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 June 30, 2006

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

In this Form 10-Q, Pediatrix Medical Group, Inc (the Company) is restating its Condensed Consolidated Balance Sheet as of December 31, 2005, the related Condensed Consolidated Statements of Income for the three and six months ended June 30, 2005 and the Condensed Consolidated Statement of Cash Flows for the six months ended June 30, 2005. This Form 10-Q also reflects the amendment of Management s Discussion and Analysis of Financial Condition and Results of Operations presented in this Form 10-Q for the three and six month periods ended June 30, 2005.

Immediately after the filing of this Form 10-Q, the Company will file a quarterly report on Form 10-Q for the quarter ended September 30, 2006 and an annual report on Form 10-K for the year ended December 31, 2006 (the 2006 Form 10-K). The Form 10-Q for the quarter ended September 30, 2006 will contain restated financial information for the three and nine months ended September 30, 2005. In the 2006 Form 10-K, the Company will restate its Consolidated Balance Sheet as of December 31, 2005, and the related Consolidated Statements of Operations, Changes in Shareholders Equity and Cash Flows for each of the fiscal years ended December 31, 2005 and 2004 and quarterly financial information for the quarter ended March 31, 2006 and each of the four quarters of 2005. The 2006 Form 10-K will also reflect the restatement of Selected Financial Data in Item 6 for the years ended December 31, 2005, 2004, 2003, and 2002. In addition, Item 7 of Management s Discussion and Analysis of Financial Condition and Results of Operations presented in the Company s Form 10-K for the year ended December 31, 2006 will reflect the restatement as it relates to the years ended December 31, 2005 and 2004.

Previously filed annual reports on Form 10-K and quarterly reports on Form 10-Q have not been amended and should not be relied upon.

Background of Restatement

In June 2006, management of the Company began an informal limited review of its past stock option grant practices in response to a shareholder inquiry following various media reports regarding option granting practices at other companies. Management apprised the Audit Committee of the Company s Board of Directors of this informal limited review and the Audit Committee provided guidance with respect to the scope of the review. In August 2006, findings from this limited review were presented to the Audit Committee and the Company s independent certified registered public accounting firm. Based on these findings, the Audit Committee decided to initiate a comprehensive review to be undertaken by the Audit Committee with the assistance of independent legal counsel and forensic accounting experts. The review covered all stock options granted by the Company from the date of its initial public offering in September 1995 through the Company s option issuances in June 2006 (the Relevant Period).

In July 2007, the Audit Committee completed its review. The key findings, based on the evidence reviewed, are as follows:

The Audit Committee identified 56 grants made on seven dates between April 1997 and August 2000 which the Audit Committee found were backdated. No instances of backdating were identified after August 2000. The Audit Committee used the term backdating to connote deliberate selection of grant measurement dates to obtain an option exercise price that was lower than would otherwise be the case. The Audit Committee used this term to describe grants which apparently involved deliberate, opportunistic use of market prices.

The Audit Committee did not find evidence establishing intentional misconduct by any of the Company s current executive officers.

The Audit Committee believes that it received full cooperation from all of the Company s current executive officers.

The Audit Committee did not find evidence establishing that the Board, any committee of the Board, or any non-executive director participated in backdating or was aware of backdating during the time that it occurred.

During the time period from April 1997 to August 2000 when backdating occurred, the administration and processing of option grants was directed by a former officer who later became a director of the Company.

This individual continued to direct the Company s options program after resigning as an officer in May 2000, while remaining with the Company to work on special projects. During this time period, this individual appears to have been responsible for selecting favorable dates for option grants in all but one instance where a record was located regarding favorable date selection. The Audit Committee concluded that this individual knew or should have known the accounting implications of his actions. Further, the Audit Committee identified three occasions on which this individual was able to benefit by affecting the measurement date of options that were granted to him. The Audit Committee found that this individual realized approximately $12,000 from the backdating of these options based on the revised measurement dates assigned to them.

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The Audit Committee identified numerous instances in which applicable accounting principles were misapplied and/or process deficiencies or administrative errors occurred resulting in the application of inappropriate measurement dates to option grants. The Audit Committee also identified inadequate record keeping, documentation, disclosure and systems with respect to the stock option grant process, including records of meetings, which in some cases, could not be corroborated in support of option grants on measurement dates that corresponded to periodic low points in the Company s stock price.

The Audit Committee determined that, although these matters did not establish that senior management engaged in intentional misconduct, current senior management did not adequately ensure that these processes and systems were proper, including the Company s current President and Chief Operating Officer and Chief Financial Officer, who were also found to have played a role in the granting of stock options to others that involved errors and process deficiencies.

With respect to the Company s current executive officers, the Audit Committee found that senior management should not have permitted the individual described above to continue to manage the options program after his resignation as a Company officer in May 2000. The Audit Committee found that, during the period in which backdating occurred, Roger J. Medel, M.D., the Company s CEO, was actively involved in determining grant recipients and amounts and was also party to e-mail correspondence concerning the selection of favorable dates for option grants; however, Dr. Medel was not the recipient of any of the grants found to be backdated. In addition, the Audit Committee found that on one occasion in 1997, Dr. Medel directed the selection of a favorable grant date for a group of regional medical officers, one of whom was his spouse, a founding physician of the Company and a full-time employee at the time of the grant. Based on its review, however, the Audit Committee believes that Dr. Medel was not aware of the accounting implications of such grants. Further, based on its review, the Audit Committee believes that Dr. Medel reasonably relied upon senior Company executives as to the administration of the Company s equity compensation plans and the accounting for awards. The Audit Committee found, however, that Dr. Medel bore overall responsibility for assuring that management s implementation of its compensation programs was appropriate but that he did not adequately assure such appropriate implementation.

In light of the evidence reviewed, the Audit Committee found that 640 grants in total required revised measurement dates, variable accounting or the recognition of compensation expense.

Audit Committee Conclusions

In connection with its investigation, the Audit Committee reviewed evidence to determine whether correct measurement dates had been used under generally accepted accounting principles (GAAP) for the Company s stock option grants during the Relevant Period. The measurement date means the date, under APB Opinion No. 25, Accounting for Stock Issued to Employees and its related interpretations (APB 25), on which all of the following are first known: (i) the individual employee who is entitled to receive the option grant, (ii) the number of options that an individual employee is entitled to receive, and (iii) the option s exercise price.

Based on the evidence reviewed, the Audit Committee concluded that: (i) in certain instances, available documentation was insufficient to support or inconsistent with the measurement date or exercise price which was originally assigned to the relevant stock option grant, (ii) certain stock option grants which required variable accounting were inappropriately accounted for as fixed awards, and (iii) modifications to certain stock option grants were not accounted for properly. In many cases, more than one of the foregoing conclusions was reached with respect to a single stock option grant.

Consistent with APB 25 and the January 2007 illustrative letter from the Chief Accountant of the SEC (the SEC Letter), grants made with incorrect measurement dates during the Relevant Period were organized into categories based on types of errors. The Audit Committee and its advisors reviewed evidence related to each grant in these categories, including electronic and physical documents, such as meeting minutes of the Compensation Committee or Board of Directors, unanimous written consents of the Compensation Committee, contemporaneous e-mails, personnel files, payroll records and various other records maintained by the Company, and the results of interviews.

Based on the relevant facts and circumstances and the evidence reviewed, the Audit Committee applied relevant GAAP and its judgment to determine, for each grant within each category, the measurement date which was most appropriate. If the Audit Committee concluded that (i) the available documentation was insufficient to support or inconsistent with the measurement date or exercise price which was originally assigned to the relevant stock option grant, (ii) the stock option grant was inappropriately accounted for as a fixed award, and/or (iii) a modification to the stock option grant was not accounted for properly, then accounting adjustments were made as required, resulting in non-cash stock-based compensation expense and related tax effects. The Audit Committee and its advisors were unable to locate the supporting documentation for option grants in many instances. In these situations, the measurement date was determined using judgment as to the most likely granting action taken by the Company and the related date based upon the available information, consistent with the SEC Letter.

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In addition, in some instances, grants were made through May 2001 by officers in exercise of authority apparently delegated to the Chief Executive Officer, but no documentation of such delegated authority has been located.

The Audit Committee concluded, based on the evidence reviewed, that options to purchase approximately 2.3 million shares of common stock 56 grants on seven dates were backdated as that term was used by the Audit Committee as described more fully above. The Audit Committee further concluded that options to purchase an additional 12.1 million shares of common stock 584 grants on 78 dates prior to 2006 had erroneous measurement dates or required variable accounting or recognition of additional expense.

For more information regarding the Audit Committee s review and the Company s restatement, refer to Note 3, Restatement of Consolidated Financial Statements in Notes to Consolidated Financial Statements in this Form 10-Q.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

PEDIATRIX MEDICAL GROUP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

	June 30, 2006 (Unaudited)	December 31, 2005 As Restated (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 28,845	$ 11,192
Short-term investments	12,449	10,920
Accounts receivable, net	113,761	111,725
Prepaid expenses	6,435	4,459
Deferred income taxes	22,361	24,400
Other assets	2,188	1,928
Total current assets	186,039	164,624
Investments	6,983	4,071
Property and equipment, net	27,871	27,855
Goodwill	746,174	680,097
Other assets, net	23,992	23,756
Total assets	$ 991,059	$ 900,403
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 161,695	$ 175,619
Current portion of long-term debt and capital lease obligations	777	882
Income taxes payable	2,898	1,157
Total current liabilities	165,370	177,658
Long-term debt and capital lease obligations	328	622
Deferred income taxes	30,641	29,617
Deferred compensation	11,560	10,372
Total liabilities	207,899	218,269
Commitments and contingencies		
Shareholders equity:		
Preferred stock; par value $.01 per share; 1,000 shares authorized; none issued		
	487	475

Common stock; par value $.01 per share; 100,000 shares authorized; 48,712 and 47,458 shares issued and outstanding, respectively				
Additional paid-in capital		501,325		472,817
Unearned compensation				(15,621)
Retained earnings		281,348		224,463
Total shareholders equity		783,160		682,134
Total liabilities and shareholders equity	$	991,059	$	900,403

(1) Includes adjustments resulting from stock option review as described in Note 3 Restatement of Consolidated Financial Statements.

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 in thousands, except for per share data)

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005 As Restated (1)	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005 As Restated (1)
Net patient service revenue	$ 203,807	$ 173,756	$ 391,486	$ 337,906
Operating expenses:				
Practice salaries and benefits	114,419	98,268	226,988	196,271
Practice supplies and other operating expenses	8,604	6,844	16,406	13,094
General and administrative expenses	24,820	22,579	52,212	51,091
Depreciation and amortization	2,404	2,529	4,752	5,176
Total operating expenses	150,247	130,220	300,358	265,632
Income from operations	53,560	43,536	91,128	72,274
Investment income	478	199	928	376
Interest expense	(411)	(846)	(820)	(1,686)
Income before income taxes	53,627	42,889	91,236	70,964
Income tax provision	20,169	16,102	34,351	26,648
Net income	$ 33,458	$ 26,787	$ 56,885	$ 44,316
Per share data:				
Net income per common and common equivalent share:				
Basic	$ 0.70	$ 0.58	$ 1.19	$ 0.97
Diluted	$ 0.68	$ 0.56	$ 1.16	$ 0.93
Weighted average shares used in computing net income per common and common equivalent share:				
Basic	48,003	46,231	47,631	45,812
Diluted	49,461	47,819	49,179	47,466

(1)

Includes adjustments resulting from stock option review as described in Note 3 Restatement of Consolidated Financial Statements.

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 CASH FLOWS
(Unaudited in thousands)

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005 As Restated (1)
Cash flows from operating activities:		
Net income	$ 56,885	$ 44,316
Adjustments to reconcile net income to net cash provided from operating activities:		
Depreciation and amortization	4,752	5,176
Stock-based compensation expense	10,188	924
Deferred income taxes	2,824	5,034
Gain on sale of assets	(1,630)	
Changes in assets and liabilities:		
Accounts receivable	(2,036)	2,010
Prepaid expenses and other assets	(2,236)	(112)
Other assets	550	31
Accounts payable and accrued expenses	(13,924)	(11,912)
Income taxes payable	2,572	8,410
Net cash provided from operating activities	57,945	53,877
Cash flows from investing activities:		
Acquisition payments, net of cash acquired	(66,665)	(65,851)
Purchase of short-term investments	(10,341)	(8,446)
Maturities of short-term investments	5,900	7,000
Purchase of property and equipment	(8,011)	(4,161)
Proceeds from sale of assets	6,102	
Net cash used in investing activities	(73,015)	(71,458)
Cash flows from financing activities:		
Borrowings on line of credit	123,000	149,000
Payments on line of credit	(123,000)	(157,800)
Payments on capital lease obligations	(399)	(135)
Payments to refinance line of credit		(172)
Excess tax benefit from exercises of stock options and vesting of restricted stock	7,561	
Proceeds from issuance of common stock	25,561	25,291
Net cash provided from financing activities	32,723	16,184

Net increase (decrease) in cash and cash equivalents	17,653	(1,397)
Cash and cash equivalents at beginning of period	11,192	7,011
Cash and cash equivalents at end of period	$ 28,845	$ 5,614

(1) Includes adjustments resulting from stock option review as described in Note 3 Restatement of Consolidated Financial Statements.

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

PEDIATRIX MEDICAL GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2006
(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 (other than as described in Note 3), 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.

On April 4, 2006, the Company announced that its Board of Directors authorized a two-for-one stock split of the Company s common stock. Shareholders of record at the close of business on April 13, 2006 received one additional share of Pediatrix common stock for each share held of record on that date. The shares were issued on April 27, 2006. In order to complete the stock split, the Company s Articles of Incorporation were amended to increase the number of authorized shares from 50 million to 100 million. Following the effective date of the stock split, the par value of the Company s common stock remained at $.01 per share. As a result, the Company increased common stock presented in the condensed consolidated balance sheet and the condensed consolidated statement of shareholders equity as of December 31, 2005 by $238,000 with a corresponding decrease in additional paid-in capital. Share and per share amounts for all periods presented in the condensed consolidated financial statements and notes thereto have been adjusted to reflect the effect of the two-for-one stock split.

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 Annual Report on Form 10-K for the year ended December 31, 2006 to be filed with the SEC.

2. Summary of Significant Accounting Policies:

Stock Incentive Plans and Employee Stock Purchase Plans

The Company awards restricted stock and grants stock options to key employees under its stock incentive plans (the Stock Incentive Plans). As permitted under Statement of Financial Accounting Standards No. 123 (FAS 123), Accounting for Stock-Based Compensation, the Company accounted for stock-based compensation to employees using the intrinsic value method prescribed by APB Opinion No. 25 Accounting for Stock Issued to Employees and its related interpretations (APB 25) through December 31, 2005. The Company recognizes compensation cost for stock-based compensation over the requisite service period using the graded vesting attribution method.

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R) (FAS 123(R)) Share-Based Payment using the modified prospective application method. This statement is a revision to

FAS 123, supersedes APB 25, amends Statement of Financial Accounting Standards No. 95, Statement of Cash Flows, and requires companies to expense stock-based awards issued to employees. The modified prospective application method of adoption applies to new stock-based awards, changes in stock-based awards and the unvested portion of outstanding stock-based awards after the effective date.

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PEDIATRIX MEDICAL GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED
(Unaudited)

2. Summary of Significant Accounting Policies, Continued:

In accordance with 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 condensed consolidated statements of income for the three and six months ended June 30, 2006 include stock-based compensation expense calculated in accordance with FAS 123(R) for the Company s Stock Incentive Plans and the Company s employee stock purchase plans (the Stock Purchase Plans). In addition, the Company s condensed consolidated statement of cash flows for the six months ended June 30, 2006 includes the excess tax benefits related to the exercise of stock options and the vesting of restricted stock as a cash inflow from financing activities. This change in cash flow presentation had the effect of decreasing cash flows from operating activities and increasing cash flows from financing activities by $7.6 million. 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 Stock Purchase Plans.

Had compensation expense been determined based on the fair value accounting provisions of FAS 123 for the three and six months ended June 30, 2005, the Company s net income and net income per share would have been reduced to the pro forma amounts below (in thousands, except per share data):

	Three Months Ended June 30, 2005 As Restated (1)	Six Months Ended June 30, 2005 As Restated (1)
Net income, as restated	$ 26,787	$ 44,316
Add: Stock-based compensation expense included in restated net income, net of related tax effects	226	624
Deduct: Total stock-based employee compensation expense related to stock options determined under fair value accounting rules, net of related tax effect	(2,358)	(4,624)
Pro forma net income, as restated	$ 24,655	$ 40,316
Net income per share:		

As restated:				
Basic	$	0.58	$	0.97
Diluted	$	0.56	$	0.93
Pro forma, as restated:				
Basic	$	0.53	$	0.88
Diluted	$	0.51	$	0.85

(1) Includes adjustments resulting from the stock option review as described in Note 3, Restatement of Consolidated Financial Statements.

Accounting Pronouncements

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. FIN 48 is effective for fiscal years beginning after December 15, 2006. The provisions of FIN 48 are effective for the Company as the beginning of 2007 with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. Based on the Company s assessment, it anticipates that it will record a decrease to opening retained earnings during the first quarter of 2007 to increase reserves for uncertain tax positions by approximately $7.7 million.

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PEDIATRIX MEDICAL GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED
(Unaudited)

2. Summary of Significant Accounting Policies, Continued:

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB No. 108), Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB No. 108 addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements and is effective for fiscal years ending after November 15, 2006. SAB No. 108 requires companies to quantify misstatements using a balance sheet and income statement approach and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. SAB No. 108 permits existing public companies to initially apply its provisions either by (i) restating prior financial statements as if the dual approach had always been used or (ii) recording the cumulative effect of initially applying the dual approach as adjustments to the carrying value of assets and liabilities as of January 1, 2006 with an offsetting adjustment recorded to the opening balance of retained earnings. The adoption of the provisions of SAB No. 108 had no impact on the Company s Consolidated Financial Statements.

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.

3. Restatement of Consolidated Financial Statements:

The Company has restated its consolidated financial statements to reflect additional non-cash stock-based compensation expense and related tax effects with regard to past stock option grants.

Background

In June 2006, management of the Company began an informal limited review of its past stock option grant practices in response to a shareholder inquiry following various media reports regarding option granting practices at other companies. Management apprised the Audit Committee of the Company s Board of Directors of this informal limited review and the Audit Committee provided guidance with respect to the scope of the review. In August 2006, findings from this limited review were presented to the Audit Committee and the Company s independent certified registered public accounting firm. Based on these findings, the Audit Committee decided to initiate a comprehensive review to be undertaken by the Audit Committee with the assistance of independent legal counsel and forensic accounting experts. The review covered all stock options granted by the Company from the date of its initial public offering in September 1995 through the Company s option issuances in June 2006 (the Relevant Period).

In July 2007, the Audit Committee completed its review. The key findings, based on the evidence reviewed, are as follows:

The Audit Committee identified 56 grants made on seven dates between April 1997 and August 2000 which the Audit Committee found were backdated. No instances of backdating were identified after August 2000. The Audit Committee used the term backdating to connote deliberate selection of grant measurement dates to obtain an option exercise price that was lower than would otherwise be the case. The Audit Committee used this term to describe grants which apparently involved deliberate, opportunistic use of market prices.

The Audit Committee did not find evidence establishing intentional misconduct by any of the Company s current executive officers.

The Audit Committee believes that it received full cooperation from all of the Company s current executive officers.

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PEDIATRIX MEDICAL GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED
(Unaudited)

3. Restatement of Consolidated Financial Statements, Continued:

The Audit Committee did not find evidence establishing that the Board, any committee of the Board, or any non-executive director participated in backdating or was aware of backdating during the time that it occurred.

During the time period from April 1997 to August 2000 when backdating occurred, the administration and processing of option grants was directed by a former officer who later became a director of the Company. This individual continued to direct the Company s options program after resigning as an officer in May 2000, while remaining with the Company to work on special projects. During this time period, this individual appears to have been responsible for selecting favorable dates for option grants in all but one instance where a record was located regarding favorable date selection. The Audit Committee concluded that this individual knew or should have known the accounting implications of his actions. Further, the Audit Committee identified three occasions on which this individual was able to benefit by affecting the measurement date of options that were granted to him. The Audit Committee found that this individual realized approximately $12,000 from the backdating of these options based on the revised measurement dates assigned to them.

The Audit Committee identified numerous instances in which applicable accounting principles were misapplied and/or process deficiencies or administrative errors occurred resulting in the application of inappropriate measurement dates to option grants. The Audit Committee also identified inadequate record keeping, documentation, disclosure and systems with respect to the stock option grant process, including records of meetings, which in some cases, could not be corroborated in support of option grants on measurement dates that corresponded to periodic low points in the Company s stock price.

The Audit Committee determined that, although these matters did not establish that senior management engaged in intentional misconduct, current senior management did not adequately ensure that these processes and systems were proper, including the Company s current President and Chief Operating Officer and Chief Financial Officer, who were also found to have played a role in the granting of stock options to others that involved errors and process deficiencies.

With respect to the Company&#