AMERIPATH INC
Form 10-Q
August 14, 2006
Table of Contents

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

or

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

Commission File Number: 000-22313

AMERIPATH, INC.

(Exact Name of Registrant as Specified in its Charter)

Delaware	**65-0642485**
(State or Other Jurisdiction of	**(I.R.S. Employer**
Incorporation or Organization)	**Identification No.)**
7111 Fairway Drive, Suite 400	
Palm Beach Gardens, Florida	**33418**
(Address of Principal Executive Offices)	**(Zip Code)**

(561) 712-6200

(Registrant s Telephone Number, Including Area Code)

Not Applicable

(Former Name, Former Address and Formal Fiscal Year, if Changed Since Last Report)

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

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

Large Accelerated Filer ¨	Accelerated Filer ¨	Non-Accelerated Filer x

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

The number of shares of common stock of the registrant outstanding as of August 14, 2006 was 100.

Table of Contents

AMERIPATH, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

INDEX

Table of Contents

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

AMERIPATH, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	June 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 8,319	$ 3,998
Restricted cash	26,960	26,684
Accounts receivable, net	126,954	84,968
Inventories	6,833	2,327
Deferred tax assets, net	11,139	10,909
Other current assets	7,734	4,963
Total current assets	187,939	133,849
PROPERTY AND EQUIPMENT, NET	93,019	49,196
OTHER ASSETS:		
Goodwill	841,960	608,160
Identifiable intangibles, net	214,388	165,878
Other	33,110	27,066
Total other assets	1,089,458	801,104
TOTAL ASSETS	$ 1,370,416	$ 984,149
LIABILITIES AND STOCKHOLDER S EQUITY		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	$ 78,261	$ 59,823
Accrued interest	11,154	9,721
Current portion of long-term debt	2,189	354
Other current liabilities	1,422	218
Total current liabilities	93,026	70,116
LONG -TERM LIABILITIES:		
Long-term debt	620,012	479,136
Other liabilities	48,037	33,228
Deferred tax liabilities, net	38,114	16,952
Total long-term liabilities	706,163	529,316
COMMITMENTS AND CONTINGENCIES		

STOCKHOLDER S EQUITY:		
Common stock, $.01 par value, 100 shares issued and outstanding at June 30, 2006 and December 31, 2005	1	1
Additional paid-in capital	552,813	369,427
Retained earnings	18,413	15,289
Total stockholder s equity	571,227	384,717
TOTAL LIABILITIES AND STOCKHOLDER S EQUITY	$ 1,370,416	$ 984,149

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

3

Table of Contents

AMERIPATH, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(in thousands)

(Unaudited)

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
NET REVENUES:				
Total net revenues	$ 191,692	$ 143,634	$ 362,628	$ 277,514
OPERATING COSTS AND EXPENSES:				
Cost of services	107,940	74,276	204,866	147,776
Selling, general and administrative expenses	38,994	27,162	74,745	52,352
Provision for doubtful accounts	18,972	18,804	38,812	36,440
Amortization expense	2,900	3,474	6,755	6,779
Merger-related charges	1,198		1,784	
Gain on sale of practice				(454)
Total operating costs and expenses	170,004	123,716	326,962	242,893
INCOME FROM OPERATIONS	21,688	19,918	35,666	34,621
OTHER INCOME (EXPENSES):				
Interest expense	(14,902)	(11,707)	(28,004)	(22,935)
Change in value of derivative	453	329	746	(291)
Write-off of deferred financing costs		(345)	(3,360)	(345)
Other income, net	559	180	897	284
Total other expenses, net	(13,890)	(11,543)	(29,721)	(23,287)
INCOME BEFORE INCOME TAXES	7,798	8,375	5,945	11,334
PROVISION FOR INCOME TAXES	2,580	3,315	2,817	4,515
NET INCOME	$ 5,218	$ 5,060	$ 3,128	$ 6,819

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

Table of Contents

AMERIPATH, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 3,128	$ 6,819
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	10,262	5,160
Amortization	6,755	6,779
Loss on disposal of assets	61	92
Provision for doubtful accounts	38,812	36,440
Gain on sale of practice		(454)
Write-off of deferred financing costs	3,360	345
Change in value of derivative	(747)	291
Non cash stock option expense	592	
Changes in assets and liabilities (net of effect of acquisitions)		
Increase in accounts receivable	(52,729)	(46,413)
Increase in inventories	(827)	(216)
(Decrease) increase in other current assets	(1,184)	1,942
Increase in accrued interest	1,433	159
Increase (decrease) in other assets	(1,377)	(191)
(Decrease) increase in accounts payable and accrued expenses	(5,620)	1,740
Net cash provided by operating activities	1,919	12,493
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisitions of property and equipment	(24,041)	(14,015)
Cash paid for acquisitions and related costs, net of cash acquired	(168,685)	
Cash received from sale of managed practice		900
(Increase) decrease in restricted cash	(276)	1,553
Investment in common stock		(150)
Payments of contingent notes	(3,351)	(8,790)
Net cash used in investing activities	(196,353)	(20,502)
CASH FLOWS FROM FINANCING ACTIVITIES		
Debt issuance costs	(5,052)	(27)
Net payments on long term debt and capital leases	(2,346)	(244)
Proceeds from new term loan facility, net of payments	202,991	
Payments on former term loan facility	(99,049)	(11,701)
Proceeds from new revolving debt facility, net of payments	69,000	
Payments on former revolving debt facility	(30,000)	
Proceeds from former revolving debt facility		2,000
Proceeds from release of contingent note fund	14,390	
Contingent note proceeds	2,746	8,566
Equity investment by parent	46,075	

Net cash provided by (used in) financing activities	198,755	(1,406)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	4,321	(9,415)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	3,998	20,980
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 8,319	$ 11,565
SUPPLEMENTAL NON-CASH TRANSACTIONS		
Property and equipment acquired pursuant to capital leases	$	$ 552
Issuance of Ameripath Group Holdings, Inc. equity in relation to Specialty Laboratories, Inc. acquisition	$ 119,581	$
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during period for interest	$ 26,747	$ 22,887
Cash paid during period for taxes	$ 1,081	$ 1,621

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

Table of Contents

Note 1 Basis of Presentation

The accompanying unaudited condensed consolidated financial statements, which include the accounts of AmeriPath, Inc. and its subsidiaries (collectively, AmeriPath or the Company), have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial reporting and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the financial statements do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, such interim financial statements contain all adjustments (consisting of normal recurring items) considered necessary for a fair presentation of the Company s financial position, results of operations and cash flows for the interim periods presented. The results of operations and cash flows for any interim period are not necessarily indicative of results that may be expected for the full year.

The accompanying unaudited interim financial statements should be read in conjunction with the audited consolidated financial statements, and the notes thereto, included in the Company s Form 10-K for the year ended December 31, 2005 and filed with the Securities and Exchange Commission (SEC) on March 28, 2006.

In order to maintain consistency and comparability between periods presented, certain amounts in the prior period s financial statements have been reclassified to conform to the financial statement presentation of the current period.

Note 2 The March 2003 Transaction

On December 8, 2002, Amy Holding Company and its wholly-owned subsidiary, Amy Acquisition Corp., entered into a merger agreement with the predecessor of AmeriPath pursuant to which Amy Acquisition Corp. merged with and into the predecessor, with AmeriPath continuing as the surviving corporation. Amy Holding Company and Amy Acquisition Corp. were Delaware corporations formed at the direction of Welsh, Carson, Anderson & Stowe IX, L.P, (WCAS). WCAS, its related investors and several employees of the Company owned 100% of the outstanding common stock of Holdings after the March 2003 Transaction. The March 2003 Transaction was approved by the Company s stockholders and subsequently consummated on March 27, 2003. As a result of the March 2003 Transaction, AmeriPath became a wholly-owned subsidiary of Amy Holding Company, which was renamed Ameripath Holdings, Inc. (Holdings).

The March 2003 Transaction was accounted for under the purchase method of accounting prescribed in SFAS No. 141, Business Combinations, (SFAS No. 141), with intangible assets recorded in accordance with SFAS No. 142, Goodwill and Other Intangible Assets , (SFAS No. 142). In accordance with the provisions of SFAS No. 142, no amortization of indefinite-lived intangible assets or goodwill is recorded.

As required under current guidance, any amounts recorded or incurred (such as goodwill or debt) by our parent as a result of the March 2003 Transaction should be pushed down and recorded on our financial statements. The following table summarizes the final allocation of the March 2003 Transaction based upon a valuation completed by an independent third-party valuation firm during September 2003.

Cash and equity contributed by WCAS	$ 319,667
Total liabilities assumed	587,801
Fair value of assets acquired	(676,458)
Excess purchase price (goodwill)	$ 231,010

In addition, Holdings issued to WCAS Capital Partners III, L.P., an investment fund affiliated with WCAS, $67.0 million in principal amount of Holdings senior subordinated notes and an agreed-upon number of shares of its common stock, for an aggregate purchase price of $67.0 million. The proceeds from this transaction were deposited into a Holdings company cash collateral account, which cash, subject to some exceptions, will be contributed to the Company from time to time to fund up to $67.0 million of future payments under the Company s contingent notes relating to acquisitions consummated prior to the March 2003 Transaction. As of June 30, 2006, approximately $48.3 million of the $67.0 million has been contributed to the Company to fund contingent note payments and approximately $14.4 million of the $67.0 million was contributed to the Company to help fund the Specialty Laboratories, Inc. acquisition. The lenders under the Company s Credit Facility have a first-priority security interest in all funds held in such cash collateral account.

Note 3 Recent Accounting Pronouncements

In December 2004, the FASB issued Statement No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123(R)), which is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123). The Statement supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25), and amends FASB

6

Table of Contents

Statement No. 95, *Statement of Cash Flows.* SFAS No. 123(R) focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, rather than as an operating cash flow, as prescribed under current accounting rules. This requirement reduces net operating cash flows and increases net financing cash flows in periods after adoption. In April 2005, the Securities and Exchange Commission adopted a new rule that amends the effective dates for SFAS No. 123(R). The Company adopted the accounting provisions of SFAS No. 123(R) on January 1, 2006.

SFAS No. 123(R) permits public companies to adopt its requirements using one of two methods, the modified prospective or modified retrospective method. The modified prospective method requires compensation cost to be recognized beginning with the effective date (a) based on the requirements of SFAS No. 123(R) for all share-based payments granted, modified or settled after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123(R) that remain unvested on the effective date. The modified retrospective method includes the requirements of the modified prospective method described above, but also requires entities to restate, based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures, either (a) all prior periods presented or (b) prior interim periods of the year of adoption. The Company adopted SFAS No. 123(R) using the modified prospective method effective January 1, 2006. See Note 12 for more information regarding our adoption of SFAS No. 123(R).

Note 4 Acquisitions

On January 31, 2006, the Company completed its acquisition of Specialty Laboratories, Inc., (Specialty) an esoteric lab in Valencia, California in a transaction valued at approximately $334.0 million. In connection with the acquisition, the Company formed a new parent entity, Ameripath Group Holdings, Inc. (Group Holdings). Subsequent to the transaction Group Holdings is the new parent of Holdings, which remains the parent of Ameripath. Under the terms of the merger agreement, the Company acquired all common shares of Specialty common stock outstanding at closing for $13.25 per common share, or $317.4 million. The Company financed the acquisition through a combination of cash on hand, contribution of shares by Specialty s majority shareholder, additional cash equity of $46.1 million from Ameripath s majority stockholder, WCAS, the release of certain contingent note funds of $14.4 million from Holdings, and borrowings under Ameripath s new credit facility. The Company paid $197.8 million in cash and issued $119.6 million or 19,930,208 shares in Group Holdings stock. Group Holdings common stock was issued at $6.00 a share, which was based on our internal valuation and previous transactions with third parties. In addition, Ameripath paid $9.7 million in cash for outstanding stock options of Specialty. Pursuant to the terms of the merger agreement, Specialty s outstanding stock options became fully vested and exercisable and were canceled in exchange for the right to receive an amount, for each share subject to the stock option, equal to the excess of $13.25 per share over the exercise price per share of such option. The aggregate purchase price of approximately $334.0 million includes transaction costs of approximately $6.9 million consisting primarily of fees and expenses of investment bankers, attorneys, and accountants.

The purchase price of the acquisition is summarized below:

Cash paid for Specialty s outstanding common stock	$ 197,801
Group Holdings common stock issued	119,581
Cash paid for Specialty s outstanding stock options	9,662
Transaction costs incurred	6,949
Total purchase price	$ 333,993

The following table summarizes the fair value of the assets acquired and liabilities assumed in connection with the acquisition, as of the date of the acquisition, as accounted for under SFAS No. 141 *Business Combinations* , which requires the use of the purchase method of accounting. The intangible asset valuation was performed by an independent third-party valuation firm during March 2006. In accordance with SFAS No. 109 *Accounting for Income Taxes* , the Company recognized a deferred tax liability of $20.7 million related to both definite and indefinite-lived intangible assets acquired in the Specialty acquisition. The allocation of the purchase price is summarized below:

Table of Contents

Cash	$ 40,986
Accounts receivable, net	27,774
Property & equipment, net	30,104
Inventory	3,679
Prepaid expenses	1,814
Intangible assets	53,390
Other investments	2,545
Other	1,598
Goodwill	225,768
Total assets	387,658
Accounts payable	10,685
Other long term liabilities	2,114
Deferred tax liabilities	20,673
Accrued liabilities	20,193
Total liabilities	53,665
Net assets acquired	$ 333,993

On March 31, 2006, the Company also acquired one hospital based anatomic pathology practice in Denver, Colorado. For the first six months of 2005, the Company did not acquire any new practices. The accompanying unaudited condensed consolidated financial statements include the results of operations of the Company s acquisitions accounted for under the purchase method from the date acquired through June 30, 2006. The following unaudited pro forma information presents the consolidated results of operations for the six months ended June 30, 2006 and 2005 as if the acquisitions had been consummated on January 1, 2006 and 2005, respectively.

The unaudited pro forma information presented below is for illustrative information purposes only and is not necessarily indicative of results which would have been achieved or results which may be achieved in the future.

	Six months ended June 30, 2006	Six months ended June 30, 2005
Net revenues	$ 375,454	$ 354,656
Net income	222	2,691

Contingent Notes Related To Past Acquisitions

During the six months ended June 30, 2006 and 2005, the Company made contingent note payments of approximately $3.4 million and $8.8 million, respectively relating to previous acquisitions. If the maximum specified levels of income from operations for all acquired operations are achieved, the Company estimates that it would make aggregate maximum principal payments of approximately $5.3 million over the next two years. A lesser amount or no payments at all would be made if the stipulated levels of income from operations or other evaluation factors specified in each agreement were not met.

Note 5 Intangible Assets

Amortization expense of identifiable intangibles was approximately $2.3 million and $2.9 million for the three months ended June 30, 2006 and 2005. Amortization expense of identifiable intangibles was approximately $5.6 million for both the six months ended June 30, 2006 and 2005.

Amortization expense related to identifiable intangibles for each of the five succeeding fiscal years and thereafter as of June 30, 2006 is as follows:

Remainder of 2006	$ 4,740
2007	9,475

2008	8,643
2009	8,364
2010	8,187
2011	7,950
Thereafter	102,451

The weighted average amortization period for identifiable intangible assets is approximately 19.6 years.

Table of Contents

Note 6 Long-term Debt

Senior Subordinated Notes On March 27, 2003, in connection with the March 2003 Transaction, Amy Acquisition Corp. issued $275.0 million of 10 1/2% Senior Subordinated Notes due 2013. The Company assumed Amy Acquisition Corp. s obligations with respect to the notes upon consummation of the March 2003 Transaction. Interest became payable semi-annually in arrears beginning in October 2003. In February 2004, the Company issued an additional $75.0 million of its 10 1/2% Senior Subordinated Notes due 2013 at a premium price of 106% plus accrued interest. The net premium amount is included in Other liabilities on the consolidated balance sheets. The notes are unconditionally guaranteed, jointly and severally and on an unsecured senior subordinated basis, by certain of the Company s current and former subsidiaries. The notes and guarantees rank junior to all of the Company s and the subsidiary guarantors existing and future senior indebtedness, on par with all of the Company s and the subsidiary guarantors existing and future senior subordinated indebtedness and senior to all of the Company s and the subsidiary guarantors existing and future subordinated indebtedness.

The Company may redeem any of the notes at any time and from time to time beginning on April 1, 2008, in whole or in part, in cash at the specified redemption prices, plus accrued and unpaid interest to the date of redemption.

If a change in control of the Company occurs, subject to certain conditions, the Company must give holders of the notes an opportunity to sell the notes to the Company at a purchase price of 101% of the principal amount of the notes, plus accrued and unpaid interest to the date of the purchase of the notes by the Company.

The indenture governing the notes contains covenants that, among other things, limit the Company s ability and the ability of the Company s restricted subsidiaries to incur or guarantee additional indebtedness, pay dividends or make other equity distributions, purchase or redeem capital stock, make certain investments, enter into arrangements that restrict dividends from subsidiaries, transfer and sell assets, engage in certain transactions with affiliates and effect a consolidation or merger.

Credit Facility On January 31, 2006, in connection with the acquisition of Specialty, the Company terminated its existing senior credit facility and entered into a new senior credit facility (the New Credit Facility) with a syndicate of financial institutions led by Wachovia Bank and Citigroup Global Markets, Inc. The new senior credit facility consists of a $203.5 million term loan and a $95.0 million revolving credit facility. The Company borrowed $203.5 million of the term loan and $52.0 million of the revolving credit to fund a portion of the Specialty acquisition consideration, to pay certain transaction costs related to the acquisition, to refinance existing indebtedness of the Company and to pay related expenses with the acquisition.

The interest rates per annum applicable to loans under the New Credit Facility are, at the Company s option, equal to either an alternate base rate or an adjusted LIBOR rate for a one, two, three or six month interest period chosen by the Company, or a nine or twelve month period if agreed to by all participating lenders, plus an applicable margin percentage in each case.

The alternate base rate is the greater of (1) the prime rate or (2) one-half of 1% over the weighted average of rates on overnight federal funds as published by the Federal Reserve Bank of New York. The adjusted LIBOR rate will be determined by reference to settlement rates established for deposits in dollars in the London interbank market for a period equal to the interest period of the loan and the maximum reserve percentages established by the Board of Governors of the United States Federal Reserve to which our lenders are subject. The facility also requires a commitment fee to be paid quarterly equal to 0.125% of any unused commitments under the revolving loan facility.

The New Credit Facility requires scheduled quarterly principal payments on the term loan in amounts equal to $508,750 on each of June 30, September 30, December 31 and March 31. On June 30, 2006, the Company made its mandatory payment of $508,750.

Indebtedness under the New Credit Facility is guaranteed by all of the Company s current restricted subsidiaries, certain of its future restricted subsidiaries and by Holdings. It is secured by a first priority security interest in substantially all of the Company s existing and future property and assets, including accounts receivable, inventory, equipment, general

Table of Contents

intangibles, intellectual property, investment property, other personal property, owned and material leased real property, cash and cash proceeds of the foregoing and a first priority pledge of the Company s capital stock and the capital stock of the guarantor subsidiaries.

The New Credit Facility requires that the Company comply on a quarterly basis with certain financial covenants, including an interest coverage ratio calculation, a fixed charge coverage ratio calculation and a maximum net senior leverage ratio calculation, which become more restrictive over time. In addition, the New Credit Facility includes negative covenants restricting or limiting the Company s ability and the ability of its subsidiaries to, among other things, incur, assume or permit to exist additional indebtedness or guarantees; incur liens and engage in sale leaseback transactions; make capital expenditures; make loans and investments; declare dividends, make payments or redeem or repurchase capital stock; engage in mergers, acquisitions and other business combinations; prepay, redeem or purchase certain indebtedness; amend or otherwise alter terms of our indebtedness; sell assets; transact with affiliates and alter the business that it conducts.

Letters of Credit

As of June 30, 2006, the Company had letters of credit outstanding totaling $13.9 million. The letters of credit secure payments under certain operating leases and insurance policies and expire at various dates in 2006 and 2007. Some of the letters of credit automatically decline in value over various lease terms. The letters of credit have annual fees averaging 2.4%. Available borrowings under the $95.0 million revolving credit facility are reduced by the notional balance outstanding on these letters of credit. In addition, the Company had $300,000 of surety bonds outstanding on June 30, 2006 to satisfy Florida Medicaid requirements.

Note 7 Derivative Instrument

In April 2004, the Company entered into a 2 $^{1}/2$ year interest rate swap transaction which involves the exchange of fixed for floating rate interest payments without the exchange of the underlying principal amount. The interest differential to be paid or received is accrued and is recognized as an adjustment to interest expense. The change in the market value of the derivative instrument is recognized in the consolidated statements of income. For the six months ended June 30, 2006 and 2005, the change in the value of the derivative was a gain of approximately $0.7 million and a loss of approximately $0.3 million, respectively, which is reflected in the accompanying consolidated statements of income. The agreement has a notional amount of $75.0 million. The Company receives interest on the notional amount if the LIBOR rate is less than 2.405% and pays interest on the notional amount if the LIBOR rate exceeds 2.405%. The floating rate resets every October 1 and April 1. In April 2005, the floating rate reset at 3.39% until October 2005. The Company locked in to a forward LIBOR rate contract for October 2005 through March 2006 at a rate of 4.216%. In April 2006, the floating rate reset at 2.405% until October 2006. This derivative instrument is being used by the Company to reduce interest rate volatility and associated risks arising from the fixed rate structure of their Senior Subordinated Notes, and is not held or issued for trading purposes.

Note 8 Commitments and Contingencies

During the ordinary course of business, the Company has become and may in the future become subject to legal actions and proceedings. The Company may have liability with respect to its employees and its pathologists and with respect to hospital employees who are under the supervision of its hospital-based pathologists. The majority of these pending legal proceedings involve claims of medical malpractice and most of those suits relate to cytology services. Based upon investigations conducted to date, the Company believes the outcome of any pending legal actions and proceedings, individually or in the aggregate, will not have a material adverse effect on the Company s financial condition, results of operations or liquidity. If the Company is ultimately found liable under the outstanding medical malpractice claims, there can be no assurance that medical malpractice insurance arrangements will be adequate to cover all such liabilities. The Company also may, from time to time, be involved with legal actions related to the acquisition of anatomic pathology operations, the prior conduct of acquired operations or the employment and restriction on competition of physicians. There can be no assurance that any costs or liabilities for which the Company becomes responsible in connection with these claims or actions will not be material or will not exceed the limitations of any applicable indemnification provisions or the financial resources of the indemnifying parties.

Healthcare Regulatory Environment and Reliance on Government Programs The healthcare industry in general, and the services that the Company provides, are subject to extensive federal and state laws and regulations. Additionally, a significant portion of the Company s net revenue is from payments by government-sponsored health care programs, principally Medicare and Medicaid, and is subject to audits and adjustments by applicable regulatory agencies. Failure to comply with any of these laws or regulations, the results of increased regulatory audits and adjustments, or changes in the interpretation of the coding of services or the amounts payable for the Company s services under these programs could have a material adverse effect on the Company s consolidated financial position and results of operations. The Company s operations are continuously subject to review and inspection by regulatory authorities.

Table of Contents

From time to time, we receive subpoenas from government officials. For instance, the Company has received subpoenas issued by the United States Attorney s office in Tampa, Florida seeking information with respect to an investigation relating to Medicare billing and possible financial inducements in connection with a Florida physician who is not an AmeriPath pathologist but was a client of AmeriPath. In addition, certain affiliates of the Company have received an investigative subpoena from the Florida Attorney General Medicaid Fraud Control Unit requesting copies of agreements that we have with certain hospitals and certain patient records. To the Company s knowledge, numerous other hospitals and facilities have received similar subpoenas, which may indicate a state-wide audit of pathology operations. Specialty Laboratories, Inc., a California corporation received a subpoena from the California Attorney General s Office. The subpoena seeks various documents including documents relating to billings to the Medicaid program with time frames ranging from three to ten years. The Company is providing or has provided information to the United States Attorney s Office, the Florida Attorney General s Office and California Attorney General s Office and intends to cooperate in the investigations. It is not possible at this point in either investigation to determine whether the government will pursue action against AmeriPath or to assess the merits of possible defenses AmeriPath might have to any such action. Accordingly, no assurances can be given regarding the ultimate outcome of these investigations.

Specialty Laboratories Asia Pte. Ltd., a Singapore corporation, (SLA), is 60% owned by Specialty Laboratories International Ltd., a British Virgin Islands corporation (SLIL) and a wholly-owned subsidiary of Specialty. SLA was headquartered in Singapore but, in early 1999, SLA ceased all operations and is currently insolvent. A former employee of SLA has obtained a judgment for $350,000 against SLA and a default judgment of approximately $2.0 million in a wrongful termination action against SLA filed by him in Singapore. The former employee has filed an action against SLA in San Diego Superior Court to attempt to collect on the Singapore judgment and has obtained a default judgment of approximately $2.5 million against SLA in California. Ameripath accrued for this matter at the time the Specialty acquisition was recorded.

In December 2003, Specialty was served with an action in which it was named as a defendant, together with certain of its former officers, SLIL, and multiple other parties located in Singapore and India, in a lawsuit brought in the High Court of the Republic of Singapore by Dragon Investment Company (Dragon), one of the shareholders in SLA. Dragon has also brought the lawsuit in the name of SLA as a derivative action. The lawsuit alleges, among other things, that SLA and Dragon suffered damages as a result of the winding up of the affairs of SLA and disposition of its assets. The lawsuit also alleges that certain of the defendants breached certain written agreements to allow Dragon to acquire more shares of SLA, that certain of Specialty s former officers conspired to run down and dissipate the assets of SLA, and that they fraudulently concealed their actions from Dragon and the other minority shareholder of SLA. Specialty has provided notice to the applicable insurance carriers. Ameripath accrued for this matter at the time the Specialty acquisition was recorded.

Note 9 Comprehensive Income

SFAS No. 130, *Comprehensive Income*, requires that an enterprise (a) classify items of other comprehensive income by their nature in the financial statements, and (b) display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the equity section of the balance sheet. For the six months ended June 30, 2006 and 2005, net income equaled comprehensive income.

Note 10 Segment Reporting

The Company operates in one reportable segment, the medical laboratory industry. Medical laboratories offer a broad range of testing services to the medical profession. The Company s testing services are categorized based upon the nature of the test: anatomic pathology, esoteric services, and dermatopathology. These testing services are used by physicians in the diagnosis, prognosis, monitoring and general management of diseases and other clinical conditions. The tests included in such services generally detect medically-significant abnormalities and visual patterns in blood, tissue samples and other specimens.

Note 11 Income Taxes

The Company s effective income tax rate was 47.4% and 39.8% for the six month periods ended June 30, 2006 and 2005, respectively. The increase in the tax rate is a result of an increase in the state income tax valuation allowance and non-deductible merger costs in connection with the acquisition of Specialty.

Table of Contents

Note 12 Stock Options

The Company grants stock options for a fixed number of common shares to employees and directors from time to time. As of June 30, 2006, approximately 40,938 shares are available for future issuance.

Prior to December 31, 2005, the Company accounted for its employee stock option plan using the intrinsic method under APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25) and related interpretations. The Company applied the provision of APB No. 25 in accounting for its employee stock option plan, and because the exercise price of its options was equal to or greater than the market value of its options at the date of grant, no compensation cost has been recognized for the option plan in the consolidated statements of income for the sic months ended June 30, 2005.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R) using the prospective transition method. Under that method, compensation cost recognized for the six months ended June 30, 2006 includes all share-based payments granted on or subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). Compensation cost related to stock awards granted is being recognized on a straight-line basis over the requisite service period. Results for the periods prior to January 1, 2006 have not been restated.

The Company calculates the fair value of employee stock options using a Black-Scholes-Merton option pricing model at the time the stock options are granted and that amount is amortized over the vesting period of the options, which is generally up to five years. The fair value for employee stock options for the six months ended June 30, 2006 was calculated based on the following assumptions: an average risk-free interest rate for the period of 4.6%; dividend yield of 0%; weighted-average volatility factor of 36.0%; and a weighted average expected life of the options of 6.5 years. The expected term was determined using the shortcut method described in Staff Accounting Bulletin Topic 14.D.2, which is based on a calculation to arrive at the midpoint between the vesting date and the end of the contractual term. The risk-free interest rate was based on the applied yield currently available on U.S treasury zero-coupon issues with a remaining term equivalent to the stock option award s expected term. The expected weighted-average volatility factor is based on the historical stock prices of two competitors of the Company whose shares are publicly traded over the most recent period, commensurate with the expected term of the stock option award.

In accordance wit the adoption of SFAS No. 123(R), the Company recorded compensation cost of approximately $449,000 and recognized a tax benefit for share-based compensation arrangements of $174,000 for the three months ended June 30, 2006. During the six months ended June 30, 2006, the Company recorded $592,000 in compensation cost and recognized a tax benefit for share-based compensation arrangements of $229,000.

As required by SFAS No. 123(R), the Company now estimates forfeitures of employee stock options and recognizes compensation cost only for those awards expected to vest. Forfeiture rates are determined for two groups of employees executives and management based on historical experience. Estimated forfeitures are now adjusted to actual forfeiture experience as needed.

The following table illustrates the effect on net income if the Company had applied the fair value recognition provisions of SFAS No. 123 to options granted under the Company s stock option plan for the six months ended June 30, 2005:

Net income reported	$ 6,819
Deduct: Total stock-based employee compensation expense determined under SFAS No. 123 for all awards, net of related tax effect	(453)
Pro forma net income	$ 6,366

Table of Contents

For purposes of this pro forma disclosure, the fair value of these options was estimated at the time of grant using a Black-Scholes-Merton option pricing model based on the following assumptions for the six months ended June 30, 2005: an average risk-free rate for the period of 4.1%; dividend yield of 0%; weighted-average volatility factor of 0%; and a weighted average expected life of the options of 8 years.

The following table summarizes information related to the Company s stock option activity for the six months ended June 30, 2006:

	Number of Shares	Weighted Average Exercise Price
Outstanding at December 31, 2005	8,241,202	$ 6.00
Granted	3,677,271	6.00
Exercised		
Terminated/lapsed	(262,265)	6.00
Outstanding at June 30, 2006	11,656,208	6.00
Exercisable at June 30, 2006	3,631,072	$ 6.00

As of June 30, 2006, there was $8.6 million of total unrecognized compensation cost related to non-vested options, which is expected to be recognized, on a straight-line basis, over a weighted average period of 4.62 years.

Note 13 Subsequent Events

On July 17, 2006 SLA, SLIL, Dragon, Specialty and the other named defendants finalized a settlement agreement with respect to the pending lawsuit regarding all parties hereon and referenced in Note 8 Commitments and Contingencies of this Form 10-Q. The settlement agreement released all claims in the related lawsuits. The terms of such settlement agreement are confidential and approximate the amount accrued for this matter at the time the Specialty acquisition was recorded.

Note 14 Guarantor Subsidiaries

The following information is presented as required by regulations of the Securities and Exchange Commission in connection with the Company s 10 $^{1}/2$% senior subordinated notes due 2013. This information is not routinely prepared for use by management. The operating and investing activities of the separate legal entities included in the Company s consolidated financial statements are fully interdependent and integrated. Accordingly, consolidating the operating results of those separate legal entities is not representative of what the actual operating results of those entities would be on a stand-alone basis. Operating expenses of those separate legal entities include intercompany charges for management fees and other services. Certain expense items and asset and liability balances that are applicable to the Company s subsidiaries are typically recorded in the books and records of AmeriPath, Inc. For purposes of this footnote disclosure, such balances and amounts have been pushed down to the respective subsidiaries either on a specific identification basis, or when such items cannot be specifically attributed to an individual subsidiary, have been allocated on an incremental or proportional cost basis to AmeriPath, Inc. and the Company s subsidiaries.

The following tables present consolidating financial information at June 30, 2006 and 2005, and December 31, 2005, for (i) AmeriPath, (ii) on a combined basis, the subsidiaries of AmeriPath that are guarantors of the Company s 10 $^{1}/2$% Senior Subordinated Notes due 2013 (the Subsidiary Guarantors) and (iii) on a combined basis, the subsidiaries of AmeriPath that are not guarantors of the Company s 10 $^{1}/2$% Senior Subordinated Notes due 2013 (the Non-Guarantor Subsidiaries). The maximum potential amount of future payments the subsidiary Guarantors could be required to make under the Guarantee is $350.0 million.

13

Table of Contents

Condensed Consolidating Balance Sheets:

As of June 30, 2006	AmeriPath, Inc.	Subsidiary Guarantors	Non Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
Assets					
Current assets:					
Cash and cash equivalents	$	$ 9,054	$ (735)		$ 8,319
Restricted cash		26,960			26,960
Accounts receivable, net	759	103,699	22,496		126,954
Inventories	321	6,288	224		6,833
Other current assets	1,122	14,762	2,989		18,873
Total current assets	2,202	160,763	24,974		187,939
Property & equipment, net	28,096	63,061	1,862		93,019
Goodwill		691,502	150,458		841,960
Identifiable intangibles, net	41,928	139,010	33,450		214,388
Investment in subsidiaries	959,034			(959,034)	
Other assets	18,668	12,365	2,077		33,110
Total assets	$ 1,049,928	$ 1,066,701	$ 212,821	$ (959,034)	$ 1,370,416
Liabilities and Stockholder s Equity					
Current liabilities:					
Accounts payable and accrued expenses	$ 26,313	$ 59,045	$ 4,057		$ 89,415
Current portion of long-term debt	2,189				2,189
Other current liabilities	1,119	303			1,422
Total current liabilities	29,621	59,348	4,057		93,026
Long-term debt	619,957	55			620,012
Other liabilities	17,354	27,078	3,605		48,037
Deferred tax liabilities, net	1,170	46,799	(9,855)		38,114
Total long-term liabilities	638,481	73,932	(6,250)		706,163
Intercompany payable (receivable)	244,194	(32,110)	32,264	(244,348)	
Stockholder s equity:					
Common stock	(1,272)	1,271	25	(23)	1
Additional paid-in capital	518,193	31,633	2,987		552,813
Retained earnings (deficit)	(379,289)	932,627	179,738	(714,663)	18,413
Total stockholder s equity	137,632	965,531	182,750	(714,686)	571,227
Total liabilities and stockholder s equity	$ 1,049,928	$ 1,066,701	$ 212,821	$ (959,034)	$ 1,370,416

As of December 31, 2005	AmeriPath, Inc.	Subsidiary Guarantors	Non Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
Assets					
Current assets:					
Cash and cash equivalents	$	$ 3,325	$ 673		$ 3,998
Restricted cash		26,684			26,684
Accounts receivable, net	450	64,421	20,097		84,968
Inventories	262	1,950	115		2,327

Other current assets	538	13,027	2,307		15,872
Total current assets	1,250	109,407	23,192		133,849
Property & Equipment, net	16,255	31,135	1,806		49,196
Goodwill, net		472,054	136,106		608,160
Other identifiable intangibles, net	16,937	116,791	32,150		165,878
Investment in subsidiaries	1,088,071			(1,088,071)	
Other assets	18,726	6,585	1,755		27,066
Total assets	$ 1,141,239	$ 735,972	$ 195,009	$ (1,088,071)	$ 984,149
Liabilities and Stockholder s Equity					
Current liabilities:					
Accounts payable and accrued expenses	$ 22,356	$ 41,698	$ 5,708		$ 69,762
Current portion of long-term debt	255	99			354
Total Current Liabilities	22,611	41,797	5,708		70,116
Long-term debt	479,056	80			479,136
Other liabilities	6,223	26,005	1,000		33,228
Deferred tax liabilities, net	536	20,926	(4,510)		16,952
Total long-term liabilities	485,815	47,011	(3,510)		529,316
Intercompany payable (receivable)	657,400	(294,073)	10,061	(373,388)	
Stockholder s equity:					
Common stock	(1,272)	1,271	25	(23)	1
Additional paid-in capital	334,807	31,633	2,987		369,427
Retained earnings (deficit)	(358,122)	908,333	179,738	(714,660)	15,289
Total stockholder s equity	(24,587)	941,237	182,750	(714,683)	384,717
Total liabilities and stockholder s equity	$ 1,141,239	$ 735,972	$ 195,009	$ (1,088,071)	$ 984,149

14

Table of Contents

Condensed Consolidating Statements of Operations:

	AmeriPath, Inc.	Subsidiary Guarantors	Non Guarantor Subsidiaries	Consolidated Total
For the six months ended June 30, 2006				
Net revenues	$	$ 297,828	$ 64,800	$ 362,628
Cost of services		181,939	22,927	204,866
Selling, general and administrative expenses	8,035	95,631	9,891	113,557
Amortization expense		5,976	779	6,755
Merger-related charges	1,784			1,784
Total operating costs and expense	9,819	283,546	33,597	326,962
(Loss) income from operations	(9,819)	14,282	31,203	35,666
Other income (expense)				
Interest expense	(27,994)	(10)		(28,004)
Management fee (A)		31,203	(31,203)	
Change in value of derivative	746			746
Write-off of deferred financing costs	(3,360)			(3,360)
Other, net	188	709		897
Total other expenses	(30,420)	31,902	(31,203)	(29,721)
(Loss) income before income taxes	(40,239)	46,184		5,945
Benefit (provision) for income taxes	19,073	(21,890)		(2,817)
Net (loss) income	$ (21,166)	$ 24,294	$	$ 3,128

	AmeriPath, Inc.	Subsidiary Guarantors	Non Guarantor Subsidiaries	Consolidated Total
For the six months ended June 30, 2005				
Net revenues	$	$ 215,394	$ 62,120	$ 277,514
Cost of services		123,244	24,532	147,776
Selling, general and administrative expenses	1,931	76,201	10,660	88,792
Amortization expense		5,996	783	6,779
Gain on sale of practice		(454)		(454)
Total operating costs and expense	1,931	204,987	35,975	242,893
(Loss) income from operations	(1,931)	10,407	26,145	34,621
Other income (expense)				
Interest expense	(22,830)	(105)		(22,935)
Management fee (A)		26,143	(26,143)	
Change in value of derivative	(291)			(291)
Write-off of deferred financing costs	(345)			(345)
Other, net	35	251	(2)	284
Total other expenses	(23,431)	26,289	(26,145)	(23,287)
(Loss) income before income taxes	(25,362)	36,696		11,334
Benefit (provision) for income taxes	10,103	(14,618)		(4,515)
Net (loss) income	$ (15,259)	$ 22,078	$	$ 6,819

(A) In accordance with the applicable management fee agreements, the Subsidiary Guarantors are the direct beneficiary of substantially all of the pre-tax income of the Non-Guarantor Subsidiaries.

Table of Contents

Condensed Consolidating Statements of Cash Flows:

	AmeriPath, Inc.	Subsidiary Guarantors	Non Guarantor Subsidiaries	Consolidated Total
For the six months ended June 30, 2006				
Cash flows from operating activities:				
Net (loss) income	$ (21,166)	$ 24,294	$	$ 3,128
Adjustments to reconcile net (loss) income to cash provided by operating activities	5,590	45,824	7,681	59,095
Changes in assets and liabilities which used cash, net of effects of acquisitions	(34,537)	(18,644)	(7,123)	(60,304)
Net cash (used) provided by operating activities	(50,113)	51,474	558	1,919
Cash flows used for investing activities	(150,988)	(43,399)	(1,966)	(196,353)
Cash flows provided by (used for) financing activities	201,101	(2,346)		198,755
(Decrease) increase in cash equivalents		5,729	(1,408)	4,321
Cash and cash equivalents, beginning of period		3,325	673	3,998
Cash and cash equivalents, end of period	$	$ 9,054	$ (735)	$ 8,319

	AmeriPath, Inc.	Subsidiary Guarantors	Non Guarantor Subsidiaries	Consolidated Total
For the six months ended June 30, 2005				
Cash flows from operating activities:				
Net (loss) income	$ (15,936)	$ 22,755	$	$ 6,819
Adjustments to reconcile net (loss) income to cash provided by operating activities	2,275	38,500	7,878	48,653
Changes in assets and liabilities which provided (used) cash, net of effects of acquisitions	19,417	(56,158)	(6,238)	(42,979)
Net cash provided by operating activities	5,756	5,097	1,640	12,493
Cash flows used for investing activities	(4,594)	(13,489)	(2,419)	(20,502)
Cash flows used for financing activities	(1,162)			