

RADIOLOGIX INC
Form 10-Q
May 04, 2006
Table of Contents

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended March 31, 2006

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____

Commission File No. 0-23311

RADIOLOGIX, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

3600 JP Morgan Chase Tower

2200 Ross Avenue

Dallas, Texas 75201-2776

(Address of principal executive offices, including zip code)

(214) 303-2776

(Registrant's telephone number, including area code)

75-2648089
(I.R.S. Employer

Identification No.)

Edgar Filing: RADIOLOGIX INC - Form 10-Q

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. 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

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

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

Class	Outstanding at April 29, 2006
Common Stock, \$0.0001 par value	22,242,417 shares

Table of Contents

RADIOLOGIX, INC.

FORM 10-Q

INDEX

	Page
<u>Part I. FINANCIAL INFORMATION</u>	
Item 1. <u>Financial Statements</u>	
<u>Consolidated Balance Sheets as of March 31, 2006 (Unaudited) and December 31, 2005 (Audited)</u>	1
<u>Consolidated Statements of Operations (Unaudited) for the three months ended March 31, 2006 and 2005</u>	2
<u>Consolidated Statements of Cash Flows (Unaudited) for the three months ended March 31, 2006 and 2005</u>	3
<u>Notes to Consolidated Financial Statements (Unaudited)</u>	4
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operation</u>	20
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	29
Item 4. <u>Controls and Procedures</u>	29
<u>Part II. OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings</u>	30
Item 1A. <u>Risk Factors</u>	30
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	39
Item 3. <u>Defaults upon Senior Securities</u>	39
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	39
Item 5. <u>Other Information</u>	39
Item 6. <u>Exhibits and Reports on Form 8-K</u>	39
<u>SIGNATURES</u>	40
<u>INDEX TO EXHIBITS</u>	41

Table of Contents**PART I: FINANCIAL INFORMATION****Item 1. Financial Statements****RADIOLOGIX, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(In thousands, except share and per share data)**

	March 31, 2006 (Unaudited)	December 31, 2005
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 44,877	\$ 36,004
Restricted cash	5,702	5,662
Accounts receivable, net of allowances	41,418	40,815
Due from affiliates	1,768	1,737
Federal and state income tax receivables	6,081	6,189
Other current assets	5,151	5,491
Total current assets	\$ 104,997	\$ 95,898
Property and equipment, net	68,154	67,965
Investments in joint ventures	8,392	10,597
Intangible assets, net	53,217	54,050
Deferred financing costs, net	4,529	4,942
Other assets	966	1,076
Total assets	\$ 240,255	\$ 234,528
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable and other accrued expenses	\$ 6,984	\$ 10,157
Accrued physician retention	8,245	7,051
Accrued salaries and benefits	8,964	6,987
Accrued interest	4,838	685
Current maturities of capital lease obligations	32	32
Other current liabilities	665	477
Total current liabilities	\$ 29,728	\$ 25,389
Long-term debt, net of current portion	158,270	158,270
Convertible debt	11,980	11,980
Capital lease obligations, net of current portion	54	62
Deferred revenue	6,392	6,494
Other liabilities	1,524	1,488
Total liabilities	\$ 207,948	\$ 203,683
Commitments and contingencies		
Minority interests in consolidated subsidiaries	913	1,874
STOCKHOLDERS EQUITY:		
Preferred stock, \$.0001 par value; 10,000,000 shares authorized; no shares issued and outstanding		

Edgar Filing: RADIOLOGIX INC - Form 10-Q

Common stock, \$.0001 par value; 50,000,000 shares authorized; 22,261,101 shares issued at March 31, 2006 and December 31, 2005, and 22,242,417 outstanding at March 31, 2006 and December 31, 2005	2	2
Treasury stock	(180)	(180)
Additional paid-in capital	16,002	15,615
Retained earnings	15,570	13,534
Total stockholders' equity	\$ 31,394	\$ 28,971
Total liabilities and stockholders' equity	\$ 240,255	\$ 234,528

See accompanying notes to consolidated financial statements.

Table of Contents**RADIOLOGIX, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except share and per share data)**

	For the Three Months Ended March 31,	
	2006	2005 (As restated) (Unaudited)
Service fee revenue	\$ 65,117	\$ 62,751
Costs of operations:		
Cost of services	39,916	39,820
Equipment leases	3,756	2,806
Provision for doubtful accounts	5,279	4,467
Depreciation and amortization	5,970	5,644
Gross profit	\$ 10,196	\$ 10,014
Corporate general and administrative	4,716	4,348
Interest expense, net, including amortization of deferred financing costs	4,477	4,676
Income before equity in earnings of unconsolidated affiliates, minority interests in consolidated subsidiaries, income taxes and discontinued operations	\$ 1,003	\$ 990
Equity in earnings of unconsolidated affiliates	1,045	622
Minority interests in income of consolidated subsidiaries	(146)	(149)
INCOME BEFORE INCOME TAXES AND DISCONTINUED OPERATIONS	\$ 1,902	\$ 1,463
Income tax expense	103	76
INCOME FROM CONTINUING OPERATIONS	\$ 1,799	\$ 1,387
Discontinued Operations:		
Income (loss) from discontinued operations before income taxes	237	(434)
Income tax expense		
Income (loss) from discontinued operations	\$ 237	\$ (434)
NET INCOME	\$ 2,036	\$ 953
INCOME (LOSS) PER COMMON SHARE:		
Income from continuing operations basic	\$ 0.08	\$ 0.06
Income (loss) from discontinued operations basic	\$ 0.01	\$ (0.02)
Net income basic	\$ 0.09	\$ 0.04
Income from continuing operations diluted	\$ 0.08	\$ 0.06
Income (loss) from discontinued operations diluted	\$ 0.01	\$ (0.02)
Net income diluted	\$ 0.09	\$ 0.04

Edgar Filing: RADIOLOGIX INC - Form 10-Q

WEIGHTED AVERAGE SHARES OUTSTANDING:

Basic	22,242,417	21,913,738
Diluted	22,242,417	22,509,821

See accompanying notes to unaudited consolidated financial statements

Table of Contents**RADIOLOGIX, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

	For the Three Months Ended	
	2006	March 31, 2005 (As restated)
	(Unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 2,036	\$ 953
Adjustments to reconcile net income to net cash provided by operating activities including discontinued operations:		
Minority interests in income of consolidated subsidiaries	146	149
Distributions to minority interests in consolidated subsidiaries	(1,106)	
Equity in earnings of unconsolidated affiliates	(1,045)	(622)
Distributions from unconsolidated affiliates	3,250	281
Depreciation and amortization	5,970	5,644
Amortization of deferred financing costs	412	412
Gains on sales of equipment	(807)	(526)
Deferred revenue	(102)	(102)
Restricted stock compensation expense	387	101
Deferred income tax expense		94
Changes in operating assets and liabilities:		
Accounts receivable, net	(603)	(107)
Income taxes receivable	108	2,040
Other assets	386	1,531
Accounts payable and accrued expenses	4,355	3,984
Net cash provided by operating activities	\$ 13,387	\$ 13,832
CASH FLOWS FROM INVESTING ACTIVITIES:		
Increase in restricted cash	(40)	(22)
Purchases of property and equipment	(5,523)	(4,473)
Proceeds from sales of equipment	957	697
Repayments from unconsolidated affiliates, net	100	
Net cash used in investing activities	\$ (4,506)	\$ (3,798)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments on long-term obligations	(8)	(101)
Proceeds from stock option exercises		391
Net cash provided by (used in) financing activities	\$ (8)	\$ 290
NET INCREASE IN CASH AND CASH EQUIVALENTS	8,873	10,324
CASH AND CASH EQUIVALENTS, beginning of period	36,004	34,084
CASH AND CASH EQUIVALENTS, end of period	\$ 44,877	\$ 44,408
SUPPLEMENTAL CASH FLOW DISCLOSURE:		

Edgar Filing: RADIOLOGIX INC - Form 10-Q

Cash paid for interest	\$	333	\$	351
Income taxes paid, net of refunds received	\$	(88)	\$	(2,040)

See accompanying notes to unaudited consolidated financial statements.

Table of Contents

RADIOLOGIX, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2006

(Unaudited)

Note 1. Description of Business

Radiologix, Inc. (together with its subsidiaries, Radiologix or the Company), a Delaware corporation, is a leading national provider of diagnostic imaging services through its ownership and operation of free-standing, outpatient diagnostic imaging centers. Radiologix utilizes sophisticated technology and technical expertise to perform a broad range of imaging procedures, such as magnetic resonance imaging (MRI), computed tomography (CT), position emission tomography (PET), nuclear medicine, ultrasound, mammography, bone densitometry (DEXA), general radiology (X-ray) and fluoroscopy. This quarterly report for Radiologix supplements our annual report to security holders on Form 10-K for the fiscal year ended December 31, 2005. As permitted by the Securities and Exchange Commission for interim reporting, we have omitted certain notes and disclosures that substantially duplicate those in the annual report on Form 10-K. Accordingly, these consolidated financial statements do not include all disclosures associated with the annual consolidated financial statements. In the opinion of management, all adjustments necessary for a fair presentation have been included in the accompanying consolidated financial statements and are of a normal recurring nature, other than those adjustments related to discontinued operations, which adjustments are discussed separately in the notes below. Interim results for the three month period ended March 31, 2006 are not necessarily indicative of the results that may be expected for the year.

Our results may be impacted by variability due to changes in modality mix and the volume of procedures performed, physician referral and vacation patterns, the impact of hospital and physician-affiliated imaging centers that compete in our primary and Questar operations, the timing and negotiation of managed care and service contracts, the availability of technologists and other personnel resources, and trends in receivable collectibility. We are impacted by seasonality in that referring physicians and technologists often schedule vacations in the summer months which typically results in a decline in our volumes and service fee revenue while increasing costs of services as we contract for the services of temporary technologists at higher rates.

For further information, refer to Management's Discussion and Analysis of Financial Condition and Results of Operation and the audited consolidated financial statements and notes included in our annual report to security holders on Form 10-K for the year ended December 31, 2005.

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and include the accounts of the Company and its wholly owned and majority owned subsidiaries. All significant intercompany transactions have been eliminated. Investments in entities that the Company does not control, but in which it has a substantial ownership interest and can exercise significant influence, are accounted for using the equity method.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, results of operations and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

We consider all highly liquid investments with original maturities of three months or less to be cash equivalents.

Property and Equipment

Edgar Filing: RADIOLOGIX INC - Form 10-Q

Property and equipment are stated at cost, net of accumulated depreciation and amortization. Property and equipment are depreciated using the straight-line method over their estimated useful life. Amortization of assets under capital leases is included in depreciation and amortization.

Table of Contents

Goodwill, Intangible and Long-lived Assets

The value of goodwill and intangible assets is stated at the lower of cost or fair value. Goodwill is not subject to amortization; however it is subject to periodic valuation assessments. Under the provisions of Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, the Company is required to perform at least an annual impairment test and to consider other indicators that may arise throughout the year to reevaluate carrying value. To the extent book value exceeds fair value, at the date an impairment is determined, the Company reduces goodwill by recording a charge to operations. The Company impaired its remaining balance of goodwill during the quarter ended December 31, 2005.

Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS No. 144), requires impairment losses to be recognized for long-lived assets through operations when indicators of impairment exist and the underlying cash flows are not sufficient to support the assets' carrying value. In addition, SFAS No. 144 requires that a long-lived asset (disposal group) to be sold that meets certain recognition criteria be classified as held for sale and measured at the lower of carrying amount or fair value less cost to sell. SFAS No. 144 also requires that a long-lived asset subject to closure (abandonment) before the end of its previously estimated useful life continue to be classified as held and used until disposal, with depreciation estimates revised to reflect the use of the asset over its shortened useful life.

In addition to the annual impairment test we perform with respect to goodwill, we regularly evaluate the carrying value of goodwill, intangible and long-lived assets for events or changes in circumstances that indicate that the carrying amount may not be recoverable or that the remaining estimated useful life should be changed. Potential indicators of impairment can include, but are not limited to (1) history of operating losses or expected future losses; (2) significant adverse change in legal factors; (3) changes in the extent or manner in which the assets are used; (4) current expectations to dispose of the assets by sale or other means and (5) reductions or expected reductions of cash flow. In the event that we determine there is an indication of impairment, we compare undiscounted net cash flows to the carrying value of the respective asset. If the carrying value exceeds the undiscounted net cash flows, we perform an impairment calculation using discounted cash flows, valuation analysis from independent valuation specialists or comparisons to recent sales or purchase transactions to determine estimated fair value.

Finite Life Intangible and Long-Lived Assets

Impairment losses are recognized for long-lived assets through operations when events or changes in circumstances that may indicate that the carrying amount may not be recoverable and the underlying net cash flows are not sufficient to support the assets' carrying value. Examples of events or changes in circumstances or in the business climate can include, but are not limited to the following:

- a. History of operating losses or expected future losses
- b. Significant adverse change in legal factors
- c. Significant adverse change in the extent or manner in which the assets are used or in the physical condition of the assets
- d. Current expectations to dispose of the assets by sale or other means
- e. Reductions or expected reductions of cash flow

Our management services agreements, included in the consolidated balance sheets as intangible assets, are not considered to have indefinite useful lives and will continue to be amortized over a useful life of no more than 25 years based on SEC guidance. We regularly evaluate the carrying value and lives of the finite lived intangible assets in light of any events or circumstances that we believe may indicate that the carrying amount or amortization period should be adjusted.

Deferred Financing Costs

Deferred financing costs are amortized on a straight-line method, which approximates the effective interest method. As of March 31, 2006 and December 31, 2005, accumulated amortization of deferred financing costs was approximately \$7.1 million and \$6.7 million, respectively.

Table of Contents

Accrued Physician Retention

Accrued physician retention represents amounts payable to contracted radiology practices under the management services agreements. The service agreements require Radiologix to remit physician retention to the contracted radiology practices by the end of the month after the month in which services were rendered.

Revenue Recognition

Service fee revenue from contracted radiology practice groups (professional revenue component) and diagnostic imaging centers (technical revenue component) is recorded when services are rendered by the contracted radiology practices and diagnostic imaging centers based on established gross charges billed and reduced by estimated contractual adjustments and amounts retained by the contracted radiology practice groups under the terms of management services agreements. Our patient accounting system currently does not record contractual adjustments at the time of billing. Instead, contractual adjustments and the provision for doubtful accounts are estimated based on historical collection experience using a retrospective collection analysis, which we began using in December 2004, payment-versus-charge schedules and aging models. Should circumstances change (shift in payor mix, decline in economic conditions or deterioration in aging of patient receivables), our estimates of the net realizable value of patient receivables could be reduced by a material amount. We have estimated that a change in our collection percentage of 1.0% could result in a change in service fee revenue of \$5.2 million per year.

Our accounts receivable write-off process is primarily system-driven whereby a series of communications requesting payment is sent to a patient who either is without healthcare benefit coverage or who owes us a co-pay amount. These communications increase in intensity and urgency as the receivable becomes more delinquent. The communication cycle is a series of billing statements and letters requesting payment. The statements and letters are normally sent to patients who are without health insurance or who owe us a co-payment or deductible after insurance has been paid. The letters are sent for up to 110 days. If the receivable remains uncollected after this 110-day period, the communication cycle is complete and the receivable is written off in our patient accounting system and referred to a collection agency. We also review accounts receivable events checklists which are designed to identify significant delinquent accounts receivable. Write-offs for accounts identified by our events checklists are approved by the Vice President of our Patient Services Group.

Revenue Presentation

The Financial Accounting Standards Board's Emerging Issues Task Force issued its abstract, Issue 97-2, Application of FASB Statement No. 94 and APB Opinion No. 16 to Physicians Practice Management Entities and Certain Other Entities with Contractual Arrangements (EITF 97-2). Since Radiologix has not established a controlling financial interest under EITF 97-2, Radiologix does not consolidate the contracted radiology practices.

Income Taxes

We account for income taxes under the asset and liability method. This approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities.

Developing our provision for income taxes, including our effective tax rate, and analysis of potential tax exposure items, if any, requires significant judgment and expertise in federal and state income tax laws, regulations and strategies, including the determination of deferred tax assets and liabilities and, any estimated valuation allowances we deem necessary to value deferred tax assets. Our judgments and tax strategies are subject to audit by various taxing authorities. While we believe we have provided adequately for our income taxes in our consolidated financial statements, adverse determinations by these taxing authorities could have a material adverse effect on our consolidated financial condition, results of operations or cash flows.

Fair Value of Financial Instruments

Statement of Financial Accounting Standards No. 107, Disclosure About Fair Value of Financial Instruments, requires disclosure about the fair value of certain financial instruments. The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses approximate fair value due to the short maturity of these instruments. The estimates of fair value are based upon the quoted market prices for the same or similar issues of long term-debt with the same maturities, when available, or discounted cash flows.

Table of Contents*Concentration of Credit Risk*

The Company's accounts receivable consist primarily of service fee revenue generated by radiology practices and imaging centers for services performed that are immediately purchased by us and ultimately due from Medicare, Medicaid, managed care and private and other payors. The Company estimates that approximately 28% of these revenues in the three months ended March 31, 2006 and 2005 were funded through the Medicare and Medicaid programs. The Company and its contracted radiology practices perform ongoing credit evaluations of their patients and generally do not require collateral. The Company and its contracted radiology practices maintain estimated allowances for potential credit losses.

Note 3. Stock-Based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, which is a revision of SFAS No. 123. SFAS 123(R) supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, (APB 25), and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 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 123(R) permits public companies to adopt its requirements using one of two methods:

1. A modified-prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123(R) that remain unvested on the effective date.
2. A modified-retrospective method which includes the requirements of the modified-prospective method described above, but also permits 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 elected to use the modified-prospective method and, accordingly, has not restated prior period results.

As a result of adopting SFAS 123(R) we recorded \$224,000 of stock-based compensation for the three months ended March 31, 2006. Pursuant to APB 25, we reported, on a proforma basis in our footnotes to our financial statements, stock compensation expense of \$160,000 for the three months ended March 31, 2005. Stock-based compensation from our adoption of SFAS 123(R) relates to our 1996 and 2004 stock option plans. This compensation is measured at the date of each grant based on the calculated fair value of each grant.

Under the 1996 Stock Option Plan (the *1996 Plan*), an initial 4,000,000 options to purchase shares of the Company's common stock were available for grant to key directors, employees and other healthcare professionals associated with Radiologix, as defined by the 1996 Plan. On July 15, 2004, the Company's stockholders approved the adoption of the 2004 Long-Term Incentive Plan. As a result, all stock award grants from then on are made under this 2004 Plan. The total number of shares reserved and available for grant under the 2004 Plan are 3,000,000 plus any shares remaining available for grant under the prior 1996 Plan. Options granted under the 2004 Plan may be either incentive stock options (*ISO*) or nonqualified stock options (*NQSO*). The option price per share under the 2004 Plan may not be less than 100% of the fair market value at the grant date for ISO and may not be less than 85% of the fair market value at the grant date for NQSO. All of the options granted under the 2004 and 1996 Plans through March 31, 2006 were at fair market value on the date of grant. Generally, options vest over a five-year period and are exercisable over a ten-year life. During the three months ended March 31, 2006, 25,000 options were granted under the 2004 plan. As of March 31, 2006 2,570,716 options were outstanding under the 2004 and 1996 Plans.

The fair value of each option grant is estimated at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions for grants during the three months ended March 31, 2006 and 2005, respectively: risk-free interest rate of 4.72% and 4.50%; expected life of 3.4 and 5.4 years; expected volatility of 101.2% and 41.0%; and dividend yield of zero in 2006 and 2005, respectively. The weighted-average grant-date fair value of new grants during the three months ended March 31, 2006 and 2005 was \$2.79 and \$2.69 per share, respectively.

No options were exercised during the three months ended March 31, 2006. Accordingly, there were no cash flow effects resulting from share-based payment arrangements.

Edgar Filing: RADIOLOGIX INC - Form 10-Q

At March 31, 2006, there were share grants outstanding under the 2004 plan related to a 300,000 Restricted Stock Award to our Chief Executive Officer and Restricted Stock Units of 66,537 to directors. Pursuant to Section 4(a) of the 2004 Long-Term Incentive

Table of Contents

Compensation Plan, these awards count as 1.5 shares for every 1 award granted, for a total of 549,806 share grants counted against the plan at March 31, 2006. The Company recorded additional stock-based compensation of \$163,000 and \$101,000 for the three months ended March 31, 2006 and 2005, respectively, related to these awards.

Note 4. Restatement of Financial Statements

In reviewing the PresGar equipment lease contract acquired on October 31, 2004, the Company determined that its original accounting treatment of capitalizing the \$13.9 million lease termination costs was incorrect and in fact should have been expensed. Accordingly, the Company restated its financial statements for the year ended December 31, 2004 to increase operating expense and decrease intangible assets, net. The Company has also restated its financial statements for the three months ended March 31, 2005 to decrease depreciation and amortization expense by \$194,000 and decrease intangible assets, net of accumulated amortization, of \$13.6 million.

We did not record a tax benefit for the \$13.9 million lease termination costs because we determined that a valuation allowance was necessary due to the fact that we have had losses for the previous three years and the realization of additional deferred tax assets is questionable. Income tax expense was decreased by \$241,000 for the three months ended March 31, 2005 due to the utilization of book net operating losses.

We have also reclassified certain previously reported amounts for all periods presented, including (1) distributions from joint ventures and distributions to minority interests in consolidated subsidiaries have been reclassified from net cash used in investing activities to net cash from operating activities in the consolidated statement of cash flows and (2) certain balances in the Consolidating Balance Sheets and the Consolidating Statements of Operations in Note 11, Supplemental Guarantor Information, have been revised; these revisions primarily consist of separate reporting of investments in subsidiaries and intercompany receivables/payables in the Consolidating Balance Sheets and separate reporting of equity in income of wholly owned subsidiaries in the Consolidating Statements of Operations.

Note 5. Revenue Presentation

Radiologix has no financial controlling interest in the contracted radiology practices, as defined in Emerging Issues Task Force Issue 97-2 (EITF 97-2), accordingly, the Company does not consolidate the financial statements of those practices in its consolidated financial statements.

The following table sets forth the amounts of revenue for the contracted radiology practices and diagnostic imaging centers that would have been presented in the consolidated statements of operations had Radiologix met the provisions of EITF 97-2 (in thousands):

	For the Three Months Ended	
	2006	March 31, 2005
Revenue for contracted radiology practices and diagnostic imaging centers, net of contractual adjustments	\$ 88,619	\$ 86,181
Less: amounts retained by contracted radiology practices	(23,502)	(23,430)
Service fee revenue	\$ 65,117	\$ 62,751

The Company's service fee revenue is dependent upon the operating results of the contracted radiology practices and diagnostic imaging centers. Where state law allows, service fees due under the service agreements for the contracted radiology practices are derived from two distinct revenue streams: (1) a negotiated percentage of the professional revenues, reduced by certain expenses, as defined in the service agreements; and (2) 100% of the adjusted technical revenues as defined in the service agreements. In states where the law requires a flat fee structure, Radiologix has negotiated a base service fee, which approximates the estimated fair market value of the services provided under the service agreements and which is renegotiated each year. Service fee revenue is comprised of the following (in thousands):

For the Three Months Ended

March 31,

Edgar Filing: RADIOLOGIX INC - Form 10-Q

	2006	2005
Professional component	\$ 9,424	\$ 8,133
Technical component	55,693	54,618
Service fee revenue	\$ 65,117	\$ 62,751

Table of Contents**Note 6. Long-Term Debt**

Long-term debt and capital lease obligations consists of the following at March 31, 2006 and December 31, 2005 (in thousands):

	2006	2005
10.5% Senior Notes, due December 15, 2008	\$ 158,270	\$ 158,270
8% Convertible Junior Subordinated Note due July 2009	11,980	11,980
Note payable to bank and capital lease obligations, various interest rates	86	94
	\$ 170,336	\$ 170,344
Current portion of long-term debt and capital lease obligations	(32)	(32)
Long-term debt and capital lease obligations, net of current portion	\$ 170,304	\$ 170,312

Senior Notes

The Company's \$158.3 million in senior notes due December 15, 2008, bear interest at 10.5% payable semiannually in arrears on June 15 and December 15. The senior notes are redeemable on or after December 15, 2005 at various redemption prices, plus accrued interest to the date of redemption. These notes are unsecured obligations, which rank senior in right of payment to all subordinated indebtedness and equal in right of payment with all other senior indebtedness. The senior notes are unconditionally guaranteed on a senior unsecured basis by certain restricted existing and future subsidiaries. The required debt incurrence ratio under these notes is 2.75. Our debt incurrence ratio of 2.50 at March 31, 2006 is not in compliance with the requirements of these notes. The non-compliance with the debt incurrence ratio imposes the following limitations on the Company: 1) limits the Company's ability to make restricted payments (e.g., retirement of the Convertible Junior Subordinated Note) to a maximum of \$5,000,000; 2) prevents sale and leaseback transactions; 3) limits the incurrence of additional indebtedness (this does not impact our lease lines or credit facility as they are Permitted Indebtedness); and 4) prevents the designation of an unrestricted subsidiary as a subsidiary. In order to pass the debt incurrence ratio of 2.75 to 1.00, the Company will need to reach \$49.8 million in EBITDA for the trailing four quarters. At March 31, 2006 and December 31, 2005, our Senior Notes were trading at 74.0% and 98.0% of face value, respectively.

Convertible Junior Subordinated Note

The Company has a \$12.0 million convertible junior subordinated note, which matures July 31, 2009, and bears interest, payable quarterly in cash or in-kind securities, at an annual rate of 8.0%. The note holder may convert borrowings under the note to common stock at \$7.52 per share. This note is considered in the calculation of diluted earnings per share, when applicable. The market value of these notes is not readily determinable.

Revolving Credit Agreement

At December 31, 2005, amounts considered outstanding under the revolving credit facility totaled \$1.4 million related to two letters of credit in connection with our high retention workers' compensation program with \$28.2 million available for borrowings. Borrowings under this line are limited to 85% of eligible accounts receivable, as defined under the credit facility. Borrowings are secured by substantially all of our assets and a pledge of the capital stock of our wholly owned subsidiaries.

Note 7. Commitments and Contingencies*Master Leases Agreement*

Radiologix maintains operating leases for certain imaging equipment under an Amended and Restated Master Lease Agreement with GE Healthcare Financial Services (GE). Through this arrangement, GE has agreed to fund up to \$60.0 million of equipment leases through December 31, 2006, and requires that at least two-thirds of the outstanding balance represent GE healthcare equipment.

In connection with the Master Lease Agreement, the Company is required to provide additional cash collateral in a restricted account equal to 20% of the aggregate amounts outstanding under the Master Lease Agreement. The accompanying March 31, 2006 balance sheet includes \$5.7 million of restricted cash under this provision.

Edgar Filing: RADIOLOGIX INC - Form 10-Q

The Master Lease Agreement also contains certain covenants related to financial leverage, fixed charge coverage, and total indebtedness to GE. Failure to comply with these covenants would restrict our ability to lease additional equipment under the Master Lease Agreement until the covenants are met. At March 31, 2006, we are in compliance with the required covenants.

Table of Contents

At March 31, 2006, applicable amounts outstanding under the Master Lease Agreement totaled \$41.4 million; and \$15.3 million remained available for future leases. Commitments for leases signed but not placed in service under the Master Lease Agreement were \$3.3 million at March 31, 2006.

Leases

The Company leases office and facility space as well as certain diagnostic equipment under operating leases.

Our facility lease terms generally vary in length from 1 year to 15 years with renewal options upon prior written notice, from 1 year to 10 years depending on the agreed upon terms with the local landlord. Facility lease amounts generally increase from 1% to 4% on an annual basis. We do not have options to purchase the facilities we currently lease. These leases usually contain exclusivity clauses prohibiting the landlord from leasing space to potentially competitive businesses within a defined distance of our existing locations.

Our equipment lease agreements are generally negotiated through either GE or Siemens Medical Solutions USA, Inc. These leases typically contain payment terms from 60 to 62 months and may include early buy-out options equal to the estimated fair market value of the equipment, plus applicable taxes, at the time of the option.

Litigation

Our current litigation is (i) expected to be covered by liability insurance or (ii) is not expected to adversely affect our business. Some risk exists, however, that we could subsequently be named as a defendant in additional lawsuits or that pending litigation could escalate and adversely affect us.

Self-insurance

At March 31, 2006, the amount of reserves related to the potential obligations under our self-insured arrangements, which are comprised of estimated health benefits and workers' compensation obligations was \$2.0 million. We believe we are adequately reserved for estimated potential obligations under these arrangements.

Note 8. Discontinued Operations

A summary of discontinued operations is as follows (in thousands):

	As of and	
	For the Three Months Ended	
	March 31,	
	2006	2005
Service fee revenues	\$	\$ 197
Pre-tax income (loss)	\$ 237	\$ (434)

Pre-tax income in 2006 is due to the recovery of litigation fees.

Assets and liabilities of discontinued operations as of March 31, 2006 and December 31, 2005 were as follows (in thousands):

	2006	2005
Assets	\$	\$ 762
Liabilities	181	177
Net assets (liabilities)	\$ (181)	\$ 584

Edgar Filing: RADIOLOGIX INC - Form 10-Q

The assets and liabilities of discontinued operations are not segregated in the consolidated balance sheets.

Table of Contents**Note 9. Earnings Per Share**

Basic earnings per share (EPS) is calculated by dividing income available to common stockholders by the weighted average number of common shares outstanding during the period.

Diluted EPS includes options, warrants, and other potentially dilutive securities, using the treasury stock method to the extent that these securities are not anti-dilutive. Our diluted EPS calculation also considers the effect of the convertible junior subordinated note using the if converted method to the extent the securities are not anti-dilutive.

	For the Three Months Ended	
	March 31,	
	2006	2005
Weighted average shares for basic earnings per share	22,242,417	21,913,738
Effect of dilutive stock options		596,083
Effect of dilutive convertible junior subordinated note		
Weighted average shares for diluted earnings per share	22,242,417	22,509,821

For the three months ended March 31, 2006 and 2005, approximately \$240,000 of interest expense and 1,593,040 of weighted average shares related to the convertible junior subordinated note were not included in the computation of diluted EPS because to do so would be anti-dilutive for the periods. For the three months ended March 31, 2006, 2,570,716 options, 300,000 Restricted Stock Award and 66,537 Restricted Stock Units, related to our 1996 and 2004 stock option plans, were not included in the computation of diluted EPS because to do so would be anti-dilutive for the period.

Note 10. Segment Reporting

The Company's primary operations consist of owning and operating diagnostic imaging centers and providing administrative, management and information services to the contracted radiology practice groups that provide professional interpretation and supervision services in connection with the Company's diagnostic imaging centers and to hospitals and radiology practices with which the Company operates joint ventures.

The following table summarizes the operating results, including continuing and discontinued operations, and assets of our primary and Questar operations (in thousands):

	For the Three Months Ended		
	March 31, 2006		
	Primary		
	Operations	Questar	Total
Service fee revenue	\$ 63,551	\$ 1,566	\$ 65,117
Total costs and expenses	53,985	1,203	55,188
Income before equity in earnings of unconsolidated affiliates, minority interests in consolidated subsidiaries, income taxes and discontinued operations	9,566	363	9,929
Equity in earnings of unconsolidated affiliates	1,045		1,045
Minority interests in income of consolidated subsidiaries	(146)		(146)
Income before income taxes from continuing operations	10,465	363	10,828
Income from discontinued operations		237	237

Edgar Filing: RADIOLOGIX INC - Form 10-Q

Income before income taxes	\$ 10,465	\$ 600	\$ 11,065
Assets	\$ 119,466	\$ 2,338	\$ 121,804
Purchases of property and equipment	\$ 5,523	\$	\$ 5,523

Table of Contents

	For the Three Months Ended		
	March 31, 2005		
	Primary		
	Operations	Questar	Total
Service fee revenue	\$ 60,695	\$ 2,056	\$ 62,751
Total costs and expenses	51,392	1,560	52,952
Income before equity in earnings of unconsolidated affiliates, minority interests in consolidated subsidiaries, income taxes and discontinued operations	9,303	496	9,799
Equity in earnings of unconsolidated affiliates	622		622
Minority interests in income of consolidated subsidiaries	(149)		(149)
Income before income taxes from continuing operations	9,776	496	10,272
Loss from discontinued operations	(62)	(372)	(434)
Income before income taxes	\$ 9,714	\$ 124	\$ 9,838
Assets	\$ 111,868	\$ 6,101	\$ 117,969
Purchases of property and equipment	\$ 3,973	\$ 218	\$ 4,191

The following table is a reconciliation of the segment income before income taxes to Radiologix's consolidated reported income before income tax expense (benefit) (in thousands):

	For the Three Months Ended	
	March 31,	
	2006	2005
Segment income before income taxes	\$ 11,065	\$ 9,838
Unallocated amounts:		
Corporate general and administrative	(4,716)	(4,348)
Corporate depreciation and amortization	(967)	(945)
Corporate interest expense	(3,243)	(3,516)
Consolidated income before income tax expense (benefit)	\$ 2,139	\$ 1,029

The following table is a reconciliation of purchases of property and equipment for the segments to Radiologix's consolidated assets and purchases of property and equipment for the three month periods ended March 31 (in thousands):

	2006	2005
Purchases of property and equipment:		
Segment amounts	\$ 5,523	\$ 4,191
Corporate		282
Total purchases of property and equipment	\$ 5,523	\$ 4,473

The following table is a reconciliation of total assets and total liabilities for the segments to Radiologix's consolidated total assets and liabilities, as of March 31 (in thousands):

Edgar Filing: RADIOLOGIX INC - Form 10-Q

	2006	2005
Total Assets		
Segment amounts	\$ 121,804	\$ 117,969
Intangible assets, net	53,217	56,550
Deferred financing costs, net	4,529	6,179
Other corporate assets	60,705	61,912

Total assets	\$ 240,255	\$ 242,610
--------------	------------	------------

	2006	2005
Total Liabilities		
Segment amounts	\$ 27,414	\$ 29,364
Corporate, primary long-term debt	180,534	181,313

Total liabilities	\$ 207,948	\$ 210,677
-------------------	------------	------------

Table of Contents**Note 11. Unconsolidated Affiliates (Joint Ventures)**

The Company has seven unconsolidated joint ventures with ownership interests ranging from 22% to 50%. These joint ventures represent partnerships with hospitals, health systems or radiology practices and were formed for the purpose of owning and operating diagnostic imaging centers. Professional services at the joint venture diagnostic imaging centers are performed by the contracted radiology practices in such market area or a radiology practice that participates in the joint venture. The Company's investments in these joint ventures are accounted for under the equity method. Total assets at March 31, 2006 and December 31, 2005 include notes receivable from certain unconsolidated joint ventures aggregating \$1.2 million and \$1.3 million, respectively. Interest income related to these notes receivable was approximately \$28,000 and \$47,000 for the three months ended March 31, 2006 and 2005, respectively. The Company also received management service fees of approximately \$859,000 and \$730,000 for the three months ended March 31, 2006 and 2005, respectively, in connection with operating the centers underlying these joint ventures. The following table is a summary of key financial data for these joint ventures (in thousands):

	March 31,	December 31,
	2006	2005
Current assets	\$ 18,043	\$ 22,689
Noncurrent assets	7,122	7,591
Current liabilities	1,598	2,160
Noncurrent liabilities	119	192

For the Three Months Ended

	March 31,	
	2006	2005
Net revenue	\$ 13,739	\$ 9,699
Pre-tax income	3,426	2,244
Minority interest	1,045	622

Note 12. Supplemental Guarantor Information

In connection with the senior notes, certain of the Company's subsidiaries (Subsidiary Guarantors) guaranteed, jointly and severally, the Company's obligation to pay principal and interest on the senior notes on a full and unconditional basis.

The non-guarantor subsidiaries include: Advanced PET Imaging of Maryland, L.P., Montgomery Community Magnetic Imaging Center Limited Partnership, Tower OpenScan MRI, and MRI at St. Joseph Medical Center LLC. The Subsidiary Guarantors include all wholly owned subsidiaries of Radiologix, Inc.

The following supplemental condensed consolidating financial information presents the balance sheets as of March 31, 2006 and December 31, 2005, and the statements of operations and cash flows for the three months ended March 31, 2006 and 2005. In the consolidating condensed financial statements, the Subsidiary Guarantors account for their investment in the non-guarantor subsidiaries using the equity method.

Table of Contents**RADIOLOGIX, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATING BALANCE SHEET (Unaudited)****March 31, 2006****(In thousands)**

	Parent	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Total Consolidated
Assets:					
Cash and cash equivalents	\$ 43,547	\$ (1,468)	\$ 2,798	\$	\$ 44,877
Accounts receivable, net		40,383	1,035		41,418
Other current assets	15,018	3,632	52		18,702
Total current assets	\$ 58,565	\$ 42,547	\$ 3,885	\$	\$ 104,997
Property and equipment, net	1,514	64,825	1,815		68,154
Investment in subsidiaries	186,691			(186,691)	
Goodwill and intangible assets, net		52,303	914		53,217
Other assets	5,254	8,633			13,887
Intercompany receivables		29,198	10,897	(40,095)	
Total assets	\$ 252,024	\$ 197,506	\$ 17,511	\$ (226,786)	\$ 240,255
Liabilities and stockholders equity:					
Accounts payable and accrued expenses	\$ 2,097	\$ 4,455	\$ 432	\$	\$ 6,984
Intercompany payables	40,095			(40,095)	
Current portion of long-term debt		32			32
Other current liabilities	8,188	14,146	378		22,712
Total current liabilities	\$ 50,380	\$ 18,633	\$ 810	\$ (40,095)	\$ 29,728
Long-term debt, net of current portion	170,250	54			170,304
Other noncurrent liabilities		7,916			7,916
Minority interests in consolidated subsidiaries			913		913
Total stockholders equity	31,394	170,903	15,788	(186,691)	31,394
Total liabilities and stockholders equity	\$ 252,024	\$ 197,506	\$ 17,511	\$ (226,786)	\$ 240,255

Table of Contents**RADIOLOGIX, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATING BALANCE SHEET (Unaudited)****December 31, 2005****(In thousands)**

	Parent	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Total Consolidated
Assets:					
Cash and cash equivalents	\$ 31,145	\$ (1,515)	\$ 6,374	\$	\$ 36,004
Accounts receivable, net		39,375	1,440		40,815
Other current assets	14,783	4,224	72		19,079
Total current assets	\$ 45,928	\$ 42,084	\$ 7,886	\$	\$ 95,898
Property and equipment, net	9,610	56,529	1,826		67,965
Investment in subsidiaries	176,481			(176,481)	
Goodwill and intangible assets, net		53,107	943		54,050
Other assets	5,777	10,838			16,615
Intercompany receivables		23,040	7,173	(30,213)	
Total assets	\$ 237,796	\$ 185,598	\$ 17,828	\$ (206,694)	\$ 234,528
Liabilities and stockholders equity:					
Accounts payable and accrued expenses	\$ 8,711	\$ 15,681	\$ 488	\$	\$ 24,880
Intercompany payables	30,213			(30,213)	
Current portion of long-term debt	(256)	32	256		32
Other current liabilities		477			477
Total current liabilities	\$ 38,668	\$ 16,190	\$ 744	\$ (30,213)	\$ 25,389
Long-term debt, net of current portion	170,157	62	93		170,312
Other noncurrent liabilities		7,982			7,982
Minority interests in consolidated subsidiaries			1,874		1,874
Total stockholders equity	28,971	161,364	15,117	(176,481)	28,971
Total liabilities and stockholders equity	\$ 237,796	\$ 185,598	\$ 17,828	\$ (206,694)	\$ 234,528

Table of Contents**RADIOLOGIX, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS (Unaudited)****For the Three Months Ended March 31, 2006****(In thousands)**

	Parent	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Total Consolidated
Service fee revenue	\$	\$ 61,996	\$ 3,121	\$	\$ 65,117
Costs of operations:					
Cost of services		38,105	1,811		39,916
Equipment leases		3,521	235		3,756
Provision for doubtful accounts		5,196	83		5,279
Depreciation and amortization	215	5,577	178		5,970
Gross profit	\$ (215)	\$ 9,597	\$ 814	\$	\$ 10,196
Corporate general and administrative	\$ 4,716	\$	\$	\$	\$ 4,716
Interest expense, net	3,243	1,237	(3)		4,477
Income (loss) before equity in earnings of unconsolidated affiliates, minority interests in consolidated subsidiaries, income taxes and discontinued operations	\$ (8,174)	\$ 8,360	\$ 817	\$	\$ 1,003
Equity in net income of wholly owned subsidiaries	10,210			(10,210)	
Equity in earnings of unconsolidated affiliates		1,045			1,045
Minority interests in income of consolidated subsidiaries			(146)		(146)
Income (loss) before income taxes and discontinued operations	\$ 2,036	\$ 9,405	\$ 671	\$ (10,210)	\$ 1,902
Income tax expense		103			103
Income (loss) from continuing operations	\$ 2,036	\$ 9,302	\$ 671	\$ (10,210)	\$ 1,799
Discontinued Operations:					
Income from discontinued operations before income taxes		237			237
Income tax expense					
Income from discontinued operations	\$	\$ 237	\$	\$	\$ 237
Net income (loss)	\$ 2,036	\$ 9,539	\$ 671	\$ (10,210)	\$ 2,036

Table of Contents**RADIOLOGIX, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS (Unaudited)****For the Three Months Ended March 31, 2005****(In thousands)****(As restated)**

	Parent	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Total Consolidated
Service fee revenue	\$	\$ 59,881	\$ 2,870	\$	\$ 62,751
Costs of operations:					
Cost of services		38,085	1,735		39,820
Equipment leases		2,750	56		2,806
Provision for doubtful accounts		4,377	90		4,467
Depreciation and amortization	193	5,282	169		5,644
Gross profit	\$ (193)	\$ 9,387	\$ 820	\$	\$ 10,014
Corporate general and administrative	\$ 4,348	\$	\$	\$	\$ 4,348
Interest expense, net	3,516	1,145	15		4,676
Income (loss) before equity in earnings of unconsolidated affiliates, minority interests in consolidated subsidiaries, income taxes and discontinued operations	\$ (8,057)	\$ 8,242	\$ 805	\$	\$ 990
Equity in net income of wholly owned subsidiaries	9,010			(9,010)	
Equity in earnings of unconsolidated affiliates		622			622
Minority interests in income of consolidated subsidiaries			(149)		(149)
Income (loss) before taxes and discontinued operations	\$ 953	\$ 8,864	\$ 656	\$ (9,010)	\$ 1,463
Income tax expense		76			76
Income (loss) from continuing operations	\$ 953	\$ 8,788	\$ 656	\$ (9,010)	\$ 1,387
Discontinued Operations:					
Loss from discontinued operations before income taxes		(379)	(55)		(434)
Income tax expense					
Loss from discontinued operations	\$	\$ (379)	\$ (55)	\$	\$ (434)
Net income (loss)	\$ 953	\$ 8,409	\$ 601	\$ (9,010)	\$ 953

Table of Contents**RADIOLOGIX, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS (Unaudited)****For the Three Months Ended March 31, 2006****(In thousands)**

	Parent	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Total Consolidated
NET CASH PROVIDED BY OPERATING ACTIVITIES	\$ (5,487)	\$ 22,222	\$ (3,348)	\$	\$ 13,387
CASH FLOWS FROM INVESTING ACTIVITIES:					
Increase in restricted cash	(40)				(40)
Purchases of property and equipment		(5,356)	(167)		(5,523)
Proceeds from sale of equipment		957			957
Repayments from unconsolidated affiliates, net	100				100
Net cash used in investing activities	\$ 60	\$ (4,399)	\$ (167)	\$	\$ (4,506)
CASH FLOWS FROM FINANCING ACTIVITIES:					
Payments on long-term obligations	66	(13)	(61)		(8)
Due to/from parent/subsidiaries	17,763	(17,763)			
Net cash provided by (used in) financing activities	\$ 17,829	\$ (17,776)	\$ (61)	\$	\$ (8)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	12,402	47	(3,576)		8,873
CASH AND CASH EQUIVALENTS, beginning of period	31,145	(1,515)	6,374		36,004
CASH AND CASH EQUIVALENTS, end of period	\$ 43,547	\$ (1,468)	\$ 2,798	\$	\$ 44,877

Table of Contents**RADIOLOGIX, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS (Unaudited)****For the Three Months Ended March 31, 2005****(In thousands)****(As restated)**

	Parent	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Total Consolidated
NET CASH PROVIDED BY OPERATING ACTIVITIES	\$ 3,079	\$ 10,288	\$ 465	\$	\$ 13,832
CASH FLOWS FROM INVESTING ACTIVITIES:					
Increase in restricted cash	(22)				(22)
Purchases of property and equipment	(229)	(4,123)	(121)		(4,473)
Proceeds from sale of equipment		697			697
Net cash used in investing activities	(251)	(3,426)	(121)		(3,798)
CASH FLOWS FROM FINANCING ACTIVITIES:					
Payments on long-term obligations	4	(45)	(60)		(101)
Due to/from parent/subsidiaries	7,671	(8,069)	398		
Proceeds from stock option exercises	391				391
Net cash provided by (used in) financing activities	8,066	(8,114)	338		290
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	10,894	(1,252)	682		10,324
CASH AND CASH EQUIVALENTS, beginning of period	30,198	249	3,637		34,084
CASH AND CASH EQUIVALENTS, end of period	\$ 41,092	\$ (1,003)	\$ 4,319	\$	\$ 44,408

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation**

The discussion and analysis presented below refers to and should be read in conjunction with the consolidated financial statements and related notes appearing elsewhere in this Form 10-Q.

Restatement of Financial Statements

In reviewing the PresGar equipment lease contract acquired on October 31, 2004, the Company determined that its original accounting treatment of capitalizing the \$13.9 million lease termination costs was incorrect and in fact should have been expensed. Accordingly, the Company restated its financial statements for the year ended December 31, 2004 to increase operating expense and decrease intangible assets, net. The Company has also restated its financial statements for the three months ended March 31, 2005 to decrease depreciation and amortization expense by \$194,000 and decrease intangible assets, net of accumulated amortization, of \$13.6 million.

We did not record a tax benefit for the \$13.9 million lease termination costs because we determined that a valuation allowance was necessary due to the fact that we have had losses for the previous three years and the realization of additional deferred tax assets is questionable. Income tax expense was decreased by \$241,000 for the three months ended March 31, 2005 due to the utilization of book net operating losses.

We have also reclassified certain previously reported amounts for all periods presented, including (1) distributions from joint ventures and distributions to minority interests in consolidated subsidiaries have been reclassified from net cash used in investing activities to net cash from operating activities in the consolidated statement of cash flows and (2) certain balances in the Consolidating Balance Sheets and the Consolidating Statements of Operations in Note 11, Supplemental Guarantor Information, have been revised; these revisions primarily consist of separate reporting of investments in subsidiaries and intercompany receivables/payables in the Consolidating Balance Sheets and separate reporting of equity in income of wholly owned subsidiaries in the Consolidating Statements of Operations.

Overview

Our results may be impacted by variability due to changes in modality mix and the volume of procedures performed, physician referral and vacation patterns, the impact of hospital and physician-affiliated imaging centers that compete in our primary and Questar operations, the timing and negotiation of managed care and service contracts, the availability of technologists and other personnel resources, and trends in receivable collectibility. We are impacted by seasonality in that referring physicians and technologists often schedule vacations in the summer months which typically results in a decline in our volumes and service fee revenue while increasing costs of services as we contract for the services of temporary technologists at higher rates.

We are a leading national provider of diagnostic imaging services through our ownership and operation of free-standing, outpatient diagnostic imaging centers. We utilize sophisticated technology and technical expertise to perform a broad range of imaging procedures, such as magnetic resonance imaging (MRI), computed tomography (CT), positron emission tomography (PET), PET/CT, nuclear medicine, ultrasound, mammography, bone densitometry (DEXA), general radiography (X-ray) and fluoroscopy. For the three months ended March 31, 2006, we derived 86% of our service fee revenue from the ownership, management and operation of our imaging center network and 14% of our service fee revenue from administrative, management and information services provided to contracted radiology practices. As of March 31, 2006, we owned, operated or maintained, through our two operating segments, an ownership interest in imaging equipment at 69 locations, with imaging centers located in 7 states, including (1) primary operations in the Mid-Atlantic; the Bay Area, California; Treasure Coast, Florida; Northeast, Kansas; and the Finger Lakes (Rochester) and Hudson Valley markets in New York state; and (2) Questar operations with imaging centers located in California, Colorado and Minnesota.

Service fee revenue from our primary operations is comprised primarily of billed charges for both the technical and professional components for services performed, reduced by estimated contractual adjustments and by amounts retained by contracted radiology practice groups for their professional services, pursuant to our management services agreements. Under these management services agreements, the Company provides contracted radiology practices with the facilities and equipment used in its medical practice, assumes responsibility for the management of the operations, and employs substantially all of the non-physician personnel utilized by the contracted radiology practices. In connection with operations related to our Questar subsidiary, service fee revenue is comprised primarily of billed charges for technical services performed at our Questar imaging centers reduced by estimated contractual adjustments. Revenue is recognized once services are performed by contracted radiology practices, the imaging centers, or both. The provision for doubtful accounts related to established charges is reflected as an operating expense rather than a reduction of revenue. Our patient accounting system currently does not record contractual adjustments at the time of billing. Instead, adjustments for contractual adjustments and doubtful accounts are estimated based on historical collection experience using a retrospective collection analysis. As these factors change, changes in estimates are made in the appropriate period.

Table of Contents

The table below reflects our consolidated accounts receivable aging report at March 31, 2006, which is used to review accounts receivable aging patterns (in thousands):

	0-30	31-60	61-90	91-180	>180	
<i>Payor</i>	<i>Days</i>	<i>Days</i>	<i>Days</i>	<i>Days</i>	<i>Days</i>	<i>Total</i>
Medicare	\$ 8,956	\$ 3,785	\$ 928	\$ 1,833	\$ 2,042	\$ 17,544
Medicaid	1,167	1,027	568	1,067	1,354	5,183
Blue Cross	6,686	1,608	905	1,126	1,725	12,050
Commercial Insurance	801	1,058	470	398	195	2,922
Managed Care	11,095	6,266	2,108	2,203	3,050	24,722
Capitated	197	24	8	29	10	268
Self Pay	508	2,769	2,691	4,239	1,963	12,170
Workers Compensation	713	992	705	697	1,480	4,587
Other	(330)	741	456	687	846	2,400
<i>Total by payor</i>	\$ 29,793	\$ 18,270	\$ 8,839	\$ 12,279	\$ 12,665	\$ 81,846
<i>Other subsidiary (1)</i>	1,322	494	138	526	402	2,882
<i>Gross accounts receivable per aging</i>	\$ 31,115	\$ 18,764	\$ 8,977	\$ 12,805	\$ 13,067	\$ 84,728
<i>Accrued gross charges (2)</i>						16,719
<i>Allowance for contractual adjustments(3)</i>						(53,672)
<i>Allowance for doubtful accounts(3)</i>						(6,553)
<i>Other</i>						196
<i>Accounts receivable, net of allowances</i>						\$ 41,418

(1) Aging by payor is not available.

(2) Procedures have been completed but charges have not been entered into the billing system.

(3) Allowances are not allocated to individual aging periods.

The Company's service fee revenue is dependent upon the operating results of the contracted radiology practice groups and diagnostic imaging centers. Where state law allows, service fees due under the management services agreements for the contracted radiology practice groups are derived from two distinct revenue streams: (1) a negotiated percentage of the professional revenues, reduced by certain expenses (non-physician salaries and benefits, rent, depreciation, insurance, interest and other physician costs), as defined in the management services agreements; and (2) 100% of the adjusted technical revenues, as defined in the management service agreements, up to a designated ceiling at which point certain of the management services agreements provide for a technical bonus to the contracted radiology practice groups for a percentage amount in excess of this ceiling. In states where the law requires a flat fee structure, the Company has negotiated a base service fee, which approximates the estimated fair market value of the services provided under the management services agreements and which is renegotiated each year to equal the fair market value of the services provided under the management services agreements.

Our diagnostic imaging centers are also principally dependent on our ability to attract referrals from primary care physicians, specialists and other healthcare providers. The referral often depends on the existence of a contractual arrangement with the referred patient's health benefit plan. The Company has contracts with health benefit plans representing many of the patients in the markets we serve.

A summary of our volumes and service fee revenue follows (in thousands):

For the Three Months Ended

March 31,

Edgar Filing: RADIOLOGIX INC - Form 10-Q

	2006	2005
High end volumes (1)	90	94
Other volumes	302	292
Professional component	\$ 9,424	\$ 8,133
Technical component	55,693	54,618
Service fee revenue	\$ 65,117	\$ 62,751

(1) Defined as MRI, PET, CT and PET/CT procedures.

Table of Contents

Capitation revenue of \$3.3 million and \$3.8 million in the three months ended March 31, 2006 and 2005, respectively, is included in service fee revenue above. For the three months ended March 31, 2006 and 2005, approximately 5% and 6%, respectively, of our diagnostic imaging center service fee revenue was generated from capitated arrangements. Of this 5% and 6%, two-thirds relates to contracts with two physician groups and the remainder relates to a contract with one managed care payor.

Our charge masters at our imaging centers are generally set at approximately two times the current Medicare fee schedule because we are generally paid the lower of (1) billed charges, (2) a negotiated flat rate or (3) a multiple of the current Medicare fee schedule. Additionally, because the majority of our managed care payor contracts have fixed rates, we generally do not raise charge master pricing (gross charges). It is our policy that proposed price (gross charge) increases to any subsidiary charge master must be approved in writing by the Vice President of our Patient Services Group.

Results of Operations

Our primary operations consist of owning and operating diagnostic imaging centers and providing administrative, management, information, and other services to certain contracted radiology practice groups. These contracted radiology practice groups provide professional interpretation and supervision services to our diagnostic imaging centers and to hospitals and joint ventures in which we participate. Our services are designed to leverage our existing infrastructure and improve radiology practice groups or joint venture profitability, efficiency and effectiveness. We also operate primarily single modality imaging centers through our Questar subsidiary. Because of different characteristics from our primary operations, including location, market concentration, contracting leverage, and capital requirements, the single modality nature of most of the centers and the structure of the management service agreements with physicians related to the Company's Questar operations, senior management makes resource allocation decisions separately for Questar and our primary operations.

Three Months Ended March 31, 2006 Compared to Three Months Ended March 31, 2005

The following tables outline our service fee revenue, volumes and operating expenses (excluding stock compensation expense of \$387,000 and \$101,000), for the quarters ended March 31, 2006 and 2005, respectively, below (in thousands):

	2006	2005	Percent Increase (Decrease)	Percent of Service Fee Revenue		Basis Point Change
				2006	2005	
Service fee revenue	\$ 65,117	\$ 62,751	3.8%			
Field salaries and benefits	\$ 23,047	\$ 22,190	3.9%	35.4%	35.4%	
Field supplies	3,609	3,708	(2.7)	5.5	5.9	(40)
Facility rent	3,694	3,479	6.2	5.7	5.5	20
Other field expenses	9,566	10,443	(8.4)	14.7	16.6	(190)
Cost of services	\$ 39,916	\$ 39,820	0.2%	61.3%	63.4%	(210)
Equipment lease	3,756	2,806	33.9	5.8	4.5	130
Provision for doubtful accounts	5,279	4,467	18.2	8.1	7.1	100
Depreciation and amortization	5,970	5,644	5.8	9.2	9.0	20
Corporate, general and administrative	4,329	4,247	1.9	6.6	6.8	(20)
Interest expense, net	4,477	4,676	(4.3)	6.9	7.5	(60)
Total operating expense	\$ 63,727	\$ 61,660	3.4%	97.9%	98.3%	(40)

Table of Contents

Comparable results excluding certain Medical Services Agreement operations (San Antonio and the terminated Mid-Atlantic agreement) the terminated MSA operations are presented below:

	2006	2005	Percent Increase (Decrease)	Percent of Service Fee Revenue		Basis Point Change
				2006	2005	
Service fee revenue	\$ 65,117	\$ 61,821	5.3%			
Field salaries and benefits	\$ 23,047	\$ 21,985	4.8%	35.4%	35.5%	(10)
Field supplies	3,609	3,697	(2.4)	5.5	6.0	(50)
Facility rent	3,694	3,448	7.1	5.7	5.6	10
Other field expenses	9,564	10,336	(7.5)	14.7	16.7	(200)
Cost of services	\$ 39,914	\$ 39,466	1.1%	61.3%	63.8%	(250)
Equipment lease	3,750	2,806	33.6	5.8	4.5	130
Provision for doubtful accounts	5,302	4,223	25.6	8.1	6.8	130
Depreciation and amortization	5,970	5,643	5.8	9.2	9.2	
Corporate, general and administrative	4,329	4,247	1.9	6.6	6.9	(30)
Interest expense, net	4,477	4,676	(4.3)	6.9	7.6	(70)
Total operating expense	\$ 63,742	\$ 61,061	4.4%	97.9%	98.8%	(90)

For the quarter ended March 31, 2006 compared to the quarter ended March 31, 2005, service fee revenue increased \$2.4 million or 3.8%. This increase is primarily attributable to (1) higher procedure volumes and (2) higher withhold payments received by our subsidiary in Rochester, New York. Two payors in that market withhold a percentage of each payment for all providers in the market and put the money into a risk-sharing pool for imaging services. At the end of each year, the payors review the utilization of imaging services to determine the amount to pay to the provider. In the first quarter of each year, we receive a settlement for the prior year.

Excluding the terminated MSA operations noted above, service fee revenue increased \$3.3 million or 5.3% for the quarter ended March 31, 2006 compared to the quarter ended March 31, 2005. This increase is due to (1) higher procedures volumes and (2) higher withhold payments received by our subsidiary in Rochester, New York (as explained above).

Field salaries and benefits as a percentage of service fee revenue from continuing operations for the three months ended March 31, 2006 and 2005 were 35.4%. This percentage remained unchanged primarily due to (1) merit increases, (2) higher technologist costs, and (3) overtime costs for employee training in connection with our REWARD program described below, all of which were offset by a decrease in bonuses accrued for field personnel.

Field salaries and benefits as a percentage of service fee revenue from continuing operations for the three months ended March 31, 2006 and 2005, excluding the terminated MSA operations, were 35.4% and 35.5%, respectively. Management continually evaluates our service offerings, patient flows and technology offerings to identify more efficient and less costly methods of providing high quality patient care and continually evaluates its back office and support operations for new opportunities to gain economies of scale. We believe our Radiologix Enhanced Workflow And Record Distribution or REWARD (a comprehensive Radiology Information System/Picture Archival Communications System) Program will help us achieve greater efficiencies and lower our operating costs. We expect REWARD to enhance operational efficiencies by: (1) standardizing processes and protocols across the Company, (2) automating, accelerating and simplifying workflow, (3) improving the capture of front-end data including billing and patient scheduling information, (4) providing more timely digitized images and records to referring physicians and (5) reducing film and storage costs once fully implemented.

Field supplies, excluding the terminated MSA operations, as a percentage of service fee revenue were 5.5% for the three months ended March 31, 2006 compared to 6.0% for the three months ended March 31, 2005. This percentage decrease was due primarily to lower film costs resulting from the ongoing implementation of our REWARD program.

Facility rent, excluding the terminated MSA operations, as a percentage of service fee revenue was 5.7% and 5.6% for the three months ended March 31, 2006 and March 31, 2005, respectively. Facility rent increased as a result of a new imaging center that began operations in April

2005.

Other field expenses, excluding the terminated MSA operations, as a percentage of service fee revenue were 14.7% for the three months ended March 31, 2006 compared to 16.7% for the three months ended March 31, 2005. The decrease is primarily due to (1) the recording of larger gains on sales of equipment during the first quarter of 2006 as compared to the first quarter of 2005 and (2) lower physician purchased service costs due primarily to paying certain physicians for incremental coverage on reading contracts during the first quarter of 2005 that were not paid in 2006 due to the closure of two centers related to this activity in December 2005 and January 2006, offset by increased service contract costs resulting from new coverage on equipment coming off warranty.

Table of Contents

Equipment lease expenses, excluding the terminated MSA operations, as a percentage of service fee revenue were 5.8% in the three months ended March 31, 2006 compared to 4.5% for the three months ended March 31, 2005. This increase was primarily due to acquiring new imaging equipment through leasing arrangements.

Provision for doubtful accounts increased by \$812,000 in the three months ended March 31, 2006 compared to the three months ended March 31, 2005 primarily due to increased write-offs in our hospital business.

Depreciation and amortization increased in the three months ended March 31, 2006 compared to the three months ended March 31, 2005 primarily due to the impact of new imaging centers and new equipment placed in service, lease buyouts, and the acquisition of diagnostic equipment.

Corporate, general and administrative expenses increased in the three months ended March 31, 2006 compared to the three months ended March 31, 2005 primarily due to costs associated with the Company's first annual leadership meeting held in February 2006.

Interest expense (net of interest income), including amortization of deferred financing costs, for the three months ended March 31, 2006 compared to the three months ended March 31, 2005 is lower due primarily to earning interest income on additional invested funds.

Income tax expense for the three months ended March 31, 2006 and 2005 was \$103,000 and \$76,000, respectively. In each period, this expense reflects state taxes only as our federal effective tax rate was zero due to the utilization of federal net operating loss carryforwards.

Income tax expense for the three months ended March 31, 2006 and 2005 was \$103,000 and \$76,000, respectively. In each period, this expense primarily reflects state taxes only as our federal effective tax rate was zero due to the utilization of federal net operating loss carryforwards.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity at March 31, 2006, was derived from cash and cash equivalents and net cash generated by operating activities. As of March 31, 2006, we had current assets of \$105.0 million, including cash and cash equivalents of \$44.9 million, and current liabilities of \$29.7 million, including current maturities of long-term debt and capital lease obligations of \$32,000. For the three months ended March 31, 2006, we generated \$13.4 million in net operating cash flow, invested \$4.5 million and used cash of \$8,000 for financing activities.

Net cash from operating activities for the three months ended March 31, 2006 of \$13.4 million decreased from \$13.8 million for the same period in 2005. Our operating cash flows are primarily impacted by the amount of service fee revenue we generate and ultimately collect, offset by the amount and timing of our payment obligations for resources used to generate service fee revenue, such as costs for payroll, supplies, equipment operating leases, equipment maintenance contracts, equipment repairs, utilities, facility rent, marketing, interest and general and administrative costs.

For the three months ended March 31, 2006, operating cash flows decreased relative to the comparable period in 2005 due primarily to the receipt of income tax refunds in 2005, and the payment of distributions to the minority interest holders in our consolidated subsidiaries in 2006, offset by distributions received from our unconsolidated joint ventures in 2006.

Our days sales outstanding on accounts receivable decreased from 48.0 days at December 31, 2005 to 43.5 days at March 31, 2006. We calculate days sales outstanding by dividing accounts receivable, net of allowances, by the two-month average revenue per day. Our days sales outstanding decreased as a result of improved denial rates and overall improved collections in the first three months of 2006.

Net cash used in investing activities for the three months ended March 31, 2006 and 2005 was \$4.5 million and \$3.8 million, respectively. Purchases of property and equipment during the three months ended March 31, 2006 and 2005 were \$5.5 million and \$4.5 million, respectively, including \$1.3 million to buyout operating leases in 2005.

Table of Contents

Net cash flows used in financing activities for the three months ended March 31, 2006 was \$8,000, compared to net cash flows provided by financing activities for the three months ended March 31, 2005 of \$290,000. We received proceeds from the exercises of stock options of \$391,000 in the three months ended March 31, 2005 compared to zero in the three months ended March 31, 2006.

At December 31, 2005, we had outstanding senior note borrowings of \$158.3 million and a \$12.0 million convertible subordinated junior note. At December 31, 2005, amounts considered outstanding under the revolving credit facility totaled \$1.4 million related to two letters of credit in connection with our high retention workers compensation program with \$28.2 million available for borrowings. Borrowings under this line are limited to 85% of eligible accounts receivable, as defined under the credit facility. Borrowings are secured by substantially all of our assets and a pledge of the capital stock of our wholly owned subsidiaries.

On July 9, 2004, we amended our master lease with GE under an Amended and Restated Master Lease Agreement. Through this arrangement, GE has agreed to fund up to \$60.0 million of equipment leases through December 31, 2006, and requires that at least two-thirds of the outstanding balance represent GE healthcare equipment. In connection with the Master Lease Agreement, the Company is required to provide additional cash collateral in a restricted account equal to 20% of the aggregate amounts outstanding under the Master Lease Agreement. The accompanying December 31, 2005 balance sheet includes \$5.7 million of restricted cash under this provision.

The required debt incurrence ratio under the senior notes is 2.75. Our debt incurrence ratio of 2.50 at March 31, 2006 is not in compliance with these notes. The non-compliance with the debt incurrence ratio limits, among other things, our ability to incur additional debt (this does not impact our lease lines or credit facility as they are Permitted Indebtedness).

At March 31, 2006, applicable amounts outstanding under the Master Lease Agreement totaled \$41.4 million; commitments for leases signed but not placed in service under the Master Lease Agreement were \$3.3 million, and \$15.3 million remained available for future leases.

In fiscal 2006, we plan to spend approximately \$7.0 million for capital expenditures in connection with our REWARD Program, \$9.0 million for expansion of centers including de novo projects and commit \$9.0 million for major diagnostic equipment leases over the respective lease terms. As of March 31, 2006, we spent approximately \$1.2 million and \$4.3 million on capital expenditures in connection with our REWARD Program and expansion of centers, respectively.

We operate in a capital intensive, high fixed-cost industry that requires significant amounts of capital to fund operations, particularly the initial start-up and development cost of new diagnostic imaging centers and the acquisition of additional centers and new diagnostic imaging equipment. We currently believe that our cash balances, the expected cash flow from operations, and our borrowing capacity under our revolving credit facility and our master lease line will be sufficient to fund our working capital, acquisitions and capital expenditure requirements for the next eighteen months. Our long-term liquidity needs will consist of working capital and capital expenditure requirements, the funding of future acquisitions and repayment of debt. We intend to fund these long-term liquidity needs from cash generated from operations, available borrowings under our revolving credit facility, our master lease line of credit, and future debt and equity financings. However, our ability to generate cash is subject to our performance, general economic conditions, industry trends and other factors. Many of these factors are beyond our control and cannot be anticipated at this time. To the extent we are unable to generate sufficient cash from our operations, or if funds are not available under our revolving credit facility or our master lease line, we may be unable to meet our capital expenditure and debt service requirements. Furthermore, we may not be able to raise any necessary additional funds through bank financing or the issuance of equity or debt securities on terms acceptable to us, if at all.

CRITICAL ACCOUNTING POLICIES

This discussion and analysis should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this report.

The preparation of our consolidated financial statements requires the use of judgments and estimates. Our critical accounting policies are described below to provide a better understanding of how we develop our judgments about future events and related estimations and how they can impact our financial statements. A critical accounting policy is one that requires our most difficult, subjective or complex estimates and assessments and is fundamental to our results of operations. We identified our most critical accounting policies to be:

revenue recognition and estimation of allowances for contractals and doubtful accounts;

Edgar Filing: RADIOLOGIX INC - Form 10-Q

evaluation of intangible assets, including goodwill, and long-lived assets for impairment; and

estimation of a valuation allowance in accounting for income taxes (deferred tax assets).

Table of Contents

Basis of Presentation

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and include the accounts of the Company and its wholly owned and majority owned subsidiaries. All significant intercompany transactions have been eliminated. Investments in entities that the Company does not control, but in which it has a substantial ownership interest and can exercise significant influence, are accounted for using the equity method.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, results of operations and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

We consider all highly liquid investments with original maturities of three months or less to be cash equivalents.

Property and Equipment

Property and equipment are stated at cost, net of accumulated depreciation and amortization. Property and equipment are depreciated using the straight-line method over their estimated useful life. Amortization of assets under capital leases is included in depreciation and amortization.

Goodwill, Intangible and Long-lived Assets

The value of goodwill and intangible assets is stated at the lower of cost or fair value. Goodwill is not subject to amortization; however it is subject to periodic valuation assessments. Under the provisions of Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, the Company is required to perform at least an annual impairment test and to consider other indicators that may arise throughout the year to reevaluate carrying value. To the extent book value exceeds fair value, at the date an impairment is determined, the Company reduces goodwill by recording a charge to operations. The Company impaired its remaining balance of goodwill during the quarter ended December 31, 2005.

Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS No. 144), requires impairment losses to be recognized for long-lived assets through operations when indicators of impairment exist and the underlying cash flows are not sufficient to support the assets' carrying value. In addition, SFAS No. 144 requires that a long-lived asset (disposal group) to be sold that meets certain recognition criteria be classified as held for sale and measured at the lower of carrying amount or fair value less cost to sell. SFAS No. 144 also requires that a long-lived asset subject to closure (abandonment) before the end of its previously estimated useful life continue to be classified as held and used until disposal, with depreciation estimates revised to reflect the use of the asset over its shortened useful life.

In addition to the annual impairment test we perform with respect to goodwill, we regularly evaluate the carrying value of goodwill, intangible and long-lived assets for events or changes in circumstances that indicate that the carrying amount may not be recoverable or that the remaining estimated useful life should be changed. Potential indicators of impairment can include, but are not limited to (1) history of operating losses or expected future losses; (2) significant adverse change in legal factors; (3) changes in the extent or manner in which the assets are used; (4) current expectations to dispose of the assets by sale or other means and (5) reductions or expected reductions of cash flow. In the event that we determine there is an indication of impairment, we compare undiscounted net cash flows to the carrying value of the respective asset. If the carrying value exceeds the undiscounted net cash flows, we perform an impairment calculation using discounted cash flows, valuation analysis from independent valuation specialists or comparisons to recent sales or purchase transactions to determine estimated fair value.

Table of Contents

Finite Life Intangible and Long-Lived Assets

Impairment losses are recognized for long-lived assets through operations when events or changes in circumstances that may indicate that the carrying amount may not be recoverable and the underlying net cash flows are not sufficient to support the assets' carrying value. Examples of events or changes in circumstances or in the business climate can include, but are not limited to the following:

- a. History of operating losses or expected future losses
- b. Significant adverse change in legal factors
- c. Significant adverse change in the extent or manner in which the assets are used or in the physical condition of the assets
- d. Current expectations to dispose of the assets by sale or other means
- e. Reductions or expected reductions of cash flow

Our management services agreements, included in the consolidated balance sheets as intangible assets, are not considered to have indefinite useful lives and will continue to be amortized over a useful life of no more than 25 years based on SEC guidance. We regularly evaluate the carrying value and lives of the finite lived intangible assets in light of any events or circumstances that we believe may indicate that the carrying amount or amortization period should be adjusted.

Deferred Financing Costs

Deferred financing costs are amortized on a straight-line method, which approximates the effective interest method. As of March 31, 2006 and December 31, 2005, accumulated amortization of deferred financing costs was approximately \$7.1 million and \$6.7 million, respectively.

Accrued Physician Retention

Accrued physician retention represents amounts payable to contracted radiology practices under the management services agreements. The service agreements require Radiologix to remit physician retention to the contracted radiology practices by the end of the month after the month in which services were rendered.

Revenue Recognition

Service fee revenue from contracted radiology practice groups (professional revenue component) and diagnostic imaging centers (technical revenue component) is recorded when services are rendered by the contracted radiology practices and diagnostic imaging centers based on established gross charges billed and reduced by estimated contractual adjustments and amounts retained by the contracted radiology practice groups under the terms of management services agreements. Our patient accounting system currently does not record contractual adjustments at the time of billing. Instead, contractual adjustments and the provision for doubtful accounts are estimated based on historical collection experience using a retrospective collection analysis, which we began using in December 2004, payment-versus-charge schedules and aging models. Should circumstances change (shift in payor mix, decline in economic conditions or deterioration in aging of patient receivables), our estimates of the net realizable value of patient receivables could be reduced by a material amount. We have estimated that a change in our collection percentage of 1.0% could result in a change in service fee revenue of \$5.2 million per year.

Our accounts receivable write-off process is primarily system-driven whereby a series of communications requesting payment is sent to a patient who either is without healthcare benefit coverage or who owes us a co-pay amount. These communications increase in intensity and urgency as the receivable becomes more delinquent. The communication cycle is a series of billing statements and letters requesting payment. The statements and letters are normally sent to patients who are without health insurance or who owe us a co-payment or deductible after insurance has been paid. The letters are sent for up to 110 days and increase in intensity and urgency as the receivable becomes more delinquent. If the

Edgar Filing: RADIOLOGIX INC - Form 10-Q

receivable remains uncollected after this 110-day period, the communication cycle is complete and the receivable is written off in our patient accounting system and referred to a collection agency. We also review accounts receivable events checklists which are designed to identify significant delinquent accounts receivable. Write-offs for accounts identified by our events checklists are approved by the Vice President of our Patient Services Group.

Table of Contents

Revenue Presentation

The Financial Accounting Standards Board's Emerging Issues Task Force issued its abstract, Issue 97-2, Application of FASB Statement No. 94 and APB Opinion No. 16 to Physicians Practice Management Entities and Certain Other Entities with Contractual Arrangements (EITF 97-2). Since Radiologix has not established a controlling financial interest under EITF 97-2, Radiologix does not consolidate the contracted radiology practices.

Income Taxes

We account for income taxes under the asset and liability method. This approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities.

Developing our provision for income taxes, including our effective tax rate, and analysis of potential tax exposure items, if any, requires significant judgment and expertise in federal and state income tax laws, regulations and strategies, including the determination of deferred tax assets and liabilities and, any estimated valuation allowances we deem necessary to value deferred tax assets. Our judgments and tax strategies are subject to audit by various taxing authorities. While we believe we have provided adequately for our income taxes in our consolidated financial statements, adverse determinations by these taxing authorities could have a material adverse effect on our consolidated financial condition, results of operations or cash flows.

Fair Value of Financial Instruments

Statement of Financial Accounting Standards No. 107, Disclosure About Fair Value of Financial Instruments, requires disclosure about the fair value of certain financial instruments. The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses approximate fair value due to the short maturity of these instruments. The estimates of fair value are based upon the quoted market prices for the same or similar issues of long term-debt with the same maturities, when available, or discounted cash flows.

Concentration of Credit Risk

The Company's accounts receivable consist primarily of service fee revenue generated by radiology practices and imaging centers for services performed, that are immediately purchased by us and ultimately due from Medicare, Medicaid, managed care and private and other payors. The Company estimates that approximately 28% of these revenues in the three months ended March 31, 2006 and 2005 were funded through the Medicare and Medicaid programs. The Company and its contracted radiology practices perform ongoing credit evaluations of their patients and generally do not require collateral. The Company and its contracted radiology practices maintain estimated allowances for potential credit losses.

Stock-Based Awards

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, which is a revision of SFAS No. 123. SFAS 123(R) supersedes APB 25, and amends SFAS No. 95, Statement of Cash Flows. Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 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 123(R) permits public companies to adopt its requirements using one of two methods:

3. A modified-prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123(R) that remain unvested on the effective date.
4. A modified-prospective method which includes the requirements of the modified-prospective method described above, but also permits 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 elected to use the modified-prospective method and accordingly have not restated prior period results.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company's exposure to market risk for changes in interest rates relates primarily to the Company's cash equivalents, revolving credit facility, and its senior and convertible notes. At March 31, 2006, Radiologix had \$1.4 million considered outstanding under its revolving credit facility related to two letters of credit in connection with our high retention workers' compensation programs. Radiologix's notes bear interest at fixed rates.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures. Based on their evaluation as of a date within 45 days of the filing date of this Quarterly Report on Form 10-Q, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-14 (c) and 15d-14 (c) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

There have been no significant changes in the Company's internal controls or in other factors that have materially affected or are reasonably likely to materially affect its internal controls during our most recent fiscal quarter, except for any corrective actions with regard to significant deficiencies and material weaknesses as follows:

As noted in our 2005 Form 10-K, subsequent to December 31, 2005, but prior to the finalization of our 2005 consolidated financial statements, the Company placed into operations new controls to address the material weakness we identified in our accounting for lease transactions, including termination of leases. Management has enhanced the review process by ensuring that future material unusual transactions are subject to a more thorough and detailed review. The Company has revised its accounting policy for material unusual transactions to include a review by senior financial officers, and outside accounting experts if deemed necessary. We believe these new controls have remediated the material weakness that existed as of December 31, 2005, and that these controls operated effectively during the first quarter of 2006.

We have investments, not material in amount, in certain unconsolidated entities. Since we do not control these entities, our disclosure controls and procedures with respect to these entities are necessarily substantially more limited than those we maintain with respect to our consolidated subsidiaries.

Table of Contents

PART II: OTHER INFORMATION

Item 1. Legal Proceedings

We are not currently subject to any material litigation nor, to our knowledge, is any material litigation threatened against us. All of our current litigation is (i) expected to be covered by liability insurance or (ii) not expected to materially adversely affect our business. Some risk exists, however, that we could subsequently be named as a defendant in additional lawsuits or that pending litigation could materially adversely affect us.

Item 1A. Risk Factors

An investment in our common stock or notes involves a high degree of risk. You should carefully consider the risk factors listed below, as well as the other information included or incorporated in this report, before investing in our common stock or notes.

Risks Related to Our Company and Our Industry

Our revenue is dependent on referrals.

We generate most of our revenue from fees charged for the use of our diagnostic imaging equipment at our centers. This revenue depends on referrals from third parties, many of which are made by physicians who have no contractual relationship with us. We also generate revenue from service fees that we receive from the contracted radiology practices. If a sufficiently large number of physicians discontinue referring patients to us, our procedure volume could decrease, which would reduce our revenue and operating margins.

Further, commercial third-party payors have implemented programs to control costs that could limit the ability of physicians to refer patients to us. For example, prepaid healthcare plans, such as health maintenance organizations, in certain instances provide diagnostic-imaging services directly and contract directly with providers and require their enrollees to obtain these services from only these providers. Some insurance companies and self-insured employers also limit these services to contracted providers. These closed panel systems are now common in the managed care environment. Other systems create an economic disincentive for referrals to providers outside of the system's designated panel of providers. We may not be able to compete successfully for managed care contracts against entities with greater resources within a market area.

Changes in third-party payment rates or methods for diagnostic imaging services could create downward pricing pressure, which would result in a decline in our revenue and harm our financial position.

Our revenue is derived through our ownership, operation and management of diagnostic imaging centers and from service fees paid to us by contracted radiology practices. Substantially all of the revenue of our diagnostic imaging centers and the contracted radiology practices is currently derived from commercial third-party payors, government sponsored healthcare programs (principally, Medicare and Medicaid) and private and other payors. For the three months ended March 31, 2006, revenue generated at our diagnostic imaging centers consisted of 62% from managed care, 29% from Medicare and Medicaid, and 9% from private and other payors.

Any change in the rates of or conditions for reimbursement from commercial third-party payors, Medicare or Medicaid could substantially reduce the amounts reimbursed to us or our contracted radiology practices for services provided. These reductions could have a significant adverse effect on our revenue and financial results by creating downward pricing pressure.

Deficit Reduction Act of 2005 (DRA).

On February 8, 2006, the President signed into law the Deficit Reduction Act of 2005 (DRA). The DRA provides that reimbursement for the technical component for imaging services (excluding diagnostic and screening mammography) in non-hospital based freestanding facilities will be capped at the lesser of reimbursement under the Medicare Part B physician fee schedule or the Hospital Outpatient Prospective Payment System (HOPPS) schedule.

Currently, the technical component of our imaging services is reimbursed under the Part B physician fee schedule, which generally allows for higher reimbursement than under the HOPPS. Under the DRA, we will be reimbursed at the lower of the two schedules, beginning January 1, 2007.

Edgar Filing: RADIOLOGIX INC - Form 10-Q

The DRA also codifies the reduction in reimbursement for multiple images on contiguous body parts previously announced by the Centers for Medicare and Medicaid Services (CMS). In November 2005, CMS announced that it will pay 100% of the technical component of the higher priced imaging procedure and 50% for the technical component of each additional imaging procedure for imaging procedures involving contiguous body parts within a family of codes when performed in the same session. Under current methodology, Medicare pays 100% of the technical component of each procedure. CMS will phase in this rate reduction over two years, so that the reduction will be 25% for each additional imaging procedure in 2006 and another 25% in 2007.

Table of Contents

We believe the implementation of the reimbursement reductions contained in the DRA will have a significant effect on our business, financial condition and results of operations.

For the fiscal year ended December 31, 2005, Medicare revenue from our imaging centers represented approximately 26% of our total revenue from our imaging centers. If both reimbursement reductions contained in the DRA had been in effect during fiscal year 2005, we estimate that our Medicare revenue would have been reduced by approximately \$13.3 million and equity in earnings of unconsolidated affiliates would have been reduced by \$1.6 million. The estimated future reduction in revenue and pre-tax earnings from the reimbursement changes contained in the DRA is as follows:

Estimated Reduction in Revenue and Pre-Tax Earnings from DRA

(In thousands of dollars)

	2006	2007
Consolidated Operations:		
Contiguous Body Parts	\$ 1,900	\$ 2,900
Fee Schedule Change		10,400
Total	\$ 1,900	\$ 13,300
Unconsolidated Operations:		
Contiguous Body Parts	\$ 200	\$ 200
Fee Schedule Change		1,400
Total	\$ 200	\$ 1,600

These estimated reductions do not include any reductions that would result if commercial payors adopt reimbursement reductions similar to those contained in the DRA. We have been notified by two payors that they will adopt the contiguous body part imaging reduction in 2006. If additional commercial payors adopt reimbursement reductions similar to those contained in the DRA, this would result in additional reductions in our estimated revenue and pre-tax earnings that could be much greater than the reductions shown above, leading to a further material and substantially negative effect on our business.

We could be harmed if the contracted radiology practices terminate their agreements with us or lose a significant number of radiologists.

Our diagnostic imaging services include a professional component that must be provided by radiologists who are not directly employed by us. We do not control the radiologists who perform professional services for us. Instead, these radiologists are employed by the contracted radiology practices that maintain agreements with us. These agreements typically have terms of between 10 and 40 years, but may be terminated by either party under certain limited conditions. Depending on the termination event, the radiology practice may have the right to require us to sell, assign and transfer to it, the assets and related liabilities and obligations associated with the professional and technical radiology services provided by the radiology practice immediately prior to the termination. The termination or material modification of any of them could reduce our revenue.

If a significant number of radiologists terminate their relationships with the contracted radiology practices and the radiology practices cannot recruit sufficient qualified radiologists to fulfill practice obligations under our agreements with them, our ability to maximize the use of our diagnostic imaging centers could be adversely affected, thereby decreasing our revenue. Competition in recruiting radiologists and a shortage of qualified radiologists has made it difficult for some contracted radiology practices to maintain adequate levels of radiologists. Neither we nor the contracted radiology practices maintain insurance on the lives of any affiliated physicians.

Our success is dependent on an operational turnaround.

We may be unable to successfully complete the operational turnaround of this Company. Over the 2 years we have reviewed our overall operations, disposed of under performing operations, invested in strategic projects such as our REWARD Program, authorized new equipment expenditures, increased marketing initiatives and placed greater focus on Physician Advisory Board (PAB) communications (which involve meetings planned throughout the year with representatives of our contracted radiology practices to discuss strategic initiatives in the market

place). There can be no assurance that these actions, or future actions that we may take, will successfully turnaround the operations of the Company.

Table of Contents

We may not be able to successfully complete our market development plans.

We intend to increase our presence in existing markets through acquisitions of centers, developing de novo centers, and adding additional equipment at existing centers, establishing additional joint venture and outsourcing relationships and selectively entering into contractual relationships with high-quality, profitable radiology practices. We may not be able to expand either within our existing markets or in new markets. In addition, any expansion may not be beneficial to our overall strategy, and any such expansion may not ultimately produce returns that justify our investment.

Our ability to expand is dependent upon many factors, including our ability to:

identify attractive and willing candidates for acquisitions, joint ventures or outsourcing relationships;

adapt our structure to comply with federal and state legal requirements affecting our arrangements with contracted radiology practices, including state prohibitions on fee-splitting, corporate practice of medicine and self-referrals;

obtain regulatory approvals and certificates of need, where necessary, and comply with licensing and certification requirements applicable to our diagnostic imaging centers, the contracted radiology practices and the physicians associated with the contracted radiology practices;

recruit a sufficient number of qualified radiology technologists;

expand our infrastructure and management; and

obtain adequate financing.

Our ability to expand is also dependent on our ability to compete for opportunities. We may not be able to compete effectively for the acquisition of diagnostic imaging centers, joint venture opportunities or other outsourcing relationships. Our competitors may have better-established operating histories and greater resources than we do. Competitors may make it more difficult to complete acquisitions or joint ventures on terms beneficial to us.

Acquisitions involve a number of special risks, including the following:

possible adverse effects on our operating results;

diversion of management's attention and resources;

failure to retain key personnel;

difficulties in integrating new operations into our existing management infrastructure;

amortization or write-offs of acquired intangible assets; and

risks associated with unanticipated events or liabilities.

Additionally, although we will continue to structure our operations in an effort to comply with applicable antitrust laws, federal or state governmental authorities may view us as being dominant in a particular market and, therefore, cause us to divest ourselves of relationships or assets.

We and the contracted radiology practices may become subject to burdensome lawsuits.

We may be subject to professional liability claims, including, without limitation, for improper use or malfunction of our diagnostic imaging equipment. Our operations, as well as the services we provide on behalf of the contracted radiology practices, also may be subject to lawsuits for inappropriate use or disclosure of individually identifiable patient health information. We maintain insurance policies with coverages that we believe are appropriate in light of the risks attendant to our business and consistent with industry practice. We also require the contracted radiology practices to maintain professional liability insurance consistent with industry practice. However, adequate liability insurance may not be available to us and the contracted radiology practices in the future at acceptable costs or at all.

Providing medical services entails the risk of professional malpractice and other similar claims. The physicians employed by the contracted radiology practices are from time to time subject to malpractice claims. We structure our relationships with the practices under our agreements with them in a manner that we believe does not constitute the practice of medicine by us or subject us to professional malpractice claims for acts or omissions of physicians in the contracted radiology practices. Nevertheless, claims, suits or complaints relating to services provided by the contracted radiology practices may be asserted against us in the future, including malpractice.

Any claim made against us not fully covered by insurance could be costly to defend against, result in a substantial damage award against us and divert the attention of our management from our operations, which could have an adverse effect on our financial performance. In addition, claims might adversely affect our business or reputation.

Table of Contents

We have assumed and succeeded to substantially all of the obligations of some of the operations that we have acquired. Therefore, claims may be asserted against us for events that occurred prior to these acquisitions. In connection with our acquisitions, the sellers of the operations that we have acquired have agreed to indemnify us for certain claims. However, we may not be able to collect payment under these indemnity agreements, which could affect us adversely.

Most of our imaging modalities require the utilization of radiation, and certain imaging modalities utilize radioactive materials. These operations generate regulated waste and could subject us to regulation, related costs and delays and potential liabilities for injuries or violations of environmental, health and safety laws.

Most of our imaging modalities utilize radiation, and certain imaging modalities utilize radioactive material. These operations generate medical and other regulated wastes. Storage, use and disposal of these materials and waste products present the risk of accidental environmental contamination and physical injury. We are subject to federal, state and local regulations governing storage, handling and disposal of these materials. We cannot completely eliminate the risk of accidental contamination or injury from these hazardous materials. In the event of an accident, we would be held liable for any resulting damages, and any liability could exceed the limits of or fall outside the coverage of our insurance. We may not be able to maintain insurance on acceptable terms, or at all. We could incur significant costs and the diversion of our management's attention to comply with current or future environmental, health and safety laws and regulations.

We may experience competition from other diagnostic imaging companies. This competition could adversely affect our revenue and our business.

The market for diagnostic imaging services is competitive. We compete principally on the basis of our reputation for providing multiple modalities, our conveniently located centers and our cost-effective, high-quality diagnostic imaging services. We compete locally with groups of radiologists and some non-radiologist physician practices, established hospitals, clinics and certain other independent organizations that own and operate imaging equipment. Our major national competitors include Alliance Imaging, Inc., InSight Health Services Corp., Medical Resources, Inc., and MedQuest, Inc. Some of our local or national competitors that provide diagnostic-imaging services may now or in the future have access to greater financial resources than we do and may have access to newer more advanced equipment.

Technological change in our industry could reduce the demand for our services and require us to incur significant costs to upgrade our equipment.

Technological change in the diagnostic imaging industry has been gradual. In the future, however, the development of new technologies or refinements of existing modalities may make our existing equipment technologically or economically obsolete, or cause a reduction in the value of, or reduce the need for, our services. Diagnostic imaging equipment is currently manufactured by numerous companies. Competition among manufacturers for a greater share of the diagnostic imaging equipment market may result in technological advances in the speed and imaging capacity of new equipment. Consequently, the obsolescence of our equipment may be accelerated. We may not have the financial ability to acquire the new or improved equipment.

A failure to meet our capital expenditure requirements could adversely affect our business.

We operate in a capital intensive, high fixed-cost industry that requires significant amounts of capital to fund operations, particularly the initial start-up and development expenses of new diagnostic imaging centers and the acquisition of additional centers and new diagnostic imaging equipment. We incur capital expenditures to, among other things:

upgrade and replace existing equipment;

purchase new diagnostic imaging equipment; and

expand within our existing markets and enter new markets.

To the extent we are unable to generate sufficient cash from our operations, funds are not available under our credit facility or we are unable to structure or obtain operating leases, we may be unable to meet our capital expenditure requirements. Furthermore, we may not be able to raise any necessary additional funds through bank financing or the issuance of equity or debt securities on terms acceptable to us, if at all.

Our success depends in part on our key personnel and we may not be able to retain sufficient qualified personnel.

Our success depends in part on our ability to attract and retain qualified senior and executive management, managerial and technical personnel. Competition in recruiting these personnel may make it difficult for us to continue our growth and success. The loss of their services or our inability in the future to attract and retain management and other key personnel could hinder the implementation of our business strategy. We do not maintain key person insurance for any of our executive officers. Recently, there has been a shortage in certain of our markets of qualified radiology technologists, the personnel who operate our equipment. If we are unable to recruit and retain a sufficient number of qualified technologists, we will be unable to operate our centers at maximum capacity or we will be forced to staff our diagnostic imaging centers with temporary personnel, thereby increasing our operating costs and reducing our operating margin profitability.

Table of Contents

Our inability to enforce non-compete agreements with the radiologists may increase competition.

Each of the contracted radiology practices under our comprehensive services model has entered into agreements with its physician shareholders and full-time employed radiologists that generally prohibit those shareholders and radiologists from competing for a period of two years within defined geographic regions after they cease to be owners or employees, as applicable. In most states, a covenant not to compete will be enforced only:

to the extent it is necessary to protect a legitimate business interest of the party seeking enforcement;

if it does not unreasonably restrain the party against whom enforcement is sought; and

if it is not contrary to public interest.

Enforceability of a non-compete covenant is determined by a court based on all of the facts and circumstances of the specific case at the time enforcement is sought. For this reason, it is not possible to predict whether, or to what extent, a court will enforce the contracted radiology practices' covenants. Our inability, or that of our contracted radiology practices, to enforce radiologists' non-compete covenants could result in increased competition from individuals who are knowledgeable about our business strategies and operations.

It is difficult to estimate our uncollectible accounts receivable and contractual allowances for billed charges, which may impact our earnings.

Due to the complex nature of billing for healthcare services, it is difficult for us to estimate our uncollectible accounts receivable and our contractual allowances for billed charges. If we have to revise our estimates and our existing reserves are not adequate, this may impact our earnings.

Our ability to maximize the use of our diagnostic imaging equipment may be subject to seasonality.

During the summer months our average daily diagnostic imaging procedures decrease, which reduces our service fee revenues during those months. The decrease in average daily diagnostic imaging procedures may have resulted from referring physicians or their patients taking vacation. We cannot give any assurance that our future procedure volume and service fee revenues will not be affected by similar circumstances during the summer months or other traditional vacation times of the year.

Severe weather conditions can adversely affect our operations. We cannot give any assurance that our future procedure volume and service fee revenues will not be adversely affected by weather-related interruptions.

Managed care contracts and capitated fee arrangements could reduce our operating margins.

Under capitated or other risk-sharing arrangements, the healthcare provider typically is paid a pre-determined amount per-patient per-month from the payor in exchange for providing all necessary covered services to patients covered under the arrangement. These contracts pass much of the financial risk of providing outpatient diagnostic imaging services, including the risk of over-use, from the payor to the provider. Our success will depend in part on our ability to negotiate effectively, on behalf of the contracted radiology practices and the diagnostic imaging centers that we own, operate or manage, contracts with HMOs, employer groups and other third-party payors for services to be provided on a risk-sharing or capitated basis by some or all of the radiology practices and/or diagnostic imaging centers. Risk-sharing arrangements result in better revenue predictability, but more unpredictability of expenses and, consequently, profitability. We may not be able to negotiate satisfactory arrangements on a capitated or other risk-sharing basis, on behalf of our diagnostic imaging centers or the contracted radiology practices. In addition, to the extent that patients or enrollees covered by these contracts require more frequent or extensive care than anticipated, we would incur unanticipated costs not offset by additional revenue, which would reduce operating margins.

We may be unable to generate revenue when our equipment is not operational.

Timely, effective service is essential to maintaining our reputation and high utilization rates on our imaging equipment. Our warranties and maintenance contracts do not compensate us for loss of revenue when our systems are not fully operational. Equipment manufacturers may not

Edgar Filing: RADIOLOGIX INC - Form 10-Q

be able to perform repairs or supply needed parts in a timely manner. Thus, if we experience more equipment malfunctions than anticipated or if we are unable to promptly obtain the service necessary to keep our equipment functioning effectively, our revenue could decline and our ability to provide services would be harmed.

Table of Contents***Our corporate organizational documents could discourage acquisition proposals and make difficult a change of control.***

Certain provisions of Radiologix's Restated Certificate of Incorporation, as amended, Radiologix's Amended and Restated Bylaws and Delaware law could discourage potential acquisition proposals, delay or prevent a change in control of Radiologix and, consequently, limit the price that investors might be willing to pay in the future for shares of our common stock. These provisions include the inability to remove directors except for cause and our ability to issue, without further stockholder approval, shares of preferred stock with rights and privileges senior to the common stock. We are also subject to Section 203 of the Delaware General Corporation Law which, subject to certain exceptions, prohibits a Delaware corporation from engaging in any of a broad range of business combinations with an interested stockholder for three years after the stockholder became an interested stockholder.

We have also entered into written employment agreements with our Chief Executive Officer and President, Senior Vice President, General Counsel and Secretary and Senior Vice President and Chief Financial Officer, which contain provisions that require us to pay certain amounts to the executives upon their termination following a change of control. These agreements may delay or prevent a change of control of Radiologix.

Risks Relating to Government Regulation of Our Business***State and federal anti-kickback and anti-self-referral laws may adversely affect our income.***

Various federal and state laws govern financial arrangements among healthcare providers. The federal anti-kickback law prohibits the knowing and willful offer, payment, solicitation or receipt of any form of remuneration in return for, or to induce, the referral of Medicare, Medicaid, or other federal healthcare program patients, or in return for, or to induce, the purchase, lease or order of items or services that are covered by Medicare, Medicaid, or other federal healthcare programs. Similarly, many state laws prohibit the solicitation, payment or receipt of remuneration in return for, or to induce the referral of patients in private as well as government programs. Violation of these anti-kickback laws may result in substantial civil or criminal penalties for individuals or entities and/or exclusion from federal or state healthcare programs. We believe that we are operating in compliance with applicable law and believe that our arrangements with providers would not be found to violate the anti-kickback laws. However, these laws could be interpreted in a manner inconsistent with our operations.

Federal law prohibiting physician self-referrals (the Stark Law) prohibits a physician from referring Medicare or Medicaid patients to an entity for certain designated health services if the physician has a prohibited financial relationship with that entity, unless an exception applies. Certain radiology services are considered designated health services under the Stark Law. Although we believe that our operations do not violate the Stark Law, our activities may be challenged. If a challenge to our activities is successful, it could have an adverse effect on our operations. In addition, legislation may be enacted in the future that further addresses Medicare and Medicaid fraud and abuse or that imposes additional requirements or burdens on us.

All of the states in which our diagnostic imaging centers are located have adopted a form of anti-kickback law and almost all of those states have also adopted a form of Stark Law. The scope of these laws and the interpretations of them vary from state to state and are enforced by state courts and regulatory authorities, each with broad discretion. A determination of liability under the laws described in this risk factor could result in fines and penalties and restrictions on our ability to operate in these jurisdictions.

Enforcement of federal and state privacy and associated laws may adversely affect our income.

How providers and their business associates use and disclose certain healthcare information has come under increasing public sensitivity and scrutiny. Additional risks for healthcare providers and their business associates are posed by the HIPAA federal standards, which set forth guidelines concerning how individually-identifiable health information may be used and disclosed. Historically, state law has governed confidentiality issues. But as a result of the enactment of HIPAA, some states have revised their existing laws and regulations. These changes may or may not be consistent with the federal HIPAA provisions. As a provider of healthcare services, we must conform to all applicable laws, both federal and state. We believe that our operations are compliant with these legal standards. Nevertheless, these laws and regulations are new and few have been interpreted by government regulators or courts. Consequently, our interpretations and activities may be challenged. If a challenge to our activities is successful, it could have an adverse effect on our operations.

Federal False Claims Act violations could affect our participation in government programs.

The Federal False Claims Act provides, in part, that the federal government may bring a lawsuit against any person whom it believes has knowingly presented, or caused to be presented, a false or fraudulent request for payment from the federal government, or who has made a false statement or used a false record to get a claim approved. The Federal False Claims Act further provides that a lawsuit may be initiated in the name of the United States by an individual who is an original source of the allegations. The government has taken the position that claims

Edgar Filing: RADIOLOGIX INC - Form 10-Q

presented in violation of the federal anti-kickback law or Stark Law may be considered a violation of the Federal False Claims Act. Penalties include fines ranging from \$5,500 to \$11,000 for each false claim, plus three times the amount of damages that the federal government sustained because of the act of that person. We believe that we are in compliance with the rules and regulations that apply to the Federal False Claims Act. However, we could be found to have violated certain rules and regulations resulting in sanctions under the Federal False Claims Act. If we are found in violation, any sanctions imposed could result in fines and penalties and restrictions on and exclusions from participation in federal and state healthcare programs that are integral to our business.

Table of Contents

Our agreements with the contracted radiology practices must be structured to avoid the corporate practice of medicine and fee-splitting.

The laws of many states, including many of the states in which the contracted radiology practices are located, prohibit us from exercising control over the medical judgments or decisions of physicians and from engaging in certain financial arrangements, such as splitting professional fees with physicians. These laws and their interpretations vary from state to state and are enforced by state courts and regulatory authorities, each with broad discretion. A component of our business has been to enter into service agreements with radiology practices. We provide management, administrative, technical and other non-medical services to the radiology practices in exchange for a service fee. We structure our relationships with the radiology practices, including the purchase of diagnostic imaging centers, in a manner that we believe keeps us from engaging in the practice of medicine or exercising control over the medical judgments or decisions of the radiology practices or their physicians or violating the prohibitions against fee-splitting. State regulatory authorities or other parties may assert that we are engaged in the corporate practice of medicine or that the payment of service fees to us by the radiology practices constitutes fee-splitting. If such a claim were successfully asserted, we could be subject to civil and criminal penalties and could be required to restructure or terminate the applicable contractual arrangements. This result, or our inability to successfully restructure our relationships to comply with these statutes, could jeopardize our business strategy.

Licensing and certification laws may limit our ability to expand.

Ownership, construction, operation, expansion and acquisition of diagnostic imaging centers are subject to various federal and state laws, regulations and approvals concerning licensing of centers, personnel, certificates of need and other required certificates for certain types of healthcare centers and major medical equipment. The laws of some of the states in which we operate limit our ability to acquire new diagnostic imaging equipment or expand or replace our existing equipment at diagnostic imaging centers in those states. In addition, free-standing diagnostic imaging centers that provide services that are not performed as part of a physician office must meet Medicare requirements to be certified as an independent diagnostic testing facility to bill the Medicare and Medicaid programs. We may not be able to receive the required regulatory approvals for any future acquisitions, expansions or replacements, and the failure to obtain these approvals could limit the market for our services.

The regulatory framework is uncertain and evolving.

Healthcare laws and regulations may change significantly in the future. We continuously monitor these developments and modify our operations from time to time as the regulatory environment changes. We cannot assure you, however, that we will be able to adapt our operations to address new regulations or that new regulations will not adversely affect our business. In addition, although we believe that we are operating in compliance with applicable federal and state laws, neither our current or anticipated business operations nor the operations of the contracted radiology practices have been the subject of judicial or regulatory interpretation. We cannot assure you that a review of our business by courts or regulatory authorities will not result in a determination that could adversely affect our operations or that the healthcare regulatory environment will not change in a way that restricts our operations.

Certain states have enacted statutes or adopted regulations affecting risk assumption in the healthcare industry, including statutes and regulations that subject any physician or physician network engaged in risk-based managed care contracting to applicable insurance laws and regulations. These laws and regulations may require physicians and physician networks to meet minimum capital requirements and other safety and soundness requirements. Implementing additional regulations or compliance requirements could result in substantial costs to us and the contracted radiology practices and limits our ability to enter into capitated or other risk sharing managed care arrangements.

We could be harmed if payors are unable to comply with HIPAA Standard Transaction and Code Set Requirements.

The administrative provisions of HIPAA direct the federal government to adopt national electronic standards for automated transfer of certain healthcare data between healthcare payors, plans and providers. HIPAA is designed to enable the entire healthcare industry to communicate electronic data using a single set of standards, thus eliminating all nonstandard formats currently in use. Our contracted radiology practices and diagnostic imaging centers are covered entities under HIPAA, and as such, have to comply with the HIPAA electronic data interchange mandates. A failure in our ability to comply with HIPAA Standards or the discontinuance of CMS or payor contingency plans could cause us to experience a delay in claims processing by its payors or lead to a large number of rejected or denied claims. Either of these results may slow our cash collections and increase our accounts receivable days sales outstanding.

Table of Contents

Risks Related to Indebtedness

Our substantial level of indebtedness could adversely affect our financial condition and prevent us from fulfilling our obligations on our notes or notes issued to replace them.

At March 31, 2006, we had approximately \$170.3 million of indebtedness. In addition, we have the ability to borrow up to \$29.6 million under our credit facility. Also, subject to restrictions in the indenture and the credit facility, we may incur additional indebtedness.

Our high level of indebtedness could have important consequences, including the following:

our ability to obtain additional financing for working capital, capital expenditures, acquisitions or general corporate purposes may be impaired;

we must use a substantial portion of our cash flow from operations to pay interest on our notes and our other indebtedness, which will reduce the funds available to us for other purposes;

all of the indebtedness outstanding under the credit facility is secured by substantially all of our assets and will mature prior to any notes;

our high level of indebtedness could place us at a competitive disadvantage to our competitors that have less debt; and

our high level of indebtedness makes us more vulnerable to economic downturns and adverse developments in our business. We expect to obtain the money to pay our expenses and to pay the amounts due under our notes and other debt from our operations, borrowings under our credit facility and new borrowings. Our ability to meet our expenses depends on our future performance, which will be affected by financial, business, economic and other factors. We will not be able to control many of these factors, such as economic conditions in the markets where we operate and pressure from competitors. Our business may not generate sufficient cash flow from operations in the future and future borrowings may not be available in an amount sufficient to enable us to repay indebtedness, including our notes, or to fund other liquidity needs. If we do not have enough money, we may be required to refinance all or part of our then existing debt (including our notes), sell assets or borrow more money. We cannot guarantee that we will be able to do so on terms acceptable to us, or at all. In addition, the terms of existing or future debt agreements, including our credit facility and any indenture, may restrict us from adopting any of these alternatives. The failure to generate sufficient cash flow or to achieve these alternatives could significantly adversely affect the value of our notes and our ability to pay the amounts due under them.

Because our notes are unsecured, the right to enforce remedies is limited by the rights of holders of secured debt.

Our notes are not secured. Our credit facility is secured by substantially all of our assets and a pledge of the capital stock of all of our wholly owned subsidiaries. If we become insolvent or are liquidated, or if any payment under the credit facility is accelerated, our lenders will be entitled to exercise the remedies available to a secured lender under applicable law and will have a claim on those assets before the holders of any notes. The liquidation value of our assets may not be sufficient to repay in full any indebtedness under the credit facility, as well as our other indebtedness, including our notes.

Our ability to repay our notes and our other debt depends on cash flow from our subsidiaries, some of which are not obligated to make funds available to make payments on notes.

We are a holding company. Our only material assets are our ownership interests in our subsidiaries. Consequently, we depend on distributions or other intercompany transfers of funds from our subsidiaries to meet our debt service and other obligations, including with respect to our notes. Our non-guarantor subsidiaries are not obligated to make funds available for payment on our notes. Only our subsidiaries that are not unrestricted subsidiaries will guarantee our notes. The financial statements included in this report are presented on a consolidated basis,

Edgar Filing: RADIOLOGIX INC - Form 10-Q

including all of our subsidiaries. The aggregate total assets at March 31, 2006 of our subsidiaries that are not guarantors of our notes were \$17.5 million, or 7.3% of our total assets at March 31, 2006. The operating results of our guarantor subsidiaries may not be sufficient to enable us to make payments on our notes. In addition, our rights and the rights of our creditors, including holders of our notes, to participate in the assets of any of our non-guarantor subsidiaries upon their liquidation or recapitalization will generally be subject to the prior claims of those subsidiaries creditors. As a result, our notes are effectively subordinated to the indebtedness of the non-guarantor subsidiaries. As of March 31, 2006, the total liabilities of our non-guarantor subsidiaries, excluding intercompany liabilities, were \$810,000, or 0.4% of our total liabilities.

The indenture for our notes and our credit facility impose significant operating and financial restrictions, which may prevent us from pursuing certain business opportunities and taking certain actions.

The indenture for our notes and our credit facility impose significant operating and financial restrictions on us. These restrictions limit our ability to, among other things:

borrow money;

pay dividends on or redeem or repurchase our stock;

Table of Contents

make investments;

create liens;

sell certain assets or merge with or into other companies;

enter into certain transaction with affiliates;

sell stock in our subsidiaries; and

restrict dividends, distributions or other payments from our subsidiaries.

If we are unable to access the full \$35 million under our credit facility, our ability to meet our capital expenditure requirements may be restricted.

Our borrowing availability under our \$35 million credit facility is determined through a formula, which allows us to borrow up to 85% of eligible accounts receivable, as defined under the credit facility. If we are unable to generate sufficient eligible accounts receivable, then we may not be able to borrow the full \$35 million. At March 31, 2006, we had \$28.2 million available for borrowing. To the extent that financing under the credit facility or other financing sources is not available to us or we are not able to generate sufficient cash through operations, we may be restricted in our ability to meet capital expenditure requirements.

A court could cancel the guarantees under certain circumstances.

Each of our subsidiaries that is not an unrestricted subsidiary guarantees our notes. If, however, a guarantor becomes a debtor in a case under the United States Bankruptcy Code or encounters other financial difficulty, under federal or state fraudulent conveyance laws a court might avoid (that is, cancel) its guarantee. The court might do so if it found that, when the guarantor entered into its guarantee or, in some states, when payments became due under its guarantee, it (i) received less than reasonably equivalent value or fair consideration for the guarantee and (ii) either (a) was or was rendered insolvent, (b) was left with inadequate capital to conduct its business, or (c) believed or should have believed that it would incur debts beyond its ability to pay. The court might also avoid a guarantee, without regard to the above factors, if it found that the guarantor entered into its guarantee with actual intent to hinder, delay, or defraud its creditors.

A court would likely find that a guarantor did not receive reasonably equivalent value or fair consideration for its guarantee unless it benefited directly or indirectly from the issuance of our notes. If a court avoided a guarantee, a note holder would no longer have a claim against the guarantor. In addition, the court might direct a note holder to repay any amounts already received from the guarantor. If the court were to avoid any guarantor's guarantee, we cannot assure a note holder that funds would be available to pay our notes from another guarantor or from any other source.

The test for determining solvency for purposes of the foregoing will depend on the law of the jurisdiction being applied. In general, a court would consider an entity insolvent either if the sum of its existing debts exceeds the fair value of all its property, or if the present fair saleable value of its assets is less than the amount required to pay the probable liability on its existing debts as they become due. For this analysis, debts includes contingent and unliquidated debts.

The indenture states that the liability of each guarantor on its guarantee is limited to the maximum amount that the subsidiary can incur without risk that the guarantee will be subject to avoidance as a fraudulent conveyance. This limitation may not protect the guarantees from a fraudulent conveyance attack or, if it does, that the guarantees will be in amounts sufficient, if necessary, to pay obligations under our notes when due.

We may not be able to satisfy our obligations to holders of our notes upon a change of control.

Upon the occurrence of a change of control, as defined in our indenture, a note holder will have the right to require us to purchase our notes at a price equal to 101% of the principal amount, together with any accrued and unpaid interest and liquidated damages, if any, to the date of

Edgar Filing: RADIOLOGIX INC - Form 10-Q

purchase. Our failure to purchase, or give notice of purchase of, our notes would be a default under the indenture, which would in turn be a default under our senior credit facility. Moreover, our failure to repay all amounts outstanding under our senior credit facility upon a default would also be a default under the indenture.

In addition, a change of control may constitute an event of default under our credit facility. A default under our credit facility will result in an event of default under the indenture if the lenders accelerate the debt under our senior credit facility.

If a change of control occurs, we may not have enough assets to satisfy all obligations under our credit facility and the indenture related to our notes. Upon the occurrence of a change of control, we could seek to refinance the indebtedness under our credit facility and our notes or obtain a waiver from the lenders or the note holders. We may not be able to obtain a waiver or refinance our indebtedness on commercially reasonable terms, if at all.

Table of Contents

No established trading market exists for our notes, and note holders may not be able to sell them quickly or at the price that note holders paid.

We do not intend to list our notes on any securities exchange or to arrange for quotation on any automated dealer quotation system. Bear Stearns Companies, Inc., Jefferies & Company, Inc. and Wachovia Securities make a market in the notes, but they are not obligated to do so. They may discontinue any market making at any time, in their sole discretion. As a result, we cannot assure you as to the liquidity of any trading market for the notes.

Note holders may not be able to sell notes at a particular time or at favorable prices. We also cannot assure note holders as to the level of liquidity of the trading market for the notes. As a result, note holders may be required to bear the financial risk of their investment in the notes indefinitely. Future trading prices of the notes may be volatile and will depend on many factors, including:

our operating performance and financial condition;

the interest of securities dealers in making a market for our notes; and

the market for similar securities.

There are inherent limitations in all control systems, and misstatements due to error or fraud may occur and not be detected.

Company management continues to monitor our controls to assure compliance with the internal controls, disclosure controls and other requirements of the Sarbanes-Oxley Act of 2002. Our management, including our Chief Executive Officer and Chief Financial Officer, cannot guarantee that our internal controls and disclosure controls will prevent all possible errors or all fraud. An internal control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objective of the control system are met. In addition, the design of a control system must reflect the fact that there are resource constraints and the benefit of controls must be relative to their costs. Because of the inherent limitations in all control systems, no system of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be challenged and that breakdowns can occur because of simple errors or mistakes. Further, controls can be circumvented by individual acts of some persons, by collusion of two or more persons, or by management override of controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, a control may be inadequate because of changes in conditions or the degree of compliance with the policies or procedures may deteriorate. Because of inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults upon Senior Securities

None

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

None

Item 5. Other Information

None

Item 6. Exhibits

(a) *Exhibits.* The list of exhibits filed as part of this report is incorporated by reference to the Index to Exhibits at the end of this report.

Table of Contents

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.

RADIOLOGIX, INC.

Date: May 4, 2006

/s/ SAMI S. ABBASI
Sami S. Abbasi

President and Chief Executive Officer

(Principal Executive Officer)

Date: May 4, 2006

/s/ MICHAEL N. MURDOCK
Michael N. Murdock

Senior Vice President and Chief Financial Officer

(Principal Accounting Officer)

Table of Contents

INDEX TO EXHIBITS

Exhibit

Number	Description
31.1	Certification of Sami S. Abbasi pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. *
31.2	Certification of Michael N. Murdock pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. *
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted pursuant to Section 906 of The Sarbanes-Oxley Act of 2002 of Sami S. Abbasi. *
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted pursuant to Section 906 of The Sarbanes-Oxley Act of 2002 of Michael N. Murdock. *

* Filed herewith.