

RADIOLOGIX INC  
Form 10-Q  
November 03, 2005  
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**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**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 September 30, 2005

**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

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**RADIOLOGIX, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of incorporation or organization)

**75-2648089**  
(I.R.S. Employer Identification No.)

**3600 JP Morgan Chase Tower**

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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)

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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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.

| <u>Class</u>                     | <u>Outstanding at October 28, 2005</u> |
|----------------------------------|--|
| Common Stock, \$0.0001 par value | 22,442,417 shares                      |

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**RADIOLOGIX, INC.**

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**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)**

|  | September 30,     | December 31,      |
|--|-------------------|-------------------|
|  | 2005              | 2004              |
|  | <u>          </u> | <u>          </u> |
|  | (Unaudited)       |                   |
| <b>ASSETS</b>                                |                   |                   |
| <b>CURRENT ASSETS:</b>                       |                   |                   |
| Cash and cash equivalents                    | \$ 42,440         | \$ 34,084         |
| Restricted cash                              | 5,613             | 5,539             |
| Accounts receivable, net of allowances       | 41,122            | 44,197            |
| Due from affiliates                          | 1,413             | 2,963             |
| Federal and state income tax receivables     | 6,954             | 3,905             |
| Assets held for sale                         |                   | 305               |
| Other current assets                         | 5,818             | 6,062             |
|  | <u>          </u> | <u>          </u> |
| Total current assets                         | 103,360           | 97,055            |
| Property and equipment, net                  | 65,449            | 58,627            |
| Investments in joint ventures                | 10,057            | 8,137             |
| Goodwill                                     | 2,241             | 2,241             |
| Intangible assets, net                       | 68,121            | 71,200            |
| Deferred financing costs, net                | 5,354             | 6,591             |
| Deferred income taxes                        | 3,639             | 8,892             |
| Other assets                                 | 1,076             | 1,328             |
|  | <u>          </u> | <u>          </u> |
| Total assets                                 | \$ 259,297        | \$ 254,071        |
|  | <u>          </u> | <u>          </u> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                   |                   |
| <b>CURRENT LIABILITIES:</b>                  |                   |                   |
| Accounts payable and other accrued expenses  | \$ 7,364          | \$ 11,342         |
| Accrued physician retention                  | 8,048             | 8,384             |
| Accrued salaries and benefits                | 9,525             | 7,339             |
| Deferred income taxes                        | 3,649             | 3,202             |
| Accrued interest                             | 4,841             | 708               |
| Current portion of capital lease obligations | 31                | 48                |
| Current portion of long-term debt            |                   | 109               |
| Other current liabilities                    | 556               | 536               |
|  | <u>          </u> | <u>          </u> |
| Total current liabilities                    | 34,014            | 31,668            |

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|   |                   |                   |
|---|-------------------|-------------------|
| Long-term debt, net of current portion  | 158,270           | 158,270           |
| Convertible debt  | 11,980            | 11,980            |
| Capital lease obligations, net of current portion   | 83                | 92                |
| Deferred revenue  | 6,596             | 6,903             |
| Other liabilities   | 1,296             | 1,000             |
|   | <u>          </u> | <u>          </u> |
| Total liabilities   | 212,239           | 209,913           |
| Commitments and contingencies   |                   |                   |
| Minority interests in consolidated subsidiaries   | 1,729             | 1,242             |
| STOCKHOLDERS' EQUITY:   |                   |                   |
| Preferred stock, \$.0001 par value; 10,000,000 shares authorized; no shares issued and outstanding  |                   |                   |
| Common stock, \$.0001 par value; 50,000,000 shares authorized; 22,461,101 and 22,135,935 shares issued in 2005 and 2004, respectively, and 22,442,417 and 22,117,251 outstanding in 2005 and 2004, respectively | 2                 | 2                 |
| Treasury stock  | (180)             | (180)             |
| Additional paid-in capital  | 15,655            | 14,210            |
| Retained earnings   | 29,852            | 28,884            |
|   | <u>          </u> | <u>          </u> |
| Total stockholders' equity  | 45,329            | 42,916            |
|   | <u>          </u> | <u>          </u> |
| Total liabilities and stockholders' equity  | \$ 259,297        | \$ 254,071        |
|   | <u>          </u> | <u>          </u> |

See accompanying notes to unaudited consolidated financial statements.

**Table of Contents****RADIOLOGIX, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)**

(In thousands, except share and per share data)

|   | For the Three Months<br>Ended September 30, |            | For the Nine Months<br>Ended September 30, |             |
|---|---|------------|--|-------------|
|   | 2005  | 2004       | 2005                                       | 2004        |
| Service fee revenue   | \$ 62,258                                   | \$ 63,613  | \$ 189,320                                 | \$ 195,866  |
| Costs of operations:  |   |            |  |             |
| Cost of services  | 40,389                                      | 39,825     | 120,838                                    | 119,408     |
| Equipment leases  | 3,545                                       | 4,554      | 9,582                                      | 13,945      |
| Provision for doubtful accounts   | 4,521                                       | 5,329      | 13,647                                     | 16,185      |
| Depreciation and amortization   | 6,125                                       | 5,449      | 18,014                                     | 17,484      |
| Gross profit  | 7,678                                       | 8,456      | 27,239                                     | 28,844      |
| Severance and other related costs   |   | 405        |  | 405         |
| Corporate general and administrative  | 3,862                                       | 5,285      | 13,195                                     | 13,783      |
| Impairment of goodwill, intangible and long-lived assets  |   | 7,474      |  | 13,226      |
| Gain on sale of operations  |   |            |  | (4,669)     |
| Interest expense, net, including amortization of deferred financing costs   | 4,561                                       | 4,603      | 13,802                                     | 14,015      |
| Income (loss) before equity in earnings of unconsolidated affiliates, minority interests in consolidated subsidiaries, income taxes and discontinued operations | (745)                                       | (9,311)    | 242  | (7,916)     |
| Equity in earnings of investments   | 1,227                                       | 982        | 2,888                                      | 2,336       |
| Minority interests in income of consolidated subsidiaries   | (184)                                       | (195)      | (487)                                      | (639)       |
| <b>INCOME (LOSS) BEFORE INCOME TAXES AND DISCONTINUED OPERATIONS</b>  | 298   | (8,524)    | 2,643                                      | (6,219)     |
| Income tax expense (benefit)  | 136   | (3,348)    | 1,065                                      | (2,706)     |
| <b>INCOME (LOSS) FROM CONTINUING OPERATIONS</b>   | 162   | (5,176)    | 1,578                                      | (3,513)     |
| Discontinued Operations:  |   |            |  |             |
| Loss from discontinued operations before income taxes   | (582)                                       | (351)      | (986)                                      | (11,150)    |
| Income tax benefit  | (221)                                       | (140)      | (376)                                      | (4,460)     |
| Loss from discontinued operations   | (361)                                       | (211)      | (610)                                      | (6,690)     |
| <b>NET INCOME (LOSS)</b>  | \$ (199)                                    | \$ (5,387) | \$ 968                                     | \$ (10,203) |
| <b>INCOME (LOSS) PER COMMON SHARE</b>   |   |            |  |             |
| Income (loss) from continuing operations basic  | \$ 0.01                                     | \$ (0.24)  | \$ 0.07                                    | \$ (0.16)   |
| Income (loss) from discontinued operations basic  | (0.02)                                      | (0.01)     | (0.03)                                     | (0.31)      |

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|  |                   |                   |                   |                   |
|--|-------------------|-------------------|-------------------|-------------------|
| Net income (loss) basic                            | \$ (0.01)         | \$ (0.25)         | \$ 0.04           | \$ (0.47)         |
| Income (loss) from continuing operations diluted   | \$ 0.01           | \$ (0.24)         | \$ 0.07           | \$ (0.16)         |
| Income (loss) from discontinued operations diluted | (0.02)            | (0.01)            | (0.03)            | (0.31)            |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Net income (loss) diluted                          | \$ (0.01)         | \$ (0.25)         | \$ 0.04           | \$ (0.47)         |
| WEIGHTED AVERAGE SHARES OUTSTANDING                |                   |                   |                   |                   |
| Basic  | 22,138,145        | 21,805,607        | 22,030,959        | 21,780,557        |
| Diluted  | 22,411,042        | 21,805,607        | 22,342,653        | 21,780,557        |

See accompanying notes to unaudited consolidated financial statements

**Table of Contents****RADIOLOGIX, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)****(In thousands)**

|  | <b>For the Nine<br/>Months Ended<br/>September 30,</b> |                |
|--|--|----------------|
|  | <b>2005</b>  | <b>2004</b>    |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |  |                |
| Net income (loss)  | \$ 968   | \$ (10,203)    |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities including discontinued operations: |  |                |
| Depreciation and amortization  | 18,014   | 18,053         |
| Impairment of goodwill, intangible and long-lived assets   |  | 24,205         |
| Gains on sales of operations and equipment   | (651)  | (5,300)        |
| Equity in earnings of unconsolidated affiliates  | (2,888)  | (2,336)        |
| Minority interests in income of consolidated subsidiaries  | 487  | 639            |
| Amortization of deferred financing costs   | 1,237  | 1,215          |
| Stock compensation expense   | 395  | 53             |
| Deferred revenue   | (307)  | (307)          |
| Deferred income tax expense (benefit)  | 570  | (10,813)       |
| Tax benefit realized for stock option exercises  | 203  |                |
| Changes in operating assets and liabilities:   |  |                |
| Accounts receivable, net   | 3,075  | 3,136          |
| Income taxes receivable  | 2,080  | 897            |
| Other assets   | 1,644  | (528)          |
| Accounts payable and accrued expenses  | 2,354  | 7,704          |
| Net cash provided by operating activities  | <u>27,181</u>  | <u>26,415</u>  |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |  |                |
| Increase in restricted cash  | (73)   | (4,820)        |
| Purchases of property and equipment  | (22,278)   | (18,097)       |
| Proceeds from sales of operations and equipment  | 1,173  | 13,743         |
| Contributions to joint ventures  | (325)  |                |
| Distributions from joint ventures  | 1,294  | 1,114          |
| Repayments from unconsolidated affiliates, net   | 698  | 673            |
| Other investments  |  | (109)          |
| Net cash used in investing activities  | <u>(19,511)</u>  | <u>(7,496)</u> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |  |                |
| Payments on long-term obligations, primarily capital leases  | (161)  | (1,606)        |
| Retirement of senior debt  |  | (1,730)        |
| Proceeds from stock option exercises   | 847  | 183            |



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|   |                  |                  |
|---|------------------|------------------|
| Net cash provided by (used in) financing activities | 686              | (3,153)          |
| <b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>    | <b>8,356</b>     | <b>15,766</b>    |
| CASH AND CASH EQUIVALENTS, beginning of period      | 34,084           | 36,766           |
| <b>CASH AND CASH EQUIVALENTS, end of period</b>     | <b>\$ 42,440</b> | <b>\$ 52,532</b> |
| <b>SUPPLEMENTAL CASH FLOW DISCLOSURE:</b>           |                  |                  |
| Cash paid for interest                              | \$ 8,437         | \$ 8,873         |
| Income taxes paid, net of refunds received          | \$ (2,164)       | \$ 2,747         |

See accompanying notes to unaudited consolidated financial statements.

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**RADIOLOGIX, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2005**

**(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), positron 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, 2004. The accompanying consolidated balance sheet, as of December 31, 2004, has been derived from the audited consolidated financial statements of the Company for the year ended December 31, 2004. 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 impairments and discontinued operations, which adjustments are discussed separately in the notes below. Interim results for the three and nine month periods ended September 30, 2005 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 operations that compete with our primary and Questar operations, the timing and negotiation of managed care and service contracts, the availability of technologists and other personnel, 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 Operations 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, 2004.

**Note 2. Summary of Significant Accounting Policies**

*Basis of Presentation*

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The unaudited 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.

We have reclassified certain previously reported amounts, including (1) balances and results of operations related to subsequently discontinued operations to conform to the current period presentation; (2) amortization of deferred financing costs from depreciation and amortization to interest expense and (3) supply rebates from general and administrative costs to field supplies, which is a component of cost of services in the accompanying consolidated statements of operations. These reclassifications have no impact on total assets, liabilities, stockholders' equity, net income (loss), or cash flows.

### *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.

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### *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. We perform our annual impairment test in the first quarter of each fiscal year.

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.

At September 30, 2005 the balance of goodwill, which relates to our two Colorado Questar centers, is approximately \$2.2 million. The performance of these centers declined in the second and third quarter of 2005. As a result, we are focusing efforts on reversing the decline in volumes that we experienced at these centers. However, if our efforts are not successful and these centers continue to experience lower than expected volumes, we may incur an impairment charge in a future period.

Impairment charges of \$5.8 million for the 2004 write-off of goodwill and long-lived assets relate to our six Questar centers that are currently in continuing operations. Impairment charges for other Questar centers in 2004 are included in discontinued operations.

### *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

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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 tax liabilities 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.

### *Stock-Based Awards*

The Company currently accounts for its employee stock-based compensation arrangements using the intrinsic-value method pursuant to the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ). Accordingly, because stock options are issued at fair value at the date of grant we do not recognize compensation expense for our stock option grants. We do recognize compensation expense on a straight-line basis for restricted stock units ( RSUs ) based on the fair value of the RSUs on the date grant and the applicable vesting period.

The Company issued 325,166 shares of common stock during the nine months ended September 30, 2005, upon exercise of stock options.

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In December 2002, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation Transition and Disclosure ( SFAS No. 148 ). SFAS No. 148 provides alternative methods of transitioning to Statement of Financial Accounting Standards No. 123 Accounting for Stock-Based Compensation ( SFAS No. 123 ), which promulgates a fair value method of accounting for stock-based employee compensation. It also requires certain disclosures in both annual and quarterly financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS No. 148 does not mandate fair value accounting for stock-based employee compensation, but does require all companies to meet the disclosure requirements.

On December 16, 2004, the FASB issued 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:

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 previously disclosed that it planned to adopt SFAS 123(R) on July 1, 2005 using the modified-prospective method. Pursuant to an SEC Amendment to Regulation S-X effective April 21, 2005, a revised date for adopting SFAS 123(R) is now the first interim reporting period of a registrant's first fiscal year beginning on or after June 15, 2005. As a result, the Company now plans to adopt SFAS 123(R) on January 1, 2006. As of September 30, 2005, we have not determined the effect that the adoption of SFAS 123(R) will have on our financial position and results of operations.

The summary below presents the pro-forma financial results that would have been reported if the Company had applied the provisions of SFAS No. 123, as amended by SFAS No. 148, during the periods ended September 30, 2005 and 2004 (dollars are presented in thousands, except per share amounts):

|  | For the Three Months<br>Ended September 30, |            | For the Nine Months<br>Ended September 30, |             |
|--|---|------------|--|-------------|
|  | 2005  | 2004       | 2005                                       | 2004        |
| Net income (loss), as reported   | \$ (199)                                    | \$ (5,387) | \$ 968                                     | \$ (10,203) |
| Add: Total stock-based compensation expensed in net income (loss), net of related tax effects                                      | 109   | 24         | 237  | 32          |
| Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects | (190)                                       | 77         | (525)                                      | (700)       |

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|                                 |           |            |         |             |
|---------------------------------|-----------|------------|---------|-------------|
| Pro forma net income (loss)     | \$ (280)  | \$ (5,286) | \$ 680  | \$ (10,871) |
| Income (loss) per common share: |           |            |         |             |
| Basic as reported               | \$ (0.01) | \$ (0.25)  | \$ 0.04 | \$ (0.47)   |
| Basic pro forma                 | \$ (0.01) | \$ (0.24)  | \$ 0.03 | \$ (0.50)   |
| Income (loss) per share:        |           |            |         |             |
| Diluted as reported             | \$ (0.01) | \$ (0.25)  | \$ 0.04 | \$ (0.47)   |
| Diluted pro forma               | \$ (0.01) | \$ (0.24)  | \$ 0.03 | \$ (0.50)   |

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 as of September 30, 2005 and 2004, respectively: risk-free interest rate of 4.20% and 4.13%; expected life of 3.4 and 5.4 years; expected volatility of 42.2% and 54.2%; and dividend yield of zero in 2005 and 2004, respectively. The weighted-average grant-date fair value of new grants during the nine months ended September 30, 2005 and 2004 was \$2.61 and \$2.22 per share, respectively.

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The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

*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 medical 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, 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 \$5.0 million per year.

**Note 3. 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<br>September 30, |           | For the Nine Months Ended<br>September 30, |            |
|---|---|-----------|--|------------|
|   | 2005  | 2004      | 2005                                       | 2004       |
| Revenue for contracted radiology practices and diagnostic imaging centers, net of contractual adjustments | \$ 86,173                                   | \$ 87,862 | \$ 260,906                                 | \$ 272,137 |
| Less: amounts retained by contracted radiology practices  | (23,915)                                    | (24,249)  | (71,586)                                   | (76,271)   |
| Service fee revenue   | \$ 62,258                                   | \$ 63,613 | \$ 189,320                                 | \$ 195,866 |

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 medical 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 as defined in the medical services agreements; and (2) 100% of the adjusted technical revenues as defined in the medical service agreements up to a designated



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ceiling at which point certain of the medical 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 prohibits fee-splitting, Radiologix has negotiated a service fee based upon the number of work units performed by radiologists, which approximates the estimated fair market value of the services provided under the service agreements. Service fee revenue is comprised of the following (in thousands):

|                            | For the Three Months Ended<br>September 30, |                  | For the Nine Months Ended<br>September 30, |                   |
|----------------------------|---|------------------|--|-------------------|
|                            | 2005  | 2004             | 2005                                       | 2004              |
| Technical component        | \$ 54,089                                   | \$ 54,439        | \$ 164,415                                 | \$ 164,221        |
| Professional component     | 8,169                                       | 9,174            | 24,905                                     | 31,645            |
| <b>Service fee revenue</b> | <b>\$ 62,258</b>                            | <b>\$ 63,613</b> | <b>\$ 189,320</b>                          | <b>\$ 195,866</b> |

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### **Note 4. Long-Term Debt**

#### *Senior Notes*

The Company's \$158.3 million 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.

#### *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 payment with 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.

#### *Revolving Credit Facility*

The Company's revolving credit facility provides for borrowings up to \$35 million through December 31, 2008. Borrowings under the credit facility bear interest at (i) an adjusted LIBOR rate, plus an applicable margin which can vary from 3.0% to 3.5% depending on monthly balances outstanding under the credit facility or (ii) the prime rate, plus an applicable margin which can vary from 1.75% to 2.25% depending on monthly balances outstanding under the credit facility. It is at the Company's discretion to borrow under an adjusted LIBOR rate or under the prime rate. There are no restrictive covenants under the credit facility.

At September 30, 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 \$27.8 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.

At September 30, 2005, we had not met certain incurrence tests under our debt agreements. As a result, we are limited to borrowing \$20.0 million under the revolving credit facility until such time as we meet this test.

### **Note 5. Commitments and Contingencies**

#### *Master Lease Agreement*

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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 September 30, 2005 balance sheet includes \$5.6 million of restricted cash under this provision.

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. GE provided us with a written waiver stating that GE agreed to waive compliance with the financial leverage ratio for the year ended December 31, 2004 and to modify this calculation for 2005 to exclude the \$9.1 million adjustment described in our 2004 Form 10-K.

At September 30, 2005, applicable amounts outstanding under the Master Lease Agreement totaled \$37.4 million; commitments for leases signed but not placed in service under the Master Lease Agreement were \$7.3 million, and \$15.3 million remained available for future leases.

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### *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 one year to 15 years with renewal options upon prior written notice. Facility rent 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*

In 2005, we incurred legal costs due to an arbitration with a former physician partner at our Questar center in Pennsylvania that was sold in June 2004. The physician agreement terminated upon the completion of the sale of the center and the physician sought additional compensation. The arbitration ruled that we were not obligated to pay any additional compensation. For the nine months ended September 30, 2005, the legal costs incurred to successfully defend our position were \$557,000.

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*

We are self-insured with respect to health benefits provided to our employees. Additionally, in connection with malpractice and workers compensation coverage, we generally are self-insured for initial retention levels between \$100,000 and \$500,000 (depending on policy year). At September 30, 2005, we believe we are adequately reserved for estimated potential obligations under these arrangements.

**Table of Contents****Note 6. Discontinued Operations**

The following reflects the reclassification from continuing operations to discontinued operations of certain results of operations (primarily related to our Questar subsidiary), previously reported in our September 30, 2004 Form 10-Q (dollars in thousands):

|   | For the Three Months<br>Ended September 30, 2004 |                           | For the Nine Months<br>Ended September 30, 2004 |                           |
|---|--|---------------------------|---|---------------------------|
|   | Restated for<br>Discontinued<br>Operations       | As Previously<br>Reported | Restated for<br>Discontinued<br>Operations      | As Previously<br>Reported |
| Service fee revenue   | \$ 63,613  | \$ 64,669                 | \$ 195,866                                      | \$ 199,224                |
| Costs of operations:  |  |                           |   |                           |
| Cost of services  | 39,825   | 40,820                    | 119,408   | 123,111                   |
| Equipment leases  | 4,554  | 4,576                     | 13,945  | 14,005                    |
| Provision for doubtful accounts   | 5,329  | 5,462                     | 16,185  | 16,637                    |
| Depreciation and amortization   | 5,449  | 5,914                     | 17,484  | 18,905                    |
| Gross profit  | 8,456  | 7,897                     | 28,844  | 26,566                    |
| Severance and other related costs   | 405  | 405                       | 405   | 405                       |
| Corporate general and administrative  | 5,285  | 5,179                     | 13,783  | 13,075                    |
| Impairment of goodwill, intangible and long-lived assets  | 7,474  | 7,612                     | 13,226  | 19,317                    |
| Gain on sale of operations  |  |                           | (4,669)   | (4,669)                   |
| Interest expense, net, including amortization of deferred financing costs   | 4,603  | 4,214                     | 14,015  | 12,858                    |
| Income (loss) before equity in earnings of unconsolidated affiliates, minority interests in consolidated subsidiaries, income taxes and discontinued operations | (9,311)  | (9,513)                   | (7,916)   | (14,420)                  |
| Equity in earnings of unconsolidated affiliates   | 982  | 983                       | 2,336   | 2,336                     |
| Minority interests in income of consolidated subsidiaries   | (195)  | (195)                     | (639)   | (639)                     |
| <b>LOSS BEFORE INCOME TAXES AND DISCONTINUED OPERATIONS</b>   | <b>(8,524)</b>                                   | <b>(8,725)</b>            | <b>(6,219)</b>                                  | <b>(12,723)</b>           |
| Income tax expense (benefit)  | (3,348)  | (3,428)                   | (2,706)   | (5,308)                   |
| <b>LOSS FROM CONTINUING OPERATIONS</b>  | <b>(5,176)</b>                                   | <b>(5,297)</b>            | <b>(3,513)</b>                                  | <b>(7,415)</b>            |
| Discontinued Operations:  |  |                           |   |                           |
| Loss from discontinued operations before income taxes   | (351)  | (150)                     | (11,150)  | (4,646)                   |
| Income tax benefit  | (140)  | (60)                      | (4,460)   | (1,858)                   |
| Loss from discontinued operations   | (211)  | (90)                      | (6,690)   | (2,788)                   |
| <b>NET LOSS</b>   | <b>\$ (5,387)</b>                                | <b>\$ (5,387)</b>         | <b>\$ (10,203)</b>                              | <b>\$ (10,203)</b>        |
| <b>INCOME (LOSS) PER COMMON SHARE:</b>  |  |                           |   |                           |
| Income (loss) from continuing operations basic  | \$ (0.24)  | \$ (0.24)                 | \$ (0.16)                                       | \$ (0.34)                 |
| Income (loss) from discontinued operations basic  | \$ (0.01)  | \$ (0.01)                 | \$ (0.31)                                       | \$ (0.13)                 |

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|  |            |            |            |            |
|--|------------|------------|------------|------------|
| Net income (loss) basic                            | \$ (0.25)  | \$ (0.25)  | \$ (0.47)  | \$ (0.47)  |
| Income (loss) from continuing operations diluted   | \$ (0.24)  | \$ (0.24)  | \$ (0.16)  | \$ (0.34)  |
| Income (loss) from discontinued operations diluted | \$ (0.01)  | \$ (0.01)  | \$ (0.31)  | \$ (0.13)  |
| Net income (loss) diluted                          | \$ (0.25)  | \$ (0.25)  | \$ (0.47)  | \$ (0.47)  |
| <b>WEIGHTED AVERAGE SHARES OUTSTANDING:</b>        |            |            |            |            |
| Basic  | 21,805,607 | 21,805,607 | 21,780,557 | 21,780,557 |
| Diluted  | 21,805,607 | 21,805,607 | 21,780,557 | 21,780,557 |

**Table of Contents****Note 7. 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<br>September 30, |            | For the Nine Months Ended<br>September 30, |            |
|--|---|------------|--|------------|
|  | 2005  | 2004       | 2005                                       | 2004       |
| Weighted average shares for basic earnings per share                             | 22,138,145                                  | 21,805,607 | 22,030,959                                 | 21,780,557 |
| Effect of dilutive stock options   | 272,897                                     |            | 311,694                                    |            |
| Effect of dilutive convertible junior subordinated note                          |   |            |  |            |
| Weighted average shares for diluted earnings per share                           | 22,411,042                                  | 21,805,607 | 22,342,653                                 | 21,780,557 |
| Tax-effectuated interest savings related to convertible junior subordinated note | \$  | \$         | \$   | \$         |

For each of the three and nine months ended September 30, 2005 and 2004, approximately \$144,000 and \$431,000, respectively, of tax-effectuated interest expense, and 1,593,040 of weighted average shares related to the convertible junior subordinated note for each period, were not included in the computation of diluted EPS because to do so would be anti-dilutive. For the three and nine months ended September 30, 2005, 272,897 and 311,694, respectively, shares related to stock options were included in the computation of dilutive EPS. Also, for the three and nine months ended September 30, 2004, 530,677 and 495,600, respectively, shares related to stock options were not included in the computation of dilutive EPS because to do so would be anti-dilutive.

**Note 8. 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):

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For the Nine Months Ended  
September 30, 2005

|  | <b>Primary<br/>Operations</b> | <b>Questar</b> | <b>Total</b> |
|--|-------------------------------|----------------|--------------|
| Service fee revenue  | \$ 183,219                    | \$ 6,101       | \$ 189,320   |
| Total costs and expenses   | 157,515                       | 5,162          | 162,677      |
| Income before equity in earnings of investments and minority interests in consolidated subsidiaries,<br>income taxes and discontinued operations | 25,704                        | 939            | 26,643       |
| Equity in earnings of investments  | 2,888                         |                | 2,888        |
| Minority interests in income of consolidated subsidiaries  | (487)                         |                | (487)        |
| Income before income taxes from continuing operations  | 28,105                        | 939            | 29,044       |
| Loss before income taxes from discontinued operations  | (75)                          | (911)          | (986)        |
| Income before income taxes   | \$ 28,030                     | \$ 28          | \$ 28,058    |
| Assets   | \$ 129,971                    | \$ 4,847       | \$ 134,818   |
| Purchases of property and equipment  | \$ 17,312                     | \$ 223         | \$ 17,535    |



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|  | For the Nine Months Ended<br>September 30, 2004 |             |            |
|--|---|-------------|------------|
|  | Primary<br>Operations                           | Questar     | Total      |
| Service fee revenue  | \$ 189,094                                      | \$ 6,772    | \$ 195,866 |
| Total costs and expenses   | 163,959   | 11,803      | 175,762    |
| Income before equity in earnings of investments and minority interests in consolidated subsidiaries,<br>income taxes and discontinued operations | 25,135  | (5,031)     | 20,104     |
| Equity in earnings of investments  | 2,336   |             | 2,336      |
| Minority interests in income of consolidated subsidiaries  | (639)   |             | (639)      |
| Income (loss) before income taxes from continuing operations   | 26,832  | (5,031)     | 21,801     |
| Loss before income taxes from discontinued operations  | (1,085)   | (10,066)    | (11,151)   |
| Income (loss) before income taxes  | \$ 25,747                                       | \$ (15,097) | \$ 10,650  |
| Assets   | \$ 124,959                                      | \$ 11,032   | \$ 135,991 |
| Purchases of property and equipment  | \$ 15,801                                       | \$ 989      | \$ 16,790  |

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

|  | For the Nine Months Ended<br>September 30, |             |
|--|--|-------------|
|  | 2005                                       | 2004        |
| Segment income before income taxes                             | \$ 28,058                                  | \$ 10,650   |
| Unallocated amounts:   |  |             |
| Corporate general and administrative                           | 13,195                                     | 14,188      |
| Corporate depreciation and amortization                        | 2,830                                      | 3,227       |
| Corporate interest expense                                     | 10,376                                     | 10,604      |
| Consolidated income (loss) before income tax expense (benefit) | \$ 1,657                                   | \$ (17,369) |

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 nine month periods ended September 30 (in thousands):

|                                      | 2005      | 2004      |
|--------------------------------------|-----------|-----------|
| Purchases of property and equipment: |           |           |
| Segment amounts                      | \$ 17,535 | \$ 16,790 |
| Corporate                            | 4,743     | 1,307     |

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|   |                  |                  |
|---|------------------|------------------|
| Total purchases of property and equipment | <u>\$ 22,278</u> | <u>\$ 18,097</u> |
|---|------------------|------------------|

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 September 30 (in thousands):

|                               | <u>2005</u>       | <u>2004</u>       |
|-------------------------------|-------------------|-------------------|
| <b>Total Assets</b>           |                   |                   |
| Segment amounts               | \$ 134,818        | \$ 135,991        |
| Intangible assets, net        | 53,568            | 56,577            |
| Deferred financing costs, net | 5,354             | 6,936             |
| Other corporate assets        | 65,557            | 69,849            |
| <b>Total assets</b>           | <u>\$ 259,297</u> | <u>\$ 269,353</u> |

|                                   | <u>2005</u>       | <u>2004</u>       |
|-----------------------------------|-------------------|-------------------|
| <b>Total Liabilities</b>          |                   |                   |
| Segment amounts                   | \$ 28,831         | \$ 33,617         |
| Corporate, primary long-term debt | 183,408           | 184,062           |
| <b>Total liabilities</b>          | <u>\$ 212,239</u> | <u>\$ 217,679</u> |

**Table of Contents****Note 9. 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. Other assets at September 30, 2005 and December 31, 2004 include notes receivable from certain unconsolidated joint ventures aggregating \$1.3 million and \$2.1 million, respectively. Interest income related to these notes receivable was approximately \$34,000 and \$58,000 for the three months ended September 30, 2005 and 2004, respectively. The Company also received management service fees of approximately \$779,000 and \$649,000 for the three months ended September 30, 2005 and 2004, respectively, in connection with operating the centers underlying these joint ventures. For the nine months ended September 30, 2005 and 2004, interest income related to these notes receivable was approximately \$119,000 and \$192,000, respectively. The Company received management service fees of approximately \$2.3 million and \$1.7 million for the nine months ended September 30, 2005 and 2004, respectively. The Company's investments in these joint ventures are accounted for under the equity method. The following table is a summary of key financial data for these joint ventures (in thousands):

|                        | <b>September 30,</b> |        | <b>December 31,</b> |        |
|------------------------|----------------------|--------|---------------------|--------|
|                        | <b>2005</b>          |        | <b>2004</b>         |        |
|                        | _____                |        | _____               |        |
| Current assets         | \$                   | 21,522 | \$                  | 17,543 |
| Noncurrent assets      |                      | 8,407  |                     | 9,087  |
| Current liabilities    |                      | 2,929  |                     | 2,480  |
| Noncurrent liabilities |                      | 264    |                     | 481    |

  

|                   | <b>For the Three Months Ended</b> |             | <b>For the Nine Months Ended</b> |             |
|-------------------|-----------------------------------|-------------|----------------------------------|-------------|
|                   | <b>September 30,</b>              |             | <b>September 30,</b>             |             |
|                   | _____                             |             | _____                            |             |
|                   | <b>2005</b>                       | <b>2004</b> | <b>2005</b>                      | <b>2004</b> |
|                   | _____                             | _____       | _____                            | _____       |
| Net revenue       | \$ 14,021                         | \$ 12,791   | \$ 39,881                        | \$ 39,125   |
| Pre-tax income    | 3,713                             | 3,418       | 9,300                            | 7,893       |
| Minority interest | 1,227                             | 982         | 2,888                            | 2,336       |

**Note 10. 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 following supplemental condensed consolidating financial information presents the balance sheets as of September 30, 2005 and December 31, 2004, and the statements of operations and cash flows for the three and nine month periods ended September 30, 2005 and 2004. In the consolidating condensed financial statements, the Subsidiary Guarantors account for their investment in the non-guarantor subsidiaries using the equity method.

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

**Table of Contents****RADIOLOGIX, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATING BALANCE SHEET (Unaudited)**

September 30, 2005

(In thousands)

|   | <u>Parent</u>  | <u>Subsidiary<br/>Guarantors</u> | <u>Non-<br/>Guarantor<br/>Subsidiaries</u> | <u>Eliminations</u> | <u>Total<br/>Consolidated</u> |
|---|----------------|----------------------------------|--|---------------------|-------------------------------|
| <b>Assets:</b>                                  |                |                                  |  |                     |                               |
| Cash and cash equivalents                       | \$ 38,651      | \$ (2,047)                       | \$ 5,836                                   | \$                  | \$ 42,440                     |
| Accounts receivable, net of allowances          |                | 39,594                           | 1,528                                      |                     | 41,122                        |
| Other current assets                            | 15,195         | 4,534                            | 69   |                     | 19,798                        |
|   | <u>53,846</u>  | <u>42,081</u>                    | <u>7,433</u>                               |                     | <u>103,360</u>                |
| Total current assets                            |                |                                  |  |                     | 103,360                       |
| Property and equipment, net                     | 8,030          | 55,458                           | 1,960                                      |                     | 65,448                        |
| Investment in subsidiaries                      | 170,303        |                                  |  | (170,303)           |                               |
| Goodwill and intangible assets, net             |                | 69,390                           | 972  |                     | 70,362                        |
| Other assets                                    | 9,829          | 10,298                           |  |                     | 20,127                        |
|   | <u>242,008</u> | <u>177,227</u>                   | <u>10,365</u>                              | <u>(170,303)</u>    | <u>259,297</u>                |
| Total assets                                    | \$ 242,008     | \$ 177,227                       | \$ 10,365                                  | \$ (170,303)        | \$ 259,297                    |
| <b>Liabilities and stockholders equity:</b>     |                |                                  |  |                     |                               |
| Accounts payable and accrued expenses           | \$ 9,936       | \$ 19,239                        | \$ 602                                     | \$                  | \$ 29,777                     |
| Current portion of long-term debt               | (282)          | 31                               | 256  |                     | 5                             |
| Other current liabilities                       | 3,649          | 583                              |  |                     | 4,232                         |
|   | <u>13,303</u>  | <u>19,853</u>                    | <u>858</u>                                 |                     | <u>34,014</u>                 |
| Total current liabilities                       |                |                                  |  |                     | 34,014                        |
| Long-term debt, net of current portion          | 170,105        | 71                               | 157  |                     | 170,333                       |
| Other noncurrent liabilities                    | 13,271         | 740                              | (6,119)                                    |                     | 7,892                         |
| Minority interests in consolidated subsidiaries |                |                                  | 1,729                                      |                     | 1,729                         |
| Total stockholders equity                       | 45,329         | 156,563                          | 13,740                                     | (170,303)           | 45,329                        |
|   | <u>242,008</u> | <u>177,227</u>                   | <u>10,365</u>                              | <u>(170,303)</u>    | <u>259,297</u>                |
| Total liabilities and stockholders equity       | \$ 242,008     | \$ 177,227                       | \$ 10,365                                  | \$ (170,303)        | \$ 259,297                    |

**Table of Contents****RADIOLOGIX, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATING BALANCE SHEET**

December 31, 2004

(In thousands)

|   | Parent            | Subsidiary<br>Guarantors | Non-<br>Guarantor<br>Subsidiaries | Eliminations        | Total<br>Consolidated |
|---|-------------------|--------------------------|-----------------------------------|---------------------|-----------------------|
| <b>Assets:</b>                                    |                   |                          |                                   |                     |                       |
| Cash and cash equivalents                         | \$ 30,198         | \$ 249                   | \$ 3,637                          | \$                  | \$ 34,084             |
| Accounts receivable, net of allowances            |                   | 42,992                   | 1,205                             |                     | 44,197                |
| Other current assets                              | 13,281            | 5,363                    | 130                               |                     | 18,774                |
| <b>Total current assets</b>                       | <b>43,479</b>     | <b>48,604</b>            | <b>4,972</b>                      |                     | <b>97,055</b>         |
| Property and equipment, net                       | 3,860             | 52,849                   | 1,918                             |                     | 58,627                |
| Investment in subsidiaries                        | 154,918           |                          |                                   | (154,918)           |                       |
| Goodwill and intangible assets, net               |                   | 72,383                   | 1,058                             |                     | 73,441                |
| Other assets                                      | 16,640            | 8,459                    | (151)                             |                     | 24,948                |
| <b>Total assets</b>                               | <b>\$ 218,897</b> | <b>\$ 182,295</b>        | <b>\$ 7,797</b>                   | <b>\$ (154,918)</b> | <b>\$ 254,071</b>     |
| <b>Liabilities and stockholders' equity:</b>      |                   |                          |                                   |                     |                       |
| Accounts payable and accrued expenses             | \$ 6,577          | \$ 20,714                | \$ 482                            | \$                  | \$ 27,773             |
| Current portion of long-term debt                 | (141)             | 48                       | 250                               |                     | 157                   |
| Other current liabilities                         | 3,202             | 536                      |                                   |                     | 3,738                 |
| <b>Total current liabilities</b>                  | <b>9,638</b>      | <b>21,298</b>            | <b>732</b>                        |                     | <b>31,668</b>         |
| Long-term debt, net of current portion            | 169,901           | 92                       | 349                               |                     | 170,342               |
| Other noncurrent liabilities                      | (3,558)           | 18,520                   | (7,059)                           |                     | 7,903                 |
| Minority interests in consolidated subsidiaries   |                   |                          | 1,242                             |                     | 1,242                 |
| <b>Total stockholders' equity</b>                 | <b>42,916</b>     | <b>142,385</b>           | <b>12,533</b>                     | <b>(154,918)</b>    | <b>42,916</b>         |
| <b>Total liabilities and stockholders' equity</b> | <b>\$ 218,897</b> | <b>\$ 182,295</b>        | <b>\$ 7,797</b>                   | <b>\$ (154,918)</b> | <b>\$ 254,071</b>     |

**Table of Contents****RADIOLOGIX, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS (Unaudited)****For the Three Months Ended September 30, 2005****(In thousands)**

|   | <u>Parent</u> | <u>Subsidiary<br/>Guarantors</u> | <u>Non-<br/>Guarantor<br/>Subsidiaries</u> | <u>Eliminations</u> | <u>Total<br/>Consolidated</u> |
|---|---------------|----------------------------------|--|---------------------|-------------------------------|
| Service fee revenue   | \$            | \$ 59,036                        | \$ 3,222                                   | \$                  | \$ 62,258                     |
| Costs of operations:  |               |                                  |  |                     |                               |
| Cost of services  |               | 38,653                           | 1,736                                      |                     | 40,389                        |
| Equipment leases  |               | 3,347                            | 198  |                     | 3,545                         |
| Provision for doubtful accounts   |               | 4,428                            | 93   |                     | 4,521                         |
| Depreciation and amortization   | 190           | 5,755                            | 180  |                     | 6,125                         |
| Gross profit (loss)   | (190)         | 6,853                            | 1,015                                      |                     | 7,678                         |
| Corporate general and administrative  | 3,862         |                                  |  |                     | 3,862                         |
| Interest expense, net, including amortization of deferred financing costs   | 3,417         | 1,149                            | (5)  |                     | 4,561                         |
| Income (loss) before equity in earnings of unconsolidated affiliates, minority interests in consolidated subsidiaries, income taxes and discontinued operations | (7,469)       | 5,704                            | 1,020                                      |                     | (745)                         |
| Equity in earnings of unconsolidated affiliates   |               | 1,227                            |  |                     | 1,227                         |
| Minority interests in income of consolidated subsidiaries   |               |                                  | (184)                                      |                     | (184)                         |
| Income (loss) before taxes and discontinued operations  | (7,469)       | 6,931                            | 836  |                     | 298                           |
| Income tax expense (benefit)  | (3,125)       | 2,916                            | 345  |                     | 136                           |
| Income (loss) from continuing operations  | (4,344)       | 4,015                            | 491  |                     | 162                           |
| Discontinued operations:  |               |                                  |  |                     |                               |
| Loss from discontinued operations before income taxes   |               | (580)                            | (2)  |                     | (582)                         |
| Income tax expense (benefit)  |               | (221)                            |  |                     | (221)                         |
| Loss from discontinued operations   |               | (359)                            | (2)  |                     | (361)                         |
| Net income (loss)   | \$ (4,344)    | \$ 3,656                         | \$ 489                                     | \$                  | \$ (199)                      |





Table of Contents**RADIOLOGIX, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS (Unaudited)****For the Nine Months Ended September 30, 2005****(In thousands)**

|   | <u>Parent</u> | <u>Subsidiary<br/>Guarantors</u> | <u>Non-<br/>Guarantor<br/>Subsidiaries</u> | <u>Eliminations</u> | <u>Total<br/>Consolidated</u> |
|---|---------------|----------------------------------|--|---------------------|-------------------------------|
| Service fee revenue   | \$            | \$ 180,098                       | \$ 9,222                                   | \$                  | \$ 189,320                    |
| Costs of operations:  |               |                                  |  |                     |                               |
| Cost of services  |               | 115,589                          | 5,249                                      |                     | 120,838                       |
| Equipment leases  |               | 8,995                            | 587  |                     | 9,582                         |
| Provision for doubtful accounts   |               | 13,348                           | 299  |                     | 13,647                        |
| Depreciation and amortization   | 574           | 16,928                           | 512  |                     | 18,014                        |
| Gross profit (loss)   | (574)         | 25,238                           | 2,575                                      |                     | 27,239                        |
| Corporate general and administrative  | 13,195        |                                  |  |                     | 13,195                        |
| Interest expense, net, including amortization of deferred financing costs   | 10,376        | 3,413                            | 13   |                     | 13,802                        |
| Income (loss) before equity in earnings of unconsolidated affiliates, minority interests in consolidated subsidiaries, income taxes and discontinued operations | (24,145)      | 21,825                           | 2,562                                      |                     | 242                           |
| Equity in earnings of unconsolidated affiliates   |               | 2,888                            |  |                     | 2,888                         |
| Minority interests in income of consolidated subsidiaries   |               |                                  | (487)                                      |                     | (487)                         |
| Income (loss) before taxes and discontinued operations  | (24,145)      | 24,713                           | 2,075                                      |                     | 2,643                         |
| Income tax expense (benefit)  | (9,729)       | 9,958                            | 836  |                     | 1,065                         |
| Income (loss) from continuing operations  | (14,416)      | 14,755                           | 1,239                                      |                     | 1,578                         |
| Discontinued operations:  |               |                                  |  |                     |                               |
| Loss from discontinued operations before income taxes   |               | (935)                            | (51)                                       |                     | (986)                         |
| Income tax benefit  |               | (357)                            | (19)                                       |                     | (376)                         |
| Loss from discontinued operations   |               | (578)                            | (32)                                       |                     | (610)                         |
| Net income (loss)   | \$ (14,416)   | \$ 14,177                        | \$ 1,207                                   | \$                  | \$ 968                        |

Table of Contents**RADIOLOGIX, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS (Unaudited)****For the Three Months Ended September 30, 2004****(In thousands)**

|   | <u>Parent</u> | <u>Subsidiary<br/>Guarantors</u> | <u>Non-<br/>Guarantor<br/>Subsidiaries</u> | <u>Eliminations</u> | <u>Total<br/>Consolidated</u> |
|---|---------------|----------------------------------|--|---------------------|-------------------------------|
| Service fee revenue   | \$            | \$ 60,476                        | \$ 3,137                                   | \$                  | \$ 63,613                     |
| Costs and expenses:   |               |                                  |  |                     |                               |
| Cost of services  |               | 38,030                           | 1,795                                      |                     | 39,825                        |
| Equipment leases  |               | 4,444                            | 110  |                     | 4,554                         |
| Provision for doubtful accounts   |               | 5,240                            | 89   |                     | 5,329                         |
| Depreciation and amortization   | 650           | 4,662                            | 137  |                     | 5,449                         |
| Gross profit (loss)   | (650)         | 8,100                            | 1,006                                      |                     | 8,456                         |
| Severance and other related costs   | 405           |                                  |  |                     | 405                           |
| Corporate general and administrative  | 5,285         |                                  |  |                     | 5,285                         |
| Impairment of goodwill, intangibles, and long lived assets  |               | 7,474                            |  |                     | 7,474                         |
| Gain on sale of operations  |               |                                  |  |                     |                               |
| Interest expense, net, including amortization of deferred financing costs   | 3,072         | 1,514                            | 17   |                     | 4,603                         |
| Income (loss) before equity in earnings of unconsolidated affiliates, minority interests in consolidated subsidiaries, income taxes and discontinued operations | (9,412)       | (888)                            | 989  |                     | (9,311)                       |
| Equity in earnings of investments   |               | 982                              |  |                     | 982                           |
| Minority interests in income of consolidated subsidiaries   |               |                                  | (195)                                      |                     | (195)                         |
| Income (loss) before taxes and discontinued operations  | (9,412)       | 94                               | 794  |                     | (8,524)                       |
| Income tax expense (benefit)  | (3,765)       | 99                               | 318  |                     | (3,348)                       |
| Income (loss) from continuing operations  | (5,647)       | (5)                              | 476  |                     | (5,176)                       |
| Discontinued operations:  |               |                                  |  |                     |                               |
| Loss from discontinued operations   |               | 3,408                            | (3,759)                                    |                     | (351)                         |
| Income tax benefit  |               | 1,364                            | (1,504)                                    |                     | (140)                         |
| Loss from discontinued operations   |               | 2,044                            | (2,255)                                    |                     | (211)                         |
| Net income (loss)   | \$ (5,647)    | \$ 2,039                         | \$ (1,779)                                 | \$                  | \$ (5,387)                    |



Table of Contents**RADIOLOGIX, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS (Unaudited)****For the Nine Months Ended September 30, 2004****(In thousands)**

|   | <u>Parent</u> | <u>Subsidiary<br/>Guarantors</u> | <u>Non-<br/>Guarantor<br/>Subsidiaries</u> | <u>Eliminations</u> | <u>Total<br/>Consolidated</u> |
|---|---------------|----------------------------------|--|---------------------|-------------------------------|
| Service fee revenue   | \$            | \$ 185,919                       | \$ 9,947                                   | \$                  | \$ 195,866                    |
| Costs and expenses:   |               |                                  |  |                     |                               |
| Cost of services  |               | 113,916                          | 5,492                                      |                     | 119,408                       |
| Equipment leases  |               | 13,614                           | 331  |                     | 13,945                        |
| Provision for doubtful accounts   |               | 15,834                           | 351  |                     | 16,185                        |
| Depreciation and amortization   | 1,949         | 15,077                           | 458  |                     | 17,484                        |
| Gross profit (loss)   | (1,949)       | 27,478                           | 3,315                                      |                     | 28,844                        |
| Severance and other related costs   | 405           |                                  |  |                     | 405                           |
| Corporate general and administrative  | 13,783        |                                  |  |                     | 13,783                        |
| Impairment of goodwill, intangibles, and long lived assets  |               | 13,226                           |  |                     | 13,226                        |
| Gain on sale of operations  |               | (4,669)                          |  |                     | (4,669)                       |
| Interest expense, net, including amortization of deferred financing costs   | 9,390         | 4,566                            | 59   |                     | 14,015                        |
| Income (loss) before equity in earnings of unconsolidated affiliates, minority interests in consolidated subsidiaries, income taxes and discontinued operations | (25,527)      | 14,355                           | 3,256                                      |                     | (7,916)                       |
| Equity in earnings of investments   |               | 2,336                            |  |                     | 2,336                         |
| Minority interests in income of consolidated subsidiaries   |               |                                  | (639)                                      |                     | (639)                         |
| Income (loss) before taxes and discontinued operations  | (25,527)      | 16,691                           | 2,617                                      |                     | (6,219)                       |
| Income tax expense (benefit)  | (10,211)      | 6,458                            | 1,047                                      |                     | (2,706)                       |
| Income (loss) from continuing operations  | (15,316)      | 10,233                           | 1,570                                      |                     | (3,513)                       |
| Discontinued operations:  |               |                                  |  |                     |                               |
| Loss from discontinued operations   |               | (7,083)                          | (4,067)                                    |                     | (11,150)                      |
| Income tax benefit  |               | (2,833)                          | (1,627)                                    |                     | (4,460)                       |
| Loss from discontinued operations   |               | (4,250)                          | (2,440)                                    |                     | (6,690)                       |
| Net income (loss)   | \$ (15,316)   | \$ 5,983                         | \$ (870)                                   | \$                  | \$ (10,203)                   |



Table of Contents**RADIOLOGIX, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS (Unaudited)****For the Nine Months Ended September 30, 2005****(In thousands)**

|   | <u>Parent</u>    | <u>Subsidiary<br/>Guarantors</u> | <u>Non-<br/>Guarantor<br/>Subsidiaries</u> | <u>Eliminations</u> | <u>Total<br/>Consolidated</u> |
|---|------------------|----------------------------------|--|---------------------|-------------------------------|
| <b>NET CASH PROVIDED BY (USED IN)</b>                           |                  |                                  |  |                     |                               |
| <b>OPERATING ACTIVITIES</b>                                     | \$ (6,012)       | \$ 31,050                        | \$ 2,143                                   | \$                  | \$ 27,181                     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                    |                  |                                  |  |                     |                               |
| Increase in restricted cash                                     | (73)             |                                  |  |                     | (73)                          |
| Purchases of property and equipment                             | (4,744)          | (16,980)                         | (554)                                      |                     | (22,278)                      |
| Proceeds from sale of equipment                                 |                  | 1,173                            |  |                     | 1,173                         |
| Joint ventures  | 698              | 969                              |  |                     | 1,667                         |
| <b>Net cash used in investing activities</b>                    | <u>(4,119)</u>   | <u>(14,838)</u>                  | <u>(554)</u>                               |                     | <u>(19,511)</u>               |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                    |                  |                                  |  |                     |                               |
| Payments on long-term obligations                               | 63               | (45)                             | (179)                                      |                     | (161)                         |
| Due to/from parent/subsidiaries                                 | 17,676           | (18,466)                         | 790  |                     |                               |
| Proceeds from stock option exercises                            | 847              |                                  |  |                     | 847                           |
| <b>Net cash provided by (used in) financing activities</b>      | <u>18,586</u>    | <u>(18,511)</u>                  | <u>611</u>                                 |                     | <u>686</u>                    |
| <b>NET INCREASE (DECREASE) IN CASH AND<br/>CASH EQUIVALENTS</b> | 8,455            | (2,299)                          | 2,200                                      |                     | 8,356                         |
| <b>CASH AND CASH EQUIVALENTS, beginning of<br/>period</b>       | <u>30,198</u>    | <u>249</u>                       | <u>3,637</u>                               |                     | <u>34,084</u>                 |
| <b>CASH AND CASH EQUIVALENTS, end of period</b>                 | <u>\$ 38,653</u> | <u>\$ (2,050)</u>                | <u>\$ 5,837</u>                            | <u>\$</u>           | <u>\$ 42,440</u>              |

**Table of Contents****RADIOLOGIX, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS (Unaudited)****For the Nine Months Ended September 30, 2004****(In thousands)**

|   | <u>Parent</u>    | <u>Subsidiary<br/>Guarantors</u> | <u>Non-<br/>Guarantor<br/>Subsidiaries</u> | <u>Eliminations</u> | <u>Total<br/>Consolidated</u> |
|---|------------------|----------------------------------|--|---------------------|-------------------------------|
| <b>NET CASH PROVIDED BY (USED IN)</b>                           |                  |                                  |  |                     |                               |
| <b>OPERATING ACTIVITIES</b>                                     | \$ (17,331)      | \$ 42,320                        | \$ 1,426                                   | \$                  | \$ 26,415                     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                    |                  |                                  |  |                     |                               |
| Increase in restricted cash                                     | (4,820)          |                                  |  |                     | (4,820)                       |
| Purchases of property and equipment                             | 956              | (21,658)                         | 2,605                                      |                     | (18,097)                      |
| Net cash received on sale of operations                         |                  | 13,743                           |  |                     | 13,783                        |
| Joint ventures  | 673              | 1,114                            |  |                     | 1,787                         |
| Other investments   |                  | (79)                             | (30)                                       |                     | (109)                         |
| <b>Net cash provided by (used in) investing activities</b>      | <b>(3,191)</b>   | <b>(6,880)</b>                   | <b>2,575</b>                               |                     | <b>(7,496)</b>                |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                    |                  |                                  |  |                     |                               |
| Payments on long-term debt, primarily capital leases            |                  | (1,265)                          | (341)                                      |                     | (1,606)                       |
| Retirement of senior debt                                       | (1,730)          |                                  |  |                     | (1,730)                       |
| Due to/from parent/subsidiaries                                 | 40,206           | (38,847)                         | (1,359)                                    |                     |                               |
| Other items   |                  | 183                              |  |                     | 183                           |
| <b>Net cash provided by (used in) financing activities</b>      | <b>38,476</b>    | <b>(39,929)</b>                  | <b>(1,700)</b>                             |                     | <b>(3,153)</b>                |
| <b>NET INCREASE (DECREASE) IN CASH AND<br/>CASH EQUIVALENTS</b> | <b>17,954</b>    | <b>(4,489)</b>                   | <b>2,301</b>                               |                     | <b>15,766</b>                 |
| <b>CASH AND CASH EQUIVALENTS, beginning of<br/>period</b>       | <b>31,625</b>    | <b>3,856</b>                     | <b>1,285</b>                               |                     | <b>36,766</b>                 |
| <b>CASH AND CASH EQUIVALENTS, end of period</b>                 | <b>\$ 49,579</b> | <b>\$ (633)</b>                  | <b>\$ 3,586</b>                            | <b>\$</b>           | <b>\$ 52,532</b>              |

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

**Overview**

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.

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 operations that compete with our primary and Questar operations, the timing and negotiation of managed care and service contracts, the availability of technologists and other personnel, 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 nine months ended September 30, 2005, we derived 87% of our service fee revenue from the ownership, management and operation of our imaging center network and 13% of our service fee revenue from administrative, management and information services provided to contracted radiology practices. As of September 30, 2005, we owned, operated or maintained, through our two operating segments, an ownership interest in imaging equipment at 73 locations, with imaging centers located in 8 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 Arizona, California, Colorado and Minnesota. Our 73 locations as of September 30, 2005 include a new multi-modality center that we opened in our Rochester market during the second quarter of 2005 and exclude a small center that we closed in the second quarter.

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 medical services agreements. Under these medical 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, payment versus charge schedules and accounts receivable aging models. As these factors change, changes in estimates are made in the appropriate period.

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 medical 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 as defined in the medical services agreements; and (2) 100% of the adjusted technical revenues as defined in the medical service agreements up to a designated ceiling at which point certain of the medical 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 prohibits fee-splitting, Radiologix has negotiated a service fee based upon the number of work units performed by radiologists, which approximates the estimated fair market value of the services provided under the



service 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. We are increasingly faced with additional competition from referral sources who elect to purchase and operate diagnostic imaging equipment in our markets.

**Table of Contents****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 subsidiary, Questar. 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.

Impairment charges of \$5.8 million for the 2004 write-off of goodwill and long-lived assets relate to our six Questar centers that are currently in continuing operations. Impairment charges for other Questar centers in 2004 are included in discontinued operations.

Legal costs of \$557,000 reflected in discontinued operations relate to our successful defense of an arbitration, brought by a former physician partner, stemming from the sale of our Questar center in Pennsylvania in June 2004. Of these costs, \$313,000 were incurred in the first six months of 2005 and were improperly reflected in our general and administrative expense from continuing operations. We reclassified the \$313,000 to discontinued operations during the third quarter of 2005 to properly reflect the fact that these costs relate to a center that was sold in 2004 and, therefore, is no longer part of our continuing operations.

**Three Months Ended September 30, 2005 Compared to Three Months Ended September 30, 2004**

The following tables outline our service fee revenue, volumes and operating expenses, (excluding 2004 impairment charges and 2004 severance, contract cancellation, litigation and other related costs) for the three months ended September 30, 2005 and 2004 below (in thousands):

|                                       | 2005      | 2004      | Percent Increase<br>(Decrease) | Percent of Service Fee Revenue |        | Basis Point Change |
|---------------------------------------|-----------|-----------|--------------------------------|--------------------------------|--------|--------------------|
|                                       |           |           |                                | 2005                           | 2004   |                    |
| Service fee revenue                   | \$ 62,258 | \$ 63,613 | (2.1)%                         | 100.0%                         | 100.0% |                    |
| Field salaries and benefits           | 21,118    | 21,111    |                                | 33.9                           | 33.2   | 70                 |
| Field supplies                        | 3,853     | 4,040     | (4.6)                          | 6.2                            | 6.4    | (20)               |
| Facility rent                         | 3,641     | 3,555     | 2.4                            | 5.8                            | 5.6    | 20                 |
| Other field expenses                  | 11,777    | 10,804    | 9.0                            | 18.9                           | 17.0   | 190                |
| Cost of services                      | 40,389    | 39,510    | 2.2                            | 64.9                           | 62.1   | 280                |
| Equipment leases                      | 3,545     | 4,554     | (22.2)                         | 5.7                            | 7.2    | (150)              |
| Provision for doubtful accounts       | 4,521     | 5,329     | (15.2)                         | 7.3                            | 8.4    | (110)              |
| Depreciation and amortization         | 6,125     | 5,449     | 12.4                           | 9.8                            | 8.6    | 120                |
| Corporate, general and administrative | 3,862     | 4,790     | (19.4)                         | 6.2                            | 7.5    | (130)              |

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|                         |                  |                  |               |               |               |           |
|-------------------------|------------------|------------------|---------------|---------------|---------------|-----------|
| Interest expense, net   | <u>4,561</u>     | <u>4,603</u>     | <u>(0.9)</u>  | <u>7.3</u>    | <u>7.2</u>    | <u>10</u> |
| Total operating expense | <u>\$ 63,003</u> | <u>\$ 64,235</u> | <u>(1.9)%</u> | <u>101.2%</u> | <u>101.0%</u> | <u>20</u> |

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

|                                       | 2005      | 2004      | Percent Increase<br>(Decrease) | Percent of Service Fee Revenue |        | Basis Point Change |
|---------------------------------------|-----------|-----------|--------------------------------|--------------------------------|--------|--------------------|
|                                       |           |           |                                | 2005                           | 2004   |                    |
| Service fee revenue                   | \$ 62,259 | \$ 62,164 | 0.2%                           | 100.0%                         | 100.0% |                    |
| Field salaries and benefits           | 21,118    | 20,781    | 1.6                            | 33.9                           | 33.4   | 50                 |
| Field supplies                        | 3,850     | 3,961     | (2.8)                          | 6.2                            | 6.4    | (20)               |
| Facility rent                         | 3,640     | 3,519     | 3.4                            | 5.8                            | 5.7    | 10                 |
| Other field expenses                  | 11,733    | 10,379    | 13.0                           | 18.8                           | 16.7   | 210                |
| Cost of services                      | 40,341    | 38,640    | 4.4                            | 64.8                           | 62.2   | 260                |
| Equipment leases                      | 3,537     | 4,562     | (22.5)                         | 5.7                            | 7.3    | (160)              |
| Provision for doubtful accounts       | 4,522     | 4,738     | (4.6)                          | 7.3                            | 7.6    | (30)               |
| Depreciation and amortization         | 6,125     | 5,387     | 13.7                           | 9.8                            | 8.7    | 110                |
| Corporate, general and administrative | 3,862     | 4,790     | (19.4)                         | 6.2                            | 7.7    | (150)              |
| Interest expense, net                 | 4,560     | 4,585     | (0.5)                          | 7.3                            | 7.4    | (10)               |
| Total operating expense               | \$ 62,947 | \$ 62,702 | 0.3%                           | 101.1%                         | 100.9% | 20                 |

A summary of our volumes, excluding certain volumes for the terminated MSA operations noted above, follows:

|                             | For the Three Months Ended<br>September 30, |         |
|-----------------------------|---|---------|
|                             | 2005  | 2004    |
| High end volumes (1):       |   |         |
| Total                       | 90,055                                      | 92,848  |
| Less terminated MSA volumes |   | 1,934   |
| Net                         | 90,055                                      | 90,914  |
| Other volumes:              |   |         |
| Total                       | 285,878                                     | 289,877 |
| Less terminated MSA volumes |   | 5,759   |
| Net                         | 285,878                                     | 284,118 |

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

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For the three months ended September 30, 2005 compared to the three months ended September 30, 2004, service fee revenue from continuing operations decreased \$1.4 million or 2.1%. This decrease is primarily attributable to (1) the termination of a medical services agreement with a Mid-Atlantic radiology group effective January 31, 2005, resulting in a decrease in service fee revenue of \$1.7 million in the third quarter 2005 compared to the third quarter 2004 (primarily due to the loss of service fee revenue generated from professional reading arrangements at certain hospitals and disposed imaging centers), and (2) the sale of our operations in San Antonio, Texas in the second quarter 2004 (our San Antonio operations generated a \$237,000 loss in service fee revenue in the third quarter 2004).

Excluding the terminated MSA operations, noted above, service fee revenue increased \$95,000 or 0.2% for the three months ended September 30, 2005 compared to the three months ended September 30, 2004. The increase is primarily due to (1) a shift in modality mix to higher-end CT and PET procedures, (2) the impact of new imaging centers and new diagnostic equipment placed into operations since September 30, 2004, (3) increased professional and outside read revenue, and (4) increased management fee and reading fee revenue at non-consolidated entities. Much of our service fee revenue increases were offset by a decrease in MRI procedures due to increased capacity introduced by competitors, competition from referring physicians who perform MRI procedures in their offices, and a change in California law which has reduced the number of MRI procedures authorized for workers in the California state workers' compensation program. In addition, our service fee revenue increases were offset by (a) increased physician retention costs at one subsidiary based on certain terms of a medical services agreement that went into effect subsequent to September 30, 2004, (b) increased physician retention costs pursuant to the existing terms of certain other medical services agreements which went into effect after June 30, 2005, and (c) a hospital associated with the Northeast region installed a CT, resulting in a decrease in the CT procedures at the imaging center offset by an increase in the professional revenue.

Field salaries and benefits as a percentage of service fee revenue from continuing operations for the three months ended September 30, 2005 were 33.9% compared to 33.2% for the three months ended September 30, 2004. This percentage increase resulted primarily from (1) merit increases that went into effect March 1, 2005 as a result of annual performance reviews completed through our Focal Point Review process (in 2004, annual merit increases went into effect based on each employee's anniversary date),

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(2) salary market adjustments effective in July 2004 for certain employees at one of our subsidiaries, (3) higher technologist costs, and (4) overtime costs for employee training in connection with our REWARD program described below. These increases 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 September 30, 2005 and 2004, excluding the terminated MSA operations, were 33.9% and 33.4%, 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 6.2% for the three months ended September 30, 2005 compared to 6.4% for the three months ended September 30, 2004. This percentage decrease was due primarily to imaging center workflow process improvement and an increase in revenue mix in areas that do not require supplies.

Facility rent, excluding the terminated MSA operations, as a percentage of service fee revenue was 5.8% and 5.7% for the three months ended September 30, 2005 and September 30, 2004, 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, were 18.8% for the three months ended September 30, 2005 compared to 16.7% for the three months ended September 30, 2004 primarily due to (1) increased service contract costs resulting from new coverage on (a) equipment coming off warranty and (b) equipment acquired in connection with the acquisition of an equipment financing right agreement effective October 31, 2004, (2) system conversion, upgrade and outsourcing costs for our patient accounting systems, (3) higher marketing costs in our primary operations, (4) higher physician purchased service costs primarily due to paying certain physicians for incremental coverage on reading contracts, (5) higher workers compensation costs, (6) higher diagnostic equipment repair costs, and (7) higher telephone and communication cost related to installation and operation of our new REWARD program.

Equipment lease expenses, excluding the terminated MSA operations, decreased in the three months ended September 30, 2005 compared to the three months ended September 30, 2004 primarily due to the impact of lease buyouts and the acquisition of an equipment financing right effective October 31, 2004, which eliminates equipment lease expense that was previously recorded based on volume. These decreased costs were offset by \$86,000 in costs we incurred to buy out certain leases in the 2005 third quarter.

Provision for doubtful accounts decreased by \$808,000 in the three months ended September 30, 2005 compared to the three months ended September 30, 2004 primarily due to reduced denial rates in 2005 and weaker than expected collection performance in 2004 on receivables for professional services at two Mid-Atlantic hospitals that were part of the terminated Mid-Atlantic MSA agreement.

Depreciation and amortization increased in the three months ended September 30, 2005 compared to the three months ended September 30, 2004 primarily due to the impact of new imaging centers and new equipment placed in service since September 30, 2004, lease buyouts, and the acquisition of an equipment financing right and related diagnostic equipment effective October 31, 2004, offset by (1) no longer operating the terminated Mid-Atlantic operations effective January 31, 2005, (2) the effect of lower asset bases as a result of asset impairments in 2004 and (3) assets that became fully depreciated since September 30, 2004.

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Corporate, general and administrative expenses decreased in the three months ended September 30, 2005 compared to the three months ended September 30, 2004 primarily due to (1) eliminating CEO recruiting process, (2) lower legal costs as a result of establishing an in-house legal department, (3) lower costs related to Sarbanes-Oxley Section 404 compliance as a result of concluding our initial stage of establishing, documenting, and implementing our company-wide internal control processes, (4) reclassified legal costs of \$313,000 related to our former Questar center in Pennsylvania to discontinued operations and (5) lower costs related to our information technology department. These decreases were offset by (1) increased costs related to our development and reimbursement operation departments, (2) \$350,000 in management bonus costs accrued in the third quarter of 2005 compared to \$125,000 bonus accrual in the third quarter of 2004, (3) travel and training costs incurred in 2005 for our REWARD program and (4) costs incurred with our initiative to facilitate our One Company, One Culture focus.

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Interest expense (net of interest income), including amortization of deferred financing costs, for the three months ended September 30, 2005 compared to the three months ended September 30, 2004 is lower due primarily to earning interest income on additional invested funds.

**Nine Months Ended September 30, 2005 Compared to Nine Months Ended September 30, 2004**

The following tables outline our service fee revenue, volumes and operating expenses, (excluding 2004 impairment charges and 2004 severance, contract cancellation, litigation and other related costs) for the nine months ended September 30, 2005 and 2004 below (in thousands):

|                                       | 2005       | 2004       | Percent Increase<br>(Decrease) | Percent of Service Fee Revenue |        | Basis Point Change |
|---------------------------------------|------------|------------|--------------------------------|--------------------------------|--------|--------------------|
|                                       |            |            |                                | 2005                           | 2004   |                    |
| Service fee revenue                   | \$ 189,320 | \$ 195,866 | (3.3)%                         | 100.0%                         | 100.0% |                    |
| Field salaries and benefits           | 65,389     | 65,003     | 0.6                            | 34.5                           | 33.2   | 130                |
| Field supplies                        | 11,508     | 11,638     | (1.1)                          | 6.1                            | 5.9    | 20                 |
| Facility rent                         | 10,514     | 10,134     | 3.7                            | 5.6                            | 5.2    | 40                 |
| Other field expenses                  | 33,427     | 32,318     | 3.4                            | 17.7                           | 16.5   | 120                |
| Cost of services                      | 120,838    | 119,093    | 1.5                            | 63.8                           | 60.8   | 300                |
| Equipment leases                      | 9,582      | 13,945     | (31.3)                         | 5.1                            | 7.1    | (200)              |
| Provision for doubtful accounts       | 13,647     | 16,185     | (15.7)                         | 7.2                            | 8.3    | (110)              |
| Depreciation and amortization         | 18,014     | 17,484     | 3.0                            | 9.5                            | 8.9    | 60                 |
| Corporate, general and administrative | 13,195     | 13,288     | (0.7)                          | 7.0                            | 6.8    | 20                 |
| Interest expense, net                 | 13,802     | 14,015     | (1.5)                          | 7.3                            | 7.2    | 10                 |
| Total operating expense               | \$ 189,078 | \$ 194,010 | (2.5)%                         | 99.9%                          | 99.1%  | 80                 |

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

|                             | 2005       | 2004       | Percent Increase<br>(Decrease) | Percent of Service Fee Revenue |        | Basis Point Change |
|-----------------------------|------------|------------|--------------------------------|--------------------------------|--------|--------------------|
|                             |            |            |                                | 2005                           | 2004   |                    |
| Service fee revenue         | \$ 188,352 | \$ 185,252 | 1.7%                           | 100.0%                         | 100.0% |                    |
| Field salaries and benefits | 65,196     | 62,902     | 3.6                            | 34.6                           | 34.0   | 60                 |
| Field supplies              | 11,468     | 11,217     | 2.2                            | 6.1                            | 6.1    |                    |
| Facility rent               | 10,487     | 9,875      | 6.2                            | 5.6                            | 5.3    | 30                 |



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|                                       |                   |                   |             |               |               |             |
|---------------------------------------|-------------------|-------------------|-------------|---------------|---------------|-------------|
| Other field expenses                  | 33,201            | 29,814            | 11.4        | 17.6          | 16.1          | 150         |
| Cost of services                      | 120,352           | 113,808           | 5.8         | 63.9          | 61.4          | 250         |
| Equipment leases                      | 9,556             | 13,836            | (30.9)      | 5.1           | 7.5           | (240)       |
| Provision for doubtful accounts       | 13,405            | 14,255            | (6.0)       | 7.1           | 7.7           | (60)        |
| Depreciation and amortization         | 18,013            | 16,798            | 7.2         | 9.6           | 9.1           | 50          |
| Corporate, general and administrative | 13,195            | 13,288            | (0.7)       | 7.0           | 7.2           | (20)        |
| Interest expense, net                 | 13,801            | 13,847            | (0.3)       | 7.3           | 7.5           | (20)        |
| <b>Total operating expense</b>        | <b>\$ 188,322</b> | <b>\$ 185,832</b> | <b>1.3%</b> | <b>100.0%</b> | <b>100.3%</b> | <b>(30)</b> |

A summary of our volumes, excluding certain volumes for the terminated MSA operations noted above, follows:

|                              | For the Nine Months Ended<br>September 30, |                |
|------------------------------|--|----------------|
|                              | 2005                                       | 2004           |
| <b>High end volumes (1):</b> |  |                |
| Total                        | 277,942                                    | 285,576        |
| Less terminated MSA volumes  | 671  | 11,036         |
| <b>Net</b>                   | <b>277,271</b>                             | <b>274,540</b> |
| <b>Other volumes:</b>        |  |                |
| Total                        | 872,675                                    | 892,374        |
| Less terminated MSA volumes  | 3,234                                      | 27,121         |
| <b>Net</b>                   | <b>869,441</b>                             | <b>865,253</b> |

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

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For the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004, service fee revenue decreased \$6.5 million or 3.3%. This decrease is primarily attributable to (1) the sale of our operations in San Antonio, Texas in the second quarter of 2004 (the San Antonio operations generated \$5.9 million in service fee revenue for the nine months ended September 30, 2004), (2) the termination of a medical services agreement with a Mid-Atlantic radiology group effective January 31, 2005, resulting in a decrease in service fee revenue of \$4.7 million for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 (primarily due to the loss of service fee revenue generated from professional reading arrangements at certain hospitals and disposed imaging centers), (3) an amendment to a medical services agreement which resulted in the establishment of a technical bonus to the contracted radiology group and a 3% reduction in our management fee effective October 1, 2004, (4) reductions due to increased physician retention costs pursuant to the existing terms of certain other medical services agreements which went into effect after September 30, 2004 and (5) a decrease in MRI procedures due to increased capacity introduced by competitors, competition from referring physicians who perform MRI procedures in their offices, a change in California law which has reduced the number of MRI procedures authorized for workers in the state workers' compensation program and open MRI technologist positions.

Excluding the terminated MSA operations noted above, service fee revenue increased \$3.1 million or 1.7% for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004. This increase is primarily due to (1) a shift in mix to higher-end CT and PET procedures, which increases have more than offset the decreases we experienced in our MRI procedures as noted above, resulting in an increase in our net technical revenue per procedure of \$142.92 for the nine months ended September 30, 2005 compared to \$140.04 for the nine months ended September 30, 2004, (2) the impact of new imaging centers and new diagnostic equipment placed into operations since September 30, 2004 and (3) increases in capitation and management service revenue. Our 2005 service fee revenue would have been higher if not for technologist shortages, reduced physician coverage, and reduced workers' compensation volumes at certain Bay Area, California facilities. In addition, our service fee revenue increases were offset by (a) increased physician retention costs based on certain terms of a medical services agreement which terms went into effect subsequent to September 30, 2004, and (b) a decrease in service fee revenue from our Questar operations primarily due to the performance of our Arizona center, which continues to struggle to overcome the transition to a new name and location as well as increased local competition, and both of our Colorado centers. Our \$2.2 million in goodwill at September 30, 2005 relates to our two Colorado Questar centers. We are focusing efforts on reversing the decline in volumes that we experienced at these centers. However, if our efforts are not successful and these centers continue to experience lower than expected volumes, we may incur an impairment charge in a future period.

Field salaries and benefits as a percentage of service fee revenue from continuing operations for the nine months ended September 30, 2005 were 34.5% compared to 33.2% for the nine months ended September 30, 2004. This percentage increase resulted primarily from (1) merit increases that went into effect March 1, 2005 as a result of annual performance reviews completed through our Focal Point Review process (in 2004, annual merit increases went into effect based on each employee's anniversary date), (2) our San Antonio operations having lower salary and benefit costs as a percentage of service fee revenue relative to the rest of our operations (primarily because the San Antonio operations allocated certain salary and benefit costs to unconsolidated joint ventures), (3) salary market adjustments effective in July 2004 for certain employees at one of our subsidiaries, (4) higher technologist costs, and (5) overtime costs for employee training in connection with our REWARD program described below. The effect of the above items was offset by the reduction in temporary labor costs, primarily for technologists that were used extensively by one of our subsidiaries in the first nine months of 2004. Field salaries and benefits as a percentage of service fee revenue from continuing operations for the nine months ended September 30, 2005 and 2004, excluding the terminated MSA operations, were 34.6% and 34.0%, 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 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 6.1% for the nine months ended September 30, 2005 compared to 6.1% for the nine months ended September 30, 2004. Field supply costs generally increase as we perform more high-end diagnostic procedures. High-end procedures typically utilize more supplies such as contrast and radio-pharmaceuticals.

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Facility rent, excluding the terminated MSA operations, as a percentage of service fee revenue was 5.6% for the nine months ended September 30, 2005 compared to 5.3% for the nine months September 30, 2004, primarily due to facility rent for a new imaging

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center that began operations in April 2005 and higher facility rent in our Bay Area, California operations, offset by the reversal of a \$229,000 lease accrual (of which \$62,000 was recorded in the 2005 first quarter) no longer required as a result of settling a facility lease obligation with the trustee of a bankrupt landlord.

Other field expenses, excluding the terminated MSA operations, were 17.6% for the nine months ended September 30, 2005 compared to 16.1% for the nine months ended September 30, 2004 primarily due to (1) increased service contract costs resulting from new coverage on (a) equipment coming off warranty and (b) equipment acquired in connection with the acquisition of an equipment financing right agreement effective October 31, 2004, (2) system conversion, upgrade and outsourcing costs for our patient accounting systems, (3) higher marketing costs in our primary operations, (4) higher physician purchased service costs primarily due to paying certain physicians for incremental coverage on related contracts, (5) higher workers compensation costs, (6) higher diagnostic equipment repair costs, (7) higher telephone and communication cost related to our operations and installation of REWARD and (8) a \$176,000 write-off of leasehold improvement costs related to an imaging center closed in the 2005 second quarter. These increased costs were offset by (1) a \$370,000 gain from insurance proceeds received in settlement for equipment damaged by a hurricane, (2) gains on sales of diagnostic equipment, (3) lower malpractice insurance costs and (4) lower off-site storage costs.

Equipment lease expenses, excluding the terminated MSA operations, decreased in the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 primarily due to the impact of lease buyouts and the acquisition of an equipment financing right effective October 31, 2004, which eliminates equipment lease expense that was previously recorded based on volume. The impact of the decrease in the nine months of 2005 would have been even greater if not for an approximate \$144,000 lease credit we received in the first quarter of 2004. These decreased costs were offset by \$86,000 in equipment lease expenses we incurred as part of lease buy out transactions in the 2005 third quarter.

Provision for doubtful accounts decreased by \$2.5 million in the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 primarily due to lower professional component revenue charges, which historically have lower collection rates, improved denial rates in 2005 and weaker than expected collection performance in 2004 on receivables for professional services at two Mid-Atlantic hospitals that were part of the terminated Mid-Atlantic MSA agreement.

Depreciation and amortization increased in the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 primarily due to (1) the impact of new imaging centers and new equipment placed in service since June 30, 2004, (2) lease buyouts and (3) the acquisition of an equipment financing right and related diagnostic equipment effective October 31, 2004, offset by (1) no longer operating the terminated San Antonio operations which were sold in the second quarter of 2004, (2) no longer operating the terminated Mid-Atlantic operations effective January 31, 2005, (3) the effect of lower asset bases as a result of asset impairments in 2004 and (4) assets that became fully depreciated since September 30, 2004.

Corporate, general and administrative expenses decreased in the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 primarily due to (1) lower executive recruiting and relocation costs, (2) reduced legal costs as a result of establishing an in-house legal department which resulted in reducing our contracted legal costs, (3) lower costs related to Sarbanes-Oxley Section 404 compliance as a result of concluding our initial stage of establishing, documenting, and implementing our company wide internal control processes, (4) lower 2005 health benefits costs, (5) a reduction in our estimated 2004 bonus and severance accruals that were finalized in the first quarter of 2005, and (6) the lack of chief operating officer salary and benefit costs in 2005 first and second quarter as this position remained open from December 2004 through July 14, 2005. These decreases were offset by (1) increased costs related to our information technology, human resource, and development departments, (2) \$894,000 in management bonus costs accrued in 2005 compared to \$125,000 bonus accrued in 2004, (3) travel and training costs incurred in 2005 for our REWARD program, (4) costs incurred with our initiative to facilitate our One Company, One Culture focus, and (5) consulting costs incurred in connection with defining and validating our strategic direction.

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Interest expense (net of interest income), including amortization of deferred financing costs, for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 is lower due primarily to our \$1.7 million retirement of debt in the second quarter of 2004 and earning interest income on additional invested funds.

### **LIQUIDITY AND CAPITAL RESOURCES**

Liquidity for the nine months ended September 30, 2005 was derived from cash and cash equivalents, and net cash generated by operating activities and amounts available under our Master Lease Agreement. As of September 30, 2005, we had current assets of \$103.4 million, including cash and cash equivalents of \$42.4 million, and current liabilities of \$34.0 million, including current maturities of long-term debt and capital lease obligations of \$5,000. For the nine months ended September 30, 2005, we generated \$27.2 million in net operating cash flow, invested \$19.5 million and had cash provided by financing activities of \$686,000.

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Net cash flows from operating activities for the nine months ended September 30, 2005 of \$27.2 million increased from \$26.4 million for the same period in 2004. 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 nine months ended September 30, 2005, the primary reasons for our increase in operating cash flows relative to the comparable period in 2004 were 1) substantially lower equipment lease expense, 2) income tax refunds received, 3) decrease in accounts receivable and 4) lower general and administrative costs.

Our days sales outstanding on accounts receivable decreased from 48 days at December 31, 2004 to 45 days at September 30, 2005. We calculated 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 reduced denial rates and overall improved collections in 2005.

Net cash used in investing activities for the nine months ended September 30, 2005 and 2004 was \$19.5 million and \$7.5 million, respectively. Purchases of property and equipment during the nine months ended September 30, 2005 and 2004 were \$22.3 million and \$18.1 million, respectively, including \$1.9 million to buyout operating leases in 2005. For the remainder of 2005, we expect to spend approximately \$1.0 million on equipment lease buyouts. In 2005, we received \$1.2 million in consideration for the sales of certain diagnostic equipment and an imaging center, compared to \$13.7 million in 2004 (of which \$10.5 million related to the sale of our San Antonio operations on April 30, 2004). Also at September 30, 2005, we had \$5.6 million in restricted cash in accordance with our Master Lease Agreement with GE Healthcare Financial Services (GE) as discussed below, of which \$4.0 million was funded in the second quarter of 2004.

Net cash flows provided by financing activities for the nine months ended September 30, 2005 was \$686,000, compared to the net cash flows used in financing activities for the nine months ended September 30, 2004 of \$3.2 million. We received proceeds from the exercises of stock options of \$847,000 in the third quarter of 2005 compared to \$183,000 in the third quarter of 2004.

At September 30, 2005, we had outstanding senior note borrowings of \$158.3 million and a \$12.0 million convertible subordinated junior note. At September 30, 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 \$27.8 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. At September 30, 2005, we had not met certain incurrence tests under our debt agreements. As a result, we are limited to borrowing \$20.0 million under the revolving credit facility until such time as we meet this test.

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 September 30, 2005 balance sheet includes \$5.6 million of restricted cash under this provision. GE provided us with a written waiver stating that GE agreed to waive compliance with the financial leverage ratio for the year ending December 31, 2004 and to modify this calculation for 2005 to exclude the \$9.1 million adjustment described in our 2004 Form 10-K.

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At September 30, 2005, applicable amounts outstanding under the Master Lease Agreement totaled \$37.4 million; commitments for leases signed but not placed in service under the Master Lease Agreement were \$7.3 million, and \$15.3 million remained available for future leases.

Based on our revised projections as of September 30, 2005, we plan to spend approximately \$8.9 million for capital expenditures in connection with our REWARD Program, \$23.0 million for expansion of centers including de novo (new) projects and commit \$20.8 million for major diagnostic equipment leases over the respective lease terms, in fiscal 2005. As of September 30, 2005, we spent approximately \$5.5 million and \$16.8 million on capital expenditures in connection with our REWARD Program and expansion of centers, respectively, and committed \$20.8 million for major diagnostic equipment leases. In 2006, we plan to spend an additional \$5.5 million in connection with our REWARD Program, or an aggregate \$16.5 million for total projected capital expenditures related to our REWARD Program.

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 costs 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,

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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, 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;

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).

### *Revenue Recognition, Contractual Allowances and Allowances for Doubtful Accounts*

In connection with our December 2004 year-end closing process, we finalized a retrospective collection analysis. This retrospective process represented an enhancement to our methodology for estimating the amount of contractual adjustments and provision for doubtful accounts necessary to reduce gross revenue (billed charges) and gross receivables to net amounts realizable from managed care, Medicare, Medicaid, private and other payors. This enhanced methodology is based on the matching of cash collections to billed charges by month of service. In connection with our provision for doubtful accounts, we continue to record this expense based on historical write-offs which experience has not significantly changed.

Service fee revenue from the 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 medical 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, write-off experience, and



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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 \$5.0 million per year.

Our accounts receivable write-off process is primarily system-driven whereby a series of communications to the patient (or their guarantor) requesting payment is sent to a private payor 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. Once the communication cycle is completed and the receivable remains uncollected, it is written off in our patient accounting system. 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.

Write-offs for accounts receivables have been relatively constant, but we can experience increases for specified events, primarily when we retain receivables for businesses we dispose of.

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*Impairment of Goodwill, Intangible and Long-Lived Assets*

*Goodwill*

Goodwill and other intangible assets with indefinite useful lives are subject to at least annual assessments for impairment by applying a fair-value-based test. We conduct our annual impairment fair-value-based test during the first quarter of each fiscal year. We also review the recoverability of our goodwill on a quarterly basis, including a review of events or changes in circumstances that may indicate that the carrying amount may not be recoverable. At September 30, 2005, the balance of goodwill, which relates to our two Colorado Questar centers, is approximately \$2.2 million. The performance of these centers declined in the second and third quarter of 2005. As a result, we are focusing efforts on reversing the decline in volumes that we experienced at these centers. However, if our efforts are not successful and these centers continue to experience lower than expected volumes, we may incur an impairment charge in a future period.

*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 medical 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 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.

*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 tax liabilities 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.

We have significant noncurrent deferred tax assets at September 30, 2005. Realization of these deferred tax assets is dependent on generating sufficient taxable income prior to expiration of the twenty-year loss carryforward period. Although realization is not assured, management believes it is more likely than not that all of the deferred tax assets will be realized. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.

Our tax strategy to realize deferred tax assets resulting from the impairment of goodwill and long-lived assets at certain of our Questar centers, involves the future disposal of the remaining six Questar centers we are currently operating at September 30, 2005. Until we dispose of all our Questar operations, we cannot, under the current tax regulations, deduct these particular impairment charges. As of September 30, 2005, we plan to operate these six Questar centers for as long as they are profitable; however, we do not plan to invest in new equipment for these six centers unless our new development team determines that it is beneficial to expand our operations in certain of these Questar markets. If the cumulative operations begin to deteriorate, we will make a cost benefit decision

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in which we will compare the estimated future profitability of these centers to the potential tax and other benefits we could realize upon disposal.

### *Forward-Looking Statements*

*Throughout this report we make forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). Forward-looking statements include words such as may, will, would, could, likely, estimate, intend, plan, continue, believe, expect or anticipate and other similar words and include all discussions about our acquisition and development plans. We do not guarantee that the transactions and events described in this report will happen as described or that any positive trends noted in this report will continue. The forward-looking statements contained in this report are generally located in the material set forth under the heading Management's Discussion and Analysis of Financial Condition and Results of Operations, but may be found in other locations as well. These forward-looking statements generally relate to our plans, objectives and expectations for future operations and are based upon management's reasonable estimates of future results or trends. Although we believe that our plans and objectives reflected in or suggested by such forward-looking statements are reasonable, we may not achieve such plans or objectives. You are cautioned not to unduly rely on such forward-looking statements when evaluating the information presented in this report. You should read this report completely and with the understanding that actual future results may be materially different from what we expect. We will not update forward-looking statements even though our situation may change in the future.*

*Specific factors that might cause actual results to differ from our expectations include, but are not limited to:*

*economic, demographic, business and other conditions in our markets;*

*the highly competitive nature of the healthcare business;*

*changes in patient referral patterns;*

*changes in the rates or methods of third-party reimbursement for diagnostic imaging services;*

*changes in our contracts with radiology practice groups;*

*changes in the number of radiologists operating in our contracted radiology practice groups;*

*the availability to recruit and retain technologists;*

*the availability of additional capital to fund capital expenditure requirements;*

*lawsuits against Radiologix and our contracted radiology practices groups;*

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*changes in operating margins, particularly changes due to our managed care contracts and capitated fee arrangements;*

*failure by Radiologix to comply with state and federal anti-kickback and anti-self referral laws or any other applicable healthcare regulations;*

*changes in business strategy and development plans;*

*changes in federal, state or local regulations affecting the healthcare industry;*

*our indebtedness, debt service requirements and liquidity constraints;*

*risk related to our Senior Notes and healthcare securities generally;*

*interruption of operations due to severe weather or other extraordinary events; and*

*charges for unusual or infrequent (non-recurring) matters.*

*A more comprehensive list of such factors is set forth in the Company's Annual Report on Form 10-K for the year ended December 31, 2004, and our other filings with the Securities and Exchange Commission.*

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**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 September 30, 2005, 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 2004 Form 10-K, subsequent to December 31, 2004, but prior to the finalization of our 2004 consolidated financial statements, the Company placed into operations new controls to address the material weakness we identified in our accounts receivable estimation process. These new controls include a retrospective collection analysis that matches cash collections to billed charges by month of service. We believe these new controls have remediated the material weakness that existed as of December 31, 2004, and that these controls operated effectively during the first nine months of 2005.

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.

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**PART II: OTHER INFORMATION**

**Item 6. Exhibits and Reports on Form 8-K**

- (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.
- (b) *Reports on Form 8-K.* The registrant filed a current report on Form 8-K on July 15, 2005 announcing the appointment of Carol A. Gleber as Senior Vice President and Chief Operating Officer.

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**SIGNATURES**

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

**RADIOLOGIX, INC.**

Date: November 3, 2005

*/s/* SAMI S. ABBASI  
**Sami S. Abbasi**  
**President and Chief Executive Officer**  
**(Principal Executive Officer)**

Date: November 3, 2005

*/s/* MICHAEL N. MURDOCK  
**Michael N. Murdock**  
**Senior Vice President and**  
**Chief Financial Officer**  
**(Principal Accounting Officer)**



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**INDEX TO EXHIBITS**

| <b><u>Exhibit<br/>Number</u></b> | <b><u>Description</u></b>   |
|----------------------------------|---|
| 10.1                             | Employment agreement between Radiologix, Inc. and Carol A. Gleber dated July 15, 2005. *  |
| 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. * |

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\* Filed herewith.