

PRIMEDEX HEALTH SYSTEMS INC

Form 10-Q/A

October 02, 2006

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington D.C. 20549

# **FORM 10-Q/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 July 31, 2006**

**or**

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

For the transition period from to

Commission File Number 0-19019

**PRIMEDEX HEALTH SYSTEMS, INC.**

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(Exact name of registrant as specified in charter)

**New York**

(State or other jurisdiction of  
incorporation or organization)

**13-3326724**

(I.R.S. Employer  
Identification No.)

**1510 Cotner Avenue**  
**Los Angeles, California**  
(Address of principal executive offices)

**90025**  
(Zip Code)

**(310) 478-7808**

**(Registrant's telephone number, including area code)**

n/a



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(Former name, former address and former fiscal year, if changed since last report)

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

Yes  No

**APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY**

**PROCEEDINGS DURING THE PRECEDING FIVE YEARS:**

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

Yes  No

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

The number of shares outstanding of the registrant's common stock as of September 6, 2006 was 42,228,761 (excluding treasury shares).

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Explanatory Note: This Amendment No. 1 on Form 10-Q/A to our Quarterly Report on Form 10-Q for the fiscal quarter ended July 31, 2006 includes a new discussion in Item 2. under Overview with respect to our evaluation of disclosure controls and procedures, clarifies our discussion in Item 4., and adds a paragraph to our CEO and CFO certifications filed as Exhibits 31.1 and 31.2.

## PART 1 FINANCIAL INFORMATION

### Item 1. Financial Statements

#### PRIMEDEX HEALTH SYSTEMS, INC. AND AFFILIATES

#### CONSOLIDATED BALANCE SHEETS

	October 31, 2005	JULY 31, 2006 (Unaudited)
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 2,000	\$ 2,000
Accounts receivable, net	22,319,000	24,299,000
Unbilled receivables and other receivables	476,000	1,035,000
Other	1,799,000	3,533,000
Total current assets	24,596,000	28,869,000
<b>PROPERTY AND EQUIPMENT, NET</b>	68,107,000	62,836,000
<b>OTHER ASSETS</b>		
Accounts receivable, net	1,267,000	1,379,000
Goodwill	23,099,000	23,099,000
Deferred financing costs	472,000	5,198,000
Trade name and other	3,692,000	5,219,000
Total other assets	28,530,000	34,895,000
Total assets	\$ 121,233,000	\$ 126,600,000
<b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>		
<b>CURRENT LIABILITIES</b>		
Cash disbursements in transit	\$ 3,425,000	\$ 5,748,000
Line of credit	13,341,000	
Accounts payable and accrued expenses	22,469,000	20,962,000
Short-term notes expected to be refinanced:		
Notes payable	69,066,000	
Obligations under capital lease	56,927,000	
Notes payable	1,101,000	867,000
Obligations under capital lease	1,697,000	1,849,000
Total current liabilities	168,026,000	29,426,000
<b>LONG-TERM LIABILITIES</b>		
Subordinated debentures payable	16,147,000	16,147,000
Line of credit		6,868,000
Notes payable to related party	3,533,000	
Notes payable, net of current portion		145,154,000
Obligations under capital lease, net of current portion	4,129,000	3,552,000
Accrued expenses	31,000	22,000

Total long-term liabilities	23,840,000	171,743,000
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS DEFICIT</b>	(70,633,000	) (74,569,000
Total liabilities and stockholders deficit	\$ 121,233,000	\$ 126,600,000

The accompanying notes are an integral part of these financial statements

**PRIMEDEX HEALTH SYSTEMS, INC. AND AFFILIATES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)**

JULY 31,	THREE MONTHS ENDED		NINE MONTHS ENDED	
	2005	2006	2005	2006
<b>NET REVENUE</b>	\$ 36,178,000	\$ 40,336,000	\$ 105,478,000	\$ 118,462,000
<b>OPERATING EXPENSES</b>				
Operating expenses	26,790,000	30,105,000	79,792,000	88,701,000
Depreciation and amortization	4,243,000	4,071,000	12,905,000	12,175,000
Provision for bad debts	946,000	2,000,000	2,789,000	4,739,000
Loss on disposal of equipment, net		224,000	698,000	210,000
Total operating expenses	31,979,000	36,400,000	96,184,000	105,825,000
<b>INCOME FROM OPERATIONS</b>	4,199,000	3,936,000	9,294,000	12,637,000
<b>OTHER EXPENSE (INCOME)</b>				
Interest expense	4,278,000	5,392,000	12,788,000	14,386,000
Loss (gain) on debt extinguishment, net			(515,000)	2,097,000
Other income	(42,000)	)	(173,000)	)
Other expense			25,000	788,000
Total other expense	4,236,000	5,392,000	12,125,000	17,271,000
<b>LOSS BEFORE EQUITY IN INCOME OF INVESTEE</b>	(37,000)	)	(1,456,000)	)
Equity in income of investee		61,000		61,000
<b>NET LOSS</b>	\$ (37,000)	)	\$ (1,395,000)	)
<b>BASIC AND DILUTED NET LOSS PER SHARE</b>	\$	(.03)	)	\$ (.07)
<b>WEIGHTED AVERAGE SHARES OUTSTANDING</b>				
Basis and diluted	41,207,900	42,039,081	41,137,405	41,663,841

The accompanying notes are an integral part of these financial statements

**PRIMEDEX HEALTH SYSTEMS, INC. AND AFFILIATES**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS DEFICIT**

**NINE MONTHS ENDED JULY 31, 2006**

	Common Stock \$.01 par value, 100,000,000 shares authorized		Paid-in	Treasury stock, at cost		Accumulated	Stockholders
	Shares	Amount	Capital	Shares	Amount	Deficit	Deficit
<b>BALANCE OCTOBER 31, 2005</b>	43,231,813	\$ 433,000	\$ 100,590,000	(1,825,000 )	\$ (695,000 )	\$ (170,961,000 )	\$ (70,633,000 )
Issuance of warrant			110,000				110,000
Exercise of warrants	819,781	8,000	173,000				181,000
Exercise of options	2,167		1,000				1,000
Share-based payments			345,000				345,000
Net loss						(4,573,000 )	(4,573,000 )
<b>BALANCE JULY 31, 2006 (UNAUDITED)</b>	44,053,761	\$ 441,000	\$ 101,219,000	(1,825,000 )	\$ (695,000 )	\$ (175,534,000 )	\$ (74,569,000 )

The accompanying notes are an integral part of these financial statements

## PRIMEDEX HEALTH SYSTEMS, INC. AND AFFILIATES

## CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

NINE MONTHS ENDED JULY 31,	2005	2006
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	\$ 6,822,000	\$ 4,633,000
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of property and equipment	(2,831,000)	(6,041,000)
Investment in membership interest of PET center		(237,000)
Proceeds from sale of equipment	65,000	
Net cash used by investing activities	(2,766,000)	(6,278,000)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Cash disbursements in transit	1,254,000	2,323,000
Principal payments on notes and leases payable	(9,565,000)	(6,105,000)
Repayment of debt upon extinguishments		(141,242,000)
Proceeds from issuance of common stock		182,000
Proceeds from sale of equipment		15,000
Proceeds from borrowings upon refinancing		146,468,000
Proceeds from borrowings from related parties	1,370,000	
Debt issue costs		(5,608,000)
Payments on line of credit	(2,398,000)	
Proceeds from short and long-term borrowings on notes payable	5,284,000	5,612,000
Net cash provided (used) by financing activities	(4,055,000)	1,645,000
<b>NET INCREASE (DECREASE) IN CASH</b>	1,000	
<b>CASH, beginning of period</b>	1,000	2,000
<b>CASH, end of period</b>	\$ 2,000	\$ 2,000
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>		
Cash paid during the period for interest	\$ 12,241,000	\$ 13,141,000

**Supplemental Non-Cash Investing and Financing Activities**

During the nine months ended July 31, 2006 and 2005, we entered into capital lease obligations for approximately \$996,000 and \$4,781,000, respectively.

The accompanying notes are an integral part of these financial statements

**PRIMEDEX HEALTH SYSTEMS, INC. AND AFFILIATES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**Nature of Business**

Primedex Health Systems, Inc., or Primedex, incorporated on October 21, 1985, provides diagnostic imaging services in the state of California. Imaging services include magnetic resonance imaging, or MRI, computer tomography, or CT, positron emission tomography, or PET, nuclear medicine, mammography, ultrasound, diagnostic radiology, or X-ray, and fluoroscopy. Our operations comprise a single segment for financial reporting purposes.

The consolidated financial statements of Primedex include the accounts of Primedex, its wholly owned direct subsidiary, Radnet Management, Inc., or Radnet, and Beverly Radiology Medical Group III, or BRMG, which is a professional corporation, all collectively referred to as us or we. The consolidated financial statements also include Radnet Sub, Inc., Radnet Management I, Inc., Radnet Management II, Inc., SoCal MR Site Management, Inc., and Diagnostic Imaging Services, Inc., or DIS, all wholly owned subsidiaries of Radnet.

The operations of BRMG are consolidated with us as a result of the contractual and operational relationship among BRMG, Dr. Berger and us. We are considered to have a controlling financial interest in BRMG pursuant to the guidance in EITF 97-2. Medical services and supervision at most of our imaging centers are provided through BRMG and through other independent physicians and physician groups. BRMG is consolidated with Pronet Imaging Medical Group, Inc. and Beverly Radiology Medical Group, both of which are 99%-owned by Dr. Berger. Radnet provides non-medical, technical and administrative services to BRMG for which they receive a management fee.

Operating activities of subsidiary entities are included in the accompanying financial statements from the date of acquisition. All intercompany transactions and balances have been eliminated in consolidation.

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X and, therefore, do not include all information and footnotes necessary for a fair presentation of financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States for complete financial statements; however, in the opinion of our management, all adjustments consisting of normal recurring adjustments necessary for a fair presentation of financial position, results of operations and cash flows for the interim periods ended July 31, 2006 and 2005 have been made. The results of operations for any interim period are not necessarily indicative of the results for a full year. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto contained in our Annual Report on Form 10-K for the year ended October 31, 2005.

**Liquidity and Capital Resources**

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We had a working capital deficit of \$557,000 at July 31, 2006 compared to a \$143.4 million deficit at October 31, 2005, and had losses from operations of \$1.4 million and \$4.6 million during the three and nine months ended July 31, 2006, respectively, and had losses from operations of \$2.9 million for the nine months ended July 31, 2005. We also had a stockholders' deficit of \$74.6 million at July 31, 2006 compared to a \$70.6 million deficit at October 31, 2005.

The working capital deficit increased as of October 31, 2005 due to the reclassification of approximately \$109 million in notes and capital lease obligations as current liabilities expected to be refinanced. We were subject to financial covenants under our debt agreements and believed we may have been unable to continue to be in compliance with our existing financial covenants during fiscal 2006. As such, the associated debt was reclassified as a current liability.

Effective March 9, 2006, we completed the issuance of a \$161 million senior secured credit facility that we used to refinance substantially all of our existing indebtedness (except for \$16.1 million of outstanding subordinated debentures and approximately \$5 million of capital lease obligations). We incurred fees and expenses for the transaction of approximately \$5.6 million. Debt issue costs are being amortized on a straight-line basis over 65 months and are classified as Deferred financing costs. In addition, we recorded a net loss on extinguishments of debt of \$2.1 million, which includes \$1.2 million in pre-payment penalty fees that are unpaid as of July 31, 2006 and classified as accrued expenses under current liabilities. The facility provides for a \$15 million five-year revolving credit facility, an \$86 million term loan due in five years and a \$60 million second lien term loan due in six years. The loans are subject to acceleration on December 27, 2007, unless we have made arrangements to discharge or extend our outstanding subordinated debentures by that date. We intend to retire the subordinated debentures prior to their due date of June 30, 2008. Under the terms and conditions of the new Second Lien Term Loan, subject to achieving certain leverage ratios, we have the right to raise up to \$16.1 million in additional funds as part of the Second Lien Term Loan for the purposes of redeeming the subordinated debentures. Additionally, under the current facilities, we have the ability to pursue other funding sources to refinance the subordinated debentures. The loans are payable interest only monthly except for the \$86 million term loan that requires amortization payments of 1.0% per annum, or \$860,000, paid quarterly.

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The revolving credit facility and the \$86 million term loan bear interest at a base rate (base rate means corporate loans posted by at least 75% of the nation's 30 largest banks as quoted by the Wall Street Journal) plus 2.5%, or at our election, the LIBOR rate plus 4.0% per annum, payable monthly. The \$60 million second lien term loan bears interest at the base rate plus 7.0%, or at our election, the LIBOR rate plus 8.5% per annum, payable monthly. The \$86 million term loan includes amortization payments of 1.0% per annum, payable in quarterly installments of \$215,000. Upon the close of the refinancing on March 9, 2006, we utilized approximately \$1.5 million of the new \$15 million revolving credit facility.

As part of the refinancing, we were required to swap at least 50% of the aggregate principal amount of the facilities to a floating rate within 90 days of the close of the agreement on March 9, 2006. On April 11, 2006, effective April 28, 2006, on \$73.0 million (one half of our First and Second Lien Term Loans of \$146.0 million), we entered into an interest rate swap fixing the LIBOR rate of interest at 5.47% for a period of three years. Previously, the interest rate on the \$73.0 million was based upon a spread over LIBOR which floats with market conditions. In addition, as a requirement of the deal, 75% of our excess cash flow is to be used to repay principal on the \$86 million term loan once per year within 105 days after our fiscal year end. Excess cash flow is defined as earnings before interest, taxes, depreciation and amortization plus decreases in working capital and extraordinary gains minus: (i) capital expenditures; (ii) interest expense; (iii) scheduled principal payments on existing debt; (iv) income taxes; (v) increases in working capital; (vi) extraordinary losses; (vii) voluntary prepayments of the \$86 million term loan; (viii) and amounts paid for acquisitions.

Under the new facility, we are subject to various financial covenants including a limitation on capital expenditures, maximum days sales outstanding, minimum fixed charge coverage ratio, maximum leverage ratio and maximum senior leverage ratio. Availability under our \$15 million revolving credit facility is governed by the margins calculated under the maximum senior leverage ratio and maximum total leverage ratio covenants. As of July 31, 2006, we had approximately \$8.1 million of availability based upon our borrowing base formula.

During the second quarter of fiscal 2006, Howard G. Berger, M.D., our president, director and largest shareholder had outstanding advances to us of \$2,605,000. Our obligation to Dr. Berger was repaid as part of our March 9, 2006 refinancing.

On July 6, 2006, Primedex entered into an agreement and plan of merger for the acquisition of Radiologix, Inc. by Primedex through the merger of a wholly-owned subsidiary of Primedex with and into Radiologix. Upon successful completion of the merger, Radiologix stockholders will receive a combination of cash and Primedex common stock in exchange for their shares of Radiologix common stock. Pursuant to the merger, Radiologix stockholders will receive aggregate consideration of 22,621,922 shares of Primedex common stock and \$42,950,000 in cash. Based upon the August 17, 2006 closing price of Primedex common stock of \$1.57, each Radiologix stockholder would receive \$1.85 in cash for each Radiologix share, plus one share of Primedex common stock for total consideration valued at \$3.42 per share. The merger agreement also provides Primedex the option to elect to reduce the share consideration by up to 3.5 million shares and to increase the cash consideration by \$2 per share, provided that Primedex advises Radiologix of its election prior to the mailing of the proxy statement. Upon completion of the merger, we estimate that, subject to adjustment as described above, Radiologix's former stockholders will own approximately 34.9% of the then-outstanding shares of Primedex common stock, based on the number of shares of Radiologix and Primedex common stock outstanding on August 17, 2006. Primedex's stockholders will continue to own their existing shares. In connection with the proposals set forth in this joint proxy statement/prospectus, Primedex stock may be subject to transfer restrictions which are necessary to preserve Primedex's unrestricted use of its net operating loss carry-forwards.

Primedex has signed a commitment letter with GE Commercial Finance Healthcare Financial Services for a \$405 million senior secured credit facility. The facility is expected to be used to finance the merger, to refinance existing indebtedness, to pay transaction costs and expenses relating to the merger and the credit facility and to provide financing for working capital needs post-merger. Consummation of the financing is a condition to the closing of the merger. The facility will consist of a revolving credit facility of up to \$45 million, a \$225 million term loan and a \$135 million second lien term loan. The revolving credit facility will have a term of five years, the term loan will have a term of six years and the second lien term loan will have a term of six and one-half years. Interest is payable on all loans initially at an Index Rate plus the Applicable Index Margin, as defined. The Index Rate is initially a floating rate equal to the higher of the rate quoted from time to time by The Wall Street Journal as the base rate on corporate loans posted by at least 75% of the nation's largest 30 banks or the Federal Funds Rate plus 50 basis points. The Applicable Index Margin on each the revolving credit facility and the term loan is 2% and on the second lien term loan is 6%. Primedex may, after a certain period, request that the interest rate instead be based on LIBOR plus the Applicable LIBOR Margin, which is 3.5% for the revolving credit facility and the term loan and 7.5% for the second lien term loan. It is anticipated that the credit facility will include customary covenants for a facility of this type, including minimum fixed charge coverage ratio, maximum total leverage ratio, maximum senior leverage ratio, limitations on indebtedness, contingent obligations, liens, capital expenditures, lease obligations, mergers and acquisitions, asset sales, dividends and distributions, redemption or repurchase of equity interests, subordinated debt payments and modifications, loans and investments, transactions with affiliates, changes of control, and payment of consulting and management fees. The credit facility will contain such conditions to funding as are customary for senior secured facilities of this type.



We operate in a capital intensive, high fixed-cost industry that requires significant amounts of capital to fund operations. In addition to operations, we require significant amounts of capital for the initial start-up and development expense of new diagnostic imaging facilities, the acquisition of additional facilities and new diagnostic imaging equipment, and to service our existing debt and contractual obligations. Because our cash flows from operations have been insufficient to fund all of these capital requirements, we have depended on the availability of financing under credit arrangements with third parties. Historically, our principal sources of liquidity have been funds available for borrowing under our existing lines of credit, now with General Electric Capital Corporation. We finance the acquisition of equipment mainly through capital and operating leases.



As of July 31, 2006 and October 31, 2005, our line of credit liabilities were \$6.9 million and \$13.3 million, respectively.

The interim disclosures regarding liquidity and capital resources should be read in conjunction with the consolidated financial statements and related notes thereto contained in our Annual Report of Form 10-K for the year ended October 31, 2005.

Our business strategy with regard to operations will focus on the following:

- Maximizing performance at our existing facilities;
- Focusing on profitable contracting;
- Expanding MRI and CT applications
- Optimizing operating efficiencies; and
- Expanding our networks.

Our ability to generate sufficient cash flow from operations to make payments on our debt and other contractual obligations will depend on our future financial performance. A range of economic, competitive, regulatory, legislative and business factors, many of which are outside of our control, will affect our financial performance. Taking these factors into account, including our historical experience and our discussions with our lenders to date, although no assurance can be given, we believe that through implementing our strategic plans and continuing to restructure our financial obligations, we will obtain sufficient cash to satisfy our obligations as they become due in the next twelve months.

## NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Revenue recognition** Revenue consists of net patient fee for service revenue and revenue from capitation arrangements, or capitation revenue.

Net patient service revenue is recognized at the time services are provided net of contractual adjustments based on our evaluation of expected collections resulting from their analysis of current and past due accounts, past collection experience in relation to amounts billed and other relevant information. Contractual adjustments result from the differences between the rates charged for services performed and reimbursements by government-sponsored healthcare programs and insurance companies for such services.

Capitation revenue is recognized as revenue during the period in which we were obligated to provide services to plan enrollees under contracts with various health plans. Under these contracts, we receive a per enrollee amount each month covering all contracted services needed by the plan enrollees.

The following table summarizes net revenue for the three and nine months ended July 31, 2005 and 2006:

	Three Months Ended		Nine Months Ended	
	2005	2006	2005	2006
Net patient service	\$ 26,544,000	\$ 29,755,000	\$ 77,670,000	\$ 86,376,000
Capitation	9,634,000	10,581,000	27,808,000	32,086,000
Net revenue	\$ 36,178,000	\$ 40,336,000	\$ 105,478,000	\$ 118,462,000

Accounts receivable are primarily amounts due under fee-for-service contracts from third party payors, such as insurance companies and patients and government-sponsored healthcare programs geographically dispersed throughout California.

Accounts receivable as of October 31, 2005 are presented net of allowances of approximately \$59,491,000, of which \$56,296,000 is included in current and \$3,195,000 is included in noncurrent. Accounts receivable as of July 31, 2006,



are presented net of allowances of approximately \$54,397,000 of which \$51,476,000 is included in current and \$2,921,000 is included in noncurrent.

**Credit risks** Financial instruments that potentially subject us to credit risk are primarily cash equivalents and accounts receivable. We have placed our cash and cash equivalents with one major financial institution. At times, the cash in the financial institution is temporarily in excess of the amount insured by the Federal Deposit Insurance Corporation, or FDIC.

With respect to accounts receivable, we routinely assess the financial strength of our customers and third-party payors and, based upon factors surrounding their credit risk, establish a provision for bad debt. Net revenue by payor for the three and nine months ended July 31, 2005 and 2006 were:

	For the Three Months Ended			For the Nine Months Ended			
	2005		2006	2005		2006	
Capitation contracts	27	%	26	% 26	%	27	%
HMO/PPO/Managed care	22	%	24	% 22	%	24	%
Medicare	15	%	15	% 15	%	15	%
Blue Cross/Shield/Champus	14	%	14	% 14	%	15	%
Special group contract	9	%	8	% 9	%	8	%
Commercial insurance	4	%	3	% 4	%	3	%
Medi-Cal	3	%	4	% 3	%	3	%
Workers compensation	3	%	3	% 3	%	2	%
Other	3	%	3	% 4	%	3	%

Management believes that its accounts receivable credit risk exposure, beyond allowances that have been provided, is limited.

The Deficit Reduction Act of 2005 (DRA) was approved by Congress and signed into law on February 9, 2006. The DRA provides that reimbursement for the technical component for imaging services (excluding diagnostic and screening mammography) in non-hospital based freestanding facilities will be capped at the lesser of reimbursement under the Medicare Part B physician fee schedule or the Hospital Outpatient Prospective Payment System (HOPPS) schedule. Currently, the technical component of our imaging services is reimbursed under the Part B physician fee schedule, which for certain modalities like MRI and CT, allows for higher reimbursement on average than under the HOPPS. For other imaging exams, such as x-ray and ultrasound, reimbursement under the HOPPS is greater on average. Under the DRA, we will be reimbursed at the lower of the two schedules, beginning January 1, 2007.

The DRA also codifies the reduction in reimbursement for multiple images on contiguous body parts previously announced by the Centers for Medicare and Medicaid Services (CMS). In November 2005, CMS announced that it will pay 100% of the technical component of the higher priced imaging procedure and 50% for the technical component of each additional imaging procedure involving contiguous body parts when performed in the same session. Under current methodology, Medicare pays 100% of the technical component of each procedure. This rate reduction will occur in two steps, so that the reduction will be 25% for each additional imaging procedure in 2006 and another 25% in 2007. For the fiscal year ended October 31, 2005, Medicare revenue from our imaging centers represented approximately 15% of our total revenue. Of this amount, approximately 54% was from MRI and CT, the modalities affected more significantly by the reimbursement reductions. If both the HOPPS and contiguous body part reimbursement reductions contained in the DRA had been in effect during fiscal year 2005, we estimate that our revenue would have been reduced by approximately \$4.5 million.

**Significant Events** On April 4, 2006, we settled a claim with Broadstream for \$500,000. This claim arose in connection with a financing agreement we entered into with a third party. James Goldfarb, a partner of Broadstream Capital Partners, LLC (Broadstream), and once a member of our Board of Directors, arranged a meeting between us and a third party to discuss the third party financing the purchase of a portion of our debt owed to DVI Financial Services, which had filed for bankruptcy. Goldfarb alleged that, on behalf of Broadstream, he entered into an oral agreement with us under which we owed Broadstream a finder's fee for setting up this meeting. Broadstream filed suit against us, and Howard G. Berger, M.D., our president, for damages. Pursuant to the settlement, we agreed to pay to Broadstream \$500,000 payable over a one and one-half year period.

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We are engaged from time to time in the defense of lawsuits arising out of the ordinary course and conduct of our business. We believe that the outcome of our current litigation will not have a material adverse impact on our business, financial condition and results of operations. However, we could be subsequently named as a defendant in other lawsuits that could adversely affect us.

**Reclassifications** Certain prior year amounts have been reclassified to conform with the current period presentation. These changes have no effect on net income.

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**NOTE 3 ACQUISITIONS AND DIVESTITURES**

**Acquisitions, openings and closings of imaging centers**

In December 2005, we entered into a new building lease in Encino, California for approximately 10,425 square feet to begin the development of a new center, San Fernando Interventional Radiology and Imaging Center, which is expected to open by the end of this fiscal year. The center will offer MRI, CT, ultrasound and x-ray services as well as biopsy, angiography, shunt, and pain management procedures. The monthly rent is approximately \$19,600 and the first month's rent will be due no later than September 2006.

Effective February 1, 2006, upon the inception of a new capitation arrangement, we opened two additional satellite offices in Yucaipa and Moreno Valley, California that provide x-ray services for our Riverside location. In addition, in February 2006, we opened one additional satellite office providing x-ray services in Temecula, California.

Effective February 1, 2006, we entered into a facility use agreement for an open MRI center in Vallejo, California. The agreement provides for the use of the equipment and facility for a monthly fee.

Effective February 1, 2006, we invested \$237,000 for a 47.5% membership interest in an entity that operates a PET center in Palm Springs, California. We account for this investment under the equity method of accounting. Income in earnings of this equity method investment was approximately \$61,000. The center will provide PET services for our existing facilities in the area replacing a prior arrangement where PET services were provided by a mobile unit for a per use fee. We have an option to purchase the other 52.5% interest subsequent to November 1, 2006 and prior to February 29, 2008 for \$512,500.

On May 15, 2006, we opened an additional multi-modality site in Emeryville, California that provides MRI, CT and x-ray services. Ultrasound services will be added in the near future. We entered into a new building lease for 6,500 square feet with a beginning monthly rental of \$9,754 and invested approximately \$1.7 million in leasehold improvements for the new center. The improvements were paid for from working capital. Subsequent to the new center's opening, we decided to close our existing Emeryville MRI only facility and incurred a loss on the disposal of leasehold improvements in that center of approximately \$143,000.

At various times, we may open or close small x-ray facilities acquired primarily to service larger capitation arrangements over a specific geographic region. Over time, patient volume from these contracts may vary, or we may end the arrangement, resulting in the subsequent closures of these smaller satellite facilities.

**NOTE 4 EQUITY BASED COMPENSATION**

We have two long-term incentive stock option plans. The 1992 plan has not issued options since the inception of the new 2000 plan. The 2000 plan reserves 2,000,000 shares of common stock. Options granted under the plan are intended to qualify as incentive stock options under existing tax regulations. In addition, we have issued non-qualified stock options from time to time in connection with acquisitions and for other purposes and have also issued stock under the plan. Employee stock options generally vest over three years and expire five to ten years from date of grant. Of the 165,000 options granted under the plan during the nine months ended July 31, 2006, 150,000 options vested in full on the date of grant and 15,000 options vest over three years in equal installments beginning on the grant date. All 165,000 options are exercisable for period up to five years from the date of grant at a price equal to the fair market value of the common shares underlying the option at the date of grant. As of July 31, 2006, 807,500, or approximately 99%, of all the outstanding stock options are fully vested.

We have issued warrants under various types of arrangements to employees, in conjunction with debt financing and in exchange for outside services. All warrants are issued with an exercise price equal to the fair market value of the underlying common stock on the date of issuance. The warrants expire from five to seven years from the date of grant. Warrants issued to employees can vest immediately or up to seven years. The vesting terms are determined by the board of directors at the date of issuance. Of the 4,650,000 warrants granted during the nine months ended July 31, 2006, 700,000 vested in full on the date of grant and 3,950,000 vest in various stages beginning one year from the date of grant up to seven years. As of July 31, 2006, 6,189,000, or 56%, of all the outstanding warrants are fully vested.

During the first quarter of fiscal 2006, we adopted SFAS No. 123(R), Share-Based Payment, applying the modified prospective method. This Statement requires all equity-based payments to employees, including grants of employee options, to be recognized in the consolidated statement of earnings based on the grant date fair value of the award. Under the modified prospective method, we are required to record equity-based compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards outstanding as of the date of adoption. The fair values of all options were valued using a Black-Scholes model.

In anticipation of the adoption of SFAS No. 123(R), we did not modify the terms of any previously granted awards.

The compensation expense recognized for all equity-based awards is net of estimated forfeitures and is recognized over the awards' service period. In accordance with Staff Accounting Bulletin (SAB) No. 107, we classified equity-based compensation within operating expenses with the same line item as the majority of the cash compensation paid to employees.

The following table illustrates the impact of equity-based compensation on reported amounts:

	For the Three Months Ended July 31, 2006(1)		For the Nine Months Ended July 31, 2006(1)	
	As Reported	Impact of Equity-Based Compensation	As Reported	Impact of Equity-Based Compensation
Income from operations (2)	\$ 3,936,000	\$ (108,000 )	\$ 12,637,000	\$ (345,000 )
Net loss	\$ (1,395,000 )	\$ (108,000 )	\$ (4,573,000 )	\$ (345,000 )
Net basic and diluted earning per share	\$ (.03 )	\$	\$ (.11 )	\$ (.01 )

(1) Prior to the first quarter of fiscal 2006, we accounted for equity-based awards under the intrinsic value method, which followed the recognition and measurement principles of APB Opinion No. 25 and related Interpretations.

(2) The expense related includes \$32,500 and \$102,600 for the three and nine months ended July 31, 2006, respectively, for the unvested portion of previously granted employee awards outstanding as of the date of adoption.

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The following summarizes all of our option transactions from November 1, 2005 to July 31, 2006:

<b>Outstanding Options</b>	<b>Shares</b>	<b>Weighted Average Exercise Price Per Common Share</b>	<b>Weighted Average Remaining Contractual Life (in years)</b>	<b>Aggregate Intrinsic Value</b>
Balance, October 31, 2005	687,167	\$ 0.51		
Granted	165,000	0.39		
Exercised	(2,167 )	0.46		
Canceled or expired	(32,500 )	0.41		
Balance, July 31, 2006	817,500	\$ 0.49	4.14	\$ 988,000
Exercisable at July 31, 2006	807,500	\$ 0.49	4.08	\$ 976,000

<b>Outstanding Warrants</b>	<b>Shares</b>	<b>Weighted Average Exercise Price Per Common Share</b>	<b>Weighted Average Remaining Contractual Life (in years)</b>	<b>Aggregate Intrinsic Value</b>
Balance, October 31, 2005	12,004,770	\$ 0.60		
Granted	4,650,000	0.66		
Exercised	(1,319,781 )	0.46		
Canceled or expired	(4,278,655 )	0.64		
Balance, July 31, 2006	11,056,334	\$ 0.63	3.80	\$ 11,867,000
Exercisable at July 31, 2006	6,189,000	\$ 0.61	2.32	\$ 6,735,000

During the nine months ended July 31, 2006, there was a cashless exercise of 1,000,000 warrant shares for which 500,000 shares of common stock were issued.

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (the difference between our closing stock price on July 31, 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holder had all option holders exercised their options on July 31, 2006. Total intrinsic value of options exercised during the nine months ended July 31, 2006 was approximately \$1.0 million. As of July 31, 2006, total unrecognized share-based compensation expense related to non-vested employee awards was approximately \$2.1 million, which is expected to be recognized over a weighted average period of approximately 7.0 years.

The weighted average fair value of options granted during the nine months ended July 31, 2006 was \$0.49.

The fair value of each option granted is estimated on the grant date using the Black-Scholes option pricing model which takes into account as of the grant date the exercise price and expected term of the option, the current price of the underlying stock and its expected volatility, expected dividends on the stock and the risk-free interest rate for the term of the option. The following is the average of the data used to calculate the fair value:

<b>June 31,</b>	<b>Risk-free interest rate</b>	<b>Expected term</b>	<b>Expected Volatility</b>	<b>Expected dividends</b>
2005	3.00%	5 years	49.00%	
2006	4.73%	5 years	99.36%	

We have determined the 2006 expected term assumption under the Simplified Method as defined in SAB 107. For fiscal 2006, expected stock price volatility is based on the historical volatility of our stock. The risk-free interest rate is based on the U.S. Treasury yield in effect at the time of grant with an equivalent remaining term. We have not paid dividends in the past and do not currently plan to pay any dividends in the near future.

#### Fair Value Disclosures Prior to Adopting SFAS No. 123(R)

We adopted SFAS 123(R) using the modified prospective transition method, which requires that application of the accounting standard as of November 1, 2005, the first day of our fiscal year 2006. Our consolidated financial statements as of and for the three and nine months ended July 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, our consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R).

The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition principles of SFAS No. 123 to stock-based employee compensation during fiscal 2005.

July 31,	Three Months Ended 2005	Nine Months Ended 2005
Net loss as reported	\$ (37,000 )	\$ (2,831,000 )
Deduct: Total stock-based employee compensation expense determined under fair value-based method	(94,000 )	(186,000 )
Pro forma net loss	\$ (131,000 )	\$ (3,017,000 )
Loss per share:		
Basic and diluted loss per share - as reported	\$	\$ (0.07 )
Basic and diluted loss per share - pro forma	\$	\$ (0.07 )

#### **NOTE 5 CAPITAL TRANSACTIONS**

On December 19, 2003, we issued a \$1.0 million convertible subordinate note payable to Galt Financial, Ltd., at a stated rate of 11% per annum with interest payable quarterly. The note payable was convertible at the holder's option anytime after January 1, 2006 at \$0.50 per share. As additional consideration for the financing, we issued a warrant for the purchase of 500,000 shares at an exercise price of \$0.50 per share. We allocated \$0.1 million to the value of the warrants. In November 2005, the right to convert the \$1.0 million obligation into 2,000,000 shares of common stock was waived in exchange for the issuance of a five-year warrant to purchase 300,000 shares of our common stock at a price of \$0.50 per share, the public market price on the date of the warrant, as consideration for the note being extended to July 1, 2006. We recorded \$0.1 million for the estimated fair value of these warrants as a deferred cost which will be amortized as interest expense to the extended date of maturity. The note was repaid as part of our March 9, 2006 refinancing.

#### **NOTE 6 SUBSEQUENT EVENTS**

On August 25, 2006, we acquired the assets and business of Corona Imaging Center, in Corona, California, from an external third party for \$1,500,000 financed through a third party lender over five years at 8.5%. In addition, we financed certain medical equipment for approximately \$243,000 as part of the transaction. The center provides MRI, CT, ultrasound, and x-ray services. The center is 2,133 square feet with a monthly rental of approximately \$3,839 per month with an initial lease term through November 2011. No goodwill is expected to be recorded in the transaction.

On September 1, 2006, effective September 5, 2006, we acquired the net assets and business of San Francisco Advanced Imaging Center, in San Francisco, California, from an external third party for \$1,650,000 paid from working capital. The center provides MRI, CT and x-ray services. The center is 7,115 square feet with a monthly rental of approximately \$29,000 with an initial lease term through April 2017. No goodwill is expected to be recorded in the transaction.

As of September 11, 2006, we were in the process of acquiring the assets and business of two additional facilities in Fresno, California and Irvine, California for an estimated \$1,500,000 in cash and \$500,000 in assumed liabilities, respectively. Both centers will offer MRI, CT, ultrasound and x-ray services and no goodwill is expected to be recorded in either transaction.



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

As of July 31, 2006, we operate a group of regional networks comprised of 61 fixed-site freestanding outpatient diagnostic imaging facilities in California. We believe our group of regional networks is the largest of its kind in California. We have strategically organized our facilities into regional networks in markets, which have both high-density and expanding populations, as well as attractive payor diversity.

All of our facilities employ state-of-the-art equipment and technology in modern, patient-friendly settings. Many of our facilities within a particular region are interconnected and integrated through our advanced information technology system. Thirty four of our facilities are multi-modality sites, offering various combinations of MRI, CT, PET, nuclear medicine, ultrasound, X-ray and fluoroscopy services. Twenty-seven of our facilities are single-modality sites, offering either X-ray, MRI or PET services. Consistent with our regional network strategy, we locate our single-modality sites near multi-modality sites to help accommodate overflow in targeted demographic areas.

We derive substantially all of our revenue, directly or indirectly, from fees charged for the diagnostic imaging services performed at our facilities. During the nine months ended July 31, 2005 and 2006, we derived 61% and 58% of our net revenue, respectively, from MRI and CT scans. Over the past years, we have increased net revenue primarily through improvements in net reimbursement, expansions of existing facilities, upgrades in equipment and development of new facilities.

The fees charged for diagnostic imaging services performed at our facilities are paid by a diverse mix of payors, as illustrated for the nine months ended July 31, 2006 by the following table:

Payor Type	Percentage of Net Revenue	
Insurance(1)	41	%
Managed Care Capitated Payors	27	
Medicare/Medi-Cal	18	
Other2	10	
Workers Compensation/Personal Injury	4	

(1) Includes Blue Cross/Blue Shield, which represented 15% of our net revenue for the nine months ended July 31, 2006.

(2) Includes co-payments, direct patient payments and payments through contracts with physician groups and other non-insurance company payors.

Our eligibility to provide service in response to a referral often depends on the existence of a contractual arrangement between the radiologists providing the professional medical services or us and the referred patient's insurance carrier or managed care organization. These contracts typically describe the negotiated fees to be paid by each payor for the diagnostic imaging services we provide. With the exception of Blue Cross/Blue Shield and government payors, no single payor accounted for more than 5% of our net revenue for the nine months ended July 31, 2006. Under our capitation agreements, we receive from the payor a pre-determined amount per member, per month. If we do not successfully manage the utilization of our services under these agreements, we could incur unanticipated costs not offset by additional revenue, which would reduce our operating margins.

The principal components of our fixed operating expenses, excluding depreciation, include professional fees paid to radiologists, except for those radiologists who are paid based on a percentage of revenue, compensation paid to technologists and other employees, and expenses related to equipment rental and purchases, real estate leases and insurance, including errors and omissions, malpractice, general liability, workers compensation and employee medical. The principal components of our variable operating expenses include expenses related to equipment maintenance, medical supplies, marketing, business development and corporate overhead. Because a majority of our expenses are fixed, increased revenue as a result of higher scan volumes per system can significantly improve our margins, while lower scan volumes can result in significantly lower margins.

BRMG strives to maintain qualified radiologists and technologists while minimizing turnover and salary increases and avoiding the use of outside staffing agencies, which are considerably more expensive and less efficient. In recent years, there has been a shortage of qualified radiologists and technologists in some of the regional markets we serve. As turnover occurs, competition in recruiting radiologists and technologists may make it difficult for our contracted radiology practices to maintain adequate levels of radiologists and technologists without

the use of outside staffing agencies. At times, this has resulted in increased costs for us.

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As part of our evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the fiscal year ended October 31, 2005, we concluded that we had insufficient personnel resources and technical accounting expertise within the accounting function to resolve the following non-routine or complex accounting matters: the recording of non-typical cost-based investments and unusual debt-related transactions and the appropriate analysis of the amortization lives of leasehold improvements in accordance with GAAP. We are committed to establish the necessary environment to ensure the effectiveness of these controls in the future and quality financial reporting. We experienced no impact on our financial statements for the year ended October 31, 2005 or for the nine months ended July 31, 2006 as a result of the ineffective controls over non-routine matters.

#### **Adoption of SFAS No. 123(R) and Equity-Based Compensation Expense**

During the first quarter of fiscal 2006, we adopted SFAS No. 123 (R), Share-Based Payment, applying the modified prospective method. This Statement requires all equity-based payments to employees, including grants of employee options, to be recognized in the consolidated statement of earnings based on the grant date fair value of the award. Under the modified prospective method, we are required to record equity-based compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards outstanding as of the date of adoption. The fair values of all options were valued using a Black-Scholes model.

In anticipation of the adoption of SFAS No. 123(R), we did not modify the terms of any previously granted awards.

Our operating earnings for the three and nine months ended July 31, 2006 were adversely affected by the impact of equity-based compensation due to the implementation of SFAS No. 123 (R). We recorded \$108,000 and \$345,000, respectively, for equity-based compensation during the three and nine months ended July 31, 2006. As of July 31, 2006, total unrecognized share-based compensation expense related to non-vested employee awards was approximately \$2.1 million, which is expected to be recognized over a weighted-average period of approximately 7.0 years. The weighted fair value of options granted during the nine months ended July 31, 2006 was \$0.49.

#### **Our Relationship with BRMG**

Howard G. Berger, M.D. is our President and Chief Executive, a member of our Board of Directors, and owns approximately 30% of Primedex's outstanding common stock. Dr. Berger also owns, indirectly, 99% of the equity interests in BRMG. BRMG provides all of the professional medical services at 46 of our facilities under a management agreement with us, and contracts with various other independent physicians and physician groups to provide all of the professional medical services at most of our other facilities. We obtain professional medical services from BRMG, rather than providing such services directly or through subsidiaries, in order to comply with California's prohibition against the corporate practice of medicine. However, as a result of our close relationship with Dr. Berger and BRMG, we believe that we are able to better ensure that professional medical services are provided at our facilities in a manner consistent with our needs and expectations and those of our referring physicians, patients and payors than if we obtained these services from unaffiliated practice groups.

Under our management agreement with BRMG, which expires on January 1, 2014, BRMG pays us, as compensation for the use of our facilities and equipment and for our services, a percentage of the gross amounts collected for the professional services it renders. The percentage, which was 79% at July 31, 2006, is adjusted annually, if necessary, to ensure that the parties receive fair value for the services they render. In operation and historically, the annual revenue of BRMG from all sources closely approximates its expenses, including Dr. Berger's compensation, fees payable to us and amounts payable to third parties. For administrative convenience and in order to avoid inconveniencing and confusing our payors, a single bill is prepared for both the professional medical services provided by the radiologists and our non-medical, or technical, services, generating a receivable for BRMG. Historically, BRMG financed these receivables under a working capital facility with Bridge Healthcare Finance LLC, or Bridge, and regularly advanced to us the funds that it drew under this working capital facility, which we used for our own working capital purposes. We repaid or offset these advances with periodic payments from BRMG to us under the management agreement. We guaranteed BRMG's obligations under this working capital facility. Effective March 9, 2006, the line of credit with Bridge was paid and closed with the issuance of a new \$161 million senior secured credit facility.

As a result of our contractual and operational relationship with BRMG and Dr. Berger, we are required to include BRMG as a consolidated entity in our consolidated financial statements.





**Results of Operations**

The following table sets forth, for the periods indicated, the percentage certain items in the statement of operations bears to net revenue.

	Nine months ended July 31,			
	2005	%	2006	%
Net revenue	100.0	%	100.0	%
Operating expenses:				
Operating expenses	75.7		74.9	
Depreciation and amortization	12.2		10.3	
Provision for bad debts	2.6		4.0	
Loss on disposal of equipment, net	0.7		0.1	
Total operating expense	91.2		89.3	
Income from operations	8.8		10.7	
Other expense (income):				
Interest expense	12.1		12.1	
Loss (gain) on debt extinguishment, net	(0.5	)	1.8	
Other income	(0.1	)		
Other expense			0.7	
Total other expense	11.5		14.6	
Loss before equity in income of investee	(2.7	)	(3.9	)
Equity in income of investee				
Net loss	(2.7	)	(3.9	)

***Nine Months Ended July 31, 2005 Compared to the Nine Months Ended July 31, 2006***

During the last nine months, we continued our efforts to enhance our operations and expand our network, while improving our financial position and cash flows. Our results for the nine months ended July 31, 2006 were affected by the opening and integration of new facilities, the restructuring of our existing line of credit, notes payable and capital lease obligations, increases in capitation reimbursement and our continuing focus on controlling operating expenses. As a result of these factors and the other matters discussed below, we experienced an increase in income from operations of \$3.3 million, but due to a increases in interest expense, a legal settlement and costs related to our debt restructuring, we also increased our net loss by \$1.7 million for the nine months ended July 31, 2006 when compared to the same period last year.

We had a working capital deficit of \$557,000 at July 31, 2006 compared to a \$143.4 million deficit at October 31, 2005, and had losses from operations of \$4.6 million and \$2.8 million for the nine months ended July 31, 2006 and 2005, respectively. We also had a stockholders' deficit of \$74.6 million at July 31, 2006 compared to a \$70.6 million deficit at October 31, 2005.

The working capital deficit as of October 31, 2005 included the reclassification of approximately \$109 million in notes and capital lease obligations as current liabilities expected to be refinanced. We were subject to financial covenants under our debt agreements and believed we may have been unable to continue to be in compliance with our existing financial covenants during fiscal 2006. As such, the associated debt was reclassified as a current liability.

Effective March 9, 2006, we completed the issuance of a \$161 million senior secured credit facility that we used to refinance substantially all of our existing indebtedness (except for \$16.1 million of outstanding subordinated debentures and approximately \$5 million of capital lease obligations). We incurred fees and expenses for the transaction of approximately \$5.6 million. Debt issue costs are being amortized on a straight-line basis over 65 months and are included in other assets. In addition, we recorded a net loss on extinguishments of debt of \$2.1 million, which includes \$1.2 million in pre-payment penalty fees that are unpaid as of July 31, 2006 and classified as accrued expenses under



current liabilities. The facility provides for a \$15 million five-year revolving credit facility, an \$86 million term loan due in five years and a \$60 million second lien term loan due in six years. The loans are subject to acceleration on December 27, 2007, unless we have made arrangements to discharge or extend our outstanding subordinated debentures by that date. We intend to retire the subordinated debentures prior to their due date of June 30, 2008. Under the terms and conditions of the new Second Lien Term Loan, subject to achieving certain leverage ratios, we have the right to raise up to \$16.1 million in additional funds as part of the Second Lien Term Loan for the purposes of redeeming the subordinated debentures. Additionally, under the current facilities, we have the ability to pursue other funding sources to refinance the subordinated debentures. The new loans are payable interest only monthly except for the \$86 million term loan that requires amortization payments of 1.0% per annum, or \$860,000, paid quarterly.

On July 6, 2006, Primedex entered into an agreement and plan of merger for the acquisition of Radiologix, Inc. by Primedex through the merger of a wholly-owned subsidiary of Primedex with and into Radiologix. Upon successful completion of the merger, Radiologix stockholders will receive a combination of cash and Primedex common stock in exchange for their shares of Radiologix common stock. Pursuant to the merger, Radiologix stockholders will receive aggregate consideration of 22,621,922 shares of Primedex common stock and \$42,950,000 in cash. Based upon the August 17, 2006 closing price of Primedex common stock of \$1.57, each Radiologix stockholder would receive \$1.85 in cash for each Radiologix share, plus one share of Primedex common stock for total consideration valued at \$3.42 per share. The merger agreement also provides Primedex the option to elect to reduce the share consideration by up to 3.5 million shares and to increase the cash consideration by \$2 per share, provided that Primedex advises Radiologix of its election prior to the mailing of the proxy statement. Upon completion of the merger, we estimate that, subject to adjustment as described above, Radiologix's former stockholders will own approximately 34.9% of the then-outstanding shares of Primedex common stock, based on the number of shares of Radiologix and Primedex common stock outstanding on August 17, 2006. Primedex's stockholders will continue to own their existing shares. In connection with the proposals set forth in this joint proxy statement/prospectus, Primedex stock may be subject to transfer restrictions which are necessary to preserve Primedex's unrestricted use of its net operating loss carry-forwards.

Primedex has signed a commitment letter with GE Commercial Finance Healthcare Financial Services for a \$405 million senior secured credit facility. The facility is expected to be used to finance the merger, to refinance existing indebtedness, to pay transaction costs and expenses relating to the merger and the credit facility and to provide financing for working capital needs post-merger. Consummation of the financing is a condition to the closing of the merger. The facility will consist of a revolving credit facility of up to \$45 million, a \$225 million term loan and a \$135 million second lien term loan. The revolving credit facility will have a term of five years, the term loan will have a term of six years and the second lien term loan will have a term of six and one-half years. Interest is payable on all loans initially at an Index Rate plus the Applicable Index Margin, as defined. The Index Rate is initially a floating rate equal to the higher of the rate quoted from time to time by The Wall Street Journal as the base rate on corporate loans posted by at least 75% of the nation's largest 30 banks or the Federal Funds Rate plus 50 basis points. The Applicable Index Margin on each the revolving credit facility and the term loan is 2% and on the second lien term loan is 6%. Primedex may, after a certain period, request that the interest rate instead be based on LIBOR plus the Applicable LIBOR Margin, which is 3.5% for the revolving credit facility and the term loan and 7.5% for the second lien term loan. It is anticipated that the credit facility will include customary covenants for a facility of this type, including minimum fixed charge coverage ratio, maximum total leverage ratio, maximum senior leverage ratio, limitations on indebtedness, contingent obligations, liens, capital expenditures, lease obligations, mergers and acquisitions, asset sales, dividends and distributions, redemption or repurchase of equity interests, subordinated debt payments and modifications, loans and investments, transactions with affiliates, changes of control, and payment of consulting and management fees. The credit facility will contain such conditions to funding as are customary for senior secured facilities of this type.

### ***Net Revenue***

Net revenue for the nine months ended July 31, 2006 was \$118.5 million compared to \$105.5 million for the same period in fiscal 2005, an increase of approximately \$13.0 million, or 12.3%.

In addition to new capitation contracts, we have continued to improve our yield from capitation as a result of contractual and negotiated increases in reimbursement coupled with improved collections of co-payments from the individual patients. For the nine months ended July 31, 2006 and 2005, net capitation revenue, including co-payments, was \$32.1 million and \$27.8 million, respectively, an increase of approximately \$4.3 million. In addition, net revenue increased for the nine months ended July 31, 2006 due to increased marketing efforts, new contracts, maturing centers, pull-through or referred business from expanding capitation arrangements, expansion of existing facilities and new satellite locations.

During the nine months ended July 31, 2006, the largest net revenue increases were at the Temecula and Tarzana facilities with combined increases of approximately \$5.5 million when comparing results with the same period last year. Tarzana's continued growth is due to hiring of key physicians in the region, the location of the facilities, the increased utilization of PET, increased marketing efforts and state of the art medical equipment. The Temecula facilities' continued growth is due to a variety of factors including their physical locations, the return of a large capitation agreement,



improvements in contracted reimbursement, the opening of additional satellite facilities, the ramp-up of the Murrieta site which opened in December 2004, and increases in patient volume and throughput.

The largest net revenue decrease was at the Beverly Hills facilities with a decrease of approximately \$0.8 million when comparing results with the same period last year. The decrease was due to increased competition in the area.

### ***Operating Expenses***

Operating expenses for the nine months ended July 31, 2006 increased approximately \$9.6 million from \$96.2 million during the nine months ended July 31, 2005 to \$105.8 million during the same period this year.

The following table sets forth our operating expenses for the nine months ended July 31, 2005 and 2006 (dollars in thousands):

	<b>Nine Months Ended July 31,</b>	
	<b>2005</b>	<b>2006</b>
Salaries and professional reading fees	\$ 49,122	\$ 55,719
Building and equipment rental	5,837	6,325
General administrative expenses	24,833	26,657
<b>Total operating expenses</b>	<b>79,792</b>	<b>88,701</b>
Depreciation and amortization	12,905	12,175
Provision for bad debt	2,789	4,739
Loss (gain) on disposal of equipment, net	698	210

- ***Salaries and professional reading fees***

Salaries and professional reading fees increased \$6.6 million, or 13.4%, for the nine months ended July 31, 2006 when compared to the same period last year. The majority of the increase is due to the \$13.0 million, or 12.3%, increase in net revenue that included the variable labor necessary to service the additional patient volume, the additional locations, and the compensation to physicians with contracted fees based upon a percentage of net revenue. During the third quarter of fiscal 2006, we incurred approximately \$500,000 in additional salaries for several physicians and supporting operational staff that we and BRMG hired in advance of several new acquisitions scheduled to open in the fourth quarter (see Note 6). In addition, during the nine months ended July 31, 2006, we recorded stock-based compensation expense of \$345,000 for the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense included compensation expense for share-based payment awards granted prior to, but not yet vested as of October 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123. No stock-based compensation expense was recognized in the nine months ended July 31, 2005.

- ***Building and equipment rental***

Building and equipment rental expenses increased \$0.5 million for the nine months ended July 31, 2006 when compared to the same period last year. The increase is primarily due to the additional of building rental expense for the new centers in Emeryville, Westlake and additional satellite facilities coupled with annual increases in base rentals from previously existing leased facilities.

- ***General and administrative expenses***

General and administrative expenses include billing fees, medical supplies, office supplies, repairs and maintenance, insurance, business tax and license, outside services, utilities, marketing, travel and other expenses. Many of these expenses are variable in nature. These expenses increased \$1.8 million during the nine months ended July 31, 2006 when compared to the same period last year. The increase is primarily due to the \$13.0 million increase in net revenue and the related variable general and administrative expenses necessary to service the additional patient volume, and other expenses that are based upon a percentage of net revenue, including equipment maintenance. The equipment maintenance agreement fees increased from 3.50% of net revenue in fiscal 2005 to 3.62% of net revenue in fiscal 2006.



- ***Depreciation and Amortization***

Depreciation and amortization decreased by \$0.7 million for the nine months ended July 31, 2006 when compared to the same period last year. At July 31, 2005, net property and equipment was \$71.0 million compared to \$62.8 million at July 31, 2006.

- ***Provision for bad debt***

The \$1.9 million increase in the provision for bad debt for the nine months ended July 31, 2006 when compared to the same period last year was primarily a result of increased revenue coupled with a change in timing of writing off older accounts receivable.

- ***Loss on disposal of equipment, net***

The \$0.2 million loss on the disposal of equipment for the nine months ended July 31, 2006 was primarily due to the write-off of \$143,000 in leasehold improvements at the Emeryville facility which was closed with the opening of the new facility in the third quarter of fiscal 2006. The \$0.7 million loss on the disposal of equipment for the nine months ended July 31, 2005 was primarily due to the trade-in of an MRI and replacing the equipment with an enhanced machine which improved throughput and volume demands at one of our Tarzana facilities.

***Interest expense***

Interest expense for the nine months ended July 31, 2006 increased \$1.6 million when compared to the same period last year. The increase was primarily due to the restructuring of our line of credit, notes payable and capital lease obligations in March 2006 and the financing of an additional \$5.6 million in transaction fees coupled with a slightly higher weighted average interest rate during the period. During the nine months ended July 31, 2006, we incurred a mark to market interest expense adjustment of approximately \$0.4 million. As part of the refinancing, we were required to swap at least 50% of the aggregate principal amount of the facilities to a floating rate within 90 days of the close of the agreement on March 9, 2006. On April 11, 2006, effective April 28, 2006, on \$73.0 million (one half of our First and Second Lien Term Loans of \$146.0 million), we entered into an interest rate swap fixing the LIBOR rate of interest at 5.47% for a period of three years. Previously, the interest rate on the \$73.0 million was based upon a spread over LIBOR which floats with market conditions.

***Loss (gain) on debt extinguishments, net***

In the nine months ended July 31, 2005, we recognized gains from extinguishments of debt for \$0.5 million for the write-off of certain notes payable past statute for \$475,000 and the settlement of other notes payable at a discount of \$40,000. During the nine months ended July 31, 2006, due to the March 2006 debt restructuring, we recognized a net loss on extinguishment of debt of \$2.1 million that is comprised of a gain of \$2.1 million for a discount on notes payable, offset by \$2.1 million in pre-payment penalties and \$2.1 million for the write-off of capitalized debt issue costs.

***Other Income***

In the nine months ended July 31, 2005, we earned other income of \$0.2 million. During the nine months ended July 31, 2005, we recognized gains from write-off of liabilities previously expensed in fiscal 2004 for approximately \$62,000, deferred rental income of \$67,000, and record copy income of \$44,000. We had no other income during the nine months ended July 31, 2006.



*Other Expense*

In the nine months ended July 31, 2005 and 2006, we incurred other expense of \$25,000 and \$0.8 million, respectively. During the nine months ended July 31, 2005, we recognized losses on the write-off of other assets of \$25,000. During the nine months ended July 31, 2006, we recorded expenses of \$788,000 that include the \$500,000 settlement with Broadstream and related legal fees.

*Equity in Income of Investee*

In the nine months ended July 31, 2006, we earned income for our 47.5% investment in a PET center of approximately \$61,000. The investment of \$237,000 was made in February 2006.

**Results of Operations**

The following table sets forth, for the periods indicated, the percentage certain items in the statement of operations bears to net revenue.

	Three months ended July 31,			
	2005	%	2006	%
Net revenue	100.0	%	100.0	%
Operating expenses:				
Operating expenses	74.1		74.6	
Depreciation and amortization	11.7		10.1	
Provision for bad debts	2.6		5.0	
Loss on disposal of equipment, net			0.5	
Total operating expense	88.4		90.2	
Income from operations	11.6		9.8	
Other expense (income):				
Interest expense	11.8		13.4	
Other income	(0.1)	)		
Total other expense	11.7		13.4	
Loss before equity in income of investee	(0.1)	)	(3.6)	)
Equity in income of investee			0.1	
Net loss	(0.1)	)	(3.5)	)

***Three Months Ended July 31, 2005 Compared to the Three Months Ended July 31, 2006******Net Revenue***

Net revenue for the three months ended July 31, 2006 was \$40.3 million compared to \$36.2 million for the same period in fiscal 2005, an increase of approximately \$4.2 million, or 11.5%.

In addition to new capitation contracts, we have continued to improve our yield from capitation as a result of contractual and negotiated increases in reimbursement coupled with improved collections of co-payments from the individual patients. For the three months ended July 31, 2006 and 2005, net capitation revenue, including co-payments, was \$10.6 million and \$9.6 million, respectively, an increase of approximately \$1.0 million. In addition, net revenue increased for the three months ended July 31, 2006 due to increased marketing efforts, new contracts, maturing centers, pull-through or referred business from expanding capitation arrangements and the expansion of existing facilities.

During the three months ended July 31, 2006, the largest net revenue increase was at the Temecula facilities that increased approximately \$0.8 million when comparing results with the same period last year. The Temecula facilities continued growth is due to a variety of factors including their physical locations, the return of a large capitation agreement, improvements in contracted reimbursement, the opening of additional satellite facilities, the ramp-up of the Murrieta site which opened in December 2004, and increases in patient volume and throughput.

The largest decrease in net revenue was at the Beverly Hills facilities which when combined decreased approximately \$0.3 million when comparing results with the same period last year. The net revenue decrease was due to increased competition in the area.



**Operating Expenses**

Operating expenses for the three months ended July 31, 2006 increased approximately \$4.4 million from \$32.0 million in the three months ended July 31, 2005 to \$36.4 million in the same period this year. The increase included \$0.2 million for the loss on the disposal of equipment during the three months ended July 31, 2006.

The following table sets forth our operating expenses for the three months ended July 31, 2005 and 2006 (dollars in thousands):

	<b>Three Months Ended July 31,</b>	
	<b>2005</b>	<b>2006</b>
Salaries and professional reading fees	\$ 16,344	\$ 19,197
Building and equipment rental	1,949	2,117
General administrative expenses	8,497	8,791
<b>Total operating expenses</b>	<b>26,790</b>	<b>30,105</b>
Depreciation and amortization	4,243	4,071
Provision for bad debt	946	2,000
Loss on disposal of equipment, net		224

- ***Salaries and professional reading fees***

Salaries and professional reading fees increased \$2.9 million, or 17.5%, for the three months ended July 31, 2006 when compared to the same period last year. The majority of the increase is due to the \$4.2 million, or 11.5%, increase in net revenue including the variable labor necessary to service the additional patient volume and the additional satellite locations, and the compensation to physicians with contracted fees based upon a percentage of net revenue. During the third quarter of fiscal 2006, we incurred approximately \$500,000 in additional salaries for several physicians and supporting operational staff that we and BRMG hired in advance of several new acquisitions scheduled to open in the fourth quarter (see Note 6). In addition, during the three months ended July 31, 2006, we recorded stock-based compensation expense of approximately \$108,000 based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense included compensation expense for share-based payment awards granted prior to, but not yet vested as of October 31, 2005, based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123. No stock-based compensation expense was recognized in the three months ended July 31, 2005.

- ***Building and equipment rental***

Building and equipment rental expenses increased \$0.2 million for the three months ended July 31, 2006 when compared to the same period last year. The increase is primarily due to the addition of building rental expense for the new centers in Emeryville, Westlake and additional satellite facilities coupled with annual increases in base rentals from previously existing leased facilities.

- ***General and administrative expenses***

General and administrative expenses include billing fees, medical supplies, office supplies, repairs and maintenance, insurance, business tax and license, outside services, utilities, marketing, travel and other expenses. Many of these expenses are variable in nature. These expenses increased \$0.3 million for the three months ended July 31 2006 when compared to the same period last year. The increase is primarily due to the \$4.2 million increase in net revenue and the related variable general and administrative expenses necessary to service the additional patient volume, and other expenses that are based upon a percentage of net revenue, including equipment maintenance. The equipment maintenance agreement fees increased from 3.50% of net revenue in fiscal 2005 to 3.62% of net revenue in fiscal 2006.

- ***Depreciation and Amortization***

Depreciation and amortization decreased by \$0.2 million for the three months ended July 31, 2006 when compared to the same period last year. At July 31, 2005, net property and equipment was \$71.0 million compared to \$62.8 million at July 31, 2006.

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- ***Provision for bad debt***

The \$1.1 million increase in the provision for bad debt for the three months ended July 31, 2006 when compared to the same period last year was primarily a result of increased revenue coupled with a change in timing of writing off older accounts receivable.

- ***Loss on disposal of equipment, net***

The \$0.2 million net loss on the disposal of equipment for the three months ended July 31, 2006 was primarily due to the write-off of \$143,000 in leasehold improvements at the Emeryville facility which was closed with the opening of the new facility in the third quarter of fiscal 2006.

***Interest expense***

Interest expense for the three months ended July 31, 2006 increased \$1.1 million when compared to the same period last year. The increase was primarily due to the restructuring of our line of credit, notes payable and capital lease obligations in March 2006 and the financing of an additional \$5.6 million in transaction fees coupled with a slightly higher weighted average interest rate during the period. During the three months ended July 31, 2006, we incurred a mark to market interest expense adjustment of approximately \$0.4 million. As part of the refinancing, we were required to swap at least 50% of the aggregate principal amount of the facilities to a floating rate within 90 days of the close of the agreement on March 9, 2006. On April 11, 2006, effective April 28, 2006, on \$73.0 million (one half of our First and Second Lien Term Loans of \$146.0 million), we entered into an interest rate swap fixing the LIBOR rate of interest at 5.47% for a period of three years. Previously, the interest rate on the \$73.0 million was based upon a spread over LIBOR which floats with market conditions.

***Other Income***

In the three months ended July 31, 2005, we earned other income of \$42,000 including deferred rental income of \$22,000 and record copy income of \$20,000. We had no other income during the three months ended July 31, 2006.

***Equity in Income of Investee***

In the three months ended July 31, 2006, we earned income for our 47.5% investment in a PET center of approximately \$61,000. The investment of \$237,000 was made in February 2006.

## Liquidity and Capital Resources

We had a working capital deficit of \$557,000 at July 31, 2006 compared to a \$143.4 million deficit at October 31, 2005, and had losses from operations of \$4.6 million and \$2.8 million for the nine months ended July 31, 2006 and 2005, respectively. We also had a stockholders' deficit of \$74.6 million at July 31, 2006 compared to a \$70.6 million deficit at October 31, 2005.

The working capital deficit as of October 31, 2005 included the reclassification of approximately \$109 million in notes and capital lease obligations as current liabilities expected to be refinanced. We were subject to financial covenants under our debt agreements and believed we may have been unable to continue to be in compliance with our existing financial covenants during fiscal 2006. As such, the associated debt was reclassified as a current liability.

Effective March 9, 2006, we completed the issuance of a \$161 million senior secured credit facility that we used to refinance substantially all of our existing indebtedness (except for \$16.1 million of outstanding subordinated debentures and approximately \$5 million of capital lease obligations). We incurred fees and expenses for the transaction of approximately \$5.6 million. Debt issue costs are being amortized on a straight-line basis over 65 months and are included in other assets. In addition, we recorded a net loss on extinguishments of debt of \$2.1 million, which includes \$1.2 million in pre-payment penalty fees that are unpaid as of July 31, 2006 and classified as accrued expenses under current liabilities. The facility provides for a \$15 million five-year revolving credit facility, an \$86 million term loan due in five years and a \$60 million second lien term loan due in six years. The loans are subject to acceleration on December 27, 2007, unless we have made arrangements to discharge or extend our outstanding subordinated debentures by that date. We intend to retire the subordinated debentures prior to their due date of June 30, 2008. Under the terms and conditions of the new Second Lien Term Loan, subject to achieving certain leverage ratios, we have the right to raise up to \$16.1 million in additional funds as part of the Second Lien Term Loan for the purposes of redeeming the subordinated debentures. Additionally, under the current facilities, we have the ability to pursue other funding sources to refinance the subordinated debentures. The new loans are payable interest only monthly except for the \$86 million term loan that requires amortization payments of 1.0% per annum, or \$860,000, paid quarterly.

The revolving credit facility and the \$86 million term loan bear interest at a base rate (base rate means corporate loans posted by at least 75% of the nation's 30 largest banks as quoted by the Wall Street Journal) plus 2.5%, or at our election, the LIBOR rate plus 4.0% per annum, payable monthly. The \$60 million second lien term loan bears interest at the base rate plus 7.0%, or at our election, the LIBOR rate plus 8.5% per annum, payable monthly. The \$86 million term loan includes amortization payments of 1.0% per annum, payable in quarterly installments of \$215,000. Upon the close of the refinancing on March 9, 2006, we utilized approximately \$1.5 million of the new \$15 million revolving credit facility.

As part of the refinancing, we were required to swap at least 50% of the aggregate principal amount of the facilities to a floating rate within 90 days of the close of the agreement on March 9, 2006. On April 11, 2006, effective April 28, 2006, on \$73.0 million (one half of our First and Second Lien Term Loans of \$146.0 million), we entered into an interest rate swap fixing the LIBOR rate of interest at 5.47% for a period of three years. Previously, the interest rate on the \$73.0 million was based upon a spread over LIBOR which floats with market conditions. In addition, as a requirement of the deal, 75% of our excess cash flow is to be used to repay principal on the \$86 million term loan once per year within 105 days after our fiscal year end. Excess cash flow is defined as earnings before interest, taxes, depreciation and amortization plus decreases in working capital and extraordinary gains minus: (i) capital expenditures; (ii) interest expense; (iii) scheduled principal payments on existing debt; (iv) income taxes; (v) increases in working capital; (vi) extraordinary losses; (vii) voluntary prepayments of the \$86 million term loan; (viii) and amounts paid for acquisitions.

Under the new facility, we are subject to various financial covenants including a limitation on capital expenditures, maximum days sales outstanding, minimum fixed charge coverage ratio, maximum leverage ratio and maximum senior leverage ratio. Availability under our \$15 million revolving credit facility is governed by the margins calculated under the maximum senior leverage ratio and maximum total leverage ratio covenants. As of July 31, 2006, we had approximately \$8.1 million of availability based upon our borrowing base formula.

During the second quarter of fiscal 2006, Howard G. Berger, M.D., our president, director and largest shareholder had outstanding advances to us of \$2,605,000. Our obligation to Dr. Berger was repaid as part of our March 9, 2006 refinancing.

On July 6, 2006, Primedex entered into an agreement and plan of merger for the acquisition of Radiologix, Inc. by Primedex through the merger of a wholly-owned subsidiary of Primedex with and into Radiologix. Upon successful completion of the merger, Radiologix stockholders will receive a combination of cash and Primedex common stock in exchange for their shares of Radiologix common stock. Pursuant to the merger, Radiologix stockholders will receive aggregate consideration of 22,621,922 shares of Primedex common stock and \$42,950,000 in cash. Based

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upon the August 17, 2006 closing price of Primedex common stock of \$1.57, each Radiologix stockholder would receive \$1.85 in cash for each Radiologix share, plus one share of Primedex common stock for total consideration valued at \$3.42 per share. The merger agreement also provides Primedex the option to elect to reduce the share consideration by up to 3.5

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million shares and to increase the cash consideration by \$2 per share, provided that Primedex advises Radiologix of its election prior to the mailing of the proxy statement. Upon completion of the merger, we estimate that, subject to adjustment as described above, Radiologix's former stockholders will own approximately 34.9% of the then-outstanding shares of Primedex common stock, based on the number of shares of Radiologix and Primedex common stock outstanding on August 17, 2006. Primedex's stockholders will continue to own their existing shares. In connection with the proposals set forth in this joint proxy statement/prospectus, Primedex stock may be subject to transfer restrictions which are necessary to preserve Primedex's unrestricted use of its net operating loss carry-forwards.

Primedex has signed a commitment letter with GE Commercial Finance Healthcare Financial Services for a \$405 million senior secured credit facility. The facility is expected to be used to finance the merger, to refinance existing indebtedness, to pay transaction costs and expenses relating to the merger and the credit facility and to provide financing for working capital needs post-merger. Consummation of the financing is a condition to the closing of the merger. The facility will consist of a revolving credit facility of up to \$45 million, a \$225 million term loan and a \$135 million second lien term loan. The revolving credit facility will have a term of five years, the term loan will have a term of six years and the second lien term loan will have a term of six and one-half years. Interest is payable on all loans initially at an Index Rate plus the Applicable Index Margin, as defined. The Index Rate is initially a floating rate equal to the higher of the rate quoted from time to time by The Wall Street Journal as the base rate on corporate loans posted by at least 75% of the nation's largest 30 banks or the Federal Funds Rate plus 50 basis points. The Applicable Index Margin on each the revolving credit facility and the term loan is 2% and on the second lien term loan is 6%. Primedex may, after a certain period, request that the interest rate instead be based on LIBOR plus the Applicable LIBOR Margin, which is 3.5% for the revolving credit facility and the term loan and 7.5% for the second lien term loan. It is anticipated that the credit facility will include customary covenants for a facility of this type, including minimum fixed charge coverage ratio, maximum total leverage ratio, maximum senior leverage ratio, limitations on indebtedness, contingent obligations, liens, capital expenditures, lease obligations, mergers and acquisitions, asset sales, dividends and distributions, redemption or repurchase of equity interests, subordinated debt payments and modifications, loans and investments, transactions with affiliates, changes of control, and payment of consulting and management fees. The credit facility will contain such conditions to funding as are customary for senior secured facilities of this type.

We operate in a capital intensive, high fixed-cost industry that requires significant amounts of capital to fund operations. In addition to operations, we require significant amounts of capital for the initial start-up and development expense of new diagnostic imaging facilities, the acquisition of additional facilities and new diagnostic imaging equipment, and to service our existing debt and contractual obligations. Because our cash flows from operations have been insufficient to fund all of these capital requirements, we have depended on the availability of financing under credit arrangements with third parties. Historically, our principal sources of liquidity have been funds available for borrowing under our existing lines of credit, now with General Electric Capital Corporation. We finance the acquisition of equipment mainly through capital and operating leases. As of July 31, 2006 and October 31, 2005, our line of credit liabilities were \$6.9 million and \$13.3 million, respectively.

The interim disclosures regarding liquidity and capital resources should be read in conjunction with the consolidated financial statements and related notes thereto contained in our Annual Report of Form 10-K for the year ended October 31, 2005.

Our business strategy with regard to operations will focus on the following:

- Maximizing performance at our existing facilities;
- Focusing on profitable contracting;
- Expanding MRI and CT applications
- Optimizing operating efficiencies; and
- Expanding our networks.

Our ability to generate sufficient cash flow from operations to make payments on our debt and other contractual obligations will depend on our future financial performance. A range of economic, competitive, regulatory, legislative and business factors, many of which are outside of our

control, will affect our financial performance. Taking these factors into account, including our historical experience and our discussions with our lenders to date, although no assurance can be given, we believe that through implementing our strategic plans and continuing to restructure our financial obligations, we will obtain sufficient cash to satisfy our obligations as they become due in the next twelve months.

*Sources and Uses of Cash*

During the nine months ended July 31, 2005, cash increased \$1,000. There was no change in cash during the nine months ended July 31, 2006.

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Cash provided by operating activities for the nine months ended July 31, 2006 was \$4.6 million compared to \$6.8 million for the same period in 2005, a decrease of \$2.2 million. The primary reasons for the decrease in cash provided by operating activities was due to increases in other current and noncurrent assets, including deposits on medical equipment, and reductions in accounts payable and accrued expenses during the nine months ended July 31, 2006.

Cash used by investing activities for the nine months ended July 31, 2006 was \$6.3 million compared to \$2.8 million for the same period in 2005. For the nine months ended July 31, 2006 and 2005, we purchased property and equipment for approximately \$6.0 million and \$2.8 million, respectively. During the nine months ended July 31, 2005, we received proceeds from the sale of equipment of \$65,000. During the nine months ended July 31, 2006, we invested \$0.2 million in a PET center.

Cash provided by financing activities for the nine months ended July 31, 2006 was \$1.6 million. Cash used for financing activities for the nine months ended July 31, 2005 was \$4.1 million. For fiscal 2006 and 2005, we made principal payments on capital leases and notes payable of \$6.1 million and \$9.6 million, respectively, increased our cash disbursements in transit by \$2.3 million and \$1.3 million, respectively, and received proceeds from borrowings on lines of credit and notes payable of approximately \$5.6 million and \$5.3 million, respectively. In addition, as part of the March 2006 debt restructuring, we repaid existing debt of \$141.2 million and debt issue costs of \$5.6 million with proceeds from borrowings on notes payable of \$146.5 million and cash. During the nine months ended July 31, 2006, we received proceeds from the issuance of common stock of \$182,000 and from the sale of equipment of \$15,000. During the nine months ended July 31, 2005, we made payments on lines of credit of \$2.4 million and received proceeds from borrowings from related parties of \$1.4 million.

#### **Contractual Commitments**

Our future obligations for notes payable, equipment under capital leases, lines of credit, subordinated debentures, equipment and building operating leases and purchase and other contractual obligations for the next five years and thereafter as of July 31, 2006 include (dollars in thousands):

<b>For the twelve months ended July 31,</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>There- after</b>	<b>Total</b>
Notes payable	\$ 873	\$ 145,100	\$ 14	\$ 14	14	34	\$ 146,049
Capital leases*	2,256	1,613	1,543	699	145		6,256
Line of credit		6,868					6,868
Subordinated debentures		16,147					16,147
Operating leases(1)	8,415	7,813	7,572	7,431	7,352	60,763	99,346
Purchase obligations(2)	625						625
<b>Total(3)</b>	<b>\$ 12,169</b>	<b>\$ 177,541</b>	<b>\$ 9,129</b>	<b>\$ 8,144</b>	<b>\$ 7,511</b>	<b>\$ 60,797</b>	<b>\$ 275,291</b>

- Includes interest.

(1) Includes all existing options to extend lease terms.

(2) Includes a three-year obligation to purchase imaging film from Fuji. We must purchase an aggregate of \$7.5 million of film at a rate of approximately \$2.5 million per year over the term of the agreement.

(3) Does not include our obligation under our maintenance agreement with GE Medical Systems described below.

In addition, we have an arrangement with GE Medical Systems under which it has agreed to be responsible for the maintenance and repair of the majority of our equipment for a fee that is based upon a percentage of our revenue, subject to a minimum payment. Net revenue is reduced by

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the provision for bad debt, mobile PET revenue and other professional reading service revenue to obtain adjusted net revenue. The fiscal 2005 annual service fee was the higher of 3.50% of our adjusted net revenue, or \$4,970,000. The fiscal 2006 annual service rate is the higher of 3.62% of our adjusted net revenue, or \$5,393,800. For the fiscal years 2007, 2008 and 2009, the annual service fee will be the higher of 3.62% of our adjusted net revenue, or \$5,430,000. We believe this framework of basing service costs on usage is an effective and unique method for controlling our overall costs on a facility-by-facility basis.

### **Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements reflect, among other things, management's current expectations and anticipated results of

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operations, all of which are subject to known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements, or industry results, to differ materially from those expressed or implied by such forward-looking statements. Therefore, any statements contained herein that are not statements of historical fact may be forward-looking statements and should be evaluated as such. Without limiting the foregoing, the words believes, anticipates, plans, intends, will, expects, should and similar words and expressions are intended to identify forward-looking statements. Except as required under the federal securities laws or by the rules and regulations of the SEC, we assume no obligation to update any such forward-looking information to reflect actual results or changes in the factors affecting such forward-looking information. The factors included in Risks Relating to Our Business, among others, could cause our actual results to differ materially from those expressed in, or implied by, the forward-looking statements.

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

- our ability to integrate our business with the Radiologix business and achieve expected synergies from the merger;
  - economic, competitive, demographic, business and other conditions in our markets;
  - a decline in patient referrals;
  - changes in the rates or methods of third-party reimbursement for diagnostic imaging services;
  - the enforceability or termination of our contracts with radiology practices;
  - the availability of additional capital to fund capital expenditure requirements;
  - burdensome lawsuits against our contracted radiology practices and us;
  - reduced operating margins due to our managed care contracts and capitated fee arrangements;
  - any failure on our part to comply with state and federal anti-kickback and anti-self-referral laws or any other applicable healthcare regulations;
  - our substantial indebtedness, debt service requirements and liquidity constraints;
  - the interruption of our operations in certain regions due to earthquake or other extraordinary events;
  - the recruitment and retention of technologists by us or by radiologists of our contracted radiology groups;
- and
- other factors discussed in the Risk Factors section or elsewhere in this report.

All future written and verbal forward-looking statements attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. In light of these risks, uncertainties and assumptions, the forward-looking events discussed in this report might not occur.

#### **Risks Relating to the Merger**

*Our failure to integrate Radiologix successfully and on a timely basis into our operations could reduce our profitability.*

We expect that the acquisition of Radiologix will result in some synergies, business opportunities and growth prospects. We may, however, never realize these expected synergies, business opportunities and growth prospects. We may experience increased competition that limits our ability to expand our business, we may not be able to capitalize on expected business opportunities, assumptions underlying estimates of expected cost savings may be inaccurate, or general industry and business condition may deteriorate. In addition, integrating operations will require significant efforts and expenses on the part of both us and Radiologix. Personnel may leave or be terminated because of the merger. Our management may have its attention diverted while trying to integrate Radiologix. If these factors limit our ability to integrate the operations of Radiologix successfully or on a timely basis, our expectations of future results of operations, including certain cost savings and synergies expected to result from the merger, may not be met. In addition, our growth and operating strategies for Radiologix's business may be different from the strategies that Radiologix currently is pursuing. If our strategies are not the proper strategies for Radiologix, it could have a material adverse effect on the business, financial condition and results of operations of the combined company.

*The merger is subject to closing conditions that, if not satisfied or waived, will result in the merger not being completed which may cause the market price of our common stock to decline.*

The merger is subject to customary conditions to closing, including the receipt of required approvals of the stockholders of Radiologix and us. If any condition to the merger is not satisfied or, if permissible, waived, the merger will not be completed. In addition, we and Radiologix may terminate the merger agreement in certain circumstances. If we or Radiologix do not complete the merger, the market price of our common stock may fluctuate to the extent that the current market prices of those shares reflect a market assumption that the merger will be completed. We will also be obligated to pay investment banking, financing, legal and accounting fees and related expenses in connection with the

merger, whether or not the merger is completed. In addition we have diverted significant management resources in an effort to complete the merger and are subject to restrictions contained in the merger agreement on the conduct of our business. If the merger is not completed, we will have incurred significant costs, including the diversion of management resources, for which we received little or no benefit. Further, in specified circumstances, we may be required to pay Radiologix expenses up to \$1.0 million if the merger agreement is terminated.

***Whether or not the merger is completed, the announcement and pendency of the merger could cause disruptions in the businesses of us and Radiologix, which could have an adverse effect on their business and financial results.***

Whether or not the merger is completed, the announcement and pendency of the merger could cause disruptions in the businesses of us and Radiologix. Specifically:

- current and prospective employees may experience uncertainty about their future roles with the combined company, which might adversely affect ours and Radiologix's ability to retain key managers and other employees; and
- the attention of management of both us and Radiologix may be directed toward the completion of the merger.

#### **Risks Relating to Our Business**

***The price of our common stock has been volatile and may continue to fluctuate significantly, which may cause you to lose a significant portion of your investment.***

The market price of our common stock has been and may continue to be volatile. From June 30, 2003, to September 8, 2006, the sale price of our common stock ranged from a low of \$0.11 per share to a high of \$2.63 per share. Our common stock may continue to be subject to fluctuations as a result of a variety of factors, including factors beyond our control. These include:

- economic, competitive, demographic, business and other conditions;
- decline in patient referrals;
- changes in the rates or methods of third-party reimbursement for diagnostic imaging services;
- the enforceability or termination of our contracts with radiology practices;
- the availability of additional capital to fund capital expenditure requirements;
- burdensome lawsuits against contracted radiology practices;
- reduced operating margins due to managed care contracts and capitated fee arrangements;

- any failure to comply with state and federal anti-kickback and anti-self-referral laws or any other applicable healthcare regulations;
- the ability to meet debt service requirements and liquidity constraints in light of our substantial indebtedness;
- the recruitment and retention of technologists by us or radiologists by our contracted radiology groups; and
- general economic conditions and normal business uncertainty.

We may fail to meet the expectations of our stockholders or of analysts at some time in the future, and our stock price could decline as a result. In addition, sales of a substantial number of shares of our common stock in the public market or the appearance that these shares are available for sale could adversely affect the market price for our common stock.

*We may not be able to generate sufficient cash flow to meet our debt service obligations.*

Our ability to generate sufficient cash flow from operations to make payments on our debt and other contractual obligations will depend on our future financial performance. A range of economic, competitive, regulatory, legislative and business factors, many of which are outside of our control, will affect our financial performance. Our inability to generate sufficient cash flow to satisfy our debt and other contractual obligations would adversely impact our business, financial condition and results of operations. Effective March 9, 2006, we completed the issuance of a \$161 million senior secured credit facility that we used to refinance substantially all of our existing indebtedness (except for \$16.1 million of outstanding subordinated debentures and approximately \$5 million of capital lease obligations). The loans are subject to acceleration on December 27, 2007, unless we have made arrangements to discharge or extend our outstanding subordinated debentures by that date.

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***Our ability to generate revenue depends in large part on referrals from physicians***

A significant reduction in referrals would have a negative impact on our business. We derive substantially all of our net revenue, directly or indirectly, from fees charged for the diagnostic imaging services performed at our facilities. We depend on referrals of patients from unaffiliated physicians and other third parties who have no contractual obligations to refer patients to us for a substantial portion of the services we perform. If a sufficiently large number of these physicians and other third parties were to discontinue referring patients to us, our scan volume could decrease, which would reduce our net revenue and operating margins. Further, commercial third-party payors have implemented programs that could limit the ability of physicians to refer patients to us. For example, prepaid healthcare plans, such as health maintenance organizations, sometimes contract directly with providers and require their enrollees to obtain these services exclusively from those providers. Some insurance companies and self-insured employers also limit these services to contracted providers. These closed panel systems are now common in the managed care environment, including California. Other systems create an economic disincentive for referrals to providers outside the system's designated panel of providers. If we are unable to compete successfully for these managed care contracts, our results and prospects for growth could be adversely affected.

***Changes in third-party reimbursement rates or methods for diagnostic imaging services could result in a decline in our net revenue and negatively impact our business***

The fees charged for the diagnostic imaging services performed at our facilities are paid by insurance companies, Medicare and Medi-Cal, workers compensation, private and other payors. Any change in the rates of or conditions for reimbursement from these sources of payment could substantially reduce the amounts reimbursed to us or to our contracted radiology practices for services provided, which could have an adverse effect on our net revenue. For example, recent legislative changes in California's workers compensation rules had a negative impact on reimbursement rates for diagnostic imaging services, and federal Medicare legislation intended to take effect January 1, 2007 is expected to have a negative impact on the rates paid for MRI services.

The Deficit Reduction Act of 2005 (DRA) was approved by Congress and signed into law on February 9, 2006. The DRA provides that reimbursement for the technical component for imaging services (excluding diagnostic and screening mammography) in non-hospital based freestanding facilities will be capped at the lesser of reimbursement under the Medicare Part B physician fee schedule or the Hospital Outpatient Prospective Payment System (HOPPS) schedule. Currently, the technical component of our imaging services is reimbursed under the Part B physician fee schedule, which for certain modalities like MRI and CT, allows for higher reimbursement on average than under the HOPPS. For other imaging exams, such as x-ray and ultrasound, reimbursement under the HOPPS is greater on average. Under the DRA, we will be reimbursed at the lower of the two schedules, beginning January 1, 2007.

The DRA also codifies the reduction in reimbursement for multiple images on contiguous body parts previously announced by the Centers for Medicare and Medicaid Services (CMS). In November 2005, CMS announced that it will pay 100% of the technical component of the higher priced imaging procedure and 50% for the technical component of each additional imaging procedure involving contiguous body parts when performed in the same session. Under current methodology, Medicare pays 100% of the technical component of each procedure. This rate reduction will occur in two steps, so that the reduction will be 25% for each additional imaging procedure in 2006 and another 25% in 2007. For the twelve months ended October 31, 2005, Medicare revenue from our imaging centers represented approximately 15% of our total revenue. Of this amount, approximately 54% was from MRI and CT, the modalities affected more significantly by the reimbursement reductions. If both the HOPPS and contiguous body part reimbursement reductions contained in the DRA had been in effect during fiscal year 2005, we estimate that our revenue would have been reduced by approximately \$4.5 million.

***Pressure to control healthcare costs could have a negative impact on our results.***

One of the principal objectives of health maintenance organizations and preferred provider organizations is to control the cost of healthcare services. Managed care contracting has become very competitive, and reimbursement schedules are at or below Medicare reimbursement levels. The development and expansion of health maintenance organizations, preferred provider organizations and other managed care organizations within the geographic areas covered by our network could have a negative impact on the utilization and pricing of our services, because these organizations will exert greater control over patients' access to diagnostic imaging services, the selections of the provider of such

services and reimbursement rates for those services.

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***If BRMG or any of our other contracted radiology practices terminate their agreements with us, our business could substantially diminish***

Our relationship with BRMG is an integral part of our business. Through our management agreement, BRMG provides all of the professional medical services at 46 of our 61 facilities, contracts with various other independent physicians and physician groups to provide all of the professional medical services at most of our other facilities, and must use its best efforts to provide the professional medical services at any new facilities that we open or acquire. In addition, BRMG's strong relationships with referring physicians are largely responsible for the revenue generated at the facilities it services. Although our management agreement with BRMG runs until 2014, BRMG has the right to terminate the agreement if we default on our obligations and fail to cure the default. Also, BRMG's ability to continue performing under the management agreement may be curtailed or eliminated due to BRMG's financial difficulties, loss of physicians or other circumstances. If BRMG cannot perform its obligation to us, we would need to contract with one or more other radiology groups to provide the professional medical services at the facilities serviced by BRMG. We may not be able to locate radiology groups willing to provide those services on terms acceptable to us, if at all. Even if we were able to do so, any replacement radiology group's relationships with referring physicians may not be as extensive as those of BRMG. In any such event, our business could be seriously harmed. In addition, BRMG is party to substantially all of the managed care contracts from which we derive revenue. If we were unable to readily replace these contracts, our revenue would be negatively affected.

Except for our management agreement with BRMG, most of the agreements we, or BRMG, have with contracted radiology practices typically have terms of one year, which automatically renew unless either party delivers a non-renewal notice to the other within a prescribed period. Most of these agreements may be terminated by either party under some conditions, including, with respect to some of those agreements, the right of either party to terminate the agreement without cause upon 30 to 120 days notice.

***If our contracted radiology practices, including BRMG, lose a significant number of their radiologists, our financial results could be adversely affected.***

Recently, there has been a shortage of qualified radiologists in some of the regional markets we serve. In addition, competition in recruiting radiologists may make it difficult for our contracted radiology practices to maintain adequate levels of radiologists. If a significant number of radiologists terminate their relationships with our contracted radiology practices and those radiology practices cannot recruit sufficient qualified radiologists to fulfill their obligations under our agreements with them, our ability to maximize the use of our diagnostic imaging facilities and our financial results could be adversely affected. For example, in fiscal 2002, due to a shortage of qualified radiologists in the marketplace, BRMG experienced difficulty in hiring and retaining physicians and thus engaged independent contractors and part-time fill-in physicians. Their cost was double the salary of a regular BRMG full-time physician. Increased expenses to BRMG will impact our financial results because the management fee we receive from BRMG, which is based on a percentage of BRMG's collections, is adjusted annually to take into account the expenses of BRMG. Neither we, nor our contracted radiology practices, maintain insurance on the lives of any affiliated physicians.

***We may not be able to successfully grow our business.***

As part of our business strategy, we intend to increase our presence in California through selectively acquiring facilities, developing new facilities, adding equipment at existing facilities, and directly or indirectly through BRMG entering into contractual relationships with high-quality radiology practices.

However, our ability to successfully expand depends upon many factors, including our ability to:

- Identify attractive and willing candidates for acquisitions;
- Identify locations in existing or new markets for development of new facilities;
- Comply with legal requirements affecting our arrangements with contracted radiology practices, including California prohibitions on fee-splitting, corporate practice of medicine and self-referrals;
- Obtain regulatory approvals where necessary and comply with licensing and certification requirements applicable to our diagnostic imaging facilities, the contracted radiology practices and the physicians associated with the contracted radiology practices;
- Recruit a sufficient number of qualified radiology technologists and other non-medical personnel;
- Expand our infrastructure and management; and
- Compete effectively for the acquisition of diagnostic imaging facilities.

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***We may become subject to professional malpractice liability.***

Providing medical services subjects us to the risk of professional malpractice and other similar claims. The physicians that our contracted radiology practices employ are from time to time subject to malpractice claims. We structure our relationships with the practices under our management agreements with them in a manner that we believe does not constitute the practice of medicine by us or subject us to professional malpractice claims for acts or omissions of physicians employed by the contracted radiology practices. Nevertheless, claims, suits or complaints relating to services provided by the contracted radiology practices have been asserted against us in the past and may be asserted against us in the future. In addition, we may be subject to professional liability claims, including, without limitation, for improper use or malfunction of our diagnostic imaging equipment. We may not be able to maintain adequate liability insurance to protect us against those claims at acceptable costs or at all.

Any claim made against us that is not fully covered by insurance could be costly to defend, result in a substantial damage award against us and divert the attention of our management from our operations, all of which could have an adverse effect on our financial performance. In addition, successful claims against us may adversely affect our business or reputation. Although California places a \$250,000 limit on non-economic damages for medical malpractice cases, no limit applies to economic damages.

***Some of our imaging modalities use radioactive materials, which generate regulated waste and could subject us to liabilities for injuries or violations of environmental and health and safety laws.***

Some of our imaging procedures use radioactive materials, which generate medical and other regulated wastes. For example, patients are injected with a radioactive substance before undergoing a PET scan. Storage, use and disposal of these materials and waste products present the risk of accidental environmental contamination and physical injury. We are subject to federal, California and local regulations governing storage, handling and disposal of these materials. We could incur significant costs and the diversion of our management's attention in order to comply with current or future environmental and health and safety laws and regulations. Also, we cannot completely eliminate the risk of accidental contamination or injury from these hazardous materials. In the event of an accident, we could be held liable for any resulting damages, and any liability could exceed the limits of or fall outside the coverage of our insurance.

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

The market for diagnostic imaging services in California is highly competitive. We compete principally on the basis of our reputation, our ability to provide multiple modalities at many of our facilities, the location of our facilities and the quality of our diagnostic imaging services. We compete locally with groups of radiologists, established hospitals, clinics and other independent organizations that own and operate imaging equipment. Our major national competitors included Radiologix, Inc., Alliance Imaging, Inc., Healthsouth Corporation and Insight Health Services. Some of our competitors may now or in the future have access to greater financial resources than we do and may have access to newer, more advanced equipment.

***State and federal anti-kickback and anti-self referral laws may adversely affect income.***

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

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

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

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

The development of new technologies or refinements of existing modalities may require us to upgrade and enhance our existing equipment before we may otherwise intend. Many companies currently manufacture diagnostic imaging equipment. Competition among manufacturers for a greater share of the diagnostic imaging equipment market may result in technological advances in the speed and imaging capacity of new equipment. This may accelerate the obsolescence of our equipment, and we may not have the financial ability to acquire the new or improved equipment. In that event, we may be unable to deliver our services in the efficient and effective manner that payors, physicians and patients expect and thus our revenue could substantially decrease. During fiscal 2005, we traded-in and upgraded our existing MRI at Tarzana Advanced to increase throughput and patient volume and compete in the marketplace. We incurred a loss on disposal of equipment of approximately \$0.7 million for the upgrade.

***We have experienced operating losses and we have a substantial accumulated deficit. If we are unable to improve our financial performance, we may be unable to pay our obligations.***

We have incurred net losses of \$2.8 million and \$4.6 million during the nine months ended July 31, 2005 and 2006, respectively, and at July 31, 2006 we had an accumulated stockholders' deficit of \$74.6 million. Also, in recent periods, we have suffered liquidity shortfalls which have led us to, among other things, undertake and complete a pre-packaged Chapter 11 plan of reorganization in 2003 and modify the terms of various of our financial obligations. While we believe that by taking these and other actions in the future we be able to address these issues and solidify our financial condition, we cannot give assurances that we will be able to generate sufficient cash flow from operations to satisfy our debt obligations.

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

We operate in a capital intensive, high fixed-cost industry that requires significant amounts of capital to fund operations, particularly the initial start-up and development expenses of new diagnostic imaging facilities and the acquisition of additional facilities and new diagnostic imaging equipment. We incur capital expenditures to, among other things, upgrade and replace existing equipment for existing facilities and expand within our existing markets and enter new markets. To the extent we are unable to generate sufficient cash from our operations, funds are not available from our lenders or we are unable to structure or obtain financing through operating leases, long-term installment notes or capital leases, we may be unable to meet our capital expenditure requirements.

***Because we have high fixed costs, lower scan volumes per system could adversely affect our business.***

The principal components of our expenses, excluding depreciation, consist of compensation paid to technologists, salaries, real estate lease expenses and equipment maintenance costs. Because a majority of these expenses are fixed, a relatively small change in our revenue could have a disproportionate effect on our operating and financial results depending on the source of our revenue. Thus, decreased revenue as a result of lower scan volumes per system could result in lower margins, which would adversely affect our business.

***Our success depends in part on our key personnel and we may not be able to retain sufficient qualified personnel. In addition, former employees could use the experience and relationships developed while employed with us to compete with us.***

Our success depends in part on our ability to attract and retain qualified senior and executive management, managerial and technical personnel. Competition in recruiting these personnel may make it difficult for us to continue our growth and success. The loss of their services or our inability in the future to attract and retain management and other key personnel could hinder the implementation of our business strategy. The loss of the services of Dr. Howard G. Berger, our President and Chief Executive Officer, or Norman R. Hames, our Chief Operating Officer, could have a significant negative impact on our operations. We believe that they could not easily be replaced with executives of equal experience and capabilities. We do not maintain key person insurance on the life of any of our executive officers with the exception of a \$5.0 million policy on the life of Dr. Berger. Also, if we lose the services of Dr. Berger, our relationship with BRMG could deteriorate, which would adversely affect our business.



Unlike many other states, California does not enforce agreements that prohibit a former employee from competing with the former employer. As a result, any of our employees whose employment is terminated is free to compete with us, subject to prohibitions on the use of confidential information and, depending on the terms of the employee's employment agreement, on solicitation of existing employees and customers. A former executive, manager or other key employee who joins one of our competitors could use the relationships he or she established with third party payors, radiologists or referring physicians while our employee and the industry knowledge he or she acquired during that tenure to enhance the new employer's ability to compete with us.

***Capitation fee arrangements could reduce our operating margins.***

For the nine months ended July 31, 2006, we derived approximately 27% of our net revenue from capitation arrangements, and we intend to increase the revenue we derive from capitation arrangements in the future. Under capitation arrangements, the payor pays a pre-determined amount per-patient per-month in exchange for us providing all necessary covered services to the patients covered under the arrangement. These contracts pass much of the financial risk of providing diagnostic imaging services, including the risk of over-use, from the payor to the provider. Our success depends in part on our ability to negotiate effectively, on behalf of the contracted radiology practices and our diagnostic imaging facilities, contracts with health maintenance organizations, employer groups and other third-party payors for services to be provided on a capitated basis and to efficiently manage the utilization of those services. If we are not successful in managing the utilization of services under these capitation arrangements or if patients or enrollees covered by these contracts require more frequent or extensive care than anticipated, we would incur unanticipated costs not offset by additional revenue, which would reduce operating margins.

***We may be unable to effectively maintain our equipment or generate revenue when our equipment is not operational.***

Timely, effective service is essential to maintaining our reputation and high use rates on our imaging equipment. Although we have an agreement with GE Medical Systems pursuant to which it maintains and repairs the majority of our imaging equipment, this agreement does not compensate us for loss of revenue when our systems are not fully operational and our business interruption insurance may not provide sufficient coverage for the loss of revenue. Also, GE Medical Systems may not be able to perform repairs or supply needed parts in a timely manner. Therefore, if we experience more equipment malfunctions than anticipated or if we are unable to promptly obtain the service necessary to keep our equipment functioning effectively, our ability to provide services would be adversely affected and our revenue could decline.

***Disruption or malfunction in our information systems could adversely affect our business.***

Our information technology system is vulnerable to damage or interruption from:

- Earthquakes, fires, floods and other natural disasters;
- Power losses, computer systems failures, internet and telecommunications or data network failures, operator negligence, improper operation by or supervision of employees, physical and electronic losses of data and similar events; and

- Computer viruses, penetration by hackers seeking to disrupt operations or misappropriate information and other breaches of security.

We, and BRMG, rely on this information technology to perform functions critical to our and its ability to operate, including patient scheduling, billing, collections, image storage and image transmission. Accordingly, an extended interruption in the system's function could significantly curtail, directly and indirectly, our ability to conduct our business and generate revenue.

*Our actual financial results may vary significantly from the projections we filed with the Bankruptcy Court.*

In connection with our pre-packaged Chapter 11 plan of reorganization that was confirmed by the Bankruptcy Court on October 20, 2003, we were required to prepare projected financial information to demonstrate to the Bankruptcy Court the feasibility of the plan of reorganization and our ability to continue operations upon our emergence from bankruptcy. In the disclosure statement contained in the plan of reorganization and the exhibits thereto, the projected financial information and various estimates of value discussed therein should not be regarded as representations or warranties by us or any other person as to the accuracy of that information or that those projections or valuations will be realized. We, and our advisors, prepared the information in the disclosure statement, including the projected financial information and estimates of value. This information was not audited or reviewed by our independent accountants. The significant assumptions used in preparation of the information and estimates of value were included as an exhibit to the disclosure statement.

Those projections are not included in this report and you should not rely upon them in any way or manner. We have not updated, nor will we update, those projections. At the time we prepared the projections, they reflected numerous assumptions concerning our anticipated future performance with respect to prevailing and anticipated market and economic conditions which were and remain beyond our control and which may not materialize. Projections are inherently subject to significant and numerous uncertainties and to a wide variety of significant business, economic and competitive risks and the assumptions underlying the projections may be wrong in many material respects. Our actual results may vary significantly from those contemplated by the projections. As a result, we caution you not to rely upon those projections.

*We are vulnerable to earthquakes and other natural disasters.*

Our headquarters and all of our facilities are located in California, an area prone to earthquakes and other natural disasters. An earthquake or other natural disaster could seriously impair our operations, and our insurance may not be sufficient to cover us for the resulting losses.

*Complying with federal and state regulations is an expensive and time-consuming process, and any failure to comply could result in substantial penalties.*

We are directly or indirectly through the radiology practices with which we contract subject to extensive regulation by both the federal government and the State of California, including:

- The federal False Claims Act;
- The federal Medicare and Medicaid anti-kickback laws, and California anti-kickback prohibitions;
- Federal and California billing and claims submission laws and regulations;
- The federal Health Insurance Portability and Accountability Act of 1996;
- The federal physician self-referral prohibition commonly known as the Stark Law and the California equivalent of the Stark Law;
- California laws that prohibit the practice of medicine by non-physicians and prohibit fee-splitting arrangements involving physicians;
- Federal and California laws governing the diagnostic imaging and therapeutic equipment we use in our business concerning patient safety, equipment operating specifications and radiation exposure levels; and
- California laws governing reimbursement for diagnostic services related to services compensable under workers compensation rules.

If our operations are found to be in violation of any of the laws and regulations to which we or the radiology practices with which we contract are subject, we may be subject to the applicable penalty associated with the violation, including civil and criminal penalties, damages, fines and the curtailment of our operations. Any penalties, damages, fines or curtailment of our operations, individually or in the aggregate, could adversely affect our ability to operate our business and our financial results. The risks of our being found in violation of these laws and regulations is increased by the fact that many of them have not been fully interpreted by the regulatory authorities or the courts, and their provisions are open to a variety of interpretations. Any action brought against us for violation of these laws or regulations, even if we successfully defend against it, could cause us to incur significant legal expenses and divert our management's attention from the operation of our business. For a more detailed discussion of the various federal and California laws and regulations to which we are subject, see Business Government Regulation.

*If we fail to comply with various licensure, certification and accreditation standards, we may be subject to loss of licensure, certification or accreditation, which would adversely affect our operations.*

Ownership, construction, operation, expansion and acquisition of our diagnostic imaging facilities are subject to various federal and California laws, regulations and approvals concerning licensing of personnel, other required certificates for certain types of healthcare facilities and certain medical equipment. In addition, freestanding diagnostic imaging facilities that provide services independent of a physician's office must be enrolled by Medicare as an independent diagnostic testing facility to bill the Medicare program. Medicare carriers have discretion in applying the independent diagnostic testing facility requirements and therefore the application of these requirements may vary from jurisdiction to jurisdiction. We may not be able to receive the required regulatory approvals for any future acquisitions, expansions or replacements, and the failure to obtain these approvals could limit the opportunity to expand our services.

Our facilities are subject to periodic inspection by governmental and other authorities to assure continued compliance with the various standards necessary for licensure and certification. If any facility loses its certification under the Medicare program, then the facility will be ineligible to receive reimbursement from the Medicare and

Medi-Cal programs. For the nine months ended July 31, 2006, approximately 18% of our net revenue came from the Medicare and Medi-Cal programs. A change in the applicable certification status of one of our facilities could adversely affect our other facilities and in turn us as a whole.

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

California law prohibits us from exercising control over the medical judgments or decisions of physicians and from engaging in certain financial arrangements, such as splitting professional fees with physicians. These laws are enforced by state courts and regulatory authorities, each with broad discretion. A component of our business has been to enter into management agreements with radiology practices. We provide management, administrative, technical and other non-medical services to the radiology practices in exchange for a service fee typically based on a percentage of the practice's revenue. We structure our relationships with the radiology practices, including the purchase of diagnostic imaging facilities, in a manner that we believe keeps us from engaging in the practice of medicine or exercising control over the medical judgments or decisions of the radiology practices or their physicians or violating the prohibitions against fee-splitting. However, because challenges to these types of arrangements are not required to be reported, we cannot substantiate our belief. There can be no assurance that our present arrangements with BRMG or the physicians providing medical services and medical supervision at our imaging facilities will not be challenged, and, if challenged, that they will not be found to violate the corporate practice prohibition, thus subjecting us to potential damages, injunction and/or civil and criminal penalties or require us to restructure our arrangements in a way that would affect the control or quality of our services and/or change the amounts we receive under our management agreements. Any of these results could jeopardize our business.

***Future federal legislation could limit the prices we can charge for our services, which would reduce our revenue and adversely affect our operating results.***

In addition to extensive existing government healthcare regulation, there are numerous initiatives affecting the coverage of and payment for healthcare services, including proposals that would significantly limit reimbursement under the Medicare and Medi-Cal programs as well as recently enacted federal legislation slated to become effective January 1, 2007 which will reduce Medicare reimbursement for MRI procedures by on average 30% to 35% and CT procedures by on average 15% to 20%. Limitations on reimbursement amounts and other cost containment pressures have in the past resulted in a decrease in the revenue we receive for each scan we perform.

***The regulatory framework in which we operate is uncertain and evolving.***

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

Certain states have enacted statutes or adopted regulations affecting risk assumption in the healthcare industry, including statutes and regulations that subject any physician or physician network engaged in risk-based managed care contracting to applicable insurance laws and regulations.

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These laws and regulations, if adopted in California, may require physicians and physician networks to meet minimum capital requirements and other safety and soundness requirements. Implementing additional regulations or compliance requirements could result in substantial costs to us and the contracted radiology practices and limit our ability to enter into capitation or other risk sharing managed care arrangements.

*Our substantial debt could adversely affect our financial condition and prevent us from fulfilling our obligations.*

Our current substantial indebtedness and any future indebtedness we incur could have important consequences by adversely affecting our financial condition, which could make it more difficult for us to satisfy our obligations to our creditors. Our substantial indebtedness could also:

- Require us to dedicate a substantial portion of our cash flow from operations to payments on our debt, reducing the availability of our cash flow to fund working capital, capital expenditures and other general corporate purposes;
- Increase our vulnerability to adverse general economic and industry conditions;

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- Limit our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate;
- Place us at a competitive disadvantage compared to our competitors that have less debt; and
- Limit our ability to borrow additional funds on terms that are satisfactory to us or at all.

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### **Item 3 Quantitative and Qualitative Disclosures About Market Risk**

We sell our services exclusively in the United States and receive payment for our services exclusively in United States dollars. As a result, our financial results are unlikely to be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets.

A large portion of our interest expense is not sensitive to changes in the general level of interest in the United States because the majority of our indebtedness has interest rates that were fixed when we entered into the note payable or capital lease obligation. As part of the refinancing, we were required to swap at least 50% of the aggregate principal amount of the facilities to a floating rate within 90 days of the close of the agreement on March 9, 2006. On April 11, 2006, effective April 28, 2006, on \$73.0 million (one half of our First and Second Lien Term Loans of \$146.0 million), we entered into an interest rate swap fixing the LIBOR rate of interest at 5.47% for a period of three years. Previously, the interest rate on the \$73.0 million was based upon a spread over LIBOR which floats with market conditions. In addition, our credit facility, classified as a long-term liability on our financial statements, is interest expense sensitive to changes in the general level of interest because it is based upon the current prime rate plus a factor.

### **Item 4 Controls and Procedures**

As of the end of the period covered by this report, we performed an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)). Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were not effective in alerting them prior to the end of a reporting period to all material information required to be included in our periodic filings with the SEC because we identified the following material weakness in the design of internal controls over financial reporting. We concluded that we had insufficient personnel resources and technical accounting expertise within the accounting function to resolve the following non-routine accounting matters, the recording of non-typical cost-based investments and unusual debt-related transactions and the appropriate analysis of the amortization lives of leasehold improvements in accordance with generally accepted accounting principles. The incorrect accounting for the foregoing was sufficient to lead management to conclude that a material weakness in the design of internal controls over the accounting for non-routine transactions existed at October 31, 2005.

Subsequent to October 31, 2005, we determined to change the design of our internal controls over non-routine accounting matters by the identification of an outside resource at a recognized professional services company that we can consult with on non-routine transactions or the employment of qualified accounting personnel to deal with this issue together with the utilization of other senior corporate accounting staff, who are responsible for reviewing all non-routine matters and preparing formal reports on their conclusions, and conducting quarterly reviews and discussions of all non-routine accounting matters with our independent public accountants. On August 1, 2006, we entered into an agreement with MorganFranklin Corporation, a professional service company with the requisite accounting expertise that is capable of providing the necessary consulting services which we believe addresses the identified weakness. We engaged MorganFranklin to assist us, from time to time, in the evaluation and application of the appropriate accounting treatment, to provide support in the form of technical analysis related to accounting and financial reporting matters that may arise, and to provide management advice with respect to their preliminary conclusions regarding issues we wish to bring to their attention. To the extent our Chief Financial Officer identifies any non-routine accounting matters which require resolution, he will contact MorganFranklin and work closely with them, our audit committee and our auditors to resolve any issues. We are continuing to evaluate additional controls and procedures that we can implement and may add additional accounting personnel during fiscal 2006 or early fiscal 2007 to enhance our technical accounting resources. We do not anticipate



that the cost of this remediation effort will be material to our financial statements. We believe that the engagement of MorganFranklin and use of their services should adequately address the identified weakness. However, if we are able to consummate the acquisition of Radiologix, we believe that the addition of their technical accounting staff will further reduce any material weakness. We experienced no impact on our financial statements for the year ended October 31, 2005 or for the nine months ended July 31, 2006 as a result of the ineffective controls over non-routine matters.

The above identified material weakness in internal control was determined by management during our year-end audit to be a material change in our internal control over financial reporting during the quarter ended October 31, 2005.

It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system will be met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events.

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## **PART II**

### **OTHER INFORMATION**

#### **Item 1. Legal Proceedings**

We are engaged from time to time in the defense of lawsuits arising out of the ordinary course and conduct of our business. We believe that the outcome of our current litigation will not have a material adverse impact on our business, financial condition and results of operations. However, we could be subsequently named as a defendant in other lawsuits that could adversely affect us.

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

During the quarter ended July 31, 2006, we sold the following securities pursuant to an exemption from registration provided under Section 4(2) of the Securities Act of 1933, as amended:

- In June 2006, we issued to one of BRMG's radiologists a five-year warrant to purchase 50,000 shares of our common stock exercisable at a price of \$1.34 per share, which was the public market closing price for our common stock on the transaction date.
- In July 2006, we issued to one of our key employees a five-year warrant to purchase 200,000 shares of our common stock exercisable at a price of \$1.55 per share, which was the public market closing price on the transaction date.

#### **Item 3. Defaults Upon Senior Securities**

There are no matters to be reported under this heading.

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

There are no matters to be reported under this heading.

#### **Item 5. Other Information**

There are no matters to be reported under this heading.

#### **Item 6. Exhibits**

- Exhibit 10.1 Agreement dated August 1, 2006 between MorganFranklin Corporation and Primedex Health Systems, Inc.
- Exhibit 31.1 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit 31.2 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit 32.1 Certification Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- Exhibit 32.2 Certification Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002



**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.

PRIMEDEX HEALTH SYSTEMS, INC.  
(Registrant)

Date: September 28, 2006

By /s/ HOWARD G. BERGER, M.D.  
Howard G. Berger, M.D., President and Director  
(Principal Executive Officer)

Date: September 28, 2006

By /s/ MARK D. STOLPER  
Mark D. Stolper, Chief Financial Officer  
(Principal Accounting Officer)

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