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PRIMEDEX HEALTH SYSTEMS INC

Form 10-Q

March 17, 2006

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE  
ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED JANUARY 31, 2006

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES  
EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_

COMMISSION FILE NUMBER 0-19019

PRIMEDEX HEALTH SYSTEMS, INC.  
(EXACT NAME OF REGISTRANT AS SPECIFIED IN CHARTER)

NEW YORK  
(STATE OR OTHER JURISDICTION  
OF INCORPORATION OR ORGANIZATION)

13-3326724  
(I.R.S. EMPLOYER  
IDENTIFICATION NO.)

1510 COTNER AVENUE  
LOS ANGELES, CALIFORNIA  
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

90025  
(ZIP CODE)

(310) 478-7808  
(REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE)

N/A  
(FORMER NAME, FORMER ADDRESS AND FORMER FISCAL YEAR,  
IF CHANGED SINCE LAST REPORT)

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

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

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY  
PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and  
reports required to be filed by Sections 12, 13 or 15(d) of the Securities  
Exchange Act of 1934 subsequent to the distribution of securities under a plan  
confirmed by a court. Yes [X] No [ ]

APPLICABLE ONLY TO CORPORATE ISSUERS:

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The number of shares outstanding of the registrant's common stock as of February 27, 2006 was 41,406,813 (excluding treasury shares).

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## PART 1 -- FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

#### PRIMEDEX HEALTH SYSTEMS, INC. AND AFFILIATES CONSOLIDATED BALANCE SHEETS

	OCTOBER 31, 2005	JANUARY 2006 (UNAUDITED)
	-----	-----
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 2,000	\$ 2,000
Accounts receivable, net	22,319,000	21,942,000
Unbilled receivables and other receivables	476,000	1,076,000
Other	1,799,000	1,800,000
	-----	-----
Total current assets	24,596,000	24,820,000
	-----	-----
PROPERTY AND EQUIPMENT, NET	68,107,000	64,886,000
	-----	-----
OTHER ASSETS		
Accounts receivable, net	1,267,000	1,245,000
Goodwill	23,099,000	23,099,000
Trade name and other	4,164,000	4,535,000
	-----	-----
Total other assets	28,530,000	28,879,000
	-----	-----
Total assets	\$ 121,233,000	\$ 118,585,000
	=====	=====
LIABILITIES AND STOCKHOLDERS' DEFICIT		
CURRENT LIABILITIES		
Cash disbursements in transit	\$ 3,425,000	\$ 5,717,000
Line of credit	13,341,000	468,000
Accounts payable and accrued expenses	22,469,000	21,580,000
Short-term notes expected to be refinanced:		
Notes payable	69,066,000	
Obligations under capital lease	56,927,000	
Notes payable	1,101,000	860,000
Obligations under capital lease	1,697,000	1,667,000
	-----	-----
Total current liabilities	168,026,000	30,292,000
	-----	-----
LONG-TERM LIABILITIES		
Subordinated debentures payable	16,147,000	16,147,000
Notes payable to related party	3,533,000	3,575,000
Notes payable, net of current portion	--	135,769,000
Obligations under capital lease, net of current portion	4,129,000	3,732,000

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Accrued expenses	31,000	30
Total long-term liabilities	23,840,000	159,253
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' DEFICIT	(70,633,000)	(70,960)
Total liabilities and stockholders' deficit	\$ 121,233,000	\$ 118,585

The accompanying notes are an integral part of these financial statements

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

	THREE MONTHS ENDED	
JANUARY 31,	2005	2006
-----	-----	-----
NET REVENUE	\$ 34,110,000	\$ 38,538,000
OPERATING EXPENSES		
Operating expenses	26,865,000	29,169,000
Depreciation and amortization	4,323,000	4,087,000
Provision for bad debts	909,000	1,349,000
	-----	-----
Total operating expenses	32,097,000	34,605,000
	-----	-----
INCOME FROM OPERATIONS	2,013,000	3,933,000
OTHER EXPENSE (INCOME)		
Interest expense	4,235,000	4,461,000
Other income	(110,000)	(51,000)
Other expense	86,000	--
	-----	-----
Total other expense	4,211,000	4,410,000
	-----	-----
NET LOSS	\$ (2,198,000)	\$ (477,000)
	=====	=====
BASIC AND DILUTED NET LOSS PER SHARE	\$ (.05)	\$ (.01)
	=====	=====
WEIGHTED AVERAGE SHARES OUTSTANDING		
Basis and diluted	41,106,813	41,406,813
	=====	=====

The accompanying notes are an integral part of these financial statements

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

THREE MONTHS ENDED JANUARY 31, 2006

	COMMON STOCK \$.01 PAR VALUE, 100,000,000 SHARES AUTHORIZED		PAID-IN CAPITAL	TREASURY STOCK, AT COST	
	SHARES	AMOUNT		SHARES	AMOUNT
BALANCE-- OCTOBER 31, 2005	43,231,813	\$ 433,000	\$ 100,590,000	(1,825,000)	\$ (695,000)
Issuance of warrant	--	--	110,000	--	--
Share-based payments	--	--	40,000	--	--
Net Loss	--	--	--	--	--
BALANCE-- JANUARY 31, 2006 (UNAUDITED)	43,231,813	\$ 433,000	\$ 100,740,000	(1,825,000)	\$ (695,000)

The accompanying notes are an integral part of these financial statements.

PRIMEDEX HEALTH SYSTEMS, INC. AND AFFILIATES  
CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

THREE MONTHS ENDED JANUARY 31, -----	2005 -----	2006 -----
NET CASH PROVIDED BY OPERATING ACTIVITIES	\$ 1,675,000 -----	\$ 2,504,000 -----
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property and equipment	(885,000)	(834,000)
Proceeds from sale of equipment	65,000 -----	-- -----
Net cash used by investing activities	(820,000) -----	(834,000) -----
CASH FLOWS FROM FINANCING ACTIVITIES		

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Cash disbursements in transit	(550,000)	2,292,000
Principal payments on notes and leases payable	(1,292,000)	(4,663,000)
Proceeds from short and long-term borrowings	987,000	701,000
	-----	-----
Net cash used by financing activities	(855,000)	(1,670,000)
	-----	-----
NET INCREASE IN CASH	--	--
CASH, beginning of period	2,000	2,000
	-----	-----
CASH, end of period	\$ 2,000	\$ 2,000
	-----	-----
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the period for interest	\$ 3,714,000	\$ 4,111,000
	=====	=====

### SUPPLEMENTAL NON-CASH INVESTING AND FINANCING ACTIVITIES

During the three months ended January 31, 2005, we entered into additional capital leases for \$2,067,000. No new capital leases were entered into during the same period in fiscal 2006.

The accompanying notes are an integral part of these financial statements

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

#### NOTE 1--BASIS OF PRESENTATION

##### NATURE OF BUSINESS

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

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

The operations of BRMG are consolidated with us as a result of the contractual and operational relationship among BRMG, Dr. Berger and us. We are considered to have a controlling financial interest in BRMG pursuant to the guidance in EITF 97-2. Medical services and supervision at most of our imaging centers are provided through BRMG and through other independent physicians and

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physician groups. BRMG is consolidated with Pronet Imaging Medical Group, Inc. and Beverly Radiology Medical Group, both of which are 99%-owned by Dr. Berger. Radnet provides non-medical, technical and administrative services to BRMG for which they receive a management fee.

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

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

### LIQUIDITY AND CAPITAL RESOURCES

We had a working capital deficit of \$5.5 million at January 31, 2006 compared to a \$143.4 million deficit at October 31, 2005, and had losses from operations of \$0.5 million and \$2.2 million during the three months ended January 31, 2006 and 2005, respectively. We also had a stockholders' deficit of \$71.0 million at January 31, 2006 compared to a \$70.6 million deficit at October 31, 2005.

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

Effective March 9, 2006, we completed the issuance of a \$161 million senior secured credit facility that we used to refinance substantially all of our existing indebtedness (except for \$16.1 million of outstanding subordinated debentures and approximately \$5 million of capital lease obligations). Included in the \$161 million senior secured credit facility were fees and expenses for the transaction of approximately \$5.2 million. The facility provides for a \$15 million five-year revolving credit facility, an \$86 million term loan due in five years and a \$60 million second lien term loan due in six years. The loans are subject to acceleration on December 27, 2007, unless we have made arrangements to discharge or extend our outstanding subordinated debentures by that date. We intend to retire the subordinated debentures prior to their due date of June 30, 2008. Under the terms and conditions of the new Second Lien Term Loan, subject to achieving certain leverage ratios, we have the right to raise up to \$16.1 million in additional funds as part of the Second Lien Term Loan for the purposes of redeeming the subordinated debentures. Additionally, under the current facilities, we have the ability to pursue other funding sources to refinance the subordinated debentures. The loans are payable interest

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only monthly except for the \$86 million term loan that requires amortization payments of 1.0% per annum.

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

As part of the refinancing, we are required to swap at least 50% of the aggregate principal amount of the facilities to a floating rate within 90 days of the close of the agreement on March 9, 2006. We have not yet entered into the swap arrangement or decided on how much of the loans will be swapped. In addition, as a requirement of the deal, 75% of our excess cash flow is to be used to repay principal on the \$86 million term loan once per year within 105 days after our fiscal year end. Excess cash flow is defined as earnings before interest, taxes, depreciation and amortization plus decreases in working capital and extraordinary gains minus: (i) capital expenditures; (ii) interest expense; (iii) scheduled principal payments on existing debt; (iv) income taxes; (v) increases in working capital; (vi) extraordinary losses; (vii) voluntary prepayments of the \$86 million term loan; (viii) and amounts paid for acquisitions.

Under the new facility, we are subject to various financial covenants including a limitation on capital expenditures, maximum days sales outstanding, minimum fixed charge coverage ratio, maximum leverage ratio and maximum senior leverage ratio. Availability under our \$15 million revolving credit facility is governed by the margins calculated under the maximum senior leverage ratio and maximum total leverage ratio covenants. Borrowings under the historical Bridge credit facility were calculated from a formula based upon our net eligible accounts receivable. As of March 9, 2006, after giving effect to the approximately \$1.5 million balance on our revolving credit facility, we had approximately \$13.5 million of availability. As a result of the completed financing, we were able to reclassify the majority of our notes and capital lease obligations as noncurrent as of January 31, 2006 and improve our working capital significantly.

We operate in a capital intensive, high fixed-cost industry that requires significant amounts of capital to fund operations. In addition to operations, we require significant amounts of capital for the initial start-up and development expense of new diagnostic imaging facilities, the acquisition of additional facilities and new diagnostic imaging equipment, and to service our existing debt and contractual obligations. Because our cash flows from operations have been insufficient to fund all of these capital requirements, we have depended on the availability of financing under credit arrangements with third parties. Historically, our principal sources of liquidity have been funds available for borrowing under our existing lines of credit, now with General Electric Capital Corporation. We finance the acquisition of equipment mainly through capital and operating leases. As of January 31, 2006 and October 31, 2005, our line of credit liabilities were \$14.0 million and \$13.3 million, respectively. As of January 31, 2006, \$468,000 of line of credit liabilities were classified as current liabilities for the unpaid balance at the closing of the refinancing transaction.

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As of January 31, 2006, Howard G. Berger, M.D., our president, director and largest shareholder had outstanding advances to us of \$1,370,000. Our obligation to Dr. Berger was repaid as part of our March 9, 2006 refinancing.

The interim disclosures regarding liquidity and capital resources should be read in conjunction with the consolidated financial statements and related notes thereto contained in our Annual Report of Form 10-K for the year ended October 31, 2005. There were no material changes in our financing agreements from October 31, 2005 to January 31, 2006.

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

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

Due to the March 9, 2006 refinancing, we will be able to use the cash savings generated from the deferral of required principal payments on notes payable and capital lease obligations of approximately \$1.2 million per month to invest in the infrastructure and to pursue future growth opportunities.

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

### NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

REVENUE RECOGNITION--Revenue consists of net patient fee for service revenue and revenue from capitation arrangements, or capitation revenue.

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

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

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



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	2005	2006
	-----	-----
Net patient service	\$24,860,000	\$27,739,000
Capitation	9,250,000	10,799,000
	-----	-----
Net revenue	\$34,110,000	\$38,538,000
	=====	=====

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

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Accounts receivable as of October 31, 2005 are presented net of allowances of approximately \$59,491,000, of which \$56,296,000 is included in current and \$3,195,000 is included in noncurrent. Accounts receivable as of January 31, 2006, are presented net of allowances of approximately \$61,871,000, of which \$58,549,000 is included in current and \$3,322,000 is included in noncurrent.

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

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

	Net Revenue	
	-----	-----
	2005	2006
	-----	-----
Capitation contracts	27%	28%
HMO/PPO/Managed care	21%	24%
Medicare	14%	15%
Blue Cross/Shield/Champus	14%	15%
Special group contract	10%	8%
Commercial insurance	5%	3%
Medi-Cal	3%	3%
Workers compensation	3%	2%
Other	3%	2%

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

STOCK-BASED COMPENSATION EXPENSE - On November 1, 2005, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors. SFAS 123(R) supersedes our previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for period beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). We have applied the provisions of SAB 107 in our adoption of SFAS 123(R).

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We adopted SFAS 123(R) using the modified prospective transition method, which requires that application of the accounting standard as of November 1, 2005, the first day of our fiscal year 2006. Our consolidated financial statements as of and for the three months ended January 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, our consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the three months ended January 31, 2006 was \$40,000. There was no stock-based compensation expense related to employee stock options recognized during the three months ended January 31, 2005.

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

Three Months Ended January 31,	2005
	-----
Net loss as reported	\$ (2,198,000)
Deduct: Total stock-based employee compensation expense determined under fair value-based method	(46,000)
	-----
Pro forma net loss	\$ (2,244,000)
	=====
Loss per share:	
Basic and diluted loss per share - as reported	\$ (0.05)
	=====
Basic and diluted loss per share - pro forma	\$ (0.05)
	=====

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SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our statement of operations. Prior to the adoption of SFAS 123(R), we accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Under the intrinsic value method, no stock-based compensation had been recognized in our statement of operations, because the exercise price of our stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in our statement of operations for the three months ended January 31, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of October 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123. We use the straight-line method of attributing the value of stock-based compensation to expense. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro forma information required under SFAS 123 for the periods prior to November 1, 2005, we accounted for forfeitures as they occurred.

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

January 31, -----	Risk-free interest rate -----	Expected life -----	Expected Volatility -----	Expected dividends -----
2005	3.00%	5 years	216.32%	---
2006	4.55%	4 years	87.50%	---

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

### NOTE 3 - ACQUISITIONS AND DIVESTITURES

#### ACQUISITIONS AND OPENINGS OF IMAGING CENTERS

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

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

### NOTE 4 - CAPITAL TRANSACTIONS

On December 19, 2003, we issued a \$1.0 million convertible subordinate note payable to Galt Financial, Ltd., at a stated rate of 11% per annum with interest payable quarterly. The note payable was convertible at the holder's option anytime after January 1, 2006 at \$0.50 per share. As additional consideration for the financing, we issued a warrant for the purchase of 500,000 shares at an exercise price of \$.50 per share. We allocated \$0.1 million to the value of the warrants. In November 2005, the right to convert the \$1.0 million obligation into 2,000,000 shares of common stock was waived in exchange for the issuance of a five-year warrant to purchase 300,000 shares of our common stock at a price of \$0.50 per share, the public market price on the date of the warrant, as consideration for the note being extended to July 1, 2006. We recorded \$0.1 million for the estimated fair value of these warrants as a deferred cost which will be amortized as interest expense to the extended date of maturity. The note was repaid as part of our March 9, 2006 refinancing.

During the three months ended January 31, 2006, we issued to one employee a five-year option exercisable at \$0.50 per share, which was the public market closing price for our common stock on the transaction date, to purchase 15,000 shares of our common stock. We allocated approximately \$2,000 to the value of

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these options. In addition, during the same period, we retired options to purchase 32,000 shares at a weighted average price of \$0.40 per share upon one employee's termination.

### NOTE 5 - SUBSEQUENT EVENTS

Effective February 1, 2006, upon the inception of a new capitation arrangement, we opened an additional satellite office in Yucaipa, California that provides x-ray services for our Riverside location.

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

Effective February 1, 2006, we invested \$237,000 for a 47.5% membership interest in an entity that operates a PET center in Palm Springs, California. The center will provide PET services for our existing facilities in the area replacing a prior arrangement where PET services were provided by a mobile unit for a "per use" fee.

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

The DRA also codifies the reduction in reimbursement for multiple images on contiguous body parts previously announced by the Centers for Medicare and Medicaid Services (CMS). In November 2005, CMS announced that it will pay 100% of the technical component of the higher priced imaging procedure and 50% for the technical component of each additional imaging procedure involving contiguous body parts when performed in the same session. Under current methodology, Medicare pays 100% of the technical component of each procedure. This rate reduction will occur in two steps, so that the reduction will be 25% for each additional imaging procedure in 2006 and another 25% in 2007. For the fiscal year ended October 31, 2005, Medicare revenue from our imaging centers represented approximately 15% of our total revenue. Of this amount, approximately 54% was from MRI and CT, the modalities affected more significantly by the reimbursement reductions. If both the HOPPS and contiguous body part reimbursement reductions contained in the DRA had been in effect during fiscal year 2005, we estimate that our revenue would have been reduced by approximately \$2.5-\$3.0 million.

On February 28, 2006, we issued a five-year warrant for the purchase of 200,000 shares of our common stock at a price of \$0.40 per share to one physician.

Effective March 9, 2006, we completed the issuance of a \$161 million senior secured credit facility that we used to refinance substantially all of our existing indebtedness (except for \$16.1 million of outstanding subordinated debentures and approximately \$5 million of capital lease obligations). Included in the \$161 million senior secured credit facility were fees and expenses for the transaction of approximately \$5.2 million. The facility provides for a \$15 million five-year revolving credit facility, an \$86 million term loan due in five years and a \$60 million second lien term loan due in six years. The loans

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are subject to acceleration on December 27, 2007, unless we have made arrangements to discharge or extend our outstanding subordinated debentures by that date. We intend to retire the subordinated debentures prior to their due date of June 30, 2008. Under the terms and conditions of the new Second Lien Term Loan, subject to achieving certain leverage ratios, we have the right to raise up to \$16.1 million in additional funds as part of the Second Lien Term Loan for the purposes of redeeming the subordinated debentures. Additionally, under the current facilities, we have the ability to pursue other funding sources to refinance the subordinated debentures. The loans are payable interest only monthly except for the \$86 million term loan that requires amortization payments of 1% per annum.

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

As part of the refinancing, we are required to swap at least 50% of the aggregate principal amount of the facilities to a floating rate within 90 days of the close of the agreement on March 9, 2006. We have not yet entered into the swap arrangement or decided on how much of the loans will be swapped. In addition, as a requirement of the deal, 75% of our excess cash flow is to be used to repay principal on the \$86 million term loan once per year within 105 days after our fiscal year end. Excess cash flow is defined as earnings before interest, taxes, depreciation and amortization plus decreases in working capital and extraordinary gains minus: (i) capital expenditures; (ii) interest expense; (iii) scheduled principal payments on existing debt; (iv) income taxes; (v) increases in working capital; (vi) extraordinary losses; (vii) voluntary prepayments of the \$86 million term loan; (viii) and amounts paid for acquisitions.

Under the new facility, we are subject to various financial covenants including a limitation on capital expenditures, maximum days sales outstanding, minimum fixed charge coverage ratio, maximum leverage ratio and maximum senior leverage ratio. Availability under our \$15 million revolving credit facility is governed by the margins calculated under the maximum senior leverage ratio and maximum total leverage ratio covenants. Borrowings under the historical Bridge credit facility were calculated from a formula based upon our net eligible accounts receivable. As of March 9, 2006, after giving effect to the approximately \$1.5 million balance on our revolving credit facility, we had approximately \$13.5 million of availability. As a result of the completed financing, we were able to reclassify the majority of our notes and capital lease obligations as noncurrent as of January 31, 2006 and improve our working capital significantly.

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

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### OVERVIEW

We operate a group of regional networks comprised of 60 fixed-site freestanding outpatient diagnostic imaging facilities in California. We believe our group of regional networks is the largest of its kind in California. We have strategically organized our facilities into regional networks in markets, which have both high-density and expanding populations, as well as attractive payor diversity.

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

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

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

PAYOR TYPE	PERCENTAGE OF NET REVENUE
-----	-----
Insurance(1)	42%
Managed Care Capitated Payors	28
Medicare/Medi-Cal	18
Other(2)	9
Workers Compensation/Personal Injury	3

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- (1) Includes Blue Cross/Blue Shield, which represented 15% of our net revenue for the three months ended January 31, 2006.
- (2) Includes co-payments, direct patient payments and payments through contracts with physician groups and other non-insurance company payors.

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

The principal components of our fixed operating expenses, excluding depreciation, include professional fees paid to radiologists, except for those

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

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

### OUR RELATIONSHIP WITH BRMG

Howard G. Berger, M.D. is our President and Chief Executive, a member of our Board of Directors, and owns approximately 30% of Primedex's outstanding common stock. Dr. Berger also owns, indirectly, 99% of the equity interests in BRMG. BRMG provides all of the professional medical services at 42 of our facilities under a management agreement with us, and contracts with various other independent physicians and physician groups to provide all of the professional medical services at most of our other facilities. We obtain professional medical services from BRMG, rather than providing such services directly or through subsidiaries, in order to comply with California's prohibition against the corporate practice of medicine. However, as a result of our close relationship with Dr. Berger and BRMG, we believe that we are able to better ensure that professional medical services are provided at our facilities in a manner consistent with our needs and expectations and those of our referring physicians, patients and payors than if we obtained these services from unaffiliated practice groups.

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

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

### RESULTS OF OPERATIONS

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

	THREE MONTHS ENDED JANUARY 31,	
	2005	2006
Net revenue	100.0%	100.0%
Operating expenses:		
Operating expenses	78.7	75.7
Depreciation and amortization	12.7	10.6
Provision for bad debts	2.7	3.5
Total operating expense	94.1	89.8
Income from operations	5.9	10.2
Other expense (income):		
Interest expense	12.4	11.5
Other income	(0.3)	(0.1)
Other expense	0.2	--
Total other expense	12.3	11.4
Net loss	(6.4)	(1.2)

### THREE MONTHS ENDED JANUARY 31, 2006 COMPARED TO THE THREE MONTHS ENDED JANUARY 31, 2005

During the last twelve months, we continued our efforts to enhance our operations and expand our network, while improving our financial position and cash flows. Our results for the three months ended January 31, 2006 were affected by the opening and integration of new facilities, the improvement in reimbursement from our managed care capitated payors, our increased marketing efforts, and our continuing focus on controlling operating expenses. As a result of these factors and the other matters discussed below, we experienced an increase in income from operations of \$1.9 million and a net loss decrease of \$1.7 million when comparing the results for the three months ended January 31, 2005 to the same period this year.

Effective March 9, 2006, we completed the issuance of a \$161 million senior secured credit facility that we used to refinance substantially all of our existing indebtedness (except for \$16.1 million of outstanding subordinated debentures and approximately \$5 million of capital lease obligations). The facility provides for a \$15 million five-year revolving credit facility, an \$86



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million term loan due in five years and a \$60 million second lien term loan due in six years. The loans are subject to acceleration on December 27, 2007, unless we have made arrangements to discharge or extend our outstanding subordinated debentures by that date. We intend to retire the subordinated debentures prior to their due date of June 30, 2008. Under the terms and conditions of the new Second Lien Term Loan, subject to achieving certain leverage ratios, we have the right to raise up to \$16.1 million in additional funds as part of the Second Lien Term Loan for the purposes of redeeming the subordinated debentures. Additionally, under the current facilities, we have the ability to pursue other funding sources to refinance the subordinated debentures. The loans are payable interest only monthly except for the \$86 million term loan that requires amortization payments of 1.0% per annum. As a result of the completed financing, we were able to reclassify the majority of our notes and capital lease obligations as noncurrent as of January 31, 2006 and improve our working capital significantly. We had a working capital deficit of \$5.5 million at January 31, 2006 compared to a \$143.4 million deficit at October 31, 2005.

### NET REVENUE

Net revenue for the three months ended January 31, 2006 was \$38.5 million compared to \$34.1 million for the same period in fiscal 2005, an increase of approximately \$4.4 million, or 13%.

The largest increases were at the facilities in Temecula, Tarzana, Thousand Oaks, Modesto, Los Coyotes, Desert and Orange with combined net revenue increases of approximately \$4.4 million when comparing results for the three months ended January 31, 2006 with the same period last year. The improvement at Temecula and Thousand Oaks was due to the expansion and opening of additional facilities in Murrieta and Westlake, California that opened in December 2004 and March 2005, respectively. The increase at the Tarzana facilities is due to the upgrade of the MRI equipment and the increased focus on the expansion of its PET business. The improvements at Modesto were due to a new capitation arrangement entered into in May 2005. The increase at the Desert, Los Coyotes and Orange facilities is due to a variety of factors including their physical locations, improvements in contracted reimbursement and increases in patient volume and throughput.

### OPERATING EXPENSES

Operating expenses for the three months ended January 31, 2006 increased approximately \$2.5 million, or 8%, from \$32.1 million in the first quarter of fiscal 2005 to \$34.6 million in the same quarter this year.

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

	Three Months Ended January 31,	
	2005	2006
Salaries and professional reading fees	\$ 16,705	\$ 18,275
Building and equipment rental	1,973	2,082
General administrative expenses	8,187	8,812
Total operating expenses	26,865	29,169
Depreciation and amortization	4,323	4,087
Provision for bad debt	909	1,349

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### o SALARIES AND PROFESSIONAL READING FEES

Salaries and professional reading fees increased \$1.6 million for the three months ended January 31, 2006 when compared to the same period last year. The increase in salaries is primarily due to the higher costs associated with recruiting and retaining key personnel, staffing the centers to manage their respective increase in volume, the hiring of key physicians and specialists in certain regions, the hiring of physician assistants, and the costs of additional personnel necessary to open additional satellite locations and operate the new centers in Murrieta and Westlake. Salaries and professional reading fees increased \$1.4 million at the centers with the largest increases in net revenue that included Temecula, Tarzana, Thousand Oaks, Modesto, Los Coyotes, Desert and Orange.

### o BUILDING AND EQUIPMENT RENTAL

Building and equipment rental expenses increased \$109,000 for the three months ended January 31, 2006 when compared to the same period last year. The increase is primarily due to the addition of building rental expense for the new centers in Murrieta and Westlake coupled with annual increases in base rentals from existing leased facilities.

### o GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses include billing fees, medical supplies, office supplies, repairs and maintenance, insurance, business tax and license, outside services, utilities, marketing, travel and other expenses. Many of these expenses are variable in nature. These expenses increased \$625,000, or 8%, for the three months ended January 31, 2006 when compared to the same period last year. The majority of the increase is attributable to those variable expenses that increased with net revenue, including medical supplies, repairs and maintenance (per the percentage of revenue agreement), billing fees, and transcription and other outside services.

### o DEPRECIATION AND AMORTIZATION

Depreciation and amortization decreased by \$236,000 for the three months ended January 31, 2006 when compared to the same period last year. Certain medical equipment and other intangible assets, including patient lists, were fully amortized during the period.

### o PROVISION FOR BAD DEBT

The \$440,000 increase in provision for bad debt for the three months ended January 31, 2006 when compared to the same period last year was primarily a result of increased net revenue and changes in payor mix during the period.

### OTHER EXPENSE (INCOME)

Other expense increased \$199,000 for the three months ended January 31, 2006 when compared to the same period last year.

### o INTEREST EXPENSE

Interest expense for the three months ended January 31, 2006 increased \$226,000 when compared to the same period last year. The increase was primarily due to increased borrowings on lines of credit coupled with increases in the prime rate of interest during the period. The outstanding line of credit liability was \$14.0 million and \$9.9 million as of January

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31, 2006 and 2005, respectively.

### o OTHER INCOME

In the three months ended January 31, 2005 and 2006, we earned other income of \$110,000 and \$51,000, respectively, principally comprised of sublease income, record copy income, the extinguishments of certain liabilities and deferred rent income. In addition, during the three months ended January 31, 2005, we recognized gains from write-offs of liabilities previously expensed in fiscal 2004 for approximately \$62,000.

### o OTHER EXPENSE

In the three months ended January 31, 2005, we incurred other expense of \$86,000 principally comprised of write-offs of other assets.

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## LIQUIDITY AND CAPITAL RESOURCES

We had a working capital deficit of \$5.5 million at January 31, 2006 compared to a \$143.4 million deficit at October 31, 2005, and had losses from operations of \$0.5 million and \$2.2 million during the three months ended January 31, 2006 and 2005, respectively. We also had a stockholders' deficit of \$71.0 million at January 31, 2006 compared to a \$70.6 million deficit at October 31, 2005.

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

Effective March 9, 2006, we completed the issuance of a \$161 million senior secured credit facility that we used to refinance substantially all of our existing indebtedness (except for \$16.1 million of outstanding subordinated debentures and approximately \$5 million of capital lease obligations). Included in the \$161 million senior secured credit facility were fees and expenses for the transaction of approximately \$5.2 million. The facility provides for a \$15 million five-year revolving credit facility, an \$86 million term loan due in five years and a \$60 million second lien term loan due in six years. The loans are subject to acceleration on December 27, 2007, unless we have made arrangements to discharge or extend our outstanding subordinated debentures by that date. We intend to retire the subordinated debentures prior to their due date of June 30, 2008. Under the terms and conditions of the new Second Lien Term Loan, subject to achieving certain leverage ratios, we have the right to raise up to \$16.1 million in additional funds as part of the Second Lien Term Loan for the purposes of redeeming the subordinated debentures. Additionally, under the current facilities, we have the ability to pursue other funding sources to refinance the subordinated debentures. The loans are payable interest only monthly except for the \$86 million term loan that requires amortization payments of 1.0% per annum.

The revolving credit facility and the \$86 million term loan bear interest at a base rate ("base rate" means corporate loans posted by at least 75% of the nation's 30 largest banks as quoted by the Wall Street Journal) plus 2.5%, or at our election, the LIBOR rate plus 4.0% per annum, payable monthly. The \$60

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million second lien term loan bears interest at the base rate plus 7.0%, or at our election, the LIBOR rate plus 8.5% per annum, payable monthly. The \$86 million term loan includes amortization payments of 1.0% per annum, payable in quarterly installments of \$215,000. Upon the close of the refinancing on March 9, 2006, we utilized approximately \$1.5 million of the new \$15 million revolving credit facility.

Under the new facility, we are subject to various financial covenants including a limitation on capital expenditures, maximum days sales outstanding, minimum fixed charge coverage ratio, maximum leverage ratio and maximum senior leverage ratio. Availability under our \$15 million revolving credit facility is governed by the margins calculated under the maximum senior leverage ratio and maximum total leverage ratio covenants. Borrowings under the historical Bridge credit facility were calculated from a formula based upon our net eligible accounts receivable. As of March 9, 2006, after giving effect to the approximately \$1.5 million balance on our revolving credit facility, we had approximately \$13.5 million of availability. As a result of the completed financing, we were able to reclassify the majority of our notes and capital lease obligations as noncurrent as of January 31, 2006 and improve our working capital significantly.

We operate in a capital intensive, high fixed-cost industry that requires significant amounts of capital to fund operations. In addition to operations, we require significant amounts of capital for the initial start-up and development expense of new diagnostic imaging facilities, the acquisition of additional facilities and new diagnostic imaging equipment, and to service our existing debt and contractual obligations. Because our cash flows from operations have been insufficient to fund all of these capital requirements, we have depended on the availability of financing under credit arrangements with third parties. Historically, our principal sources of liquidity have been funds available for borrowing under our existing lines of credit, now with General Electric Capital Corporation. We finance the acquisition of equipment mainly through capital and operating leases. As of January 31, 2006 and October 31, 2005, our line of credit liabilities were \$14.0 million and \$13.3 million, respectively. As of January 31, 2006, \$468,000 of line of credit liabilities were classified as current liabilities for the unpaid balance at the closing of the refinancing transaction.

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As of January 31, 2006, Howard G. Berger, M.D., our president, director and largest shareholder had outstanding advances to us of \$1,370,000. Our obligation to Dr. Berger was repaid as part of our March 9, 2006 refinancing.

The interim disclosures regarding liquidity and capital resources should be read in conjunction with the consolidated financial statements and related notes thereto contained in our Annual Report of Form 10-K for the year ended October 31, 2005. There were no material changes in our financing agreements from October 31, 2005 to January 31, 2006.

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

- o Maximizing performance at our existing facilities;
- o Focusing on profitable contracting;
- o Expanding MRI and CT applications

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- o Optimizing operating efficiencies; and
- o Expanding our networks.

Due to the March 9, 2006 refinancing, we will be able to use the cash savings generated from the deferral of required principal payments on notes payable and capital lease obligations of approximately \$1.2 million per month to invest in the infrastructure and to pursue future growth opportunities.

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

### SOURCES AND USES OF CASH

Cash provided by operating activities for the three months ended January 31, 2006 was \$2.5 million compared to \$1.7 million for the same period in 2005. The primary reason for the increase in cash was due to the improvement in net income from operations

Cash used by investing activities for the three months ended January 31, 2006 was \$834,000 compared to \$820,000 for the same period in 2005. For the three months ended January 31, 2006 and 2005, we purchased property and equipment for approximately \$834,000 and \$885,000, respectively, and during the three months ended January 31, 2005, we received proceeds from the sale of equipment of \$65,000.

Cash used for financing activities for fiscal 2006 was \$1,670,000 compared to \$855,000 for the same period in 2005. For fiscal 2006 and 2005, we made principal payments on capital leases, notes payable and lines of credit of approximately \$4,663,000 and \$1,292,000, respectively, and received proceeds from borrowings under existing lines of credit and refinancing arrangements of approximately \$701,000 and \$987,000, respectively. During the three months ended January 31, 2006, we increased cash disbursements in transit by \$2,292,000 compared to a decrease in cash disbursements in transit of \$550,000 during the same period in 2005. During the third quarter of fiscal 2004, we renegotiated our existing notes and capital lease obligations with our three primary lenders, General Electric, or GE, DVI Financial Services and U.S. Bank. As part of the restructure, interest only payments were required for the majority of the first quarter of fiscal 2005.

### CONTRACTUAL COMMITMENTS

Effective March 9, 2006, we completed the issuance of a \$161 million senior secured credit facility that we used to refinance substantially all of our existing indebtedness (except for \$16.1 million of outstanding subordinated debentures and approximately \$5 million of capital lease obligations). The facility provides for a \$15 million five-year revolving credit facility, an \$86 million term loan due in five years and a \$60 million second lien term loan due in six years. The loans are subject to acceleration on December 27, 2007, unless

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we have made arrangements to discharge or extend our outstanding subordinated debentures by that date. We intend to retire the subordinated debentures prior to their due date of June 30, 2008. Under the terms and conditions of the new Second Lien Term Loan, subject to achieving certain leverage ratios, we have the right to raise up to \$16.1 million in additional funds as part of the Second Lien Term Loan for the purposes of redeeming the subordinated debentures. Additionally, under the current facilities, we have the ability to pursue other funding sources to refinance the subordinated debentures. The loans are payable interest only monthly except for the \$86 million term loan that requires amortization payments of 1.0% per annum.

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

As part of the refinancing, we are required to swap at least 50% of the aggregate principal amount of the facilities to a floating rate within 90 days of the close of the agreement on March 9, 2006. We have not yet entered into the swap arrangement or decided on how much of the loans will be swapped. In addition, as a requirement of the deal, 75% of our excess cash flow is to be used to repay principal on the \$86 million term loan once per year within 105 days after our fiscal year end. Excess cash flow is defined as earnings before interest, taxes, depreciation and amortization plus decreases in working capital and extraordinary gains minus: (i) capital expenditures; (ii) interest expense; (iii) scheduled principal payments on existing debt; (iv) income taxes; (v) increases in working capital; (vi) extraordinary losses; (vii) voluntary prepayments of the \$86 million term loan; (viii) and amounts paid for acquisitions.

Under the new facility, we are subject to various financial covenants including a limitation on capital expenditures, maximum days sales outstanding, minimum fixed charge coverage ratio, maximum leverage ratio and maximum senior leverage ratio. Availability under our \$15 million revolving credit facility is governed by the margins calculated under the maximum senior leverage ratio and maximum total leverage ratio covenants. Borrowings under the historical Bridge credit facility were calculated from a formula based upon our net eligible accounts receivable. As of March 9, 2006, after giving effect to the approximately \$1.5 million balance on our revolving credit facility, we had approximately \$13.5 million of availability. As a result of the completed financing, we were able to reclassify the majority of our notes and capital lease obligations as noncurrent as of January 31, 2006 and improve our working capital significantly.

In addition, we have an arrangement with GE Medical Systems under which it has agreed to be responsible for the maintenance and repair of the majority of our equipment for a fee that is based upon a percentage of our revenue, subject to a minimum payment. Net revenue is reduced by the provision for bad debt, mobile PET revenue and other professional reading service revenue to obtain adjusted net revenue. The fiscal 2005 annual service fee was the higher of 3.50% of our adjusted net revenue, or \$4,970,000. The fiscal 2006 annual service rate is the higher of 3.62% of our adjusted net revenue, or \$5,393,800. For the fiscal years 2007, 2008 and 2009, the annual service fee will be the higher of 3.62% of our adjusted net revenue, or \$5,430,000. We believe this framework of basing service costs on usage is an effective and unique method for controlling our overall costs on a facility-by-facility basis.

#### FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements reflect, among other things, management's current expectations and anticipated results of operations, all of which are subject to known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements, or industry results, to differ materially from those expressed or implied by such forward-looking statements. Therefore, any statements contained herein that are not statements of historical fact may be forward-looking statements and should be evaluated as such. Without limiting the foregoing, the words "believes," "anticipates," "plans," "intends," "will," "expects," "should" and similar words and expressions are intended to identify forward-looking statements. Except as required under the federal securities laws or by the rules and regulations of the SEC, we assume no obligation to update any such forward-looking information to reflect actual results or changes in the factors affecting such forward-looking information. The factors included in "Risks Relating to Our Business," among others, could cause our actual results to differ materially from those expressed in, or implied by, the forward-looking statements.

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

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

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

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### RISKS RELATING TO OUR BUSINESS

#### WE MAY NOT BE ABLE TO GENERATE SUFFICIENT CASH FLOW TO MEET OUR DEBT SERVICE OBLIGATIONS.

Our ability to generate sufficient cash flow from operations to make payments on our debt and other contractual obligations will depend on our future financial performance. A range of economic, competitive, regulatory, legislative and business factors, many of which are outside of our control, will affect our financial performance. Our inability to generate sufficient cash flow to satisfy our debt and other contractual obligations would adversely impact our business, financial condition and results of operations. Effective March 9, 2006, we completed the issuance of a \$161 million senior secured credit facility that we used to refinance substantially all of our existing indebtedness (except for \$16.1 million of outstanding subordinated debentures and approximately \$5 million of capital lease obligations). The facility provides for a \$15 million five-year revolving credit facility, an \$86 million term loan due in five years and a \$60 million second lien term loan due in six years. The loans are subject to acceleration on December 27, 2007, unless we have made arrangements to discharge or extend our outstanding subordinated debentures by that date. As a result of the completed financing, we were able to reclassify the majority of our notes and capital lease obligations as noncurrent as of January 31, 2006 and improve our working capital significantly.

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#### OUR ABILITY TO GENERATE REVENUE DEPENDS IN LARGE PART ON REFERRALS FROM PHYSICIANS.

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

#### CHANGES IN THIRD-PARTY REIMBURSEMENT RATES OR METHODS FOR DIAGNOSTIC IMAGING SERVICES COULD RESULT IN A DECLINE IN OUR NET REVENUE AND NEGATIVELY IMPACT OUR BUSINESS.

The fees charged for the diagnostic imaging services performed at our facilities are paid by insurance companies, Medicare and Medi-Cal, workers compensation, private and other payors. Any change in the rates of or conditions for reimbursement from these sources of payment could substantially reduce the amounts reimbursed to us or to our contracted radiology practices for services provided, which could have an adverse effect on our net revenue. For example,



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recent legislative changes in California's workers compensation rules had a negative impact on reimbursement rates for diagnostic imaging services, although because we derive only a small portion of our net revenue from workers compensation, we did not experience a significant impact.

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

The DRA also codifies the reduction in reimbursement for multiple images on contiguous body parts previously announced by the Centers for Medicare and Medicaid Services (CMS). In November 2005, CMS announced that it will pay 100% of the technical component of the higher priced imaging procedure and 50% for the technical component of each additional imaging procedure involving contiguous body parts when performed in the same session. Under current methodology, Medicare pays 100% of the technical component of each procedure. This rate reduction will occur in two steps, so that the reduction will be 25% for each additional imaging procedure in 2006 and another 25% in 2007. For the fiscal year ended October 31, 2005, Medicare revenue from our imaging centers represented approximately 15% of our total revenue. Of this amount, approximately 54% was from MRI and CT, the modalities affected more significantly by the reimbursement reductions. If both the HOPPS and contiguous body part reimbursement reductions contained in the DRA had been in effect during fiscal year 2005, we estimate that our revenue would have been reduced by approximately \$2.5-\$3.0 million.

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PRESSURE TO CONTROL HEALTHCARE COSTS COULD HAVE A NEGATIVE IMPACT ON OUR RESULTS.

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

IF BRMG OR ANY OF OUR OTHER CONTRACTED RADIOLOGY PRACTICES TERMINATE THEIR AGREEMENTS WITH US, OUR BUSINESS COULD SUBSTANTIALLY DIMINISH.

Our relationship with BRMG is an integral part of our business. Through our management agreement, BRMG provides all of the professional medical services at 42 of our 60 facilities, contracts with various other independent physicians and physician groups to provide all of the professional medical services at most of our other facilities, and must use its best efforts to provide the professional medical services at any new facilities that we open or acquire. In addition,

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

Except for our management agreement with BRMG, most of the agreements we, or BRMG, have with contracted radiology practices typically have terms of one year, which automatically renew unless either party delivers a non-renewal notice to the other within a prescribed period. Most of these agreements may be terminated by either party under some conditions, including, with respect to some of those agreements, the right of either party to terminate the agreement without cause upon 30 to 120 days notice. For example, in October 2003, our management agreement with Tower Imaging Medical Group, Inc. was terminated as the result of the settlement of litigation between Tower and us. The termination or material modification of any of the agreements we, or BRMG, have with the radiologists that provide professional medical services at our facilities could reduce our revenue, at least in the short term.

IF OUR CONTRACTED RADIOLOGY PRACTICES, INCLUDING BRMG, LOSE A SIGNIFICANT NUMBER OF THEIR RADIOLOGISTS, OUR FINANCIAL RESULTS COULD BE ADVERSELY AFFECTED.

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

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WE MAY NOT BE ABLE TO SUCCESSFULLY GROW OUR BUSINESS.

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

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

- o Identify attractive and willing candidates for acquisitions;
- o Identify locations in existing or new markets for development of new facilities;
- o Comply with legal requirements affecting our arrangements with contracted radiology practices, including California prohibitions on fee-splitting, corporate practice of medicine and self-referrals;
- o Obtain regulatory approvals where necessary and comply with licensing and certification requirements applicable to our diagnostic imaging facilities, the contracted radiology practices and the physicians associated with the contracted radiology practices;
- o Recruit a sufficient number of qualified radiology technologists and other non-medical personnel;
- o Expand our infrastructure and management; and
- o Compete for opportunities. We may not be able to compete effectively for the acquisition of diagnostic imaging facilities. Our competitors may have more established operating histories and greater resources than we do. Competition also may make any acquisitions more expensive.

Acquisitions involve a number of special risks, including the following:

- o Obtain adequate financing.
- o Possible adverse effects on our operating results;
- o Diversion of management's attention and resources;
- o Failure to retain key personnel;
- o Difficulties in integrating new operations into our existing infrastructure; and
- o Amortization or write-offs of acquired intangible assets.

### WE MAY BECOME SUBJECT TO PROFESSIONAL MALPRACTICE LIABILITY.

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

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

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SOME OF OUR IMAGING MODALITIES USE RADIOACTIVE MATERIALS, WHICH GENERATE REGULATED WASTE AND COULD SUBJECT US TO LIABILITIES FOR INJURIES OR VIOLATIONS OF ENVIRONMENTAL AND HEALTH AND SAFETY LAWS.

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

WE EXPERIENCE COMPETITION FROM OTHER DIAGNOSTIC IMAGING COMPANIES AND HOSPITALS. THIS COMPETITION COULD ADVERSELY AFFECT OUR REVENUE AND BUSINESS.

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

In addition, in the past some non-radiologist physician practices have refrained from establishing their own diagnostic imaging facilities because of the federal physician self-referral legislation. Final regulations issued in January 2001 clarify exceptions to the physician self-referral legislation, which created opportunities for some physician practices to establish their own diagnostic imaging facilities within their group practices and to compete with us. In the future, we could experience significant competition as a result of those final regulations.

TECHNOLOGICAL CHANGE IN OUR INDUSTRY COULD REDUCE THE DEMAND FOR OUR SERVICES AND REQUIRE US TO INCUR SIGNIFICANT COSTS TO UPGRADE OUR EQUIPMENT.

The development of new technologies or refinements of existing modalities may require us to upgrade and enhance our existing equipment before we may otherwise intend. Many companies currently manufacture diagnostic imaging equipment. Competition among manufacturers for a greater share of the diagnostic imaging equipment market may result in technological advances in the speed and imaging capacity of new equipment. This may accelerate the obsolescence of our

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equipment, and we may not have the financial ability to acquire the new or improved equipment. In that event, we may be unable to deliver our services in the efficient and effective manner that payors, physicians and patients expect and thus our revenue could substantially decrease. During fiscal 2005, we traded-in and upgraded our existing MRI at Tarzana Advanced to increase throughput and patient volume and compete in the marketplace. We incurred a loss on disposal of equipment of approximately \$696,000 for the upgrade.

WE HAVE EXPERIENCED OPERATING LOSSES AND WE HAVE A SUBSTANTIAL ACCUMULATED DEFICIT. IF WE ARE UNABLE TO IMPROVE OUR FINANCIAL PERFORMANCE, WE MAY BE UNABLE TO PAY OUR OBLIGATIONS.

We have incurred net losses of \$2.2 million and \$0.5 million during the three months ended January 31, 2005 and 2006, respectively, and at January 31, 2006 we had an accumulated stockholders' deficit of \$71.0 million. Also, in recent periods, we have suffered liquidity shortfalls which have led us to, among other things, undertake and complete a "pre-packaged" Chapter 11 plan of reorganization and modify the terms of various of our financial obligations. While we believe that by taking these and other actions in the future we be able to address these issues and solidify our financial condition, we cannot give assurances that we will be able to generate sufficient cash flow from operations to satisfy our debt obligations.

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A FAILURE TO MEET OUR CAPITAL EXPENDITURE REQUIREMENTS COULD ADVERSELY AFFECT OUR BUSINESS.

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

BECAUSE WE HAVE HIGH FIXED COSTS, LOWER SCAN VOLUMES PER SYSTEM COULD ADVERSELY AFFECT OUR BUSINESS.

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

OUR SUCCESS DEPENDS IN PART ON OUR KEY PERSONNEL AND WE MAY NOT BE ABLE TO RETAIN SUFFICIENT QUALIFIED PERSONNEL. IN ADDITION, FORMER EMPLOYEES COULD USE THE EXPERIENCE AND RELATIONSHIPS DEVELOPED WHILE EMPLOYED WITH US TO COMPETE WITH US.

Our success depends in part on our ability to attract and retain qualified senior and executive management, managerial and technical personnel. Competition in recruiting these personnel may make it difficult for us to continue our growth and success. The loss of their services or our inability in the future to

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attract and retain management and other key personnel could hinder the implementation of our business strategy. The loss of the services of Dr. Howard G. Berger, our President and Chief Executive Officer, or Norman R. Hames, our Chief Operating Officer, could have a significant negative impact on our operations. We believe that they could not easily be replaced with executives of equal experience and capabilities. We do not maintain key person insurance on the life of any of our executive officers with the exception of a \$5.0 million policy on the life of Dr. Berger. Also, if we lose the services of Dr. Berger, our relationship with BRMG could deteriorate, which would adversely affect our business.

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

### CAPITATION FEE ARRANGEMENTS COULD REDUCE OUR OPERATING MARGINS.

For the three months ended January 31, 2006, we derived approximately 28% of our net revenue from capitation arrangements, and we intend to increase the revenue we derive from capitation arrangements in the future. Under capitation arrangements, the payor pays a pre-determined amount per-patient per-month in exchange for us providing all necessary covered services to the patients covered under the arrangement. These contracts pass much of the financial risk of providing diagnostic imaging services, including the risk of over-use, from the payor to the provider. Our success depends in part on our ability to negotiate effectively, on behalf of the contracted radiology practices and our diagnostic imaging facilities, contracts with health maintenance organizations, employer groups and other third-party payors for services to be provided on a capitated basis and to efficiently manage the utilization of those services. If we are not successful in managing the utilization of services under these capitation arrangements or if patients or enrollees covered by these contracts require more frequent or extensive care than anticipated, we would incur unanticipated costs not offset by additional revenue, which would reduce operating margins.

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### WE MAY BE UNABLE TO EFFECTIVELY MAINTAIN OUR EQUIPMENT OR GENERATE REVENUE WHEN OUR EQUIPMENT IS NOT OPERATIONAL.

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

### DISRUPTION OR MALFUNCTION IN OUR INFORMATION SYSTEMS COULD ADVERSELY AFFECT OUR BUSINESS.

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

- o Earthquakes, fires, floods and other natural disasters;
- o Power losses, computer systems failures, internet and telecommunications or data network failures, operator negligence, improper operation by or supervision of employees, physical and electronic losses of data and similar events; and
- o Computer viruses, penetration by hackers seeking to disrupt operations or misappropriate information and other breaches of security.

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

OUR ACTUAL FINANCIAL RESULTS MAY VARY SIGNIFICANTLY FROM THE PROJECTIONS WE FILED WITH THE BANKRUPTCY COURT.

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

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

WE ARE VULNERABLE TO EARTHQUAKES AND OTHER NATURAL DISASTERS.

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

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COMPLYING WITH FEDERAL AND STATE REGULATIONS IS AN EXPENSIVE AND TIME-CONSUMING PROCESS, AND ANY FAILURE TO COMPLY COULD RESULT IN SUBSTANTIAL PENALTIES.

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

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

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

IF WE FAIL TO COMPLY WITH VARIOUS LICENSURE, CERTIFICATION AND ACCREDITATION STANDARDS, WE MAY BE SUBJECT TO LOSS OF LICENSURE, CERTIFICATION OR ACCREDITATION, WHICH WOULD ADVERSELY AFFECT OUR OPERATIONS.

Ownership, construction, operation, expansion and acquisition of our diagnostic imaging facilities are subject to various federal and California laws, regulations and approvals concerning licensing of personnel, other required certificates for certain types of healthcare facilities and certain medical equipment. In addition, freestanding diagnostic imaging facilities that provide services independent of a physician's office must be enrolled by Medicare as an independent diagnostic testing facility to bill the Medicare



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program. Medicare carriers have discretion in applying the independent diagnostic testing facility requirements and therefore the application of these requirements may vary from jurisdiction to jurisdiction. We may not be able to receive the required regulatory approvals for any future acquisitions, expansions or replacements, and the failure to obtain these approvals could limit the opportunity to expand our services.

Our facilities are subject to periodic inspection by governmental and other authorities to assure continued compliance with the various standards necessary for licensure and certification. If any facility loses its certification under the Medicare program, then the facility will be ineligible to receive reimbursement from the Medicare and Medi-Cal programs. For the year ended October 31, 2005, approximately 18% of our net revenue came from the Medicare and Medi-Cal programs. A change in the applicable certification status of one of our facilities could adversely affect our other facilities and in turn us as a whole.

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OUR AGREEMENTS WITH THE CONTRACTED RADIOLOGY PRACTICES MUST BE STRUCTURED TO AVOID THE CORPORATE PRACTICE OF MEDICINE AND FEE-SPLITTING.

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

FUTURE FEDERAL LEGISLATION COULD LIMIT THE PRICES WE CAN CHARGE FOR OUR SERVICES, WHICH WOULD REDUCE OUR REVENUE AND ADVERSELY AFFECT OUR OPERATING RESULTS.

In addition to extensive existing government healthcare regulation, there are numerous initiatives affecting the coverage of and payment for healthcare services, including proposals that would significantly limit reimbursement under the Medicare and Medi-Cal programs. Limitations on reimbursement amounts and other cost containment pressures have in the past resulted in a decrease in the revenue we receive for each scan we perform.

THE REGULATORY FRAMEWORK IN WHICH WE OPERATE IS UNCERTAIN AND EVOLVING.

Healthcare laws and regulations may change significantly in the future. We continuously monitor these developments and modify our operations from time to

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

Certain states have enacted statutes or adopted regulations affecting risk assumption in the healthcare industry, including statutes and regulations that subject any physician or physician network engaged in risk-based managed care contracting to applicable insurance laws and regulations. These laws and regulations, if adopted in California, may require physicians and physician networks to meet minimum capital requirements and other safety and soundness requirements. Implementing additional regulations or compliance requirements could result in substantial costs to us and the contracted radiology practices and limit our ability to enter into capitation or other risk sharing managed care arrangements.

OUR SUBSTANTIAL DEBT COULD ADVERSELY AFFECT OUR FINANCIAL CONDITION AND PREVENT US FROM FULFILLING OUR OBLIGATIONS.

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

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

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

### 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.

The majority of our interest expense is not sensitive to changes in the general level of interest in the United States because the majority of our

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indebtedness has interest rates that were fixed when we entered into the note payable or capital lease obligation. None of our long-term liabilities have variable interest rates. Our credit facility, classified as a current liability on our financial statements, is interest expense sensitive to changes in the general level of interest because it is based upon the current prime rate plus a factor.

### ITEM 4 CONTROLS AND PROCEDURES

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

We are in the process of remediating this weakness. Subsequent to October 31, 2005, we determined to change the design of our internal controls over non-routine accounting matters by the identification of an outside resource at a recognized professional services company that we can consult with on non-routine transactions or the employment of qualified accounting personnel to deal with this issue together with the utilization of other senior corporate accounting staff, who are responsible for reviewing all non-routine matters and preparing formal reports on their conclusions, and conducting quarterly reviews and discussions of all non-routine accounting matters with our independent public accountants. We believe we will substantially address the identified weakness through the change in the design of our internal controls, and subject to confirmation of the effectiveness of our implementation of these remediation measures, anticipate that the material weakness should be remediated prior to the end of fiscal 2006. We are continuing to evaluate additional controls and procedures that we can implement and may add additional accounting personnel during fiscal 2006 to enhance our technical accounting resources. We do not anticipate that the cost of this remediation effort will be material to our financial statements.

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

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

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## PART II

### OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

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

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

In November 2005, we issued to a lender in consideration of its agreement to waive its right to convert our \$1,000,000 obligation into 2,000,000 shares of our common stock a five-year warrant exercisable at a price of \$0.50 per share, which was the public market closing price for our common stock on the transaction date, to purchase 300,000 shares of our common stock.

#### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

There are no matters to be reported under this heading.

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

There are no matters to be reported under this heading.

#### ITEM 5. OTHER INFORMATION

There are no matters to be reported under this heading.

#### ITEM 6. EXHIBITS

- a) Exhibit 31.1 -- Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- b) Exhibit 31.2 -- Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- c) Exhibit 32.1 -- Certification Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- d) Exhibit 32.2 -- Certification Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PRIMEDEX HEALTH SYSTEMS, INC.

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(Registrant)

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Date: March 17, 2006

By /s/ HOWARD G. BERGER, M.D.

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Howard G. Berger, M.D., President and Director

Date: March 17, 2006

By /s/ MARK D. STOLPER

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Mark D. Stolper, Chief Financial Officer  
(Principal Accounting Officer)