

ORION HEALTHCORP INC

Form 10QSB/A

November 09, 2006

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**U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-QSB/A
AMENDMENT NO. 1
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006
Commission File No. 001-16587
ORION HEALTHCORP, INC.
(NAME OF SMALL BUSINESS ISSUER IN ITS CHARTER)**

Delaware
(STATE OR OTHER JURISDICTION
OF INCORPORATION OR ORGANIZATION)

58-1597246
(IRS EMPLOYER IDENTIFICATION NO.)

1805 Old Alabama Road
Suite 350, Roswell GA
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

30076
(ZIP CODE)

**ISSUER S TELEPHONE NUMBER: (678) 832-1800
SECURITIES REGISTERED UNDER SECTION 12(B) OF THE ACT:**

TITLE OF EACH CLASS	NAME OF EACH EXCHANGE ON WHICH REGISTERED
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Class A Common Stock, \$0.001 par value per share	The American Stock Exchange
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Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.)

Yes No

As of August 9, 2006, 12,788,776 shares of the registrant s Class A Common Stock, par value \$0.001, were outstanding, 10,448,470 shares of the registrant s Class B Common Stock, par value \$0.001, were outstanding and 1,437,572 shares of the registrant s Class C Common Stock, par value \$0.001, were outstanding.

Transitional Small Business Disclosure Format:

Yes No



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ORION HEALTHCORP, INC.
 Quarterly Report on Form 10-QSB/A
 For the Quarterly Period Ended June 30, 2006

EXPLANATORY NOTE

We are filing this Amendment No. 1 to our Quarterly Report on Form 10-QSB/A (the Amendment) to amend and restate the Quarterly Report on Form 10-QSB for the three months ended June 30, 2006 filed with the Securities and Exchange Commission (the SEC) on August 9, 2006 (the Original Filing) in response to comments by the Staff of the SEC in connection with their review of our preliminary proxy statement on Schedule 14A filed with the SEC on September 11, 2006. The consolidated condensed statements of operations and statements of cash flows for the three months and six months ended June 30, 2005, respectively, have been restated after determining that the Company's presentation of the charge for impairment of intangible assets in continuing operations rather than in discontinued operations was inconsistent with the guidelines set forth under Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Accordingly, this Amendment includes our restated financial statements for the three months and six months ended June 30, 2005, respectively, with accompanying notes, which reflect the reclassification of the charge for impairment of intangible assets from continuing operations to discontinued operations. This Amendment also updates disclosure in Item 2. Management's Discussion and Analysis or Plan of Operation to reflect the reclassification. The reclassification had no effect on the consolidated net income or cash flows of the Company for the periods presented.

Pursuant to the rules of the SEC, we have included currently-dated certifications from our principal executive and principal accounting officers, as required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002. These certifications are attached as Exhibits 31.1, 31.2, 32.1 and 32.2, respectively. Except for the restated information described above, this Amendment continues to describe conditions as of the Original Filing and we have not updated the disclosures contained herein to reflect events that have occurred subsequent to that date. Accordingly, this Amendment should be read in conjunction with our other filings, if any, made with the SEC subsequent to the filing of the Original Filing, including any amendments to those filings.

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UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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NOTE REGARDING FORWARD-LOOKING STATEMENTS

Certain statements in this Quarterly Report on Form 10-QSB/A constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended, (the Exchange Act, and collectively, with the Securities Act, the Acts). Forward-looking statements include statements preceded by, followed by or that include the words may, will, would, could, should, estimates, predicts, potential, continue, strategy, believes, anticipates, plans, expect, or similar expressions. Any statements contained herein that are not statements of historical fact are deemed to be forward-looking statements.

The forward-looking statements in this report are based on current beliefs, estimates and assumptions concerning the operations, future results, and prospects of Orion HealthCorp, Inc. and its affiliated companies (Orion or the Company) described herein. As actual operations and results may materially differ from those assumed in forward-looking statements, there is no assurance that forward-looking statements will prove to be accurate. Forward-looking statements are subject to the safe harbors created in the Acts. Any number of factors could affect future operations and results, including, without limitation, changes in federal or state healthcare laws and regulations and third party payer requirements, changes in costs of supplies, the loss of major customers, labor and employee benefits, the inability to obtain a forbearance on the Company s revolving lines of credit as a result of the Company s default of its financial covenants, increases in interest rates on the Company s indebtedness as well as general market conditions, competition and pricing, and the Company s ability to successfully implement its business strategies. The Company undertakes no obligation to update publicly any forward-looking statements, whether as a result of new information or future events.

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

The Company s unaudited consolidated condensed financial statements and related notes thereto are included as a separate section of this report but included herein, commencing on page F-1.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

The following Management s Discussion and Analysis of Financial Condition and Results of Operations highlights the principal factors that have affected the Company s financial condition and results of operations as well as the Company s liquidity and capital resources for the periods described. All significant intercompany balances and transactions have been eliminated in consolidation.

Overview

Orion is a healthcare services organization providing outsourced business services to physicians, serving the physician market through two subsidiaries, Medical Billing Services, Inc. (MBS) and Integrated Physician Solutions, Inc. (IPS). MBS provides billing, collection, accounts receivable management, coding and reimbursement services, reimbursement analysis, practice consulting, managed care contract management and accounting and bookkeeping services, primarily to hospital-based physicians such as pathologists, anesthesiologists and radiologists. MBS currently provides services to approximately 58 clients, representing 337 physicians. IPS serves the general and subspecialty pediatric physician market, providing accounting and bookkeeping, human resource management, accounts receivable management, quality assurance services, physician credentialing, fee schedule review, training and continuing education and billing and reimbursement analysis. IPS currently provides services to five pediatric groups in Illinois and Ohio, representing 37 physicians. The Company believes the core competency of the Company is its long-term experience and success in working with and creating value for physicians.

Company History

The Company was incorporated in Delaware on February 24, 1984 as Technical Coatings, Incorporated. On December 15, 2004, the Company completed a transaction to acquire IPS (the IPS Merger) and to acquire Dennis Cain Physician Solutions, Ltd. (DCPS) and MBS (the DCPS/MBS Merger) (collectively, the 2004 Mergers). As a result of these transactions, IPS and MBS became wholly owned subsidiaries of the Company, and DCPS is a wholly owned subsidiary of MBS. On December 15, 2004, and simultaneous with the consummation of the 2004 Mergers, the Company changed its name from SurgiCare, Inc. to Orion HealthCorp, Inc. and consummated its restructuring transactions (the Closing), which included issuances of new equity securities for cash and contribution of outstanding

debt, and the restructuring of its debt facilities. The Company also created Class B Common Stock and Class C Common Stock, which were issued in connection with the equity investments and acquisitions.

Table of Contents**Strategic Focus**

In 2005, the Company initiated a strategic plan designed to accelerate its growth and enhance its future earnings potential. As part of this plan, since the first quarter of 2005, the Company began divesting certain non-strategic assets and ceased investing in business lines that did not complement the Company's plan, and redirected financial resources and company personnel to areas that management believes enhances long-term growth potential. Specifically, in the first quarter of 2006, the Company sold SurgiCare Memorial Village, L.P. (*Memorial Village*) to First Surgical Memorial Village, L.P. (*First Surgical*) and sold San Jacinto Surgery Center, Ltd. (*San Jacinto*) to San Jacinto Methodist Hospital (*Methodist*). Additionally, in early 2006, the Company was notified by Union Hospital that it was exercising its option to terminate the management services agreements for Tuscarawas Ambulatory Surgery Center, LLC (*TASC*) and Tuscarawas Open MRI, L.P. (*TOM*). With the completion of these activities, the Company no longer has any ownership or management interests in ambulatory surgery and diagnostic centers.

Additionally, the Company believes that it is now positioned to focus on its physician services business and the physician billing and collections market, leveraging its existing presence to expand into additional geographic regions and increase the range of services it provides to physicians. Part of this strategy will include acquiring financially successful billing companies focused on providing services to hospital-based physicians and increasing sales and marketing efforts in existing markets.

Financial Overview

As more fully described below, the Company's results of operations for the three months and six months ended June 30, 2006 as compared to the same periods in 2005 reflect several important factors, many relating to the impact of transactions which occurred as part of the Company's strategic plan referred to above.

The Company sold substantially all of the assets of Memorial Village and recorded a gain on disposition of discontinued components of \$574,321 in the first quarter of 2006;

The Company sold substantially all of the assets of San Jacinto and recorded a gain on disposition of discontinued components of \$94,066 in the first quarter of 2006; and

The Company paid \$112,500 in satisfaction of a \$778,000 debt and recognized a gain on forgiveness of debt totaling \$665,463 in the first quarter of 2006.

Critical Accounting Policies and Estimates

The preparation of the Company's financial statements is in conformity with accounting principles generally accepted in the United States, which require management to make estimates and assumptions that affect the amounts reported in the financial statements and footnotes. The Company's management bases these estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments that are not readily apparent from other sources. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Changes in the facts or circumstances underlying these estimates could result in material changes and actual results could differ from these estimates. The Company believes the following critical accounting policies affect the most significant areas involving management's judgments and estimates. In addition, please refer to Note 1. General of the Company's unaudited consolidated condensed financial statements included beginning on Page F-7 of this report for further discussion of the Company's accounting policies.

Consolidation of Physician Practice Management Companies. In March 1998, the Emerging Issues Task Force (*EITF*) of the Financial Accounting Standards Board (*FASB*) issued its Consensus on Issue 97-2 (*EITF 97-2*). *EITF 97-2* addresses the ability of physician practice management (*PPM*) companies to consolidate the results of medical groups with which it has an existing contractual relationship. Specifically, *EITF 97-2* provides guidance for consolidation where PPM companies can establish a controlling financial interest in a physician practice through contractual management arrangements. A controlling financial interest exists, if, for a requisite period of time, the PPM has control over the physician practice and has a financial interest that meets six specific requirements. The six requirements for a controlling financial interest include:

(a) the contractual arrangement between the PPM and physician practice (1) has a term that is either the entire remaining legal life of the physician practice or a period of 10 years or more, and (2) is not terminable by the physician practice except in the case of gross negligence, fraud, or other illegal acts by the PPM or bankruptcy of the PPM;

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(b) the PPM has exclusive authority over all decision making related to (1) ongoing, major, or central operations of the physician practice, except the dispensing of medical services, and (2) total practice compensation of the licensed medical professionals as well as the ability to establish and implement guidelines for the selection, hiring, and firing of them;

(c) the PPM must have a significant financial interest in the physician practice that (1) is unilaterally salable or transferable by the PPM and (2) provides the PPM with the right to receive income, both as ongoing fees and as proceeds from the sale of its interest in the physician practice, in an amount that fluctuates based upon the performance of the operations of the physician practice and the change in fair value thereof.

IPS is a PPM company. IPS's MSAs governing the contractual relationship with its affiliated medical groups are for forty year terms; are not terminable by the physician practice other than for bankruptcy or fraud; provide IPS with decision making authority other than related to the practice of medicine; provide for employment and non-compete agreements with the physicians governing compensation; provide IPS the right to assign, transfer or sell its interest in the physician practice and assign the rights of the MSAs; provide IPS with the right to receive a management fee based on results of operations and the right to the proceeds from a sale of the practice to an outside party or, at the end of the MSA term, to the physician group. Based on this analysis, IPS has determined that its contracts meet the criteria of EITF 97-2 for consolidating the results of operations of the affiliated medical groups and has adopted EITF 97-2 in its statement of operations. EITF 97-2 also has addressed the accounting method for future combinations with individual physician practices. IPS believes that, based on the criteria set forth in EITF 97-2, any future acquisitions of individual physician practices would be accounted for under the purchase method of accounting.

Revenue Recognition. MBS's principal source of revenues is fees charged to clients based on a percentage of net collections of the client's accounts receivable. MBS recognizes revenue and bills its clients when the clients receive payment on those accounts receivable. MBS typically receives payment from the client within 30 days of billing. The fees vary depending on specialty, size of practice, payer mix, and complexity of the billing. In addition to the collection fee revenue, MBS also earns fees from the various consulting services that MBS provides, including medical practice management services, managed care contracting, coding and reimbursement services.

IPS records revenue based on patient services provided by its affiliated medical groups. Net patient service revenue is impacted by billing rates, changes in current procedural terminology code reimbursement and collection trends. IPS reviews billing rates at each of its affiliated medical groups on at least an annual basis and adjusts those rates based on each insurer's current reimbursement practices. Amounts collected by IPS for treatment by its affiliated medical groups of patients covered by Medicare, Medicaid and other contractual reimbursement programs, which may be based on cost of services provided or predetermined rates, are generally less than the established billing rates of IPS's affiliated medical groups. IPS estimates the amount of these contractual allowances and records a reserve against accounts receivable based on historical collection percentages for each of the affiliated medical groups, which include various payer categories. When payments are received, the contractual adjustment is written off against the established reserve for contractual allowances. The historical collection percentages are adjusted quarterly based on actual payments received, with any differences charged against net revenue for the quarter. Additionally, IPS tracks cash collection percentages for each medical group on a monthly basis, setting quarterly and annual goals for cash collections, bad debt write-offs and aging of accounts receivable. IPS is not aware of any material claims, disputes or unsettled matters with third party payers and there have been no material settlements with third party payers for the three months and six months ended June 30, 2006 and 2005, respectively.

Accounts Receivable and Allowance for Doubtful Accounts. MBS records uncollectible accounts receivable using the direct write-off method of accounting for bad debts. Historically, MBS has experienced minimal credit losses and has not written-off any material accounts during the three months and six months ended June 30, 2006 or 2005, respectively.

IPS's affiliated medical groups grant credit without collateral to its patients, most of which are insured under third-party payer arrangements. The provision for bad debts that relates to patient service revenues is based on an evaluation of potentially uncollectible accounts. The provision for bad debts includes a reserve for 100% of the accounts receivable older than 180 days. Establishing an allowance for bad debt is subjective in nature. IPS uses historical collection percentages to determine the estimated allowance for bad debts, and adjusts the percentage on a

quarterly basis.

Investment in Limited Partnerships. At June 30, 2005, the Company owned a 10% general partnership interest in San Jacinto. The investment is accounted for using the equity method. Under the equity method, the investment is initially recorded at cost and is subsequently increased to reflect the Company's share of the income of the investee and reduced to reflect the share of the losses of the investee or distributions from the investee. Effective March 1, 2006, the Company sold its interest in San Jacinto. (See Results of Operations - Discontinued Operations .)

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The general partnership interest was accounted for as an investment in limited partnership due to the interpretation of SFAS 94/Accounting Research Bulletin 51 and the interpretations of such by Issue 96-16 and Statement of Position SOP 78-9. Under those interpretations, the Company could not consolidate its interest in an entity in which it held a minority general partnership interest due to management restrictions, shared operating decision-making, and capital expenditure and debt approval by limited partners and the general form versus substance analysis.

Goodwill and Intangible Assets. Goodwill and intangible assets represent the excess of cost over the fair value of net assets of companies acquired in business combinations accounted for using the purchase method. In July 2001, the FASB issued SFAS No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 141 eliminates pooling-of-interest accounting and requires that all business combinations initiated after June 30, 2001, be accounted for using the purchase method. SFAS No. 142 eliminates the amortization of goodwill and certain other intangible assets and requires the Company to evaluate goodwill for impairment on an annual basis by applying a fair value test. SFAS No. 142 also requires that an identifiable intangible asset that is determined to have an indefinite useful economic life not be amortized, but separately tested for impairment using a fair value-based approach at least annually. The Company evaluates its goodwill and intangible assets in the fourth quarter of each fiscal year, unless circumstances require testing at other times. (See Results of Operations Discontinued Operations for additional discussion regarding the impairment testing of identifiable intangible assets.)

Recent Accounting Pronouncements

In December 2004, the FASB published SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)). SFAS 123(R) requires that the compensation cost relating to share-based payment transactions, including grants of employee stock options, be recognized in the financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. SFAS 123(R) covers a wide range of share-based compensation arrangements including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. SFAS 123(R) is a replacement of SFAS No. 123, Accounting for Stock-Based Compensation, and supersedes Auditing Practices Board Opinion No. 25, Accounting for Stock Issued to Employees, and its related interpretive guidance (APB 25).

The effect of SFAS 123(R) will be to require entities to measure the cost of employee services received in exchange for stock options based on the grant-date fair value of the award, and to recognize the cost over the period the employee is required to provide services for the award. SFAS 123(R) permits entities to use any option-pricing model that meets the fair value objective in SFAS 123(R). The Company was required to begin to apply SFAS 123(R) for its quarter ending March 31, 2006.

SFAS 123(R) allows two methods for determining the effects of the transition: the modified prospective transition method and the modified retrospective method of transition. The Company has adopted the modified prospective transition method beginning in 2006.

Results of Operations

The IPS Merger was treated as a reverse acquisition, meaning that the purchase price, comprised of the fair value of the outstanding shares of the Company prior to the transaction, plus applicable transaction costs, were allocated to the fair value of the Company's tangible and intangible assets and liabilities prior to the transaction, with any excess being considered goodwill. IPS was treated as the continuing reporting entity, and, thus, IPS's historical results became those of the combined company. The Company's results for the three months and six months ended June 30, 2006 and 2005 include the results of IPS, MBS and the Company's ambulatory surgery and diagnostic center business. The descriptions of the business and results of operations of MBS set forth in this report include the business and results of operations of DCPS. This discussion should be read in conjunction with the Company's unaudited consolidated condensed financial statements for the three months and six months ended June 30, 2006 and 2005 and related notes thereto, which are included as a separate section of this report commencing on page F-1.

Pursuant to paragraph 43 of SFAS 144, which states that, in a period in which a component of an entity either has been disposed of or is classified as held for sale, the income statement of a business enterprise for current and prior periods shall report the results of operations of the component, including any gain or loss recognized, in discontinued operations. As such, the Company's financial results for the three months and six months ended June 30, 2005 have been reclassified to reflect the operations, including its surgery and diagnostic center businesses, which were

discontinued in 2005.

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The following table sets forth selected statements of operations data expressed as a percentage of the Company's net operating revenue for the three months and six months ended June 30, 2006 and 2005, respectively. The Company's historical results and period-to-period comparisons are not necessarily indicative of the results for any future period.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005 (Restated)	2006	2005 (Restated)
Net operating revenues	100.0%	100.0%	100.0%	100.0%
Total operating expenses	105.1%	117.4%	105.0%	117.5%
Loss from continuing operations before other income (expenses)	(5.1%)	(17.4%)	(5.0%)	(17.5%)
Total other income (expenses), net	(1.8%)	(1.4%)	3.0%	(1.1%)
Loss from continuing operations	(6.9%)	(18.8%)	(2.0%)	(18.6%)
Discontinued operations Income (loss) from operations of discontinued components, including net gain on disposal	0.0%	(90.2%)	4.1%	(47.0%)
Net income (loss)	(6.9%)	(109.0%)	2.1%	(65.6%)

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The following table sets forth, for the periods indicated, the consolidated statements of operations of the Company.

	For the Three Months Ended June 30,	
	2006 (Unaudited)	2005 (Unaudited) (Restated)
Net operating revenues	\$ 6,931,714	\$ 7,651,291
Operating expenses		
Salaries and benefits	2,773,316	3,156,954
Physician group distribution	1,920,041	2,270,672
Facility rent and related costs	390,890	430,259
Depreciation and amortization	408,930	843,979
Professional and consulting fees	361,044	516,079
Insurance	158,121	228,768
Provision for doubtful accounts	140,396	298,326
Other expenses	1,134,022	1,240,771
Total operating expenses	7,286,760	8,985,808
Loss from continuing operations before other income (expenses)	(355,046)	(1,334,517)
Other income (expenses)		
Interest expense	(121,631)	(94,094)
Other expense, net	(4,488)	(16,353)
Total other income (expenses), net	(126,119)	(110,447)
Loss from continuing operations	(481,165)	(1,444,964)
Discontinued operations		
Income (loss) from operations of discontinued components	968	(6,902,825)
Net loss	\$ (480,197)	\$ (8,347,789)

Net Operating Revenues. Net operating revenues of the Company consist of patient service revenue, net of contractual adjustments, related to the operations of IPS's affiliated medical groups, billing services revenue related to MBS and other revenue. For the three months ended June 30, 2006, consolidated net operating revenues decreased \$719,576, or 9.4%, to \$6,931,714, as compared with \$7,651,291 for the three months ended June 30, 2005.

MBS's net operating revenues totaled \$2,361,762 for the three months ended June 30, 2006 as compared to net operating revenues totaling \$2,653,017 for the same period in 2005, a decrease of \$291,255, or 10.9%. The decrease in net operating revenues for MBS was primarily the result of the loss of two customers in August 2005, one of which retired from medical practice and one group which decided to bring their billing in-house, which accounted for approximately \$260,000 in net operating revenues in the second quarter of 2005. This decrease was partially offset in the second quarter of 2006 by the addition of two new customers accounting for approximately \$58,000 in net operating revenues.

IPS's net patient service revenue decreased \$428,322, or 8.6%, from \$4,998,274 for the three months ended June 30, 2005 to \$4,569,952 for the three months ended June 30, 2006. The decrease in net patient service revenue for IPS's affiliated medical groups was primarily the result of decreases in patient volume as a consequence of a diminished cold and flu season in the second quarter of 2006 as compared to the same period in 2005. All of IPS's four clinic-based affiliated pediatric groups experienced decreases in patient volume in the second quarter of 2006, with total procedures and office visits for all clinic-based facilities decreasing 7,811 and 6,025, respectively, to 91,303 and 35,068 for the three months ended June 30, 2006.

Other revenue, which represents revenue from the Company's vaccine program, a group purchasing alliance for vaccines and medical supplies, totaled \$17,656 for the second three months of 2005, increasing \$83,540, or 473.2%, to \$101,196 for the three months ended June 30, 2006. The vaccine program, which had a total of 482 enrolled participants at March 31, 2006, added approximately 8 members during the second quarter of 2006.

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Operating Expenses

Salaries and Benefits. Consolidated salaries and benefits decreased \$383,639 to \$2,773,316 for the three months ended June 30, 2006, as compared to \$3,156,954 for the same period in 2005.

MBS' s salaries and benefits totaled \$1,471,325 for the three months ended June 30, 2006 as compared to \$1,586,823 for the three months ended June 30, 2005, a decrease of \$115,499. This decrease is primarily the result of a reduction in health benefit costs related to the consolidation of MBS' s benefit plans with the IPS benefit plans at the beginning of 2006, thereby allowing greater negotiating leverage with benefit providers.

Clinical salaries & benefits include wages for the nurse practitioners, nursing staff and medical assistants employed by the affiliated medical groups and fluctuate indirectly to increases and decreases in productivity and patient volume.

Clinical salaries, bonuses, overtime and health insurance collectively totaled \$431,385 for the second three months of 2006, a decrease of \$5,173 from the same period in 2005. These expenses represented approximately 9.7% and 8.8% of net operating revenues for the three months ended June 30, 2006 and 2005, respectively. The increase, as a % of net operating revenues, is related to the fixed nature of salaries and benefits needed to maintain minimum staffing levels.

In August 2005, the Company consolidated its corporate operations into the Roswell, Georgia office. Prior to the staff reductions resulting from this corporate consolidation, salaries and benefits related to corporate staff in Houston, Texas totaled \$267,352 for the three months ended June 30, 2005.

Administrative salaries and benefits, excluding MBS and the former staff of the Company' s Houston, Texas office, represent the employee-related costs of all non-clinical practice personnel at IPS' s affiliated medical groups as well as the Company' s corporate staff in Roswell, Georgia. These expenses increased \$6,487, or 0.8%, from \$831,323 for the three months ended June 30, 2005 to \$837,810 for the same period in 2006. These expenses include the adoption of SFAS 123(R), beginning in the first quarter of 2006, which resulted in stock option compensation expense totaling \$49,642. The costs associated with the addition of one billing FTE and the promotion of three employees to supervisor at two of IPS' s affiliated medical groups as the result of billing office reorganizations were offset by staffing adjustments at the Company' s corporate office.

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Physician Group Distribution. Physician group distribution decreased \$350,631, or 15.4%, for the three months ended June 30, 2006 to \$1,920,041, as compared with \$2,270,672 for the three months ended June 30, 2005. Pursuant to the terms of the MSAs governing each of IPS' s affiliated medical groups, the physicians of each medical group receive disbursements after the payment of all clinic facility expenses as well as a management fee to IPS. The management fee revenue and expense, which is eliminated in the consolidation of the Company' s financial statements, is either a fixed fee or is calculated based on a percentage of net operating income. For the three months ended June 30, 2006, management fee revenue totaled \$316,042 and represented approximately 14.1% of net operating income as compared to management fee revenue totaling \$380,566 and representing approximately 14.4% of net operating income for the same period in 2005. Physician group distribution represented 43.0% of net operating revenues in the second quarter of 2006, compared to 45.6% of net operating revenues for the three months ended June 30, 2005. The decrease in physician group distribution for the three months ended June 30, 2006 was directly related to the decrease in net patient service revenue, which was primarily the result of decreased patient volume during the second three months of 2006.

Facility Rent and Related Costs. Facility rent and related costs decreased \$39,370, or 9.2%, from \$430,259 for the three months ended June 30, 2005 to \$390,890 for the three months ended June 30, 2006.

MBS' s facility rent and related costs totaled \$127,442 for the three months ended June 30, 2006 as compared to \$122,955 for the same period in 2005. This increase can be explained generally by increases in utilities and off-site storage costs for the second three months of 2006.

Facility rent and related costs associated with IPS' s affiliated medical groups and Orion' s corporate office totaled \$248,504 for the three months ended June 30, 2006 compared to \$257,679 for the same period in 2005. Rent expense related to the Company' s corporate office in Roswell, Georgia was partially offset in the second quarter of 2006 by approximately \$27,000 in rent payments received for the sublease between eClinicalWeb and the Company as a result of the IntegriMED Agreement in June 2005.

In August 2005, the Company consolidated its corporate operations into the Roswell, Georgia office. Prior to this consolidation, facility-related costs such as utilities and personal property taxes associated with the Company' s former office in Houston, Texas totaled approximately \$35,000 for the three months ended June 30, 2005.

Depreciation and Amortization. Consolidated depreciation and amortization expense totaled \$408,930 for the three months ended June 30, 2006, a decrease of \$435,048 from the three months ended June 30, 2005.

For the three months ended June 30, 2006, depreciation expense related to the fixed assets of MBS totaled \$17,250 as compared to \$20,218 for the same period in 2005. Depreciation expense related to the fixed assets of IPS and Orion totaled \$39,946 and \$26,466 for the three months ended June 30, 2006 and 2005, respectively. Depreciation expense associated with fixed assets related to the Company' s former Houston, Texas office, which was closed in August 2005, totaled \$11,682 for the three months ended June 30, 2005.

As part of the DCPS/MBS Merger, the Company purchased MBS and DCPS for a combination of cash, notes and stock. Since the consideration for this purchase transaction exceeded the fair value of the net assets of MBS and DCPS at the time of the purchase, a portion of the purchase price was allocated to intangible assets. The amortization expense related to the intangible assets recorded as a result of the DCPS/MBS Merger totaled \$265,523 for the three months ended June 30, 2006 and 2005, respectively.

Amortization expense related to the MSAs for IPS' s affiliated medical groups totaled \$86,211 and \$88,392 for the three months ended June 30, 2006 and 2005, respectively. The decrease is directly related to the Mutual Release and Settlement Agreement (the Sutter Settlement) with John Ivan Sutter, M.D., PA (Dr. Sutter) to settle disputes that had arisen between IPS and Dr. Sutter and to avoid the risk and expense of litigation. As part of the Sutter Settlement, which was executed on October 31, 2005, Dr. Sutter and IPS agreed that Dr. Sutter would purchase the assets owned by IPS and used in connection with Dr. Sutter' s practice, in exchange for termination of the related MSA.

As part of the IPS Merger, the purchase price, comprised of the fair value of the outstanding shares of the Company prior to the transaction, plus applicable transaction costs, was allocated to the fair value of the Company' s tangible and intangible assets and liabilities prior to the transaction, with any excess being considered goodwill. As a result of the dispositions related to the Company' s surgery and diagnostic center business, which was discontinued in 2005, and the uncertainty of future cash flows related to the Company' s surgery center business, the Company impaired substantially

all of the intangible assets related to the IPS Merger in 2005. Therefore, there was no amortization expense related to the intangible assets in the second quarter of 2006. Amortization expense for the intangible assets recorded as a result of the IPS Merger totaled \$431,697 for the three months ended June 30, 2005. (See Discontinued Operations for additional discussion regarding the disposition of intangible assets and goodwill recorded as a result of the IPS Merger.)

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Professional and Consulting Fees. For the three months ended June 30, 2006, professional and consulting fees totaled \$361,044, a decrease of \$155,036, or 30.0%, from the same period in 2005.

For the second three months of 2006, MBS recorded professional and consulting expenses totaling \$47,621 as compared with \$68,776 for the same period in 2005, a decrease of \$21,155. This change is primarily the result of a decrease in contract labor used in the second quarter of 2005 as a result of staffing shortages. This contract labor was not utilized in the second quarter of 2006 because MBS's position inventory is fully staffed.

IPS's and Orion's professional and consulting fees, which include the costs of corporate accounting, financial reporting and compliance, and legal fees, decreased from \$376,916 for the three months ended June 30, 2005 to \$313,423 for the three months ended June 30, 2006. The decrease is primarily the result of reduced legal fees and expenses related to the divestiture of the Company's surgery and diagnostic business in 2005.

Insurance. Consolidated insurance expense, which includes the costs of professional liability for affiliated physicians, property and casualty and general liability insurance and directors and officers' liability insurance, decreased from \$228,768 for the three months ended June 30, 2005 to \$158,121 for the three months ended June 30, 2006. Insurance expense related to the directors and officers' liability policies in the first quarter of 2005 included approximately \$40,000 of premiums for run-off policies related to SurgiCare and IPS. The run-off policies were expensed fully in 2005.

Provision for Doubtful Accounts. The Company's consolidated provision for doubtful accounts, or bad debt expense, decreased \$157,930, or 52.9%, for the three months ended June 30, 2006 to \$140,396. The entire provision for doubtful accounts for the quarter ended June 30, 2006 related to IPS's affiliated medical groups and accounted for 3.1% of IPS's net operating revenues as compared to 6.0% of IPS's net operating revenues for the same period in 2005. The total collection rate, after contractual allowances, for IPS's affiliated medical groups was 72.6% for the three months ended June 30, 2006, compared to 64.3% for the same period in 2005.

Other Expenses. Consolidated other expenses totaled \$1,134,023 for the three months ended June 30, 2006, a decrease of \$106,749 from the same period in 2005. Other expenses include general and administrative expenses such as office supplies, telephone & data communications, printing & postage, transfer agent fees, and board of directors compensation and meeting expenses, as well as some direct clinical expenses, which are expenses that are directly related to the practice of medicine by the physicians that practice at the affiliated medical groups managed by IPS. MBS's other expenses totaled \$269,923 for the three months ended June 30, 2006 as compared to \$323,082 for the three months ended June 30, 2005. Of the total decrease, approximately \$43,000 and \$2,000 related to decreases in office supplies and postage and courier expenses, respectively, in the second three months of 2006 as compared to the same period in 2005. These expense fluctuations are the direct result of the decrease in net operating revenues in the second quarter of 2006. Additionally, MBS renegotiated its long distance rates in the fall of 2005, which resulted in approximately \$27,000 in cost savings in the second three months of 2006 as compared to the same period in 2005. For the three months ended June 30, 2006, IPS's direct clinical expenses, other than salaries and benefits, totaled \$581,083, an increase of \$18,929 over second quarter 2005 direct clinical expenses, which totaled \$562,154. Vaccine expenses increased approximately \$29,500 in the second three months of 2006 when compared to the same period in 2005. IPS's affiliated medical groups began using two new vaccines in late 2005—Menactra and Decavac—which replaced lower-priced vaccines previously utilized by the medical groups.

The Company's and IPS's general and administrative expenses totaled \$163,956 for the three months ended June 30, 2006, a decrease of \$69,243 from the same period in 2005. There were approximately \$74,000 of expense decreases related to cost efficiencies and expense reductions as a result of the consolidation of corporate functions into the Company's Roswell, Georgia office in August 2005.

Other Income and Expenses.

Interest Expense. Consolidated interest expense totaled \$121,631 for the three months ended June 30, 2006, an increase of \$27,537 from the same period in 2005. Interest expense activity in the second quarter of 2006, including increases from the second three months of 2005, can be explained generally by the following:

MBS Notes. On April 19, 2006, the Company executed subordinated promissory notes with the former equity owners of MBS and DCPS for an aggregate of \$714,336. This represented the retroactive purchase price increase due to the former equity owners of MBS and DCPS based on

the financial results of the newly formed MBS, required by the merger agreement governing the DCPS/MBS Merger. The notes bear interest at the rate of 8% per annum, payable monthly beginning on April 30, 2006, and will mature on December 15, 2007. Interest expense related to these notes totaled approximately \$11,429 for the three months ended June 30, 2006.

Line of Credit. As part of the restructuring transactions, the Company also entered into a new secured two-year revolving credit facility pursuant to the Loan and Security Agreement (the Loan and Security Agreement), dated December 15, 2004, by and among the Company, certain of its affiliates and subsidiaries, and CIT Healthcare, LLC (formerly known as Healthcare Business Credit Corporation)(CIT), borrowing \$1.6 million under this facility concurrently with the Closing. (See Liquidity and Capital Resources

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for additional discussion regarding the Loan and Security Agreement.) Interest expense related to this line of credit totaled \$51,363 for the three months ended June 30, 2006, compared to \$42,768 for the three months ended June 30, 2005. The increase in interest expense on the line of credit facility was a direct result of interest rate increases for the second three months of 2006 as compared to the same period in 2005. In December 2005, the Company received notification from CIT stating that certain events of default under the Loan and Security Agreement had occurred as a result of the Company being out of compliance with two financial covenants. As a result of the events of default, CIT raised the interest rate for monies borrowed under the Loan and Security Agreement to a default rate of prime rate plus 6% as compared to the stated interest rate of prime rate plus 3% as of the Closing. (See Part II, Item 3. Defaults Upon Senior Securities for additional discussion regarding the Company's defaults under the Loan and Security Agreement.) The loan balance for this facility was \$998,668 and \$1,681,450 at June 30, 2006 and 2005, respectively. Additionally, the average prime rate for the second quarter of 2006 was 7.92% as compared to 5.92% for the same three-month period in 2005.

Discontinued Operations.

IntegriMED. On June 7, 2005, InPhySys, Inc. (formerly known as IntegriMED, Inc.) (IntegriMED), a wholly owned subsidiary of IPS, executed an Asset Purchase Agreement (the IntegriMED Agreement) with eClinicalWeb, LLC (eClinicalWeb) to sell substantially all of the assets of IntegriMED. As a result of this transaction, the Company recorded a loss on disposal of this discontinued component of \$47,101 for the quarter ended June 30, 2005. The operations of this component are reflected in the Company's consolidated condensed statements of operations as loss from operations of discontinued components for the three months ended June 30, 2005. There were no operations for this component in the Company's financial statements after June 30, 2005.

The following table contains selected financial statement data related to IntegriMED as of and for the three months ended June 30, 2005:

	June 30, 2005
Income statement data:	
Net operating revenues	\$ 82,155
Operating expenses	392,931
Net loss	\$ (310,776)
Balance sheet data:	
Current assets	\$ (24,496)
Other assets	
Total assets	\$ (24,496)
Current liabilities	\$ 17,022
Other liabilities	
Total liabilities	\$ 17,022

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TASC and TOM. On June 13, 2005, the Company announced that it had accepted an offer to purchase its interests in TASC and TOM in Dover, Ohio. On September 30, 2005, the Company executed purchase agreements to sell its 51% ownership interest in TASC and its 41% ownership interest in TOM to Union Hospital (Union). Additionally, as part of the transactions, TASC, as the sole member of TASC Anesthesia, L.L.C. (TASC Anesthesia), executed an Asset Purchase Agreement to sell certain assets of TASC Anesthesia to Union. The limited partners of TASC and TOM also sold a certain number of their units to Union such that at the closing of these transactions, Union owned 70% of the ownership interests in TASC and TOM. The Company no longer has an ownership interest in TASC, TOM or TASC Anesthesia. As a result of these transactions, as well as the uncertainty of future cash flows related to the Company's surgery center business, the Company determined that the joint venture interests associated with TASC and TOM were impaired and recorded a charge for impairment of intangible assets related to TASC and TOM of \$2,122,445 for the three months ended June 30, 2005. Also as a result of these transactions, the Company recorded a gain on disposal of this discontinued component (in addition to the charge for impairment of intangible assets) of \$1,357,712 for the quarter ended December 31, 2005. The Company allocated the goodwill recorded as part of the IPS Merger to each of the surgery center reporting units and recorded a loss on the write-down of goodwill related to TASC and TOM totaling \$789,173 for the quarter ended December 31, 2005, which reduced the gain on disposal. In early 2006, the Company was notified by Union that it was exercising its option to terminate the management services agreements of TOM and TASC as of March 12, 2006 and April 3, 2006, respectively. As a result, the Company recorded a charge for impairment of intangible assets of \$1,021,457 for the three months ended December 31, 2005 related to the TASC and TOM management services agreements. The operations of this component are reflected in the Company's consolidated condensed statements of operations as "loss from operations of discontinued components" for the three months ended June 30, 2005. There were no operations for this component in the Company's financial statements after September 30, 2005.

The following table contains selected financial statement data related to TASC and TOM as of and for the three months ended June 30, 2005:

	June 30, 2005
Income statement data:	
Net operating revenues	\$ 873,959
Operating expenses	799,418
Net income	\$ 74,541
Balance sheet data:	
Current assets	\$ 794,831
Other assets	1,487,732
Total assets	\$ 2,282,563
Current liabilities	\$ 709,779
Other liabilities	907,390
Total liabilities	\$ 1,617,169

Sutter. On October 31, 2005, IPS executed the Sutter Settlement with Dr. Sutter to settle disputes that had arisen between IPS and Dr. Sutter and to avoid the risk and expense of litigation. As part of the Sutter Settlement, Dr. Sutter and IPS agreed that Dr. Sutter would purchase the assets owned by IPS and used in connection with Dr. Sutter's practice, in exchange for termination of the related MSA. Additionally, among other provisions, after October 31,

2005, Dr. Sutter and IPS have been released from any further obligation to each other arising from any previous agreement. As a result of this transaction, the Company recorded a loss on disposal of this discontinued component (in addition to the charge for impairment of intangible assets of \$38,440 recorded in the fourth quarter of 2005) of \$279 for the quarter ended December 31, 2005. The operations of this component are reflected in the Company's consolidated condensed statements of operations as "loss from operations of discontinued components" for the three months ended June 30, 2005. There were no operations for this component in the Company's financial statements after October 31, 2005.

The following table contains selected financial statement data related to Sutter as of and for the three months ended June 30, 2005:

	June 30, 2005
Income statement data:	
Net operating revenues	\$ 107,419
Operating expenses	105,171
Net income	\$ 2,248
Balance sheet data:	
Current assets	\$ 113,819
Other assets	15,033
Total assets	\$ 128,852
Current liabilities	\$ 7,839
Other liabilities	
Total liabilities	\$ 7,839

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Memorial Village. As a result of the uncertainty of future cash flows related to our surgery center business as well as the transactions related to TASC and TOM, the Company determined that the joint venture interest associated with Memorial Village was impaired and recorded a charge for impairment of intangible assets related to Memorial Village of \$3,229,462 for the three months ended June 30, 2005. In November 2005, the Company decided that, as a result of ongoing losses at Memorial Village, it would need to either find a buyer for the Company's equity interests in Memorial Village or close the facility. In preparation for this pending transaction, the Company tested the identifiable intangible assets and goodwill related to the surgery center business using the present value of cash flows method. As a result of the decision to sell or close Memorial Village, as well as the uncertainty of cash flows related to the Company's surgery center business, the Company recorded an additional charge for impairment of intangible assets of \$1,348,085 for the three months ended September 30, 2005. On February 8, 2006, Memorial Village executed an Asset Purchase Agreement (the "Memorial Agreement") for the sale of substantially all of its assets to First Surgical. Memorial Village was approximately 49% owned by Town & Country SurgiCare, Inc., a wholly owned subsidiary of the Company. The Memorial Agreement was deemed to be effective as of January 31, 2006. As a result of this transaction, the Company recorded a gain on the disposal of this discontinued component (in addition to the charge for impairment of intangible assets) of \$574,321 for the quarter ended March 31, 2006. The Company allocated the goodwill recorded as part of the IPS Merger to each of the surgery center reporting units and recorded a loss on the write-down of goodwill related to Memorial Village totaling \$2,005,383 for the quarter ended December 31, 2005. The operations of this component are reflected in the Company's consolidated statements of operations as "loss from operations of discontinued components" for the three months ended June 30, 2005. There were no operations for this component in the Company's financial statements after March 31, 2006. The following table contains selected financial statement data related to Memorial Village as of and for the three months ended June 30, 2005:

	June 30, 2005
Income statement data:	
Net operating revenues	\$ 684,676
Operating expenses	812,407
Net loss	\$ (127,731)
Balance sheet data:	
Current assets	\$ 861,111
Other assets	767,497
Total assets	\$ 1,628,608
Current liabilities	\$ 729,567
Other liabilities	725,884
Total liabilities	\$ 1,455,451

San Jacinto. On March 1, 2006, San Jacinto executed an Asset Purchase Agreement for the sale of substantially all of its assets to Methodist. San Jacinto was approximately 10% owned by Baytown SurgiCare, Inc., the Company's wholly owned subsidiary, and is not consolidated in our financial statements. As a result of this transaction, the Company recorded a gain on disposal of this discontinued operation of \$94,066 for the quarter ended March 31, 2006. As a result of the uncertainty of future cash flows related to the surgery center business, and in conjunction with the transactions related to TASC and TOM, the Company determined that the joint venture interest associated with San

Jacinto was impaired and recorded a charge for impairment of intangible assets related to San Jacinto of \$734,522 for the three months ended June 30, 2005. The Company also recorded an additional \$2,113,262 charge for impairment of intangible assets for the three months ended September 30, 2005 related to the management contracts with San Jacinto. The Company allocated the goodwill recorded as part of the IPS Merger to each of the surgery center reporting units and recorded a loss on the write-down of goodwill related to San Jacinto totaling \$694,499 for the quarter ended December 31, 2005. There were no operations for this component in our financial statements after March 31, 2006.

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Orion. Prior to the divestiture of the Company's ambulatory surgery center business, the Company recorded management fee revenue, which was eliminated in the consolidation of the Company's financial statements, for Bellaire SurgiCare, Inc. (Bellaire SurgiCare), TASC and TOM and Memorial Village. The management fee revenue for San Jacinto was not eliminated in consolidation. The management fee revenue associated with the discontinued operations in the surgery center business totaled \$968 for the three months ended June 30, 2006. For the three months ended June 30, 2005, the Company generated management fee revenue of \$112,155 and net minority interest losses totaling \$3,318. For the quarters ended June 30, 2005 and December 31, 2005, the Company recorded a charge for impairment of intangible assets of \$276,420 and \$142,377, respectively, related to trained work force and non-compete agreements affected by the surgery center operations the Company discontinued in 2005 and early 2006. The following table summarizes the components of income (loss) from operations of discontinued components:

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005 (Restated)
CARDC		
Gain on disposal		(238,333)
IntegriMED		
Net loss		(310,776)
Loss on disposal		(47,101)
TASC and TOM		
Net income		74,541
Loss on disposal		(2,122,445)
Sutter		
Net income		2,248
Memorial Village		
Net loss		(127,731)
Loss on disposal		(3,229,462)
San Jacinto		
Loss on disposal		