

MATRIA HEALTHCARE INC

Form 10-Q

August 07, 2007

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**SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED June 30, 2007
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 0-20619
MATRIA HEALTHCARE, INC.
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

20-2091331
(I.R.S. Employer
Identification No.)

1850 Parkway Place
Marietta, Georgia 30067

(770) 767-4500

(Address of principal executive offices) (Zip Code)

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined by 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

The number of shares outstanding of the issuer's only class of common stock, \$.01 par value, as of August 1, 2007, was 21,379,089.

MATRIA HEALTHCARE, INC.
QUARTERLY REPORT ON FORM 10-Q
JUNE 30, 2007
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Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements**

Matria Healthcare, Inc. and Subsidiaries
Consolidated Condensed Balance Sheets
(Amounts in thousands, except per share amounts)
(Unaudited)

| | June 30, 2007 | December 31, 2006 |
|--|--------------------------|----------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 14,152 | \$ 19,839 |
| Restricted cash | | 1,372 |
| Trade accounts receivable, less allowances of \$3,616 and \$4,397 at June 30, 2007 and December 31, 2006, respectively | 53,245 | 52,985 |
| Prepaid expenses and other current assets | 13,970 | 14,234 |
| Deferred income taxes | 18,684 | 8,087 |
| Total current assets | 100,051 | 96,517 |
| Property and equipment, net | 39,617 | 38,950 |
| Goodwill, net | 497,435 | 500,830 |
| Other intangibles, net | 52,319 | 55,891 |
| Deferred income taxes | | 5,564 |
| Other assets | 11,418 | 13,621 |
| | \$ 700,840 | \$ 711,373 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable, principally trade | \$ 8,306 | \$ 13,846 |
| Current installments of long-term debt | 45,002 | 4,197 |
| Unearned revenues | 13,184 | 13,493 |
| Acquisition contingent consideration | | 54,223 |
| Accrued liabilities | 19,128 | 22,661 |
| Total current liabilities | 85,620 | 108,420 |
| Long-term debt, excluding current installments | 265,071 | 275,938 |
| Deferred tax liability | 8,083 | |
| Other long-term liabilities | 6,575 | 8,039 |
| Total liabilities | 365,349 | 392,397 |
| Shareholders' equity: | | |
| Preferred stock, \$.01 par value. Authorized 50,000 shares; none outstanding at June 30, 2007 and December 31, 2006 | | |

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| | | |
|---|------------|------------|
| Common stock, \$.01 par value. Authorized 50,000 shares; issued and outstanding 21,362 and 21,255 at June 30, 2007 and December 31, 2006, respectively | 214 | 213 |
| Additional paid-in capital | 423,276 | 415,950 |
| Accumulated deficit | (88,101) | (97,149) |
| Accumulated other comprehensive earnings (loss) | 102 | (38) |
| Total shareholders' equity | 335,491 | 318,976 |
| | \$ 700,840 | \$ 711,373 |

See accompanying notes to consolidated condensed financial statements.

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Matria Healthcare, Inc. and Subsidiaries
Consolidated Condensed Statements of Operations

(Amounts in thousands, except per share amounts)

(Unaudited)

| | Three Months Ended | | Six Months Ended | |
|---|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2007 | 2006 | 2007 | 2006 |
| Revenues | \$ 88,120 | \$ 82,627 | \$ 174,144 | \$ 163,533 |
| Cost of revenues | 26,719 | 26,590 | 53,212 | 52,861 |
| Selling and administrative expenses | 44,881 | 38,857 | 88,045 | 78,818 |
| Provision for doubtful accounts | 1,183 | 912 | 2,402 | 1,764 |
| Amortization of intangible assets | 1,786 | 1,786 | 3,572 | 3,572 |
| Total costs and operating expenses | 74,569 | 68,145 | 147,231 | 137,015 |
| Operating earnings from continuing operations | 13,551 | 14,482 | 26,913 | 26,518 |
| Interest income | 534 | 353 | 912 | 731 |
| Interest expense | (6,017) | (6,992) | (11,665) | (13,563) |
| Other income, net | 4 | 464 | 327 | 569 |
| Earnings from continuing operations before income taxes | 8,072 | 8,307 | 16,487 | 14,255 |
| Income tax expense | (3,157) | (3,473) | (6,611) | (6,005) |
| Earnings from continuing operations | 4,915 | 4,834 | 9,876 | 8,250 |
| Earnings (loss) from discontinued operations, net of income taxes | (6) | 2,391 | (160) | 3,898 |
| Net earnings | \$ 4,909 | \$ 7,225 | \$ 9,716 | \$ 12,148 |
| Net earnings per common share: | | | | |
| Basic: | | | | |
| Continuing operations | \$ 0.23 | \$ 0.23 | \$ 0.46 | \$ 0.39 |
| Discontinued operations | | 0.11 | | 0.19 |
| | \$ 0.23 | \$ 0.34 | \$ 0.46 | \$ 0.58 |
| Diluted: | | | | |
| Continuing operations | \$ 0.22 | \$ 0.22 | \$ 0.45 | \$ 0.38 |
| Discontinued operations | | 0.11 | (0.01) | 0.18 |
| | \$ 0.22 | \$ 0.33 | \$ 0.44 | \$ 0.56 |

Weighted average shares outstanding:

| | | | | |
|---------|--------|--------|--------|--------|
| Basic | 21,347 | 20,970 | 21,326 | 20,916 |
| Diluted | 21,952 | 21,574 | 21,898 | 21,660 |

See accompanying notes to consolidated condensed financial statements.

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Matria Healthcare, Inc. and Subsidiaries
Consolidated Condensed Statements of Cash Flows
(Amounts in thousands)
(Unaudited)

| | Six Months Ended | |
|--|-------------------------|-------------|
| | June 30, | |
| | 2007 | 2006 |
| Cash Flows from Operating Activities: | | |
| Net earnings | \$ 9,716 | \$ 12,148 |
| Less earnings (loss) from discontinued operations, net of income taxes | (160) | 3,898 |
| Earnings from continuing operations | 9,876 | 8,250 |
| Adjustments to reconcile earnings from continuing operations to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization (including debt discount and expenses) | 10,742 | 10,167 |
| Provision for doubtful accounts | 2,402 | 1,764 |
| Deferred income taxes | 3,050 | 6,005 |
| Share-based compensation | 5,864 | 3,248 |
| Excess tax benefit share-based compensation | (150) | |
| Imputed interest on acquisition consideration | | 1,747 |
| Changes in assets and liabilities: | | |
| Trade accounts receivable | (2,661) | (6,150) |
| Prepaid expenses and other current assets | (419) | (56) |
| Noncurrent assets | (241) | (222) |
| Accounts payable | (5,540) | (4,631) |
| Accrued and other liabilities | (3,163) | (18,003) |
| Net cash provided by continuing operations | 19,760 | 2,119 |
| Net cash used in discontinued operations | (1,543) | (5,732) |
| Net cash provided by (used in) operating activities | 18,217 | (3,613) |
| Cash Flows from Investing Activities: | | |
| Purchases of property and equipment | (6,406) | (5,526) |
| Payment of acquisition obligations | (50,745) | (1,677) |
| Decrease in restricted cash | 1,372 | 11 |
| Purchases of property and equipment related to discontinued operations | | (327) |
| Acquisition of business, net of cash received | | (434,727) |
| Net cash used in investing activities | (55,779) | (442,246) |
| Cash Flows from Financing Activities: | | |
| Proceeds from the issuance of long-term debt, net of transaction costs | | 443,977 |
| Proceeds from short-term borrowings | 41,799 | 2,556 |
| Principal repayments of debt | (11,539) | (2,648) |

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| | | |
|--|-----------|-----------|
| Proceeds from issuance of common stock | 1,465 | 2,139 |
| Excess tax benefit share-based compensation | 150 | |
| Net cash provided by financing activities | 31,875 | 446,024 |
| Effect of exchange rate changes on cash and cash equivalents | | 336 |
| Net increase (decrease) in cash and cash equivalents | (5,687) | 501 |
| Cash and cash equivalents at beginning of year | 19,839 | 22,758 |
| Cash and cash equivalents at end of period | \$ 14,152 | \$ 23,259 |
| Supplemental disclosure of cash paid for: | | |
| Interest | \$ 10,275 | \$ 15,939 |
| Income taxes | \$ 2,410 | \$ 1,345 |

See accompanying notes to consolidated condensed financial statements.

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(Unaudited)**1. General**

The consolidated condensed financial statements as of June 30, 2007, and for the three-month and six-month periods ended June 30, 2007 and 2006, respectively, are unaudited. The consolidated condensed balance sheet as of December 31, 2006, was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States. In preparing financial statements, it is necessary for management to make assumptions and estimates affecting the amounts reported in the consolidated financial statements and related notes. These estimates and assumptions are developed based upon all information available. Actual results could differ from estimated amounts. In the opinion of management, all adjustments, consisting of normal recurring accruals, necessary for fair presentation of the consolidated condensed financial position and results of operations for the periods presented have been included. The results for the three and six months ended June 30, 2007, are not necessarily indicative of the results that may be expected for the full year ending December 31, 2007.

The consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2006. References herein to we, us, our, the Company, and Matria refer to Matria Healthcare, Inc. and its consolidated subsidiaries.

2. Recently Issued and Recently Adopted Accounting Standards

Accounting for Uncertainty in Income Taxes. We adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48 or Interpretation) on January 1, 2007. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. See Note 5, Income Taxes.

Fair Value Option. In February 2007, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* (SFAS 159), which permits entities to choose to measure many financial instruments and certain other items at fair value. Entities that elect the fair value option will report unrealized gains and losses in earnings at each subsequent reporting date. The fair value option may be elected on an instrument-by-instrument basis with a few exceptions. SFAS 159 also establishes presentation and disclosure requirements to facilitate comparisons between companies that choose different measurement attributes for similar assets and liabilities. The requirements of SFAS 159 are effective for our fiscal year beginning January 1, 2008. We are currently assessing the potential impact of implementing this standard. However, we do not expect the implementation to have a material adverse effect on our results of operations or financial position.

3. Acquisition Contingent Consideration

In connection with Matria's acquisitions of WinningHabits, Inc. (WinningHabits) on October 1, 2005, and Miavita LLC (Miavita) on April 1, 2005, we were required to pay additional consideration in future periods, based upon the financial performance of these businesses in specified post-closing periods.

The additional consideration for the WinningHabits acquisition is based on the acquired company's 2006 financial performance. At March 31, 2007, we computed the additional consideration pursuant to the terms of our earn-out agreement to be \$27.9 million. On May 1, 2007, the sellers filed a notice of objection,

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objecting to certain aspects of the calculation. The sellers agreed to accept \$28.7 million of additional consideration, which we paid on June 8, 2007.

The second earn-out period for the Miavita acquisition ended March 31, 2007. On November 6, 2006, the Company and the seller entered into a Settlement Agreement and Release that effectively amended the terms of the original acquisition agreement to fix the amount payable for the second earn-out period at \$20.0 million plus 3.575 times net revenues from certain new customers between November 6, 2006, and March 31, 2007, provided that no payment was payable in respect of the second earn-out period unless payments received from such new customers between November 6, 2006, and May 1, 2007, were at least \$500,000. The \$500,000 threshold was met, and the Company paid a total of \$22.0 million during the quarter with respect to the second earn-out period. Additional earn-out payments will be payable in future periods based on a percentage of specified revenues pertaining to certain customer agreements.

We decreased goodwill by \$3.4 million in the first six months of 2007 for the change in additional consideration payable under the earn-out agreements noted above.

4. Comprehensive Earnings

Comprehensive earnings generally include all changes in equity during a period except those resulting from investments by owners and distributions to owners. Comprehensive earnings consist of net earnings, foreign currency translation adjustments (net of income taxes) and net unrealized gains on derivative instruments. Comprehensive earnings for the three-month and six-month periods ended June 30, 2007 were \$5.1 million and \$9.9 million, respectively, and for the corresponding periods in 2006 were \$8.7 million and \$14.0 million, respectively.

5. Income Taxes

As required, we adopted FIN 48 on January 1, 2007. As a result of implementing this Interpretation, we derecognized \$524,000 in income tax benefits for certain tax positions for which there is uncertainty and recognized \$145,000 of related interest and penalties. These adjustments resulted in increases of \$669,000 to beginning Accumulated deficit and to Other long-term liabilities. As of January 1, 2007 and June 30, 2007, the amount of unrecognized tax benefits was \$524,000 that, if recognized, would favorably affect the effective income tax rate in future periods. During the first six months of 2007, we recorded interest and penalties of approximately \$33,000. It is our policy to classify interest and penalties recognized on underpayment of income taxes as Interest expense and Other income, net, respectively.

At this time, we do not believe that it is reasonably possible that there will be a material change in the estimated unrecognized tax benefits within the next twelve months.

The Company and its subsidiaries file income tax returns in the U.S. Federal jurisdiction and in various states. Tax years that remain subject to examination for federal and various state jurisdictions are from 1996 to present.

Table of Contents**6. Earnings (Loss) Per Share**

The computations for basic and diluted net earnings (loss) per common share are as follows (in thousands, except per share amounts):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--|-------------|--------------------------------------|-------------|
| | 2007 | 2006 | 2007 | 2006 |
| Net earnings (loss) basic and diluted: | | | | |
| Continuing operations | \$ 4,915 | \$ 4,834 | \$ 9,876 | \$ 8,250 |
| Discontinued operations | (6) | 2,391 | (160) | 3,898 |
| Net earnings available to common shareholders | \$ 4,909 | \$ 7,225 | \$ 9,716 | \$ 12,148 |
| Shares: | | | | |
| Weighted average common shares outstanding basic | 21,347 | 20,970 | 21,326 | 20,916 |
| Dilutive effect of: | | | | |
| Stock options and employee stock purchase plan | 495 | 604 | 476 | 744 |
| Unvested restricted stock awards | 110 | | 96 | |
| Weighted average common shares outstanding diluted | 21,952 | 21,574 | 21,898 | 21,660 |
| Basic: | | | | |
| Continuing operations | \$ 0.23 | \$ 0.23 | \$ 0.46 | \$ 0.39 |
| Discontinued operations | | 0.11 | | 0.19 |
| | \$ 0.23 | \$ 0.34 | \$ 0.46 | \$ 0.58 |
| Diluted: | | | | |
| Continuing operations | \$ 0.22 | \$ 0.22 | \$ 0.45 | \$ 0.38 |
| Discontinued operations | | 0.11 | (0.01) | 0.18 |
| | \$ 0.22 | \$ 0.33 | \$ 0.44 | \$ 0.56 |

The calculation of diluted earnings (loss) per share excludes the antidilutive effect of 1.2 million shares for stock options in both the three-month and six-month periods ended June 30, 2007, and 1.2 million and 1.1 million shares, respectively, in the corresponding periods of 2006. In the three-month and six-month periods of 2007, the computation excludes the antidilutive effect of 377,000 shares for unvested restricted stock awards; the computation for the comparable periods in 2006 excludes the antidilutive effect of 230,000 shares for unvested restricted stock awards.

7. Share -Based Compensation

The Company's Long-Term Stock Incentive Plan (the "LTIP") and 2005 Directors' Non-Qualified Stock Option Plan provide for the issuance of stock options, restricted stock units and other share based awards to employees and to non-employee directors. At June 30, 2007, the plans permit the granting of share based awards of up to approximately 836,000 shares of common stock. The options are granted with an exercise price equal to the fair market value of the Company's common stock on the date of grant and vest monthly over 12 months from the date of grant under the 2005 Director's Non-Qualified Stock Option Plan and over a period of years (generally three to five) under the LTIP, subject

to eligibility status as specified in the individual option agreement. The term of each stock option is ten years from the date of grant. Restricted stock vests over a period of years (generally three), subject to eligibility status and, in some cases, satisfactory achievement of performance goals, in each case as specified in the individual restricted stock agreement.

The Company also has options and shares available for grant under various other plans, the provisions of which are similar to the plans described above. Due to forfeitures of previously issued grants, at June 30, 2007, there were approximately 2,000 options and shares available for grant under these plans.

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Our Employee Stock Purchase Plan (the "Purchase Plan") allows employees to purchase the Company's common stock at the lower of 85% of the fair market value per share on either the first or last business day of the quarter, limited to a maximum of the lesser of 10% of the employee's compensation or 375 shares of common stock per quarter. During the six months ended June 30, 2007 and 2006, we issued approximately 36,000 and 19,000 shares, respectively, under the Purchase Plan. At June 30, 2007, approximately 76,000 shares were reserved for purchase under the Purchase Plan.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model. The weighted average fair values of stock options granted during the six months ended June 30, 2007 and 2006 were \$13.22 and \$16.17, respectively. The following assumptions were used for calculating the fair value of our option awards:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------------|--------------------------------|-------|------------------------------|-------|
| | 2007 | 2006 | 2007 | 2006 |
| Risk-free interest rates | 4.95% | 5.20% | 4.95% | 4.88% |
| Expected lives (in years) | 4 | 4 | 4 | 4 |
| Dividend yield | NA | NA | NA | NA |
| Expected volatility | 46.4% | 53.8% | 46.4% | 56.1% |

The following table summarizes our stock option activity during the six months ended June 30, 2007 (shares in thousands):

| | Shares | Exercise Price | Weighted Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value |
|--------------------------------------|--------|----------------|---|---------------------------|
| Outstanding at January 1, 2007 | 2,487 | \$ 22.26 | | |
| Granted | 42 | \$ 31.41 | | |
| Exercised | (63) | \$ 11.79 | | |
| Forfeited/expired/cancelled | (83) | \$ 28.90 | | |
| Outstanding at the June 30, 2007 | 2,383 | \$ 22.46 | 6.8 | \$ 21,302 |
| Options exercisable at June 30, 2007 | 1,295 | \$ 18.05 | 5.7 | \$ 16,667 |

The total aggregate intrinsic value of options exercised during the six-month period ended June 30, 2007, was \$1.0 million.

The following table summarizes information regarding our stock options outstanding at June 30, 2007 (shares in thousands):

| Range of Exercise Prices | Shares | Outstanding | Weighted Average Exercise Price | Exercisable | Weighted Average Exercise Price |
|--------------------------|--------|---|---------------------------------|-------------|---------------------------------|
| | | Weighted Average Remaining Contractual Life (years) | | Shares | |
| \$4.57 - \$12.37 | 636 | 4.2 | \$ 9.70 | 591 | \$ 9.85 |

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|---------|---------|-------|-----|---------|-------|---------|
| \$12.61 | \$28.03 | 685 | 6.8 | \$19.05 | 315 | \$16.45 |
| \$28.16 | \$34.11 | 630 | 8.3 | \$29.94 | 255 | \$29.70 |
| \$34.47 | \$40.33 | 432 | 8.3 | \$35.80 | 134 | \$35.90 |
| | | 2,383 | 6.8 | \$22.46 | 1,295 | \$18.05 |

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The following table summarizes our restricted stock award activity for the six-month period ended June 30, 2007 (shares in thousands):

| | Shares | Weighted Average Grant Date Fair Value Per Share |
|------------------------------|---------------|---|
| Nonvested at January 1, 2007 | 221 | \$28.10 |
| Granted | 448 | 27.97 |
| Vested | (11) | 28.16 |
| Forfeited | (23) | 28.04 |
| Nonvested at June 30, 2007 | 635 | \$28.00 |

For the three months and six months ended June 30, 2007, we recorded share-based compensation of \$3.2 million (\$2.1 million net of income tax, or \$0.10 per diluted share) and \$5.9 million (\$3.9 million net of income tax, or \$0.18 per diluted share), respectively. For the corresponding periods in 2006, we recorded share-based compensation of \$1.8 million (\$1.3 million net of income tax, or \$0.06 per diluted share) and \$3.2 million (\$2.3 million net of income tax, or \$0.11 per diluted share), respectively. The expense is included in Selling and administrative expenses on the consolidated condensed statement of operations. We did not capitalize any share-based compensation costs in any period. Cash received from option exercises and shares issued under all share-based payment arrangements for the six months ended June 30, 2007 and 2006 was \$1.5 million and \$2.1 million, respectively.

At June 30, 2007, total compensation cost related to unvested share-based awards granted to employees under stock option plans but not yet recognized was approximately \$23.5 million, after estimating forfeitures and before income taxes. The cost of all unvested share-based awards is expected to be recognized over an estimated weighted average period of approximately 3.0 years. Our restricted stock awards are performance-based and service-based. Expense for restricted stock awards is recognized using the tranche method (performance-based awards) or the straight line method (service-based awards) over the vesting period, which is the longer of the service period or the period that the performance condition is expected to be met. As a result, the remaining unrecognized compensation costs for the performance-based restricted stock awards may vary each reporting period based on changes in the expected achievement of performance measures.

8. Long-Term Debt

On January 19, 2006, in connection with our acquisition of CorSolutions, we entered into a \$485.0 million credit agreement and a second lien term loan facility with Bank of America, N.A., as administrative and collateral agent (the Credit Facilities). Amounts borrowed under the Credit Facilities, as amended, accrue interest at a variable spread over LIBOR, with the applicable spread determined by the Company's consolidated leverage ratio, as described in the applicable credit agreement. Interest rates for the Credit Facilities are reset quarterly. Amounts borrowed are fully and unconditionally guaranteed on a joint and several basis by substantially all of our subsidiaries. The Credit Facilities mature on January 19, 2012. As of June 30, 2007, the outstanding balance under the Credit Facilities was \$268.5 million.

The Credit Facilities also provide for a Revolving Credit Facility. Amounts borrowed under the Revolving Credit Facility accrue interest at a variable spread over LIBOR or the prime rate, at our option, with the applicable spread determined by reference to our consolidated leverage ratio, as described in the credit agreement. On February 23, 2007, we entered into a third amendment to the Credit Facilities, the terms of which increased our borrowing capacity under the Revolving Credit Facility from \$30.0 million to \$50.0 million. All other terms of the Credit Facilities, as amended, remain unchanged. At June 30, 2007, there was \$40.0 million outstanding under the Revolving Credit Facility, and the available balance was \$8.6 million.

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The Credit Facilities contain, among other things, various representations, warranties and affirmative, negative and financial covenants customary for financings of this type. The negative covenants include, without limitation, certain limitations on transactions with affiliates, liens, making investments, the incurrence of debt, sales of assets, and changes in business. The financial covenants contained in the Credit Facilities include a consolidated leverage ratio and a consolidated fixed charges coverage ratio. At June 30, 2007, we were in compliance with all covenants of the Credit Facilities.

The weighted average interest rates, including amortization of debt discount and expense, on all outstanding indebtedness were 8.72% and 8.40% for the three-month and six-month periods ended June 30, 2007, respectively, and 9.00% and 9.15% for the corresponding periods in 2006.

9. Derivative Financial Instruments

In February and May 2006, we entered into two interest rate swap agreements, each with a notional amount of \$100.0 million, to hedge exposure to fluctuations in interest rates related to our Credit Facilities. The agreements, which have two-year terms, have the economic effect of converting \$200.0 million of floating-rate debt under the Credit Facilities to fixed-rate debt. Under the terms of the agreements, we will pay the bank fixed base rates of 5.065% and 5.350%, respectively, and the bank will pay us floating rates based on three-month LIBOR (5.36% at June 30, 2007). The variable rates are reset quarterly.

On the dates the interest rate swap derivative contracts were entered into, we designated the derivatives as hedges of the variability of cash flow to be paid (cash flow hedge). Under cash flow hedge accounting, changes in the fair value of a derivative that is qualified, designated and highly effective as a cash flow hedge are recorded in other comprehensive income until earnings are affected by the variability of cash flows. We reflected the interest rate swap agreements on the consolidated condensed balance sheets at fair value (\$167,000 receivable and \$62,000 payable at June 30, 2007 and December 31, 2006, respectively), which was based upon the estimated amount we would receive or pay upon settlement of the agreements taking into account interest rates on those dates. For the three-month and six-month periods ended June 30, 2007, we recognized net gains of \$75,000 and \$153,000, respectively, from the cash flow hedges. We recognized net losses of \$53,000 and \$82,000 for the corresponding periods in 2006. These amounts are included in Interest expense in the consolidated condensed statements of operations.

10. Contingencies

Pursuant to the CorSolutions Merger Agreement, we are pursuing a claim before a contractually-designated settlement accountant for certain post-closing adjustments including a \$4.0 million claim relating to a liability resulting from CorSolutions pre-closing performance under a customer contract and a \$1.3 million claim relating to certain preacquisition tax obligations. We are also pursuing claims for fraud and breach of contract before the American Arbitration Association in Chicago, Illinois, seeking damages in an unspecified amount exclusive of and in addition to the amounts claimed as post-closing adjustments. There is no assurance that we will prevail in either of these proceedings. However, if we do prevail, any resulting award will impact our goodwill and/or our pretax earnings.

We are involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, based in part on the advice of counsel, the ultimate disposition of these matters will not have a material adverse effect on the Company's consolidated balance sheet, results of operations or liquidity.

Table of Contents**11. Divestitures**

On September 1, 2006, and October 17, 2006, we completed the sales of Facet Technologies, LLC (Facet) and our foreign diabetes services operations in Germany (Dia Real), respectively. As a result, the accompanying consolidated condensed financial statements reflect the operations of these divisions as discontinued operations for all periods presented. In connection with the sales, we accrued \$1.3 million for other liabilities related to the divestitures. A reconciliation of the accrued liability balance is as follows (in thousands):

| | Employee Termination Benefits | Lease Obligations | Other Accruals | Total |
|--------------------------|--|------------------------------|---------------------------|--------------|
| Balance January 1, 2007 | \$ 290 | 872 | 124 | \$ 1,286 |
| Charges | 6 | | 98 | 104 |
| Payments | (296) | (872) | (195) | (1,363) |
| Balance at June 30, 2007 | \$ | | 27 | \$ 27 |

The operating results of discontinued operations are as follows (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--|-------------|--------------------------------------|-------------|
| | 2007 | 2006 | 2007 | 2006 |
| Revenues | \$ | \$ 38,064 | \$ | \$ 72,628 |
| Earnings (loss) from discontinued operations | \$ (56) | \$ 4,052 | \$ (265) | \$ 6,634 |
| Income tax benefit (expense) | 50 | (1,661) | 105 | (2,736) |
| Discontinued operations, net of tax | \$ (6) | \$ 2,391 | \$ (160) | \$ 3,898 |

Earnings from discontinued operations before income tax expense for the three-month and six-month periods ended June 30, 2006, include charges of \$2.8 million and \$6.4 million, respectively, for interest expense and deferred financing fees related to our Credit Facilities. These amounts were allocated in accordance with Emerging Issues Task Force (EITF) Issue 87-24, *Allocation of Interest to Discontinued Operations*. Under EITF Issue 87-24, interest on debt that must be repaid upon disposal of discontinued operations must be allocated to discontinued operations. In accordance with the terms of the Credit Facilities, we used the net proceeds from the sales of Facet and Dia Real during the third and fourth quarters of 2006, respectively, to repay a portion of the outstanding indebtedness.

12. Supplemental Disclosures Regarding Revenue

We have one reportable segment that includes our disease and condition management services, wellness programs and maternity management services. The following table summarizes our revenues for these services and programs (amounts in thousands):

| | Three months ended June 30, | | Six months ended June 30, | |
|----------------------------------|--|-------------|--------------------------------------|-------------|
| | 2007 | 2006 | 2007 | 2006 |
| Disease and Condition Management | \$ 54,767 | \$ 51,201 | \$ 107,525 | \$ 102,182 |
| Wellness | 7,202 | 4,463 | 14,032 | 9,001 |
| Maternity Management | 26,151 | 26,963 | 52,587 | 52,350 |

\$ 88,120 \$ 82,627 \$ 174,144 \$ 163,533

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis should be read in conjunction with the other financial information in this Report and the consolidated financial statements and related notes and other financial information in our Annual Report on Form 10-K for the year ended December 31, 2006, as filed with the Securities and Exchange Commission (the Commission or SEC). The discussion contains forward-looking statements that involve risks and uncertainties. Actual results could differ materially from those anticipated in the forward-looking statements as a result of a variety of factors, including those discussed in Risk Factors in the Annual Report. The historical results of operations are not necessarily indicative of future results.

Executive Overview

We are a leading provider of comprehensive, integrated programs and services focused on wellness, disease and condition management, productivity enhancement and informatics. This suite of services, which we call Health Enhancement, is designed to reduce health-related costs and enhance the health and quality of life of the individuals we serve. We provide services to self-insured employers, private and government-sponsored health plans, pharmaceutical companies and patients. Our employer clients are primarily Fortune 1000 companies that self-insure the medical benefits provided to their employees, dependents and retirees. Our health plan customers are regional and national health plans, as well as government-sponsored health plans, such as state Medicaid programs.

Our online, interactive wellness programs address issues such as: smoking cessation, weight loss, exercise, healthier diet, stress relief, healthy aging, and productivity enhancement. These programs are designed to help employees and health plan members live healthier and longer lives while reducing their healthcare costs and increasing their productivity.

Our disease and condition management programs focus on the most costly medical conditions including, without limitation, diabetes, cardiovascular diseases, respiratory disorders, depression, chronic pain, hepatitis C, cancer and high-risk pregnancies. We assist individuals to better manage their conditions by increasing their knowledge about their illnesses or conditions, potential complications and the importance of medication and treatment plan compliance. Depending on acuity, our specialized nurses proactively contact patients to monitor their progress and ensure they are following the plan of care set by their physician.

Table of Contents**Results of Operations****Three Months Ended June 30, 2007, Compared to Three Months Ended June 30, 2006**

The following table summarizes key components in our financial statements for continuing operations for the three-month periods ended June 30, 2007 and 2006, respectively, expressed as a percentage of revenues. An explanation of the results follows the table.

| | Three Months Ended June 30, | |
|---|--|-------------|
| | 2007 | 2006 |
| Revenues | 100.0% | 100.0% |
| Cost of revenues | 30.3% | 32.2% |
| Gross margin | 69.7% | 67.8% |
| Selling and administrative expenses | 50.9% | 47.0% |
| Provision for doubtful accounts | 1.3% | 1.1% |
| Amortization of intangible assets | 2.0% | 2.2% |
| Operating earnings ⁽¹⁾ | 15.4% | 17.5% |
| Interest expense, net | -6.2% | -8.0% |
| Other income, net | 0.0% | 0.6% |
| Earnings from continuing operations before income taxes | 9.2% | 10.1% |
| Income tax expense | -3.6% | -4.2% |
| Earnings from continuing operations | 5.6% | 5.9% |

(1) Amounts may not add due to rounding.

Revenues increased by \$5.5 million, or 6.6%, to \$88.1 million for the three months ended June 30, 2007, from \$82.6 million in the same period in 2006. This increase was due primarily to the implementation of new and expanded disease management and wellness contracts, net of attrition, partially offset by a decrease in revenues from our maternity management services. Disease and condition management program revenues increased \$3.6 million, or 7.0%, to \$54.8 million for the three months ended June 30, 2007. Wellness program revenues were \$7.2 million for the three months ended June 30, 2007, compared to \$4.5 million for the same period in 2006, increasing 61.4%. Maternity management program revenues decreased \$813,000, or 3.0%, to \$26.2 million for the three months ended June 30, 2007, primarily due to decreased preterm labor management revenues, partially offset by higher revenues from our MaternaLink[®] services, which include risk assessment and early intervention programs.

Cost of revenues as a percentage of revenues decreased to 30.3% for the three months ended June 30, 2007, from 32.2% for the same period in 2006. This decrease was primarily due to: (i) an increase in our high-margin disease management and wellness revenues, and (ii) the availability of a lower cost generic drug for Zofran, which is used for nausea and vomiting in our maternity management services.

Selling and administrative expenses increased \$6.0 million to \$44.9 million in the second quarter of 2007, compared to \$38.9 million in the same period of 2006. We incurred increased costs primarily for salaries and other personnel-related expenses and increased depreciation and amortization expenses related to our technology investments. Share-based compensation increased \$1.4 million due to an increase in expense related to our restricted stock awards, which are performance-based and service-based and have shorter vesting periods than the continuing expense resulting from prior years grants of certain stock options dating back to 2003. As a percentage of revenues,

selling and administrative expenses increased to 50.9% in 2007 compared to 47.0% in 2006.

The provision for doubtful accounts as a percentage of revenues was 1.3% for the three months ended June 30, 2007, compared to 1.1% for the same period in 2006. The provision, which is recorded primarily for our maternity management program revenues, is adjusted periodically based upon our quarterly evaluation of historical collection experience, recoveries of amounts previously provided, industry reimbursement trends

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and other relevant factors. The percentage increase results from an increase in bad debts for our disease and condition management and wellness revenues.

Interest expense decreased to \$6.0 million in 2007, from \$7.0 million in 2006, due primarily to lower interest rates combined with a lower outstanding balance of our Credit Facilities, which we entered into in January 2006 in conjunction with our acquisition of CorSolutions. In November 2006, we amended the terms of our Credit Facilities, effectively reducing the interest rate on outstanding indebtedness to LIBOR plus 2.0%, a 475 basis point reduction. The weighted average interest rates, including amortization of debt discount and expense, on all outstanding indebtedness were 8.72% and 9.00% for the three-month periods ended June 30, 2007 and 2006, respectively.

Income tax expense was \$3.2 million and \$3.5 million for the three months ended June 30, 2007 and 2006, respectively. The effective income tax rate is higher than the statutory federal tax rate due to state income taxes and certain non-deductible expenses for tax purposes. Cash outflows for income taxes for continuing and discontinued operations in 2007 and 2006 were \$2.3 million and \$333,000, respectively, comprised of federal alternative minimum taxes, state income taxes and, in 2006, foreign taxes. As of December 31, 2006, our remaining net operating loss carryforwards were \$67.0 million, which will be available to offset future taxable income, subject to certain limitations. We expect to use approximately \$21.7 million of our net operating loss carryforwards in 2007.

Discontinued operations include the operations of Facet Technologies, LLC (Facet) and Dia Real, our foreign diabetes services operations in Germany. The loss from discontinued operations in 2007 was \$6,000, net of tax, compared to earnings of \$2.4 million for the same period in 2006. In the second quarter of 2006, we allocated \$2.8 million of interest expense and amortization expense of deferred financing fees related to the Credit Facilities to discontinued operations in accordance with Emerging Issues Task Force (EITF) Issue 87-24, *Allocation of Interest to Discontinued Operations*. EITF Issue 87-24 states that interest on debt that must be repaid when the disposal of discontinued operations occurs should be allocated to discontinued operations. In accordance with the terms of the Credit Facilities, we used the net proceeds from the sales of Facet in the third quarter of 2006 and Dia Real in the fourth quarter of 2006 to repay a portion of the outstanding indebtedness.

Table of Contents***Six Months Ended June 30, 2007, Compared to Six Months Ended June 30, 2006***

The following table summarizes key components in our financial statements for continuing operations for the six-month periods ended June 30, 2007 and 2006, respectively, expressed as a percentage of revenues. An explanation of the results follows the table.

| | Six Months Ended June 30, | |
|---|--------------------------------------|-------------|
| | 2007 | 2006 |
| Revenues | 100.0% | 100.0% |
| Cost of revenues | 30.6% | 32.3% |
| Gross margin | 69.4% | 67.7% |
| Selling and administrative expenses | 50.6% | 48.2% |
| Provision for doubtful accounts | 1.4% | 1.1% |
| Amortization of intangible assets | 2.1% | 2.2% |
| Operating earnings ⁽¹⁾ | 15.5% | 16.2% |
| Interest expense, net | -6.2% | -7.8% |
| Other income, net | 0.2% | 0.3% |
| Earnings from continuing operations before income taxes | 9.5% | 8.7% |
| Income tax expense | -3.8% | -3.7% |
| Earnings from continuing operations | 5.7% | 5.0% |

(1) Amounts may not add due to rounding.

Revenues increased by \$10.6 million, or 6.5%, to \$174.1 million for the six months ended June 30, 2007, from \$163.5 million in the same period in 2006. The increases were due primarily to the implementation of new and expanded disease management and wellness contracts, net of attrition. Disease and condition management program revenues increased \$5.3 million, or 5.2%, to \$107.5 million for the six-month period ended June 30, 2007. Wellness program revenues increased \$5.0 million, or 55.9%, to \$14.0 million in 2007 from \$9.0 million for the same period in 2006. Maternity management program revenues increased \$238,000, or 0.5%, to \$52.6 million for the six months ended June 30, 2007.

Cost of revenues as a percentage of revenues decreased to 30.6% for the six months ended June 30, 2007, from 32.3% for the same period in 2006. This decrease was primarily due to (i) an increase in our high-margin disease management and wellness revenues, and (ii) the availability of a lower cost generic drug for Zofran, which is used for nausea and vomiting in our maternity management services.

Selling and administrative expenses increased \$9.2 million, or 11.7%, to \$88.0 million in the six months ended June 30, 2007, from \$78.8 million in the same period of 2006. Selling and administrative expenses as a percentage of revenues increased to 50.6% in 2007 from 48.2% in 2006. As noted above, increased costs for salaries and other personnel-related expenses, as well as depreciation and amortization expenses, were major contributors to the increase. Our share-based compensation increased \$2.6 million in the six-month period ended June 30, 2007, due to the recognition of expense from our performance-based and service-based restricted stock awards, which have shorter vesting periods than the continuing expense from prior years grants of certain stock options dating back to 2003.

The provision for doubtful accounts as a percentage of revenues was 1.4% for the six months ended June 30, 2007, compared to 1.1% for the same period in 2006 as a result of an increase in bad debts for our disease and

condition management and wellness revenues.

Interest expense decreased \$1.9 million to \$11.7 million in 2007, from \$13.6 million in 2006 due primarily to lower interest rates and a lower outstanding balance of our Credit Facilities. As noted above, we amended the terms of our Credit Facilities in November 2006, effectively reducing the interest rate on outstanding indebtedness. The weighted average interest rates, including amortization of debt discount and expense, on all outstanding indebtedness were 8.40% and 9.15% for the six months ended June 30, 2007 and 2006, respectively.

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Income tax expense was \$6.6 million and \$6.0 million for the six months ended June 30, 2007 and 2006, respectively. Our effective income tax rates were 40.1% in 2007 and 42.1% in 2006. The effective income tax rate is higher than the statutory federal tax rate due to state income taxes and certain non-deductible expenses for tax purposes. Cash outflows for income taxes for continuing and discontinued operations in 2007 and 2006 were \$2.4 million and \$1.3 million, respectively, comprised of federal alternative minimum taxes, state income taxes and, in 2006, foreign taxes. As of December 31, 2006, our remaining net operating loss carryforwards were \$67.0 million, which will be available to offset future taxable income, subject to certain limitations. We expect to use approximately \$21.7 million of our net operating loss carryforwards in 2007.

Discontinued operations include the operations of Facet and Dia Real. The loss from discontinued operations for the six-month period ended June 30, 2007 was \$160,000, net of tax, compared to earnings of \$3.9 million for 2006. Discontinued operations in 2006 include a pre-tax expense of \$6.4 million for the allocation of interest and deferred financing fees related to the Credit Facilities as discussed above.

Liquidity and Capital Resources***Operating Activities***

As of June 30, 2007, we had cash and cash equivalents of \$14.2 million. In the first six months of 2007, operating activities from continuing operations provided \$19.8 million of cash, compared with \$2.1 million provided in the comparable period of 2006. This increase was due primarily to decreases in accrued and other liabilities in the first six months of 2006 for the payment of transaction-related expenses incurred in the CorSolutions acquisition and a decrease in our days sales outstanding, or DSO, to 54 days at June 30, 2007, from 57 days at June 30, 2006. Our DSO at December 31, 2006, was 54 days.

Net cash used in discontinued operations was \$1.5 million and \$5.8 million for the six-month periods ended June 30, 2007 and 2006, respectively, driven primarily by the payment of certain sale-related expenses. The 2006 period reflects the allocation of \$6.4 million in interest expense (before taxes) referenced above.

Investing Activities

Net cash used in investing activities totaled \$55.8 million and \$442.2 million for the six months ended June 30, 2007 and 2006, respectively. During the second quarter of 2007, we paid \$50.7 million of additional earn-out consideration for our acquisitions of Miavita LLC (April 2005) and WinningHabits, Inc. (October 2005). In 2006, we paid \$1.7 million of additional earn-out consideration for the first earn-out period of the Miavita acquisition. These payments were recorded as additional goodwill.

We used \$6.4 million and \$5.5 million in 2007 and 2006, respectively, for capital expenditures for continuing operations. Capital expenditures for both periods related to the replacement and enhancement of computer information systems and to the replacement of medical devices used in our maternity management programs. We expect to expend a total of approximately \$14 million for capital items in 2007, including capital expenditures made in the first six months.

In 2006, we used \$434.7 million, net of cash acquired, in connection with the acquisition of CorSolutions. We completed the acquisition on January 19, 2006, and results of operations of this business have been included in our consolidated results of operations effective January 1, 2006.

Table of Contents***Financing Activities***

Net cash provided by financing activities was \$31.9 million and \$446.0 million for the six months ended June 30, 2007 and 2006, respectively. During the second quarter of 2007, we borrowed \$40.0 million under our Revolving Credit Facility (described below). We repaid \$11.5 million and \$2.6 million of short-term indebtedness and capital lease obligations during the six-month periods ended June 30, 2007 and 2006, respectively. Our 2007 repayments include \$7.0 million for prepayment on our Credit Facilities and \$2.0 million for the remaining balance of our unsecured 11% Senior Notes, of which \$120 million of the \$122 million then outstanding notes were redeemed in June 2004. Additionally, we received \$1.5 million and \$2.1 million from participants under our stock purchase and stock option plans in the six-month periods ended June 30, 2007 and 2006, respectively. During 2006, we used proceeds of \$444.0 million, net of debt issuance costs of \$11.0 million, from our Credit Facilities described below to fund the acquisition of CorSolutions.

Our Credit Facilities, which mature on January 19, 2012, include a \$485.0 million credit agreement and a second lien term loan facility with Bank of America, N.A., as administrative and collateral agent. Amounts borrowed under the Credit Facilities, as amended, accrue interest at a variable spread over LIBOR, with the applicable spread determined by the Company's consolidated leverage ratio, as described in the applicable credit agreement. Interest rates for the Credit Facilities are reset quarterly. Amounts borrowed are fully and unconditionally guaranteed on a joint and several basis by substantially all of our subsidiaries. As of June 30, 2007, the outstanding balance under the Credit Facilities was \$268.5 million.

The Credit Facilities also provide for a Revolving Credit Facility. Amounts borrowed under the Revolving Credit Facility accrue interest at a variable spread over LIBOR or the prime rate, at our option, with the applicable spread determined by reference to our consolidated leverage ratio, as described in the credit agreement. On February 23, 2007, we entered into a third amendment to the Credit Facilities, the terms of which increased our borrowing capacity under the Revolving Credit Facility from \$30.0 million to \$50.0 million. All other terms of the Credit Facilities, as amended, remain unchanged. At June 30, 2007, \$40.0 million was outstanding under the Revolving Credit Facility, and the available balance was \$8.6 million.

The Credit Facilities contain, among other things, various representations, warranties and affirmative, negative and financial covenants customary for financings of this type. The negative covenants include, without limitation, certain limitations on transactions with affiliates, liens, making investments, the incurrence of debt, sales of assets, and changes in business. The financial covenants contained in the Credit Facilities include a consolidated leverage ratio and a consolidated fixed charges coverage ratio. At June 30, 2007, we were in compliance with all covenants of the Credit Facilities.

In February and May 2006, we entered into two interest rate swap agreements totaling \$200 million notional amount to hedge our exposure to fluctuations in interest rates related to the Credit Facilities. The swap agreements had the economic effect of converting \$200 million of our floating-rate debt under the Credit Facilities to fixed-rate debt. Under the terms of the agreements, we will pay the bank fixed base rates of 5.065% and 5.350%, respectively, and the bank will pay us floating rates based on three-month LIBOR (5.36% at June 30, 2007). We reflected the interest rate swap agreements on the consolidated condensed balance sheet at a fair value of \$167,000 and (\$62,000) at June 30, 2007 and December 31, 2006, respectively, based upon the estimated amount we would receive (pay) upon settlement of the agreements taking into account interest rates on those dates. For the three-month and six-month periods ended June 30, 2007, we recognized net gains of \$75,000 and \$153,000, respectively, from the cash flow hedges. We recognized net losses of \$53,000 and \$82,000 for the corresponding three-month and six-month periods in 2006. These amounts are included in Interest expense in the consolidated condensed statements of operations.

We believe that our cash, other liquid assets, operating cash flows and Credit Facilities, taken together, will provide adequate resources to fund ongoing operating requirements, planned capital expenditures and contractual obligations through at least the next twelve months.

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

We have various contractual obligations that are recorded as liabilities in our consolidated condensed financial statements. Certain other items, such as operating lease obligations, are not recognized as liabilities in our consolidated condensed financial statements but are required to be disclosed. The following sets forth our future minimum payments required under our contractual obligations as of June 30, 2007 (in thousands):

| | Payments Due by Year | | | | |
|---|-----------------------------|-----------------------------|------------------------|------------------------|----------------------------------|
| | Total | Less than 1 Year | 1 - 3 Years | 3 - 5 Years | More than 5 Years |
| Long-term debt obligations ⁽¹⁾ | \$ 391,566 | \$ 66,140 | \$ 46,262 | \$ 279,164 | \$ |
| Capital lease obligations | 63 | 63 | | | |
| Operating lease obligations | 26,593 | 8,210 | 11,663 | 3,613 | 3,107 |
| Other long-term obligations | 5,086 | 1,339 | 2,662 | 1,085 | |
| | \$ 423,308 | \$ 75,752 | \$ 60,587 | \$ 283,862 | \$ 3,107 |

(1) Includes projected interest payments.

Principal and interest payments of \$1.7 million and \$11.2 million, respectively, under the Credit Facilities are payable in the remaining six months of 2007. Capital expenditures of approximately \$14 million, including capital expenditures made in the first six months, are estimated in 2007 as we continue to enhance our computer information systems.

As of June 30, 2007, we did not have any significant off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K, except for our indemnification obligations related to potential breaches of the representations and warranties contained in the definitive agreements to sell Facet and Dia Real, which obligations are capped at \$12.5 million and \$9.9 million, respectively.

Other Factors Affecting Liquidity

In connection with our acquisition of Miavita LLC, we will be required to pay additional earn-out consideration in future periods, based upon specified revenues pertaining to certain customer agreements. In accordance with SFAS No. 141, *Business Combinations*, we accrue contingent consideration obligations upon attainment of the objectives. Additionally, any such payments would result in increases in goodwill.

Uncertainties

We are subject to various legal claims and actions incidental to our business and the businesses of our predecessors, including product liability claims and professional liability claims. We maintain insurance, including insurance covering professional and product liability claims, with customary deductible amounts. There can be no assurance, however, that (i) lawsuits will not be filed against us in the future, (ii) our prior experience with respect to the disposition of litigation is representative of the results that will occur in pending or future cases or (iii) adequate insurance coverage will be available at acceptable prices, if at all, for incidents arising or claims made in the future. There are no pending legal or governmental proceedings to which we are a party that we believe would, if adversely resolved, have a material adverse effect on us. For a discussion of other risks and uncertainties that may affect our business, see *Risk Factors* in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2006.

Table of Contents**Critical Accounting Policies and Estimates**

Critical accounting policies are those policies that require management to make the most challenging, subjective or complex judgments, often because they must estimate the effect of matters that are inherently uncertain and may change in subsequent periods. Critical accounting policies involve judgments and uncertainties that are sufficiently sensitive to result in materially different results under different assumptions and conditions. We believe our most critical accounting policies are described below.

Revenue Recognition and Allowances for Uncollectible Accounts. Our services are provided telephonically and through home-based nursing services through care centers located throughout the United States. In addition, our services are provided through access to our online health and wellness based tools. Revenues are recognized as the related services are rendered and are net of contractual allowances and related discounts.

Our services are paid for primarily on the basis of (i) monthly fees for each employee or member enrolled in a health plan, (ii) each member identified with a particular chronic disease or condition under contract, (iii) each member enrolled in our programs, (iv) fee-for-service, or (v) a fixed rate per case. Billings for certain services occur in advance of services being performed. Such amounts are recorded as Unearned revenues in the consolidated condensed balance sheets. Such amounts are subsequently recognized as revenue as services are performed.

Some contracts provide that a portion of our fees are at-risk (i.e., refundable) if our programs do not achieve certain financial cost savings and clinical performance criteria. Revenues subject to refund are not recognized if (i) sufficient information is not available to calculate performance measurements, or (ii) interim performance measurements indicate that we are not meeting performance targets. If either of these two conditions exists, we record the amounts as Unearned revenues in the consolidated condensed balance sheets. If we do not meet performance levels by the end of the operations period under the contract, we are contractually obligated to refund some or all of the at-risk fees. Historically, such adjustments have been immaterial to our financial condition and results of operations.

A significant portion of our revenues is billed to third-party reimbursement sources. Therefore, the collectibility of all of our accounts receivable varies based on payor mix, general economic conditions and other factors. A provision for doubtful accounts is made for revenues estimated to be uncollectible and is adjusted periodically based upon our evaluation of current industry conditions, historical collection experience, recoveries of amounts previously provided, industry reimbursement trends and other relevant factors which, in the opinion of management, deserve recognition in estimating the allowance for uncollectible accounts. The evaluation is performed at each reporting period for each operating unit with an overall assessment at the consolidated level. The evaluation of the monthly estimates of revenues estimated to be uncollectible has not resulted in material adjustments in any recent period; however, special charges have resulted from certain specific circumstances affecting collectibility. While estimates and judgments are involved and factors impacting collectibility may change, management believes adequate provision has been made for any adjustments that may result from final determination of amounts to be collected.

Goodwill and Identifiable Intangible Assets. Goodwill represents the excess of cost over fair value of net assets acquired. Goodwill arising from business combinations is accounted for under the provisions of SFAS No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*, and is not amortized. Our identifiable intangible assets are amortized over their respective estimated useful lives. As of June 30, 2007, we reported goodwill and identifiable intangible assets at net carrying amounts of \$497.4 million and \$52.3 million, respectively. The total of \$549.7 million represents approximately 78% of our total assets as of June 30, 2007.

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We review goodwill and identifiable intangibles for impairment annually as of December 31 and whenever events or changes in circumstances indicate that the carrying value may not be recoverable. In testing for impairment, we compare the book value of net assets to the fair value of the related reporting units that have goodwill and indefinite life intangibles assigned to them. If the fair value is determined to be less than book value, a second step is performed to compute the amount of impairment. We estimate the fair values of the reporting units based upon earnings multiples for similar precedent transactions as well as the present value of estimated future free cash flows. The approach utilized is dependent on a number of factors, including estimates of future revenues and operating costs, appropriate discount rates and other variables. We base our estimates on assumptions that we believe to be reasonable, but which are unpredictable and inherently uncertain. Therefore, future impairments could result if actual results differ from those estimates. Based on our evaluation, we concluded that no impairment of recorded goodwill and intangibles existed at December 31, 2006.

Accounting for Income Taxes. We account for income taxes using an asset and liability approach. Deferred income taxes are recognized for the tax consequences of temporary differences by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities and net operating loss and tax credit carryforwards. Additionally, the effect on deferred taxes of a change in tax rates is recognized in earnings in the period that includes the enactment date.

The income tax expense for continuing operations was \$6.6 million and \$6.0 million for the six-month periods ended June 30, 2007 and 2006, respectively. Reflected in each period were various non-deductible permanent differences between tax and financial reporting. As of December 31, 2006, our remaining net operating loss carryforwards of \$67.0 million, the tax effect of which is reflected as an asset on the balance sheet in the Deferred income taxes, will be available to offset future taxable income liabilities. Based on projections of taxable income in 2007 and future years, we believe that it is more likely than not that we will fully realize the value of the recorded deferred income tax assets. The amount of the deferred tax asset considered realizable, however, could be reduced if estimates of future taxable income during the carryforward period are reduced. We expect to use approximately \$21.7 million of our net operating loss carryforwards in 2007.

We account for our income tax uncertainties in accordance with the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48), which we adopted on January 1, 2007. See *Recently Issued and Recently Adopted Accounting Standards* below and Note 2 and Note 5 of our Notes to Consolidated Condensed Financial Statements.

Share-Based Compensation. On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)). SFAS 123(R) establishes standards for the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for either equity instruments of the enterprise or liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. SFAS 123(R) eliminates the ability to account for share-based compensation transactions, as we formerly did, using the intrinsic value method as prescribed by Accounting Principles Board, (APB), Opinion No. 25, *Accounting for Stock Issued to Employees*, and generally requires that such transactions be accounted for using a fair-value-based method. Changes in assumptions as to the employee forfeitures assumptions, exercise dates and volatility could have a significant impact on the stock compensation fair value determinations.

The above listing is not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by accounting principles generally accepted in the United States, with no need for management's judgment in their application. There

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are also areas in which management's judgment in selecting any available alternative would not produce a materially different result. See the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2006, which contain additional accounting policies and other disclosures required by accounting principles generally accepted in the United States.

Our senior management has discussed the development and selection of our critical accounting estimates, and this disclosure, with the Audit Committee of our Board of Directors.

Recently Issued and Recently Adopted Accounting Standards

Accounting for Uncertainty in Income Taxes. We adopted the provisions of FIN 48 on January 1, 2007. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. We undertook a comprehensive review of our tax positions, and the cumulative effect of adopting the provisions of FIN 48 to all tax positions resulted in a cumulative effect adjustment to Accumulated deficit of \$669,000. As of the date of adoption, the total amount of unrecognized tax benefits was \$524,000, and interest and penalties were \$145,000.

Fair Value Option. In February 2007, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* (SFAS 159), which permits entities to choose to measure many financial instruments and certain other items at fair value. Entities that elect the fair value option will report unrealized gains and losses in earnings at each subsequent reporting date. The fair value option may be elected on an instrument-by-instrument basis with a few exceptions. SFAS 159 also establishes presentation and disclosure requirements to facilitate comparisons between companies that choose different measurement attributes for similar assets and liabilities. The requirements SFAS 159 are effective for our fiscal year beginning January 1, 2008. We are currently assessing the potential impact of implementing this standard. However, we do not expect the implementation to have a material adverse effect on our results of operations or financial position.

Our Annual Report on Form 10-K for the year ended December 31, 2006, as filed with the Commission, also contains a discussion of recently issued accounting standards and the expected impact on our financial statements.

Forward-Looking Information

This Form 10-Q, including the information incorporated by reference herein, contains various forward-looking statements and information that are based on our beliefs and assumptions, as well as information currently available to us. From time to time, the Company and its officers, directors or employees may make other oral or written statements (including statements in press releases or other announcements) that contain forward-looking statements and information. Without limiting the generality of the foregoing, the words believe, anticipate, estimate, expect, intend, plan, seek and similar expressions, when used in this Form 10-Q and in such other statements, are intended to identify forward-looking statements, although some statements may use other phrasing. All statements that express expectations and projections with respect to future matters, including, without limitation, statements relating to growth, new lines of business and general optimism about future operating results, are forward-looking statements. All forward-looking statements and information in this Quarterly Report are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act, as amended, and are intended to be covered by the safe harbors created thereby. Such

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forward-looking statements are not guarantees of future performance and are subject to risks, uncertainties and other factors that may cause the actual results, performance or achievements of the Company to differ materially from historical results or from any results expressed or implied by such forward-looking statements. Such factors include, without limitation:

- (i) Changes in reimbursement rates, policies or payment practices by third-party payors, whether initiated by the payor or legislatively mandated, or uncollectible accounts in excess of current estimates;
- (ii) The loss of major payors or customers;
- (iii) Impairment of the Company's rights in intellectual property;
- (iv) Increased or more effective competition;
- (v) New technologies that render obsolete or non-competitive products and services offered by the Company;
- (vi) Changes in or new interpretations of laws or regulations applicable to the Company, its customers or referral sources or failure to comply with existing laws and regulations;
- (vii) Increased exposure to professional negligence liability;
- (viii) Difficulties in successfully integrating recently acquired businesses into the Company's operations and uncertainties related to the future performance of such businesses;
- (ix) Changes in company-wide or business unit strategies;
- (x) The effectiveness of the Company's advertising, marketing and promotional programs;
- (xi) Market acceptance of the Company's wellness and disease and condition management programs and the Company's ability to sign and implement new wellness and disease and condition management contracts;
- (xii) Inability to successfully manage the Company's growth;
- (xiii) Acquisitions that strain the Company's financial and operational resources;
- (xiv) Inability to forecast accurately or effect cost savings and clinical outcomes improvements or penalties for failure to meet the clinical or cost savings performance criteria under the Company's disease management contracts or inability to reach agreement with the Company's disease management customers with respect to the same;
- (xv) Inability of the Company's disease management customers to provide timely and accurate data that is essential to the operation and measurement of the Company's performance under its disease management contracts;
- (xvi) Increases in interest rates;
- (xvii)

Changes in the number of covered lives enrolled in the health plans with which the Company has agreements for payment;

- (xviii) The availability of adequate financing and cash flows to fund the Company's capital and other anticipated expenditures;
- (xix) Higher than anticipated costs of doing business that cannot be passed on to customers;
- (xx) Pricing pressures;
- (xxi) Information technology failures or obsolescence or the inability to effectively integrate new technologies;
- (xxii) The outcome of legal proceedings or investigations involving the Company, and the adequacy of insurance coverage in the event of an adverse judgment;
- (xxiii) Competition for staff;
- (xxiv) Changes in earn-out consideration; and
- (xxv) The risk factors discussed from time to time in the Company's SEC reports, including but not limited to, the Company's Annual Report on Form 10-K for the year ended December 31, 2006. These factors are not intended to be an all-encompassing list of risks and uncertainties that may affect the operations, performance, development and results of our business. Many of such factors are beyond the Company's ability to control or predict, and readers are cautioned not to put undue reliance on such forward-looking statements. In providing forward-looking statements, the Company expressly

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disclaims any obligation to update these statements publicly or otherwise, whether as a result of new information, future events or otherwise, except as may be required by law.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

For a discussion of certain of the market risks to which we are exposed, see the Quantitative and Qualitative Disclosures About Market Risk included in Item 7A to our Annual Report on Form 10-K for the year ended December 31, 2006.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and our Chief Financial Officer have evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of June 30, 2007. No process, no matter how well designed and operated, can provide absolute assurance that the objectives of the process are met in all cases. However, our disclosure controls and procedures are designed to provide reasonable assurance that the certifying officers will be alerted on a timely basis to material information relating to the Company, including the Company's consolidated subsidiaries, required to be included in our reports filed or submitted under the Exchange Act.

Based on such evaluation, such officers have concluded that our disclosure controls and procedures were effective as of June 30, 2007, to provide reasonable assurance that the objectives of the disclosure controls and procedures were met.

(b) Changes in Internal Control Over Financial Reporting

During the three months ended June 30, 2007, there were no significant changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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As of the date of the report, there have been no material changes to the risk factors included in Item 1A to our Annual Report on Form 10-K for the year ended December 31, 2006.

Item 4. Submission of Matters to a Vote of Security Holders

The directors of the Company are divided into three classes. The class composed of J. Terry Dewberry, Richard M. Hassett, M.D., Kaaren J. Street and Wayne P. Yetter will continue to serve until the 2009 annual meeting of stockholders and until their successors are elected and qualified. The class composed of Guy W. Millner and Thomas S. Stribling will continue to serve until the 2008 annual meeting of stockholders and until their successors are elected and qualified.

At the annual meeting of stockholders held June 5, 2007, each of the following directors was elected, to serve until the annual meeting of stockholders in the year in which his or her term expires and until their successors are elected and qualified:

| Nominee | Term Expiring | Affirmative Votes | Withheld Votes |
|-------------------|--------------------------|------------------------------|---------------------------|
| Parker H. Petit | 2010 | 15,553,430 | 3,467,201 |
| Joseph G. Bleser | 2010 | 18,651,481 | 369,150 |
| Myldred H. Mangum | 2010 | 18,369,423 | 651,208 |
| Donald J. Lothrop | 2008 | 18,651,936 | 368,695 |

In addition, the following proposals were approved at the annual meeting as follows:

To approve the amendment and restatement of the Matria Healthcare, Inc. Long-Term Stock Incentive Plan:

| Affirmative Votes | Negative Votes | Abstentions | Non Votes |
|--------------------------|-----------------------|--------------------|------------------|
| 12,630,606 | 4,075,345 | 21,503 | 2,293,177 |

To ratify the appointment of KPMG LLP as independent auditors for the year ending December 31, 2007:

| Affirmative Votes | Negative Votes | Abstentions | Non Votes |
|--------------------------|-----------------------|--------------------|------------------|
| 18,910,372 | 99,008 | 11,251 | -0- |

Item 6. Exhibits**Exhibit**

| Number | Description |
|---------------|--|
| 10.1 | Long-term Stock Incentive Plan (incorporated by reference to Appendix A to the Company's Definitive Proxy Statement filed with the Commission on April 30, 2007) |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification by Parker H. Petit |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification by Jeffrey L. Hinton |
| 32.1 | Section 1350 Certification by Parker H. Petit |
| 32.2 | Section 1350 Certification by Jeffrey L. Hinton |

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SIGNATURES

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

MATRIA HEALTHCARE, INC.

August 7, 2007

By: /s/ Parker H. Petit
Parker H. Petit
Chairman of the Board and Chief
Executive Officer

/s/ Jeffrey L. Hinton
Jeffrey L. Hinton
Senior Vice President and Chief
Financial Officer

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