

MATRIA HEALTHCARE INC
Form 10-Q
May 10, 2007

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 **March 31, 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

(Address of principal executive
offices)(Zip Code)

(770) 767-4500

(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 May 1, 2007, was 21,325,042.

MATRIA HEALTHCARE, INC.
QUARTERLY REPORT ON FORM 10-Q
MARCH 31, 2007

TABLE OF CONTENTS

PART I - FINANCIAL INFORMATION

| | | |
|---------|--|----|
| Item 1. | Financial Statements | 3 |
| Item 2. | Management's Discussion and Analysis of Financial Condition and Results of Operations | 13 |
| Item 3. | Quantitative and Qualitative Disclosures About Market Risk | 22 |
| Item 4. | Controls and Procedures | 22 |

PART II - OTHER INFORMATION

| | | |
|----------|--------------|----|
| Item 1A. | Risk Factors | 23 |
| Item 6. | Exhibits | 23 |

| | | |
|-------------------|--|-----------|
| SIGNATURES | | 24 |
|-------------------|--|-----------|

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)

| | March 31, 2007 | December 31, 2006 |
|---|-------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 22,118 | \$ 19,839 |
| Restricted cash | 1,388 | 1,372 |
| Trade accounts receivable, less allowances of \$3,870 and \$4,397 at March 31, 2007 and December 31, 2006, respectively | 55,001 | 52,985 |
| Prepaid expenses and other current assets | 14,240 | 14,234 |
| Deferred income taxes | 18,684 | 8,087 |
| Total current assets | 111,431 | 96,517 |
| Property and equipment, net | 39,268 | 38,950 |
| Goodwill, net | 496,594 | 500,830 |
| Other intangibles, net | 54,105 | 55,891 |
| Deferred income taxes | - | 5,564 |
| Other assets | 11,991 | 13,621 |
| | \$ 713,389 | \$ 711,373 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable, principally trade | \$ 8,983 | \$ 13,846 |
| Current installments of long-term debt | 12,526 | 4,197 |
| Unearned revenues | 15,457 | 13,493 |
| Acquisition contingent consideration | 49,938 | 54,223 |
| Accrued liabilities | 19,958 | 22,661 |
| Total current liabilities | 106,862 | 108,420 |
| Long-term debt, excluding current installments | 266,231 | 275,938 |
| Deferred tax liability | 7,049 | - |
| Other long-term liabilities | 6,561 | 8,039 |
| Total liabilities | 386,703 | 392,397 |
| Shareholders' equity: | | |
| Preferred stock, \$.01 par value. Authorized 50,000 shares; none outstanding at March 31, 2007 and December 31, 2006 | - | - |
| Common stock, \$.01 par value. Authorized 50,000 shares; issued and outstanding 21,316 and 21,255 at March 31, 2007 and December 31, 2006, respectively | 213 | 213 |
| Additional paid-in capital | 419,618 | 415,950 |
| Accumulated deficit | (93,010) | (97,149) |
| Accumulated other comprehensive earnings | (135) | (38) |

| | | |
|----------------------------|------------|------------|
| Total shareholders' equity | 326,686 | 318,976 |
| | \$ 713,389 | \$ 711,373 |

See accompanying notes to consolidated condensed financial statements.

Matria Healthcare, Inc. and Subsidiaries
Consolidated Condensed Statements of Operations
(Amounts in thousands, except per share amounts)
(Unaudited)

| | Three Months Ended | |
|---|---------------------------|-------------|
| | March 31, | |
| | 2007 | 2006 |
| Revenues | \$ 86,024 | \$ 80,906 |
| Cost of revenues | 26,493 | 26,271 |
| Selling and administrative expenses | 43,164 | 39,961 |
| Provision for doubtful accounts | 1,219 | 852 |
| Amortization of intangible assets | 1,786 | 1,786 |
| Total costs and operating expenses | 72,662 | 68,870 |
| Operating earnings from continuing operations | 13,362 | 12,036 |
| Interest income | 378 | 378 |
| Interest expense | (5,648) | (6,571) |
| Other income, net | 323 | 105 |
| Earnings from continuing operations before income taxes | 8,415 | 5,948 |
| Income tax expense | (3,454) | (2,532) |
| Earnings from continuing operations | 4,961 | 3,416 |
| Earnings (loss) from discontinued operations, net of income taxes | (154) | 1,507 |
| Net earnings | \$ 4,807 | \$ 4,923 |
| Net earnings per common share: | | |
| Basic: | | |
| Continuing operations | \$ 0.23 | \$ 0.16 |
| Discontinued operations | - | 0.08 |
| | \$ 0.23 | \$ 0.24 |
| Diluted: | | |
| Continuing operations | \$ 0.23 | \$ 0.16 |
| Discontinued operations | (0.01) | 0.07 |
| | \$ 0.22 | \$ 0.23 |
| Weighted average shares outstanding: | | |
| Basic | 21,307 | 20,869 |
| Diluted | 21,828 | 21,661 |

See accompanying notes to consolidated condensed financial statements.

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

| | Three Months Ended | |
|--|---------------------------|-------------|
| | March 31, | |
| | 2007 | 2006 |
| Cash Flows from Operating Activities: | | |
| Net earnings | \$ 4,807 | \$ 4,923 |
| Less earnings (loss) from discontinued operations, net of income taxes | (154) | 1,507 |
| Earnings from continuing operations | 4,961 | 3,416 |
| Adjustments to reconcile earnings from continuing operations to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization (including debt discount and expenses) | 5,191 | 5,018 |
| Provision for doubtful accounts | 1,219 | 852 |
| Deferred income taxes | 1,547 | 2,532 |
| Share-based compensation | 2,709 | 1,451 |
| Excess tax benefits - share-based compensation | (118) | - |
| Imputed interest on acquisition consideration | - | 1,747 |
| Changes in assets and liabilities: | | |
| Trade accounts receivable | (3,234) | (4,664) |
| Prepaid expenses and other current assets | (690) | 2,191 |
| Noncurrent assets | (136) | (94) |
| Accounts payable | (4,863) | (4,445) |
| Accrued and other liabilities | (362) | (18,748) |
| Net cash provided by (used in) continuing operations | 6,224 | (10,744) |
| Net cash provided by (used in) discontinued operations | (519) | 1,597 |
| Net cash provided by (used in) operating activities | 5,705 | (9,147) |
| Cash Flows from Investing Activities: | | |
| Purchases of property and equipment | (3,105) | (2,886) |
| Purchases of property and equipment related to discontinued operations | - | (159) |
| Acquisition of business, net of cash received | - | (434,727) |
| Increase in restricted cash | (16) | (216) |
| Net cash used in investing activities | (3,121) | (437,988) |
| Cash Flows from Financing Activities: | | |
| Proceeds from the issuance of long-term debt, net of transaction costs | - | 443,977 |
| Principal repayments of long-term debt | (1,383) | (1,304) |
| Proceeds from issuance of common stock | 960 | 1,115 |
| Excess tax benefits - share-based compensation | 118 | - |
| Net cash provided by (used in) financing activities | (305) | 443,788 |
| Effect of exchange rate changes on cash and cash equivalents | - | 94 |
| Net increase (decrease) in cash and cash equivalents | 2,279 | (3,253) |
| Cash and cash equivalents at beginning of year | 19,839 | 22,758 |
| Cash and cash equivalents at end of period | \$ 22,118 | \$ 19,505 |

Supplemental disclosure of cash paid for:

| | | | | |
|--------------|----|-------|----|-------|
| Interest | \$ | 5,127 | \$ | 5,246 |
| Income taxes | \$ | 70 | \$ | 1,015 |

See accompanying notes to consolidated condensed financial statements.

Notes to Consolidated Condensed Financial Statements
(Unaudited)

1. General

The consolidated condensed financial statements as of March 31, 2007, and for the three-month periods ended March 31, 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 financial position and results of operations for the periods presented have been included. The results for the three months ended March 31, 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 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.

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 are 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. We have computed the additional consideration pursuant to the terms of our earn-out agreement to be \$27.9 million. This amount is included in Acquisition contingent consideration on the consolidated condensed balance sheet. On May 1, 2007, the sellers filed a notice of objection, objecting to certain aspects of the calculation. See Note 12, Subsequent Events.

We have also accrued in Acquisition contingent consideration \$22.0 million of earn-out consideration for the second earn-out period ending March 31, 2007, for the Miavita acquisition. On November 6, 2006, the Company and the seller entered into a Settlement Agreement and Release that effectively amends 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 is payable in respect of the second earn-out period unless payments received from such new customers between November 6, 2006, and May 1, 2007, are at least \$500,000. The threshold has been met, and on May 1, 2007, the Company paid the initial \$20.0 million to the seller. See Note 12.

Goodwill was decreased by \$4.3 million in the first three months of 2007 for the change in estimate of additional consideration payable under the WinningHabits earn-out agreement 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 periods ended March 31, 2007 and 2006 were \$4.7 million and \$5.3 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. This resulted in a reduction to beginning Accumulated deficit and an increase to Other long-term liabilities of \$669,000. As of January 1, 2007, the amount of unrecognized tax benefits was \$524,000. The total amount of unrecognized tax benefits that, if recognized, would favorably affect the effective income tax rate in future periods. Interest and penalties recognized at the adoption of FIN 48 were \$145,000. It is our policy to classify interest and penalties recognized on underpayment of income taxes as Interest expense and Other income (expense), 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 and foreign jurisdictions. Tax years that remain subject to examination for federal and various state jurisdictions are from 1996 to present.

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 | |
|--|--------------------|----------|
| | March 31, | |
| | 2007 | 2006 |
| Net earnings (loss) - basic and diluted: | | |
| Continuing operations | \$ 4,961 | \$ 3,416 |
| Discontinued operations | (154) | 1,507 |
| Net earnings available to common shareholders | \$ 4,807 | \$ 4,923 |
| Shares: | | |
| Weighted average common shares outstanding - basic | 21,307 | 20,869 |
| Dilutive effect of: | | |
| Stock options and employee stock purchase plan | 444 | 792 |
| Unvested restricted stock awards | 77 | - |
| Weighted average common shares outstanding - diluted | 21,828 | 21,661 |
| Basic: | | |
| Continuing operations | \$ 0.23 | \$ 0.16 |
| Discontinued operations | - | 0.08 |
| | \$ 0.23 | \$ 0.24 |
| Diluted: | | |
| Continuing operations | \$ 0.23 | \$ 0.16 |
| Discontinued operations | (0.01) | 0.07 |
| | \$ 0.22 | \$ 0.23 |

The calculation of diluted earnings (loss) per share excludes 1.3 million and 1.0 million shares in the three month periods ended March 31, 2007 and 2006, respectively, since the effect of assumed exercise of the related options would be antidilutive. In 2007, the computation excludes the antidilutive effect of 274,000 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 March 31, 2007, the plans permit the granting of share based awards of up to approximately 174,000 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 (2005 Director's Non-Qualified Stock Option Plan) or over a period of years (generally three to five), subject to eligibility status as specified in the individual option agreement (the LTIP). 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 March 31, 2007, there were approximately 12,000 options and shares available for grant under these plans.

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. For the three months ended March 31, 2007 and 2006, 16,700 and 8,800 shares were purchased at prices of \$22.93 per share and \$31.99 per share, respectively. At March 31, 2007, approximately 91,000 shares were reserved for purchase under the Purchase Plan.

We adopted SFAS No. 123 (Revised 2004), *Share-Based Payment* ("SFAS 123(R)") effective January 1, 2006. SFAS 123(R) requires all share-based payments, including grants of employee stock options, to be recognized in the financial statements based on their fair values. We elected the modified prospective transition method, and therefore adjustments to prior periods were not required. Accordingly, we recorded share-based compensation expense for awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption.

During the three months ended March 31, 2007, we granted only restricted stock awards, the fair value of which is based on the Company's stock price on the date of grant. For options granted in 2006, we calculated the fair value of each option award on the date of grant using the Black-Scholes option-pricing model. The following assumptions were used for calculating the fair value of our option awards:

| | Three Months Ended | |
|---------------------------|--------------------|-------|
| | March 31, | |
| | 2007 | 2006 |
| Risk-free interest rates | NA | 4.67% |
| Expected lives (in years) | NA | 4 |
| Dividend yield | NA | NA |
| Expected volatility | NA | 57.7% |

The following table summarizes our stock option activity during the quarter ended March 31, 2007 (shares in thousands):

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (Years) | | Aggregate Intrinsic Value |
|---------------------------------------|--------|--|--|----|---------------------------------|
| | | | | | |
| Outstanding at January 1, 2007 | 2,487 | \$ 22.26 | | | |
| Granted | - | \$ - | | | |
| Exercised | (44) | \$ 13.03 | | | |
| Forfeited/expired/cancelled | (58) | \$ 28.47 | | | |
| Outstanding at March 31, 2007 | 2,385 | \$ 22.28 | 7.0 | \$ | 16,164 |
| Options exercisable at March 31, 2007 | 1,246 | \$ 17.35 | 5.8 | \$ | 13,154 |

The total aggregate intrinsic value of options exercised was \$635,000 during the three month period ended March 31, 2007.

The following table summarizes our restricted stock award activity for the three-month period ended March 31, 2007 (shares in thousands):

| | Shares | Weighted Average Grant Date Fair Value Per Share |
|------------------------------|--------|--|
| Nonvested at January 1, 2007 | 221 | \$ 28.10 |
| Granted | 282 | \$ 26.46 |
| Vested | - | \$ - |
| Forfeited | (11) | \$ 28.16 |
| Nonvested at March 31, 2007 | 492 | \$ 27.15 |

For the three month periods ended March 31, 2007 and 2006, we recorded share-based compensation of \$2.7 million (\$1.8 million net of income tax, or \$0.08 per diluted share) and \$1.5 million (\$1.0 million net of income tax, or \$0.05 per diluted share), respectively, which are included in Selling and administrative expenses on the consolidated condensed statement of operations. We did not capitalize any share-based compensation costs in either period. Cash received from option exercises and shares issued under all share-based payment arrangements for the three months ended March 31, 2007 and 2006 was \$960,000 and \$1.1 million, respectively.

At March 31, 2007, total compensation cost related to unvested share-based awards granted to employees under stock option plans but not yet recognized was approximately \$22.5 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 domestic subsidiaries. As of March 31, 2007, the outstanding balance under the Credit Facilities was \$276.4 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 March 31, 2007, there

were no amounts outstanding under the Revolving Credit Facility, and the available balance was \$48.5 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 March 31, 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 8.07% and 9.30% for the three-month periods ended March 31, 2007 and 2006, respectively.

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% and 5.35%, respectively, at March 31, 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 (\$159,000 and \$62,000 at March 31, 2007 and December 31, 2006, respectively), which was based upon the estimated amount we would pay upon settlement of the agreements taking into account interest rates on those dates. For the three-month periods ended March 31, 2007 and 2006, we recognized a net gain of \$79,000 and a net loss of \$29,000, respectively, from the cash flow hedges, which is 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 million claim relating to a liability resulting from CorSolutions' pre-closing performance under a customer contract. We are also pursuing a related claim for fraudulent misrepresentation and concealment before the American Arbitration Association in Chicago, Illinois, seeking damages in an unspecified amount exceeding \$4 million. There is no assurance that we will prevail in either of these proceedings.

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.

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”). 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) | (51) | (102) | (449) |
| Balance at March 31, 2007 | \$ - | 821 | 120 | \$ 941 |

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

| | Three Months Ended March 31, | |
|--|---------------------------------|-----------|
| | 2007 | 2006 |
| Revenues | \$ - | \$ 34,564 |
| Earnings (loss) from discontinued operations | \$ (208) | \$ 2,582 |
| Income tax benefit (expense) | 54 | (1,075) |
| Discontinued operations, net of tax | \$ (154) | \$ 1,507 |

Earnings from discontinued operations before income tax expense for the three-month period ended March 31, 2006, include a charge of \$3.5 million for interest expense and deferred financing fees related to our Credit Facilities. This amount was 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. Subsequent Events

Acquisition Obligations. At March 31, 2007, we computed the additional consideration pursuant to the terms of our WinningHabits earn-out agreement to be \$27.9 million. On May 1, 2007, the sellers filed a notice of objection, objecting to certain aspects of the calculation. Pursuant to the terms of the acquisition agreement, the parties have 30 days to try to resolve their differences. If there is no resolution, the calculation will be submitted for determination to a

contractually designated settlement accountant.

On May 1, 2007, we paid \$20.0 million to the sellers of Miavita, in accordance with the terms of the Settlement Agreement and Release entered into on November 6, 2006. The remaining \$2.0 million of acquisition consideration, which is based on the achievement of certain milestones as defined in the Settlement Agreement and Release, will be paid on May 15, 2007.

12

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.

Results of Operations

The following table summarizes key components in our financial statements for continuing operations expressed as a percentage of revenues. An explanation of the results follows the table.

| | Three Months Ended | |
|---|--------------------|--------|
| | March 31, | |
| | 2007 | 2006 |
| Revenues | 100.0% | 100.0% |
| Cost of revenues | 30.8% | 32.5% |
| Gross margin | 69.2% | 67.5% |
| Selling and administrative expenses | 50.2% | 49.4% |
| Provision for doubtful accounts | 1.4% | 1.1% |
| Amortization of intangible assets | 2.1% | 2.2% |
| Operating earnings | 15.5% | 14.9% |
| Interest expense, net | 6.1% | 7.7% |
| Other income, net | 0.4% | 0.1% |
| Earnings from continuing operations before income taxes | 9.8% | 7.4% |

| | | |
|-------------------------------------|------|------|
| Income tax expense | 4.0% | 3.1% |
| Earnings from continuing operations | 5.8% | 4.2% |

Three Months Ended March 31, 2007, Compared to Three Months Ended March 31, 2006

Revenues increased by \$5.1 million, or 6.3%, to \$86.0 million for the three months ended March 31, 2007, from \$80.9 million in the same period in 2006. This increase was due primarily to: (i) the implementation of new and expanded disease management and wellness contracts, net of attrition, and (ii) the increase in our MaternaLink[®] services. Disease and condition management program revenues increased \$1.8 million, or 3.5%, to \$52.8 million for the three months ended March 31, 2007. Wellness program revenues were \$6.8 million for the three months ended March 31, 2007, compared to \$4.5 million for the same period in 2006, increasing 50.5%. Maternity management program revenues increased \$1.1 million, or 4.1%, to \$26.4 million for the three months ended March 31, 2007. This increase was primarily due to higher revenues from our MaternaLink[®] services, which include risk assessment and early intervention programs.

Cost of revenues as a percentage of revenues decreased to 30.8% for the three months ended March 31, 2007, from 32.5% 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 \$3.2 million to \$43.2 million in the first quarter of 2007, compared to \$40.0 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. Additionally, share-based compensation increased \$1.2 million due to the 2007 grants of restricted stock awards, which 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 percentage of revenues, selling and administrative expenses increased to 50.2% in 2007, compared to 49.4% in 2006.

The provision for doubtful accounts as a percentage of revenues was 1.4% for the three months ended March 31, 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 and other relevant factors. The percentage increase results from an increase in bad debts for our disease and condition management and wellness revenues.

We recorded \$1.8 million in expense for the amortization of intangible assets in each of the periods ended March 31, 2007 and 2006. Amortization expense results from our 2006 and 2005 acquisitions.

Interest expense decreased to \$5.6 million in 2007, from \$6.6 million in 2006, due to the lower outstanding balance of our Credit Facilities, which we entered into in January 2006 in conjunction with our acquisition of CorSolutions. In the first quarter of 2006, we allocated \$3.5 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 Technologies, LLC (“Facet”) in the third quarter of 2006 and Dia Real, our foreign diabetes services operations in Germany, in the fourth quarter of 2006 to repay a portion of the outstanding indebtedness. The weighted average interest rates,

including amortization of debt discount and expense, on all outstanding indebtedness were 8.07% and 9.30% for the three-month periods ended March 31, 2007 and 2006, respectively.

Income tax expense was \$3.5 million and \$2.5 million for the three months ended March 31, 2007 and 2006, respectively. Our effective income tax rates were 41.0% in 2007 and 42.6% 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 \$70,000 and \$1.0 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.

Discontinued operations include the operations of Facet and Dia Real. The loss from discontinued operations in 2007 was \$154,000, net of tax, compared to earnings of \$1.5 million for the same period in 2006. Discontinued operations in 2006 include a pre-tax expense of \$3.5 million for the allocation of interest and deferred financing fees related to the Credit Facilities as described above.

Liquidity and Capital Resources

Operating Activities

As of March 31, 2007, we had cash and cash equivalents of \$22.1 million. In the first three months of 2007, operating activities from continuing operations provided \$6.2 million of cash, compared with \$10.7 million of net cash used by operating activities in the comparable period of 2006. This increase was due primarily to decreases in accrued and other liabilities in the first quarter of 2006 for the payment of transaction-related expenses incurred in the CorSolutions acquisition.

Cash flows from discontinued operations were (\$519,000) and \$1.6 million for the three-month periods ended March 31, 2007 and 2006, respectively, driven primarily by the earnings (loss) from discontinued operations. The 2006 period also reflects the allocation of \$3.5 million in interest expense (before taxes) referenced above.

Our accounts receivable days' sales outstanding, or DSO, were 58 days and 54 days at March 31, 2007, and December 31, 2006, respectively.

Investing Activities

Net cash used in investing activities totaled \$3.1 million and \$438.0 million for the three months ended March 31, 2007 and 2006, respectively. We used \$3.1 million and \$2.9 million in 2007 and 2006, respectively, for capital expenditures. 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 \$19 million for capital items in 2007, including capital expenditures made in the first three 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.

Financing Activities

Net cash used in financing activities was \$305,000 for the three months ended March 31, 2007, compared to net cash provided of \$443.8 million for the same period in 2006. During the three months ended March 31, 2007 and 2006, we repaid \$1.4 million and \$1.3 million, respectively, of short-term indebtedness and capital lease obligations. We also received \$960,000 and \$1.1 million from participants under our stock purchase and stock option plans in the three-month periods ended March 31, 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.

The Credit Facilities consist of a \$485.0 million credit agreement and a second lien term loan facility with Bank of America, N.A., as administrative and collateral agent, and matures on January 19, 2012. 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 domestic subsidiaries. As of March 31, 2007, the outstanding balance under the Credit Facilities was \$276.4 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 March 31, 2007, there were no amounts outstanding under the Revolving Credit Facility, and the available balance was \$48.5 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 March 31, 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% and 5.35%, respectively, at March 31, 2007). We reflected the interest rate swap agreements on the consolidated condensed balance sheet at a fair value of \$159,000 and \$62,000 at March 31, 2007 and December 31, 2006, respectively, based upon the estimated amount we would pay upon settlement of the agreements taking into account interest rates on those dates. For the three month periods ended March 31, 2007 and 2006, we recognized a net gain of \$79,000 and a net loss of \$29,000, respectively, from the cash flow hedges, which 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.

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 financial statements but are required to be disclosed. The following sets forth our future minimum payments required under our contractual obligations as of March 31, 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) \$ 278,532 | \$ 12,470 | \$ 6,600 | \$ 259,462 | \$ - |
| Capital lease obligations | 89 | 79 | 10 | - | - |
| Operating lease obligations | 29,440 | 8,488 | 13,387 | 4,294 | 3,271 |
| Other long-term obligations | 6,004 | 1,704 | 3,254 | 1,046 | - |
| Acquisition obligations | 49,938 | 49,938 | - | - | - |
| | \$ 364,003 | \$ 72,679 | \$ 23,251 | \$ 264,802 | \$ 3,271 |

(1) Does not include interest expense associated with our long-term debt obligations.

Principal and interest payments of \$9.5 million and \$16.6 million, respectively, under the Credit Facilities are payable in the remaining nine months of 2007. Capital expenditures of approximately \$19 million, including capital expenditures made in the first three months, are estimated in 2007 as we continue to enhance our computer information systems.

We have restricted funds of \$1.4 million as of March 31, 2007, which represent amounts held in escrow related to customer contracts. Funds are held in interest-bearing investment accounts.

As of March 31, 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 acquisitions of WinningHabits and Miavita, we will be required to pay additional consideration in future periods, based upon the attainment of defined operating objectives of these businesses. 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.

We have computed the additional consideration pursuant to the terms of our earn-out agreement for the WinningHabits acquisition to be \$27.9 million. This amount is included in Acquisition contingent consideration on the consolidated condensed balance sheet. The sellers have filed a notice of objection, objecting to certain aspects of the calculation. Pursuant to the terms of the acquisition agreement, the parties have 30 days to try to resolve their differences. If there is no resolution, the calculation will be submitted for determination to a contractually designated settlement accountant.

Also included in Acquisition contingent consideration is \$22.0 million of earn-out consideration for the second earn-out period ending March 31, 2007, for the Miavita acquisition. On November 6, 2006, we entered into a

Settlement Agreement and Release with the seller that effectively amends the terms of the original acquisition agreement to fix the amount payable for the second earn-out period at \$20 million

17

plus 3.575 times net revenues from certain new customers between November 6, 2006, and March 31, 2007, provided that no payment is payable in respect of the second earn-out period unless payments received from such new customers between November 6, 2006, and May 1, 2007, are at least \$500,000.

Goodwill was decreased by \$4.3 million in the first three months of 2007 for the change in estimate of additional consideration payable under the WinningHabits earn-out agreement noted above. See Note 12, Subsequent Events, for additional information on Acquisition contingent consideration.

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.

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 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 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 March 31, 2007, we reported goodwill and identifiable intangible assets at net carrying amounts of \$496.6 million and \$54.1 million, respectively. The total of \$550.7 million represents approximately 77% of our total assets as of March 31, 2007.

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 \$3.5 million and \$2.5 million for the three-month periods ended March 31, 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 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 generally accepted accounting principles, with no need for management’s judgment in their application. There 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 generally accepted accounting principles.

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 Retained Earnings of \$669,000. As of the date of adoption, the total amount of unrecognized tax benefits as of the date of adoption 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 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 operation 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 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) Losses due to foreign currency exchange rate fluctuations or deterioration of economic conditions in foreign markets;
 - (x) Changes in company-wide or business unit strategies;
 - (xi) The effectiveness of the Company’s advertising, marketing and promotional programs;
- (xii) 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;
 - (xiii) Inability to successfully manage the Company’s growth;
 - (xiv) Acquisitions that strain the Company’s financial and operational resources;
- (xv) 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;
- (xvi) 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;
 - (xvii) Increases in interest rates;
- (xviii) Changes in the number of covered lives enrolled in the health plans with which the Company has agreements for payment;

- (xix) The availability of adequate financing and cash flows to fund the Company's capital and other anticipated expenditures;
- (xx) Higher than anticipated costs of doing business that cannot be passed on to customers;
- (xxi) Pricing pressures;
- (xxii) Information technology failures or obsolescence or the inability to effectively integrate new technologies;
- (xxiii) The outcome of legal proceedings or investigations involving the Company, and the adequacy of insurance coverage in the event of an adverse judgment;
- (xxiv) Competition for staff;
- (xxv) Changes in earn-out consideration; and
- (xxvi) 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 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 March 31, 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 March 31, 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 March 31, 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.

PART II^{3/4} OTHER INFORMATION

Item 1A. Risk Factors

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 6. Exhibits

Exhibit Number

- | | |
|------|--|
| 3.1 | Amended Bylaws of Matria Healthcare, Inc. (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K dated April 13, 2007). |
| 10.1 | Third Amendment to Credit Agreement, dated February 23, 2007, by and among Matria, certain of its domestic subsidiaries, as guarantors and Bank of America, N.A. as administrative agent and collateral agent (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K dated February 23, 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 |

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.

May 10, 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