value of redeemable preferred stock conversion feature | \$ 9,993,750 | \$ | \$ (9,993,750) | (100)% |
| <i>Percentage of service revenue</i> | 65% | 0% | | |

During the second quarter of 2005, the fair value of the redeemable preferred stock conversion feature increased by a total of \$10 million resulting in a non-cash expense of \$10 million for the second quarter of 2005. At the time of the closing of our initial public offering, all outstanding shares of redeemable preferred stock converted into common stock, and, as a result, after such date we do not record any additional expenses associated with the change in fair value of the conversion feature of our redeemable preferred stock. As a result, there was no expense related to this conversion feature in the second quarter of 2006 and there will not be any additional such expense in the future.

Income Tax Expense

| | Fiscal Quarter Ended June 30, | | Change | |
|--------------------------------------|----------------------------------|--------------|--------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Income tax expense | \$ 904,949 | \$ 3,214,631 | \$ 2,309,682 | 255% |
| <i>Percentage of service revenue</i> | 6% | 14% | | |

We recorded an income tax expense of approximately \$900,000 for the second quarter of 2005 and approximately \$3.2 million for the second quarter of 2006. The increase in our income tax expense was due primarily to the increase in book income before taxes.

Preferred Stock Accretion

| | Fiscal Quarter Ended June 30, | | Change | |
|--------------------------------------|----------------------------------|------|--------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Preferred stock accretion | \$ 263,288 | \$ | \$ (263,288) | (100)% |
| <i>Percentage of service revenue</i> | 2% | 0% | | |

The preferred stock accretion for 2005 was comprised of two types of accretion based on the underlying redeemable convertible preferred stock. For the second quarter of 2005, the preferred stock accretion consisted of \$206,399 as a result of the accretion of dividends at a daily rate of 6% per annum, and \$56,889 as a result of the amortization of the carrying amount of the redeemable convertible preferred to its redemption value using the effective interest method through the redemption period. At the time of the closing of our initial public offering, all outstanding shares of redeemable preferred stock converted into common stock and, as a result, after such date we do not record any additional accretion and amortization associated with the preferred stock. As a result, there was no preferred stock accretion expense in the second quarter of 2006 and there will not be any additional preferred stock accretion in the future.

Comparison of Six Month Periods Ended June 30, 2005 and June 30, 2006*Service Revenue*

| | Six Months Ended June 30, | | Change | |
|-----------------|------------------------------|---------------|---------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Service revenue | \$ 28,443,923 | \$ 42,915,772 | \$ 14,471,849 | 51% |

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

The increase in service revenue from the six months ended June 30, 2005 to the six months ended June 30, 2006 resulted primarily from a 60% increase in volumes primarily due to an increase in the number of our radiology group customers and their affiliated hospitals, an increase in utilization by our customers of our hours of service and the growth in the use of diagnostic imaging technologies and procedures in the healthcare market during this period. The number of radiology group and hospital customers to which we provided service increased from 357 as of June 30, 2005 to 517 as of June 30, 2006, a 45% increase in customers, and the number of hospital sites to which we provided service increased from

Table of Contents

714 as of June 30, 2005 to 933 as of June 30, 2006, a 31% increase. The increase in the number of our customers and hospitals served resulted primarily from increased market acceptance of teleradiology as a solution, an increase in the recognition by the marketplace of the quality of our service offerings, the success by our sales professionals in generating new customers, and an improvement in our ability to meet the increased demand for our service, primarily through the addition of affiliated radiologists and the expansion of our hours of service. In addition, the ATN acquisition, completed on September 30, 2005, contributed 51 new customers. The increase in service revenue was offset partially by pricing declines.

*Operating Costs and Expenses**Professional Services*

| | Six Months Ended June 30, | | Change | |
|--------------------------------------|------------------------------|---------------|--------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Professional services (1) | \$ 9,514,299 | \$ 16,948,047 | \$ 7,433,748 | 78% |
| <i>Percentage of service revenue</i> | 33% | 39% | | |

(1) Includes non-cash stock-based compensation expense of \$241,388 for the six-months ended June 30, 2005 and \$2,246,683 for the six-months ended June 30, 2006.

The increase in professional services expense from the six-months ended June 30, 2005 compared to the six-months ended June 30, 2006 resulted primarily from an increase in the number of our affiliated radiologists providing service, an increase in our physician stock-based compensation expense, as well as an increase in the service fees we paid to our affiliated radiologists as a result of increased volumes and scheduled increases in hourly compensation under the terms of the professional services agreements with our affiliated radiologists. From the six-months ended June 30, 2005 to the six-months ended June 30, 2006, we increased the number of our affiliated radiologists from 30 to 54. This increase was driven primarily by the increased demand for our services and was attributable to our ability to effectively recruit additional radiologists to meet such demand. While our professional services expense increased by 78% for the period, our professional services expense as a percentage of service revenue increased from 33% for the six-months ended June 30, 2005, to 39% for the six-months ended June 30, 2006 due to the expenses described below. The following expenses comprise our professional services expense:

Physician Compensation Expense. Our physician compensation expense increased from \$8.8 million for the six-months ended June 30, 2005 to \$14.1 million for the six-months ended June 30, 2006, a 60% increase, and as a percentage of service revenue from 31% to 33% during that same period. These increases were largely due to (i) the compensation structure for the physicians who were part of the ATN acquisition and (ii) a decrease in unit pricing which was largely driven by lower priced contracts assumed from the ATN acquisition and (iii) pricing pressure from increased competition.

Medical Liability Expense. Our medical liability expense increased from approximately \$457,000 for the six-months ended June 30, 2005 to approximately \$625,000 for the six-months ended June 30, 2006, a 37% increase. As a percentage of service revenue, medical liability expense decreased slightly from 1.6% to 1.5% of service revenue. We had no claims loss contingency expense for either period and expenses are solely related to medical liability premiums. The increase as compared to the prior year was partially due to premiums we paid in connection with a policy we acquired in connection with our acquisition of ATN. This policy was subsequently cancelled in February 2006 and its coverage incorporated into the renewal of our overall medical liability policy.

Physician Stock-Based Compensation Expense. We experienced a significant increase in non-cash physician stock-based compensation expense from approximately \$241,000 for the six-months ended June 30, 2005 to approximately \$2.2 million for the six-months ended June 30, 2006. As a percentage of revenue, physician stock-based compensation expense increased from less than 1% for the six-months ended June 30, 2005 to 5% for the six-months ended June 30, 2006. This increase was driven primarily by the increased number of physicians, increased vesting in options held by independent contractors and a significant increase in our stock price in the first half of 2006 which was primarily due to the completion of our initial public offering.

Table of Contents*Sales, General and Administrative*

| | Six Months Ended June 30, | | Change | |
|---------------------------------------|------------------------------|---------------|------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Sales, general and administrative (1) | \$ 11,600,119 | \$ 12,353,305 | \$ 753,186 | 6% |
| <i>Percentage of service revenue</i> | <i>41%</i> | <i>29%</i> | | |

(1) Includes non-cash stock-based compensation expense of \$3,030,503 for the six-months ended June 30, 2005 and \$351,444 for the six-months ended June 30, 2006.

Of the \$11.6 million expense in the first half of 2005, approximately \$2.9 million was due to a one time non-cash stock compensation expense associated with a restricted stock grant to one of our board members. Including non-cash stock compensation expense, expressed as a percentage of service revenue, sales, general and administrative expense is down from 41% for the six-months ended June 30, 2005 to 29% for the six-months ended June 30, 2006. Excluding non-cash stock compensation expense, expressed as a percentage of revenue, sales, general and administrative expense improved from 30% for the first half of 2005 to 28% for the first half of 2006. The increases in sales, general and administrative expense were primarily due to increases in payroll expense due to additional hiring and costs associated with operating as a public company in 2006. The following expenses comprise our sales, general and administrative expense:

Payroll and Related Expense. Our sales, general and administrative headcount increased from 132 at June 30, 2005 to 200 at June 30, 2006, a 52% increase, and resulted in an increase in payroll expense from \$5.0 million for the six-months ended June 30, 2005 to \$7.7 million for the six-months ended June 30, 2006, a 55% increase. This increase in payroll expense resulted primarily from personnel additions in our quality control, information technology, finance, business development, sales, and licensing and privileging departments. Expressed as a percentage of service revenue, our sales, general and administrative payroll and related expenses remained consistent at 18% of service revenue for both periods.

Information Technology and Telecommunications Expense. Our non-payroll information technology and telecommunications expense increased from approximately \$824,000 for the six-months ended June 30, 2005 to approximately \$943,000 for the six-months ended June 30, 2006, a 14% increase. As a percentage of service revenue, IT and telecommunications expense decreased from 3% for the six-months ended June 30, 2005 to 2% for the six-months ended June 30, 2006. This decrease resulted primarily from lower telephone service costs as the Company implemented cost reduction initiatives.

Facilities Expense. Our facilities and office-based expense increased from approximately \$745,000 for the six-months ended June 30, 2005 to \$967,000 for the six-months ended June 30, 2006, a 30% increase. As a percentage of service revenue, facilities expense decreased from 3% for the six-months ended June 30, 2005 to 2% for the six-months ended June 30, 2006. The increase in facilities and office-based expense was driven primarily by increased facilities and occupancy expenses associated with our facilities in Sydney, Australia, Zurich, Switzerland, Milwaukee, Wisconsin, Coeur d Alene, Idaho and Roanoke, Virginia.

Licensing and Privileging Expense. Our non-payroll licensing and privileging expense consists primarily of fees paid in connection with the state medical licenses and hospital privileges we obtain on behalf of our affiliated radiologists. Our affiliated radiologists are licensed to practice medicine in an average of 35 states and have been granted privileges at an average of 446 hospitals. As a result of our efforts to obtain these medical licenses and staff privileges for our affiliated radiologists, we incur administrative expenses as well as fees payable to the states and hospitals. Each state typically requires a fee to be paid in connection with the issuance of a medical license as well as an additional annual fee that must be paid to maintain the medical license. In addition, many hospitals have annual fees associated with the granting of medical staff privileges. Non-payroll licensing and privileging expenses increased from approximately \$537,000 for the six-months ended June 30, 2005 to approximately \$652,000 for the six-months ended June 30, 2006, a 21% increase. As a percentage of service revenue, licensing and privileging costs were relatively consistent at 2% for both periods. Licensing and privileging expense is driven by the timing of new contracted physicians and the timing of renewals for existing physicians licenses and credentials.

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

Other General and Administrative Expense. Our other general and administrative expense consists primarily of professional accounting, legal and consulting services, general liability insurance and employee related expenses such as recruiting, travel and entertainment. Other general and administrative expense increased from approximately \$1.3 million for the six-months ended June 30, 2005 to approximately \$1.5 million for the six-months ended June 30, 2006, a 21% increase. The increase in other general and administrative expense was driven primarily by increased costs associated with operating as a public company such as, investor relations and

Table of Contents

increased directors and officer's insurance policy premiums offset by lower accounting, legal, consulting and recruiting costs. In addition, we incurred higher travel and entertainment expenses as well as increased training and costs associated with the additional headcount. As a percentage of service revenue, other general and administrative expense remained relatively consistent at 4% for both periods.

Non-Physician Stock-Based Compensation Expense. Our non-physician stock-based compensation expense decreased from approximately \$3 million for the six-months ended June 30, 2005 to approximately \$351,000 for the six-months ended June 30, 2006. As a percentage of revenue, these costs were approximately 11% of revenue for the six-months ended June 30, 2005 compared to less than 1% for the six-months ended June 30, 2006. In the six-months ended June 30, 2005, approximately \$2.9 million of our non-physician stock-based compensation expense related to a restricted stock grant to one of our board members.

*Other Income (Expense)**Interest Expense*

| | Six Months Ended June 30, | | Change | |
|--------------------------------------|------------------------------|------------|------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Interest expense | \$ 461,424 | \$ 559,671 | \$ 98,247 | 21% |
| <i>Percentage of service revenue</i> | 2% | 1% | | |

The interest expense for the six-months ended June 30, 2005 consisted primarily of interest payable under outstanding promissory notes issued to certain affiliates of Summit Partners and interest payable under a \$3 million revolving line of credit with Silicon Valley Bank. The aggregate principal balance of the outstanding promissory notes was approximately \$9 million through March 31, 2005. The aggregate principal balance of our revolving credit facility with Silicon Valley Bank was \$3 million through March 31, 2005. On April 20, 2005, we entered into a loan agreement with Comerica Bank that provided us a \$12 million term loan facility and a \$3 million revolving line of credit. We used the proceeds from the term loan facility to repay in full all outstanding indebtedness under the promissory notes held by the entities affiliated with Summit Partners and the revolving credit facility with Silicon Valley Bank. In September 2005, we borrowed an additional \$13 million under our term loan facility with Comerica Bank and distributed the full amount as a special distribution to the holders of our common stock and redeemable preferred stock. Prior to the initial public offering in February 2006, we borrowed an additional \$7 million under our term loan facility with Comerica Bank and distributed the full amount as a special distribution to the holders of our common stock and redeemable preferred stock. Thus, our interest expense for the first half of 2006 consisted primarily of interest payable under our credit facility with Comerica Bank up until the termination of that agreement in February 2006. Upon the initial public offering in first quarter of 2006, the company repaid the balance of the term loan with Comerica Bank and terminated the loan facility. Additionally, in the six-months ended June 30, 2006 we incurred an expense of approximately \$326,000 related to unamortized deferred loan fees as a result of terminating our credit facilities with Comerica Bank.

Interest Income

| | Six Months Ended June 30, | | Change | |
|--------------------------------------|------------------------------|--------------|--------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Interest Income | \$ 32,131 | \$ 1,151,284 | \$ 1,119,153 | 3,483% |
| <i>Percentage of service revenue</i> | 0% | 3% | | |

Interest income for the six-months ended June 30, 2006 consisted primarily of interest income on cash balances and short-term investments of the cash we received in connection with our initial public offering. We received cash proceeds of \$86.3 million, of which approximately \$30.1 million was used to repay all outstanding indebtedness to Comerica Bank. We invested the remaining balance in a mix of highly-liquid, investment-grade securities and cash, primarily consisting of securities issued by U.S. government and federal agencies along with money market accounts and municipal securities.

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

| | Six Months Ended June 30, | | Change | |
|---|------------------------------|---------------|---------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Change in fair value of redeemable preferred stock conversion feature | \$ 11,372,221 | \$ 44,183,770 | \$ 32,811,549 | 289% |
| <i>Percentage of service revenue</i> | 40% | 103% | | |

During the six-months ended June 30, 2005, the fair value of the redeemable preferred stock conversion feature increased by a total of \$11.4 million resulting in a non-cash expense of \$11.4 million for the six-months ended June 30, 2005. In 2006 through the closing of our initial public offering, the fair value of the redeemable preferred stock conversion feature increased by a total of \$44.2 million, resulting in a non-cash expense of \$44.2 million for the six-months ended June 30, 2006. At the time of the closing of our initial public offering, all outstanding shares of redeemable preferred stock converted into common stock, and, as a result, after such date we do not record any additional expenses associated with the change in fair value of the conversion feature of our redeemable preferred stock.

Income Tax Expense

| | Six Months Ended June 30, | | Change | |
|--------------------------------------|------------------------------|--------------|--------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Income tax expense | \$ 2,464,155 | \$ 5,114,917 | \$ 2,650,762 | 108% |
| <i>Percentage of service revenue</i> | 9% | 12% | | |

We recorded an income tax expense of approximately \$2.5 million for the six-months ended June 30, 2005 and approximately \$5.1 million for the six-months ended June 30, 2006. The increase in our income tax expense was due primarily to the increase in book income before taxes, excluding the change in fair value of the preferred stock conversion feature, which is excluded when determining our income tax expense.

Preferred Stock Accretion

| | Six Months Ended June 30, | | Change | |
|--------------------------------------|------------------------------|------------|--------------|------------|
| | 2005 | 2006 | In Dollars | Percentage |
| Preferred stock accretion | \$ 521,053 | \$ 117,534 | \$ (403,519) | (77)% |
| <i>Percentage of service revenue</i> | 1% | 1% | | |

The preferred stock accretion is comprised of two types of accretion based on the underlying redeemable convertible preferred stock. For the six-months ended June 30, 2005, the preferred stock accretion consisted of \$407,554 as a result of the accretion of dividends at a daily rate of 6% per annum, and \$113,499 as a result of the amortization of the carrying amount of the redeemable convertible preferred to its redemption value using the effective interest method through the redemption period. For the six-months ended June 30, 2006, the preferred stock accretion consisted of \$92,516 as a result of the accretion of dividends at a daily rate of 6% per annum, and \$25,018 as a result of the amortization of the carrying amount of the redeemable convertible preferred to its redemption value using the effective interest method through the redemption period. At the time of the closing of our initial public offering, all outstanding shares of redeemable preferred stock converted into common stock and, as a result, after such date we do not record any additional accretion and amortization associated with the preferred stock. Thus, because we recorded an expense due to the accretion of our preferred stock for only a portion of the first quarter of 2006 and no expense in the second quarter of 2006, we experienced lower expense than that recorded in the six-months ended June 30, 2005. We will no longer record this expense in future periods.

Liquidity and Capital Resources*Cash, Cash Equivalents and Short-term Investments*

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

Our financial position includes cash, cash equivalents and short-term investments of \$12.6 million at December 31, 2005 and \$73.3 million at June 30, 2006. During the six-months ended June 30, 2006, we received net cash proceeds of \$85.1 million from our initial public offering, after deducting an aggregate of \$6.5 million in underwriting discounts and commissions and approximately \$1.2 million in other costs paid in connection with the offering. Approximately \$460,000 of equity offering costs are included in accounts payable at June 30, 2006.

Table of Contents

During the six-months ended June 30, 2006 we used approximately \$31.0 million to repay outstanding debt.

Operating Activities

Since our inception in August 2001, we have funded our operations primarily from cash flows generated by our operating activities. Net cash from operations was approximately \$2.2 million during the six-months ended June 30, 2005 and approximately \$7.6 million for the six-months ended June 30, 2006, a 247% increase.

For the six-months ended June 30, 2006, we generated net cash from operations of approximately \$7.6 million from a net loss of approximately \$36.2 million (which net loss reflects approximately \$46.6 million of non-cash charges that did not impact our net cash from operations during this period). Our net cash from operations during this period included an increase in our accounts payable and accrued expenses of approximately \$14,000 and was offset by an increase in accounts receivable of approximately \$894,000, a decrease in accrued payroll and related benefits of approximately \$246,000, an increase in prepaid expenses and other assets of approximately \$1.3 million and a decrease in our accrued interest payable of approximately \$425,000. These changes can be attributed primarily to the growth in our business as well as other factors described more fully below.

For the six-months ended June 30, 2005, we generated net cash from operations of approximately \$2.2 million from a net loss of approximately \$7.5 million (which reflects approximately \$14.9 million of non-cash charges that did not impact our net cash from operations during this period). Our net cash from operations during this period included an increase in our accounts payable and accrued expenses of approximately \$524,000 and was offset by an increase in accounts receivable of approximately \$4.0 million, a decrease in our accrued payroll and related benefits of approximately \$194,000 and an increase in prepaid expenses and other assets of approximately \$1.3 million. These changes were all in the ordinary course and can be attributed primarily to the growth in our business and the timing of our cash receipts and disbursements.

The changes in our operating assets and liabilities and the associated impacts on our net cash from operations during the six-months ended June 30, 2005 as compared to the changes during the six-months ended June 30, 2006 are primarily due to the following factors:

Accounts Receivable. Net cash from accounts receivable decreased by \$894,000 during the six-months ended June 30, 2006 compared to a \$4.0 million decrease during the six-months ended June 30, 2005. This change was attributable primarily to a decrease in our days sales outstanding, or DSO, from 53 to 45. We calculate our DSO based upon a three month average of accounts receivable and revenue. The decrease in our DSO was primarily due to improved turnaround of invoicing associated with our implementation of an automated billing system. We completed implementation of this automated billing process in September 2005 and believe it, together with an increased focus on the collection process, has enabled us to prepare and deliver invoices more quickly.

Accounts Payable and Accrued Expenses. Net cash from accounts payable and accrued expenses increased by approximately \$14,000 during the six-months ended June 30, 2006 and approximately \$524,000 during the six-months ended June 30, 2005. This increase was primarily due to the mix and timing of accounts payable payments.

Deferred Income Tax Expense. Net cash used for deferred income tax expense increased by approximately \$1.3 million during the six-months ended June 30, 2006 and approximately \$352,000 during the six months ended June 30, 2005. The increase in cash used is primarily due to an increase in taxes paid resulting from temporary non-deductible higher stock compensation expense in 2006 than in the first half of 2005.

Net Cash Used in Investing Activities

Net cash used in investing activities was \$1.6 million for the six-months ended June 30, 2005 compared to \$38.3 million for the six-months ended June 30, 2006. Investments in securities with maturities greater than ninety days are classified as investing activities on the Statement of Cash Flows. This increase in net cash used in investing activities over this period resulted primarily from the purchase of these short-term investments from part of the net cash proceeds received from our recent initial public offering. We also received \$4.5 million for maturities of investments during the six month period ended June 30, 2006. We also invested approximately \$1.3 million in property and equipment during the six-months ended June 30, 2006 and approximately \$1.1 million during the six-months ended June 30, 2005. The majority of these capital expenditures were associated with purchases of equipment and the continued investment in our information technology infrastructure.

Net Cash Provided By Financing Activities

Net cash provided by financing activities was \$54.1 million for the six-months ended June 30, 2006. During the first six months of 2006 we completed our initial public offering from which we received net proceeds of \$85.1 million after

Table of Contents

deducting discounts and commissions paid to our underwriters and approximately \$1.2 million in offering costs paid during the six month period.

On January 2, 2006, we paid a regularly scheduled debt payment to Comerica Bank in the amount of \$1,074,219. On February 8, 2006, we borrowed an additional \$7.0 million under our term loan facility and distributed the full amount as a special dividend to the holders of our common stock and our then-outstanding redeemable convertible preferred stock. On February 14, 2006, we repaid in full the outstanding principal with Comerica Bank in the amount of \$29,851,563 with proceeds from our initial public offering. After repaying this outstanding debt, we terminated our term and revolving loan facilities with Comerica Bank.

We believe that our cash balances and the expected cash flow from operations will be sufficient to fund our operating activities, working capital, acquisitions and capital expenditure requirements for the next eighteen months. We expect our long-term liquidity needs to consist primarily of working capital, capital expenditure requirements and future acquisitions. We intend to fund these long-term liquidity needs from cash generated from operations. However, our ability to generate cash is subject to our performance, general economic conditions, industry trends and other factors. Many of these factors are beyond our control and cannot be anticipated at this time. To the extent that funds generated by our initial public offering, together with existing cash and securities and cash from operations, are insufficient to fund our future activities, we may need to raise additional funds through public or private equity or debt financing. If additional funds are obtained by issuing equity securities, substantial dilution to existing stockholders may result. Other than our agreement with ATN, we are not currently a party to any agreement or binding letter of intent with respect to potential investments in, or acquisitions of, complementary businesses, services or technologies, although we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

Off-Balance Sheet Arrangements and Contractual Obligations

Off-Balance Sheet Arrangements

The Company's Sydney office lease and our medical liability insurance policy are collateralized by separate letters of credit in the amounts of \$157,284 and \$400,000 as of June 30, 2006.

Contractual Obligations

During the six months ended June 30, 2006, the Company signed a lease for its Information Technology department in Milwaukee, Wisconsin. The lease expires in 2012 and resulted in an additional lease commitment of approximately \$500,000.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

Foreign Currency Exchange Risk

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

Interest Rate Sensitivity

We had cash and cash equivalents totaling \$36.1 million at June 30, 2006. These amounts were invested primarily in U.S. government securities. Additionally, the Company had short-term investments totaling \$37.2 million at June 30, 2006. These amounts were invested primarily in U.S. government securities and municipal securities. The cash and cash equivalents are held for working capital purposes. We do not enter into investments for trading or speculative purposes. We believe that we do not have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates. However, any declines in interest rates will reduce future investment income. In addition, because we used a portion of the proceeds of the initial public offering to repay all outstanding debt obligations other than long-term capital lease obligations, we have determined that our debt is not subject to material interest rate risk.

Table of Contents

ITEM 4. Controls and Procedures

Disclosure Controls and Procedures

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934).

PART II OTHER INFORMATION

ITEM 1. Legal Proceedings

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

ITEM 1A. Risk Factors

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

Risks Related to Our Business and Industry

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

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

effectively manage our business and technology,

recruit and retain radiologists and other key personnel,

acquire additional customers,

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

manage rapid growth in personnel and operations,

effectively manage our medical liability risk,

develop new services that complement our existing business, and

Table of Contents

successfully address the other risks described throughout this report.

We may not be able to successfully address these risks. Failure to adequately do so would harm our business and cause our operating results to suffer.

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

The market for radiology services is competitive and rapidly changing, barriers to entry are relatively low, and with the introduction of new technologies and market entrants, we expect competition to intensify in the future. If we fail to compete effectively, our operating results will be harmed. Some of our principal competitors offer their services at a lower price, which has resulted and will continue to result in pricing pressure. If we are unable to maintain our current pricing, our operating results could be negatively impacted. In addition, pricing pressures and increased competition could result in reduced revenue, reduced profits or the failure of our service to achieve or maintain more widespread market acceptance, any of which could harm our business.

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

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

The laws of many states, including states in which our customers are located, prohibit us from exercising control over the medical judgments or decisions of physicians and from engaging in certain financial arrangements, such as splitting professional fees with physicians. These laws and their interpretations vary from state to state and are enforced by state courts and regulatory authorities, each with broad discretion. We enter into agreements with our affiliated radiologists pursuant to which the radiologists render professional medical services. In addition, we enter into agreements with our customers to deliver professional radiology interpretation services in exchange for a service fee. We structure our relationships with our affiliated radiologists and our customers in a manner that we believe is in compliance with prohibitions against the corporate practice of medicine and fee splitting. However, if a state regulatory or similar authority were to determine that these arrangements violate state statutes, or if we are unable to successfully restructure our relationships with our affiliated radiologists to comply with these statutes, we would be required to eliminate customers located in certain states from the market for our services, which would have a materially adverse effect on our business, financial condition and operations.

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

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

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

Our success is dependent upon our continuing ability to recruit and retain qualified radiologists to work at our reading facilities located in Australia and Switzerland. An inability to recruit and retain radiologists would have a material adverse

Table of Contents

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

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

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

Our business entails the risk of medical liability claims against our affiliated radiologists and us. Although we maintain medical liability insurance for ourselves and our affiliated radiologists with coverages that we believe are appropriate in light of the risks attendant to our business, successful medical liability claims could result in substantial damage awards which exceed the limits of our insurance coverage. In addition, medical liability insurance is expensive and insurance premiums may increase significantly in the future, particularly as we expand our services to include primary reads. As a result, adequate medical liability insurance may not be available to our affiliated radiologists or us in the future at acceptable costs or at all.

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

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

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

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

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

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

The use and disclosure of certain healthcare information by healthcare providers and their business associates have come under increasing public scrutiny. Recent federal standards under the Health Insurance Portability and Accountability

Table of Contents

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

Our business could be adversely affected if additional patient privacy restrictions are imposed through federal or state legislation or regulation.

On April 14, 2005, U.S. Senator Hillary Clinton and U.S. Representative Edward Markey reintroduced legislation that, if enacted, would prohibit healthcare organizations from sharing patient information with foreign affiliates or subcontractors without first obtaining consent from patients. A similar type of provision was proposed, but was not enacted, in the 2004 California legislative session. If a provision such as this were passed, it could impede our ability to obtain service contracts with radiology group practices or hospitals, as those providers would be required to obtain patient consent prior to transmitting the patient's information to any of our reading facilities located outside of the United States.

Changes in the regulatory environment may constrain or require us to restructure our operations, which may harm our revenue and operating results.

Healthcare laws and regulations change frequently and may change significantly in the future. We monitor legal and regulatory developments and modify our operations from time to time as the regulatory environment changes. However, we may not be able to adapt our operations to address every new regulation, and new regulations may adversely affect our business. In addition, although we believe that we are operating in compliance with applicable foreign, federal and state laws, neither our current nor anticipated business operations have been scrutinized or assessed by judicial or regulatory agencies. We cannot assure you that a review of our business by courts or regulatory authorities would not result in a determination that adversely affects our operations or that the healthcare regulatory environment will not change in a way that restricts our operations.

Our growth and our transition to a publicly-traded company could strain our personnel, management and infrastructure resources, which may harm our business.

We are currently experiencing a period of rapid growth in our headcount and operations, which has placed, and will continue to place, a significant strain on our management, administrative, operational and financial infrastructure. We also anticipate that further growth will be required to address increases in the scope of our operations and size of our customer base. Our success will depend in part upon the ability of our current senior management team to manage this growth, as well as to manage our business as a publicly-traded company effectively. None of our executive officers has previously held a senior management position at a publicly-traded company.

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

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

We have experienced increased demand for and revenues from our services during the second and third fiscal quarters of each year. We believe that these increases are a result of increased outdoor and transportation activities during summer months. During the first and fourth quarters of each fiscal year, when weather conditions are colder for a large portion of the United States, we have historically experienced relatively lower

volumes than those experienced during the second and third

Table of Contents

quarters. We may continue to experience this or other seasonality in the future. These seasonal factors may lead to unpredictable variations in our quarterly operating results and cause the trading price of our common stock to decline.

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

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

In addition, most of our affiliated radiologists live in Australia and Switzerland, but receive compensation from us in U.S. dollars. Any relative weakness in the U.S. dollar compared to the Australian dollar or Swiss franc may increase the cost of living for our affiliated radiologists and make it less attractive for our affiliated radiologists to sign or renew their service contracts with us. As a result, foreign currency exchange fluctuations may make it difficult for us to attract and retain qualified radiologists to work in our reading centers in Australia and Switzerland.

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

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

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

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

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

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

Table of Contents

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

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

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

Our success depends in part upon our ability to market our services under the NightHawk brand. However, we believe that the term NightHawk cannot be afforded trademark protection as it is a generic term used to describe the provision of off-hours radiology services. Other than DayHawk, we have not secured registrations of our other marks. Other businesses may have prior rights in the brand names that we market under or in similar names, which could limit or prevent our ability to use these marks, or to prevent others from using similar marks. If we are unable to prevent others from using our brand names, or if others prohibit us from using them, our revenue could be adversely affected. Even if we are able to protect our intellectual property rights in such brands, we could incur significant costs in doing so.

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

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

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

The information technology industry is characterized by the existence of a large number of patents, trademarks and copyrights and by frequent litigation based on allegations of infringement or other violations of intellectual property rights. If a third party asserts that our technology violates that third-party's proprietary rights, or if a court holds that our technology violates such rights, we may be required to re-engineer our technology, obtain licenses from third parties to continue using our technology without substantial re-engineering or remove the infringing functionality or feature. In addition, we may incur substantial costs defending against any such claim. We may also become subject to damage awards, which could cause us to incur additional losses and hurt our financial position.

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

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

Our success depends largely upon the continued services of our executive officers, particularly Dr. Paul Berger, our Chief Executive Officer and Chairman of the Board. The loss of Dr. Berger, Christopher R. Huber, our Chief Financial Officer and Vice President of Operations, or Jon D. Berger, our Vice President of Sales, Marketing and Business Development, could have a material adverse effect on our business, financial condition, results of operations and the trading price of our common stock. Each of these named executives is employed on an at-will basis. In addition, the search for

Table of Contents

replacements could be time consuming and could distract our management team from the day-to-day operations of our business.

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

A key element of our strategy is to pursue strategic acquisitions that are complementary to our business or offer us other strategic benefits. For example, in September 2005, we acquired American Teleradiology Nighthawks, Inc., or ATN. Our acquisition of ATN, as well as other acquisitions in which we may engage, involve numerous risks, including:

difficulties in integrating operations, technologies, services and personnel,

diversion of financial and management resources from existing operations,

risk of entering new markets,

potential write-offs of acquired assets,

potential loss of key employees, and

inability to generate sufficient revenue to offset acquisition costs.

In addition, if we finance acquisitions by issuing convertible debt or equity securities, our existing stockholders may be diluted which could affect the market price of our stock. We have only made two acquisitions to date, and our management has limited experience in completing acquisitions and integrating acquired businesses with our operations. If we fail to properly evaluate and execute acquisitions, our business and prospects may be harmed.

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

We have focused our business on providing emergency radiology services during the hours of 5:00 p.m. to 8:00 a.m. and 24-hours per day on weekends and holidays. We have recently expanded our hours of service to enter into other markets beyond the off-hours emergency radiology market. However, any efforts to expand beyond the off-hours emergency radiology market may not result in significant revenue growth for us. In addition, efforts to expand our services beyond the off-hours emergency radiology market may divert management resources from existing operations and require us to commit significant financial resources to an unproven business, or may be resisted by our radiology group customers, which in each case may harm our business and operating results or impair our growth.

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

Effective internal controls are necessary for us to provide reliable financial reports in a timely manner and to prevent fraud. As a private company, we had limited accounting personnel and other resources with which to design and implement our internal controls and procedures. As a result, in their audit of our fiscal 2004 financial statements, our independent auditors identified in their report to our audit committee material weaknesses relating to the adequacy and competency of our financial reporting personnel. Following receipt of our auditor's report, we consulted with our audit committee and undertook remedial steps to address these deficiencies, including hiring additional staff and training our new and existing staff. Although our auditors did not identify material weaknesses in our internal controls in connection with their audit of our financial statements for the fiscal year ended December 31, 2005, we cannot assure you that we will maintain an effective system of internal controls in the future. Beginning with our annual report on Form 10-K for our fiscal year ending December 31, 2007, we will be required to comply with the requirement of Section 404 of the Sarbanes-Oxley Act of 2002 to include in each of our annual reports an assessment by our management of

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

the effectiveness of our internal controls over financial reporting and a report of our independent registered public accounting firm addressing these assessments. If we fail to adequately staff our accounting and finance function to meet the demands that will be placed upon us as a public company, including the requirements of the Sarbanes-Oxley Act of 2002, or fail to maintain adequate internal controls, any resulting material weakness in internal controls could prevent our management from concluding the internal controls are effective and impair our ability to prevent material misstatements in our financial statements, which could cause our business to suffer. In addition, investors' perceptions that our internal controls are inadequate or that we are unable to produce accurate financial statements in a timely manner or prevent fraud may negatively affect the trading price of our stock or result in stockholder litigation.

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

Our independent contractor agreements with our affiliated radiologists typically provide that the radiologists may not compete with us for a period of time, typically one year, after the agreements terminate. These covenants not to compete are

Table of Contents

enforceable to varying degrees from jurisdiction to jurisdiction. In most jurisdictions, a covenant not to compete will be enforced only to the extent that it is necessary to protect the legitimate business interest of the party seeking enforcement, that it does not unreasonably restrain the party against whom enforcement is sought and that it is not contrary to the public interest. This determination is made based upon all the facts and circumstances of the specific case at the time enforcement is sought. It is unclear whether our interests will be viewed by courts as the type of protected business interest that would permit us to enforce a non-competition covenant against the radiologists. Since our success depends in substantial part on our ability to preserve the business of our affiliated radiologists, a determination that these provisions are not enforceable could have a material adverse effect on us.

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

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

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

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

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

In its Fiscal Year 2004 Work Plan, the HHS-OIG indicated that it would conduct a study and issue a report assessing the appropriateness of Medicare billings for diagnostic tests performed in hospital emergency rooms. Part of the assessment will include a determination as to whether the tests were interpreted contemporaneously with the patient's treatment. It is possible that in the final report, the HHS-OIG could recommend to the Medicare program that it change its reimbursement rules to clearly indicate that Medicare will only pay for interpretations performed contemporaneously with the patient's treatment by a physician located within the United States. If the HHS-OIG makes such a recommendation, it could adversely impact our business, financial condition and operations.

The trading price of our common stock may be volatile.

The trading prices of many newly publicly-traded companies are highly volatile, particularly companies such as ours that have limited operating histories. Accordingly, the trading price of our common stock may be subject to wide fluctuations. Factors affecting the trading price of our common stock will include:

variations in our operating results,

Table of Contents

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

recruitment or departure of key personnel,

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

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

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

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

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

Future sales of shares by existing stockholders could cause our stock price to decline.

If our existing stockholders sell, or indicate an intent to sell, substantial amounts of our common stock in the public market after the 180-day contractual lock-up agreements (which may be extended by up to 34 days under certain conditions) and other legal restrictions on resale discussed in our prospectus filed with the Securities and Exchange Commission lapse, the trading price of our common stock could decline. Based on shares outstanding as of June 30, 2006, we have outstanding 29,811,955 shares of common stock. Of these shares, only the 7,245,000 shares of common stock sold in our initial public offering is freely tradable, without restriction, in the public market as of the date of this annual report. Morgan Stanley & Co. Incorporated may, in its sole discretion, permit our officers, directors, employees and current stockholders who are subject to the 180-day contractual lock-up to sell shares prior to the expiration of the lock-up agreements.

After the lock-up agreements pertaining to our initial public offering expire, up to an additional 22,249,952 shares will be immediately eligible for sale in the public market, 18,170,494 of which are held by directors, executive officers and other affiliates and will be subject to volume limitations under Rule 144 under the Securities Act and various vesting agreements. In addition, the 1,916,627 shares that are subject to equity awards outstanding as of June 30, 2006 under our 2004 Stock Plan and our 2006 Equity Incentive Plan will become eligible for sale in the public market to the extent permitted by the provisions of various vesting agreements, the lock-up agreements and Rules 144 and 701 under the Securities Act of 1933, as amended, or the Securities Act. If these additional shares are sold, or if it is perceived that they will be sold, in the public market, the trading price of our common stock could decline.

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

Our executive officers, directors, affiliates and affiliated entities together beneficially own approximately 61% of our common stock outstanding. As a result, these stockholders, acting together, have control over most matters that require approval by our stockholders, including the election of directors and approval of significant corporate transactions. Corporate action might be taken even if other stockholders oppose them. This concentration of ownership might also have the effect of delaying or preventing a change of control of our company that other stockholders may view as beneficial.

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

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

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

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

Table of Contents

provide that directors may only be removed for cause,

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

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

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

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

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

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

ITEM 6. Exhibits

Exhibit

| Number | Description |
|---------------|---|
| 31.1 | Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

Table of Contents

SIGNATURES

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

NIGHTHAWK RADIOLOGY HOLDINGS, INC.

Date: August 11, 2006

By: */s/* CHRISTOPHER R. HUBER
Christopher R. Huber
Vice President of Operations and

Chief Financial Officer