

ALLIANCE IMAGING INC /DE/  
Form 10-Q  
November 09, 2006

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

For Quarter Ended: September 30, 2006

Commission File Number: 1-16609

**ALLIANCE IMAGING, INC.**

(Exact name of registrant as specified in its charter)

**DELAWARE**

(State or other jurisdiction of  
incorporation or organization)

**33-0239910**

(IRS Employer Identification Number)

**1900 South State College Boulevard  
Suite 600  
Anaheim, California 92806**  
(Address of principal executive office)

**(714) 688-7100**  
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer  Accelerated Filer  Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of October 31, 2006:

Common Stock, \$.01 par value, 49,843,683 shares



ALLIANCE IMAGING, INC.  
FORM 10-Q  
September 30, 2006  
Index

|   | Page |
|---|------|
| <u>PART I FINANCIAL INFORMATION</u>   |      |
| <u>Item 1 Financial Statements:</u>   |      |
| <u>Condensed Consolidated Balance Sheets</u>  |      |
| <u>December 31, 2005 and September 30, 2006 (Unaudited)</u>   | 3    |
| <u>Condensed Consolidated Statements of Operations and Comprehensive Income</u>                     |      |
| <u>Quarter and nine months ended September 30, 2005 and 2006 (Unaudited)</u>                        | 4    |
| <u>Condensed Consolidated Statements of Cash Flows</u>  |      |
| <u>Nine months ended September 30, 2005 and 2006 (Unaudited)</u>                                    | 5    |
| <u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>                             | 6    |
| <u>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 19   |
| <u>Item 3 Quantitative and Qualitative Disclosures about Market Risk</u>                            | 29   |
| <u>Item 4 Controls and Procedures</u>   | 30   |
| <u>PART II OTHER INFORMATION</u>  |      |
| <u>Item 1 Legal Proceedings</u>   | 31   |
| <u>Item 1A Risk Factors</u>   | 31   |
| <u>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</u>                           | 43   |
| <u>Item 3 Defaults Upon Senior Securities</u>   | 43   |
| <u>Item 4 Submission of Matters to a Vote of Security Holders</u>                                   | 43   |
| <u>Item 5 Other Information</u>   | 43   |
| <u>Item 6 Exhibits</u>  | 44   |
| <u>SIGNATURES</u>   | 47   |

**PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

**ALLIANCE IMAGING, INC**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(Unaudited)  
(in thousands)

|   | December 31,<br>2005 | September 30,<br>2006 |
|---|----------------------|-----------------------|
| <b>ASSETS</b>   |                      |                       |
| Current assets:   |                      |                       |
| Cash and cash equivalents                                   | \$ 13,421            | \$ 12,914             |
| Accounts receivable, net of allowance for doubtful accounts | 48,236               | 56,465                |
| Deferred income taxes                                       | 6,186                | 18,008                |
| Prepaid expenses and other current assets                   | 3,686                | 4,788                 |
| Other receivables   | 8,983                | 12,356                |
| Total current assets  | 80,512               | 104,531               |
| Equipment, at cost  | 752,128              | 761,356               |
| Less accumulated depreciation                               | (393,179 )           | (414,884 )            |
| Equipment, net  | 358,949              | 346,472               |
| Goodwill  | 154,656              | 154,723               |
| Other intangible assets, net                                | 39,071               | 36,985                |
| Deferred financing costs, net                               | 8,236                | 7,293                 |
| Other assets  | 33,918               | 24,264                |
| Total assets  | \$ 675,342           | \$ 674,268            |
| <b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>                 |                      |                       |
| Current liabilities:  |                      |                       |
| Accounts payable  | \$ 23,672            | \$ 12,349             |
| Accrued compensation and related expenses                   | 14,088               | 16,910                |
| Accrued interest payable                                    | 4,561                | 7,504                 |
| Income taxes payable  | 87                   |                       |
| Other accrued liabilities                                   | 29,064               | 30,728                |
| Current portion of long-term debt                           | 7,781                | 6,750                 |
| Total current liabilities                                   | 79,253               | 74,241                |
| Long-term debt, net of current portion                      | 418,260              | 383,467               |
| Senior subordinated notes                                   | 153,541              | 153,541               |
| Minority interests and other liabilities                    | 4,400                | 4,131                 |
| Deferred income taxes                                       | 60,144               | 81,096                |
| Total liabilities   | 715,598              | 696,476               |
| Commitments and contingencies (Note 11)                     |                      |                       |
| Stockholders' deficit:                                      |                      |                       |
| Common stock  | 496                  | 499                   |
| Additional paid-in deficit                                  | (11,876 )            | (8,639 )              |
| Accumulated comprehensive income                            | 3,217                | 3,027                 |
| Accumulated deficit   | (32,093 )            | (17,095 )             |
| Total stockholders' deficit                                 | (40,256 )            | (22,208 )             |
| Total liabilities and stockholders' deficit                 | \$ 675,342           | \$ 674,268            |

See accompanying notes.

**ALLIANCE IMAGING, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**AND COMPREHENSIVE INCOME**  
**(Unaudited)**  
**(in thousands, except per share amounts)**

|   | Quarter Ended         |            | Nine Months Ended     |            |
|---|-----------------------|------------|-----------------------|------------|
|   | September 30,<br>2005 | 2006       | September 30,<br>2005 | 2006       |
| Revenues  | \$ 106,198            | \$ 113,468 | \$ 320,596            | \$ 344,116 |
| Costs and expenses:   |                       |            |                       |            |
| Cost of revenues, excluding depreciation and amortization   | 55,901                | 60,163     | 163,729               | 182,621    |
| Selling, general and administrative expenses  | 11,747                | 13,669     | 37,110                | 41,037     |
| Employment agreement costs  |                       |            | 366                   |            |
| Severance and related costs   |                       |            |                       | 536        |
| Depreciation expense  | 20,385                | 20,818     | 61,311                | 62,738     |
| Amortization expense  | 937                   | 1,230      | 2,719                 | 3,703      |
| Interest expense, net of interest income  | 9,117                 | 10,053     | 27,686                | 30,343     |
| Other (income) and expense, net   | 56                    | (174)      | (331)                 | 298        |
| Total costs and expenses  | 98,143                | 105,759    | 292,590               | 321,276    |
| Income before income taxes, minority interest expense, and earnings from unconsolidated investees | 8,055                 | 7,709      | 28,006                | 22,840     |
| Income tax expense  | 3,494                 | 3,392      | 11,795                | 10,401     |
| Minority interest expense   | 550                   | 551        | 1,506                 | 1,586      |
| Earnings from unconsolidated investees  | (1,000)               | (1,129)    | (2,596)               | (4,145)    |
| Net income  | \$ 5,011              | \$ 4,895   | \$ 17,301             | \$ 14,998  |
| Comprehensive income, net of taxes:   |                       |            |                       |            |
| Net income  | \$ 5,011              | \$ 4,895   | \$ 17,301             | \$ 14,998  |
| Unrealized gain (loss) on hedging transactions, net of taxes                                      | 1,450                 | (1,311)    | 3,051                 | (190)      |
| Comprehensive income  | \$ 6,461              | \$ 3,584   | \$ 20,352             | \$ 14,808  |
| Earnings per common share:  |                       |            |                       |            |
| Basic   | \$ 0.10               | \$ 0.10    | \$ 0.35               | \$ 0.30    |
| Diluted   | \$ 0.10               | \$ 0.10    | \$ 0.34               | \$ 0.30    |
| Weighted average number of shares of common stock and common stock equivalents:                   |                       |            |                       |            |
| Basic   | 49,517                | 49,844     | 49,313                | 49,737     |
| Diluted   | 50,368                | 50,505     | 50,311                | 50,239     |

See accompanying notes.

**ALLIANCE IMAGING, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**  
**(in thousands)**

|   | <b>Nine Months Ended</b> |             |
|---|--------------------------|-------------|
|   | <b>September 30,</b>     |             |
|   | <b>2005</b>              | <b>2006</b> |
| <b>Operating activities:</b>  |                          |             |
| Net income  | \$ 17,301                | \$ 14,998   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |             |
| Provision for doubtful accounts   | 2,035                    | 2,625       |
| Non-cash share-based compensation   | 189                      | 1,965       |
| Depreciation and amortization   | 64,030                   | 66,441      |
| Amortization of deferred financing costs  | 1,834                    | 1,193       |
| Distributions greater than equity in undistributed income of investees            | 70                       | 134         |
| Deferred income taxes   | 10,838                   | 9,453       |
| (Gain) loss on sale of assets   | (331)                    | 298         |
| Changes in operating assets and liabilities:                                      |                          |             |
| Accounts receivable   | (1,558)                  | (10,922)    |
| Prepaid expenses and other current assets   | (1,249)                  | (1,102)     |
| Other receivables   | (3,951)                  | (3,373)     |
| Other assets  | (1,825)                  | (243)       |
| Accounts payable  | (3,276)                  | (11,212)    |
| Accrued compensation and related expenses   | (3,133)                  | 2,822       |
| Accrued interest payable  | 6,208                    | 2,943       |
| Income taxes payable  | (410)                    | (87)        |
| Other accrued liabilities   | 6,189                    | 1,591       |
| Minority interests and other liabilities  | 66                       | (357)       |
| Net cash provided by operating activities   | 93,027                   | 77,167      |
| <b>Investing activities:</b>  |                          |             |
| Equipment purchases   | (46,497)                 | (56,516)    |
| (Increase) decrease in deposits on equipment                                      | (512)                    | 7,944       |
| Acquisitions, net of cash received  | (7,650)                  |             |
| Proceeds from sale of assets  | 1,455                    | 4,663       |
| Net cash used in investing activities   | (53,204)                 | (43,909)    |
| <b>Financing activities:</b>  |                          |             |
| Principal payments on equipment debt  | (4,485)                  | (2,716)     |
| Proceeds from equipment debt  | 558                      |             |
| Principal payments on revolving loan facility                                     | (15,000)                 | (52,000)    |
| Proceeds from revolving loan facility   | 15,000                   | 22,500      |
| Principal payments on term loan facility  | (25,000)                 | (2,675)     |
| Payments of debt issuance costs   | (531)                    | (250)       |
| Proceeds from exercise of employee stock options                                  | 2,265                    | 1,376       |
| Net cash used in financing activities   | (27,193)                 | (33,765)    |
| Net increase (decrease) in cash and cash equivalents                              | 12,630                   | (507)       |
| Cash and cash equivalents, beginning of period                                    | 20,721                   | 13,421      |
| Cash and cash equivalents, end of period  | \$ 33,351                | \$ 12,914   |
| <b>Supplemental disclosure of cash flow information:</b>                          |                          |             |
| Interest paid   | \$ 20,074                | \$ 26,682   |
| Income taxes paid, net of refunds   | 1,489                    | 1,327       |
| <b>Supplemental disclosure of non-cash investing and financing activities:</b>    |                          |             |
| Net book value of assets exchanged  | \$ 5,698                 | \$ 6,361    |
| Capital lease obligations assumed for the purchase of equipment debt              | 1,577                    | 1,839       |
| Equipment debt transferred to unconsolidated investee                             |                          | (2,772)     |
| Comprehensive income from hedging transactions, net of taxes                      | 3,051                    | (190)       |

See accompanying notes.

**ALLIANCE IMAGING, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2006**

**(Unaudited)**

**(Dollars in thousands, except per share amounts)**

**1. Basis of Presentation, Principles of Consolidation, and Use of Estimates**

**Basis of Presentation** The accompanying unaudited condensed consolidated financial statements have been prepared by Alliance Imaging, Inc. (the Company) in accordance with accounting principles generally accepted in the United States of America and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (including normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine-month period ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes to the consolidated financial statements for the year ended December 31, 2005.

**Principles of Consolidation** The accompanying unaudited condensed consolidated financial statements of the Company include the assets, liabilities, revenues and expenses of all majority owned subsidiaries over which the Company exercises control. Intercompany transactions have been eliminated. We record minority interest expense related to our consolidated subsidiaries which are not wholly owned. Investments in unconsolidated investees are accounted for under the equity method.

**Use of Estimates** The preparation of condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

## 2. Share-Based Compensation

In December 2004, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 123(R) (revised December 2004), Share-Based Payment ( SFAS 123(R) ), which is a revision of SFAS No. 123, Accounting for Stock-Based Compensation ( SFAS 123 ) and supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ). This statement requires that the fair value at the grant date resulting from all share-based payment transactions be recognized in the financial statements. Further, SFAS 123(R) requires entities to apply a fair-value based measurement method in accounting for these transactions. This value is recorded over the vesting period. The statement is effective for the first fiscal year beginning after June 15, 2005.

The Company adopted SFAS 123(R) for the fiscal year beginning January 1, 2006, using the modified prospective application transition method and, accordingly, has not restated the consolidated financial statements for prior interim periods or fiscal years. Under SFAS 123(R), the Company now records in its consolidated statements of operations (i) compensation cost for options granted, modified, repurchased or cancelled on or after January 1, 2006 under the provisions of SFAS 123(R) and (ii) compensation cost for the unvested portion of options granted prior to January 1, 2006 over their remaining vesting periods using the amounts previously measured under SFAS 123 for pro forma disclosure purposes.



**Stock Option Plans and Awards**

In December 1997, the Company adopted an employee stock option plan ( 1997 Equity Plan ) pursuant to which options with respect to a total of 4,685,450 shares of the Company's common stock were available for grant. Options were granted at their fair value at the date of grant. All options have 10-year terms. On November 2, 1999, in connection with a series of transactions contemplated by an Agreement and Plan of Merger between Viewer Acquisition Corp and the Company in November 1999 (the 1999 Recapitalization Merger ), all options under the 1997 Equity Plan became fully vested.

In connection with the Company's acquisition of all of the outstanding common stock of Three Rivers Holding Corporation ( Three Rivers ), the parent corporation of SMT Health Services, Inc., in 1999, outstanding employee stock options under the 1997 Three Rivers Stock Option Plan were converted into options to acquire shares of the Company's common stock. The Three Rivers stock option plan allowed for options with respect to a total of 2,825,200 shares of the Company's common stock to be available for grant. Options were granted at their fair value at the date of grant. All options have 10-year terms. On November 2, 1999, in connection with the 1999 Recapitalization Merger, all options under the 1997 Three Rivers Stock Option Plan became fully vested.

In connection with the 1999 Recapitalization Merger, the Company adopted an employee stock option plan ( the 1999 Equity Plan ) pursuant to which options with respect to a total of 6,325,000 shares of the Company's common stock became available for grant. As of September 30, 2006, a total of 1,290,375 shares are available for grant under the 1999 Equity Plan. Options are granted with exercise prices equal to fair value of the Company's common stock at the date of grant, except as noted below. All options have 10-year terms. A portion of the options vest in equal increments over five years and a portion vest after eight years (subject to acceleration if certain financial performance targets are achieved). The Company settles stock option exercises with newly issued shares of common stock.

Consistent with the valuation method for the disclosure-only provisions of SFAS 123, the Company is using the Black-Scholes option pricing model to value the compensation expense associated with stock-based awards under SFAS 123(R). The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model that uses the assumptions noted in the table below. In addition, forfeitures are estimated when recognizing compensation expense, and the estimate of forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized through a cumulative catch-up adjustment in the period of change and will also impact the amount of compensation expense to be recognized in future periods. For the quarter and nine months ended September 30, 2005, the Company recorded \$57 and \$171, respectively, in non-cash share-based compensation for stock options granted with exercise prices below the fair value of the Company's common stock at the date of grant and for certain stock options subject to amended performance targets under the 1999 Equity Plan, as discussed below. For the quarter and nine months ended September 30, 2006, of the total \$657 and \$1,965, respectively, in non-cash share-based compensation recorded, \$501 and \$1,489, respectively, was incremental share-based compensation as a result of the adoption of SFAS 123 (R).

The following weighted average assumptions were used in the estimated grant date fair value calculations for stock option awards:

|                                  | <b>Quarter Ended<br/>September 30,<br/>2006</b> | <b>Nine Months Ended<br/>September 30,<br/>2005</b> | <b>2006</b> |
|----------------------------------|---|---|-------------|
| Risk free interest rate          | 4.84 %  | 3.79 %  | 4.58 %      |
| Expected dividend yield          | 0.00 %  | 0.00 %  | 0.00 %      |
| Expected stock price volatility  | 56.7 %  | 52.8 %  | 56.7 %      |
| Average expected life (in years) | 6.51  | 5.52  | 6.67        |

There were no stock options granted during the third quarter ended September 30, 2005.

The expected stock price volatility rates are based on a blend of the historical volatility of the Company's common stock and peer implied volatility. The risk free interest rates are based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding with the expected life of the option or award. The average expected life represents the weighted average period of time that options or awards granted are expected to be outstanding, as calculated using the simplified method described in the Securities and Exchange Commission's Staff Accounting Bulletin No. 107.

In November 2000, the Company granted stock options to certain employees at exercise prices below the fair value of the Company's common stock, of which 35,000 options were outstanding at September 30, 2006. The exercise prices of these options and the fair value of the Company's common stock on the grant date were \$5.60 and \$9.52 per share, respectively. The Company recorded non-cash share-based compensation of \$6 and \$18, respectively, for the quarter and nine months ended September 30, 2005, with an offset to paid-in-capital deficit. As the Company adopted SFAS 123 (R) effective January 1, 2006, any non-cash share-based compensation as a result of granting these stock options is included in the Company's consolidated total of share-based compensation of \$657 and \$1,965, respectively, for the quarter and nine months ended September 30, 2006.

Under the 1999 Equity Plan, a portion of the options granted are performance options. These options vest on the eighth anniversary of the grant date if the option holder is still an employee, but the vesting accelerates if the Company meets the operating performance targets specified in the option agreements. On June 20, 2001, the Company's compensation committee authorized the Company to amend the option agreements under its 1999 Equity Plan to reduce the performance targets for 1,899,600 performance options out of the 2,284,222 performance options outstanding. On May 18, 2004, the Company's compensation committee authorized the Company to make a second amendment to the option agreements under its 1999 Equity Plan to further reduce the performance targets for all of the 1,914,500 performance options outstanding. As a result of the amendment, if the Company achieves the reduced performance targets but does not achieve the original performance targets, and an option holder terminates employment prior to the eighth anniversary of the option grant date, the Company would be required to record a non-cash stock-based compensation charge equal to the amount by which the actual value of the shares subject to the performance option on the date of the amendment exceeded the option's exercise price. For the quarter and nine months ended September 30, 2005 the Company recorded \$57 and \$171, respectively, in non-cash share-based compensation as a result of the amendment. As the Company adopted SFAS 123 (R) effective January 1, 2006, any non-cash share-based compensation as a result of these amendments is included in the Company's consolidated total of non-cash stock-based compensation of \$657 and \$1,965, respectively, for the quarter and nine months ended September 30, 2006.

The following table summarizes the Company's stock option activity:

|   | Number of<br>Shares | Weighted-<br>Average<br>Exercise Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value |
|---|---------------------|--|--|---------------------------------|
| Outstanding at December 31, 2005                                | 3,571,275           | \$ 6.25                                |  |                                 |
| Granted   | 961,500             | 4.45                                   |  |                                 |
| Exercised   | (301,575 )          | 4.48                                   |  |                                 |
| Canceled  | (352,150 )          | 7.51                                   |  |                                 |
| Outstanding at September 30, 2006                               | 3,879,050           | \$ 5.82                                | 8.56   | \$ 13,303                       |
| Vested and expected to vest in the future at September 30, 2006 | 3,683,576           | \$ 5.81                                | 7.95   | \$ 12,618                       |
| Exercisable at September 30, 2006                               | 1,269,954           | \$ 5.16                                | 6.43   | \$ 4,167                        |

The weighted average grant-date fair value of options granted during the quarter ended September 30, 2006 was \$3.87 per share. The weighted average grant-date fair value of options granted during the nine months ended September 30, 2005 and 2006 was \$6.12 per share and \$2.71 per share, respectively. The total intrinsic value of options exercised during the quarters ended September 30, 2005 and 2006 was \$1,304 and \$118, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2005 and 2006 was \$3,610 and \$507, respectively. The total cash received from employees as a result of stock option exercises was \$1,211 and \$314 for the quarters ended September 30, 2005 and 2006, respectively. The total cash received from employees as a result of stock option exercises was \$2,265 and \$1,376 for the nine months ended September 30, 2005 and 2006, respectively.

The following table summarizes the Company's unvested stock option activity:

|                                | Shares     | Weighted<br>Average<br>Grant-Date<br>Fair Value |
|--------------------------------|------------|---|
| Unvested at December 31, 2005  | 2,243,851  | \$ 3.86   |
| Granted                        | 961,500    | \$ 2.71   |
| Vested                         | (341,405 ) | \$ 3.27   |
| Canceled                       | (254,850 ) | \$ 3.96   |
| Unvested at September 30, 2006 | 2,609,096  | \$ 3.50   |

At September 30, 2006, the total unrecognized fair value compensation cost related to unvested stock options granted to both employees and non-employees was \$7,015, which is expected to be recognized over a remaining weighted-average period of 3.65 years. The valuation model applied in this calculation utilizes highly subjective assumptions that could potentially change over time, including the expected forfeiture rate and performance targets. Therefore the amount of unrecognized compensation expense noted above does not necessarily represent the value that will ultimately be realized by the Company in the statements of operations. The total fair value of shares vested during the quarters ended September 30, 2005 and 2006 were \$102, and \$91 respectively. The total fair value of shares vested during the nine months ended September 30, 2005 and 2006 were \$775, and \$1,115, respectively.

***Employee Share-Based Compensation Expense***

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The table below shows the amounts recognized in the financial statements for the quarter and nine months ended September 30, 2006 for awards newly subject to compensation expense under SFAS 123(R). As discussed previously, prior to the adoption of SFAS 123(R), the Company recorded compensation expense for stock options granted with exercise prices below the fair value of the Company's common stock at the date of grant, certain stock options subject to amended performance targets under the 1999 Equity Plan, and non-employee share-based awards granted to members of the Company's advisory committee. The table below, therefore, excludes the effect of these awards.

|  | Quarter Ended<br>September 30,<br>2006 | Nine Months Ended<br>September 30,<br>2006 |
|--|--|--|
| Selling, general, and administrative expenses  | \$ 501                                 | \$ 1,489                                   |
| Total cost of non-cash share-based compensation included in income,<br>before income tax | 501                                    | 1,489                                      |
| Amount of income tax recognized in earnings  | (205 )                                 | (610 )                                     |
| Amount charged against income  | \$ 296                                 | \$ 879                                     |
| Impact on net income per share:  |  |  |
| Basic earnings per share:  | \$ 0.01                                | \$ 0.02                                    |
| Diluted earnings per share:  | \$ 0.01                                | \$ 0.02                                    |

**Pro Forma Share-Based Compensation**

Prior to the adoption of SFAS 123(R), the Company accounted for non-cash share-based compensation awards using the intrinsic value method prescribed under APB 25, and its related interpretations, as permitted by SFAS 123, as amended by SFAS 148, Accounting for Stock-Based Compensation Transition and Disclosure. Under the intrinsic value method, the difference between the market price on the date of grant and the exercise price is charged to the consolidated statements of operations over the vesting period. Prior to the adoption of SFAS 123(R), the Company recognized compensation cost for only certain awards, as discussed above. All other employee share-based awards were granted with an exercise price equal to the market value of the underlying common stock on the date of grant and no compensation cost is reflected in income from operations for those awards. SFAS 123, as amended by SFAS 148, required presentation of pro forma information regarding net income and earnings per share determined as if the Company had accounted for its employee stock options under the fair value method of that Statement.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' expected vesting period. Had compensation cost for the Company's stock option plan been determined based on the estimated fair value at the grant dates for awards under the plan consistent with the fair value method of SFAS 123 utilizing the Black-Scholes option-pricing model, the Company's net income and basic and diluted earnings per share for the quarter and nine months ended September 30, 2005 would have approximated the pro forma amount indicated below:

|  | Quarter Ended<br>September 30,<br>2005 | Nine Months Ended<br>September 30,<br>2005 |
|--|--|--|
| Net income:  |  |  |
| As reported  | \$ 5,011                               | \$ 17,301                                  |
| Add: Non-cash share-based compensation expense included in reported net income, net of related tax effects             | 37                                     | 113  |
| Deduct: Non-cash share-based compensation expense determined under fair value based method, net of related tax effects | (349 )                                 | (1,062 )                                   |
| Pro forma net income   | \$ 4,699                               | \$ 16,352                                  |
| Basic earnings per share:  |  |  |
| As reported  | \$ 0.10                                | \$ 0.35                                    |
| Pro forma  | 0.09                                   | 0.33                                       |
| Diluted earnings per share:  |  |  |
| As reported  | 0.10                                   | 0.34                                       |
| Pro forma  | 0.09                                   | 0.33                                       |

**3. Recent Accounting Pronouncements**

**Accounting Changes and Error Corrections** In May 2005, the FASB issued SFAS 154, Accounting for Changes and Error Corrections ( SFAS 154 ), which is a replacement of APB Opinion No. 20, Accounting Changes, and SFAS 3, Reporting Accounting Changes in Interim Financial Statements. This statement changes the requirements for the accounting for and reporting of all voluntary changes in accounting principle and in the instance that a pronouncement does not include specific transition provisions. This statement requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes and corrections of errors

made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 did not have a material impact on the Company's consolidated financial position or results of operations.

**Limited Partnerships** In June 2005, the FASB issued Emerging Issues Task Force Issue No. 04-05, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights* ( EITF 04-05 ). EITF 04-05 clarifies how general partners in a limited partnership should determine whether they control a limited partnership. A general partner of a limited partnership is presumed to control the limited partnership unless the limited partners have substantive kick-out rights or participating rights. For general partners of all new limited partnerships formed and for existing limited partnerships for which the partnership agreements are modified, EITF 04-05 is effective after June 29, 2005. For general partners in all other limited partnerships, EITF 04-05 is effective for the first period in fiscal years beginning after December 15, 2005. The adoption of EITF 04-05 did not have a material impact on the Company's consolidated financial position or results of operations.

**Uncertainty in Income Taxes** In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ), an interpretation of FASB Statement No. 109, *Accounting for Income Taxes* ( FASB 109 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB 109. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the provisions of FIN 48 and the impact on its consolidated financial position and results of operations. The Company will adopt FIN 48 for the fiscal year beginning January 1, 2007.

**Fair Value Measurements** In September 2006, the FASB issued SFAS 157, *Fair Value Measurements* ( SFAS 157 ), which enhances the existing guidance for measuring assets and liabilities using fair value. This statement provides a single definition of fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 emphasizes fair value as a market-based measurement instead of an entity-specific measurement. The statement sets out a fair value hierarchy with the highest priority being quoted prices in active markets. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently evaluating the provisions of SFAS 157 and the impact on its consolidated financial position and results of operations. The Company will adopt SFAS 157 for the fiscal year beginning January 1, 2008.

**Guidance on Materiality** In September 2006, the Securities Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements* ( SAB 108 ), which states that registrants should use both a balance sheet approach and an income statement approach when quantifying and evaluating the materiality of a misstatement, contains guidance on correcting errors under the dual approach, and provides transition guidance for correcting errors existing in prior years. SAB 108 is effective for fiscal years ending after November 15, 2006. The Company does not believe the adoption of SAB 108 will have a material impact on the Company's consolidated financial position or results of operations.

#### 4. Transactions

Effective September 1, 2005, the Company acquired certain assets associated with nine multi-modality fixed-site diagnostic imaging centers. The multi-modality fixed-site diagnostic imaging centers include one MRI system, six CT systems, and 29 other modality systems. The purchase price consisted of \$7,650 in cash and \$826 in assumed liabilities and transaction costs. The acquisition was financed using the Company's



internally generated funds. As a result of this acquisition, the Company recorded goodwill and intangible assets of \$2,246 and \$2,400, respectively. The intangible assets were recorded at fair value at the acquisition date. All recorded goodwill is deductible for tax purposes and will be amortized over 15 years for tax purposes. The acquisition also includes \$246 of contingent payment due to the shareholders of the centers if certain performance targets are met over a three year period. When the contingency is resolved and consideration is distributable, the Company will record the fair value of the consideration as additional purchase price to goodwill. Adjustments to goodwill may occur in future periods as a result of changes in the original valuation of assets and liabilities acquired. During the quarter ended September 30, 2006, the company increased goodwill by \$91 as a result of changes in the original valuation of assets and liabilities acquired. During the nine months ended September 30, 2006, the company increased goodwill by \$14 as a result of changes in the original valuation of assets and liabilities acquired. The Company has not included pro forma information as this acquisition did not have a material impact on the Company's consolidated financial position or results of operations.

Effective October 1, 2005, the Company acquired 100% of the outstanding stock of PET Scans of America Corp. (PSA), a mobile provider of PET and PET/CT services primarily to hospitals in 13 states. The purchase price consisted of \$36,596 in cash and \$3,692 in assumed liabilities and transaction costs. The acquisition was financed using the Company's revolving line of credit, internally generated funds, and capital leases. As a result of this acquisition the Company acquired intangible assets of \$11,400, of which \$9,100 was assigned to PSA customer contracts, which will be amortized over 10 years, and \$2,100 was assigned to certificates of need held by PSA, which have indefinite useful lives and are not subject to amortization. These assets were recorded at fair value at the acquisition date. The Company recorded total goodwill of \$22,472, which includes \$3,007 of goodwill related to income tax timing differences as a result of the acquisition. None of the goodwill recorded is deductible for tax purposes. Adjustments to goodwill may occur in future periods as a result of changes in the original valuation of assets and liabilities acquired. During the quarter ended September 30, 2006, the company increased goodwill by \$20 as a result of changes in the original valuation of assets and liabilities acquired. During the nine months ended September 30, 2006, the company decreased goodwill by \$3 as a result of changes in the original valuation of assets and liabilities acquired. The Company has not included pro forma information as this acquisition did not have a material impact on the Company's consolidated financial position or results of operations.

In late December 2005, the Company purchased an additional equity interest in a joint venture the Company formed in 2004 with the University of Pittsburgh Medical Center. The joint venture, Alliance Oncology (AO), is designed to partner with hospitals to build and operate radiation oncology centers, with an emphasis on intensity modulated radiation therapy and image guided radiation therapy. The purchase price for the additional equity interest was \$8,000, which was financed through the Company's revolving line of credit. The Company now owns 80% of AO. As a result of this acquisition the Company recorded goodwill of \$6,946, which is deductible for tax purposes and will be amortized over 15 years for tax purposes. Adjustments to goodwill may occur in future periods as a result of changes in the original valuation of assets and liabilities acquired. There were no adjustments recorded to goodwill during the quarter ended September 30, 2006. During the nine months ended September 30, 2006, the company increased goodwill by \$56 as a result of changes in the original valuation of assets and liabilities acquired. During the quarter and nine months ended September 30, 2005 the Company recorded earnings in unconsolidated investees for the Company's share of AO's previously unconsolidated earnings. The Company has not included pro forma information as this acquisition did not have a material impact on the Company's consolidated financial position or results of operations.



## 5. Goodwill and Intangible Assets

Changes in the carrying amount of goodwill are as follows:

|   |            |
|---|------------|
| Balance at December 31, 2005            | \$ 154,656 |
| Additions to goodwill during the period | 67         |
| Balance at September 30, 2006           | \$ 154,723 |

Intangible assets consisted of the following:

|  | December 31, 2005        |                             | Intangible<br>Assets, net | September 30, 2006       |                             | Intangible<br>Assets, net |
|--|--------------------------|-----------------------------|---------------------------|--------------------------|-----------------------------|---------------------------|
|  | Gross Carrying<br>Amount | Accumulated<br>Amortization |                           | Gross Carrying<br>Amount | Accumulated<br>Amortization |                           |
| Amortizing intangible<br>assets:                 |                          |                             |                           |                          |                             |                           |
| Customer contracts                               | \$ 51,063                | \$ (18,791 )                | \$ 32,272                 | \$ 51,063                | \$ (21,879 )                | \$ 29,184                 |
| Other  | 4,467                    | (1,910 )                    | 2,557                     | 7,147                    | (2,525 )                    | 4,622                     |
| Total amortizing intangible<br>assets            | \$ 55,530                | \$ (20,701 )                | \$ 34,829                 | \$ 58,210                | \$ (24,404 )                | \$ 33,806                 |
| Intangible assets not subject<br>to amortization |                          |                             | \$ 4,242                  |                          |                             | \$ 3,179                  |
| Total other intangible assets                    |                          |                             | \$ 39,071                 |                          |                             | \$ 36,985                 |

The Company reviews the recoverability of the carrying value of goodwill on an annual basis or more frequently when an event occurs or circumstances change to indicate an impairment of these assets has possibly occurred. Goodwill is allocated to the Company's various reporting units which represent the Company's geographical regions. The Company compares the fair value of the reporting unit to its carrying amount to determine if there is potential impairment. The implied fair value for goodwill is determined based on the fair value of assets and liabilities of the respective reporting units, in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," based on discounted cash flows, market multiples, or appraised values as appropriate.

Amortization expense for intangible assets subject to amortization was \$937 and \$1,230 for the quarters ended September 30, 2005 and 2006, respectively, and \$2,719 and \$3,703 for the nine months ended September 30, 2005 and 2006, respectively. The intangible assets not subject to amortization represent certificate of needs and regulatory authority rights which have indefinite useful lives.

Estimated annual amortization expense for each of the fiscal years ending December 31, is presented below:

|      |          |
|------|----------|
| 2006 | \$ 4,933 |
| 2007 | 4,722    |
| 2008 | 4,508    |
| 2009 | 4,187    |
| 2010 | 4,117    |

**6. Other Accrued Liabilities**

Other accrued liabilities consisted of the following:

|  | December 31,<br>2005 | September 30,<br>2006 |
|--|----------------------|-----------------------|
| Accrued systems rental and maintenance costs | \$ 5,801             | \$ 2,463              |
| Accrued site rental fees                     | 1,242                | 1,570                 |
| Accrued property and sales taxes payable     | 10,569               | 11,477                |
| Accrued self-insurance expense               | 5,725                | 6,429                 |
| Other accrued expenses                       | 5,727                | 8,789                 |
| Total  | \$ 29,064            | \$ 30,728             |

**7. Long-Term Debt and Senior Subordinated Credit Facility**

Long-term debt consisted of the following:

|   | December 31,<br>2005 | September 30,<br>2006 |
|---|----------------------|-----------------------|
| Term loan facility                        | \$ 384,875           | \$ 382,200            |
| Revolving loan facility                   | 29,500               |                       |
| Senior subordinated notes                 | 153,541              | 153,541               |
| Equipment debt                            | 11,666               | 8,017                 |
| Long-term debt, including current portion | 579,582              | 543,758               |
| Less current portion                      | 7,781                | 6,750                 |
| Long-term debt                            | \$ 571,801           | \$ 537,008            |

**8. Derivatives**

In the second quarter of 2004, the Company entered into interest rate swap agreements, with notional amounts of \$56,813, \$46,813 and \$48,438 to hedge the future cash interest payments associated with a portion of the Company's variable rate bank debt. These agreements are three years in length and mature in 2007. As of September 30, 2005, and 2006, the fair value of the Company's interest rate swap agreements was an accumulated income of \$2,440 and \$2,332, respectively. Under these arrangements, the Company receives three-month London Interbank Offered Rate (LIBOR) and pays a fixed rate of 3.15%, 3.89% and 3.69%, respectively. The net effect of the hedges is to record interest expense at fixed rates of 5.65%, 6.39% and 6.19%, respectively, as the debt incurs interest based on three-month LIBOR plus 2.50%. For the quarter and nine months ended September 30, 2005 the Company paid net settlement amounts of \$102 and \$848, respectively. For the quarter and nine months ended September 30, 2006, the Company received net settlement amounts of \$649 and \$1,420, respectively. The Company has designated these swaps as cash flow hedges of variable future cash flows associated with its long-term debt. For the quarter and nine months ended September 30, 2005, the Company recognized comprehensive income, net of tax, of \$842, and \$1,742, respectively, based on the change in fair value of these instruments. For the quarter and nine months ended September 30, 2006, the Company recognized a comprehensive loss, net of tax, of \$591, and \$295, respectively, based on the change in fair value of these instruments. The Company will continue to record subsequent changes in the fair value of the swaps through comprehensive income during the period these instruments are designated as hedges.

In the first quarter of 2005, the Company entered into multiple interest rate collar agreements for its variable rate bank debt. The total underlying notional amount of the debt was \$178,000. Under these arrangements the Company has purchased a cap on the interest rate of 4.00% and has sold a floor of 2.25%. The Company paid a net purchase price of \$1,462 for these collars. These agreements are two and three years in length and mature at various dates between January 2007 and January 2008. As of September 30, 2005 and 2006, the fair value of the Company's interest rate collar agreements was an accumulated income of \$2,181 and \$2,701, respectively. For the quarter and nine month period ended September 30, 2005, the Company did not record any net settlement amount. For the quarter and nine month period ended September 30, 2006, the Company received a net settlement amount of \$519 and \$874, respectively. The Company has designated these collars as cash flow hedges of variable future cash flows associated with its long-term debt. For the quarter and nine month period ended September 30, 2005, the Company recognized comprehensive income, net of tax, of \$608 and \$1,309 based on the change in fair value of these instruments. For the quarter ended September 30, 2006, the Company recognized a comprehensive loss, net of tax, of \$720 based on the change in fair value of these instruments. For the nine months ended September 30, 2006, the Company recognized comprehensive income, net of tax, of \$105 based on the change in fair value of these instruments. The Company will record subsequent changes in the fair value of the collars through comprehensive income during the period these instruments are designated as hedges.

The Company accounts for derivative instruments and hedging activities in accordance with the provisions of SFAS 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133) and SFAS 138, Accounting for Certain Derivative Instruments and Hedging Activities (SFAS 138), an amendment of SFAS 133. On the date the Company enters into a derivative contract, management designates the derivative as a hedge of the identified exposure. The Company does not enter into derivative instruments that do not qualify as cash flow hedges as described in SFAS 133 and SFAS 138. The Company formally documents all relationships between hedging instruments and hedged items, as well as the risk-management objective and strategy for undertaking various hedge transactions. In this documentation, the Company specifically identifies the firm commitment or forecasted transaction that has been designated as a hedged item and states how the hedging instrument is expected to hedge the risks related to the hedged item. The Company formally measures effectiveness of its hedging relationships, both at the hedge inception and on an ongoing basis, in accordance with its risk management policy. The Company would discontinue hedge accounting prospectively (i) if it is determined that the derivative is no longer effective in offsetting change in the cash flows of a hedged item, (ii) when the derivative expires or is sold, terminated or exercised, (iii) because it is probable that the forecasted transaction will not occur, (iv) because a hedged firm commitment no longer meets the definition of a firm commitment, or (v) if management determines that designation of the derivative as a hedge instrument is no longer appropriate. The Company's derivatives are recorded on the balance sheet at their fair value. For derivatives accounted for as cash flow hedges any unrealized gains or losses on fair value are included in comprehensive income, net of tax.

## 9. Income Taxes

For the quarter and nine months ended September 30, 2006, the Company recorded a provision for income taxes of \$3,392 and \$10,401, or 40.9% and 41.0% of the Company's pretax income, respectively. For the quarter and nine months ended September 30, 2005, the Company recorded a provision for income taxes of \$3,494 and \$11,795, or 41.1% and 40.5% of the Company's pretax income, respectively. The Company's effective tax rate was higher than statutory rates primarily as a result of state income taxes.

## 10. Earnings Per Common Share

The following table sets forth the computation of basic and diluted earnings per share (amounts in thousands, except per share amounts):

|   | Quarter Ended<br>September 30, |          | Nine Months Ended<br>September 30, |           |
|---|--------------------------------|----------|------------------------------------|-----------|
|   | 2005                           | 2006     | 2005                               | 2006      |
| <b>Numerator:</b>   |                                |          |                                    |           |
| Net income  | \$ 5,011                       | \$ 4,895 | \$ 17,301                          | \$ 14,998 |
| <b>Denominator:</b>   |                                |          |                                    |           |
| Denominator for basic earnings per share weighted-average shares                                  | 49,517                         | 49,844   | 49,313                             | 49,737    |
| <b>Effect of dilutive securities:</b>   |                                |          |                                    |           |
| Employee stock options  | 851                            | 661      | 998                                | 502       |
| Denominator for diluted earnings per share adjusted weighted-average shares                       | 50,368                         | 50,505   | 50,311                             | 50,239    |
| <b>Earnings per common share:</b>   |                                |          |                                    |           |
| Basic   | \$ 0.10                        | \$ 0.10  | \$ 0.35                            | \$ 0.30   |
| Diluted   | \$ 0.10                        | \$ 0.10  | \$ 0.34                            | \$ 0.30   |
| <b>Stock options excluded from the computation of diluted per share amounts:</b>                  |                                |          |                                    |           |
| Weighted-average shares for which the exercise price exceeds average market price of common stock | 1,329                          | 703      | 1,219                              | 765       |
| Average exercise price per share that exceeds average market price of common stock                | \$ 11.57                       | \$ 11.69 | \$ 11.74                           | \$ 11.55  |

## 11. Commitments and Contingencies

The Company has applied the disclosure provisions of FASB Interpretation No. 45 ( FIN 45 ), Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, to its agreements that contain guarantee or indemnification clauses. These disclosure provisions expand those required by FASB Statement No. 5, Accounting for Contingencies, by requiring a guarantor to disclose certain type of guarantees, even if the likelihood of requiring the guarantor s performance is remote. The following is a description of arrangements in which the Company is the guarantor or indemnifies a party.

In the normal course of business, the Company has made certain guarantees and indemnities, under which it may be required to make payments to a guaranteed or indemnified party, in relation to certain transactions. The Company indemnifies other parties, including customers, lessors, and parties to other transactions with the Company, with respect to certain matters. The Company has agreed to hold the other party harmless against losses arising from certain events as defined within the particular contract, which may include, for example, litigation or claims arising from a breach of representations or covenants. In addition, the Company has entered into indemnification agreements with its executive officers and directors and the Company s bylaws contain similar indemnification obligations. Under these arrangements, we are obligated to indemnify, to the fullest extent permitted under applicable law, our current or former officers and directors for various amounts incurred with respect to actions, suits or proceedings in which they were made, or threatened to be made, a party as a result of acting as an officer or director.

It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and

circumstances involved in each particular agreement. Historically, payments made related to these indemnifications have been immaterial. At September 30, 2006 the Company has determined that no liability is necessary related to these guarantees and indemnities.

The Company guarantees a portion of a loan on behalf of an unconsolidated investee under an agreement executed prior to 2002. The maximum potential future payment under this financial guarantee is \$117 at September 30, 2006. The Company has not recorded an obligation for this guarantee.

On May 5, 2005, Alliance Imaging, Inc. was served with a complaint (the Class Action Complaint) filed in Alameda County Superior Court alleging wage and hour claims on behalf of a putative class of approximately 400 former and current California employees of the Company. On August 19, 2005, the plaintiffs filed an amended complaint, which the Company answered on September 23, 2005. In this suit, captioned Linda S. Jones, et al. v. Alliance Imaging, Inc., et al., the plaintiffs allege violations of California's wage, meal period, and break time laws and regulations. Plaintiffs sought recovery of unspecified economic damages, statutory penalties, attorneys' fees, and costs of suit. On or about March 10, 2006, plaintiffs filed a second amended complaint (later further amended by a third amended complaint) adding a cause of action for conversion and a plea for punitive damages. The Company filed a demurrer and motion to strike seeking to dismiss the new claim and plea. On July 19, 2006, the Company and the Plaintiffs entered into a tentative settlement of the Class Action Complaint pursuant to which the Company has agreed to pay \$2,500, which is included in other accrued liabilities at September 30, 2006, in exchange for a dismissal with prejudice of all claims brought on behalf of the putative class under the Class Action Complaint. On September 8, 2006, the settlement was preliminarily approved by the court and a conditional class was certified for purposes of seeking class approval of the settlement. On October 2, 2006, notice was mailed to the conditional class members outlining the terms of the settlement and providing all class members with an opportunity to opt out of the settlement prior to the final approval hearing scheduled for November 27, 2006.

The Company from time to time is involved in routine litigation and regulatory matters incidental to the conduct of its business. The Company believes that resolution of such matters will not have a material adverse effect on its consolidated results of operations or financial position.

## 12. Related-Party Transactions

The Company recorded management fees payable to Kohlberg Kravis Roberts & Co (KKR) of \$163 and \$488 for each of the quarters and nine months ended September 30, 2005 and 2006, respectively, and will continue to receive financial advisory services from KKR on an ongoing basis. At September 30, 2005 and 2006, the Company has accrued \$163 related to these services.

Revenue from management agreements with unconsolidated equity investees was \$3,338 and \$4,346 for the quarters ended September 30, 2005 and 2006, respectively, and \$10,638 and \$12,875 for the nine months ended September 30, 2005 and 2006, respectively.

## 13. Investments in Unconsolidated Investees

The Company has direct ownership in five unconsolidated investees at September 30, 2006. The Company owns between 33.3 percent and 50 percent of these investees, and provides management services under agreements with four of these investees, expiring at various dates through 2023. As discussed in Note 4, in late December 2005 the Company purchased an additional equity interest in AO, a joint venture formed in 2004, which was an unconsolidated investee prior to purchase of the additional equity interest. The Company's earnings in unconsolidated investees for the nine months ended September 30, 2005 includes the Company's percentage of AO's earnings for this period. At September 30, 2006 the Company also has ownership in an unconsolidated investee of AO. AO owns 50% of this investee and provides management services under an agreement which expires in 2025. All of these investees are accounted for

under the equity method since the Company does not exercise control over the operations of these investees.

Set forth below is certain financial data of these investees (amounts in thousands):

|                                     | December 31,<br>2005 | September 30,<br>2006 |
|-------------------------------------|----------------------|-----------------------|
| <b>Combined Balance Sheet Data:</b> |                      |                       |
| Current assets.                     | \$ 11,232            | \$ 12,198             |
| Noncurrent assets                   | 31,958               | 31,617                |
| Current liabilities.                | 12,230               | 10,898                |
| Noncurrent liabilities.             | 12,779               | 14,790                |

|  | Quarter Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--|--------------------------------|-----------|------------------------------------|-----------|
|  | 2005                           | 2006      | 2005                               | 2006      |
| <b>Combined Operating Results:</b>             |                                |           |                                    |           |
| Revenues.                                      | \$ 9,156                       | \$ 10,056 | \$ 25,153                          | \$ 30,806 |
| Expenses                                       | 6,922                          | 7,722     | 19,242                             | 23,584    |
| Net income.                                    | 2,234                          | 2,334     | 5,911                              | 7,222     |
| Equity in earnings of unconsolidated investees | 1,000                          | 1,129     | 2,596                              | 4,145     |

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Overview**

We are a leading national provider of shared-service and fixed-site diagnostic imaging services, based upon annual revenue and number of diagnostic imaging systems deployed. Our principal sources of revenue are derived from magnetic resonance imaging (MRI) and positron emission tomography and positron emission tomography/computed tomography (PET and PET/CT). We provide imaging and therapeutic services primarily to hospitals and other healthcare providers on a shared and full-time service basis. We also provide services through a growing number of fixed sites primarily to hospitals or health systems. Our services normally include the use of our imaging systems, technologists to operate the systems, equipment maintenance and upgrades and management of day-to-day shared-service and fixed-site diagnostic imaging operations. We also provide non scan-based services, which includes only the use of our imaging systems under a short-term contract. In the first nine months of 2006, MRI services and PET and PET/CT services generated 62% and 29% of our revenue, respectively. The remaining revenue was comprised of other modality diagnostic imaging services revenue, primarily computed tomography (CT), and management contract revenue. We had 494 diagnostic imaging systems, including 334 MRI systems and 71 PET or PET/CT systems and served over 1,000 clients in 43 states at September 30, 2006. Of these 494 diagnostic imaging systems, 74 were located in fixed-sites, which constitutes systems installed in hospitals or other buildings on hospital campuses, including modular buildings, systems installed inside medical groups offices or medical buildings, and free-standing fixed-sites, which includes systems installed in a medical office building, ambulatory surgical center, or other retail space. Of these 74 fixed-sites, 60 were MRI fixed-sites, 3 were PET or PET/CT fixed-sites and 11 were other modality fixed sites.

Approximately 87% of our revenues for the first nine months ended September 30, 2006 were generated by providing services to hospitals and other healthcare providers, which we refer to as wholesale revenues. Our wholesale revenues are typically generated from contracts that require our clients to pay us based on the number of scans we perform on patients on our clients behalf, although some pay us a flat fee for a period of time regardless of the number of scans we perform. These payments are due to us independent of our clients' receipt of reimbursement from third-party payors. We typically deliver our services for a set number of days per week through exclusive, long-term contracts with hospitals and other healthcare providers. The initial terms of these contracts average approximately three years in length for mobile services and approximately seven to ten years in length for fixed-site arrangements. These contracts often contain automatic renewal provisions and certain contracts have cancellation clauses if the hospital or other healthcare provider purchases their own system. We price our contracts based on the type of system used, the scan volume, and the number of ancillary services provided. Pricing is also affected by competitive pressures.

Approximately 13% of our revenues for the nine months ended September 30, 2006 were generated by providing services directly to patients from our sites located at or near hospitals or other healthcare provider facilities, which we refer to as retail revenue. Our revenue from these sites is generated from direct billings to patients or their third-party payors, including Medicare, which are recorded net of contractual discounts and other arrangements for providing services at discounted prices. We typically charge a higher price per scan under retail billing than we do under wholesale billing.

Fixed-sites can be structured as either wholesale or retail arrangements. Revenues from these fixed-sites are included in both our wholesale or retail revenues, respectively.

On February 8, 2006, the Deficit Reduction Act of 2005 ( DRA ) was signed into law by President George W. Bush. The DRA imposes caps on Medicare payment rates for certain imaging services, including MRI, PET and PET/CT, furnished in physician's offices and other non-hospital based settings. Under the cap, payments for specified imaging services cannot exceed the hospital outpatient payment

rates for those services. This change is to apply to services furnished on or after January 1, 2007. The limitation is applicable to the technical component of the services only, which is the payment the Company receives for the services for which the Company bills directly under the Medicare Physician Fee Schedule. The technical reimbursement under the Physician Fee Schedule generally allows for higher reimbursement than under the hospital outpatient prospective payment system ( HOPPS ). The implementation of this reimbursement reduction contained in the DRA will have a significant effect on our financial condition and results of operations beginning in 2007.

On July 18, 2006, the U.S. House of Representatives Energy and Commerce Committee's Subcommittee on Health conducted a hearing regarding quality and utilization of imaging services and the provisions of the DRA that directly effect Medicare payment for imaging services. Many members of Congress have expressed concern about the impact of the DRA, and a legislation bill has been introduced to delay the effective date of the DRA for two years. Our current view is that the two year delay regarding implementation of the DRA is unlikely to be upheld by Congress and that the DRA as it is currently structured will become effective January 1, 2007.

In August 2006, the Centers for Medicare and Medicaid Services ( CMS ) proposed reducing Medicare Part B HOPPS reimbursement for PET and PET/CT imaging procedures. On November 1, 2006, CMS issued a final determination of Medicare Part B HOPPS reimbursement rates for PET and PET/CT imaging procedures. The national rate for PET scans will be reduced from the current rate of \$1,150 per scan to \$855 per scan effective January 1, 2007. The national rate for PET/CT scans will be reduced from the current rate of \$1,250 per scan to \$950 per scan effective January 1, 2007.

For full year 2006, we estimate that approximately 5.6% of our revenue will be billed directly to the Medicare program, which has increased from approximately 4.3% of our revenue billed directly to the Medicare program in 2005. If the DRA had been in effect for full year 2006, we estimate the reduction in Medicare revenue due to the DRA reimbursement rate decrease would have reduced revenue by approximately \$9.7 million. Additionally, the PET and PET/CT Medicare HOPPS reduction would have reduced revenue by approximately \$2.8 million. Combined, the DRA and PET and PET/CT Medicare HOPPS rate reductions would have negatively impacted Alliance's 2006 revenue by a total of \$12.5 million. We expect that the entire revenue decrease will directly effect earnings.

In addition, the DRA also codifies the reduction in reimbursement for multiple images on contiguous body parts. Effective January 1, 2006, CMS pays 100% of the technical component of the higher priced imaging procedure and 75% for the technical component of each additional imaging procedure for multiple images of contiguous body parts within a family of codes performed in the same session. We believe that the implementation of this reimbursement reduction in 2006 has not had a significant impact on our financial condition and results of operation.

The principal components of our cost of revenues are compensation paid to technologists and drivers, system maintenance costs, medical supplies, system transportation and technologists' travel costs. Because a majority of these expenses are fixed, increased revenues as a result of higher scan volumes per system significantly improves our margins while lower scan volumes result in lower margins.

The principal components of selling, general and administrative expenses are sales and marketing costs, corporate overhead costs, provision for doubtful accounts, and non-cash share-based compensation.

We record minority interest expense and earnings from unconsolidated investees related to our consolidated and unconsolidated subsidiaries, respectively. These subsidiaries primarily provide shared-service and fixed-site diagnostic imaging and therapeutic services.

In 2005 and the first nine months of 2006, the growth rate of MRI industry wide scan volumes has slowed in part due to weak hospital volumes as reported by several investor-owned hospital companies, a growing number of medical groups adding imaging capacity within their practice setting, the increasing



trend of third-party payors intensifying their utilization management efforts to control MRI scan volume growth rate and additional patient-related cost-sharing programs. We expect that this trend will continue throughout 2006.

In recent years, we began to see an increase in the competitive climate in the MRI industry, resulting in an increase in activity by original equipment manufacturers, or OEM s, selling systems directly to certain of our clients. Typically, OEM s target our higher scan volume clients. This increase in activity by OEM s has resulted in overcapacity of systems in the marketplace, especially related to medical groups adding imaging capacity within their practice setting. This has caused an increase in the number of our higher scan volume clients deciding not to renew their contracts. We replace these higher volume scan clients typically with lower volume clients. During 2006, our MRI revenues modestly declined compared to 2005 levels and we believe that MRI revenues will continue to modestly decline in future years.

#### **Seasonality**

We experience seasonality in the revenues and margins generated for our services. First and fourth quarter revenues are historically lower than those from the second and third quarters. First quarter revenue is affected primarily by fewer calendar days and inclement weather, typically resulting in fewer patients being scanned during the period. Fourth quarter revenue is affected primarily by holiday and client and patient vacation schedules and inclement weather, also resulting in fewer scans during the period. The variability in margins is higher than the variability in revenues due to the fixed nature of our costs.

In 2006, there are five fewer scanning days in the second half of 2006 compared to the first half of 2006. We generated approximately \$1.6 million per scanning day in the first half of 2006. If our revenue per scanning day for the second half of 2006 remains flat with the first half of 2006, this would result in a decrease in revenue of approximately \$8.0 million in the second half of 2006 compared to the first half of 2006.

**Results of Operations**

The following table shows our consolidated statements of income as a percentage of revenues for each of the quarters ended September 30:

|  | Quarter Ended<br>September 30, |         | Nine Months Ended<br>September 30, |         |
|--|--------------------------------|---------|------------------------------------|---------|
|  | 2005                           | 2006    | 2005                               | 2006    |
| Revenues   | 100.0 %                        | 100.0 % | 100.0 %                            | 100.0 % |
| Costs and expenses:  |                                |         |                                    |         |
| Cost of revenues, excluding depreciation and amortization  | 52.6                           | 53.0    | 51.1                               | 53.1    |
| Selling, general and administrative expenses   | 11.1                           | 12.0    | 11.6                               | 11.9    |
| Employment agreement costs   |                                |         | 0.1                                |         |
| Severance and related costs  |                                |         |                                    | 0.2     |
| Depreciation expense   | 19.2                           | 18.4    | 19.1                               | 18.2    |
| Amortization expense   | 0.9                            | 1.1     | 0.9                                | 1.1     |
| Interest expense, net of interest income   | 8.6                            | 8.9     | 8.6                                | 8.8     |
| Other (income) and expense, net  |                                | (0.2 )  | (0.1 )                             | 0.1     |
| Total costs and expenses   | 92.4                           | 93.2    | 91.3                               | 93.4    |
| Income before income taxes, minority interest expense and earnings from unconsolidated investees | 7.6                            | 6.8     | 8.7                                | 6.6     |
| Income tax expense   | 3.3                            | 3.0     | 3.7                                | 3.0     |
| Minority interest expense  | 0.5                            | 0.5     | 0.5                                | 0.4     |
| Earnings from unconsolidated investees   | (0.9 )                         | (1.0 )  | (0.9 )                             | (1.2 )  |
| Net income   | 4.7 %                          | 4.3 %   | 5.4 %                              | 4.4 %   |

The table below provides MRI statistical information:

|   | Quarter Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|---|--------------------------------|-----------|------------------------------------|-----------|
|   | 2005                           | 2006      | 2005                               | 2006      |
| MRI statistics                                |                                |           |                                    |           |
| Average number of total systems               | 328.3                          | 332.6     | 332.3                              | 322.0     |
| Average number of scan-based systems          | 280.6                          | 265.9     | 282.5                              | 273.2     |
| Scans per system per day (scan-based systems) | 9.53                           | 9.37      | 9.53                               | 9.37      |
| Total number scan-based MRI scans             | 188,731                        | 172,791   | 575,251                            | 535,082   |
| Price per scan                                | \$ 350.80                      | \$ 361.05 | \$ 353.77                          | \$ 360.38 |

The table below provides PET and PET/CT statistical information:

|                                      | Quarter Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|--------------------------------------|--------------------------------|----------|------------------------------------|----------|
|                                      | 2005                           | 2006     | 2005                               | 2006     |
| PET and PET/CT statistics            |                                |          |                                    |          |
| Average number of systems            | 52.2                           | 68.2     | 51.6                               | 68.1     |
| Scans per system per day             | 5.45                           | 6.01     | 5.34                               | 5.91     |
| Total number of PET and PET/CT scans | 17,342                         | 25,521   | 50,150                             | 74,719   |
| Price per scan                       | \$ 1,320                       | \$ 1,310 | \$ 1,339                           | \$ 1,312 |

Following are the components of revenue (in millions):

|                                    | Quarter Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|------------------------------------|--------------------------------|----------|------------------------------------|----------|
|                                    | 2005                           | 2006     | 2005                               | 2006     |
| Total MRI revenue                  | \$ 72.7                        | \$ 69.1  | \$ 223.6                           | \$ 212.7 |
| PET and PET/CT revenue             | 23.0                           | 33.9     | 67.5                               | 99.2     |
| Other modalities and other revenue | 10.5                           | 10.5     | 29.5                               | 32.2     |
| Total                              | \$ 106.2                       | \$ 113.5 | \$ 320.6                           | \$ 344.1 |

|  | Quarter Ended<br>September 30, |         | Nine Months Ended<br>September 30, |         |
|--|--------------------------------|---------|------------------------------------|---------|
|  | 2005                           | 2006    | 2005                               | 2006    |
| Total fixed-site revenue (in millions) | \$ 17.1                        | \$ 18.8 | \$ 50.1                            | \$ 55.5 |

#### *Quarter Ended September 30, 2006 Compared to Quarter Ended September 30, 2005*

Revenue increased \$7.3 million, or 6.8%, to \$113.5 million in the third quarter of 2006 compared to \$106.2 million in the third quarter of 2005 primarily due to an increase in PET and PET/CT revenues offset by lower MRI revenue. Other modalities and other revenue was \$10.5 million in both the third quarters of 2005 and 2006. PET and PET/CT revenue in the third quarter of 2006 increased \$10.9 million, or 47.3%, compared to the third quarter of 2005. Total PET and PET/CT scan volumes increased 47.2% to 25,521 scans in the third quarter of 2006 from 17,342 scans in the third quarter of 2005, primarily as a result of growth in our core PET business and the PET Scans of America Corp. acquisition. The average number of PET and PET/CT systems in service increased to 68.2 systems in the third quarter of 2006 from 52.2 systems in the third quarter of 2005. Scans per system per day increased 10.3%, to 6.01 scans per system per day in the third quarter of 2006 from 5.45 scans per system per day in the third quarter of 2005. These increases were partially offset by a 0.8% decline in the average price per PET and PET/CT scan, to \$1,310 per scan in the third quarter of 2006 compared to \$1,320 per scan in the third quarter of 2005. MRI revenue decreased \$3.6 million in the third quarter of 2006, or 5.0%, compared to the third quarter of 2005. Scan-based MRI revenue decreased \$3.8 million in the third quarter of 2006, or 5.8%, to \$62.4 million, from \$66.2 million in the third quarter of 2005. This decrease is primarily a result of an 8.4% decrease in our scan-based MRI scan volume. Scan-based MRI scan volume decreased to 172,791 scans in the third quarter of 2006 from 188,731 scans in the third quarter of 2005, primarily due to a decrease in the average number of scan-based systems in service due to lower client demand. Scan-based systems in service decreased to 265.9 systems in the third quarter of 2006 from 280.6 systems in the third quarter of 2005 to adjust to modestly declining scan volumes and to increase the efficiency of our mobile MRI systems. Average scans per system per day also decreased by 1.7% to 9.37 in the third quarter of 2006 from 9.53 in the third quarter of 2005. These decreases were partially offset by a 2.9% increase in the average price per MRI scan to \$361.05 per scan in the third quarter of 2006 compared to \$350.80 per scan in the third quarter of 2005 and an increase in non-scan based MRI revenue of \$0.2 million in the third quarter of 2006 over the same period in 2005.

We had 334 MRI systems at September 30, 2006 compared to 350 MRI systems at September 30, 2005. We had 71 PET and PET/CT systems at September 30, 2006 compared to 58 PET and PET/CT systems at September 30, 2005. We operated 74 fixed sites at September 30, 2006, compared to 72 fixed sites at September 30, 2005.

Cost of revenues, excluding depreciation and amortization, increased \$4.3 million, or 7.6%, to \$60.2 million in the third quarter of 2006 compared to \$55.9 million in the third quarter of 2005. Compensation and related employee expenses increased \$1.4 million, or 5.1%, primarily as a result of an increase in the number of PET and PET/CT technologists who have a higher average hourly wage rate

than MRI technologists and an increase in mileage reimbursement rates. This increase in compensation was partially offset by a lower average headcount of MRI technologists as a result of a decrease in the average number of MRI systems in use. Medical supplies increased \$1.1 million, or 26.2%, primarily as a result of an increase in the number of PET and PET/CT scans, which use a radiopharmaceutical as a component of the PET and PET/CT scan. Maintenance and related costs increased \$0.8 million, or 6.8%, primarily due to an increase in the number of PET/CT systems in service, which have a higher average service cost per system than MRI systems. Management contract expenses increased \$0.5 million, or 16.6%, primarily as a result of an increase in expenses incurred on behalf of unconsolidated investees. Site fee expenses increased \$0.2 million, or 18.0%, primarily due to an increase in the number of retail sites in operation. All other cost of revenues, excluding depreciation and amortization, increased \$0.3 million, or 3.7%. Cost of revenues, as a percentage of revenue, increased to 53.0% in the third quarter of 2006 from 52.6% in the third quarter of 2005 as a result of the factors described above.

Selling, general and administrative expenses increased \$2.0 million, or 16.4%, to \$13.7 million in the third quarter of 2006 compared to \$11.7 million in the third quarter of 2005. Non-cash share-based compensation increased \$0.6 million in the third quarter of 2006 from the third quarter of 2005, primarily as a result of the adoption of SFAS 123 (R), effective January 1, 2006. Professional services increased \$0.5 million, or 32.9%, primarily due to legal costs associated with the tentative settlement on our class action lawsuit settlement. The provision for doubtful accounts increased \$0.5 million, or 85.2%. The provision for doubtful accounts as a percentage of revenue was 0.9% and 0.5% for each of the quarters ended September 30, 2006 and 2005, respectively. Compensation and related employee expenses increased \$0.3 million, or 3.5%, primarily due to an increase in management incentive compensation. All other selling, general and administrative expenses increased \$0.1 million, or 6.4%. Selling, general and administrative expenses as a percentage of revenue were 12.0% and 11.1% in the third quarter of 2006 and 2005, respectively.

Depreciation expense increased \$0.4 million, or 2.1%, to \$20.8 million in the third quarter of 2006 compared to \$20.4 million in the third quarter of 2005.

Amortization expense increased by \$0.3 million, or 31.2%, to \$1.2 million in the third quarter of 2006 compared to \$0.9 million in the third quarter of 2005, primarily due to the amortization of intangible assets acquired in conjunction with our acquisitions in the third and fourth quarters of 2005.

Interest expense, net, increased \$1.0 million, or 10.3%, to \$10.1 million in the third quarter of 2006 compared to \$9.1 million in the third quarter of 2005. This increase is due to higher average debt balances during the third quarter of 2006 as a result of 2005 acquisitions and higher average interest rates on our variable rate term loans. The increase in interest rates on our variable rate term loans was partially offset by the execution of various interest rate swap and collar agreements in 2004 and 2005 to hedge against future interest rate increases on most of our variable rate term loans.

Income tax expense was \$3.4 million and \$3.5 million in the third quarter of 2006 and 2005, respectively, resulting in effective tax rates of 40.9% and 41.1% in the third quarter of 2006 and 2005, respectively. Our effective tax rates were higher than statutory rates principally as a result of state income taxes.

Minority interest expense was \$0.5 million in both the third quarter of 2006 and the third quarter of 2005.

Earnings from unconsolidated investees increased by \$0.1 million, or 12.8%, to \$1.1 million in the third quarter of 2006 compared to \$1.0 million in the third quarter of 2005.

Our net income was \$4.9 million, or \$0.10 per share on a diluted basis, in the third quarter of 2006 compared to \$5.0 million, or \$0.10 per share on a diluted basis, in the third quarter of 2005.

*Nine Months Ended September 30, 2006 Compared to September 30, 2005*

Revenue increased \$23.5 million, or 7.3%, to \$344.1 million in the first nine months of 2006 compared to \$320.6 million in the first nine months of 2005 primarily due to an increase in PET and PET/CT revenues and higher other modalities and other revenue, offset by lower MRI revenue. PET and PET/CT revenue in the first nine months of 2006 increased \$31.7 million, or 46.8%, compared to the first nine months of 2005. Total PET and PET/CT scan volumes increased 49.0% to 74,719 scans in the first nine months of 2006 from 50,150 scans in the first nine months of 2005, primarily as a result of growth in our core PET and PET/CT business and the PET Scans of America Corp. acquisition. The average number of PET and PET/CT systems in service increased to 68.1 systems in the first nine months of 2006 from 51.6 systems in the first nine months of 2005. Scans per system per day increased 10.7%, to 5.91 scans per system per day in the first nine months of 2006 from 5.34 scans per system per day in the first nine months of 2005. These increases were partially offset by a 2.0% decline in the average price per PET and PET/CT scan, to \$1,312 per scan in the first nine months of 2006 compared to \$1,339 per scan in the first nine months of 2005. Other modalities and other revenue increased \$2.7 million, or 9.5%, to \$32.2 million in the first nine months of 2006 compared to \$29.5 million in the first nine months of 2005 primarily due to an increase in other fixed-site modality revenue, management contract revenue for our managed contracts and reimbursement of out-of-pocket expenses from unconsolidated investees. MRI revenue decreased \$10.9 million in the first nine months of 2006, or 4.9%, compared to the first nine months of 2005. Scan-based MRI revenue decreased \$10.6 million in the first nine months of 2006, or 5.2%, to \$192.9 million, from \$203.5 million in the first nine months of 2005. This decrease is , primarily a result of a 7.0% decrease in our scan-based MRI scan volume. Scan-based MRI scan volume decreased to 535,082 scans in the first nine months of 2006 from 575,251 scans in the first nine months of 2005, primarily due to a decrease in the average number of scan-based systems in service due to lower client demand. Scan-based systems in service decreased to 273.2 systems in the first nine months of 2006 from 282.5 systems in the first nine months of 2005 to adjust to modestly declining scan volumes and to increase the efficiency of our mobile MRI systems. Average scans per system per day also decreased by 1.7% to 9.37 in the first nine months of 2006 from 9.53 in the first nine months of 2005. Non-scan based MRI revenue decreased \$0.3 million in the first nine months of 2006 over the same period in 2005. These decreases were partially offset by a 1.9% increase in average price per MRI scan to \$360.38 per scan in first nine months of 2006 compared to \$353.77 per scan in the first nine months of 2005.

We had 334 MRI systems at September 30, 2006 compared to 350 MRI systems at September 30, 2005. We had 71 PET and PET/CT systems at September 30, 2006 compared to 58 PET and PET/CT systems at September 30, 2005. We operated 74 fixed-sites at September 30, 2006 compared to 72 fixed sites at September 30, 2005.

Cost of revenues, excluding depreciation and amortization, increased \$18.9 million, or 11.5%, to \$182.6 million in the first nine months of 2006 compared to \$163.7 million in the first nine months of 2005. Compensation and related employee expenses increased \$5.9 million, or 7.4%, primarily as a result of an increase in the number of PET and PET/CT technologists who have a higher average hourly wage rate than MRI technologists and an increase in mileage reimbursement rates. This increase in compensation was partially offset by a lower average headcount of MRI technologists as a result of a decrease in the average number of MRI systems in use. Medical supplies increased \$3.8 million, or 30.4%, primarily as a result of an increase in the number of PET and PET/CT scans, which use a radiopharmaceutical as a component of the PET and PET/CT scan. During the first nine months of 2006, we recorded a tentative settlement on our class action lawsuit of \$2.5 million. Management contract expenses increased \$1.8 million, or 21.4%, primarily as a result of an increase in expenses incurred on behalf of unconsolidated investees. Maintenance and related costs increased \$1.6 million, or 5.1%, primarily due to an increase in the number of PET/CT systems in service, which have a higher average service cost per system than MRI systems. Equipment rental expense increased \$0.7 million, or 21.0%, primarily due to a higher number of

rental systems in use to support current clients while continuing to improve route efficiency. Fuel expenses increased \$0.7 million, or 14.8%, primarily due to higher average diesel fuel prices in 2006. Site fee expenses increased \$0.4 million, or 14.6%, primarily due to an increase in the number of retail sites in operation. Outside medical services increased \$0.2 million, or 2.6%, primarily as a result of an increase in outside radiologists service costs and physicist service costs associated with PET and PET/CT services. Tractor and transportation expenses increased \$0.1 million, or 6.7%, primarily due to an increase in the number of tractors on operating leases. All other cost of revenues, excluding depreciation and amortization, increased \$1.2 million, or 10.7%. Cost of revenues, as a percentage of revenue, increased to 53.1% in the first nine months of 2006 from 51.1% in the first nine months of 2005 as a result of the factors described above.

Selling, general and administrative expenses increased \$3.9 million, or 10.6%, to \$41.0 million in the first nine months of 2006 compared to \$37.1 million in the first nine months of 2005. Non-cash share-based compensation increased \$1.8 million in the first nine months of 2006 from the first nine months of 2005, primarily as a result of the adoption of SFAS 123 (R), effective January 1, 2006. Compensation and related employee expenses increased \$1.0 million, or 4.0%, primarily due to an increase in management incentive compensation. These increases were partially offset by a decrease in recruiting costs. The provision for doubtful accounts increased \$0.6 million, or 29.0%. The provision for doubtful accounts as a percentage of revenue was 0.8% for the nine month period ended September 30, 2006 compared to 0.6% for the nine month period ended September 30, 2005. All other selling, general and administrative expenses increased \$0.5 million, or 5.4%. Selling, general and administrative expenses as a percentage of revenue were 11.9% and 11.6% in the first nine months of 2006 and 2005, respectively.

We recorded employment agreement costs of \$0.4 million in the first nine months of 2005 related to payments under an amendment to an employment agreement with our former chairman of the board.

We recorded severance and related costs of \$0.6 million in the first nine months of 2006 primarily for severance costs associated with reductions-in-force primarily due to our consolidation of five geographic regions to four geographic regions and a reduction in administrative headcount.

Depreciation expense increased \$1.4 million, or 2.3%, to \$62.7 million in the first nine months of 2006 compared to \$61.3 million in the first nine months of 2005.

Amortization expense increased by \$1.0 million, or 36.2%, to \$3.7 million in the first nine months of 2006 compared to \$2.7 million in the first nine months of 2005, primarily due to the amortization of intangible assets acquired in conjunction with our acquisitions in the third and fourth quarters of 2005.

Interest expense, net, increased \$2.6 million, or 9.6%, to \$30.3 million in the first nine months of 2006 compared to \$27.7 million in the first nine months of 2005. This increase is due to higher average debt balances during the third quarter of 2006 as a result of 2005 acquisitions and higher average interest rates on our variable rate term loans. The increase in interest rates on our variable rate term loans was partially offset by the execution of various interest rate swap and collar agreements in 2004 and 2005 to hedge against future interest rate increases on most of our variable rate term loans.

Income tax expense was \$10.4 million and \$11.8 million in the first nine months of 2006 and 2005, respectively, resulting in effective tax rates of 41.0% and 40.5% in the first nine months of 2006 and 2005, respectively. Our effective tax rates were higher than statutory rates for the first nine months of 2006 and 2005 primarily as a result of state income taxes.

Minority interest expense increased \$0.1 million, or 5.3%, to \$1.6 million in the first nine months of 2006 compared to \$1.5 million in the first nine months of 2005.

Earnings from unconsolidated investees increased by \$1.5 million, or 59.7%, to \$4.1 million in the first nine months of 2006 compared to \$2.6 million in the first nine months of 2005.

Our net income was \$15.0 million, or \$0.30 per share on a diluted basis, in the first nine months of 2006 compared to \$17.3 million, or \$0.34 per share on a diluted basis, in the first nine months of 2005.

### **Liquidity and Capital Resources**

Our primary source of liquidity is cash provided by operating activities. We generated \$77.2 million and \$93.0 million of cash flow from operating activities in the first nine months of 2006 and 2005, respectively. Our ability to generate cash flow is affected by numerous factors, including demand for MRI, PET and other diagnostic imaging services. Our ability to generate cash flow from operating activities is also dependent upon the collections of our accounts receivable. The provision for doubtful accounts increased by \$0.6 million in the first nine months of 2006 compared to the first nine months of 2005. Our number of days of revenue outstanding for our accounts receivable was 50 days and 48 days as of September 30, 2006 and 2005, which we believe is among the more favorable in the healthcare service industry. The number of days revenue outstanding as of September 30, 2006 were negatively impacted due to a Centers for Medicare and Medicaid Services ( CMS ) claims payment hold for the last 9 days of September 2006 due to CMS 's budget issues faced at its fiscal year end, which was September 30, 2006. We resumed receiving Medicare claims payments in October 2006. In addition, as of September 30, 2006, we had \$64.1 million available borrowings under our revolving line of credit.

Our primary use of capital resources is to fund capital expenditures. We used cash of \$43.9 million and \$53.2 million for investing activities in the first nine months of 2006 and 2005, respectively. We incur capital expenditures for the purposes of:

- purchasing new systems;
- replacing less advanced systems with new systems;
- providing upgrades of our MRI and PET and PET/CT systems and upgrading our corporate infrastructure for future growth.

Capital expenditures totaled \$56.5 million and \$46.5 million in the first nine months of 2006 and 2005, respectively. During the first nine months of 2006 we purchased 9 MRI systems, 20 PET/CT systems and 4 CT systems. We traded-in or sold a total of 46 total systems for the nine months ended September 30, 2006. Our decision to purchase a new system is typically predicated on obtaining new or extending existing client contracts, which serve as the basis of demand for the new system. We expect to purchase additional systems in 2006 and finance substantially all of these purchases with our available cash, cash from operating activities, our revolving line of credit, and equipment leases. Based upon the client demand described above, which dictates the type of equipment purchased, we expect capital expenditures to total approximately \$75 to \$80 million in 2006.

We believe that, based on current levels of operations, our cash flow from operating activities, together with other available sources of liquidity, including borrowings available under our revolving loan facility, will be sufficient over the next one to two years to fund anticipated capital expenditures and make required payments of principal and interest on our debt.

### **Recent Accounting Pronouncements**

In May 2005, the FASB issued SFAS 154, Accounting for Changes and Error Corrections ( SFAS 154 ), which is a replacement of APB Opinion No. 20, Accounting Changes, and SFAS 3, Reporting Accounting Changes in Interim Financial Statements. This statement changes the requirements for the accounting for and reporting of all voluntary changes in accounting principle and in the instance that a pronouncement does not include specific transition provisions. This statement requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change.

SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 did not have a material impact on our consolidated financial position or results of operations.

In June 2005, the FASB issued Emerging Issues Task Force Issue No. 04-05, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights* ( EITF 04-05 ). EITF 04-05 clarifies how general partners in a limited partnership should determine whether they control a limited partnership. A general partner of a limited partnership is presumed to control the limited partnership unless the limited partners have substantive kick-out rights or participating rights. For general partners of all new limited partnerships formed and for existing limited partnerships for which the partnership agreements are modified, EITF 04-05 is effective after June 29, 2005. For general partners in all other limited partnerships, EITF 04-05 is effective for the first period in fiscal years beginning after December 15, 2005. The adoption of EITF 04-05 did not have a material impact on our consolidated financial position or results of operations.

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ), an interpretation of FASB Statement No. 109, *Accounting for Income Taxes* ( FASB 109 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB 109. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the provisions of FIN 48 and the impact on our consolidated financial position and results of operations. We will adopt FIN 48 for the fiscal year beginning January 1, 2007.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements* ( SFAS 157 ), which enhances the existing guidance for measuring assets and liabilities using fair value. This statement provides a single definition of fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 emphasizes fair value as a market-based measurement instead of an entity-specific measurement. The statement sets out a fair value hierarchy with the highest priority being quoted prices in active markets. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently evaluating the provisions of SFAS 157 and the impact on our consolidated financial position and results of operations. We will adopt SFAS 157 for the fiscal year beginning January 1, 2008.

In September 2006, the Securities Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements* ( SAB 108 ), which states that registrants should use both a balance sheet approach and an income statement approach when quantifying and evaluating the materiality of a misstatement, contains guidance on correcting errors under the dual approach, and provides transition guidance for correcting errors existing in prior years. SAB 108 is effective for fiscal years ending after November 15, 2006. We do not believe the adoption of SAB 108 will have a material impact on our consolidated financial position and results of operations.



Cautionary Statement Pursuant to the Private Securities Litigation Reform Act of 1995

Certain statements contained in Management's Discussion and Analysis of Financial Condition and Results of Operations, particularly in the section entitled Liquidity and Capital Resources, and elsewhere in this quarterly report on Form 10-Q, are forward-looking statements, within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Statements which address activities, events or developments that we expect or anticipate will or may occur in the future, including such things as results of operations and financial condition, capital expenditures, the consummation of acquisitions and financing transactions and the effect of such transactions on our business and our plans and objectives for future operations and expansion are examples of forward-looking statements. In some cases you can identify these statements by forward-looking words like may, will, should, expect, anticipate, believe, estimate, predict, continue or similar words. These forward-looking statements are subject to risks and uncertainties which could cause actual outcomes and results to differ materially from our expectations, forecasts and assumptions. These risks and uncertainties include factors affecting our leverage, including fluctuations in interest rates, the risk that the counter-parties to our interest rate swap agreements fail to satisfy their obligations under these agreements, our ability to incur financing, the effect of operating and financial restrictions in our debt instruments, the accuracy of our estimates regarding our capital requirements, the effect of intense levels of competition in our industry, changes in the rates or methods of third party reimbursements for diagnostic imaging services, changes in the healthcare regulatory environment, our ability to keep pace with technological developments within our industry, and other risks and uncertainties, including those enumerated and described under Risk Factors in our Form 10-K, as filed with the Securities and Exchange Commission, for the fiscal year ended December 31, 2005. The foregoing should not be construed as an exhaustive list of all factors which could cause actual results to differ materially from those expressed in forward-looking statements made by us.

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.

Our interest expense is sensitive to changes in the general level of interest rates in the United States, particularly because the majority of our indebtedness has interest rates which are variable. The recorded carrying amount of our long-term debt under our existing credit agreement approximates fair value as these borrowings have variable rates that reflect currently available terms and conditions for similar debt. To decrease the risk associated with interest rate increases, we entered into multiple interest rate swap and collar agreements for a portion of our variable rate debt. These swaps and collars are designated as cash flow hedges of variable future cash flows associated with our long-term debt.

During 2004 we entered into swap agreements which have notional amounts of \$56.8 million, \$46.8 million and \$48.4 million at September 30, 2006. Under the terms of these agreements, we receive three-month LIBOR and pay a fixed rate of 3.15%, 3.89%, and 3.69%, respectively. The net effect of the hedges is to record interest expense at fixed rates of 5.65%, 6.39% and 6.19% respectively, as the debt incurs interest based on three-month LIBOR plus 2.50%. For the quarter and nine months ended September 30, 2006, we received a net settlement amount of \$0.6 million and \$1.4 million, respectively. For the quarter and nine months ended September 30, 2005 we paid a net settlement amount of \$0.1 million and \$0.8 million, respectively. The swap agreements mature during 2007.

During 2005 we entered into multiple interest rate collar agreements which have a notional amount of \$178.0 million. Under the terms of these agreements, we have purchased a cap on the interest rate of 4.00% and have sold a floor of 2.25%. For the quarter and nine months ended September 30, 2006, we

received a net settlement amount of \$0.5 million and \$0.9 million, respectively, on these collar agreements. For the quarter and nine months ended September 30, 2005, we did not record any net settlement on these collar agreements. The collar agreements mature at various dates between January 2007 and January 2008.

The swap and collar agreements have been designated as cash flow hedges of variable future cash flows associated with our long term debt. In accordance with SFAS 133, the swaps and collars are recorded at fair value. On a quarterly basis, the fair value of the swaps and collars will be determined based on quoted market prices and, assuming perfect effectiveness, the difference between the fair value and the book value of the swaps and collars will be recognized in comprehensive income, a component of shareholders' equity. Any ineffectiveness of the swaps and collars is required to be recognized in earnings.

The outstanding interest rate swaps and collars expose us to credit risk in the event that the counterparties to the agreements do not or cannot meet their obligations. The notional amount is used to measure interest to be paid or received and does not represent the amount of exposure to credit loss. The loss would be limited to the amount that would have been received, if any, over the remaining life of the swap and collar agreements. The counterparties to the swaps and collars are major financial institutions and we expect the counterparties to be able to perform their obligations under the swaps and collars. We use derivative financial instruments for hedging purposes only and not for trading or speculative purposes.

Our interest income is sensitive to changes in the general level of interest rates in the United States, particularly because the majority of our investments are in cash equivalents. The recorded carrying amounts of cash and cash equivalents approximate fair value due to their short-term maturities.

#### **ITEM 4. CONTROLS AND PROCEDURES**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures. Also, we have investments in certain unconsolidated entities. As we do not control or manage these entities, our disclosure controls and procedures with respect to such entities are more limited than those we maintain with respect to our consolidated subsidiaries. These unconsolidated entities are not considered material to our consolidated financial position or results of operations.

As required by SEC Rule 13a-15(b), we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the quarter covered by this report. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

There have been no changes in the Company's internal control over financial reporting occurring during the fiscal quarter covered by this report which have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

## PART II OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

On May 5, 2005, Alliance Imaging, Inc. was served with a complaint (the Class Action Complaint ) filed in Alameda County Superior Court alleging wage and hour claims on behalf of a putative class of approximately 400 former and current California employees of the Company. On August 19, 2005, the plaintiffs filed an amended complaint, which the Company answered on September 23, 2005. In this suit, captioned Linda S. Jones, et al. v. Alliance Imaging, Inc., et al., the plaintiffs allege violations of California's wage, meal period, and break time laws and regulations. Plaintiffs sought recovery of unspecified economic damages, statutory penalties, attorneys' fees, and costs of suit. On or about March 10, 2006, plaintiffs filed a second amended complaint (later further amended by a third amended complaint) adding a cause of action for conversion and a plea for punitive damages. The Company has filed a demurrer and motion to strike seeking to dismiss the new claim and plea. On July 19, 2006, the Company and the Plaintiffs entered into a tentative settlement of the Class Action Complaint pursuant to which the Company has agreed to pay \$2.5 million in exchange for a dismissal with prejudice of all claims brought on behalf of the putative class under the Class Action Complaint. On September 8, 2006, the settlement was preliminarily approved by the court and a conditional class was certified for purposes of seeking class approval of the settlement. On October 2, 2006, notice was mailed to the conditional class members outlining the terms of the settlement and providing all class members with an opportunity to opt out of the settlement prior to the final approval hearing scheduled for November 27, 2006.

From time to time, we are involved in routine litigation incidental to the conduct of our business. We believe that none of this litigation pending against us will have a material adverse effect on our business.

### ITEM 1A. RISK FACTORS

#### Risks Related to Our Business

**Changes in the rates or methods of third-party reimbursements for diagnostic imaging services could result in reduced demand for our services or create downward pricing pressure, which would result in a decline in our revenues and harm to our financial position.**

We derive approximately 13% of our revenues from direct billings to patients and third-party payors such as Medicare, Medicaid or private health insurance companies, and changes in the rates or methods of reimbursement for the services we provide could have a significant negative impact on those revenues. Approximately 87% of our revenues are derived from healthcare provider clients including hospitals, that generally rely on reimbursement from third-party payors. From time to time, initiatives have been proposed which, if implemented, could have the effect of substantially decreasing reimbursement rates for diagnostic imaging services.

For example, on February 8, 2006, the Deficit Reduction Act of 2005, or DRA, was signed into law by President George W. Bush. The DRA imposes caps on Medicare payment rates for certain imaging services, including MRI, PET and CT, furnished in physician's offices and other non-hospital based settings. Under the cap, payments for specified imaging services cannot exceed the hospital outpatient payment rates for those services. This change is to apply to services furnished on or after January 1, 2007. The limitation is applicable to the technical component of the services only (which is the payment we receive for the services for which we bill directly under the Medicare Physician Fee Schedule). If the technical component of the service established under the Physician Fee Schedule (without including geographic adjustments) exceeds the hospital outpatient payment amount for the service (also without including geographic adjustments), then the payment is to be reduced. In other words, in those instances where the technical component for the particular service is greater for the non-hospital site, the DRA directs that the hospital outpatient payment rate be substituted for the otherwise applicable Physician Fee

Schedule payment rates. The implementation of this reimbursement reduction contained in the DRA will have a significant effect on our financial condition and results of operations beginning in 2007. On November 1, 2006, the Centers for Medicare and Medicaid Services ( CMS ) issued a final rule for the Medicare Part B hospital outpatient prospective payment system, or HOPPS reimbursement rates for PET and PET/CT imaging procedures. The national payment rate for nonmyocardial PET scans will be reduced from the current rate of \$1,150 per scan to \$855.43 per scan effective January 1, 2007. The national payment rate for PET/CT scans will be reduced from the current rate of \$1,250 per scan to \$950 per scan effective, also January 1, 2007.

For full year 2006, Alliance estimates that approximately 5.6% of the Company's revenue will be billed directly to the Medicare program, which has increased from approximately 4.3% of the Company's revenue billed directly to the Medicare program in 2005. If the DRA had been in effect for full year 2006, Alliance estimates the reduction in Medicare revenue due to the DRA reimbursement rate decrease would have reduced revenue by approximately \$9.7 million. Additionally, the PET and PET/CT Medicare HOPPS reduction would have reduced revenue by approximately \$2.8 million. Combined, the DRA and PET and PET/CT Medicare HOPPS rate reductions described above would have negatively impacted Alliance's 2006 revenue by a total of \$12.5 million. Because a high percentage of our expenses are fixed, we expect a significant portion of this decrease in revenue to directly affect earnings.

In addition, the DRA also codifies the reduction in reimbursement for multiple images on contiguous body parts which was previously announced by the Center for Medicare and Medicaid Services, or CMS. The DRA mandates payment at 100% of the technical component of the higher priced imaging procedure and 50% for the technical component of each additional imaging procedure for multiple images of contiguous body parts within a family of codes performed in the same session. Initially, CMS announced that it would phase in this reimbursement reduction over a two-year period, resulting in a 25% reduction for each additional imaging procedure on contiguous body parts in 2006 and an additional 25% reduction in 2007. On November 1, 2006, however, CMS announced that it would not implement the additional 25% reduction in 2007. The Company believes that the implementation of this reimbursement reduction will not have a significant impact on the financial condition and results of operation in the future.

**Our revenues may fluctuate or be unpredictable and this may harm our financial results.**

The amount and timing of revenues that we may derive from our business will fluctuate based on:

- variations in the rate at which clients renew their contracts;
- the extent to which our mobile shared-service clients become full-time clients;
- changes in the number of days of service we can offer with respect to a given diagnostic imaging system due to equipment malfunctions or the seasonal factors discussed below; and
- the mix of wholesale and retail billing for our services.

In addition, we experience seasonality in the sale of our services. For example, our revenues typically decline from our third fiscal quarter to our fourth fiscal quarter. First and fourth quarter revenues are typically lower than those from the second and third quarters. First quarter revenue is affected primarily by fewer calendar days and inclement weather, the results of which are fewer patient scans during the period. Fourth quarter revenue is affected primarily by holiday and client and patient vacation schedules and inclement weather, the results of which are fewer patient scans during the period. As a result, our revenues may significantly vary from quarter to quarter, and our quarterly results may be below market expectations. We may not be able to reduce our expenses, including our debt service obligations, quickly enough to respond to these declines in revenue, which would make our business difficult to operate and would harm our financial results. If this happens, the price of our common stock may decline.

**We may experience competition from other medical diagnostic companies and equipment manufacturers and this competition could adversely affect our revenues and our business.**

The market for diagnostic imaging services and systems is competitive. Our major competitors include InSight Health Services Corp., Medquest, Inc., Radiologix, Inc., Medical Resources, Inc., Shared Medical Services, Kings Medical Company Inc. and Otter Tail Power Company. In addition to direct competition from other mobile providers, we compete with independent imaging centers and referring physicians with diagnostic imaging systems in their own offices, as well as with original equipment manufacturers, or OEM's, that aggressively sell or lease imaging systems to healthcare providers for full-time installation. In recent years we have seen an increase in activity by OEM's sale of systems directly to a certain number of our clients. Typically, OEM's target our higher scan volume clients. This increase in activity by OEM's has resulted in overcapacity of systems in the marketplace, especially related to medical groups adding imaging capacity within their practice setting. This has caused an increase in the number of our higher scan volume clients deciding not to renew their contracts. We replace these higher volume scan clients typically with lower volume clients. During 2005 our MRI revenues modestly declined compared to 2004 levels and we believe that MRI revenues will continue to modestly decline in future years.

While we believe that we had a greater number of diagnostic imaging systems deployed at the end of 2005 than our principal competitors and also had greater revenue from diagnostic imaging services during our 2005 fiscal year than they did, some of our direct competitors which provide diagnostic imaging services may now or in the future have access to greater financial resources than we do and may have access to newer, more advanced equipment. In addition, some clients have in the past elected to provide imaging services to their patients directly rather than renewing their contracts with us. Finally, we face competition from providers of competing technologies such as ultrasound and may face competition from providers of new technologies in the future. If we are unable to successfully compete, our client base would decline and our business and financial condition would be harmed.

**Managed care organizations may prevent healthcare providers from using our services which would cause us to lose current and prospective clients.**

Healthcare providers participating as providers under managed care plans may be required to refer diagnostic imaging tests to specific imaging service providers depending on the plan in which each covered patient is enrolled. These requirements currently inhibit healthcare providers from using our diagnostic imaging services in some cases. The proliferation of managed care may prevent an increasing number of healthcare providers from using our services in the future which would cause our revenues to decline.

**We may be unable to effectively maintain our imaging systems or generate revenue when our systems are not working.**

Timely, effective service is essential to maintaining our reputation and high utilization rates on our imaging systems. Repairs to one of our systems can take up to two weeks and result in a loss of revenue. Our warranties and maintenance contracts do not fully compensate us for loss of revenue when our systems are not working. The principal components of our operating costs include depreciation, salaries paid to technologists and drivers, annual system maintenance costs, insurance and transportation costs. Because the majority of these expenses are fixed, a reduction in the number of scans performed due to out-of-service equipment will result in lower revenues and margins. Repairs of our equipment are performed for us by the equipment manufacturers. These manufacturers may not be able to perform repairs or supply needed parts in a timely manner. Thus, if we experience greater than anticipated system malfunctions or if we are unable to promptly obtain the service necessary to keep our systems functioning effectively, our revenues could decline and our ability to provide services would be harmed.

**Our ability to maximize the utilization of our diagnostic imaging equipment may be adversely impacted by harsh weather conditions which may affect our ability to generate revenue.**

Harsh weather conditions can adversely impact our operations and financial condition. To the extent severe weather patterns affect the regions in which we operate, potential patients may find it difficult to travel to our centers and we may have difficulty moving our mobile systems along their scheduled routes. As a result, we would experience a decrease in scan volume during that period. Our equipment utilization, scan volume or revenues could be adversely affected by similar conditions in the future.

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

We operate in a competitive, capital intensive, high fixed-cost industry. The development of new technologies or refinements of existing ones might make our existing systems technologically or economically obsolete, or reduce the need for our systems. MRI, PET and PET/CT and other diagnostic imaging systems are currently manufactured by numerous companies. Competition among manufacturers for a greater share of the MRI, PET and PET/CT and other diagnostic imaging systems market has resulted in and likely will continue to result in technological advances in the speed and imaging capacity of these new systems. Consequently, the obsolescence of our systems may be accelerated. Should new technological advances occur, we may not be able to acquire the new or improved systems. In the future, to the extent we are unable to generate sufficient cash from our operations or obtain additional funds through bank financing or the issuance of equity or debt securities, we may be unable to maintain a competitive equipment base. In addition, advancing technology may enable hospitals, physicians or other diagnostic service providers to perform procedures without the assistance of diagnostic service providers such as ourselves. As a result, we may not be able to maintain our competitive position in our targeted regions or expand our business.

**Natural disasters could adversely affect our business and operations.**

Our corporate headquarters is located in California and we currently operate in 43 states, located in various geographic regions across the country, subject to varying risks for natural disaster, including but not limited to, hurricanes, blizzards, floods, earthquakes and tornados. Depending upon their severity, these natural disasters could damage our facilities and imaging systems or prevent potential patients from traveling to our centers. Damage to our equipment or any interruption in our business would adversely affect our financial condition and could result in the loss of the capital invested in the damaged facilities or imaging systems or anticipated future cash flows from those facilities or imaging systems.

**Continued high fuel costs would harm our operations.**

Fuel costs constitute a significant portion of our mobile operating expenses. Historically, fuel costs have been subject to wide price fluctuations based on geopolitical issues and supply and demand. Fuel availability is also affected by demand for home heating oil, diesel, gasoline and other petroleum products. Because of the effect of these events on the price and availability of fuel, the cost and future availability of fuel cannot be predicted with any degree of certainty. In the event of a fuel supply shortage or further increases in fuel prices, a curtailment of scheduled mobile service could result. There have been significant increases in fuel costs and continued high fuel costs or further increases would harm our financial condition and results of operations.

**We may be unable to renew or maintain our client contracts which would harm our business and financial results.**

Upon expiration of our clients' contracts, we are subject to the risk that clients will cease using our imaging services and purchase or lease their own imaging systems or use our competitors' imaging systems.

During the year ended December 31, 2005, we continued to experience a high rate of contract terminations primarily due to stepped up marketing, sales and attractive financing alternatives being offered by original equipment manufacturers to our clients. A portion of our clients can execute their early termination clause and discontinue service prior to maturity. As a result, our 2005 MRI revenues declined compared to 2004 levels and we believe that MRI revenues from our shared-service operations will continue to decline in future periods. If these contracts are not renewed, it could result in a significant negative impact on our business. It is not always possible to immediately obtain replacement clients, and historically many replacement clients have been smaller facilities which have a lower number of scans than lost clients.

**Because a high percentage of our operating expenses are fixed, a relatively small decrease in revenues could have a significant negative impact on our financial results.**

A high percentage of our expenses are fixed, meaning they do not vary significantly with the increase or decrease in revenues. Such expenses include, but are not limited to, debt service and capital lease payments, rent and operating lease payments, salaries, maintenance, insurance and vehicle operation costs. As a result, a relatively small reduction in the prices we charge for our services or procedure volume could have a disproportionate negative effect on our financial results.

**We may be subject to professional liability risks which could be costly and negatively impact our business and financial results.**

We may be subject to professional liability claims. Although there currently are no known hazards associated with MRI or our other scanning technologies when used properly, hazards may be discovered in the future. Furthermore, there is a risk of harm to a patient during an MRI if the patient has certain types of metal implants or cardiac pacemakers within his or her body. Patients are carefully screened to safeguard against this risk, but screening may nevertheless fail to identify the hazard. Any claim made against us could be costly to defend against, result in a substantial damage award against us and divert the attention of our management from our operations, which could have an adverse effect on our financial performance.

**Loss of key executives and failure to attract qualified managers and sales persons could limit our growth and negatively impact our operations.**

We depend upon our management team to a substantial extent. In particular, we depend upon Mr. Viviano, our Chief Executive Officer and the Chairman of our Board of Directors for his skills, experience and knowledge of the company and industry contacts. Effective May 9, 2005, Mr. Viviano entered into an employment agreement which ends on the second anniversary of the effective date. The term of this agreement is subject to automatic extensions on a quarterly basis after the initial term has been completed. Mr. Viviano can prevent a quarterly extension by giving notice of a desire to modify or terminate the agreement at least thirty days prior to the quarterly extension date. In addition, we do not have key employee insurance policies covering any of our management team. The loss of Mr. Viviano or other members of our management team, could have a material adverse effect on our business, results of operations or financial condition.

As we grow, we will increasingly require field managers and sales persons with experience in our industry to operate our diagnostic equipment. It is impossible to predict the availability of qualified field managers and sales persons or the compensation levels that will be required to hire them. The loss of the services of any member of our senior management or our inability to hire qualified field managers and sales persons at economically reasonable compensation levels could adversely affect our ability to operate and grow our business.

**Loss of, and failure to attract, qualified employees and technologists, could limit our growth and negatively impact our operations.**

Our future success depends on our continuing ability to identify, hire, develop, motivate and retain highly skilled personnel for all areas of our organization. Competition in our industry for qualified employees is intense. In particular, there is a very high demand for qualified technologists who are necessary to operate our systems, particularly PET and PET/CT technologists. We may not be able to hire and retain a sufficient number of technologists, and we expect that our costs for the salaries and benefits of technologists will continue to increase for the foreseeable future because of the industry's competitive demand for their services. Our continued ability to compete effectively depends on our ability to attract new employees and to retain and motivate our existing employees.

**Our positron emission tomography and positron emission tomography/computed tomography, or PET and PET/CT services and some of our other imaging services require the use of radioactive materials, which could subject us to regulation related costs and delays and potential liabilities for injuries or violations of environmental, health and safety laws.**

Our PET and PET/CT service and some of our other imaging services require radioactive materials. While this radioactive material has a short half-life, meaning it quickly breaks down into inert, or non-radioactive substances, storage, use and disposal of these materials presents the risk of accidental environmental contamination and physical injury. We are subject to federal, state and local regulations governing storage, handling and disposal of these materials and waste products. Although we believe that our safety procedures for storing, handling and disposing of these hazardous materials comply with the standards prescribed by law and regulation, we cannot completely eliminate the risk of accidental contamination or injury from those hazardous materials. We maintain professional liability insurance with coverage that we believe is consistent with industry practice and appropriate in light of the risks attendant to our business. However, in the event of an accident, we could be held liable for any damages that result, and any liability could exceed the limits or fall outside the coverage of our insurance. We may not be able to maintain insurance on acceptable terms, or at all. We could incur significant costs and the diversion of our management's attention in order to comply with current or future environmental, health and safety laws and regulations.

**We may not be able to achieve the expected benefits from future acquisitions which would adversely affect our financial condition and results.**

We have historically relied on acquisitions as a method of expanding our business. In addition, we will consider future acquisitions as opportunities arise. If we do not successfully integrate acquisitions, we may not realize anticipated operating advantages and cost savings. The integration of companies that have previously operated separately involves a number of risks, including:

- demands on management related to the increase in our size after an acquisition;
- the diversion of our management's attention from the management of daily operations to the integration of operations;
- difficulties in the assimilation and retention of employees;
- potential adverse effects on operating results; and
- challenges in retaining clients.

We may not be able to maintain the levels of operating efficiency acquired companies have achieved or might achieve separately. Successful integration of each of their operations will depend upon our ability to manage those operations and to eliminate redundant and excess costs. Because of difficulties in



combining operations, we may not be able to achieve the cost savings and other size related benefits that we hoped to achieve after these acquisitions which would harm our financial condition and operating results.

**We are controlled by a single stockholder who will be able to exert significant influence over matters requiring stockholder approval, including change of control transactions.**

Viewer Holdings L.L.C., an affiliate of Kohlberg Kravis Roberts & Co, or KKR, owns approximately 70% of our common equity without giving effect to phantom shares held by three members of KKR's management who are on our board of directors. These directors in the aggregate hold 49,231 phantom shares, which gives them the right to receive an equivalent number of shares of our common stock, or cash, upon their retirement or separation from the board of directors or upon the occurrence of a change of control. KKR 1996 GP L.L.C. is the sole general partner of KKR Associates 1996 L.P., which is the sole general partner of KKR 1996 Fund L.P. As of the date hereof, KKR 1996 Fund L.P. is the senior member of Viewer Holdings L.L.C. Michael W. Michelson, a member of our board of directors, is a member of KKR 1996 GP L.L.C. Mr. Michelson is also the Chairperson of our Compensation Committee and a member of our Executive Committee. James C. Momtazee and Kenneth W. Freeman, who are also executives of KKR and limited partners of KKR Associates 1996 L.P., are also members of our board of directors. Mr. Momtazee is also a member of our Compensation Committee and our Executive Committee. We sometimes refer to KKR 1996 GP L.L.C., KKR Associates 1996 L.P., KKR 1996 Fund L.P. and various affiliated entities as KKR. KKR provides management, consulting and financial services to us and we paid KKR an annual fee of \$650,000 in 2005 and will pay \$650,000 in 2006 in quarterly installments in arrears at the end of each calendar quarter for those services.

As a result of the arrangements described above, KKR controls us and has the power to elect all of our directors, appoint new management and approve any action requiring the approval of the holders of shares of our common stock, including adopting amendments to our certificate of incorporation and approving mergers, consolidations or sales of all or substantially all of our assets. This concentration of ownership may also delay or prevent a change of control of our company or reduce the price investors might be willing to pay for our common stock. The interests of KKR may conflict with the interests of other holders of our common stock.

**Possible volatility in our stock price could negatively affect us and our stockholders.**

The trading price of our common stock on the New York Stock Exchange has fluctuated significantly in the past. During the period from January 1, 2004 through September 30, 2006, the trading price of our common stock fluctuated from a high of \$14.15 per share to a low of \$3.38 per share. In the past, we have experienced a drop in stock price following an announcement of disappointing earnings or earnings guidance. Any such announcement in the future could lead to a similar drop in stock price. The price of our common stock could also be subject to wide fluctuations in the future as a result of a number of other factors, including the following:

- changes in expectations as to future financial performance or buy/sell recommendations of securities analysts;
- our, or a competitor's, announcement of new products or services, or significant acquisitions, strategic partnerships, joint ventures or capital commitments; and
- the operating and stock price performance of other comparable companies.

In addition, the U.S. securities markets have experienced significant price and volume fluctuations. These fluctuations often have been unrelated to the operating performance of companies in these markets. Broad market and industry factors may lead to volatility in the price of our common stock, regardless of

our operating performance. Moreover, our stock has limited trading volume, and this illiquidity may increase the volatility of our stock price.

In the past, following periods of volatility in the market price of an individual company's securities, securities class action litigation often has been instituted against that company. The institution of similar litigation against us could result in substantial costs and a diversion of our management's attention and resources, which could negatively affect our business, results of operations or financial condition.

**Recently enacted and proposed changes in securities laws and regulations are likely to increase our costs and may affect our ability to be in compliance with such new corporate governance provisions in the future.**

The existing federal securities laws and regulations impose complex and continually changing regulatory requirements on our operations and reporting. With the enactment of the Sarbanes-Oxley Act of 2002 in July 2002, a significant number of new corporate governance requirements have been adopted. These new requirements impose comprehensive reporting and disclosure requirements, set stricter independence and financial expertise standards for audit committee members, and impose increased civil and criminal penalties for companies, their chief executive officers, chief financial officers and directors for securities law violations. We expect these developments to increase our legal compliance costs, increase the difficulty and expense in obtaining director and officer liability insurance, and make it harder for us to attract and retain qualified members of our board of directors and/or qualified executive officers. Such developments could harm our results of operations and divert management's attention from business operations.

## **Risks Related to Government Regulation of Our Business**

### **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 our clients subject to extensive regulation by both the federal government and the states in which we conduct our business, including the federal Anti-Kickback Law and similar state anti-kickback laws, the Stark Law and similar state laws affecting physician referrals, the federal False Claims Act, the Health Insurance Portability and Accountability Act of 1996 and similar state laws addressing privacy and security, state unlawful practice of medicine and fee splitting laws, state certificate of need laws, the Medicare and Medicaid statutes and regulations, the Medicare Prescription Drug, Improvement and Modernization Act of 2003, and requirements for handling biohazardous and radioactive materials and wastes.

If our operations are found to be in violation of any of the laws and regulations to which we or our clients 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 risk 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 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.

### **Federal and state anti-kickback and anti-self-referral laws may adversely affect our operations and income.**

Various federal and state laws govern financial arrangements among health care 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. Many state laws also 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 laws may result in substantial civil or criminal penalties and/or exclusion from participation in federal or state healthcare programs. We believe that we are operating in compliance with applicable laws and believe that our arrangements with providers would not be found to violate the federal and state anti-kickback laws. However, these laws could be interpreted in a manner inconsistent with, and that could have an adverse effect on, our operations.

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

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

In addition, under the DRA, States are encouraged to adopt false claims acts similar to the federal False Claims Act, which establish liability for submission of fraudulent claims to the State Medicaid Program and contain qui tam or whistleblower provisions. States enacting such false claims statutes will receive an increased percentage of any recovery from a State Medicaid judgment or settlement. Adoption of new false claims statutes in states where we operate may impose additional requirements or burdens on us.

**Healthcare reform legislation and future regulations could impact our operations or limit the prices we can charge for our services, which would reduce our revenues and harm our operating results.**

In addition to extensive existing government healthcare regulation, there have been and continue to be numerous initiatives at the federal and state levels for reforms affecting the payment for and availability of healthcare services, including proposals that would significantly limit reimbursement under the Medicare and Medicaid Programs. 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. For example, the DRA, which was signed into law on February 8, 2006, contains provisions affecting Medicare payment for imaging services furnished in a number of settings.

In addition, on November 1, 2006, CMS issued a rule that describes 14 new supplier standards applicable to independent diagnostic testing facilities, or IDTFs, enrolled or enrolling in the Medicare program, which includes some of the Company's facilities. CMS has designed these standards to ensure that minimum quality standards are met to protect beneficiaries. If an IDTF fails to meet one or more of the proposed standards at the time of enrollment or at the time of re-enrollment, then its application will be denied or the agency will revoke an IDTF's billing privileges. These new standards go into effect on January 1, 2007, and IDTFs must meet these standards to obtain or retain enrollment in the Medicare program. We believe we already meet the requirements in all material respects. At this time, we cannot predict the impact that these new standards will have on our business.

It is not clear at this time what existing or future proposals, if any, will be made or adopted and, if adopted, what effect these proposals would have on our business. Aspects of certain of these healthcare proposals, such as payment reductions in the Medicare and Medicaid Programs, containment of healthcare costs on an interim basis by means that could include a short-term freeze on prices charged by healthcare providers, and permitting greater state flexibility in the administration of Medicaid, could limit the demand for our services or affect the revenue per procedure that we can collect which would harm our business and results of operations.

**The application or repeal of state certificate of need regulations could harm our business and financial results.**

Some states require a certificate of need or similar regulatory approval prior to the acquisition of high-cost capital items including diagnostic imaging systems or provision of diagnostic imaging services by us or our clients. Seventeen of the 43 states in which we operate require a certificate of need and more states may adopt similar licensure frameworks in the future. In many cases, a limited number of these certificates are available in a given state. If we are unable to obtain the applicable certificate or approval or additional certificates or approvals necessary to expand our operations, these regulations may limit or preclude our operations in the relevant jurisdictions.

Conversely, states in which we have obtained a certificate of need may repeal existing certificate of need regulations or liberalize exemptions from the regulations. For example, Pennsylvania, Nebraska, New York, Ohio and Tennessee have liberalized exemptions from certificate of need programs. The repeal of certificate of need regulations in states in which we have obtained a certificate of need or a certificate of

need exemption would lower barriers to entry for competition in those states and could adversely affect our business.

**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.**

All of the states in which we operate require that the imaging technologists that operate our computed tomography, single photon emission computed tomography, and positron emission tomography systems be licensed or certified. Also, each of our retail sites must continue to meet various requirements in order to receive payments from the Medicare Program. In addition, we are currently accredited by the Joint Commission on Accreditation of Healthcare Organizations, an independent, non-profit organization that accredits various types of healthcare providers such as hospitals, nursing homes and providers of diagnostic imaging services. In the healthcare industry, various types of organizations are accredited to meet certain Medicare certification requirements, expedite third-party payment, and fulfill state licensure requirements. Some managed care providers prefer to contract with accredited organizations. Any lapse in our licenses, certifications or accreditations, or those of our technologists, or the failure of any of our retail sites to satisfy the necessary requirements under Medicare could adversely affect our operations and financial results.

**Risks Related to Our Indebtedness**

**Our substantial indebtedness could restrict our operations and make us more vulnerable to adverse economic conditions.**

Our substantial indebtedness could have important consequences for our stockholders. For example, it could:

- require us to dedicate a substantial portion of our cash flow from operations to payments on our indebtedness, thereby reducing the availability of our cash flow to fund working capital, capital expenditures and acquisitions and for other general corporate purposes;
- increase our vulnerability to economic downturns and competitive pressures in our industry;
- place us at a competitive disadvantage compared to our competitors that have less debt in relation to cash flow; and
- limit our flexibility in planning for, or reacting to, changes in our business and our industry.

**If there is a default under the agreements governing our material indebtedness, the value of our assets may not be sufficient to repay our creditors.**

Our property and equipment which make up a significant portion of our tangible assets, had a net book value as of December 31, 2005 of \$358.9 million and \$346.5 million as of September 30, 2006. The book value of these assets should not be relied on as a measure of realizable value for such assets. The realizable value may be greater or lower than such net book value. The value of our assets in the event of liquidation will depend upon market and economic conditions, the availability of buyers and similar factors. A sale of these assets in a bankruptcy or similar proceeding would likely be made under duress, which would reduce the amounts that could be recovered. Furthermore, such a sale could occur when other companies in our industry also are distressed, which might increase the supply of similar assets and therefore reduce the amounts that could be recovered. Our goodwill and other intangible assets had a net book value as of December 31, 2005 of \$193.7 million and \$191.7 million as of September 30, 2006. These assets primarily consist of the excess of the acquisition cost over the fair market value of the net assets acquired in purchase transactions, customer contracts and costs to obtain certificates of need. The value of goodwill and other intangible assets will continue to depend significantly upon the success of our business

as a going concern and the growth in future cash flows. As a result, in the event of a default under the agreements governing our material indebtedness or any bankruptcy or dissolution of our company, the realizable value of these assets will likely be substantially lower and may be insufficient to satisfy the claims of our creditors.

The condition of our assets will likely deteriorate during any period of financial distress preceding a sale of our assets. In addition, much of our assets consist of illiquid assets that may have to be sold at a substantial discount in an insolvency situation. Accordingly, the proceeds of any such sale of our assets may not be sufficient to satisfy, and may be substantially less than, amounts due to our creditors.

**Despite current indebtedness levels, we and our subsidiaries may still be able to incur substantially more indebtedness which could increase the risks described above.**

We and our subsidiaries may be able to incur substantial additional indebtedness in the future. The terms of the indentures that govern our 10<sup>3</sup>/<sub>8</sub>% senior subordinated notes due 2011 and 7<sup>1</sup>/<sub>4</sub>% senior subordinated notes due 2012 permit us or our subsidiaries to incur additional indebtedness, subject to certain restrictions. Further, the indentures allow for the incurrence of indebtedness by our subsidiaries, all of which would be structurally senior to the notes. In addition, as of September 30, 2006, our revolving credit facility permitted additional borrowings of up to approximately \$64.1 million subject to the covenants contained in the credit facility, and all of those borrowings would be senior to the notes. If new debt is added to our and our subsidiaries' current debt levels, the risks discussed above could intensify.

**If we are unable to generate or borrow sufficient cash to make payments on our indebtedness or to refinance our indebtedness on acceptable terms, our financial condition would be materially harmed, our business may fail and you may lose all of your investment.**

Our ability to make scheduled payments on or to refinance our obligations with respect to our debt will depend on our financial and operating performance, which will be affected by general economic, financial, competitive, business and other factors beyond our control. We cannot assure you that our business will generate sufficient cash flow from operations or that future borrowings will be available to us in an amount sufficient to enable us to service our debt or to fund our other liquidity needs. If we are unable to meet our debt obligations or fund our other liquidity needs, we may need to restructure or refinance all or a portion of our debt on or before maturity or sell certain of our assets. We cannot assure you that we will be able to restructure or refinance any of our debt on commercially reasonable terms, if at all, which could cause us to default on our debt obligations and impair our liquidity. Any refinancing of our debt could be at higher interest rates and may require us to comply with more onerous covenants, which could further restrict our business operations.

**We may not be able to finance future needs or adapt our business plan to changes because of restrictions placed on us by our credit facility, the indentures governing our notes and instruments governing our other indebtedness.**

The indentures for our notes and our credit facility contain affirmative and negative covenants which restrict, among other things, our ability to:

- incur additional debt;
- sell assets;
- create liens or other encumbrances;
- make certain payments and dividends; or
- merge or consolidate.

All of these restrictions could affect our ability to operate our business and may limit our ability to take advantage of potential business opportunities as they arise. A failure to comply with these covenants and restrictions would permit the relevant creditors to declare all amounts borrowed under the relevant facility, together with accrued interest and fees, to be immediately due and payable. If the indebtedness under the credit facility or our notes is accelerated, we may not have sufficient assets to repay amounts due under the credit facility, the notes or on other indebtedness then outstanding. If we are not able to refinance our debt, we could become subject to bankruptcy proceedings, and you may lose all or a portion of your investment because the claims of our creditors on our assets are prior to the claims of our stockholders.

**Rises in interest rates could adversely affect our financial condition.**

An increase in prevailing interest rates would have an immediate effect on the interest rates charged on our variable rate debt, which rise and fall upon changes in interest rates. At September 30, 2006, \$230.1 million of our debt was at variable interest rates. However, during 2005, we entered into multiple interest rate collar agreements which have a total notional amount of \$178.0 million, which reduces our exposure on our total variable rate to the terms of these agreements. Under the terms of these agreements, we have purchased a cap on the interest rate of 4.00% and have sold a floor of 2.25%. The collar agreements mature at various dates between January 2007 and January 2008. Increases in interest rates would also impact the refinancing of our fixed rate debt. If interest rates are higher when our fixed debt becomes due, we may be forced to borrow at the higher rates. If prevailing interest rates or other factors result in higher interest rates, the increased interest expense would adversely affect our cash flow and our ability to service our debt. As a protection against rising interest rates, we may enter into agreements such as interest rate swaps, caps, floors and other interest rate exchange contracts. These agreements, however, increase our risks as to the other parties to the agreements not performing or that the agreements could be unenforceable.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Not applicable.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Not applicable.

**ITEM 5. OTHER INFORMATION**

Not applicable.

**ITEM 6. EXHIBITS**

**(a) Exhibits**

| Exhibit No. | Description  |
|-------------|--|
| 3.1         | Amended and Restated Certificate of Incorporation of Alliance.(7)  |
| 3.2         | Amended and Restated By-laws of Alliance.(7)   |
| 4.1         | Indenture dated as of April 10, 2001 by and between the Registrant and the Bank of New York with respect to \$260 million aggregate principal amount of 10 <sup>3</sup> / <sub>8</sub> % Senior Subordinated Notes due 2011.(5)  |
| 4.2         | Credit Agreement dated as of November 2, 1999, as amended.(5)  |
| 4.3         | Specimen certificate for shares of common stock, \$.01 par value, of Alliance.(7)  |
| 4.4         | Second Amendment dated as of June 10, 2002 to Credit Agreement.(8)   |
| 4.5         | Indenture dated as of December 29, 2004 by and between the Registrant and the Bank of New York with respect to \$150 million aggregate principal amount of 7 <sup>1</sup> / <sub>4</sub> % Senior Subordinated Notes due 2012 and 7 <sup>1</sup> / <sub>4</sub> % Series B Senior Subordinated Notes due 2012.(12) |
| 4.6         | Supplemental Indenture dated as of December 14, 2004 by and between Registrant and the Bank of New York with respect to 10 <sup>3</sup> / <sub>8</sub> % Senior Subordinated Notes due 2011.(12)   |
| 4.7         | Third Amendment dated as of December 29, 2004 to Credit Agreement.(12)   |
| 4.8         | Fourth Amendment dated as of December 19, 2005 to Credit Agreement.(14)  |
| 10.1        | The 1999 Equity Plan for Employees of Alliance and Subsidiaries, as amended and restated.(17)  |
| 10.2        | The Alliance 1997 Stock Option Plan, including form of option agreement used thereunder, as amended.(5)  |
| 10.3        | The Three Rivers Holding Corp. 1997 Stock Option Plan, as amended.(5)  |
| 10.4        | Alliance Directors' Deferred Compensation Plan, as amended.(6)   |
| 10.5        | 2003 Incentive Plan(9)   |
| 10.6        | Employment Agreement dated as of July 23, 1997 between Alliance and Richard N. Zehner.(1)  |
| 10.7        | Agreement Not to Compete dated as of July 23, 1999 between Alliance and Richard N. Zehner.(1)  |
| 10.8        | Amendment to Employment Agreement dated as of July 23, 1997 between Alliance and Richard N. Zehner.(2)   |
| 10.9        | Amendment to Employment Agreement dated as of December 31, 1997 between Alliance and Richard N. Zehner.(3)   |
| 10.10       | Second Amendment to Employment Agreement dated as of February 5, 1998 between Alliance and Richard N. Zehner.(3)   |
| 10.11       | Employment Agreement dated as of January 19, 1998 between Alliance and Kenneth S. Ord.(4)  |
| 10.12       | Agreement Not to Compete dated as of January 19, 1998 between Alliance and Kenneth S. Ord.(4)  |
| 10.15       | Employment Agreement dated as of April 29, 1998 between Alliance and Russell D. Phillips, Jr.(3)   |
| 10.16       | Agreement Not to Compete dated as of April 29, 1998 between Alliance and Russell D. Phillips, Jr.(3)   |
| 10.17       | Employment Agreement dated as of January 1, 2003 between Alliance and Paul S. Viviano.(9)  |
| 10.18       | Agreement Not to Compete dated as of January 1, 2003 between Alliance and Paul S. Viviano(9)   |
| 10.19       | Stock Subscription Agreement dated as of January 2, 2003 between Alliance and Paul S. Viviano.(9)  |
| 10.20       | Stock Subscription Agreement dated as of February 3, 2003 between Alliance and Paul S. Viviano.(9)   |

44



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| 10.21 | Form of Stockholder s Agreement.(5)  |
| 10.23 | Registration Rights Agreement dated as of November 2, 1999.(5)   |
| 10.24 | Management Agreement, dated as of November 2, 1999, between Alliance and Kohlberg Kravis Roberts & Co., LLP.(5)  |
| 10.25 | Amendment No. 1 to Management Agreement, effective as of January 1, 2000, between Alliance and Kohlberg Kravis Roberts & Co., LLP.(5)                                    |
| 10.26 | Form of Indemnification Agreement.(6)  |
| 10.27 | Amendment to Employment Agreement, Non-Qualified Stock Option Agreement and Non-Compete Agreement, dated as of May 21, 2003, between Alliance and Richard N. Zehner.(10) |
| 10.29 | Amendment to Employment Agreement and Stockholders Agreement, dated March 29, 2004 by and between Alliance, Viewer Holdings, LLC and Kenneth S. Ord.(11)                 |
| 10.30 | Amended and Restated Employment Agreement dated as of May 9, 2005 between Alliance and Paul S. Viviano.(13)  |
| 10.31 | Agreement Not to Compete dated as of May 9, 2005 between Alliance and Paul S. Viviano.(13)   |
| 10.32 | Employment Agreement dated as of May 9, 2005 between Alliance and Andrew P. Hayek.(13)   |
| 10.33 | Agreement Not to Compete dated as of May 9, 2005 between Alliance and Andrew P. Hayek.(13)   |
| 10.34 | Employment Agreement dated as of December 1, 2005 between Alliance and Howard K. Aihara.(15)   |
| 10.35 | Agreement Not to Compete dated as of December 1, 2005 between Alliance and Howard K. Aihara.(15)   |
| 10.36 | Separation and Consulting Agreement and General Release, dated January 26, 2006, between Alliance and Russell D. Phillips, Jr.(16)                                       |
| 10.37 | 2006 Executive Incentive Plan (16)   |
| 10.38 | Summary of compensation award to Nicholas A. Poan(18)  |
| 21.1  | List of subsidiaries.(15)  |
| 31    | Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.(19)                                     |
| 32    | Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.(19)                                     |

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(1) Incorporated by reference to exhibits filed with the Company s Registration Statement on Form S-2, No. 333-33817.

(2) Incorporated by reference herein to the indicated Exhibit in response to Item 14(a)(3), Exhibits of the Company s Annual Report on Form 10-K for the year ended December 31, 1997 (File No. 000-16334).

(3) Incorporated by reference herein to the indicated Exhibit in response to Item 14(a)(3), Exhibits of the Company s Annual Report on Form 10-K for the year ended December 31, 1998 (File No. 000-16334).

(4) Incorporated by reference to exhibits filed in response to Item 6, Exhibits of the Company s Quarterly Report on Form 10-Q for the quarter ended March 31, 1998 (File No. 000-16334).

(5) Incorporated by reference to exhibits filed with the Company s Registration Statement on Form S-4, No. 333-60682, as amended.

(6) Incorporated by reference to exhibits filed with the Company s Registration Statement on Form S-1, No. 333-64322, as amended.

- (7) Incorporated by reference to exhibits filed in response to Item 6, Exhibits of the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2001 (File No. 001-16609).
- (8) Incorporated by reference to exhibits filed in response to Item 6, Exhibits of the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002 (File No. 001-16609).
- (9) Incorporated by reference herein to the indicated Exhibit response in Item 15(a)(3), Exhibits of the Company's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 001-16609).
- (10) Incorporated by reference to exhibits filed in response to Item 6, Exhibits of the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 001-16609).
- (11) Incorporated by reference to exhibits filed in response to Item 6, Exhibits of the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004 (File No. 001-16609).
- (12) Incorporated by reference to exhibits filed in response to Item 9.01(c), Exhibits of the Company's Current Report on Form 8-K, dated December 29, 2004 (File No. 001-16609).
- (13) Incorporated by reference to exhibits filed in response to Item 6, Exhibits of the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005 (File No. 001-16609).
- (14) Incorporated by reference to exhibits filed in response to Item 9.01(d), Exhibits of the Company's Current Report on Form 8-K, dated December 22, 2005 (File No. 001-16609).
- (15) Incorporated by reference herein to the indicated Exhibit response in Item 15(a)(1), Exhibits of the Company's Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 001-16609).
- (16) Incorporated by reference to exhibits filed in response to Item 6, Exhibits of the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 (File No. 001-16609).
- (17) Incorporated by reference to Appendix A to the Company's Proxy Statement on Schedule 14A relating to its 2006 Annual Meeting (File No. 001-16609).
- (18) Incorporated by reference to Item 1.01, of the Company's Current Report on Form 8-K, dated October 17, 2006 (File No. 001-16609).
- (19) Filed herewith

Portions of this Exhibit have been redacted due to a request for confidential treatment.

**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.

**ALLIANCE, IMAGING, INC.**

November 9, 2006

By: /s/ PAUL S. VIVIANO  
Paul S. Viviano  
*Chairman of the Board and Chief Executive Officer  
(Principal Executive Officer)*

November 9, 2006

By: /s/ HOWARD K. AIHARA  
Howard K. Aihara  
*Executive Vice President and Chief Financial Officer  
(Principal Financial Officer)*

November 9, 2006

By: /s/ NICHOLAS A. POAN  
Nicholas A. Poan  
*Senior Vice President and Corporate Controller  
(Principal Accounting Officer)*