PEDIATRIX MEDICAL GROUP INC
Form 10-Q
August 07, 2007

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the Quarterly Period Ended March 31, 2007

OR

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

Commission File Number **001-12111**

PEDIATRIX MEDICAL GROUP, INC.

(Exact name of registrant as specified in its charter)

Florida	**65-0271219**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1301 Concord Terrace
Sunrise, Florida 33323
(Address of principal executive offices)
(Zip Code)

(954) 384-0175
(Registrant s telephone number, including area code)

Not Applicable
(Former name, former address and fiscal year, if changed since last report)

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 o No x

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 (Check one):

Large accelerated filer x Accelerated filer o Non-accelerated filer o

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock as of the latest practicable date:

Shares of Common Stock outstanding as of July 20, 2007: 49,020,190.

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EXPLANATORY NOTE

Immediately prior to the filing of this Form 10-Q, the Company filed its Form 10-K for the year ended December 31, 2006 (the 2006 Form 10-K). The 2006 Form 10-K contains restated financial information related to the completion of the Company s stock option review as discussed in Note 3, Restatement of Consolidated Financial Statements. The filing of this Form 10-Q was delayed as a result of the stock option review.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

PEDIATRIX MEDICAL GROUP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2007 (Unaudited)	December 31, 2006
	(in thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 71,632	$ 69,595
Short-term investments	17,185	65,660
Accounts receivable, net	127,773	125,573
Prepaid expenses	3,855	4,863
Deferred income taxes	41,967	30,569
Other assets	4,495	5,339
Total current assets	266,907	301,599
Investments	12,428	6,669
Property and equipment, net	29,636	29,939
Goodwill	780,811	770,289
Other assets, net	28,586	26,674
Total assets	$ 1,118,368	$ 1,135,170
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 136,855	$ 206,552
Current portion of long-term debt and capital lease obligations	405	483
Income taxes payable	4,669	14,280
Total current liabilities	141,929	221,315
Line of credit		
Long-term debt and capital lease obligations	170	377
Deferred income taxes	36,056	34,272
Other liabilities	45,365	13,405
Total liabilities	223,520	269,369
Commitments and contingencies		
Shareholders equity:		
Preferred stock; par value $.01 per share; 1,000 shares authorized; none issued		
Common stock; par value $.01 per share; 100,000 shares authorized; 48,965 and 48,861 shares issued and outstanding, respectively	490	489

Additional paid-in capital	527,529	516,384
Retained earnings	366,829	348,928
Total shareholders equity	894,848	865,801
Total liabilities and shareholders equity	$ 1,118,368	$ 1,135,170

The accompanying notes are an integral part of
these condensed consolidated financial statements.

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PEDIATRIX MEDICAL GROUP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended March 31,	
	2007	2006
	(in thousands, except for per share data)	
Net patient service revenue	$ 214,456	$ 187,679
Operating expenses:		
Practice salaries and benefits	130,945	112,569
Practice supplies and other operating expenses	8,900	7,802
General and administrative expenses	33,615	27,392
Depreciation and amortization	2,473	2,348
Total operating expenses	175,933	150,111
Income from operations	38,523	37,568
Investment income	1,864	450
Interest expense	(221)	(409)
Income before income taxes	40,166	37,609
Income tax provision	14,584	14,182
Net income	$ 25,582	$ 23,427
Per share data:		
Net income per common and common equivalent share:		
Basic	$ 0.53	$ 0.50
Diluted	$ 0.51	$ 0.48
Weighted average shares used in computing net income per common and common equivalent share:		
Basic	48,366	47,268
Diluted	49,910	48,906

The accompanying notes are an integral part of
these condensed consolidated financial statements.

PEDIATRIX MEDICAL GROUP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended March 31,	
	2007	2006
	(in thousands)	
Cash flows from operating activities:		
Net income	$ 25,582	$ 23,427
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	2,473	2,348
Stock-based compensation expense	4,476	5,257
Recognition of tax benefit from uncertain tax position	(1,181)	
Deferred income taxes	230	3,329
Changes in assets and liabilities:		
Accounts receivable	(2,200)	(4,034)
Prepaid expenses and other assets	1,852	(1,910)
Other assets	274	370
Accounts payable and accrued expenses	(60,764)	(42,431)
Income taxes payable	(9,454)	3,804
Other liabilities	7,936	
Net cash used in operating activities	(30,776)	(9,840)
Cash flows from investing activities:		
Acquisition payments, net of cash acquired	(11,958)	(63,264)
Purchases of investments	(13,538)	(5,434)
Proceeds from sales or maturities of investments	56,254	3,900
Purchases of property and equipment	(1,469)	(1,562)
Net cash provided from (used in) investing activities	29,289	(66,360)
Cash flows from financing activities:		
Borrowings on line of credit		109,000
Payments on line of credit		(68,000)
Payments on long-term debt and capital lease obligations	(285)	(325)
Excess tax benefit from exercises of stock options and vesting of restricted stock	612	6,484
Proceeds from issuance of common stock	3,197	22,356
Net cash provided from financing activities	3,524	69,515
Net increase (decrease) in cash and cash equivalents	2,037	(6,685)

Cash and cash equivalents at beginning of period	69,595	11,192
Cash and cash equivalents at end of period	$ 71,632	$ 4,507

The accompanying notes are an integral part of
these condensed consolidated financial statements.

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PEDIATRIX MEDICAL GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2007
(Unaudited)

1. Basis of Presentation:

The accompanying unaudited condensed consolidated financial statements of Pediatrix Medical Group, Inc. and the notes thereto presented in this Form 10-Q have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC) applicable to interim financial statements, and do not include all disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, these financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results of interim periods. The financial statements include all the accounts of Pediatrix Medical Group, Inc. and its consolidated subsidiaries (collectively, PMG) together with the accounts of PMG s affiliated professional associations, corporations and partnerships (the affiliated professional contractors). PMG has contractual management arrangements with its affiliated professional contractors, which are separate legal entities that provide physician services in certain states and Puerto Rico. The terms Pediatrix and the Company refer collectively to Pediatrix Medical Group, Inc., its subsidiaries, and the affiliated professional contractors.

The consolidated results of operations for the interim periods presented are not necessarily indicative of the results to be experienced for the entire fiscal year. In addition, the accompanying unaudited condensed consolidated financial statements and the notes thereto should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company s most recent Annual Report on Form 10-K.

2. Summary of Significant Accounting Policies:

Stock Incentive Plans and Employee Stock Purchase Plans

In accordance with Statement of Financial Accounting Standards No. 123(R) (FAS 123(R)), the Company measures the cost of employee services received in exchange for stock-based awards based on grant-date fair value. As prescribed under FAS 123(R), the Company estimates the grant-date fair value of stock option grants using a valuation model known as the Black-Scholes-Merton formula or the Black-Scholes Model and allocates the resulting compensation expense over the corresponding requisite service period associated with each grant. The Black-Scholes Model requires the use of several variables to estimate the grant-date fair value of stock options including expected term, expected volatility, expected dividends and risk-free interest rate. The Company performs significant analyses to calculate and select the appropriate variable assumptions used in the Black-Scholes Model. The Company also performs significant analyses to estimate forfeitures of stock-based awards as required by FAS 123(R). The Company is required to adjust its forfeiture estimates on at least an annual basis based on the number of share-based awards that ultimately vest. The selection of assumptions and estimated forfeiture rates is subject to significant judgment and future changes to these assumptions and estimates may have a material impact on the Consolidated Financial Statements. The Company recognizes compensation cost for stock-based compensation over the requisite service period using the graded vesting attribution method.

The condensed consolidated statements of income for the three months ended March 31, 2007 and 2006 include stock-based compensation expense calculated in accordance with FAS 123(R) for the Company s stock incentive plans (the Stock Incentive Plans) and the Company s employee stock purchase plans (the Stock Purchase Plans). In addition, the Company s condensed consolidated statements of cash flows for the three months ended March 31, 2007 and 2006 include the excess tax benefits related to the exercise of stock options and the vesting of restricted stock as a cash inflow from financing activities. In accordance with Financial Accounting Standards Board (FASB)

Staff Position No. FAS 123(R)-3, Transition Election to Accounting for the Tax Effects of Share-Based Payment Awards, the Company has elected to use the short-cut method to account for its historical pool of excess tax benefits related to stock-based awards. See Note 6 to the Condensed Consolidated Financial Statements for more information on the Company s Stock Incentive Plans and the Stock Purchase Plans.

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Accounting Pronouncements

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159 (FAS 159), The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115. FAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. FAS 159 is effective for fiscal years beginning after November 15, 2007. The Company has not yet completed an evaluation of the potential impact of FAS 159.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (FAS 157), Fair Value Measures. FAS 157 creates a common definition for fair value for recognition or disclosure purposes under generally accepted accounting principles (GAAP). FAS 157 also establishes a framework for measuring fair value and enhances disclosures about fair value measures required under other accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. FAS 157 is effective for fiscal years beginning after November 15, 2007. The Company has not yet completed its evaluation of the potential impact of FAS 157.

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company adopted FIN 48 effective January 1, 2007. See Note 7 to the Condensed Consolidated Financial Statements for more information on the Company s accounting for uncertain tax positions.

Reclassifications

Deferred compensation as presented in the consolidated balance sheet of the Company s Annual Report on Form 10-K for the year ended December 31, 2006 has been included in other liabilities to conform with the current quarter presentation. At March 31, 2007, other liabilities include deferred compensation of approximately $14.0 million.

3. Business Acquisitions:

The Company acquired two physician group practices during the three months ended March 31, 2007. In connection with these acquisitions, the Company recorded goodwill of approximately $10.0 million, other identifiable intangible assets consisting of physician and hospital agreements, of approximately $2.3 million, and liabilities of $847,000. The Company also recorded goodwill of $500,000 during the three months ended March 31, 2007 for the payment of contingent consideration related to a prior year acquisition based on volume and other performance measures. The Company may be required to pay similar contingent consideration under certain contract provisions relating to acquisitions completed during the three months ended March 31, 2007, as well as other acquisitions completed in prior years; however, the amount to be paid, if any, is not determinable at this point.

The results of operations of the two practices acquired during the three months ended March 31, 2007 have been included in the Company s condensed consolidated financial statements from their respective dates of acquisition. The following unaudited pro forma information combines the consolidated results of operations of the Company and the physician group practice operations acquired during 2007 and 2006 as if the transactions had occurred at the beginning of the respective periods (in thousands, except for per share data);

	Three Months Ended March 31,	
	2007	2006
Net patient service revenue	$ 215,013	$ 196,712
Net income	25,724	25,682
Net income per share:		
Basic	0.53	0.54
Diluted	0.52	0.53

The pro forma results do not necessarily represent results which would have occurred if the acquisitions had taken place at the beginning of the period, nor are they indicative of the results of future combined operations.

4. Investments:

Investments consist of held-to-maturity securities issued primarily by the U.S. Treasury, other U.S. Government corporations and agencies and states of the United States and available-for-sale securities consisting of investment grade variable rate demand bonds. Investments with remaining maturities of less than one year are classified as short-term investments.

The Company intends and has the ability to hold its held-to-maturity securities to maturity, and therefore carries such investments at amortized cost in accordance with the provisions of Financial Accounting Standards No. 115 (FAS 115), Accounting for Certain Investments in Debt and Equity Securities.

Variable rate demand bonds are backed by municipal debt obligations with long-term contractual maturities and contain demand purchase option provisions allowing the Company to liquidate its investment in such securities over short-term intervals. Based on the provisions of these securities and the Company s intent to carry all such securities as short-term investments, the Company has classified its variable rate demand bonds as available-for-sale short-term investments. Under the provisions of FAS 115, available-for-sale investments are carried at fair value, with any unrealized gains and losses included in comprehensive income as a separate component of shareholders equity.

The amortized cost associated with the Company s available-for-sale investments held at December 31, 2006 equaled fair value. Therefore, the Company had no unrealized gains and losses reported as a separate component of shareholders equity at December 31, 2006. The Company did not hold any available-for-sale investments at March 31, 2007. The Company s investments held at March 31, 2007 and December 31, 2006 are summarized as follows:

	March 31, 2007		December 31, 2006	
	Short-Term	Long-Term	Short-Term	Long-Term
	(in thousands)			
Variable Rate Demand Bonds	$	$	$ 51,850	$
U.S. Treasury Securities	4,889	500	5,867	500
Federal Home Loan Securities	2,992	4,097	3,497	1,494
Municipal Debt Securities	4,521	7,831	3,946	4,675
Commercial Paper	4,283			
Federal Farm Credit Bank Discount Note	500		500	
	$ 17,185	$ 12,428	$ 65,660	$ 6,669

5. Accounts Payable and Accrued Expenses:

Accounts payable and accrued expenses consist of the following:

	March 31, 2007	December 31, 2006
	(in thousands)	
Accounts payable	$ 3,100	$ 5,945

Accrued salaries and bonuses	34,444	103,434
Accrued payroll taxes and benefits	11,503	13,414
Accrued professional liability risks	61,578	55,773
Accrual for uncertain tax positions	10,691	19,623
Other accrued expenses	15,539	8,363
	$ 136,855	$ 206,552

The decrease in accrued salaries and bonuses from $103.4 million at December 31, 2006 to $34.4 million at March 31, 2007 is primarily due to the decrease in the Company s liabilities for performance-based incentive compensation.

The Company s annual payments due under its performance-based incentive compensation program are made during the first quarter of each year.

6. Stock Incentive Plans and Employee Stock Purchase Plans:

The Company has a stock option plan (the Option Plan) under which stock options are presently outstanding but no new additional grants may be made. The Company also has a 2004 Incentive Compensation Plan (the 2004 Incentive Plan) under which stock options, restricted stock, stock appreciation rights, deferred stock, other stock related and performance related awards may be made to key employees. To date, the Company has only awarded restricted stock and granted stock options under the 2004 Incentive Plan. Collectively, the Option Plan and the 2004 Incentive Plan are the Company s Stock Incentive Plans (the Stock Incentive Plans). The Company also has Stock Purchase Plans under which employees may purchase the Company s common stock at 85% of market value on designated dates.

Under the 2004 Incentive Plan, options to purchase shares of common stock may be granted at a price not less than fair market value of the shares on the date of grant. The options must be exercised within 10 years from the date of grant and generally become exercisable on a pro rata basis over a three-year period from the date of grant. Restricted stock awards generally vest over periods of three years upon the fulfillment of specified service-based conditions and in certain instances performance-based conditions. The Company recognizes compensation expense related to its restricted stock awards ratably over the corresponding vesting periods. During the three months ended March 31, 2007, the Company granted 7,000 stock options to key employees under the 2004 Incentive Plan. At March 31, 2007, the Company had approximately 1.9 million shares available for future grants and awards under the 2004 Incentive Plan. During the three months ended March 31, 2007, approximately 18,000 shares were issued under the Stock Purchase Plans. At March 31, 2007, the Company had approximately 180,000 shares reserved under the Stock Purchase Plans.

The Company recognized approximately $4.5 million and $5.3 million of stock-based compensation expense related to the Stock Incentive Plans and the Stock Purchase Plans during the three months ended March 31, 2007 and 2006, respectively. The after-tax impact of stock-based compensation expense on net income was approximately $2.7 million and $3.3 million for the three months ended March 31, 2007 and 2006, respectively. The excess tax benefit related to the exercise of stock options and the vesting of restricted stock for the three months ended March 31, 2007 and 2006 was approximately $769,000 and $7.5 million, respectively.

In July 2007, the Audit Committee of the Board of Directors completed an independent comprehensive review of the Company s stock option granting practices and made certain findings with respect to these practices. Based on these findings, management concluded that incorrect measurement dates were used for certain stock option grants in prior periods.

After considering the application of Section 409A of the Internal Revenue Code on stock options with revised measurement dates, in February 2007, the Company s Board of Directors approved the Company s election to participate in a compliance resolution program offered by the Internal Revenue Service for certain employees who exercised certain stock options in 2006. Under this program, the Company paid to the Internal Revenue Service taxes and related interest imposed on employees, other than executive officers, as a result of the revision of measurement dates. In connection with this program, the Company will reimburse these employees for any additional taxes resulting from the payment of the Section 409A taxes on their behalf.

In February 2007, the Board of Directors adopted a program providing for increases in the exercise price of certain options that were subject to changes in measurement dates and authorizing the Company to make compensating payments for the difference to affected employees, other than executive officers, in 2008. In July 2007, the Board of Directors finalized the increase in the exercise price of these options and authorization of these compensating payments.

The Company has recorded a liability of approximately $6.4 million at March 31, 2007 for amounts it expects to pay to the Internal Revenue Service on behalf of its employees and directly to employees under these programs.

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7. Accounting for Uncertain Tax Positions:

Effective January 1, 2007, the Company adopted the provisions of FIN 48. As part of the implementation of FIN 48, the Company evaluated its open tax positions using the recognition and measurement criteria established by FIN 48 and, as a result, recorded a $7.7 million cumulative effect adjustment to the opening balance of retained earnings. In addition, the Company reclassified approximately $10.7 million from deferred taxes payable to its current liability for uncertain tax positions which represented taxes due in relation to tax positions taken on temporary differences.

The Company s total liability for unrecognized tax benefits was $37.1 million as of January 1, 2007. The Company had approximately $20.3 million of unrecognized tax benefits that, if recognized, would favorably impact its effective tax rate at January 1, 2007.

The Company anticipates that its liability for uncertain tax positions will be reduced over the next 12 months by approximately $2.6 million due to the expiration of statutes of limitation. Additionally, the Company anticipates that its liability for uncertain tax positions will be increased over the next 12 months for accrued interest and additional taxes of approximately $2.7 million and $1.4 million, respectively. Although the Company anticipates additional changes in its liability for uncertain tax positions related to certain temporary differences, an estimate of such changes cannot be made at this time.

The Company is currently subject to U.S. Federal income tax examinations for the tax years 2003 through 2006 and Commonwealth of Puerto Rico income tax examinations for the tax years 2001 and 2003 through 2006. During the three months ended March 31, 2007, the Company reduced its liability for uncertain tax positions related to the deductibility of certain compensation payments by approximately $3.9 million as a result of the expiration of the statute of limitations on certain filed tax returns. Of this $3.9 million liability reduction, $2.7 million was recorded as an increase in additional paid-in capital with the remainder recorded as a tax benefit.

The Company includes interest and penalties related to income tax liabilities in income tax expense. As of January 1, 2007, the Company s accrued interest and penalties totaled $5.1 million.

At March 31, 2007, other liabilities and accounts payable and accrued expenses as presented in the Company s condensed consolidated balance sheet include $31.3 million and $10.7 million, respectively, related to the Company s total liability for unrecognized tax benefits of $42.0 million.

8. Net Income Per Share:

Basic net income per share is calculated by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is calculated by dividing net income by the weighted average number of common and potential common shares outstanding during the applicable period. Potential common shares consist of the dilutive effect of outstanding options and non-vested restricted stock calculated using the treasury stock method. Under the treasury stock method, the Company calculates the assumed excess tax benefits related to the potential exercise or vesting of its stock-based awards using the sum of the average market price for the applicable period less the option price, if any, and the fair value of the stock-based award on the date of grant multiplied by the applicable tax rate.

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The calculations of basic and diluted net income per share for the three months ended March 31, 2007 and 2006 are as follows:

	Three Months Ended March 31,	
	2007	2006
	(in thousands, except for per share data)	
Basic:		
Net income applicable to common stock	$ 25,582	$ 23,427
Weighted average number of common shares outstanding	48,366	47,268
Basic net income per share	$ 0.53	$ 0.50
Diluted:		
Net income applicable to common stock	$ 25,582	$ 23,427
Weighted average number of common shares outstanding	48,366	47,268
Weighted average number of dilutive common stock equivalents	1,544	1,638
Weighted average number of common and common equivalent shares outstanding	49,910	48,906
Diluted net income per share	$ 0.51	$ 0.48

For the three months ended March 31, 2007 and 2006, the Company had approximately 7,000 and 20,000 outstanding employee stock options, respectively, that were excluded from the computation of diluted earnings per share because they were anti-dilutive.

9. Contingencies:

The Audit Committee of the Company s Board of Directors conducted a comprehensive review of the Company s historical practices related to the granting of stock options with the assistance of independent legal counsel and forensic accounting experts. The Company voluntarily contacted the staff of the SEC regarding the Audit Committee s review and subsequently the SEC notified the Company that it had commenced a formal investigation into the Company s stock option practices. The Company has also had discussions with the U.S. Attorney s office for the Southern District of Florida regarding the Audit Committee s review. Based on these discussions, the Company believes that the U.S. Attorney s office may make a request for various documents and information related to the review and the Company s stock option granting practices. The Company intends to continue full cooperation with the U.S. Attorney s office and the SEC. The Company cannot predict the outcome of these matters.

In September 2006, the Company announced that it had completed a final settlement agreement with the Department of Justice and the relator who initiated the qui tam complaint (Federal Settlement Agreement). In February 2007, the Company announced that it had completed separate state settlement agreements with each state Medicaid pro