RADIOLOGIX INC
Form 10-Q
November 04, 2004
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended September 30, 2004

¨ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from _________

Commission File No. 0-23311

RADIOLOGIX, INC.

(Exact name of registrant as specified in its charter)

Delaware	**75-2648089**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

3600 JP Morgan Chase Tower

2200 Ross Avenue

Dallas, Texas 75201-2776

(Address of principal executive offices, including zip code)

(214) 303-2776

(Registrant s telephone number, including area code)

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 x No ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes x No ¨

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

Class	Outstanding at October 29, 2004
Common Stock, $0.0001 par value	**21,814,418 shares**

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FORM 10-Q

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

RADIOLOGIX, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands)

	September 30, 2004	December 31, 2003
	(Unaudited)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 52,532	$ 36,766
Restricted cash	4,820	
Accounts receivable, net of allowances	56,396	58,746
Due from affiliates	2,386	4,104
Assets held for sale	620	251
Other current assets	7,333	7,571
Total current assets	124,087	107,438
PROPERTY AND EQUIPMENT, net	57,676	62,655
INVESTMENTS IN JOINT VENTURES	8,698	10,665
GOODWILL	3,651	20,110
INTANGIBLE ASSETS, net	58,215	67,917
DEFERRED FINANCING COSTS, net	6,936	8,151
DEFERRED INCOME TAXES	8,647	
OTHER ASSETS	1,443	2,200
Total assets	$ 269,353	$ 279,136
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable and other accrued expenses	$ 13,399	$ 11,986
Accrued physician retention	8,785	8,821
Accrued salaries and benefits	7,484	7,788
Accrued interest	4,959	815
Deferred income taxes	3,891	1,797
Current portion of capital lease obligations	314	1,438
Current portion of long-term debt		261
Other current liabilities	693	482
Total current liabilities	39,525	33,388
DEFERRED INCOME TAXES		4,260
LONG-TERM DEBT, net of current portion	158,270	160,000

CONVERTIBLE DEBT	11,980	11,980
CAPITAL LEASE OBLIGATIONS, net of current portion		376
DEFERRED REVENUE	7,005	7,312
OTHER LIABILITIES	900	319
Total liabilities	217,680	217,635
COMMITMENTS AND CONTINGENCIES		
MINORITY INTERESTS IN CONSOLIDATED SUBSIDIARIES	979	817
STOCKHOLDERS EQUITY:		
Preferred stock, $.0001 par value; 10,000,000 shares authorized; no shares issued and outstanding		
Common stock, $.0001 par value; 50,000,000 shares authorized; 21,814,418 and 21,765,985 shares issued in 2004 and 2003, respectively, and 21,795,734 and 21,747,301 outstanding in 2004 and 2003, respectively	2	2
Treasury stock	(180)	(180)
Additional paid-in capital	14,155	13,942
Retained earnings	36,717	46,920
Total stockholders equity	50,694	60,684
Total liabilities and stockholders equity	$ 269,353	$ 279,136

See accompanying notes to consolidated financial statements.

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RADIOLOGIX, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands, except per share data)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2004	2003	2004	2003
SERVICE FEE REVENUE	$ 64,669	$ 61,508	$ 199,224	$ 183,913
COSTS OF OPERATIONS:				
Cost of services	40,819	37,863	123,111	112,489
Equipment lease	4,576	4,318	14,005	13,030
Provision for doubtful accounts	5,462	5,272	16,637	15,730
Depreciation and amortization	5,914	6,418	18,905	19,450
Gross profit	7,898	7,637	26,566	23,214
SEVERANCE AND OTHER RELATED COSTS	405		405	1,280
CORPORATE GENERAL AND ADMINISTRATIVE	5,179	3,560	13,075	10,576
IMPAIRMENT OF GOODWILL, INTANGIBLE AND LONG-LIVED ASSETS	7,612		19,317	
GAIN ON SALE OF OPERATIONS			(4,669)	
INTEREST EXPENSE, NET	4,214	4,389	12,858	13,510
LOSS BEFORE EQUITY IN EARNINGS OF UNCONSOLIDATED AFFILIATES, MINORITY INTERESTS IN CONSOLIDATED SUBSIDIARIES, INCOME TAXES AND DISCONTINUED OPERATIONS	(9,512)	(312)	(14,420)	(2,152)
Equity In Earnings of Unconsolidated Affiliates	983	647	2,336	3,159
Minority Interests In Income of Consolidated Subsidiaries	(195)	(200)	(639)	(730)
INCOME (LOSS) BEFORE INCOME TAXES AND DISCONTINUED OPERATIONS	(8,724)	135	(12,723)	277
Income Tax Expense (Benefit)	(3,428)	54	(5,308)	111
INCOME (LOSS) FROM CONTINUING OPERATIONS	(5,296)	81	(7,415)	166
Discontinued Operations:				
Loss from discontinued operations before income taxes	(150)	(1,211)	(4,646)	(8,577)
Income tax benefit	(60)	(484)	(1,858)	(3,431)

Loss from discontinued operations	(90)	(727)	(2,788)	(5,146)
NET LOSS	$ (5,386)	$ (646)	$ (10,203)	$ (4,980)
INCOME (LOSS) PER COMMON SHARE				
Income (loss) from continuing operations basic	$ (0.24)	$ 0.00	$ (0.34)	$ 0.01
Income (loss) from discontinued operations basic	(0.01)	(0.03)	(0.13)	(0.24)
Net income (loss) basic	$ (0.25)	$ (0.03)	$ (0.47)	$ (0.23)
Income (loss) from continuing operations diluted	$ (0.24)	$ 0.00	$ (0.34)	$ 0.01
Income (loss) from discontinued operations diluted	(0.01)	(0.03)	(0.13)	(0.24)
Net income (loss) diluted	$ (0.25)	$ (0.03)	$ (0.47)	$ (0.23)
WEIGHTED AVERAGE SHARES OUTSTANDING				
Basic	21,805,607	21,741,317	21,780,557	21,710,702
Diluted	21,805,607	22,223,909	21,780,557	21,906,781

See accompanying notes to unaudited consolidated financial statements

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RADIOLOGIX, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	For the Nine Months Ended September 30,	
	2004	2003
	(Unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (10,203)	$ (4,980)
Adjustments to reconcile net loss to net cash provided by operating activities including discontinued operations:		
Minority interests in income of consolidated subsidiaries	639	730
Equity in earnings of unconsolidated affiliates	(2,336)	(3,159)
Depreciation and amortization	19,268	20,682
Impairment of goodwill, intangible and long-lived assets	24,205	7,400
Gains on sales of operations, net	(5,300)	
Deferred revenue	(307)	(307)
Changes in operating assets and liabilities		
Accounts receivable, net	3,136	6,689
Other assets	1,299	(511)
Accounts payable and accrued expenses	(3,986)	(3,950)
Net cash provided by operating activities	26,415	22,594
CASH FLOWS FROM INVESTING ACTIVITIES:		
Increase in restricted cash	(4,820)	
Purchases of property and equipment	(18,097)	(15,284)
Net cash received on sales of operations	13,743	
Contributions to joint ventures		(620)
Distributions from joint ventures	1,114	2,941
Repayments from (advances to) unconsolidated affiliates, net	673	(1,144)
Other investments	(109)	
Net cash used in investing activities	(7,496)	(14,107)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments on long-term obligations, primarily capital leases	(1,606)	(3,176)
Retirement of senior debt	(1,730)	
Other items	183	253
Net cash used in financing activities	(3,153)	(2,923)
NET INCREASE IN CASH AND CASH EQUIVALENTS	15,766	5,564
CASH AND CASH EQUIVALENTS, beginning of period	36,766	19,153

CASH AND CASH EQUIVALENTS, end of period	$ 52,532	$ 24,717
SUPPLEMENTAL CASH FLOW DISCLOSURE:		
Cash paid for interest	$ 8,873	$ 9,552
Income taxes paid, net of refunds received	$ 2,747	$ 806

See accompanying notes to unaudited consolidated financial statements.

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RADIOLOGIX, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2004

(Unaudited)

Note 1. Basis of Presentation

Radiologix, Inc. (together with its subsidiaries, Radiologix or the Company), a Delaware corporation, is a leading national provider of diagnostic imaging services through its ownership and operation of free-standing, outpatient diagnostic imaging centers. This quarterly report for Radiologix supplements our annual report to security holders on Form 10-K, as amended, for the fiscal year ended December 31, 2003. As permitted by the Securities and Exchange Commission for interim reporting, we have omitted certain notes and disclosures that substantially duplicate those in the annual report on Form 10-K. Accordingly, these consolidated financial statements do not include all disclosures associated with the annual consolidated financial statements. In the opinion of management, all adjustments necessary for a fair presentation have been included in the accompanying consolidated financial statements and are of a normal recurring nature, other than those adjustments related to impairments, discontinued operations, the sales of operations and severance and other related costs, which adjustments are discussed separately in the notes below. Interim results for the three and nine-month periods ended September 30, 2004 are not necessarily indicative of the results that may be expected for the year. Variability may be due to changes in modality mix and the volume of procedures performed, physician referral and vacation patterns, the impact of hospital and physician-affiliated imaging centers that compete in our operating markets, the timing and negotiation of managed care and service contracts, the availability of technologists and other personnel resources, and trends in receivable collectibility, including the ability of payors to convert to HIPAA electronic payment standards. For further information, refer to Management s Discussion and Analysis of Financial Condition and Results of Operations and the audited consolidated financial statements and notes included in our annual report to security holders on Form 10-K, as amended, for the year ended December 31, 2003.

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

We have reclassified certain previously reported amounts, including (1) our results of operations to a gross profit presentation and (2) balances and results of operations related to subsequently discontinued operations to conform to the current period presentation. These reclassifications have no impact on total assets, liabilities, stockholders equity, net income (loss), or cash flows.

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

Note 2. Impairment of Goodwill, Intangible and Long-Lived Assets

Goodwill is not subject to amortization; however it is subject to periodic valuation assessments. Under the provisions of Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, the Company is required to perform at least an annual impairment test and to consider other indicators that may arise throughout the year to reevaluate carrying value. To the extent book value exceeds fair value, at the date an impairment is determined, the Company reduces goodwill by recording a charge to operations.

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

In addition to continually assessing the financial viability of our imaging centers, management also evaluates the businesses surrounding our relationships with radiologists and radiology practice groups that have reading privileges at our facilities. These businesses may include Radiologix imaging centers and/or professional reading agreements involving another entity s inpatient or outpatient imaging centers.

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In most cases, individual radiologists and radiology practice groups serve in our facilities pursuant to medical services agreements entered into when Radiologix acquired the practice group s assets. The value of these arrangements is recorded as intangible assets when acquired. Although the agreements may extend for longer periods, the value of the intangible assets is amortized over 25 years based on SEC guidance.

During the third quarter of 2004, management determined that the ability of one of the radiology groups to perform in accordance with a medical services agreement administered by one of our Mid-Atlantic subsidiaries had diminished significantly. With several owned imaging centers covered by the medical services agreement operating at financial losses, deteriorating financial conditions at hospitals involving professional reading arrangements, and the resignation from the practice of two physician leaders, management concluded that the value of our intangible asset had become significantly impaired.

Radiologix and the radiology group have agreed to terminate the medical services agreement. The Company has decided to dispose of three unprofitable imaging centers and to transfer the professional reading responsibility for certain other centers to another radiology group that operates under a medical services agreement with us. We also are in the process of determining the best disposition of professional reading arrangements at certain hospitals.

Based on our assessment and the actions that we have undertaken, the Company recorded impairment charges of: $6.5 million to write off the unamortized portion of intangible assets related to this group s medical services agreement, and $800,000 to write off long-lived assets related to the centers planned for disposition.

Continuing operations include revenue and pretax income (loss) for the three centers planned for disposition as follows (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
Service fee revenue	$ 871	$ 1,000	$ 2,715	$ 2,790
Pretax income (loss)	$ (669)	$ 324	$ (552)	$ 629

In June 2004, after performing an extensive assessment of our Questar imaging center portfolio, management concluded that certain centers were not strategic to our future plans and would be unable to meet and sustain our profitability requirements going forward. That assessment considered: location, contracting leverage, expected capital requirements, the single modality nature of most of these centers, current operating trends, and the sale of our most profitable Questar center on June 21, 2004. Plans for disposition were enacted before June 30, 2004, with five centers reclassified to discontinued operations. Two other Questar centers were scheduled for closure of which one was closed in July 2004 and one is scheduled for sale in the fourth quarter of 2004.

The Company s decision to dispose of this group of imaging centers created an event that required us to reassess the carrying value of the assets related to these centers, including goodwill at our Questar segment. This reassessment considered the impact on the value of the ongoing, deteriorating operating trends in these centers, as well as the implications of disposing of individual centers versus operating those centers as part

of an ongoing operating enterprise.

To assist us in that reassessment, we engaged an independent valuation firm to estimate the fair value of our combined Questar sites that currently remain in continuing operations as of June 30, 2004. The valuation performed by this firm was based on a blending of: (1) discounted cash flows and an exit multiple for the business, (2) a market approach using public company information, discounted to reflect the nature of the Questar operations, and (3) individual transactions experienced by Radiologix and similar companies in recent months. At management s recommendation, the valuation firm applied a high (70%) weighting factor to the valuation derived under the individual transaction method described in (3) above.

Based on the independent valuation, Radiologix recognized an impairment charge to continuing operations of $8.7 million in the three months ended June 30, 2004 to reduce the Questar goodwill carrying value to estimated fair value. This charge is in addition to the $5.5 million charge we recorded in the first quarter of 2004 related to Questar in connection with our annual assessment of goodwill. The first quarter valuation included the operating results of our most profitable Questar center and also gave equal weighting factors to an income and market approach. The balance of goodwill, which relates entirely to Questar, is approximately $3.7 million at September 30, 2004.

The Company regularly considers whether events or circumstances may affect either the fair value of recorded intangible assets or their associated useful lives. At September 30, 2004, the combined operations of our remaining Questar centers are generating

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positive cash flow; and the Company does not believe there are any additional indicators that the carrying values or the useful lives of these assets need to be adjusted. However, in the event we decide to dispose of any remaining Questar centers, additional charges may result depending on cash flow and market conditions at the time of disposal.

The components of our impairment charges are as follows (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2004	2003	2004	2003
Continuing Operations:				
Impairment of goodwill and intangible assets	$ 6,556	$	$ 20,756	$
Reclassification of goodwill impairment			(2,771)	
	6,556		17,985	
Impairment of long-lived assets	1,056		1,510	
Reclassification of long-lived assets impairment			(178)	
	$ 7,612	$	$ 19,317	$
Discontinued Operations:				
Impairment of goodwill and intangible assets	$	$ 500	$ 1,759	$ 7,400
Reclassification of goodwill impairment			2,771	
		500	4,530	7,400
Impairment of long-lived assets	17		180	
Reclassification of long-lived assets impairment			178	
	$ 17	$ 500	$ 4,888	$ 7,400

These impairment charges are currently not deductible for income tax purposes. Consequently, we have significant noncurrent deferred tax assets at September 30, 2004. Management believes that the realization of these deferred tax assets is more likely than not based on fiscal 2003 taxable income, projected future taxable income and potential tax strategies we may employ in the future.

In the third quarter of 2004, we also recorded $315,000 for lease termination costs related to diagnostic equipment no longer in use; $200,000 to write-off software costs associated with canceling a software contract and $295,000 for a litigation settlement with a physician related to our Southeastern operations. For the nine months ended September 30, 2003, we recorded a $500,000 charge for regulatory matters.

Note 3. Discontinued Operations

We are in discussions to sell our 80% joint venture interest in our Questar Tampa operations, including accounts receivable, to our venture partner. The discussions are subject to normal due diligence and other customary considerations and a final agreement is expected to close in the fourth quarter of 2004 at which time these operations will be reclassified to discontinued operations.

In August 2004, we sold three Questar centers previously placed in discontinued operations for an aggregate $959,000 and recognized a net loss of $50,000 on these sales which loss is included in discontinued operations.

In June 2004, management concluded that five Questar centers would be designated as discontinued operations and two other centers would be closed. We also sold one center for $3.1 million in cash and recognized a gain on this sale of $682,000 ($0.03 per dilutive share), which gain is included in discontinued operations.

The results of operations of imaging centers in discontinued operations are as follows (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2004	2003	2004	2003
Service fee revenue	$ 1,684	$ 4,398	$ 7,791	$ 13,875
Pre-tax loss from discontinued operations	(150)	(1,211)	(4,646)	(8,577)
Income tax benefit	(60)	(484)	(1,858)	(3,431)
Net loss from discontinued operations	$ (90)	$ (727)	$ (2,788)	$ (5,146)

Assets and liabilities of discontinued operations as of September 30, 2004 and 2003 were as follows (in thousands):

	2004	2003
Assets	$ 3,859	$ 15,536
Liabilities	794	3,697
Net assets of discontinued operations	$ 3,065	$ 11,839

Long-lived assets classified as assets held for sale in the accompanying balance sheets are included in the assets above. The remainder of the above Assets and Liabilities will remain with Radiologix at disposition.

Note 4. Gain on Sale of Operations

Effective April 30, 2004, we completed the sale of our operations in San Antonio, Texas. The purchase price was $10.5 million, resulting in a gain on sale of approximately $4.7 million or $3.1 million net of taxes ($0.14 per dilutive share). Net cash received was $9.7 million after purchase price adjustments. The sale included (1) assets we owned and leased in our operation of M&S Imaging Partners, Inc., (2) a diagnostic imaging center, and (3) certain partnership interests, but did not include accounts receivable aggregating approximately $4.7 million, which we retained.

Results of operations for the San Antonio operations were as follows (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
Service fee revenue	$ (238)	$ 3,777	$ 5,882	$ 11,603
Cost of services	496	1,319	3,443	4,875
Equipment lease		4	5	11
Provision for doubtful accounts	207	567	1,171	1,694
Depreciation and amortization		356	510	1,069
Gross profit (loss)	(941)	1,531	753	3,954
Other net		341	130	232
Pre-tax income (loss) from operations	(941)	1,190	623	3,722
Income tax expense (benefit)	(320)	404	212	1,265
Net income (loss) from operations	$ (621)	$ 786	$ 411	$ 2,457

The net loss from operations for the three months ended September 30, 2004 resulted primarily from costs associated with outsourcing the billing and collection function and from weaker than expected collection performance on accounts receivable assumed in the sale of these operations.

Note 5. Severance and Other Related Costs

Effective September 20, 2004 our chief executive officer resigned his positions as CEO, President and director of the Company. The Board of Directors is currently directing a search for a successor CEO. Severance and other related costs aggregated $405,000 in September 2004 related to this matter. For the nine months ended September 30, 2003, we recognized $1.3 million in connection with severance and other related costs for changes in the Company s senior management team.

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Note 6. Revenue Recognition

Service fee revenue is comprised of billed charges for both the technical and professional components of service, reduced by estimated contractual adjustments and by amounts retained by contracted radiology practice groups under the medical service agreements. Revenue is recognized when services are rendered by contracted radiology practice groups the imaging centers, or both. Provision for doubtful accounts related to established charges is reflected as an operating expense rather than a reduction of revenue. Contractual adjustments and provision for doubtful accounts are estimated based on historical collection experience as adjusted for increases or decreases in allowances for doubtful accounts as determined by our accounts receivable aging model. Because Radiologix has no financial controlling interest in the radiology practice groups, as defined in Emerging Issues Task Force Issue 97-2 (EITF 97-2), the Company does not consolidate the financial statements of those practices in its consolidated financial statements.

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2004	2003	2004	2003
Revenue for contracted radiology practices and diagnostic imaging centers, net of contractual adjustments	$ 89,133	$ 86,806	$ 276,175	$ 257,925
Less: amounts retained by contracted radiology practices	(24,464)	(25,298)	(76,951)	(74,012)
Service fee revenue	$ 64,669	$ 61,508	$ 199,224	$ 183,913

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2004	2003	2004	2003
Professional component	$ 10,349	$ 11,957	$ 34,554	$ 35,196
Technical component	54,320	49,551	164,670	148,717
Service fee revenue	$ 64,669	$ 61,508	$ 199,224	$ 183,913

Note 7. Long-Term Debt

Senior Notes

The Company s $158.3 million in senior notes due December 15, 2008, bear interest at 10.5% payable semiannually in arrears on June 15 and December 15. The senior notes are redeemable on or after December 15, 2005 at various redemption prices, plus accrued interest to the date of redemption. These notes are unsecured obligations, which rank senior in right of payment to all subordinated indebtedness and equal in right of payment with all other senior indebtedness. The senior notes are unconditionally guaranteed on a senior unsecured basis by certain restricted existing and future subsidiaries. In the 2004 second quarter, the Company retired $1.73 million of these senior notes at a price equal to 103.25% of face value.

Convertible Junior Subordinated Note

The Company has a $12.0 million convertible junior subordinated note, which matures July 31, 2009, and bears interest, payable quarterly in cash or in-kind securities, at an annual rate of 8.0%. The note holder may convert borrowings under the note to common stock at $7.52 per share.

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Master Lease Agreement

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

In connection with the Master Lease Agreement, the Company is required to provide additional cash collateral in a restricted account equal to 20% of the aggregate amounts outstanding under the Master Lease Agreement. The accompanying September 30, 2004 balance sheet includes $4.8 million of restricted cash under this provision.

The Master Lease Agreement also contains certain covenants related to financial leverage, fixed charge coverage, and total indebtedness to GE. Failure to comply with these covenants would restrict our ability to lease additional equipment under the Master Lease Agreement until the covenants are met. At September 30, 2004, Radiologix was in compliance with these covenants.

At September 30, 2004 applicable amounts outstanding under the Master Lease Agreement totaled $24.5 million; and $35.5 million remained available for future leases. Commitments for leases signed but not placed in service under the Master Lease Agreement were $4.8 million at September 30, 2004.

Revolving Credit Facility

The Company also maintains a revolving credit facility with GE, enabling the Company to borrow up to 85% of eligible accounts receivable, as defined, with a maximum borrowing limit of $35.0 million. Borrowings under the credit facility are secured by substantially all of the Company s assets, including the capital stock of our wholly owned subsidiaries. The credit facility expires December 31, 2008 and bears a commitment fee ranging from 0.50% to 0.75% of the unused balance, based on amounts borrowed.

Under the revolving credit facility, borrowings bear interest, at the option of the Company, either (i) at a fixed rate comprised of LIBOR plus a margin ranging from 3.0% to 3.5%, depending on monthly amounts outstanding or (ii) at a variable rate based on prime plus a margin ranging from 1.75% to 2.25%, depending on monthly amounts outstanding.

At September 30, 2004, applicable amounts considered outstanding under the revolving credit facility totaled $750,000 related to a letter of credit in connection with our high retention workers compensation program; and $34.2 million, subject to eligible accounts receivable, remained available for borrowings.

Note 8. Variable Interest Entities

In January 2003, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards Board Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 41 (FIN 46). In December 2003, the FASB modified FIN 46 to make certain technical corrections and address certain implementation issues that had arisen. FIN 46 provides a new framework for identifying variable interest entities (VIEs) and determining when a company should include the assets, liabilities, non-controlling interests and results of activities of a VIE in its consolidated financial statements.

In general, a VIE is a corporation, partnership, limited liability corporation, trust or any other legal structure used to conduct activities or hold assets that either (1) has an insufficient amount of equity to carry out its principal activities without additional subordinated financial support, (2) has a group of equity owners that are unable to make significant decisions about its activities, or (3) has a group of equity owners that do not have the obligation to absorb losses or the right to receive returns generated by its operations. However, FIN 46 specifically excludes a VIE that is a business if the variable interest holder did not participate significantly in the design or redesign of the entity.

We adopted the provisions of FIN 46 as of March 31, 2004. We have reviewed the Company s non-consolidated joint ventures under the provision and have determined that none of the joint ventures meets the definition of a variable interest entity at September 30, 2004.

Note 9. Stock-Based Awards

As permitted by Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123), the Company does not currently recognize compensation expense related to stock option grants to its employees under any of its stock award plans; however it does account for stock-based compensation of non-employees under the provisions of SFAS 123.

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Option awards have generally been granted under the terms of the 1996 Stock Option Plan, as amended, and are priced at fair market value on the date granted. On July 15, 2004, the Company s stockholders approved the adoption of the 2004 Long-Term Incentive Plan. As a result, all future grants will be made under the 2004 Plan and no more grants will be made under the 1996 Plan.

During the nine months ended September 30, 2004, the Company granted 610,000 options to purchase the Company s common stock, primarily as employment inducements for key executives. Of these options, 410,000 vest over a five-year period, and 200,000 vest in specified increments, based on the performance (at stock prices ranging from $5.00 to $17.50 per share) of the Company s common stock for consecutive 20-day periods applicable to the increment. None of these options has vested to date.

The summary below presents the pro-forma financial results that would have been reported if the Company had applied the provisions of SFAS No. 123, as amended by Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (dollars are presented in thousands, except per share amounts):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2004	2003	2004	2003
Net income (loss), as reported	$ (5,386)	$ (646)	$ (10,203)	$ (4,980)
Total stock-based compensation expensed in net loss, net of related tax effects	24		32	
Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	77	(236)	(700)	(1,290)
Pro forma net loss	$ (5,285)	$ (882)	$ (10,871)	$ (6,270)
Income (loss) per common share:				
Basic as reported	$ (0.25)	$ (0.03)	$ (0.47)	$ (0.23)
Basic pro forma	$ (0.24)	$ (0.04)	$ (0.50)	$ (0.29)
Loss per share:				
Diluted as reported	$ (0.25)	$ (0.03)	$ (0.47)	$ (0.23)
Diluted pro forma	$ (0.24)	$ (0.04)	$ (0.50)	$ (0.29)

The fair value of each option grant is estimated at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions for grants at September 30, 2004 and 2003, respectively: risk-free interest rate of 4.13% and 4.27%; expected life of 5.4 and 7.5 years; expected volatility of 54.2% and 67.5%; and dividend yield of zero. The weighted-average grant-date fair value of new grants during the nine months ended September 30, 2004 and 2003 was $2.22 per share and $2.56 per share, respectively. The stock-based compensation expense determined under fair value based method presented on a pro forma basis includes an adjustment during the three months ended September 30, 2004 to reverse expenses related to certain variable options that were cancelled. As permitted by Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25), the Company originally reported an expense for the total estimated amount for these options on a pro forma basis in the period the options were granted.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company s employee stock options have characteristics significantly different from those of traded

options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

Note 10. Earnings Per Share

Basic earnings per share (EPS) is calculated by dividing income available to common stockholders by the weighted average number of common shares outstanding during the period. The weighted average number of common shares outstanding increased during the nine months ended September 30, 2004 and 2003 primarily due to the exercise of stock options. Stock options exercised were 48,433 and 66,666, respectively.

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2004	2003	2004	2003
Weighted average shares for basic earnings per share	21,805,607	21,741,317	21,780,557	21,710,702
Effect of dilutive stock options		482,592		196,079
Effect of dilutive convertible junior subordinated note				
Weighted average shares for diluted earnings per share	21,805,607	22,223,909	21,780,557	21,906,781
Tax-effected interest savings related to convertible junior subordinated note	$	$	$	$

For the three months ended September 30, 2004 and 2003, approximately $144,000 and $145,000, respectively, of tax-effected interest and 1,593,040 of weighted average shares related to the convertible junior subordinated note were not included in the computation of diluted EPS because to do so would be anti-dilutive. Also, for the three months ended September 30, 2004, 530,677 shares related to stock options were not included in the computation of dilutive EPS because to do so would be anti-dilutive. For the three months ended September 30, 2003, 482,592 shares related to stock options were included in the computation of dilutive EPS.

For the nine months ended September 30, 2004 and 2003, approximately $431,000 and $435,000, respectively, of tax-effected interest and 1,593,040 of weighted average shares related to the convertible junior subordinated note were not included in the computation of diluted EPS because to do so would be anti-dilutive. Also, for the nine months ended September 30, 2004, 495,600 shares related to stock options were not included in the computation of dilutive EPS because to do so would be anti-dilutive. For the nine months ended September 30, 2003 196,079 shares related to stock options were included in the computation of dilutive EPS.

Note 11. Segment Reporting

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

The Company previously reported its primary operations through four reportable segments comprised of four designated regions of the United States of America. As a result of an assessment of these operations, including how resources are allocated by members of our senior management team (the chief operating decision maker function), and because the four designated regions have: (1) substantially all resources allocated to them, (2) similar economic characteristics, (3) similar operations and (4) similar regulatory environments, we have aggregated them into a single reportable operating segment.

Because of different characteristics from our primary operations, including location, market concentration, contracting leverage, capital requirements, the single modality nature of most of the centers and the structure of the management service agreements with physicians related to the Company s Questar operations, senior management makes resource allocation decisions separately for Questar and its primary operations.

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

	For the Nine Months Ended September 30, 2004		
	Primary Operations	Questar	Total
Service fee revenue	$ 190,010	9,214	$ 199,224
Total costs and expenses	$ 166,114	20,218	$ 186,332
Income (loss) before equity in earnings of investments and minority interests in consolidated subsidiaries, income taxes and discontinued operations	$ 23,896	(11,004)	$ 12,892
Equity in earnings of investments	$ 2,336		$ 2,336
Minority interests in income of consolidated subsidiaries	$ (639)		$ (639)
Income (loss) before income taxes from continuing operations	$ 25,593	(11,004)	$ 14,589
Loss before income taxes from discontinued operations	$ (553)	(4,093)	$ (4,646)
Income (loss) before income taxes	$ 25,040	(15,097)	$ 9,943
Assets	$ 124,960	11,032	$ 135,992
Purchases of property and equipment	$ 15,800	989	$ 16,789

	For the Nine Months Ended September 30, 2003		
	Primary Operations	Questar	Total
Service fee revenue	$ 174,474	9,439	$ 183,913
Total costs and expenses	$ 150,602	9,269	$ 159,871
Income before equity in earnings of investments and minority interests in consolidated subsidiaries, income taxes and discontinued operations	$ 23,872	170	$ 24,042
Equity in earnings of investments	$ 3,159		$ 3,159
Minority interests in income of consolidated subsidiaries	$ (689)	(41)	$ (730)
Income before income taxes from continuing operations	$ 26,342	129	$ 26,471
Loss before income taxes from discontinued operations	$ (255)	(8,322)	$ (8,577)
Income (loss) before income taxes	$ 26,087	(8,193)	$ 17,894
Assets	$ 154,463	39,047	$ 193,510
Purchases of property and equipment	$ 12,586	2,421	$ 15,007

The following is a reconciliation of segment income before income taxes to consolidated loss before income taxes (including continuing and discontinued operations) and purchases of property and equipment by the Company s reportable segments for the nine months ended September 30, 2004 and 2003 (in thousands):

	For the Nine Months Ended September 30,	
	2004	**2003**
Segment income before income taxes	$ 9,943	$ 17,894
Unallocated amounts:		
Corporate general and administrative	(13,075)	(10,576)
Corporate severance and other related costs	(405)	(1,027)
Corporate depreciation and amortization	(4,442)	(4,646)
Corporate interest expense	(9,390)	(9,945)
Consolidated loss before income taxes, continuing and discontinued operations	$ (17,369)	$ (8,300)

	2004	**2003**
Purchases of property and equipment		
Segment amounts	$ 16,789	$ 15,007
Corporate amount	1,308	277
Total purchases of property and equipment	$ 18,097	$ 15,284

Note 12. Supplemental Guarantor Information

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

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

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Condensed consolidating financial statements for the Company and its subsidiaries including Radiologix only, the combined Guarantor Subsidiaries and the combined Non-Guarantor Subsidiaries are as follows:

RADIOLOGIX, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATING BALANCE SHEET (Unaudited)

September 30, 2004

(In thousands)

	Parent	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Total Consolidated
Assets:					
Cash and cash equivalents	$ 49,579	$ (633)	$ 3,586	$	$ 52,532
Accounts receivable, net		54,754	1,642		56,396
Other current assets	4,948	14,729	(4,518)		15,159
Total current assets	54,527	68,850	710		124,087
Property and equipment, net	3,011	52,481	2,184		57,676
Investment in subsidiaries	156,792			(156,792)	
Goodwill and intangible assets, net		60,425	1,441		61,866
Other assets	16,840	9,493	(609)		25,724
	$ 231,170	$ 191,249	$ 3,726	$ (156,792)	$ 269,353
Liabilities and stockholders equity:					
Accounts payable and accrued expenses	$ 14,306	$ 23,407	$ 805	$	$ 38,518
Current portion of long-term debt	(80)	(43)	437		314
Other current liabilities	(113)	806			693
Total current liabilities	14,113	24,170	1,242		39,525
Long-term debt, net of current portion	169,837		413		170,250
Other noncurrent liabilities	(3,474)	19,298	(7,919)		7,905
Minority interests in consolidated subsidiaries			979		979
Stockholders equity	50,694	147,781	9,011	(156,792)	50,694
	$ 231,170	$ 191,249	$ 3,726	$ (156,792)	$ 269,353

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RADIOLOGIX, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATING BALANCE SHEET

December 31, 2003

(In thousands)

	Parent	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Total Consolidated
Assets:					
Cash and cash equivalents	$ 31,625	$ 3,856	$ 1,285	$	$ 36,766
Accounts receivable, net		55,246	3,500		58,746
Other current assets	1,034	19,587	(8,695)		11,926
Total current assets	32,659	78,689	(3,910)		107,438
Property and equipment, net	2,587	57,465	2,603		62,655
Investment in subsidiaries	152,103			(152,103)	
Goodwill and intangible assets, net		80,139	7,888		88,027
Other assets	12,227	8,962	(173)		21,016
	$ 199,576	$ 225,255	$ 6,408	$ (152,103)	$ 279,136
Liabilities and stockholders equity:					
Accounts payable and accrued expenses	$ 6,612	$ 23,502	$ 1,093	$	$ 31,207
Current portion of long-term debt	45	1,145	509		1,699
Other current liabilities		482			482
Total current liabilities	6,657	25,129	1,602		33,388
Long-term debt, net of current portion	171,506	168	682		172,356
Other noncurrent liabilities	(39,271)	58,163	(7,001)		11,891
Minority interests in consolidated subsidiaries			817		817
Stockholders equity	60,684	141,795	10,308	(152,103)	60,684
	$ 199,576	$ 225,255	$ 6,408	$ (152,103)	$ 279,136

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RADIOLOGIX, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS (Unaudited)

For the Three Months Ended September 30, 2004

(In thousands)

	Parent	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Total Consolidated
Service fee revenue	$	$ 60,710	$ 3,959	$	$ 64,669
Costs of operations:					
Cost of services		38,336	2,483		40,819
Equipment lease		4,410	166		4,576
Provision for doubtful accounts		5,241	221		5,462
Depreciation and amortization	650	5,114	150		5,914
Gross profit	(650)	7,609	939		7,898
Severance and other related costs	405				405
Corporate operating expenses	5,179				5,179
Impairment of goodwill, intangible and long-lived assets		7,612			7,612
Interest expense, net	3,072	1,116	26		4,214
Income (loss) before equity in earnings of unconsolidated affiliates, minority interests in consolidated subsidiaries, income taxes and discontinued operations	(9,306)	(1,119)	913		(9,512)
Equity in earnings of unconsolidated affiliates		983			983
Minority interests in income of consolidated subsidiaries			(195)		(195)
Income (loss) before taxes and discontinued operations	(9,306)	(136)	718		(8,724)
Income tax expense (benefit)	(3,722)	7	287		(3,428)
Income (loss) from continuing operations	(5,584)	(143)	431		(5,296)
Discontinued operations:					
Loss from discontinued operations		(150)			(150)
Income tax benefit		(60)			(60)
Loss from discontinued operations		(90)			(90)
Net income (loss)	$ (5,584)	$ (233)	$ 431	$	$ (5,386)

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RADIOLOGIX, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS (Unaudited)

For the Nine Months Ended September 30, 2004

(In thousands)

	Parent	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Total Consolidated
Service fee revenue	$	$ 186,443	$ 12,781	$	$ 199,224
Costs of operations:					
Cost of services		115,217	7,894		123,111
Equipment lease		13,490	515		14,005
Provision for doubtful accounts		15,797	840		16,637
Depreciation and amortization	1,949	16,389	567		18,905
Gross profit	(1,949)	25,550	2,965		26,566