ORION HEALTHCORP INC
Form 10QSB
November 13, 2006

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-QSB

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006

COMMISSION FILE NO. 001-16587

ORION HEALTHCORP, INC.
(NAME OF SMALL BUSINESS ISSUER IN ITS CHARTER)

| | |
|---|---|
| DELAWARE | 58-1597246 |
| (STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION) | (IRS EMPLOYER IDENTIFICATION NO.) |

| | |
|---|---|
| 1805 OLD ALABAMA ROAD<br>SUITE 350, ROSWELL GA | 30076 |
| (ADDRESS OF PRINCIPAL EXECUTIVE OFFICES) | (ZIP CODE) |

ISSUER'S TELEPHONE NUMBER: (678) 832-1800

SECURITIES REGISTERED UNDER SECTION 12(B) OF THE ACT:

| TITLE OF EACH CLASS | NAME OF EACH EXCHANGE ON WHICH REGISTERED |
|---|---|
| CLASS A COMMON STOCK, $0.001 PAR VALUE PER SHARE | THE AMERICAN STOCK EXCHANGE |

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes [X] No [_]

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

Yes [_] No [X]

As of November 10, 2006, 12,913,776 shares of the registrant's Class A Common Stock, par value $0.001, were outstanding, 10,448,470 shares of the registrant's Class B Common Stock, par value $0.001, were outstanding and 1,437,572 shares of the registrant's Class C Common Stock, par value $0.001, were outstanding.

Transitional Small Business Disclosure Format:

Yes [_] No [X]

ORION HEALTHCORP, INC.
QUARTERLY REPORT ON FORM 10-QSB
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006

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NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

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

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

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

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

OVERVIEW

Orion is a healthcare services organization providing outsourced business services to physicians, serving the physician market through two subsidiaries, Medical Billing Services, Inc. ("MBS") and Integrated Physician Solutions, Inc. ("IPS"). MBS provides billing, collection, accounts receivable management, coding and reimbursement services, reimbursement analysis, practice consulting, managed care contract management and accounting and bookkeeping services, primarily to hospital-based physicians such as pathologists, anesthesiologists and radiologists. MBS currently provides services to approximately 59 clients, representing 339 physicians. IPS serves the general and subspecialty pediatric physician market, providing accounting and bookkeeping, human resource management, accounts receivable management, quality assurance services, physician credentialing, fee schedule review, training and continuing education and billing and reimbursement analysis. IPS currently provides services to five pediatric groups in Illinois and Ohio, representing 37 physicians. The Company believes the core competency of the Company is its long-term experience and success in working with and creating value for physicians.

COMPANY HISTORY

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

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STRATEGIC FOCUS

In 2005, the Company initiated a strategic plan designed to accelerate its growth and enhance its future earnings potential. The plan focuses on the Company's strengths, which include providing billing, collections and complementary business management services to physician practices. In 2005 and early 2006, the Company divested certain non-strategic assets and ceased investment in business lines that did not complement the Company's strategic plans, redirecting financial resources and company personnel to areas that management believes enhances long-term growth potential. With the completion of these divestitures, the Company no longer has any ownership or management interests in ambulatory surgery and diagnostic centers.

The Company believes that it is now positioned to focus on its physician services business and the physician billing and collections market, leveraging its existing presence to expand into additional geographic regions and increase the range of services it provides to physicians, and has identified several acquisition opportunities to expand its business that are consistent with its strategic plan. The Company signed definitive agreements in September 2006 for the acquisition of two of these targets and plans to consummate the transactions in the fourth quarter of 2006. The Company also entered into definitive agreements for additional equity and mezzanine debt financing in September 2006, which it expects to consummate simultaneously with the two acquisitions. On November 9, 2006, the Company filed a definitive proxy statement with the Securities and Exchange Commission (the "SEC") on Form DEF14A with respect to the transactions contemplated by the definitive agreements, which are described in greater detail below, and set a special stockholders meeting date of November 27, 2006 for approval of certain changes in corporate structure which will enable the Company to consummate the transactions.

The first acquisition involves the purchase of all of the issued and outstanding capital stock of Rand Medical Billing, Inc ("Rand"). Rand is a full service billing agency, providing medical billing exclusively for anatomic and clinical pathology practices located in Simi Valley, California.

On September 8, 2006 the Company entered into a Stock Purchase Agreement (the "Rand Stock Purchase Agreement") with Rand Medical Billing, Inc. and the stockholder of Rand to purchase all of the issued and outstanding capital stock of Rand for an aggregate purchase price of $9,365,333, subject to adjustments conditioned upon future revenue results. A portion of the purchase price is payable by the issuance of such number of shares of the Company's Class A Common Stock having a value of $600,000 based on the average closing price per share of the Company's Class A Common Stock for the twenty day period prior to the closing of the Rand acquisition. The remainder of the purchase price is payable in a combination of cash and the issuance of an unsecured subordinated promissory note in the original principal amount of $1,365,333. At the closing of the Rand acquisition, $6,800,000 of the purchase price will be paid in cash and the balance will be placed in escrow (including the shares of the Company's Class A Common Stock) pending resolution of the purchase price adjustments and subject to claims, if any, for indemnification. The Rand Stock Purchase Agreement is incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed on September 11, 2006.

The second acquisition involves the purchase of all the issued and outstanding capital stock of two related companies, On Line Alternatives, Inc. ("OLA") and On Line Payroll Services, Inc. ("OLP") (collectively, "Online").

OLA is an outsourcing company providing data entry, insurance filing, patient statements, payment posting, collection follow-up and patient refund processing to medical practices. Most of OLA's customers are hospital-based physician practices including radiology, neurology and emergency medicine. Customers also include some other specialties as plastic surgery, family practice, internal medicine and orthopedics. All billing functions are the responsibility of OLA, and include credentialing and accounts payable processing. OLA also has a group of contract transcriptionists who work out of their homes and OLA offers these services to clients as well.

OLP provides payroll processing services to small businesses, a few of which are also customers of OLA. OLP provides payroll services including direct deposit, time clock interface and tax reporting to clients in Alabama, Florida, Georgia, Louisiana, Mississippi, Tennessee and Texas.

On September 8, 2006 the Company entered into a Stock Purchase Agreement (the "Online Stock Purchase Agreement") with OLA, OLP and the stockholders of each of OLA and OLP to purchase all of the issued and outstanding capital stock of both OLA and OLP for an aggregate purchase price of $3,310,924, subject to adjustments conditioned upon future revenue results. The purchase price is payable in a combination of cash and the issuance of unsecured subordinated promissory notes. At the closing of the On Line acquisition, $2,476,943 of the purchase price will be paid in cash and the remainder through the issuance of an unsecured subordinated promissory note in the original principal amount of $833,981. The Company also has an option to pay up to $75,000 of the purchase price in the form of an additional unsecured promissory note in lieu of cash at the closing. The Online Stock Purchase Agreement is incorporated by reference to Exhibit 10.2 of the Company's Current Report on Form 8-K filed on September 11, 2006.

Both the Rand Stock Purchase Agreement and the Online Stock Purchase Agreement contain customary representations and warranties and terms and conditions to closing.

In addition to the Rand Stock Purchase Agreement and the Online Stock Purchase Agreement, the Company also entered into a Stock Purchase Agreement on September 8, 2006 with Phoenix Life Insurance Company ("Phoenix") and Brantley Partners IV, L.P. ("Brantley IV") (the "Stock Purchase Agreement"). Pursuant to the terms of the Stock Purchase Agreement, Phoenix and Brantley IV will purchase, for an aggregate purchase price of $4,650,000, shares of the Company's Class D Common Stock representing upon conversion 19.375% of the Company's outstanding Class A Common Stock as of the date of issuance of the Class D Common Stock, on a fully-diluted basis taking into account the issuance of the shares of Class D Common Stock but excluding certain of the Company's outstanding options, warrants and convertible securities and certain shares of Class B Common Stock to be purchased by the Company from Brantley Capital Corporation. Since the Company's charter documents do not currently authorize the issuance of the Company's Class D Common Stock, the Company will amend and restate its Certificate of Incorporation to provide for such shares upon shareholder approval. The Stock Purchase Agreement is incorporated by reference to Exhibit 10.3 of the Company's Current Report on Form 8-K filed on September 11, 2006.

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As of September 30, 2006, Brantley IV owns 7,863,996 shares of the Company's Class B Common Stock, warrants to purchase 20,455 shares of the Company's Class A Common Stock and notes which are currently convertible into 1,358,054 shares of the Company's Class A Common Stock. As of September 30, 2006, this represents 35.4% of the Company's voting power and 51.7% of the Company's voting power on an as converted basis. As of September 30, 2006, Brantley IV and its affiliates own 44.8% of the Company's voting power and 59.5% of the Company's voting power on an as converted basis.

Phoenix is a limited partner in Brantley IV and Brantley Partners V, L.P and has also co-invested with Brantley IV and its affiliates in a number of transactions. Phoenix does not currently own, of record, any shares of the Company's capital stock. Two of the Company's directors, Paul H. Cascio and

Michael J. Finn, are affiliated with Brantley IV and its related entities. Paul Cascio and Michael J. Finn serve as general partners of the general partner of Brantley Venture Partners III, L.P. ("Brantley III") and Brantley IV and are limited partners in these funds. Neither Phoenix, Brantley IV nor Messrs. Cascio or Finn is affiliated with Brantley Capital Corporation. The advisor to Brantley III is Brantley Venture Management III, L.P. and the advisor to Brantley IV is Brantley Management IV, L.P.

Brantley IV will purchase, for an aggregate purchase price of $1,650,000, such number of shares of Class D Common Stock representing upon conversion 6.875% of the Company's outstanding Class A Common Stock as of the date of issuance of the Class D Common Stock, on a fully-diluted basis taking into account the issuance of the shares of Class D Common Stock but excluding certain of the Company's outstanding options, warrants and convertible securities and certain shares of Class B Common Stock to be purchased by the Company from Brantley Capital Corporation.

Phoenix will purchase, for an aggregate purchase price of $3,000,000, such number of shares of Class D Common Stock, representing upon conversion 12.5% of the Company's outstanding Class A Common Stock as of the date of issuance of the Class D Common Stock, on a fully-diluted basis taking into account the issuance of the shares of Class D Common Stock but excluding certain of the Company's outstanding options, warrants and convertible securities and certain shares of Class B Common Stock to be purchased by the Company from Brantley Capital Corporation.

The Class D Common Stock, upon stockholder approval, will have the following rights and preferences:

- The holders of the Class D Common Stock will have priority in certain distributions made to the other holders of Common Stock. The holders of the shares of Class D Common Stock (other than shares concurrently being converted into Class A Common Stock), as a single and separate class, will be entitled to receive all distributions until there has been paid with respect to each such share from amounts then and previously distributed an amount equal to 9% per annum on the Class D issuance amount, without compounding, from the date the Class D Common Stock is first issued.

- In addition to receiving any accrued but unpaid distributions described above, the holders of the Class D Common Stock will have the right to receive distributions pari passu with the holders of the shares of the Class A Common Stock, assuming for purposes of such calculation that each share of Class D Common Stock represented one share of Class A Common Stock (subject to adjustment to such conversion ratio for subsequent issuances by the Company of shares of the Company's capital stock, or rights to acquire such shares, for less than the price the holders of the Class D Common Stock paid for their shares and for stock splits, combinations, stock dividends and certain other actions as more fully specified in the Company's certificate of incorporation).

- The holders of a majority of the Class D Common Stock have the ability to authorize any payment that might otherwise be considered a distribution for purposes of the Company's amended and restated certificate of incorporation to be excluded from the distribution priority provisions described above.

- Each share of Class D Common Stock will be entitled to one vote. The Class D Common Stock will vote together with all other classes of the Company's Common Stock and not as a separate class, except as otherwise required by law or in the event of certain actions adversely affecting the rights and preferences of the Class D Common Stock as more fully specified in the Company's certificate of incorporation.

- At the option of each holder of Class D Common Stock, exercisable at any time and from time to time by notice to the Company, each outstanding share of Class D Common Stock held by such investor will convert into a number of shares of Class A Common Stock equal to the "Class D Conversion Factor" in effect at the time such notice is given. The Class D Conversion Factor will initially be one share of Class A Common Stock for each share of Class D Common Stock, subject to adjustment to such conversion ratio for subsequent issuances by the Company of shares of the Company's capital stock, or rights to acquire such shares, for less than the price the holders of the Class D Common Stock paid for their shares and for stock splits, combinations, stock dividends and certain other actions as more fully specified in the Company's certificate of incorporation.

On September 8, 2006 the Company also entered into a Note Purchase Agreement with Phoenix (the "Note Purchase Agreement," and together with the Stock Purchase Agreement, the "Private Placement Agreements"). Pursuant to the terms of the Note Purchase Agreement, Phoenix will purchase, for an aggregate purchase price of $3,350,000, (i) the Company's senior unsecured subordinated promissory notes, due 2011, in the original principal amount of $3,350,000 and (ii) warrants to purchase shares of the Company's Class A Common Stock equal to 1.117% of the Company's outstanding Class A Common Stock on the date of issuance of the warrants, on a fully-diluted basis taking into account the issuance of the shares of Class D Common Stock described above and the shares of Class A Common Stock covered by the warrants but excluding certain of the Company's outstanding options, warrants and convertible securities and certain shares of Class B Common Stock to be purchased by the Company from Brantley Capital Corporation. The Note Purchase Agreement is incorporated by reference to Exhibit 10.4 of the Company's Current Report on Form 8-K filed on September 11, 2006.

The Company's senior unsecured subordinated promissory notes will bear interest at the combined rate of (i) 12% per annum payable in cash on a quarterly basis and (ii) 2% per annum payable in kind (meaning that the accrued interest will be capitalized as principal) on a quarterly basis, subject to the Company's right to pay such amount in cash. The notes will be unsecured and subordinated to all of the Company's other senior debt. Upon the occurrence and during the continuance of an event of default the interest rate on the cash portion of the interest shall increase from 12% per annum to 14% per annum, for a combined rate of default interest of 16% per annum. The Company may prepay outstanding principal (together with accrued interest) on the note subject to certain prepayment penalties and the Company is required to prepay outstanding principal (together with accrued interest) on the note upon certain specified circumstances.

The warrants provide the holder with the right to purchase shares of the Company's Class A Common Stock equal to 1.117% of the Company's outstanding Class A Common Stock on the date of issuance of the warrants, on a fully-diluted basis taking into account the issuance of the shares of Class D Common Stock described above and the shares of Class A Common Stock covered by the warrants but excluding certain of the Company's outstanding options and warrants and certain shares of Class B Common Stock to be purchased by the Company from Brantley Capital Corporation. The warrants will be exercisable for five years from the date of issuance of the warrants at $0.01 per share.

Some or all of the proceeds the Company receives upon consummation of the sale of the Class D Common Stock, senior unsecured subordinated promissory notes and warrants in the private placement, along with proceeds from senior bank financing and other funds available to the Company, will be used to finance a portion of the acquisitions of the Rand and On Line businesses, the Company's purchase of certain shares of the Company's Class B Common Stock from Brantley Capital Corporation, to repay certain outstanding senior indebtedness and for general working capital purposes.

The obligations of Phoenix and Brantley IV to close under the Private Placement Agreements are subject to the satisfaction or waiver of many conditions in accordance with each of the Stock Purchase Agreement and Note Purchase Agreement, including:

- receipt of approval from the Company's stockholders of the amendments to the Company's certificate of incorporation and issuance of the Company's shares of Class D Common Stock and Class A Common Stock;

- the absence of any material adverse change in the Company's business and operations, and the business and operations of the Rand and On Line businesses, since June 30, 2006;

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- in the case of the Stock Purchase Agreement, the filing of the Company's Second Amended and Restated Certificate of Incorporation with the Secretary of State of Delaware and its acceptance thereof and the Company's reservation of a sufficient number of shares of Class A common Stock for issuance on conversion of the Class D Common Stock;

- the conversion to Class A Common Stock by Brantley IV of the entire unpaid principal amount of, including accrued but unpaid interest on, the Company's convertible subordinated promissory notes in the aggregate original principal amount of $1,250,000;

- consummation, in the case of the Stock Purchase Agreement, of the transactions contemplated by the Note Purchase Agreement and, in the case of the Note Purchase Agreement, of the transactions contemplated by the Stock Purchase Agreement;

- in the case of the Stock Purchase Agreement, consummation by each of Phoenix and Brantley IV of their respective obligations under the Stock Purchase Agreement;

- consummation of the acquisitions of the Rand and On Line businesses;

- the accuracy of the Company's representations and warranties in the Private Placement Agreements as of the closing date taking into account in certain instances the inclusion of the Rand and On Line businesses as part of the Company's business;

- delivery of pro forma financial statements giving effect to the acquisitions of the Rand and On Line businesses, the consummation of the private placement, the conversion of the Brantley IV notes and the consummation of senior financing that are satisfactory to Phoenix and Brantley IV;

- the performance and compliance with all of the covenants made, and obligations to be performed, by the other parties in the Private Placement Agreements prior to the closing;

- the receipt of all requisite third-party consents;

- consummation with one or more senior lenders for the provision of not less than $6,500,000 of senior secured financing and, in the case of the Note Purchase Agreement, execution of mutually acceptable intercreditor and subordination agreement(s) among Phoenix, the Company's senior lender and certain of the Company's existing debt holders; and

- conversion of all shares of Class B Common Stock and Class C Common Stock by the holders thereof into shares of Class A Common Stock or the Company's acquisition and retirement of all such shares, including the Company's purchase and retiring of the 1,722,983 shares of Class B Common Stock held by Brantley Capital Corporation.

In connection with the private placement, the parties will enter into a registration rights agreement, pursuant to which the holders of a majority of the shares of Class A Common Stock issuable upon either conversion of the Class D Common Stock or the exercise of the warrants will have the right to require the Company to register their shares of Class A Common Stock under the Securities Act. The agreement allows them one right to demand that the Company register their shares of Class A Common Stock under the Securities Act on a registration statement filed with the SEC and unlimited rights to include (or "piggy-back") the registration of their shares of Class A Common Stock on certain registration statements that the Company may file with the SEC for other purposes.

On September 8, 2006 the Company also entered into a Purchase Agreement (the "Purchase Agreement") with Brantley Capital Corporation to purchase all 1,722,983 shares of the Company's Class B Common Stock owned by Brantley Capital Corporation at any time between now and December 31, 2006 for an aggregate purchase price of $482,435. Upon the Company's acquisition of these shares of Class B Common Stock they will be retired in accordance with the terms of the Company's certificate of incorporation. The Company plans to consummate this purchase simultaneous with the closing of the private placement. The Company anticipates using a portion of the proceeds from the private placement, along with proceeds from senior bank financing and other funds available to the Company, to fund the purchase price for the Company's purchase of the shares of Class B Common Stock owned by Brantley Capital Corporation. The Purchase Agreement is incorporated by reference to Exhibit 10.5 of the Company's Current Report on Form 8-K filed on September 11, 2006.



These shares represent about 16.5% of the Company's outstanding shares of Class B Common Stock (and about 11.5% of the Company's outstanding shares of Class A Common Stock on a fully-diluted basis assuming conversion as of September 30, 2006) and the Company's acquisition of these shares will assist the Company in satisfying the closing condition to the private placement that requires all holders of shares of the Company's Class B Common Stock and Class C Common Stock to have converted or been acquired by the Company. Brantley Capital Corporation had previously informed the Company that they would not convert their shares as required in connection with the consummation of the private placement and the Company's board of directors determined that the terms of this acquisition were in the best interests of the Company's stockholders and the Company's ability to consummate the private placement.

The transactions contemplated by the foregoing agreements are all expected to close simultaneously, if stockholder approval is obtained as required under the Private Placement Agreements and upon satisfaction of the other relevant closing conditions. On November 9, 2006, the Company filed a definitive proxy statement with the SEC on Form DEF14A with respect to the transactions contemplated by the Rand Stock Purchase Agreement, the Online Stock Purchase Agreement, the Private Placement Agreements and the Purchase Agreement, which are described above, and set a special shareholder meeting date of November 27, 2006 for approval of the aforementioned transactions.

This description of the material terms of each of the agreements referenced above is qualified by reference to the complete text of the agreements.

FINANCIAL OVERVIEW

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

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

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

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

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



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

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

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

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

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

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

ACCOUNTS RECEIVABLE AND ALLOWANCE FOR DOUBTFUL ACCOUNTS. MBS records uncollectible accounts receivable using the direct write-off method of accounting for bad debts. Historically, MBS has experienced minimal credit losses and has not written-off any material accounts during the three months and nine months ended September 30, 2006 or 2005, respectively.

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

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



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

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

RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements," ("SAB 108") which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. SAB 108 is effective for fiscal years ending after November 15, 2006. The Company will adopt the provisions of SAB 108 for its fiscal year ended December 31, 2006 and does not expect the impact of SAB 108 to be material to its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," ("SFAS 157") which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Earlier application is encouraged provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. The Company does not expect the impact of SFAS 157 to be material to its consolidated financial statements.

In June 2006, the FASN issued Financial Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," ("FIN 48") which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." FIN 48 provides that a tax benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained upon examination, based on the technical merits. This interpretation also provides guidance on measurement, de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 will become effective for fiscal years beginning after December 15, 2006. The Company does not expect the impact of FIN 48 to be material to its consolidated financial statements.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS 154"). SFAS 154 replaces Auditing Practices Board ("APB") Opinion NO. 20, "Accounting Changes" ("APB 20") and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements," and changes the requirements for the accounting and reporting of a change in accounting principle. SFAS 154 applies to all voluntary changes in accounting principle as well as to changes required by an accounting pronouncement that does not include specific transition provisions. Previously, most changes in accounting principles were required to be recognized by way of including the cumulative effect of the changes in accounting principle in the income statement of the period of change. SFAS 154 requires that such changes in accounting principle be retrospectively applied as of the beginning of the first period presented as if that accounting principle had always been used, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. However, SFAS 154 does not change the transition provisions of any existing accounting pronouncements. The adoption of SFAS 154 was not material to the Company's consolidated financial statements.



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

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

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

RESULTS OF OPERATIONS

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

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

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

| | THREE MONTHS ENDED SEPTEMBER 30, 2006 | 2005 |
|---|---|---|
| Net operating revenues | 100.0% | 100.0% |
| Total operating expenses | 104.8% | 124.1% |
| Loss from continuing operations before other income (expenses) | (4.8%) | (24.1%) |
| Total other income (expenses), net | (1.7%) | (1.4%) |
| Loss from continuing operations | (6.5%) | (25.5%) |
| Discontinued operations | | |
| Income (loss) from operations of discontinued components, including net gain on disposal | 0.0% | (58.3%) |
| Net loss | (6.5%) | (83.8%) |



THREE MONTHS ENDED SEPTEMBER 30, 2006 AS COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2005

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

| | FOR THE THREE MONTHS SEPTEMBER 30, 2006 (Unaudited) | (Un |
|---|---|---|
| Net operating revenues | $ 7,474,193 | $ 7 |
| Operating expenses | | |
| Salaries and benefits | 2,782,117 | 3 |
| Physician group distribution | 2,112,603 | 2 |
| Facility rent and related costs | 455,403 | |
| Depreciation and amortization | 407,964 | |
| Professional and consulting fees | 393,774 | |
| Insurance | 163,139 | |
| Provision for doubtful accounts | 146,895 | |

| | | |
|---|---|---|
| Other expenses | 1,373,470 | 1 |
| Total operating expenses | 7,835,365 | 9 |
| Loss from continuing operations before other income (expenses) | (361,172) | (1 |
| Other income (expenses) | | |
| Interest expense | (122,169) | |
| Other expense, net | (4,365) | |
| Total other income (expenses), net | (126,534) | |
| Loss from continuing operations | (487,706) | (1 |
| Discontinued operations | | |
| Income (loss) from operations of discontinued components | -- | (4 |
| Net loss | $ (487,706) | $(6 |

NET OPERATING REVENUES. Net operating revenues of the Company consist of patient service revenue, net of contractual adjustments, related to the operations of IPS's affiliated medical groups, billing services revenue related to MBS and other revenue. For the three months ended September 30, 2006, consolidated net operating revenues increased $218,651, or 3.0%, to $7,474,193, as compared with $7,255,542 for the three months ended September 30, 2005.

MBS's net operating revenues totaled $2,451,464 for the three months ended September 30, 2006 as compared to net operating revenues totaling $2,491,109 for the same period in 2005, a decrease of $39,645, or 1.6%. The decrease in net operating revenues for MBS was primarily the result of the loss of two customers in the third quarter of 2005, one of which retired from medical practice and one group which decided to bring their billing in-house, which accounted for approximately $120,000 in net operating revenues in the third quarter of 2005. This decrease was partially offset in the third quarter of 2006 by the addition of two new customers accounting for approximately $104,000 in net operating revenues.

IPS's net patient service revenue increased $257,982, or 5.4%, from $4,764,747 for the three months ended September 30, 2005 to $5,022,729 for the three months ended September 30, 2006. The increase in net patient service revenue for IPS's affiliated medical groups was primarily the result of increases in immunizations administered and office procedures related to well-child visits and back to school check-ups in the third quarter of 2006 as compared to the same period in 2005. Three of IPS's four clinic-based affiliated pediatric groups experienced increases in procedures and immunizations administered in the third quarter of 2006, with total procedures and immunizations for all clinic-based facilities increasing 534 and 619, respectively, to 101,346 and 19,711 for the three months ended September 30, 2006.

Other revenue, which represents revenue from the Company's vaccine program, a group purchasing alliance for vaccines and medical supplies, totaled $44,626 for the third quarter of 2005, increasing $34,515, or 77.3%, to $79,141 for the three months ended September 30, 2006. The vaccine program had a total of 485 enrolled participants at September 30, 2006.

OPERATING EXPENSES

SALARIES AND BENEFITS. Consolidated salaries and benefits decreased

$790,386 to $2,782,117 for the three months ended September 30, 2006, as compared to $3,572,503 for the same period in 2005.

MBS's salaries and benefits totaled $1,440,599 for the three months ended September 30, 2006 as compared to $1,537,438 for the three months ended September 30, 2005, a decrease of $96,839. This decrease is primarily the result of a reduction in health benefit costs related to the consolidation of MBS's benefit plans with the IPS benefit plans at the beginning of 2006, thereby allowing greater negotiating leverage with benefit providers.

Clinical salaries & benefits include wages for the nurse practitioners, nursing staff and medical assistants employed by the affiliated medical groups and fluctuate indirectly to increases and decreases in productivity and patient volume. Clinical salaries, bonuses, overtime and health insurance collectively totaled $440,999 for the three months ended September 30, 2006, an increase of $18,037 from the same period in 2005. These expenses represented approximately 8.9% and 9.0% of net operating revenues for the three months ended September 30, 2006 and 2005, respectively. The fact that these expenses, as a percentage of net operating revenues, remained virtually flat is related to the fixed nature of salaries and benefits needed to maintain minimum staffing levels.

In August 2005, the Company consolidated its corporate operations into the Roswell, Georgia office. Prior to the staff reductions resulting from this corporate consolidation, salaries and benefits related to corporate staff in Houston, Texas totaled $181,568 for the three months ended September 30, 2005. Additionally, salaries and benefits for the third quarter of 2005 included accruals of $484,520 for separation benefits for Orion's former president, Keith LeBlanc, who resigned from the Company on November 8, 2005, and $69,750 for retention costs and accrued vacation related to the aforementioned staff reductions.

Administrative salaries and benefits, excluding MBS and the former staff of the Company's Houston, Texas office, represent the employee-related costs of all non-clinical practice personnel at IPS's affiliated medical groups as well as the Company's corporate staff in Roswell, Georgia. These expenses increased $25,374, or 3.0%, from $843,841 for the three months ended September 30, 2005 to $869,215 for the same period in 2006. These expenses include the adoption of SFAS 123(R), beginning in the first quarter of 2006, which resulted in stock option compensation expense totaling $49,642. The costs associated with the addition of one billing FTE and the promotion of three employees to supervisor at two of IPS's affiliated medical groups as the result of billing office reorganizations were offset by staffing adjustments at the Company's corporate office.



PHYSICIAN GROUP DISTRIBUTION. Physician group distribution increased $108,607, or 5.4%, for the three months ended September 30, 2006 to $2,112,603, as compared with $2,003,996 for the three months ended September 30, 2005. Pursuant to the terms of the MSAs governing each of IPS's affiliated medical groups, the physicians of each medical group receive disbursements after the payment of all clinic facility expenses as well as a management fee to IPS. The management fee revenue and expense, which is eliminated in the consolidation of the Company's financial statements, is either a fixed fee or is calculated based on a percentage of net operating income. For the three months ended September 30, 2006, management fee revenue totaled $359,071 and represented approximately 14.5% of net operating income as compared to management fee revenue totaling $359,802 and representing approximately 15.2% of net operating income for the same period in 2005. Physician group distribution represented 42.1% of net operating revenues for the three months ended September 30, 2006 and 2005. The increase in physician group distribution for the three months ended September

30, 2006 was directly related to the increase in net patient service revenue, which was primarily the result of increased procedure volume during the third quarter of 2006.

FACILITY RENT AND RELATED COSTS. Facility rent and related costs increased $22,099, or 5.1%, from $433,303 for the three months ended September 30, 2005 to $455,403 for the three months ended September 30, 2006.

MBS's facility rent and related costs totaled $135,380 for the three months ended September 30, 2006 as compared to $127,199 for the same period in 2005. This increase can be explained generally by increases in utilities and off-site storage costs for the third quarter of 2006.

Facility rent and related costs associated with IPS's affiliated medical groups and Orion's corporate office totaled $320,023 for the three months ended September 30, 2006 compared to $280,539 for the same period in 2005. The sublease between eClinicalWeb and the Company as a result of the IntegriMED Agreement in June 2005 ended as of June 30, 2006, resulting in the loss of $27,000 in rent expense offsets for the Company's corporate office in Roswell, Georgia. Additionally, one of the Company's affiliated medical groups moved to a new office location in the third quarter of 2006, which resulted in an increase of approximately $8,700 in facility related costs as compared to the third quarter of 2005.

In August 2005, the Company consolidated its corporate operations into the Roswell, Georgia office. Prior to this consolidation, facility-related costs such as utilities and personal property taxes associated with the Company's former office in Houston, Texas totaled approximately $25,000 for the three months ended September 30, 2005.

DEPRECIATION AND AMORTIZATION. Consolidated depreciation and amortization expense totaled $407,964 for the three months ended September 30, 2006, a decrease of $200,581 from the three months ended September 30, 2005.

For the three months ended September 30, 2006, depreciation expense related to the fixed assets of MBS totaled $16,986 as compared to $19,657 for the same period in 2005. Deprecation expense related to the fixed assets of IPS and Orion totaled $39,243 and $28,024 for the three months ended September 30, 2006 and 2005, respectively. Depreciation expense associated with fixed assets related to the Company's former Houston, Texas office, which was closed in August 2005, totaled $11,843 for the three months ended September 30, 2005.

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

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

As part of the IPS Merger, the purchase price, comprised of the fair value of the outstanding shares of the Company prior to the transaction, plus applicable transaction costs, was allocated to the fair value of the Company's tangible and intangible assets and liabilities prior to the transaction, with any excess being considered goodwill. As a result of the dispositions related to the Company's surgery and diagnostic center business, which was discontinued in 2005, and the uncertainty of future cash flows related to the Company's surgery center business, the Company impaired substantially all of the intangible assets related to the IPS Merger in 2005. Therefore, there was no amortization expense related to the intangible assets in the third quarter of 2006. Amortization expense for the intangible assets recorded as a result of the IPS Merger totaled $195,105 for the three months ended September 30, 2005. (See "Discontinued Operations" for additional discussion regarding the disposition of intangible assets and goodwill recorded as a result of the IPS Merger.)

PROFESSIONAL AND CONSULTING FEES. For the three months ended September 30, 2006, professional and consulting fees totaled $393,774, a decrease of $173,149, or 30.5%, from the same period in 2005.

For the three months ended September 30, 2006, MBS recorded professional and consulting expenses totaling $43,980 as compared with $79,257 for the same period in 2005, a decrease of $35,277. MBS utilized contract labor in the third quarter of 2005 as a result of staffing shortages. This contract labor was not utilized in the third quarter of 2006 because MBS's position inventory is fully staffed.

IPS's and Orion's professional and consulting fees, which include the costs of corporate accounting, financial reporting and compliance, and legal fees, decreased from $487,666 for the three months ended September 30, 2005 to $349,794 for the three months ended September 30, 2006. The decrease is primarily the result of reduced legal fees and expenses related to the divestiture of the Company's surgery and diagnostic business in 2005, including an accrual of $90,000 related to a legal settlement recorded in the third quarter of 2005.

INSURANCE. Consolidated insurance expense, which includes the costs of professional liability for affiliated physicians, property and casualty and general liability insurance and directors and officers' liability insurance, decreased from $238,315 for the three months ended September 30, 2005 to $163,139 for the three months ended September 30, 2006. The decrease can be explained generally by the following: (i) insurance expense related to the directors and officers' liability policies in the third quarter of 2005 included approximately $40,000 of premiums for run-off policies related to SurgiCare and IPS; (ii) general liability insurance premiums related to the Company's former Houston, Texas office, which was closed in August 2005, totaled approximately $15,000 in the third quarter of 2005; and (iii) professional liability insurance premiums for the Company's affiliated medical groups decreased approximately $15,000 in the third quarter of 2006 when compared with the same period in 2005.

PROVISION FOR DOUBTFUL ACCOUNTS. The Company's consolidated provision for doubtful accounts, or bad debt expense, decreased $131,289, or 47.2%, for the three months ended September 30, 2006 to $146,895. The entire provision for doubtful accounts for the quarter ended September 30, 2006 related to IPS's affiliated medical groups and accounted for 2.9% of IPS's net operating revenues as compared to 5.3% of IPS's net operating revenues for the same period in 2005. The total collection rate, after contractual allowances, for IPS's affiliated medical groups was 71.2% for the three months ended September 30, 2006, compared to 70.3% for the same period in 2005.

OTHER EXPENSES. Consolidated other expenses totaled $1,373,470 for the three months ended September 30, 2006, an increase of $68,110, or 5.2%, from the same period in 2005. Other expenses include general and administrative expenses such as office supplies, telephone & data communications, printing & postage, transfer agent fees, and board of directors' compensation and meeting expenses, as well as some direct clinical expenses, which are expenses that are directly related to the practice of medicine by the physicians that practice at the affiliated medical groups managed by IPS.

MBS's other expenses totaled $303,678 for the three months ended September 30, 2006 as compared to $305,813 for the three months ended September 30, 2005. Cost savings of approximately $27,000 as a result of renegotiated long distance rates were offset by an increase of approximately $29,000 in courier expenses in the third quarter of 2006. Courier expenses fluctuate as a result of increases or decreases in net operating revenues.

For the three months ended September 30, 2006, IPS's direct clinical expenses, other than salaries and benefits, totaled $736,581, an increase of $99,747 over direct clinical expenses in the third quarter of 2005, which totaled $636,834. Vaccine expenses increased approximately $101,000 in the third quarter of 2006 when compared to the same period in 2005, and accounted for 12.8% and 11.3% of net operating revenues for the three months ended September 30, 2006 and 2005, respectively. IPS's affiliated medical groups began using two new vaccines in late 2005 -- Menactra and Decavac -- which replaced lower-priced vaccines previously utilized by the medical groups.



The Company's and IPS's general and administrative expenses totaled $186,124 for the three months ended September 30, 2006, a decrease of $55,639 from the same period in 2005. There were approximately $43,000 of expense decreases related to cost efficiencies and expense reductions as a result of the consolidation of corporate functions into the Company's Roswell, Georgia office in August 2005.

OTHER INCOME AND EXPENSES.

INTEREST EXPENSE. Consolidated interest expense totaled $122,169 for the three months ended September 30, 2006, an increase of $24,992 from the same period in 2005. Interest expense activity in the third quarter of 2006, including increases from the third quarter of 2005, can be explained generally by the following:

- MBS NOTES. On April 19, 2006, the Company executed subordinated promissory notes with the former equity owners of MBS and DCPS for an aggregate of $714,336. This represented the retroactive purchase price increase due to the former equity owners of MBS and DCPS based on the financial results of the newly formed MBS, required by the merger agreement governing the DCPS/MBS Merger. The notes bear interest at the rate of 8% per annum, payable monthly beginning on April 30, 2006, and will mature on December 15, 2007. Interest expense related to these notes totaled approximately $14,287 for the three months ended September 30, 2006.

- LINE OF CREDIT. As part of the restructuring transactions, the Company also entered into a new secured two-year revolving credit facility pursuant to the Loan and Security Agreement (the "Loan and Security Agreement"), dated December 15, 2004, by and among the Company, certain of its affiliates and subsidiaries, and CIT Healthcare, LLC (formerly known as Healthcare Business Credit Corporation) ("CIT"), borrowing $1.6 million under this facility concurrently with the Closing. (See "Liquidity and Capital Resources" for additional discussion regarding the Loan and Security Agreement.) Interest expense related to this line of credit totaled $49,351 for the three months ended September 30, 2006, compared to $48,359 for the three months ended September 30, 2005.



DISCONTINUED OPERATIONS.

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

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

| | SEPTEMBER 30, 2005 |
|---|---|
| Income statement data: | |
| Net operating revenues | $ 737,355 |
| Operating expenses | 827,429 |

| | |
|---|---|
| Net loss | $ (90,074) |
| Balance sheet data: | |
| Current assets | $ 641,172 |
| Other assets | 1,398,449 |
| Total assets | $ 2,039,621 |
| Current liabilities | $ 617,186 |
| Other liabilities | 828,312 |
| Total liabilities | $ 1,445,498 |

SUTTER. On October 31, 2005, IPS executed the Sutter Settlement with Dr. Sutter to settle disputes that had arisen between IPS and Dr. Sutter and to avoid the risk and expense of litigation. As part of the Sutter Settlement, Dr. Sutter and IPS agreed that Dr. Sutter would purchase the assets owned by IPS and used in connection with Dr. Sutter's practice, in exchange for termination of the related MSA. Additionally, among other provisions, after October 31, 2005, Dr. Sutter and IPS have been released from any further obligation to each other arising from any previous agreement. As a result of this transaction, the Company recorded a loss on disposal of this discontinued component (in addition to the charge for impairment of intangible assets of $38,440 recorded in the fourth quarter of 2005) of $279 for the quarter ended December 31, 2005. The operations of this component are reflected in the Company's consolidated condensed statements of operations as `loss from operations of discontinued components' for the three months ended September 30, 2005. There were no operations for this component in the Company's financial statements after October 31, 2005.

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

| | SEPTEMBER 30, 2005 |
|---|---|
| Income statement data: | |
| Net operating revenues | $ 106,151 |
| Operating expenses | 103,440 |
| Net income | $ 2,711 |
| Balance sheet data: | |
| Current assets | $ 102,924 |
| Other assets | 14,066 |
| Total assets | $ 116,990 |
| Current liabilities | $ 21,778 |
| Other liabilities | -- |
| Total liabilities | $ 21,778 |

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

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

| | SEPTEMBER 30, 2005 |
|---|---|
| Income statement data: | |
| Net operating revenues | $ 61,046 |
| Operating expenses | 817,575 |
| Net loss | $ (756,529) |
| Balance sheet data: | |
| Current assets | $ 414,255 |
| Other assets | 552,107 |
| Total assets | $ 966,362 |
| Current liabilities | $ 940,149 |
| Other liabilities | 52,546 |
| Total liabilities | $ 992,695 |

SAN JACINTO. On March 1, 2006, San Jacinto executed an Asset Purchase Agreement for the sale of substantially all of its assets to Methodist. San Jacinto was approximately 10% owned by Baytown SurgiCare, Inc., the Company's wholly owned subsidiary, and is not consolidated in our financial statements. As a result of this transaction, the Company recorded a gain on disposal of this discontinued operation of $94,066 for the quarter ended March 31, 2006. As a result of the uncertainty of future cash flows related to the surgery center business, and in conjunction with the transactions related to TASC and TOM, the Company determined that the joint venture interest associated with San Jacinto was impaired and recorded a charge for impairment of intangible assets related to San Jacinto of $734,522 for the three months ended June 30, 2005. The Company also recorded an additional $2,113,262 charge for impairment of intangible assets for the three months ended September 30, 2005 related to the management contracts with San Jacinto. The Company allocated the goodwill recorded as part of the IPS Merger to each of the surgery center reporting units and recorded a loss on the write-down of goodwill related to San Jacinto totaling $694,499 for the quarter ended December 31, 2005. There were no operations for this component in our financial statements after March 31, 2006.

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ORION. Prior to the divestiture of the Company's ambulatory surgery center business, the Company recorded management fee revenue, which was eliminated in the consolidation of the Company's financial statements, for Bellaire SurgiCare, TASC and TOM and Memorial Village. The management fee revenue for San Jacinto was not eliminated in consolidation. There was no management fee revenue associated with the discontinued operations in the surgery center business for the three months ended September 30, 2006. For the three months ended September 30, 2005, the Company generated management fee revenue of $101,662 and net minority interest losses totaling $24,823. For the quarters ended June 30, 2005 and December 31, 2005, the Company recorded a charge for impairment of intangible assets of $276,420 and $142,377, respectively, related to trained work force and non-compete agreements affected by the surgery center operations the Company discontinued in 2005 and early 2006.

The following table summarizes the components of income (loss) from operations of discontinued components:

| | THREE MONTHS END SEPTEMBER 30, 20 |
|---|---|
| TASC and TOM | |
| Net loss | $ -- |
| Sutter | |
| Net income | -- |
| Memorial Village | |
| Net loss | -- |
| Loss on disposal | -- |
| San Jacinto | |
| Loss on disposal | -- |
| Orion | |
| Net income | -- |
| Total income (loss) from operations of discontinued components, including net gain (loss) on disposal | $ -- |

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NINE MONTHS ENDED SEPTEMBER 30, 2006 AS COMPARED TO
NINE MONTHS ENDED SEPTEMBER 30, 2005

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

| | FOR THE NINE MONTHS SEPTEMBER 30, | |
|---|---|---|
| | 2006 | |
| | (Unaudited) | (U |
| Net operating revenues | $ 21,559,921 | $ |
| Operating expenses | | |
| Salaries and benefits | 8,317,365 | |
| Physician group distribution | 6,135,949 | |
| Facility rent and related costs | 1,247,678 | |
| Depreciation and amortization | 1,226,791 | |
| Professional and consulting fees | 1,100,885 | |
| Insurance | 502,499 | |
| Provision for doubtful accounts | 446,041 | |
| Other expenses | 3,646,413 | |
| Total operating expenses | 22,623,622 | |
| Loss from continuing operations before other income (expenses) | (1,063,701) | |
| Other income (expenses) | | |
| Interest expense | (356,313) | |
| Gain on forgiveness of debt | 665,463 | |
| Other expense, net | (18,517) | |
| Total other income (expenses), net | 290,633 | |
| Minority interest earnings in partnership | -- | |
| Loss from continuing operations | (773,068) | |
| Discontinued operations | | |
| Income (loss) from operations of discontinued components | 576,390 | ( |
| Net loss | $ (196,678) | $( |

NET OPERATING REVENUES. Net operating revenues of the Company consist of patient service revenue, net of contractual adjustments, related to the operations of IPS's affiliated medical groups, billing services revenue related to MBS and other revenue. For the nine months ended September 30, 2006, consolidated net operating revenues decreased $976,734, or 4.3%, to $21,559,921, as compared to consolidated net operating revenues of $22,536,655 for the nine months ended September 30, 2005.

MBS's net operating revenues totaled $7,207,517 for the nine months ended September 30, 2006 as compared to net operating revenues totaling $7,684,641 for the same period in 2005, a decrease of $477,124, or 6.2%. The decrease in net operating revenues for MBS was primarily the result of the loss of two customers in the third quarter of 2005, one of which retired from medical practice and one group which decided to bring their billing in-house, which accounted for approximately $606,000 in net operating revenues in the first nine months of 2005. This decrease was partially offset in the first nine months of 2006 by the addition of three new customers accounting for approximately $248,000 in net operating revenues in the first nine months of 2006.

IPS's net patient service revenue decreased $499,924, or 3.4%, from $14,852,328 for the nine months ended September 30, 2005 to $14,352,404 for the nine months ended September 30, 2006. The decrease in net patient service revenue for IPS's affiliated medical groups was primarily the result of decreases in patient volume as a consequence of a diminished cold and flu season in the first half of 2006 as compared with the same period in 2005. These patient volume decreases were partially offset by the third quarter 2006 increases in immunizations and procedures associated with well-child and back to school visits at the Company's affiliated medical groups. Three of IPS's four clinic-based affiliated pediatric groups experienced decreases in patient volume in the first nine months of 2006, with total procedures and office visits for all clinic-based facilities decreasing 12,888 and 12,193, respectively, to 292,470 and 114,335 for the nine months ended September 30, 2006.

Other revenue, which represents revenue from the Company's vaccine program, a group purchasing alliance for vaccines and medical supplies, totaled $86,215 for the first nine months of 2005, increasing $173,563, or 201.3%, to $259,778 for the nine months ended September 30, 2006. The vaccine program, which had a total of 428 enrolled participants at December 31, 2005, added approximately 57 members during the first nine months of 2006.

OPERATING EXPENSES

SALARIES AND BENEFITS. Consolidated salaries and benefits decreased $1,460,994 to $8,317,365 for the nine months ended September 30, 2006, as compared to $9,778,358 for the same period in 2005.

MBS's salaries and benefits totaled $4,362,967 for the nine months ended September 30, 2006 as compared to $4,638,394 for the nine months ended September 30, 2005, a decrease of $275,427. This decrease is primarily the result of a reduction in health benefit costs related to the consolidation of MBS's benefit plans with the IPS benefit plans at the beginning of 2006, thereby allowing greater negotiating leverage with benefit providers.

Clinical salaries & benefits include wages for the nurse practitioners, nursing staff and medical assistants employed by the affiliated medical groups and fluctuate indirectly to increases and decreases in productivity and patient volume. Clinical salaries, bonuses, overtime and health insurance collectively totaled $1,306,669 for the first nine months of 2006, an increase of $27,371 over the same period in 2005. There was one additional medical assistant on the payroll of one of IPS's affiliated medical groups in the first nine months of 2006 as compared to the staffing levels for the first nine months of 2005. These expenses represented approximately 9.3% and 8.7% of net operating revenues for the nine months ended September 30, 2006 and 2005, respectively. The increase, as a percentage of net operating revenues, is related to the fixed nature of salaries and benefits needed to maintain minimum staffing levels.

In August 2005, the Company consolidated its corporate operations into the Roswell, Georgia office. Prior to the staff reductions resulting from this corporate consolidation, salaries and benefits related to corporate staff in Houston, Texas totaled $746,594 for the nine months ended September 30, 2005. Additionally, salaries and benefits for the third quarter of 2005 included accruals of $484,520 for separation benefits for Orion's former president, Keith LeBlanc, who resigned from the Company on November 8, 2005, and $69,750 for retention costs and accrued vacation related to the aforementioned staff reductions.

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Administrative salaries and benefits, excluding MBS and the former staff of the Company's Houston, Texas office, represent the employee-related costs of all non-clinical practice personnel at IPS's affiliated medical groups as well as the Company's corporate staff in Roswell, Georgia. These expenses increased $92,503, or 3.8%, from $2,449,147 for the nine months ended September 30, 2005 to $2,541,650 for the same period in 2006. The additional expense can be attributed primarily to the adoption of SFAS 123(R) in the first quarter of 2006, which resulted in stock option compensation expense totaling approximately $147,000 for the first nine months of 2006.

PHYSICIAN GROUP DISTRIBUTION. Physician group distribution decreased $471,805, or 7.1%, for the nine months ended September 30, 2006 to $6,135,949, as compared with $6,607,754 for the nine months ended September 30, 2005. Pursuant to the terms of the MSAs governing each of IPS's affiliated medical groups, the physicians of each medical group receive disbursements after the payment of all clinic facility expenses as well as a management fee to IPS. The management fee revenue and expense, which is eliminated in the consolidation of the Company's financial statements, is either a fixed fee or is calculated based on a percentage of net operating income. For the nine months ended September 30, 2006, management fee revenue totaled $1,019,585 and represented approximately 14.2% of net operating income as compared to management fee revenue totaling $1,111,655 and representing approximately 14.4% of net operating income for the same period in 2005. Physician group distribution represented 42.8% of net operating revenues in the first nine months of 2006, compared to 44.5% of net operating revenues for the nine months ended September 30, 2005. The decrease in physician group distribution for the nine months ended September 30, 2006 was directly related to the decrease in net patient service revenue, which was primarily the result of decreased patient volume during the first nine months of 2006.

FACILITY RENT AND RELATED COSTS. Facility rent and related costs decreased $43,724, or 3.4%, from $1,291,402 for the nine months ended September 30, 2005 to $1,247,678 for the nine months ended September 30, 2006.

MBS's facility rent and related costs totaled $392,274 for the nine months ended September 30, 2006 as compared to $369,976 for the same period in 2005. This increase can be explained generally by increases in utilities and off-site storage costs for the first nine months of 2006.

Facility rent and related costs associated with IPS's affiliated medical groups and Orion's corporate office totaled $812,986 for the nine months ended September 30, 2006 compared to $819,945 for the same period in 2005. Rent expense related to the Company's corporate office in Roswell, Georgia decreased for the first six months of 2006 due to approximately $54,000 in rent payments received for the sublease between eClinicalWeb and the Company as a result of the IntegriMED Agreement in June 2005.

In August 2005, the Company consolidated its corporate operations into the Roswell, Georgia office. Prior to this consolidation, facility-related costs such as utilities and personal property taxes associated with the Company's former office in Houston, Texas totaled approximately $101,000 for the nine months ended September 30, 2005.

DEPRECIATION AND AMORTIZATION. Consolidated depreciation and amortization expense totaled $1,226,791 for the nine months ended September 30, 2006, a decrease of $1,108,954 from the nine months ended September 30, 2005.

For the nine months ended September 30, 2006, depreciation expense related to the fixed assets of MBS totaled $51,823 as compared to $61,492 for the same period in 2005. Deprecation expense related to the fixed assets of IPS and Orion totaled $119,766 and $86,840 for the nine months ended September 30, 2006 and 2005, respectively. Depreciation expense associated with fixed assets related to the Company's former Houston, Texas office, which was closed in August 2005, totaled $34,611 for the nine months ended September 30, 2005.

As part of the DCPS/MBS Merger, the Company purchased MBS and DCPS for a combination of cash, notes and stock. Since the consideration for this purchase transaction exceeded the fair value of the net assets of MBS and DCPS at the time of the purchase, a portion of the purchase price was allocated to intangible assets. The amortization expense related to the intangible assets recorded as a result of the DCPS/MBS Merger totaled $796,570 for the nine months ended September 30, 2006 and 2005, respectively.

Amortization expense related to the MSAs for IPS's affiliated medical groups totaled $258,633 and $297,733 for the nine months ended September 30, 2006 and 2005, respectively. The decrease is directly related to the Sutter Settlement and the CARDC Settlement.



As part of the IPS Merger, the purchase price, comprised of the fair value of the outstanding shares of the Company prior to the transaction, plus applicable transaction costs, was allocated to the fair value of the Company's tangible and intangible assets and liabilities prior to the transaction, with any excess being considered goodwill. Amortization expense for the intangible assets recorded as a result of the IPS Merger totaled $1,058,499 for the nine months ended September 30, 2005. As a result of the dispositions related to the Company's surgery and diagnostic center business, which was discontinued in 2005, and the uncertainty of future cash flows related to the Company's surgery center business, the Company impaired substantially all of the intangible assets related to the IPS Merger in 2005. Therefore, there was no amortization expense related to the intangible assets in the first nine months of 2006. (See "Discontinued Operations" for additional discussion regarding the disposition of intangible assets and goodwill recorded as a result of the IPS Merger.)

PROFESSIONAL AND CONSULTING FEES. For the nine months ended September 30, 2006, professional and consulting fees totaled $1,100,885, a decrease of $397,677, or 26.5%, from the same period in 2005.

For the first nine months of 2006, MBS recorded professional and consulting expenses totaling $132,455 as compared with $221,518 for the first nine months of 2005, a decrease of $89,063. This change is primarily the result of a decrease in contract labor used in 2005 as a result of staffing shortages. This contract labor was not utilized in the first nine months of 2006 because MBS's position inventory is fully staffed.

IPS's and Orion's professional and consulting fees, which include the

costs of corporate accounting, financial reporting and compliance, and legal fees, decreased from $1,277,044 for the nine months ended September 30, 2005 to $968,430 for the nine months ended September 30, 2006. The decrease is primarily the result of reduced legal fees and expenses related to the divestiture of the Company's surgery and diagnostic business in 2005, including an accrual of $90,000 related to a legal settlement recorded in the third quarter of 2005.
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INSURANCE. Consolidated insurance expense, which includes the costs of professional liability for affiliated physicians, property and casualty and general liability insurance and directors and officers' liability insurance, decreased from $679,588 for the nine months ended September 30, 2005 to $502,499 for the nine months ended September 30, 2006. The decrease can be explained generally by the following: (i) insurance expense related to the directors and officers' liability policies for the first nine months of 2005 included approximately $115,000 of premiums for run-off policies related to SurgiCare and IPS; (ii) general liability insurance premiums related to the Company's former Houston, Texas office, which was closed in August 2005, totaled approximately $54,000 for the nine months ended September 30, 2005; and (iii) professional liability insurance premiums for the Company's affiliated medical groups decreased approximately $6,500 for the nine months ended September 30, 2006 when compared with the same period in 2005.

PROVISION FOR DOUBTFUL ACCOUNTS. The Company's consolidated provision for doubtful accounts, or bad debt expense, decreased $468,978, or 51.3%, for the nine months ended September 30, 2006 to $446,041. The entire provision for doubtful accounts for the nine months ended September 30, 2006 related to IPS's affiliated medical groups and accounted for 3.1% of IPS's net operating revenues as compared to 6.0% of IPS's net operating revenues for the same period in 2005. The total collection rate, after contractual allowances, for IPS's affiliated medical groups was 70.8% for the nine months ended September 30, 2006, compared to 66.0% for the same period in 2005.

OTHER EXPENSES. Consolidated other expenses totaled $3,646,414 for the nine months ended September 30, 2006, a decrease of $209,041 from the same period in 2005. Other expenses include general and administrative expenses such as office supplies, telephone & data communications, printing & postage, transfer agent fees, and board of directors' compensation and meeting expenses, as well as some direct clinical expenses, which are expenses that are directly related to the practice of medicine by the physicians that practice at the affiliated medical groups managed by IPS.

MBS's other expenses totaled $860,298 for the nine months ended September 30, 2006 as compared to $968,769 for the nine months ended September 30, 2005. Of the total decrease, approximately $116,000 related to decreases in office supplies in the first nine months of 2006 as compared to the same period in 2005. These expense fluctuations are the direct result of the decrease in net operating revenues in the first nine months of 2006. Additionally, MBS renegotiated its long distance rates in the fall of 2005, which resulted in approximately $53,000 in cost savings in the first nine months of 2006 as compared to the same period in 2005.

For the nine months ended September 30, 2006, IPS's direct clinical expenses, other than salaries and benefits, totaled $1,883,398, an increase of $134,539 over direct clinical expenses in the first nine months of 2005, which totaled $1,748,962. Vaccine expenses accounted for approximately $144,000 of the total increase in direct clinical expenses in the first nine months of 2006. IPS's affiliated medical groups began using two new vaccines in late 2005 -- Menactra and Decavac -- which replaced lower-priced vaccines previously utilized by the medical groups.

The Company's and IPS's general and administrative expenses totaled $520,902 for the nine months ended September 30, 2006, a decrease of $256,111 from the same period in 2005. Of the total decrease, approximately $240,000 relates to cost efficiencies and expense reductions as a result of the consolidation of corporate functions into the Company's Roswell, Georgia office in August 2005.

OTHER INCOME AND EXPENSES.

INTEREST EXPENSE. Consolidated interest expense totaled $356,313 for the nine months ended September 30, 2006, an increase of $108,744 from the same period in 2005. Interest expense activity in the nine months ended September 30, 2006, including increases from the first nine months of 2005, can be explained generally by the following:

- BRANTLEY DEBT. In March and April 2005, the Company borrowed an aggregate of $1,250,000 from Brantley Partners IV, L.P. ("Brantley IV"). (See "Liquidity and Capital Resources.") Interest expense related to these notes totaled approximately $85,313 for the nine months ended September 30, 2006 as compared to $59,963 for the same period in 2005.

- MBS NOTES. On April 19, 2006, the Company executed subordinated promissory notes with the former equity owners of MBS and DCPS for an aggregate of $714,336. This represented the retroactive purchase price increase due to the former equity owners of MBS and DCPS based on the financial results of the newly formed MBS, as required by the merger agreement governing the DCPS/MBS Merger. The notes bear interest at the rate of 8% per annum, payable monthly beginning on April 30, 2006, and will mature on December 15, 2007. Interest expense related to these notes totaled approximately $85,828 for the nine months ended September 30, 2006.

- LINE OF CREDIT. As part of the restructuring transactions, the Company also entered into a new secured two-year revolving credit facility pursuant to the Loan and Security Agreement borrowing $1.6 million under this facility concurrently with the Closing. (See "Liquidity and Capital Resources" for additional discussion regarding the Loan and Security Agreement.) Interest expense related to this line of credit totaled $164,158 for the nine months ended September 30, 2006, compared to $158,777 for the nine months ended September 30, 2005. The increase in interest expense on the line of credit facility was a direct result of interest rate increases for the first nine months of 2006 as compared to the same period in 2005. In December 2005, the Company received notification from CIT stating that certain events of default under the Loan and Security Agreement had occurred as a result of the Company being out of compliance with two financial covenants. As a result of the events of default, CIT raised the interest rate for monies borrowed under the Loan and Security Agreement to a default rate of prime rate plus 6% as compared to the stated interest rate of prime rate plus 3% as of the Closing. (See "Part II, Item 3. Defaults Upon Senior Securities" for additional discussion regarding the Company's defaults under the Loan and Security Agreement.) The loan balance for this facility was $1,008,282 and $2,260,601 at September 30, 2006 and 2005, respectively. Additionally, the average prime rate for the first nine months of 2006 was 7.86% as compared to 5.89% for the same nine-month period in 2005.

GAIN ON FORGIVENESS OF DEBT. On August 25, 2003, the Company's lender, DVI, announced that it was seeking protection under Chapter 11 of the United States Bankruptcy laws. Both IPS and SurgiCare had loans outstanding to DVI in the form of term loans and revolving lines of credit. As part of the IPS Merger, the Company negotiated a discount on the term loans and a buy-out of the revolving lines of credit. As part of that agreement, the Company executed a new loan agreement with U.S. Bank Portfolio Services, as Servicer for payees, for payment of the revolving lines of credit and renegotiation of the term loans. In the first quarter of 2006, the Company negotiated an 85% discount on the revolving line of credit, which had a balance of $778,000 at December 31, 2005. As of March 13, 2006, the Company had made aggregate payments in the amount of $112,500 in satisfaction of the $778,000 debt, and recognized a gain on forgiveness of debt totaling $665,463 in the first quarter of 2006.

DISCONTINUED OPERATIONS.

BELLAIRE SURGICARE. As of the Closing, the Company's management expected the case volumes at Bellaire SurgiCare, Inc. ("Bellaire SurgiCare") to improve in 2005. However, by the end of February 2005, it was determined that the expected case volume increases were not going to be realized. On March 1, 2005, the Company closed Bellaire SurgiCare and consolidated its operations with the operations of Memorial Village. The Company tested the identifiable intangible assets and goodwill related to the surgery center business using the present value of cash flows method. As a result of the decision to close Bellaire SurgiCare and the resulting impairment of the joint venture interest and management contracts related to the surgery centers, the Company recorded a charge for impairment of intangible assets of $4,090,555 for the year ended December 31, 2004. The Company also recorded a loss on disposal of this discontinued component (in addition to the charge for impairment of intangible assets) of $163,049 for the quarter ended March 31, 2005. There were no operations for this component after March 31, 2005.

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The following table contains selected financial statement data related to Bellaire SurgiCare as of and for the nine months ended September 30, 2005:

| | SEPTEMBER 30, 2005 |
|---|---|
| Income statement data: | |
| Net operating revenues | $ 161,679 |
| Operating expenses | 350,097 |
| Net loss | $ (188,418) |
| Balance sheet data: | |
| Current assets | $ -- |
| Other assets | -- |
| Total assets | $ -- |
| Current liabilities | $ -- |
| Other liabilities | -- |
| Total liabilities | $ -- |

CAPITAL ALLERGY AND RESPIRATORY DISEASE CENTER ("CARDC"). On April 1, 2005, IPS entered into a Mutual Release and Settlement Agreement (the "CARDC Settlement") with Dr. Bradley E. Chipps, M.D. and CARDC to settle disputes as to the existence and enforceability of certain contractual obligations. As part of the CARDC Settlement, Dr. Chipps, CARDC, and IPS agreed that CARDC would purchase the assets owned by IPS and used in connection with CARDC, in exchange for termination of the MSA between IPS and CARDC. Additionally, among other provisions, after April 1, 2005, Dr. Chipps, CARDC and IPS have been released from any further obligation to each other arising from any previous agreement. As a result of the CARDC dispute, the Company recorded a charge for impairment of intangible assets related to CARDC of $704,927 for the year ended December 31, 2004. The Company also recorded a gain on disposal of this discontinued component (in addition to the charge for impairment of intangible assets) of $506,625 for the quarter ended March 31, 2005. For the quarter ended June 30, 2005, the Company reduced the gain on disposal of this discontinued component by $238,333 as the result of post-settlement adjustments related to the reconciliation of balance sheet accounts. There were no operations for this component in the Company's financial statements after March 31, 2005.

The following table contains selected financial statement data related to CARDC as of and for the nine months ended September 30, 2005:

| | SEPTEMBER 30, 2005 |
|---|---|
| Income statement data: | |
| Net operating revenues | $ 848,373 |
| Operating expenses | 809,673 |
| Net income | $ 38,700 |
| Balance sheet data: | |
| Current assets | $ -- |
| Other assets | -- |
| Total assets | $ -- |
| Current liabilities | $ -- |
| Other liabilities | -- |
| Total liabilities | $ -- |



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

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

| | SEPTEMBER 30, 2005 |
|---|---|
| Income statement data: | |
| Net operating revenues | $ 191,771 |
| Operating expenses | 899,667 |
| Net loss | $ (707,896) |
| Balance sheet data: | |
| Current assets | $ -- |
| Other assets | -- |
| Total assets | $ -- |
| Current liabilities | $ -- |
| Other liabilities | -- |
| Total liabilities | $ -- |

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

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

| | SEPTEMBER 30, 2005 |
|---|---|
| Income statement data: | |
| Net operating revenues | $ 2,408,156 |
| Operating expenses | 2,467,110 |
| Net loss | $ (58,956) |
| Balance sheet data: | |
| Current assets | $ 641,172 |
| Other assets | 1,398,449 |
| Total assets | $ 2,039,621 |
| Current liabilities | $ 617,186 |
| Other liabilities | 828,312 |
| Total liabilities | $ 1,445,498 |

SUTTER. On October 31, 2005, IPS executed the Sutter Settlement with Dr. Sutter to settle disputes that had arisen between IPS and Dr. Sutter and to avoid the risk and expense of litigation. As part of the Sutter Settlement, Dr. Sutter and IPS agreed that Dr. Sutter would purchase the assets owned by IPS and used in connection with Dr. Sutter's practice, in exchange for termination of the related MSA. Additionally, among other provisions, after October 31, 2005, Dr. Sutter and IPS have been released from any further obligation to each other arising from any previous agreement. As a result of this transaction, the Company recorded a loss on disposal of this discontinued component (in addition to the charge for impairment of intangible assets of $38,440 recorded in the fourth quarter of 2005) of $279 for the quarter ended December 31, 2005. The operations of this component are reflected in the Company's consolidated condensed statements of operations as `loss from operations of discontinued components' for the nine months ended September 30, 2005. There were no operations for this component in the Company's financial statements after October 31, 2005.

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

| | SEPTEMBER 30, 2005 |
|---|---|
| Income statement data: | |
| Net operating revenues | $ 322,470 |
| Operating expenses | 314,049 |
| Net income | $ 8,421 |

| | |
|---|---|
| Balance sheet data: | |
| Current assets | $ 102,924 |
| Other assets | 14,066 |
| Total assets | $ 116,990 |
| Current liabilities | $ 21,778 |
| Other liabilities | -- |
| Total liabilities | $ 21,778 |

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

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The following table contains selected financial statement data related to Memorial Village as of and for the nine months ended September 30, 2006 and 2005, respectively:

| | SEPTEMBER 30, 2006 |
|---|---|
| Income statement data: | |
| Net operating revenues | $ 17,249 |
| Operating expenses | 170,285 |

| | |
|---|---|
| Net loss | $ (153,036) |
| Balance sheet data: | |
| Current assets | $ - |
| Other assets | - |
| Total assets | $ - |
| Current liabilities | $ - |
| Other liabilities | |
| Total liabilities | $ - |

SAN JACINTO. On March 1, 2006, San Jacinto executed an Asset Purchase Agreement for the sale of substantially all of its assets to Methodist. San Jacinto was approximately 10% owned by Baytown SurgiCare, Inc., a wholly owned subsidiary of the Company, and is not consolidated in the Company's financial statements. As a result of this transaction, the Company recorded a gain on disposal of this discontinued operation of $94,066 for the quarter ended March 31, 2006. As a result of the uncertainty of future cash flows related to the surgery center business, and in conjunction with the transactions related to TASC and TOM, the Company determined that the joint venture interest associated with San Jacinto was impaired and recorded a charge for impairment of intangible assets related to San Jacinto of $734,522 for the three months ended June 30, 2005. The Company also recorded an additional $2,113,262 charge for impairment of intangible assets for the three months ended September 30, 2005 related to the management contracts with San Jacinto. The Company allocated the goodwill recorded as part of the IPS Merger to each of the surgery center reporting units and recorded a loss on the write-down of goodwill related to San Jacinto totaling $694,499 for the quarter ended December 31, 2005. There were no operations for this component in the Company's financial statements after March 31, 2006.

ORION. Prior to the divestiture of the Company's ambulatory surgery center business, the Company recorded management fee revenue, which was eliminated in the consolidation of the Company's financial statements, for Bellaire SurgiCare, TASC and TOM and Memorial Village. The management fee revenue for San Jacinto was not eliminated in consolidation. The management fee revenue associated with the discontinued operations in the surgery center business totaled $61,039 for the nine months ended September 30, 2006. For the nine months ended September 30, 2005, the Company generated management fee revenue of $320,069 and net minority interest losses totaling $67,588. For the quarters ended June 30, 2005 and December 31, 2005, the Company recorded a charge for impairment of intangible assets of $276,420 and $142,377, respectively, related to trained work force and non-compete agreements affected by the surgery center operations the Company discontinued in 2005 and early 2006.

The following table summarizes the components of income (loss) from operations of discontinued components:

| | NINE MONTHS ENDE SEPTEMBER 30, 200 |
|---|---|
| Bellaire SurgiCare | |

| | |
|---|---|
| Net loss | $ -- |
| Loss on disposal | -- |
| CARDC | |
| Net income | -- |
| Gain on disposal | -- |
| IntegriMED | |
| Net loss | -- |
| Loss on disposal | -- |
| TASC and TOM | |
| Net loss | -- |
| Loss on disposal | -- |
| Sutter | |
| Net income | -- |
| Memorial Village | |
| Net loss | (153, |
| Gain (loss) on disposal | 574, |
| San Jacinto | |
| Gain (loss) on disposal | 94, |
| Orion | |
| Net income (loss) | 61, |
| Total income (loss) from operations of discontinued components, including net gain (loss) on disposal | $ 576, |



LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operating activities totaled $220,919 for the three months ended September 30, 2006 as compared to cash used in operating activities of $122,402 for the three months ended September 30, 2005. For the nine months ended September 30, 2006, net cash used in operating activities totaled $359,403 as compared to net cash used in operating activities totaling $2,151,458 for the same period in 2005. The net impact of discontinued operations on net cash provided by operating activities in the first nine months of 2006 totaled $230,743.

For the three months ended September 30, 2006, net cash used in investing activities totaled $36,785 compared to $93,929 in net cash provided by investing activities for the same period in 2005. For the nine months ended September 30, 2006, net cash provided by investing activities totaled $380,446 as compared to $349,949 in net cash provided by investing activities in the nine months ended September 30, 2005. The net impact of discontinued operations on net cash provided by investing activities totaled $430,244 in the first nine months of 2006.

Net cash used in financing activities totaled $219,058 for the nine months ended September 30, 2006 as compared to $1,870,761 in net cash provided by financing activities for the nine months ended September 30, 2005. The change in cash uses related to financing activities from 2005 to 2006 can be explained generally by the following:

- o Net repayments on the CIT revolving credit facility totaled $708,607 in the first nine months of 2006, including approximately $300,000 in repayments related to discontinued operations;

- o As discussed below, in March and April of 2005, the Company borrowed an aggregate of $1,250,000 from Brantley IV. o The Company made aggregate payments in the amount of $112,500 in the first quarter of 2006 in satisfaction of a $778,000 debt, and recognized a gain on forgiveness of debt totaling $665,463 for the nine months ended September 30, 2006; and

- The Company repaid approximately $200,000 in satisfaction of a working capital note from the sellers of MBS in the first quarter of 2006.

The Company's unaudited consolidated condensed financial statements have been prepared in conformity with GAAP, which contemplate the continuation of the Company as a going concern. The Company incurred substantial operating losses during 2005, and has used substantial amounts of working capital in its operations. Additionally, as described more fully below, the Company received notification from CIT in December 2005 that certain events of default under the Loan and Security Agreement had occurred as a result of the Company being out of compliance with two financial covenants relating to its debt service coverage ratio and its minimum operating income level. These conditions raise substantial doubt about the Company's ability to continue as a going concern.

The Company has financed its growth and operations primarily through the issuance of equity securities, secured and/or convertible debt, most recently by completing the 2004 Mergers and restructuring transactions in December 2004, which are described under the caption "Company History," and borrowing from related parties. On December 15, 2004, the Company also entered into a new secured two-year revolving credit facility pursuant to the Loan and Security Agreement. Under this facility, initially up to $4,000,000 of loans could be made available to the Company, subject to a borrowing base. As discussed below, the amount available under this credit facility has been reduced. The Company borrowed $1,600,000 under this facility concurrently with the Closing. The interest rate under this facility is the prime rate plus 6%. Upon an event of default, CIT can accelerate the loans or call the Guaranties described below. (See "Part II, Item 3. Defaults Upon Senior Securities" for additional discussion regarding the Company's defaults under the Loan and Security Agreement.) In connection with entering into this new facility, the Company also restructured its previously-existing debt facilities, which resulted in a decrease in aggregate debt owed to DVI from approximately $10.1 million to a combined principal amount of approximately $6.5 million, of which approximately $2.0 million was paid at the Closing.



Pursuant to a Guaranty Agreement (the "Brantley IV Guaranty"), dated as of December 15, 2004, provided by Brantley IV to CIT, Brantley IV agreed to provide a deficiency guaranty in the initial amount of $3,272,727. As discussed below, the amount of this Brantley IV Guaranty has been reduced. Pursuant to a Guaranty Agreement (the "Brantley Capital Guaranty" and collectively with the Brantley IV Guaranty, the "Guaranties"), dated as of December 15, 2004, provided by Brantley Capital Corporation ("Brantley Capital") to CIT, Brantley Capital agreed to provide a deficiency guarantee in the initial amount of $727,273. As discussed below, the amount of this Brantley Capital Guaranty has been reduced. In consideration for the Guaranties, the Company issued warrants to purchase 20,455 shares of Class A Common Stock, at an exercise price of $0.01 per share, to Brantley IV, and issued warrants to purchase 4,545 shares of Class A Common Stock, at an exercise price of $0.01 per share, to Brantley Capital. None of these warrants, which expire on December 15, 2009, have been exercised as of September 30, 2006.

On March 16, 2005, Brantley IV loaned the Company an aggregate of $1,025,000 (the "First Loan"). On June 1, 2005, the Company executed a convertible subordinated promissory note in the principal amount of $1,025,000 (the "First Note") payable to Brantley IV to evidence the terms of the First

Loan. The material terms of the First Note are as follows: (i) the First Note is unsecured; (ii) the First Note is subordinate to the Company's outstanding loan from CIT and other indebtedness for monies borrowed, and ranks pari passu with general unsecured trade liabilities; (iii) principal and interest on the First Note is due in a lump sum on April 19, 2006 (the "First Note Maturity Date"); (iv) the interest on the First Note accrues from and after March 16, 2005, at a per annum rate equal to nine percent (9.0%) and is non-compounding; (v) if an event of default occurs and is continuing, Brantley IV, by notice to the Company, may declare the principal of the First Note to be due and immediately payable; and (vi) on or after the First Note Maturity Date, Brantley IV, at its option, may convert all or a portion of the outstanding principal and interest due of the First Note into shares of Class A Common Stock of the Company at a price per share equal to $1.042825 (the "First Note Conversion Price"). The number of shares of Class A Common Stock to be issued upon conversion of the First Note shall be equal to the number obtained by dividing (x) the aggregate amount of principal and interest to be converted by (y) the First Note Conversion Price (as defined above); provided, however, the number of shares to be issued upon conversion of the First Note shall not exceed the lesser of: (i) 1,159,830 shares of Class A Common Stock, or (ii) 16.3% of the then outstanding Class A Common Stock. As of September 30, 2006, if Brantley IV were to convert the First Note, the Company would have to issue 1,121,251 shares of Class A Common Stock. On May 9, 2006, Brantley IV and the Company executed an amendment to the First Note (the "First and Second Note Amendment") extending the First Note Maturity Date to August 15, 2006. On August 8, 2006, Brantley IV and the Company executed a second amendment to the First Note (the "First and Second Note Second Amendment") extending the First Note Maturity Date to October 15, 2006, and as of October 15, 2006, Brantley IV and the Company executed a third amendment to the First Note (the "First and Second Note Third Amendment") further extending the First Note Maturity Date to November 30, 2006. A copy of the First and Second Note Third Amendment is incorporated by reference to Exhibit 10.1 on the Company's Current Report on Form 8-K filed on October 19, 2006.

On April 19, 2005, Brantley IV loaned the Company an additional $225,000 (the "Second Loan"). On June 1, 2005, the Company executed a convertible subordinated promissory note in the principal amount of $225,000 (the "Second Note") payable to Brantley IV to evidence the terms of the Second Loan. The material terms of the Second Note are as follows: (i) the Second Note is unsecured; (ii) the Second Note is subordinate to the Company's outstanding loan from CIT and other indebtedness for monies borrowed, and ranks pari passu with general unsecured trade liabilities; (iii) principal and interest on the Second Note is due in a lump sum on April 19, 2006 (the "Second Note Maturity Date"); (iv) the interest on the Second Note accrues from and after April 19, 2005, at a per annum rate equal to nine percent (9.0%) and is non-compounding; (v) if an event of default occurs and is continuing, Brantley IV, by notice to the Company, may declare the principal of the Second Note to be due and immediately payable; and (vi) on or after the Second Note Maturity Date, Brantley IV, at its option, may convert all or a portion of the outstanding principal and interest due of the Second Note into shares of Class A Common Stock of the Company at a price per share equal to $1.042825 (the "Second Note Conversion Price"). The number of shares of Class A Common Stock to be issued upon conversion of the Second Note shall be equal to the number obtained by dividing (x) the aggregate amount of principal and interest to be converted by (y) the Second Note Conversion Price (as defined above); provided, however, the number of shares to be issued upon conversion of the Second Note shall not exceed the lesser of: (i) 254,597 shares of Class A Common Stock, or (ii) 3.6% of the then outstanding Class A Common Stock. As of September 30, 2006, if Brantley IV were to convert the Second Note, the Company would have to issue 244,294 shares of Class A Common Stock. On May 9, 2006, Brantley IV and the Company executed the First and Second Note Amendment extending the Second Note Maturity Date to August 15, 2006. On August 8, 2006, Brantley IV and the Company executed the First and Second Note Second Amendment extending the Second Note

Maturity Date to October 15, 2006, and as of October 15, 2006, Brantley IV and the Company executed the First and Second Note Third Amendment further extending the Second Note Maturity Date to November 30, 2006.



Additionally, in connection with the First Loan and the Second Loan, the Company entered into a First Amendment to the Loan and Security Agreement (the "First Amendment"), dated March 22, 2005, with certain of the Company's affiliates and subsidiaries, and CIT, whereby its $4,000,000 secured two-year revolving credit facility has been reduced by the amount of the loans from Brantley IV to $2,750,000. As a result of the First Amendment, the Brantley IV Guaranty was amended by the Amended and Restated Guaranty Agreement, dated March 22, 2005, which reduced the deficiency guaranty provided by Brantley IV by the amount of the First Loan to $2,247,727. Also as a result of the First Amendment, the Brantley Capital Guaranty was amended by the Amended and Restated Guaranty Agreement, dated March 22, 2005, which reduced the deficiency guaranty provided by Brantley Capital by the amount of the Second Loan to $502,273. Paul H. Cascio, the Chairman of the board of directors of the Company, and Michael J. Finn, a director of the Company, are affiliates of Brantley IV.

As part of the Loan and Security Agreement, the Company is required to comply with certain financial covenants, measured on a quarterly basis. The financial covenants include maintaining a required debt service coverage ratio and meeting a minimum operating income level for the surgery and diagnostic centers before corporate overhead allocations. As of and for the three months and nine months ended September 30, 2006, the Company was out of compliance with both of these financial covenants and has notified the lender as such. Under the terms of the Loan and Security Agreement, failure to meet the required financial covenants constitutes an event of default. Under an event of default, the lender may (i) accelerate and declare the obligations under the credit facility to be immediately due and payable; (ii) withhold or cease to make advances under the credit facility; (iii) terminate the credit facility; (iv) take possession of the collateral pledged as part of the Loan and Security Agreement; (v) reduce or modify the revolving loan commitment; and/or (vi) take necessary action under the Guaranties. The revolving credit facility is secured by the Company's assets. As of September 30, 2006, the outstanding principal under the revolving credit facility was $1,008,282. The full amount of the loan as of September 30, 2006 is recorded as a current liability. In December 2005, the Company received notification from CIT stating that (i) certain events of default under the Loan and Security Agreement had occurred as a result of the Company being out of compliance with two financial covenants relating to its debt service coverage ratio and its minimum operating income level, (ii) as a result of the events of default, CIT raised the interest rate for monies borrowed under the Loan and Security Agreement to the provided "Default Rate" of prime rate plus 6%, (iii) the amount available under the revolving credit facility was reduced to $2,300,000 and (iv) CIT reserved all additional rights and remedies available to it as a result of these events of default. The Company is currently in negotiations with CIT to obtain, among other provisions, a waiver of the events of default. In the event CIT declares the obligations under the Loan and Security Agreement to be immediately due and payable or exercises its other rights described above, the Company would not be able to meet its obligations to CIT or its other creditors. As a result, such action would have a material adverse effect on the Company's ability to continue as a going concern. The Company is currently negotiating the terms of a new senior secured credit facility in the aggregate principal amount of $16,500,000, consisting of a $2,000,000 revolving loan commitment, a $4,500,000 term loan and a $10,000,000 acquisition facility commitment available for future acquisitions. The proceeds from the new facility would be used to repay the Company's current credit facility with CIT and provide capital to enable the Company to execute components of its strategic plan, including the acquisitions of Rand and Online, which are described in greater detail under the caption "Strategic Focus." If the Company is unable to reach an agreement on a credit facility with this lender, then we will seek to find another institutional lender to provide a credit facility on similar terms, but there is no guarantee that we will be able to find such a lender or be able to negotiate similar terms to such credit facility.

As of September 30, 2006, the Company's existing credit facility with CIT had limited availability to provide for working capital shortages. Although the Company believes that it will generate cash flows from operations in the future, there is substantial doubt as to whether it will be able to fund its operations solely from its cash flows. In April 2005, the Company initiated a strategic plan designed to accelerate the Company's growth and enhance its future earnings potential, primarily by focusing on the Company's strengths, which include providing billing, collections and complementary business management services to physician practices. In 2005 and early 2006, the Company ceased investment in business lines that did not complement the Company's strategic plans. Additionally, the Company redirected financial resources and company personnel to areas that management believes enhance long-term growth potential. A key component of our long-term strategic plan was the identification of potential acquisition targets that would increase the Company's presence in the markets it serves and enhance stockholder value. The Company has identified several acquisition opportunities to expand its business that are consistent with its strategic plan. The Company signed definitive agreements in September 2006 for the acquisition of two of these targets, Rand and Online. In addition to the Rand Stock Purchase Agreement and the Online Stock Purchase Agreement, in September 2006 the Company also executed the Private Placement Agreements and the Purchase Agreement. The Rand Stock Purchase Agreement, the Online Stock Purchase Agreement, the Private Placement Agreements and the Purchase Agreement are all described in greater detail under the caption "Strategic Focus."

The Company intends to continue to manage its use of cash. However, the Company's business is still faced with many challenges. If cash flows from operations and borrowings are not sufficient to fund the Company's cash requirements, the Company may be required to further reduce its operations and/or seek additional public or private equity financing or financing from other sources or consider other strategic alternatives, including possible additional divestitures of specific assets or lines of business. Any acquisitions will require additional capital. There can be no assurances that additional financing will be available, or that, if available, the financing will be obtainable on terms acceptable to the Company or that any additional financing would not be substantially dilutive to the Company's existing stockholders.



ITEM 3. CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES. The Company maintains a set of disclosure controls and procedures that are designed to provide reasonable assurance that information required to be disclosed by the Company in its reports filed under the Exchange Act is recorded, processed, summarized and reported accurately and within the time periods specified in the SEC's rules and forms. As of the end of the period covered by this report, the Company evaluated, under the supervision and with the participation of its management, including the Chief Executive Officer and Chief Financial Officer, the design and effectiveness of its disclosure controls and procedures pursuant to Rule 13a-15(c) of the Exchange Act. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that its disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in its periodic filings.

CHANGES IN INTERNAL CONTROLS. During the most recent fiscal quarter, there have been no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

On July 12, 2005, the Company was named as a defendant in a suit entitled American International Industries, Inc. ("AII") vs. Orion HealthCorp, Inc. (previously known as SurgiCare, Inc.), Keith G. LeBlanc, Paul Cascio, Brantley Capital Corporation, Brantley Venture Partners III, L.P., Brantley Partners IV, L.P. (collectively, "the Named Defendants") and UHY Mann Frankfort Stein & Lipp CPAs, LLP ("UHY Mann") in the 80th Judicial District Court of Harris County, Texas, Cause No. 2005-44326. The case involved allegations that the Company made material and intentional misrepresentations regarding the financial condition of the parties to the acquisition and restructuring transactions effected on December 15, 2004 for the purpose of inducing AII to convert its SurgiCare Class AA convertible preferred stock into shares of the Company's Class A Common Stock. AII asserted that the value of its Class A Common Stock of Orion had fallen as a direct result of the alleged material misrepresentations by the Company. AII was seeking an aggregate of $7,600,000 in damages (actual damages of $3,800,000 and punitive damages of $3,800,000), and rescission of the agreement to convert the SurgiCare Class AA convertible preferred stock into Class A Common Stock. On September 8, 2006, the Company entered into a Settlement Agreement with a Joint and Mutual Release and Indemnity Agreement (the "AII Settlement Agreement") in which the claims by AII against the Named Defendants were fully settled as to all claims, with complete mutual releases for all of the Named Defendants and AII. Under the terms of the AII Settlement Agreement, AII will receive $750,000, paid primarily by various insurance carriers of the Named Defendants, on or before 45 days from the execution of the AII Settlement Agreement. As part of the AII Settlement Agreement, the Named Defendants vigorously denied any liability and AII acknowledged the highly disputed nature of its claims against the Named Defendants. Both the Named Defendants and AII acknowledged that the AII Settlement Agreement was made as a compromise to avoid further expense and to terminate for all time the controversy underlying the lawsuit. A copy of the AII Settlement Agreement is incorporated by reference to Exhibit 10.1 on the Company's Current Report on Form 8-K filed on September 14, 2006.

In addition, the Company is involved in various other legal proceedings and claims arising in the ordinary course of business. The Company's management believes that the disposition of these additional matters, individually or in the aggregate, is not expected to have a materially adverse effect on the Company's financial condition. However, depending on the amount and timing of such disposition, an unfavorable resolution of some or all of these matters could materially affect the Company's future results of operations or cash flows in a particular period.

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

On November 1, 2006, the Company issued 125,000 shares of Class A Common Stock to Keith LeBlanc, former president of the Company, in connection with restricted stock units that were granted to him on August 31, 2005. Per the terms of Mr. LeBlanc's separation agreement, 125,000 of the 250,000 restricted stock units vested on January 1, 2006 and the remaining 125,000 units will vest on January 1, 2007. In the separation agreement, Mr. LeBlanc agreed to refrain from trading any of the restricted stock units for a period of one year commencing on November 1, 2005.

There was no placement agent or underwriter for the stock issuance. The Company processed the stock issuance internally. The shares were not sold for cash. The Company did not receive any consideration in connection with the stock issuance. In connection with the issuance of the Class A Common Stock, the Company relied upon the exemption from the registration requirements of the Securities Act by virtue of Section 4(2) of the Securities Act.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

As part of the Loan and Security Agreement, the Company is required to comply with certain financial covenants, measured on a quarterly basis. The financial covenants include maintaining a required debt service coverage ratio and meeting a minimum operating income level for the surgery and diagnostic centers before corporate overhead allocations. As of and for the three months and nine months ended September 30, 2006, the Company was out of compliance with both of these financial covenants and has notified the lender as such. Under the terms of the Loan and Security Agreement, failure to meet the required financial covenants constitutes an event of default. Under an event of default, the lender may (i) accelerate and declare the obligations under the credit facility to be immediately due and payable; (ii) withhold or cease to make advances under the credit facility; (iii) terminate the credit facility; (iv) take possession of the collateral pledged as part of the Loan and Security Agreement; (v) reduce or modify the revolving loan commitment; and/or (vi) take necessary action under the Guaranties. The revolving credit facility is secured by the Company's assets. As of September 30, 2006, the outstanding principal under the revolving credit facility was $1,008,282. The full amount of the loan as of September 30, 2006 is recorded as a current liability. In December 2005, the Company received notification from CIT stating that (i) certain events of default under the Loan and Security Agreement had occurred as a result of the Company being out of compliance with two financial covenants relating to its debt service coverage ratio and its minimum operating income level, (ii) as a result of the events of default, CIT raised the interest rate for monies borrowed under the Loan and Security Agreement to the provided "Default Rate" of prime rate plus 6%, (iii) the amount available under the revolving credit facility was reduced from $2,750,000 to $2,300,000 and (iv) CIT reserved all additional rights and remedies available to it as a result of these events of default. The Company is currently in negotiations with CIT to obtain, among other provisions, a waiver of the events of default. In the event CIT declares the obligations under the Loan and Security Agreement to be immediately due and payable or exercises its other rights described above, the Company would not be able to meet its obligations to CIT or its other creditors. As a result, such action would have a material adverse effect on the Company`s ability to continue as a going concern.

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ITEM 6. EXHIBITS

| EXHIBIT NO. | DESCRIPTION |
|---|---|
| Exhibit 31.1 | Rule 13a-14(a)/15d-14(a) Certification |
| Exhibit 31.2 | Rule 13a-14(a)/15d-14(a) Certification |
| Exhibit 32.1 | Section 1350 Certification |
| Exhibit 32.2 | Section 1350 Certification |

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## SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ORION HEALTHCORP, INC.

By: /s/ Terrence L. Bauer

Dated: November 13, 2006

Terrence L. Bauer
President, Chief Executive Officer and Director
(Duly Authorized Representative)

## POWER OF ATTORNEY

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears on the signature page to this Report constitutes and appoints Terrence L. Bauer and Stephen H. Murdock, and each of them, his true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this Report, and to file the same, with all exhibits hereto, and other documents in connection herewith with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents or any of them, or their or his substitutes, may lawfully do or cause to be done by virtue hereof.

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on November 13, 2006.

By: /s/ Terrence L. Bauer

Terrence L. Bauer
President, Chief Executive Officer and Director (Principal Executive Officer)

By: /s/ Michael J. Finn

Michael J. Finn
Director

By: /s/ Paul H. Cascio

Paul H. Cascio
Director and Non-Executive Chairman of the Board

By: /s/ Joseph M. Valley, Jr.

Joseph M. Valley, Jr.
Director

By: /s/ David Crane

David Crane
Director

By: /s/ Stephen H. Murdock

Stephen H. Murdock
Chief Financial Officer (Prin
and Financial Officer)

ORION HEALTHCORP, INC.

INDEX TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS





Orion HealthCorp, Inc.
Consolidated Condensed Balance Sheets

| | September 30, 2006 |
|---|---|
| Current assets | |
| Cash and cash equivalents | $ 100,795 |
| Accounts receivable, net | 2,745,039 |
| Inventory | 282,202 |
| Prepaid expenses and other current assets | 732,970 |
| Assets held for sale | -- |
| Total current assets | 3,861,006 |
| Property and equipment, net | 620,173 |
| Other long-term assets | |
| Intangible assets, excluding goodwill, net | 12,742,510 |
| Goodwill | 2,490,695 |
| Other assets, net | 62,643 |
| Total other long-term assets | 15,295,848 |
| Total assets | $ 19,777,027 |

| | |
|---|---|
| Current liabilities | |
| Accounts payable and accrued expenses | $ 5,843,410 |
| Other current liabilities | -- |
| Current portion of capital lease obligations | 92,397 |
| Current portion of long-term debt | 3,491,527 |
| Liabilities held for sale | -- |
| Total current liabilities | 9,427,334 |
| Long-term liabilities | |
| Capital lease obligations, net of current portion | 145,374 |
| Long-term debt, net of current portion | 3,795,381 |
| Minority interest in partnership | -- |
| Total long-term liabilities | 3,940,755 |
| Commitments and contingencies | -- |
| Stockholders' equity | |
| Preferred stock, par value $0.001; 20,000,000 shares authorized; no shares issued and outstanding | -- |
| Common Stock, Class A, par value $0.001; 70,000,000 shares authorized, 12,788,776 and 12,428,042 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively | 12,788 |
| Common Stock, Class B, par value $0.001; 25,000,000 shares authorized, 10,448,470 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively | 10,448 |
| Common Stock, Class C, par value $0.001; 2,000,000 shares authorized, 1,437,572 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively | 1,438 |
| Additional paid-in capital | 57,075,010 |
| Accumulated deficit | (50,652,428) |
| Treasury stock - at cost; 9,140 shares | (38,318) |
| Total stockholders' equity | 6,408,938 |
| Total liabilities and stockholders' equity | $ 19,777,027 |

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



Orion HealthCorp, Inc.
Consolidated Condensed Statements of Operations

For the Three Mont
2006

| | |
|---|---|
| | (Unaudited) |
| Net operating revenues | $ 7,474,193 |
| Operating expenses | |
| Salaries and benefits | 2,782,117 |
| Physician group distribution | 2,112,603 |
| Facility rent and related costs | 455,403 |
| Depreciation and amortization | 407,964 |
| Professional and consulting fees | 393,774 |
| Insurance | 163,139 |
| Provision for doubtful accounts | 146,895 |
| Other expenses | 1,373,470 |
| Total operating expenses | 7,835,365 |
| Loss from continuing operations before other income (expenses) | (361,172) |
| Other income (expenses) | |
| Interest expense | (122,169) |
| Other expense, net | (4,365) |
| Total other income (expenses), net | (126,534) |
| Loss from continuing operations | (487,706) |
| Discontinued operations | |
| Income (loss) from operations of discontinued components | -- |
| Income (loss) before provision for income taxes | (487,706) |
| Provision for income taxes | -- |
| Net loss | $ (487,706) |
| Weighted average common shares outstanding | |
| Basic | 12,777,363 |
| Diluted | 12,777,363 |
| Income (loss) per share | |
| Basic | |
| Net loss per share from continuing operations | $ (0.04) |
| Net income (loss) per share from discontinued operations | $ -- |
| Net loss per share | $ (0.04) |
| Diluted | |
| Net loss per share from continuing operations | $ (0.04) |
| Net income (loss) per share from discontinued operations | $ -- |
| Net loss per share | $ (0.04) |

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



Orion HealthCorp, Inc.
Consolidated Condensed Statements of Operations

| | For the Nine Months 2006 (Unaudited) |
|---|---|
| Net operating revenues | $ 21,559,921 |
| Operating expenses | |
| Salaries and benefits | 8,317,365 |
| Physician group distribution | 6,135,949 |
| Facility rent and related costs | 1,247,678 |
| Depreciation and amortization | 1,226,791 |
| Professional and consulting fees | 1,100,885 |
| Insurance | 502,499 |
| Provision for doubtful accounts | 446,041 |
| Other expenses | 3,646,413 |
| Total operating expenses | 22,623,622 |
| Loss from continuing operations before other income (expenses) | (1,063,701) |
| Other income (expenses) | |
| Interest expense | (356,313) |
| Gain on forgiveness of debt | 665,463 |
| Other expense, net | (18,517) |
| Total other income (expenses), net | 290,633 |
| Minority interest earnings in partnership | -- |
| Loss from continuing operations | (773,068) |
| Discontinued operations | |
| Income (loss) from operations of discontinued components | 576,390 |
| Net loss | $ (196,678) |
| Weighted average common shares outstanding | |
| Basic | 12,600,820 |
| Diluted | 12,600,820 |
| Income (loss) per share | |
| Basic | |

| | |
|---|---|
| Net loss per share from continuing operations | $ (0.06) |
| Net income (loss) per share from discontinued operations | $ 0.05 |
| Net loss per share | $ (0.01) |
| Diluted | |
| Net loss per share from continuing operations | $ (0.06) |
| Net income (loss) per share from discontinued operations | $ 0.05 |
| Net loss per share | $ (0.01) |

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



Orion HealthCorp, Inc.
Consolidated Statements of Cash Flows

| | For the Three M 2006 |
|---|---|
| Operating activities | |
| Net loss | $ (487,706) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | |
| Provision for doubtful accounts | 146,895 |
| Depreciation and amortization | 407,964 |
| Stock option compensation expense | 49,642 |
| Impact of discontinued operations | - |
| Changes in operating assets and liabilities: | |
| Accounts receivable | (562,070) |
| Inventory | (111,817) |
| Prepaid expenses and other assets | (113,116) |
| Other assets | 1,400 |
| Accounts payable and accrued expenses | 447,891 |
| Deferred revenues and other liabilities | - |
| Net cash used in operating activities | (220,919) |
| Investing activities | |
| Sale (purchase) of property and equipment | (36,785) |
| Impact of discontinued operations | - |
| Net cash provided by (used in) investing activities | (36,785) |
| Financing activities | |
| Net repayments of capital lease obligations | (22,463) |

| | |
|---|---|
| Net borrowings on line of credit | 9,614 |
| Net repayments of notes payable | 409 |
| Net borrowings (repayments) of other obligations | 42,016 |
| Net cash provided by financing activities | 29,576 |
| Net increase (decrease) in cash and cash equivalents | (228,128) |
| Cash and cash equivalents, beginning of quarter | 328,923 |
| Cash and cash equivalents, end of quarter | $ 100,795 |
| Supplemental cash flow information | |
| Cash paid during the quarter for | |
| Income taxes | $ - |
| Interest | $ 93,419 |

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

Beginning in the fourth quarter of 2005, the Company separately disclosed the operating, investing and financing components of the cash flows attributable to its discontinued operations, which in prior periods were reported on a combined basis as a single amount.

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Orion HealthCorp, Inc.
Consolidated Statements of Cash Flows

| | For the Nine Mon |
|---|---|
| | 2006 |
| Operating activities | |
| Net loss | $ (196,6 |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | |
| Minority interest in earnings of partnerships | |
| Provision for doubtful accounts | 446,0 |
| Depreciation and amortization | 1,226,7 |
| Gain on forgiveness of debt | (665,4 |
| Stock option compensation expense | 147,3 |
| Conversion of notes payable to common stock | |
| Impact of discontinued operations | 230,7 |
| Changes in operating assets and liabilities: | |
| Accounts receivable | (392,7 |
| Inventory | (75,8 |
| Prepaid expenses and other assets | (199,0 |
| Other assets | 14,3 |
| Accounts payable and accrued expenses | (894,8 |
| Deferred revenues and other liabilities | |

| | |
|---|---|
| Net cash used in operating activities | (359,4 |
| Investing activities | |
| Sale (purchase) of property and equipment | (49,7 |
| Impact of discontinued operations | 430,2 |
| Net cash provided by investing activities | 380,4 |
| Financing activities | |
| Net repayments of capital lease obligations | (68,1 |
| Net borrowings (repayments) on line of credit | (408,6 |
| Net borrowings of notes payable | |
| Net repayments of notes payable | 389,5 |
| Net borrowings (repayments) of other obligations | 168,1 |
| Impact of discontinued operations | (300,0 |
| Net cash provided by (used in) financing activities | (219,0 |
| Net increase (decrease) in cash and cash equivalents | (198,0 |
| Cash and cash equivalents, beginning of period | 298,8 |
| Cash and cash equivalents, end of period | $ 100,7 |
| Supplemental cash flow information | |
| Cash paid during the period for | |
| Income taxes | $ |
| Interest | $ 271,0 |

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

Beginning in the fourth quarter of 2005, the Company separately disclosed the operating, investing and financing components of the cash flows attributable to its discontinued operations, which in prior periods were reported on a combined basis as a single amount.



ORION HEALTHCORP, INC.
NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
SEPTEMBER 30, 2006 AND 2005

NOTE 1. GENERAL

Orion HealthCorp, Inc. (formerly SurgiCare, Inc. "SurgiCare") and its subsidiaries ("Orion" or the "Company") maintain their accounts on the accrual method of accounting in accordance with accounting principles generally accepted in the United States of America ("GAAP"). Accounting principles followed by the Company and its subsidiaries and the methods of applying those principles, which materially affect the determination of financial position, results of operations and cash flows are summarized below.

The unaudited consolidated condensed financial statements include the accounts of the Company and all of its majority-owned subsidiaries. Orion's results for the three months and nine months ended September 30, 2006 and 2005 include the results of IPS, MBS and the Company's ambulatory surgery and diagnostic center business. The descriptions of the business and results of operations of MBS set forth in these notes include the business and results of operations of DCPS. All material intercompany balances and transactions have been eliminated in consolidation.

These financial statements have been prepared in accordance with GAAP for interim financial reporting and in accordance with the instructions to Form 10-QSB and Item 310-(b) of Regulation S-B. Accordingly, they do not contain all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, the accompanying unaudited consolidated condensed financial statements include adjustments consisting of only normal recurring adjustments necessary for a fair presentation of the Company's financial position and results of operations and cash flows of the interim periods presented. The results of operations for any interim period are not necessarily indicative of results for the full year.

The accompanying unaudited consolidated condensed financial statements should be read in conjunction with the financial statements and related notes therein included in the Company's Annual Report on Form 10-KSB/A for the year ended December 31, 2005.

DESCRIPTION OF BUSINESS

Orion is a healthcare services organization providing outsourced business services to physicians. The Company serves the physician market through two subsidiaries, Medical Billing Services, Inc. ("MBS"), which provides billing, collection and practice management services, primarily to hospital-based physicians; and Integrated Physician Solutions, Inc. ("IPS"), which provides business and management services to general and subspecialty pediatric physician practices.

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

In April 2005, the Company initiated a strategic plan designed to accelerate the Company's growth and enhance its future earnings potential. The plan focuses on the Company's strengths, which include providing billing, collections and complementary business management services to physician practices. As part of this strategic plan, the Company began to divest certain non-strategic assets. In addition, the Company ceased investment in business lines that did not complement the Company's strategic plan and redirected financial resources and Company personnel to areas that management believes enhance long-term growth potential. Beginning in the third quarter of 2005, the Company successfully completed the consolidation of corporate functions into its Roswell, Georgia facility. Consistent with its strategic plan, the Company also completed a series of transactions involving the divestiture of non-strategic assets in 2005.

MEDICAL BILLING SERVICES

MBS is based in Houston, Texas and was incorporated in Texas on October 16, 1985. DCPS is based in Houston, Texas and was organized as a Texas limited liability company on September 16, 1998. DCPS reorganized as a Texas limited partnership on August 31, 2003. MBS (which includes the operations of DCPS) offers its clients a complete outsourcing service, which includes practice management and billing and collection services, allowing them to avoid the infrastructure investment in their own back-office operations. These services help clients to be financially successful by improving cash flows and reducing administrative costs and burdens.

MBS provides services to approximately 59 customers throughout Texas. These customers include anesthesiologists, pathologists, and radiologists, imaging centers, comprehensive breast centers, hospital labs, cardio-thoracic surgeons and ambulatory surgery centers ("ASCs.")

INTEGRATED PHYSICIAN SOLUTIONS

IPS, a Delaware corporation, was founded in 1996 to provide physician practice management services to general and subspecialty pediatric practices. IPS commenced its business activities upon consummation of several medical group business combinations effective January 1, 1999.

As of September 30, 2006, IPS managed nine practice sites, representing five medical groups in Illinois and Ohio. IPS provides human resources management, accounting, group purchasing, public relations, marketing, information technology, and general day-to-day business operations management services to these medical groups. The physicians, who are all employed by separate corporations, provide all clinical and patient care related services.

There is a standard forty-year management service agreement ("MSA") between IPS and the various affiliated medical groups whereby a management fee is paid to IPS. IPS owns all of the assets used in the operation of the medical groups. IPS manages the day-to-day business operations of each medical group and provides the assets for the physicians to use in their practice, for a fixed fee or percentage of the net operating income of the medical group. All revenues are collected by IPS, the fixed fee or percentage payment to IPS is taken from the net operating income of the medical group and the remainder of the net operating income of the medical group is paid to the physicians and treated as an expense on IPS's financial statements as "physician group distribution."

On April 1, 2005, IPS entered into a Mutual Release and Settlement Agreement (the "CARDC Settlement") with Bradley E. Chipps, M.D. ("Dr. Chipps") and Capital Allergy and Respiratory Disease Center, a medical corporation ("CARDC") to settle disputes as to the existence and enforceability of certain contractual obligations. As part of the CARDC Settlement, Dr. Chipps, CARDC, and IPS agreed that CARDC would purchase the assets owned by IPS and used in connection with CARDC in exchange for termination of the MSA between IPS and CARDC. Additionally, among other provisions, after April 1, 2005, Dr. Chipps, CARDC and IPS have been released from any further obligation to each other.

On June 7, 2005, InPhySys, Inc. (formerly known as IntegriMED, Inc.) ("IntegriMED"), a wholly owned subsidiary of IPS, executed an Asset Purchase Agreement (the "IntegriMED Agreement") with eClinicalWeb, LLC ("eClinicalWeb") to sell substantially all of the assets of IntegriMED. The IntegriMED Agreement was deemed to be effective as of midnight on June 6, 2005.

As consideration for the purchase of the acquired assets, eClinicalWeb issued to IntegriMED the following: (i) a two percent (2%) ownership interest in eClinicalWeb; and (ii) $69,034 for the payoff of certain leases and purchase of certain software. Also eClinicalWeb agreed to sublease certain office space from IPS that was occupied by employees of IntegriMED.

On October 31, 2005, IPS executed a Mutual Release and Settlement Agreement (the "Sutter Settlement") with John Ivan Sutter, M.D., PA ("Dr. Sutter") to settle disputes that had arisen between IPS and Dr. Sutter and to avoid the risk and expense of litigation. As part of the Sutter Settlement, Dr. Sutter and IPS agreed that Dr. Sutter would purchase the assets owned by IPS and used in connection with Dr. Sutter's practice, in exchange for termination of the related MSA. Additionally, among other provisions, after October 31, 2005, Dr. Sutter and IPS have been released from any further obligation to each other.

AMBULATORY SURGERY CENTER BUSINESS

As of September 30, 2006, the Company no longer has ownership or management interests in surgery and diagnostic centers.

On March 1, 2005, the Company closed its wholly owned subsidiary, Bellaire SurgiCare, Inc. ("Bellaire SurgiCare"), and consolidated its operations with the operations of SurgiCare Memorial Village, L.P. ("Memorial Village").

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In April 2005, due to unsatisfactory financial performance of the Company's surgery centers and in accordance with its strategic plan, the Company began the process of divesting its surgery center ownership interests.

On September 30, 2005, Orion executed purchase agreements to sell its 51% ownership interest in Tuscarawas Ambulatory Surgery Center, L.L.C. ("TASC") and its 41% ownership interest in Tuscarawas Open MRI, L. P. ("TOM") both located in Dover, Ohio, to Union Hospital ("Union"). Additionally, as part of the transactions, TASC, as the sole member of TASC Anesthesia, L.L.C. ("TASC Anesthesia"), executed an Asset Purchase Agreement to sell certain assets of TASC Anesthesia to Union. The limited partners of TASC and TOM also sold a certain number of their units to Union such that at the closing of these transactions, Union owned 70% of the ownership interests in TASC and TOM.

As consideration for the purchase of the 70% ownership interests in TASC and TOM, Union Hospital paid purchase prices of $950,000 and $2,188,237, respectively. Orion's portion of the total proceeds for TASC, TASC Anesthesia and TOM, after closing costs of $82,632, was cash in the amount of $1,223,159 and a note due on or before March 30, 2006 in the amount of $530,547. The March 30, 2006 note was not fully paid by Union and the remaining balance of $261,357 was written off against the gain on disposition for the quarter ended December 31, 2005. As a result of these transactions, Orion no longer has an ownership interest in TASC, TOM or TASC Anesthesia.

Additionally, as part of the TASC and TOM transactions, Orion executed two-year management services agreements (the "TASC MSA" and the "TOM MSA") with terms substantially the same as those of the management services agreements under which Orion performed management services to TASC and TOM prior to the transactions.

On January 12, 2006, the Company was notified by Union that it was exercising its option to terminate the TOM MSA as of March 12, 2006. Management fee revenue related to TOM was $0 and $14,669 for the three months ended September 30, 2006 and 2005, respectively. For the nine months ended September 30, 2006 and 2005, management fee revenue related to TOM was $7,217 and $32,020, respectively.

On February 3, 2006, the Company was notified by Union that it was exercising its option to terminate the TASC MSA as of April 3, 2006. Management fee revenue related to TASC was $0 and $20,135 for the three months ended September 30, 2006 and 2005, respectively. For the nine months ended September 30, 2006 and 2005, management fee revenue related to TASC was $22,525 and $72,173, respectively.

On February 8, 2006, Memorial Village executed an Asset Purchase Agreement (the "Memorial Agreement") for the sale of substantially all of its assets to First Surgical Memorial Village, L.P. ("First Surgical"). Memorial Village is approximately 49% owned by Town & Country SurgiCare, Inc., a wholly owned subsidiary of Orion. The Memorial Agreement was deemed to be effective as of January 31, 2006.

The property sold by Memorial Village to First Surgical (hereinafter collectively referred to as the "Memorial Acquired Assets") included the equipment, inventory, goodwill, contracts, leasehold improvements, equipment leases, books and records, permits and licenses and other personal property owned by Memorial Village and used in the operation of Memorial Village's business. The Memorial Acquired Assets did not include any of the following: accounts receivable, cash and cash equivalents, marketable securities, insurance policies, prepaid expenses, deposits with utility and/or service providers, shares of corporations, real estate owned by Memorial Village, or liabilities, other than those expressly assumed by the First Surgical in the Agreement.

As consideration for the Memorial Acquired Assets, Memorial Village received a total purchase price of $1,100,000, of which Orion received approximately $815,000 after payment of certain legal and other post-closing expenses. The proceeds received by Orion consisted of the following amounts:

i. Approximately $677,000 representing the principal amount of a note payable owed to Orion from Memorial Village;

ii. Approximately $99,000 representing Orion's pro-rata share of the net proceeds after payment of certain legal and other post-closing expenses; and

iii. A reserve fund of approximately $39,000, pending approval of the assumption of certain capital leases by First Surgical.

On March 1, 2006, San Jacinto Surgery Center, Ltd. ("San Jacinto") executed an Asset Purchase Agreement (the "San Jacinto Agreement") for the sale of substantially all of its assets to San Jacinto Methodist Hospital ("Methodist"). San Jacinto is approximately 10% owned by Baytown SurgiCare, Inc., a wholly owned subsidiary of Orion.



The property sold by San Jacinto to Methodist (hereinafter collectively referred to as the "San Jacinto Acquired Assets"), included the leasehold title to real property, together with all improvements, buildings and fixtures, all major, minor or other equipment, all computer equipment and hardware, furniture and furnishings, inventory and supplies, current financial, patient, credentialing and personnel records, interest in all commitments, contracts, leases and agreements outstanding in respect to San Jacinto, to the extent assignable, all licenses and permits held by San Jacinto, all patents and patent applications and all logos, names, trade names, trademarks and service marks, all computer software, programs and similar systems owned by or licensed to San Jacinto, goodwill and all interests in property, real, personal and mixed, tangible and intangible acquired by San Jacinto prior to March 1, 2006. The San Jacinto Acquired Assets did not include any of the following: restricted and unrestricted cash and cash equivalents, marketable securities, certificates of deposit, bank accounts, temporary investments, accounts receivable, notes receivable intercompany accounts of San Jacinto, and all commitments, contracts, leases and agreements other than those expressly assumed by Methodist in the San Jacinto Agreement.

As consideration for the San Jacinto Acquired Assets, San Jacinto received a total purchase price of $5,500,000, of which Orion received a net amount of approximately $598,000. The proceeds received by Orion consisted of the following amounts:

i. Approximately $450,000 representing Orion's pro-rata share of the net proceeds; and

ii. Approximately $148,000 representing the principal and interest amounts of a note payable owed to Orion from San Jacinto.

As part of the closing of the Agreement, Orion was obligated to make payments, totaling $607,000, from its portion of the proceeds as follows:

i. Approximately $357,000 representing distributions due to the limited partners of San Jacinto for cash collections previously received by Orion, and payment of accounts payable and other expenses; and

ii. Approximately $250,000 to CIT, which represents repayment of the obligations related to San Jacinto under the Loan and Security Agreement.

NOTE 2. GOING CONCERN

The accompanying unaudited consolidated condensed financial statements have been prepared in conformity with GAAP, which contemplate the continuation of the Company as a going concern. The Company incurred substantial operating losses during 2005, and has used substantial amounts of working capital in its operations. Additionally, as described more fully below, the Company received notification from CIT Healthcare, LLC (formerly known as Healthcare Business Credit Corporation) ("CIT") in December 2005 that certain events of default under the Loan and Security Agreement had occurred as a result of the Company being out of compliance with two financial covenants relating to its debt service coverage ratio and its minimum operating income level. These conditions raise substantial doubt about the Company's ability to continue as a going concern.

The Company has financed its growth and operations primarily through the issuance of equity securities, secured and/or convertible debt, most recently by completing a series of acquisitions and restructuring transactions (the "Restructuring"), which occurred in December 2004, and borrowing from related parties. In connection with the closing of these transactions, the

Company entered into a new secured two-year revolving credit facility pursuant to a Loan and Security Agreement (the "Loan and Security Agreement"), dated December 15, 2004, by and among Orion, certain of its affiliates and subsidiaries, and CIT. Under this facility, initially up to $4,000,000 of loans could be made available to Orion, subject to a borrowing base, which is determined based on a percentage of eligible outstanding accounts receivable less than 180 days old. As discussed below, the amount available under this credit facility has been reduced. Orion borrowed $1,600,000 under this facility concurrently with the closing of the Restructuring. The interest rate under this facility is the prime rate plus 6%. Upon an event of default, CIT can accelerate the loans or call the Guaranties described below. (See Note 10. Long-Term Debt and Lines of Credit, for additional discussion regarding the Company's defaults under the Loan and Security Agreement.) In connection with entering into this new facility, Orion also restructured its previously-existing debt facilities, which resulted in a decrease in aggregate debt owed to DVI Business Credit Corporation and DVI Financial Services, Inc. (collectively, "DVI") from approximately $10.1 million to a combined principal amount of approximately $6.5 million, of which approximately $2.0 million was paid at the Closing.

Pursuant to a Guaranty Agreement (the "Brantley IV Guaranty"), dated as of December 15, 2004, provided by Brantley Partners IV, L.P. ("Brantley IV") to CIT, Brantley IV agreed to provide a deficiency guaranty in the initial amount of $3,272,727. As discussed below, the amount of this Brantley IV Guaranty has been reduced. Pursuant to a Guaranty Agreement (the "Brantley Capital Guaranty" and collectively with the Brantley IV Guaranty, the "Guaranties"), dated as of December 15, 2004, provided by Brantley Capital Corporation ("Brantley Capital") to CIT, Brantley Capital agreed to provide a deficiency guarantee in the initial amount of $727,273. As discussed below, the amount of this Brantley Capital Guaranty has been reduced. In consideration for the Guaranties, Orion issued warrants to purchase 20,455 shares of Class A Common Stock, at an exercise price of $0.01 per share, to Brantley IV, and issued warrants to purchase 4,545 shares of Class A Common Stock, at an exercise price of $0.01 per share, to Brantley Capital. None of these warrants, which expire on December 15, 2009, have been exercised as of September 30, 2006.



On March 16, 2005, Brantley IV loaned the Company an aggregate of $1,025,000 (the "First Loan"). On June 1, 2005, the Company executed a convertible subordinated promissory note in the principal amount of $1,025,000 (the "First Note") payable to Brantley IV to evidence the terms of the First Loan. The material terms of the First Note are as follows: (i) the First Note is unsecured; (ii) the First Note is subordinate to the Company's outstanding loan from CIT and other indebtedness for monies borrowed, and ranks pari passu with general unsecured trade liabilities; (iii) principal and interest on the First Note is due in a lump sum on April 19, 2006 (the "First Note Maturity Date"); (iv) the interest on the First Note accrues from and after March 16, 2005, at a per annum rate equal to nine percent (9.0%) and is non-compounding; (v) if an event of default occurs and is continuing, Brantley IV, by notice to the Company, may declare the principal of the First Note to be due and immediately payable; and (vi) on or after the First Note Maturity Date, Brantley IV, at its option, may convert all or a portion of the outstanding principal and interest due of the First Note into shares of Class A Common Stock of the Company at a price per share equal to $1.042825 (the "First Note Conversion Price"). The number of shares of Class A Common Stock to be issued upon conversion of the First Note shall be equal to the number obtained by dividing (x) the aggregate amount of principal and interest to be converted by (y) the First Note Conversion Price (as defined above); provided, however, the number of shares to be issued upon conversion of the First Note shall not exceed the lesser of: (i) 1,159,830 shares of Class A Common Stock, or (ii) 16.3% of the then outstanding

Class A Common Stock. As of September 30, 2006, if Brantley IV were to convert the First Note, the Company would have to issue 1,121,251 shares of Class A Common Stock. On May 9, 2006, Brantley IV and the Company executed an amendment to the First Note (the "First and Second Note Amendment") extending the First Note Maturity Date to August 15, 2006. On August 8, 2006, Brantley IV and the Company executed a second amendment to the First Note (the "First and Second Note Second Amendment") extending the First Note Maturity Date to October 15, 2006, and as of October 15, 2006, Brantley IV and the Company executed a third amendment to the First Note (the "First and Second Note Third Amendment") further extending the First Note Maturity Date to November 30, 2006.

On April 19, 2005, Brantley IV loaned the Company an additional $225,000 (the "Second Loan"). On June 1, 2005, the Company executed a convertible subordinated promissory note in the principal amount of $225,000 (the "Second Note") payable to Brantley IV to evidence the terms of the Second Loan. The material terms of the Second Note are as follows: (i) the Second Note is unsecured; (ii) the Second Note is subordinate to the Company's outstanding loan from CIT and other indebtedness for monies borrowed, and ranks pari passu with general unsecured trade liabilities; (iii) principal and interest on the Second Note is due in a lump sum on April 19, 2006 (the "Second Note Maturity Date"); (iv) the interest on the Second Note accrues from and after April 19, 2005, at a per annum rate equal to nine percent (9.0%) and is non-compounding; (v) if an event of default occurs and is continuing, Brantley IV, by notice to the Company, may declare the principal of the Second Note to be due and immediately payable; and (vi) on or after the Second Note Maturity Date, Brantley IV, at its option, may convert all or a portion of the outstanding principal and interest due of the Second Note into shares of Class A Common Stock of the Company at a price per share equal to $1.042825 (the "Second Note Conversion Price"). The number of shares of Class A Common Stock to be issued upon conversion of the Second Note shall be equal to the number obtained by dividing (x) the aggregate amount of principal and interest to be converted by (y) the Second Note Conversion Price (as defined above); provided, however, the number of shares to be issued upon conversion of the Second Note shall not exceed the lesser of: (i) 254,597 shares of Class A Common Stock, or (ii) 3.6% of the then outstanding Class A Common Stock. As of September 30, 2006, if Brantley IV were to convert the Second Note, the Company would have to issue 244,294 shares of Class A Common Stock. On May 9, 2006, Brantley IV and the Company executed the First and Second Note Amendment extending the Second Note Maturity Date to August 15, 2006. On August 8, 2006, Brantley IV and the Company executed the First and Second Note Second Amendment extending the Second Note Maturity Date to October 15, 2006, and as of October 15, 2006, Brantley IV and the Company executed the First and Second Note Third Amendment further extending the Second Note Maturity Date to November 30, 2006.

Additionally, in connection with the First Loan and the Second Loan, the Company entered into a First Amendment to the Loan and Security Agreement (the "First Amendment"), dated March 22, 2005, with certain of the Company's affiliates and subsidiaries, and CIT, whereby its $4,000,000 secured two-year revolving credit facility has been reduced by the amount of the loans from Brantley IV to $2,750,000. As a result of the First Amendment, the Brantley IV Guaranty was amended by the Amended and Restated Guaranty Agreement, dated March 22, 2005, which reduced the deficiency guaranty provided by Brantley IV by the amount of the First Loan to $2,247,727. Also as a result of the First Amendment, the Brantley Capital Guaranty was amended by the Amended and Restated Guaranty Agreement, dated March 22, 2005, which reduced the deficiency guaranty provided by Brantley Capital by the amount of the Second Loan to $502,273. Paul H. Cascio, the Chairman of the board of directors of the Company, and Michael J. Finn, a director of the Company, are affiliates of Brantley IV.

As part of the Loan and Security Agreement, the Company is required to comply with certain financial covenants, measured on a quarterly basis. The financial covenants include maintaining a required debt service coverage ratio and meeting a minimum operating income level for the surgery and diagnostic centers before corporate overhead allocations. As of and for the three months and nine months ended September 30, 2006, the Company was out of compliance with both of these financial covenants and has notified the lender as such. Under the terms of the Loan and Security Agreement, failure to meet the required financial covenants constitutes an event of default. Under an event of default, the lender may (i) accelerate and declare the obligations under the credit facility to be immediately due and payable; (ii) withhold or cease to make advances under the credit facility; (iii) terminate the credit facility; (iv) take possession of the collateral pledged as part of the Loan and Security Agreement; (v) reduce or modify the revolving loan commitment; and/or (vi) take necessary action under the Guaranties. The revolving credit facility is secured by the Company's assets. As of September 30, 2006, the outstanding principal under the revolving credit facility was $1,008,282. The full amount of the loan as of September 30, 2006 is recorded as a current liability. In December 2005, the Company received notification from CIT stating that (i) certain events of default under the Loan and Security Agreement had occurred as a result of the Company being out of compliance with two financial covenants relating to its debt service coverage ratio and its minimum operating income level, (ii) as a result of the events of default, CIT raised the interest rate for monies borrowed under the Loan and Security Agreement to the provided "Default Rate" of prime rate plus 6%, (iii) the amount available under the revolving credit facility was reduced from $2,750,000 to $2,300,000 and (iv) CIT reserved all additional rights and remedies available to it as a result of these events of default. The Company is currently in negotiations with CIT to obtain, among other provisions, a waiver of the events of default. In the event CIT declares the obligations under the Loan and Security Agreement to be immediately due and payable or exercises its other rights described above, the Company would not be able to meet its obligations to CIT or its other creditors. As a result, such action would have a material adverse effect on the Company`s ability to continue as a going concern. The Company is currently negotiating the terms of a new senior secured credit facility in the aggregate principal amount of $16,500,000, consisting of a $2,000,000 revolving loan commitment, a $4,500,000 term loan and a $10,000,000 acquisition facility commitment available for future acquisitions. The proceeds from the new facility would be used to repay the Company's current credit facility with CIT and provide capital to enable the Company to execute components of its strategic plan, including acquisition opportunities, two of which are described in greater detail below. If the Company is unable to reach an agreement on a credit facility with this lender, then we will seek to find another institutional lender to provide a credit facility on similar terms, but there is no guarantee that we will be able to find such a lender or be able to negotiate similar terms to such credit facility.

As of September 30, 2006, the Company's existing credit facility with CIT had limited availability to provide for working capital shortages. Although the Company believes that it will generate cash flows from operations in the future, there is substantial doubt as to whether it will be able to fund its operations solely from its cash flows. In April 2005, the Company initiated a strategic plan designed to accelerate the Company's growth and enhance its future earnings potential. The plan focuses on the Company's strengths, which include providing billing, collections and complementary business management services to physician practices. In 2005 and early 2006, the Company ceased investment in business lines that did not complement the Company's strategic plans. On June 7, 2005, as described in Note 1. General - Description of Business - Integrated Physician Solutions, IPS completed the sale of substantially all of the assets of IntegriMED, and on October 1, 2005, the Company completed the sale of its interests in TASC and TOM in Dover, Ohio. Beginning in the third quarter of 2005, the Company successfully completed the consolidation of corporate functions into its Roswell, Georgia facility.

Additionally, consistent with its strategic plan, the Company sold its interest in Memorial Village effective January 31, 2006 and in San Jacinto effective March 1, 2006. (See Note 1. General - Description of Business - Ambulatory Surgery Center Business).

Additionally, the Company redirected financial resources and company personnel to areas that management believes enhance long-term growth potential. A key component of the Company's long-term strategic plan was the identification of potential acquisition targets that would increase the Company's presence in the markets it serves and enhance stockholder value.

The Company has identified several acquisition opportunities to expand its business that are consistent with its strategic plan. The Company signed definitive agreements in September 2006 for the acquisition of two of these targets and plans to consummate the transactions in the fourth quarter of 2006. The Company also entered into definitive agreements for additional equity and mezzanine debt financing in September 2006, which it expects to consummate simultaneously with the two acquisitions. On November 9, 2006, the Company filed a definitive proxy statement with the Securities and Exchange Commission (the "SEC") on Form DEF14A with respect to the transactions contemplated by the definitive agreements, which are described in greater detail below, and set a special stockholders meeting date of November 27, 2006 for approval of certain changes in corporate structure which will enable the Company to consummate the transactions.

The first acquisition involves the purchase of all of the issued and outstanding capital stock of Rand Medical Billing, Inc. ("Rand"). Rand is a full service billing agency, providing medical billing exclusively for anatomic and clinical pathology practices located in Simi Valley, California.

On September 8, 2006 the Company entered into a stock purchase agreement with Rand Medical Billing, Inc. and the stockholder of Rand to purchase all of the issued and outstanding capital stock of Rand for an aggregate purchase price of $9,365,333, subject to adjustments conditioned upon future revenue results. A portion of the purchase price is payable by the issuance of such number of shares of the Company's Class A Common Stock having a value of $600,000 based on the average closing price per share of the Company's Class A Common Stock for the twenty day period prior to the closing of the Rand acquisition. The remainder of the purchase price is payable in a combination of cash and the issuance of an unsecured subordinated promissory note in the original principal amount of $1,365,333. At the closing of the Rand acquisition, $6,800,000 of the purchase price will be paid in cash and the balance will be placed in escrow (including the shares of the Company's Class A Common Stock) pending resolution of the purchase price adjustments and subject to claims, if any, for indemnification.



The second acquisition involves the purchase of all the issued and outstanding capital stock of two related companies, On Line Alternatives, Inc. ("OLA") and On Line Payroll Services, Inc. ("OLP") (collectively, "Online").

OLA is an outsourcing company providing data entry, insurance filing, patient statements, payment posting, collection follow-up and patient refund processing to medical practices. Most of OLA's customers are hospital-based physician practices including radiology, neurology and emergency medicine. Customers also include some other specialties as plastic surgery, family practice, internal medicine and orthopedics. All billing functions are the responsibility of OLA, and include credentialing and accounts payable processing. OLA also has a group of contract transcriptionists who work out of their homes and OLA offers these services to clients as well.

OLP provides payroll processing services to small businesses, a few of which are also customers of OLA. OLP provides payroll services including direct deposit, time clock interface and tax reporting to clients in Alabama, Florida, Georgia, Louisiana, Mississippi, Tennessee and Texas.

On September 8, 2006 the Company entered into a stock purchase agreement with OLA, OLP and the stockholders of each of OLA and OLP to purchase all of the issued and outstanding capital stock of both OLA and OLP for an aggregate purchase price of $3,310,924, subject to adjustments conditioned upon future revenue results. The purchase price is payable in a combination of cash and the issuance of unsecured subordinated promissory notes. At the closing of the On Line acquisition, $2,476,943 of the purchase price will be paid in cash and the remainder through the issuance of an unsecured subordinated promissory note in the original principal amount of $833,981. The Company also has an option to pay up to $75,000 of the purchase price in the form of an additional unsecured promissory note in lieu of cash at the closing.

Each of the stock purchase agreements with Rand and On Line contains customary representations and warranties and terms and conditions to closing.

In addition to the Rand and On Line agreements, the Company also entered into a Stock Purchase Agreement on September 8, 2006 with Phoenix Life Insurance Company ("Phoenix") and Brantley IV (the "Stock Purchase Agreement"). Pursuant to the terms of the Stock Purchase Agreement, Phoenix and Brantley IV will purchase, for an aggregate purchase price of $4,650,000, shares of the Company's Class D Common Stock representing upon conversion 19.375% of the Company's outstanding Class A Common Stock as of the date of issuance of the Class D Common Stock, on a fully-diluted basis taking into account the issuance of the shares of Class D Common Stock but excluding certain of the Company's outstanding options, warrants and convertible securities and certain shares of Class B Common Stock to be purchased by the Company from Brantley Capital Corporation. Since the Company's charter documents do not currently authorize the issuance of the Company's Class D Common Stock, the Company will amend and restate its Certificate of Incorporation to provide for such shares upon shareholder approval.

As of September 30, 2006, Brantley IV owns 7,863,996 shares of the Company's Class B Common Stock, warrants to purchase 20,455 shares of the Company's Class A Common Stock and notes which are currently convertible into 1,358,054 shares of the Company's Class A Common Stock. As of September 30, 2006, this represents 31.9% of the Company's voting power and 52.4% of the Company's voting power on an as converted basis (at the closing price of the Company's Class A Common Stock on the record date of $0.25 per share). As of September 30, 2006, Brantley IV and its affiliates own 44.8% of the Company's voting power and 60.5% of the Company's voting power on an as converted basis (at the closing price of the Company's Class A Common Stock on the record date of $0.25 per share).

Phoenix is a limited partner in Brantley IV and Brantley Partners V, L.P and has also co-invested with Brantley IV and its affiliates in a number of transactions. Phoenix does not currently own, of record, any shares of the Company's capital stock. Two of the Company's directors, Paul H. Cascio and Michael J. Finn, are affiliated with Brantley IV and its related entities. Paul Cascio and Michael J. Finn serve as general partners of the general partner of Brantley Venture Partners III, L.P. ("Brantley III") and Brantley IV and are limited partners in these funds. Neither Phoenix, Brantley IV nor Messrs. Cascio or Finn is affiliated with Brantley Capital Corporation. The advisor to Brantley III is Brantley Venture Management III, L.P. and the advisor to Brantley IV is Brantley Management IV, L.P.

Brantley IV will purchase, for an aggregate purchase price of $1,650,000, such number of shares of Class D Common Stock representing upon conversion 6.875% of the Company's outstanding Class A Common Stock as of the date of issuance of the Class D Common Stock, on a fully-diluted basis taking into account the issuance of the shares of Class D Common Stock but excluding certain of the Company's outstanding options, warrants and convertible securities and certain shares of Class B Common Stock to be purchased by the Company from Brantley Capital Corporation.



Phoenix will purchase, for an aggregate purchase price of $3,000,000, such number of shares of Class D Common Stock, representing upon conversion 12.5% of the Company's outstanding Class A Common Stock as of the date of issuance of the Class D Common Stock, on a fully-diluted basis taking into account the issuance of the shares of Class D Common Stock but excluding certain of the Company's outstanding options, warrants and convertible securities and certain shares of Class B Common Stock to be purchased by the Company from Brantley Capital Corporation.

The Class D Common Stock, upon stockholder approval, will have the following rights and preferences:

- The holders of the Class D Common Stock will have priority in certain distributions made to the other holders of Common Stock. The holders of the shares of Class D Common Stock (other than shares concurrently being converted into Class A Common Stock), as a single and separate class, will be entitled to receive all distributions until there has been paid with respect to each such share from amounts then and previously distributed an amount equal to 9% per annum on the Class D issuance amount, without compounding, from the date the Class D Common Stock is first issued.

- In addition to receiving any accrued but unpaid distributions described above, the holders of the Class D Common Stock will have the right to receive distributions pari passu with the holders of the shares of the Class A Common Stock, assuming for purposes of such calculation that each share of Class D Common Stock represented one share of Class A Common Stock (subject to adjustment to such conversion ratio for subsequent issuances by the Company of shares of the Company's capital stock, or rights to acquire such shares, for less than the price the holders of the Class D Common Stock paid for their shares and for stock splits, combinations, stock dividends and certain other actions as more fully specified in the Company's certificate of incorporation).

- The holders of a majority of the Class D Common Stock have the ability to authorize any payment that might otherwise be considered a distribution for purposes of the Company's amended and restated certificate of incorporation to be excluded from the distribution priority provisions described above.

- Each share of Class D Common Stock will be entitled to one vote. The Class D Common Stock will vote together with all other classes of the Company's Common Stock and not as a separate class, except as otherwise required by law or in the event of certain actions adversely affecting the rights and preferences of the Class D Common Stock as more fully specified in the Company's certificate of incorporation.

- At the option of each holder of Class D Common Stock, exercisable at any time and from time to time by notice to the Company, each outstanding share of Class D Common Stock held by such investor will convert into a number of shares of Class A Common Stock equal to the "Class D Conversion Factor" in effect at the time such notice is given. The Class D Conversion Factor will initially be one share of Class A Common Stock for each share of Class D Common Stock, subject to adjustment to such conversion ratio for subsequent issuances by the Company of shares of the Company's capital stock, or rights to acquire such shares, for less than the price the holders of the Class D Common Stock paid for their shares and for stock splits, combinations, stock dividends and certain other actions as more fully specified in the Company's certificate of incorporation.

On September 8, 2006 the Company also entered into a Note Purchase Agreement with Phoenix (the "Note Purchase Agreement," and together with the Stock Purchase Agreement, the "Private Placement Agreements"). Pursuant to the terms of the Note Purchase Agreement, Phoenix will purchase, for an aggregate purchase price of $3,350,000, (i) the Company's senior unsecured subordinated promissory notes, due 2011, in the original principal amount of $3,350,000 and (ii) warrants to purchase shares of the Company's Class A Common Stock equal to 1.117% of the Company's outstanding Class A Common Stock on the date of issuance of the warrants, on a fully-diluted basis taking into account the issuance of the shares of Class D Common Stock described above and the shares of Class A Common Stock covered by the warrants but excluding certain of the Company's outstanding options, warrants and convertible securities and certain shares of Class B Common Stock to be purchased by the Company from Brantley Capital Corporation.

The Company's senior unsecured subordinated promissory notes will bear interest at the combined rate of (i) 12% per annum payable in cash on a quarterly basis and (ii) 2% per annum payable in kind (meaning that the accrued interest will be capitalized as principal) on a quarterly basis, subject to the Company's right to pay such amount in cash. The notes will be unsecured and subordinated to all of the Company's other senior debt. Upon the occurrence and during the continuance of an event of default the interest rate on the cash portion of the interest shall increase from 12% per annum to 14% per annum, for a combined rate of default interest of 16% per annum. The Company may prepay outstanding principal (together with accrued interest) on the note subject to certain prepayment penalties and the Company is required to prepay outstanding principal (together with accrued interest) on the note upon certain specified circumstances.



The warrants provide the holder with the right to purchase shares of the Company's Class A Common Stock equal to 1.117% of the Company's outstanding Class A Common Stock on the date of issuance of the warrants, on a fully-diluted basis taking into account the issuance of the shares of Class D Common Stock described above and the shares of Class A Common Stock covered by the warrants but excluding certain of the Company's outstanding options and warrants and certain shares of Class B Common Stock to be purchased by the Company from Brantley Capital Corporation. The warrants will be exercisable for five years from the date of issuance of the warrants at $0.01 per share.

Some or all of the proceeds the Company receives upon consummation of the sale of the Class D Common Stock, senior unsecured subordinated promissory notes and warrants in the private placement, along with proceeds from senior bank financing and other funds available to the Company, will be used to finance a portion of the acquisitions of the Rand and On Line businesses, the Company's purchase of certain shares of the Company's Class B

Common Stock from Brantley Capital Corporation, to repay certain outstanding senior indebtedness and for general working capital purposes.

The obligations of Phoenix and Brantley IV to close under the Private Placement Agreements are subject to the satisfaction or waiver of many conditions in accordance with each of the Stock Purchase Agreement and Note Purchase Agreement, including:

- receipt of approval from the Company's stockholders of the amendments to the Company's certificate of incorporation and issuance of the Company's shares of Class D Common Stock and Class A Common Stock;

- the absence of any material adverse change in the Company's business and operations, and the business and operations of the Rand and On Line businesses, since June 30, 2006;

- in the case of the Stock Purchase Agreement, the filing of the Company's Second Amended and Restated Certificate of Incorporation with the Secretary of State of Delaware and its acceptance thereof and the Company's reservation of a sufficient number of shares of Class A common Stock for issuance on conversion of the Class D Common Stock;

- the conversion to Class A Common Stock by Brantley IV of the entire unpaid principal amount of, including accrued but unpaid interest on, the Company's convertible subordinated promissory notes in the aggregate original principal amount of $1,250,000;

- consummation, in the case of the Stock Purchase Agreement, of the transactions contemplated by the Note Purchase Agreement and, in the case of the Note Purchase Agreement, of the transactions contemplated by the Stock Purchase Agreement;

- in the case of the Stock Purchase Agreement, consummation by each of Phoenix and Brantley IV of their respective obligations under the Stock Purchase Agreement;

- consummation of the acquisitions of the Rand and On Line businesses;

- the accuracy of the Company's representations and warranties in the Private Placement Agreements as of the closing date taking into account in certain instances the inclusion of the Rand and On Line businesses as part of the Company's business;

- delivery of pro forma financial statements giving effect to the acquisitions of the Rand and On Line businesses, the consummation of the private placement, the conversion of the Brantley IV notes and the consummation of senior financing that are satisfactory to Phoenix and Brantley IV;

- the performance and compliance with all of the covenants made, and obligations to be performed, by the other parties in the Private Placement Agreements prior to the closing;



- the receipt of all requisite third-party consents;

- consummation with one or more senior lenders for the provision of not less than $6,500,000 of senior secured financing and, in the case of the Note Purchase Agreement, execution of mutually acceptable intercreditor and subordination agreement(s) among Phoenix, the

Company's senior lender and certain of the Company's existing debt holders; and

- conversion of all shares of Class B Common Stock and Class C Common Stock by the holders thereof into shares of Class A Common Stock or the Company's acquisition and retirement of all such shares, including the Company's purchase and retiring of the 1,722,983 shares of Class B Common Stock held by Brantley Capital Corporation.

In connection with the private placement, the parties will enter into a registration rights agreement, pursuant to which the holders of a majority of the shares of Class A Common Stock issuable upon either conversion of the Class D Common Stock or the exercise of the warrants will have the right to require the Company to register their shares of Class A Common Stock under the Securities Act. The agreement allows them one right to demand that the Company register their shares of Class A Common Stock under the Securities Act on a registration statement filed with the SEC and unlimited rights to include (or "piggy-back") the registration of their shares of Class A Common Stock on certain registration statements that the Company may file with the SEC for other purposes.

On September 8, 2006 the Company also entered into a purchase agreement with Brantley Capital Corporation to purchase all 1,722,983 shares of the Company's Class B Common Stock owned by Brantley Capital Corporation at any time between now and December 31, 2006 for an aggregate purchase price of $482,435. Upon the Company's acquisition of these shares of Class B Common Stock they will be retired in accordance with the terms of the Company's certificate of incorporation. The Company plans to consummate this purchase simultaneous with the closing of the private placement. The Company anticipates using a portion of the proceeds from the private placement, along with proceeds from senior bank financing and other funds available to the Company, to fund the purchase price for the Company's purchase of the shares of Class B Common Stock owned by Brantley Capital Corporation.

These shares represent about 16.5% of the Company's outstanding shares of Class B Common Stock (and about 11.5% of the Company's outstanding shares of Class A Common Stock on a fully-diluted basis assuming conversion as of September 30, 2006) and the Company's acquisition of these shares will assist the Company in satisfying the closing condition to the private placement that requires all holders of shares of the Company's Class B Common Stock and Class C Common Stock to have converted or been acquired by the Company. Brantley Capital Corporation had previously informed the Company that they would not convert their shares as required in connection with the consummation of the private placement and the Company's board of directors determined that the terms of this acquisition were in the best interests of the Company's stockholders and the Company's ability to consummate the private placement.

The transactions contemplated by the foregoing agreements are all expected to close simultaneously, if stockholder approval is obtained as required under the Private Placement Agreements and upon satisfaction of the other relevant closing conditions.

The Company intends to continue to manage its use of cash. However, the Company's business is still faced with many challenges. If cash flows from operations and borrowings are not sufficient to fund the Company's cash requirements, the Company may be required to further reduce its operations and/or seek additional public or private equity financing or financing from other sources or consider other strategic alternatives, including possible additional divestitures of specific assets or lines of business. Any acquisitions will require additional capital. There can be no assurances that additional financing will be available, or that, if available, the financing will be obtainable on terms acceptable to the Company or that any additional financing would not be substantially dilutive to the Company's existing stockholders.

NOTE 3. REVENUE RECOGNITION

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



IPS records revenue based on patient services provided by its affiliated medical groups. Net patient service revenue is impacted by billing rates, changes in Current Procedure Terminology code reimbursement and collection trends. IPS reviews billing rates at each of its affiliated medical groups on at least an annual basis and adjusts those rates based on each insurer's current reimbursement practices. Amounts collected by IPS for treatment by its affiliated medical groups of patients covered by Medicare, Medicaid and other contractual reimbursement programs, which may be based on cost of services provided or predetermined rates, are generally less than the established billing rates of IPS's affiliated medical groups. IPS estimates the amount of these contractual allowances and records a reserve against accounts receivable based on historical collection percentages for each of the affiliated medical groups, which include various payer categories. When payments are received, the contractual adjustment is written off against the established reserve for contractual allowances. The historical collection percentages are adjusted quarterly based on actual payments received, with any differences charged against net revenue for the quarter. Additionally, IPS tracks cash collection percentages for each medical group on a monthly basis, setting quarterly and annual goals for cash collections, bad debt write-offs and aging of accounts receivable.

As of September 30, 2006, the Company no longer has ownership or management interests in surgery and diagnostic centers. Orion's principal source of revenues from its surgery center business was a surgical facility fee charged to patients for surgical procedures performed in its ASCs and for diagnostic services performed at TOM. Orion depended upon third-party programs, including governmental and private health insurance programs to pay these fees on behalf of its patients. Patients were responsible for the co-payments and deductibles when applicable. The fees varied depending on the procedure, but usually included all charges for operating room usage, special equipment usage, supplies, recovery room usage, nursing staff and medications. Facility fees did not include the charges of the patient's surgeon, anesthesiologist or other attending physicians, which were billed directly to third-party payers by such physicians. In addition to the facility fee revenues, Orion also earned management fees from its operating facilities and development fees from centers that it developed. ASCs, such as those in which Orion owned an interest prior to September 30, 2006, depend upon third-party reimbursement programs, including governmental and private insurance programs, to pay for services rendered to patients. The Medicare program currently pays ASCs and physicians in accordance with fee schedules, which are prospectively determined. In addition to payment from governmental programs, ASCs derive a significant portion of their net revenues from private healthcare reimbursement plans. These plans include standard indemnity insurance programs as well as managed care structures such as preferred provider organizations, health maintenance organizations and other similar structures.

NOTE 4. USE OF ESTIMATES

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. While management believes current estimates are reasonable and appropriate, actual results could differ from those estimates.

NOTE 5. SEGMENT REPORTING

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 131, "Disclosures about Segments of an Enterprise and Related Information," the Company has determined that it has two reportable segments - IPS and MBS. The reportable segments are strategic business units that offer different products and services. They are managed separately because each business requires different technology, operational support and marketing strategies. The Company's reportable segments consist of: (i) IPS, which includes the pediatric medical groups that provide patient care operating under the MSA; and (ii) MBS, which provides practice management, billing and collections, managed care consulting and coding and reimbursement services to hospital-based physicians and clinics. Management chose to aggregate the MSAs into a single operating segment consistent with the objective and basic principles of SFAS No. 131 based on similar economic characteristics, including the nature of the products and services, the type of customer for their services, the methods used to provide their services and in consideration of the regulatory environment under Medicare and the Health Insurance Portability and Accountability Act of 1996.



The following table summarizes key financial information, by reportable segment, as of and for the three months and nine months ended September 30, 2006 and 2005, respectively:

| | For the Three Months Ended September 30, 2006 | | | For the Nine Month | |
|---|---|---|---|---|---|
| | IPS | MBS | Total | IPS | |
| Net operating revenues | $ 4,943,588 | $ 2,451,464 | $ 7,395,052 | $ 14,092,619 | $ 7, |
| Income from continuing operations | 272,860 | 230,982 | 503,842 | 760,952 | |
| Depreciation and amortization | 107,266 | 282,510 | 389,776 | 323,754 | |
| Total assets | 8,458,400 | 9,677,957 | 18,136,357 | 8,458,400 | 9, |

| | For the Three Months Ended September 30, 2005 | | | For the Nine Month | |
|---|---|---|---|---|---|
| | IPS | MBS | Total | IPS | |
| Net operating revenues | $ 4,720,121 | $ 2,491,109 | $ 7,211,230 | $ 14,766,113 | $ 7, |

| | | | | | |
|---|---|---|---|---|---|
| Income from continuing operations | 271,410 | 150,838 | 422,248 | 813,922 | |
| Depreciation and amortization | 107,748 | 285,180 | 392,928 | 352,758 | |
| Total assets | 9,792,125 | 9,930,670 | 19,722,795 | 9,792,125 | 9, |

The following schedules provide a reconciliation of the key financial information by reportable segment to the consolidated totals found in Orion's consolidated balance sheets and statements of operations as of and for the three months and nine months ended September 30, 2006 and 2005, respectively:

| | Three Months Ended September 30, | | Nine Months Septembe | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | |
| Net operating revenues: | | | | |
| Total net operating revenues for reportable segments | $ 7,395,052 | $ 7,211,230 | $21,300,136 | $ |
| Corporate revenue | 79,141 | 44,312 | 259,785 | |
| Total consolidated net operating revenues | $ 7,474,193 | $ 7,255,542 | $21,559,921 | $ |
| Income (loss) from continuing operations: | | | | |
| Total income from continuing operations for reportable segments | $ 503,842 | $ 422,248 | $ 1,330,824 | $ |
| Extraordinary gain | - | - | 665,463 | |
| Corporate overhead | (991,547) | (2,276,132) | (2,769,355) | |
| Total consolidated income (loss) from continuing operations | $ (487,705) | $(1,853,884) | $ (773,068) | $ |
| Depreciation and amortization: | | | | |
| Total depreciation and amortization for reportable segments | $ 389,776 | $ 392,928 | $ 1,172,146 | $ |
| Corporate depreciation and amortization | 18,188 | 215,616 | 54,645 | |
| Total consolidated depreciation and amortization | $ 407,964 | $ 608,544 | $ 1,226,791 | $ |
| Total assets: | | | | |
| Total assets for reportable segments | $18,136,357 | $19,722,795 | $18,136,357 | $ |
| Corporate assets | 1,640,670 | 1,870,063 | 1,640,670 | |
| Assets held for sale or related to discontinued operations (1) | - | 8,595,427 | - | |
| Total consolidated assets | $19,777,027 | $30,188,285 | $19,777,027 | $ |

(1) The balance at September 30, 2005 includes $5,522,881 of intangible assets and goodwill that were impaired in 2005.

NOTE 6. GOODWILL AND INTANGIBLE ASSETS

Goodwill and intangible assets represent the excess of cost over the fair value of net assets of companies acquired in business combinations accounted for using the purchase method. In July 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 eliminates pooling-of-interest accounting and requires that all business combinations initiated after June 30, 2001, be accounted for using the purchase method. SFAS No. 142 eliminates the amortization of goodwill and certain other intangible assets and requires the Company to evaluate goodwill for impairment on an annual basis by applying a fair value test. SFAS No. 142 also requires that an identifiable intangible asset that is determined to have an indefinite useful economic life not be amortized, but separately tested for impairment using a fair value-based approach at least annually.

The Company adopted SFAS No. 142 effective January 1, 2002. As a result, IPS determined that its long-term MSAs, executed as part of the medical group business combinations consummated in 1999, are an identifiable intangible asset in accordance with paragraph 39 of SFAS No. 141.

As part of the acquisition and restructuring transactions that closed on December 15, 2004, the Company recorded intangible assets and goodwill related to the 2004 Mergers. As of the Closing, the Company's management expected the case volumes at Bellaire SurgiCare to improve in 2005. However, by the end of February 2005, it was determined that the expected case volume increases were not going to be realized. On March 1, 2005, the Company closed Bellaire SurgiCare and consolidated its operations with the operations of Memorial Village. The Company tested the identifiable intangible assets and goodwill related to the surgery center business using the present value of cash flows method. As a result of the decision to close Bellaire SurgiCare and the resulting impairment of the joint venture interest and management contracts related to the surgery centers, the Company recorded a charge for impairment of intangible assets of $4,090,555 for the year ended December 31, 2004.

As a result of the CARDC Settlement described in Note 1. General - Description of Business - Integrated Physician Solutions, the Company recorded a charge for impairment of intangible assets related to CARDC of $704,927 for the year ended December 31, 2004.

On June 13, 2005, the Company announced that it had accepted an offer to purchase its interests in TASC and TOM in Dover, Ohio. In preparation for this pending transaction, the Company tested the identifiable intangible assets related to the surgery center business using the present value of cash flows method as of June 30, 2005. Based on the pending sales transaction involving TASC and TOM, as well as the uncertainty of future cash flows related to the Company's surgery center business, the Company determined that the joint venture interests associated with TASC, TOM and Memorial Village were impaired and recorded a charge for impairment of intangible assets of $6,362,849 for the quarter ended June 30, 2005. The sale of the Company's interests in TASC and TOM was completed effective as of October 1, 2005. (See Note 1. General - Description of Business - Ambulatory Surgery Center Business).

In November 2005, the Company decided that, as a result of ongoing losses at Memorial Village, it would need to either find a buyer for the Company's equity interests in Memorial Village or close the facility. In preparation for this expected transaction, the Company once again tested the identifiable intangible assets related to the surgery center business using the present value of cash flows method at September 30, 2005. Based on the decision to sell or close Memorial Village, as well as the continuing uncertainty of cash flows related to the Company's surgery center segment, the Company determined that the joint venture interests for San Jacinto, as well as the management contracts associated with Memorial Village and San Jacinto, were impaired and recorded an additional charge for impairment of intangible assets totaling $3,461,351 for the quarter ended September 30, 2005.

As described in Note 1. General - Description of Business - Ambulatory Surgery Center Business, effective January 31, 2006 and March 1, 2006, respectively, the Company executed Asset Purchase Agreements to sell substantially all of the assets of Memorial Village and San Jacinto. Also in the first quarter of 2006, the Company was notified by Union that it was exercising its option to terminate the TASC MSA and TOM MSA. As a result of the sales of Memorial Village and San Jacinto, as well as the termination of the TASC MSA and TOM MSA, the Company no longer has an ownership or management interest in any ambulatory surgery centers and, as such, the Company tested the remaining identifiable intangible assets related to the surgery centers from the IPS Merger at December 31, 2005. Based on the terminations of the TASC MSA and TOM MSA, as well as the sales of Memorial Village and San Jacinto, the Company determined that the management contracts associated with TASC and TOM were impaired and recorded an additional charge for impairment of intangible assets of $1,163,830 for the quarter ended December 31, 2005.

As a result of the Sutter Settlement, which is described in Note 1. General - Description of Business - Integrated Physician Solutions, the Company also recorded an additional $38,440 charge for impairment of intangible assets for the quarter ended December 31, 2005.

All of the charges for impairment of intangible assets are included in discontinued operations.

In order to determine whether the goodwill recorded as a result of the IPS Merger was impaired at December 31, 2005, the Company compared the fair value of each ASC's assets to its net carrying value. As each of the ASCs was sold between October 1, 2005 and March 1, 2006, the fair value of each ASC was best determined by the purchase price of the assets. Since TASC and TOM were sold effective October 1, 2005, the balance sheet at September 30, 2005 was used to determine the fair value of its assets. Since the Memorial Village and San Jacinto transactions took place after year-end, the December 31, 2005 balance sheets were used to determine the carrying value of the assets of those entities. The Company determined that the fair value of each ASC was greater than the carrying value in each case and concluded that there was no impairment of goodwill at December 31, 2005. As a result of the sale of all of the entities related to the Company's ambulatory surgery center business, the Company allocated the goodwill recorded as part of the IPS Merger to each of the surgery center reporting units and recorded a loss on the write-down of goodwill of $3,489,055 for the quarter ended December 31, 2005. The charge for the write-down of goodwill was included in discontinued operations in 2005.

## NOTE 7. EARNINGS PER SHARE

Basic earnings per share are calculated on the basis of the weighted average number of shares of Class A Common Stock outstanding at the end of the reporting periods. Diluted earnings per share, in addition to the weighted average determined for basic earnings per share, include common stock equivalents which would arise from the exercise of stock options and warrants using the treasury stock method, conversion of debt and conversion of Class B Common Stock and Class C Common Stock.

| | FOR THE THREE MONTHS ENDED SEPTEMBER 30, | | F E |
|---|---|---|---|
| | 2006 | 2005 | 200 |

| | | | |
|---|---|---|---|
| Net loss | $ (487,706) | $ (6,082,287) | $ (19 |
| Weighted average number of shares of Class A Common Stock outstanding for basic net loss per share | 12,777,363 | 11,344,066 | 12,60 |
| Dilutive stock options, warrants and restricted stock units | (a) | (a) | (a) |
| Convertible notes payable | (b) | (b) | (b) |
| Class B Common Stock | (c) | (c) | (c) |
| Class C Common Stock | (d) | (d) | (d) |
| Weighted average number of shares of Class A Common Stock outstanding for diluted net loss per share | 12,777,363 | 11,344,066 | 12,60 |
| Net loss per share - Basic | $ (0.04) | $ (0.53) | $ |
| Net loss per share - Diluted | $ (0.04) | $ (0.53) | $ |

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The following potentially dilutive securities are not included in the calculation of weighted average number of shares of Class A Common Stock outstanding for diluted net loss per share for the three months and nine months ended September 30, 2006 and 2005, respectively, because the effect would be anti-dilutive due to the net loss for the periods:

(1) 2,612,347 and 1,786,841 options, warrants and restricted stock units were outstanding as of September 30, 2006 and 2005, respectively.

(2) $1,300,000 of notes was convertible into Class A Common Stock at September 30, 2006 and 2005, respectively. Of the total, $50,000 was convertible into 391,832 shares of Class A Common Stock based on a conversion price equal to 75% of the average closing price for the 20 trading days immediately prior to September 30, 2006. The remaining $1,250,000 was convertible into 1,365,546 and shares of Class A Common Stock at September 30, 2006.

(3) 10,448,470 and 10,642,306 shares of Class B Common Stock were outstanding at September 30, 2006 and 2005, respectively. Holders of shares of Class B Common Stock have the option to convert their shares of Class B Common Stock into Class A Common Stock at any time based on a conversion factor in effect at the time of the transaction. The conversion factor is designed to yield one share of Class A Common Stock per share of Class B Common Stock converted, plus such additional shares of Class A Common Stock, or portions thereof, necessary to approximate the unpaid portion of the return of the original purchase price for the Class B Common Stock and a nine percent (9%) return on the original purchase price for the Class B Common Stock without compounding, from the date of issuance through the date of conversion. As of September 30, 2006 and 2005, respectively, each share of Class B Common Stock was convertible into 6.564372146119 and 4.158844397612 shares of Class A Common Stock.

(4) 1,437,572 and 1,462,121 shares of Class C Common Stock were outstanding at September 30, 2006 and 2005, respectively. Holders of shares of Class C Common Stock have the option to convert their shares of Class C Common Stock into shares of Class A Common Stock at any time based on a conversion factor in effect at the time of the

transaction. The conversion factor is designed initially to yield one share of Class A Common Stock per share of Class C Common Stock converted, with the number of shares of Class A Common Stock reducing to the extent that distributions are paid on the Class C Common Stock. The conversion factor is calculated as (x) the amount by which $3.30 exceeds the aggregate distributions made with respect to a share of Class C Common Stock divided by (y) $3.30. The initial conversion factor was one (one share of Class C Common Stock converts into one share of Class A Common Stock) and is subject to adjustment as discussed below. If the fair market value used in determining the conversion factor for the Class B Common Stock in connection with any conversion of Class B Common Stock is less than $3.30 (subject to adjustment to account for stock splits, stock dividends, combinations or other similar events affecting Class A Common Stock), holders of shares of Class C Common Stock have the option to convert their shares of Class C Common Stock (within 10 days of receipt of notice of the conversion of the Class B Common Stock) into a number of shares of Class A Common Stock equal to (x) the amount by which $3.30 exceeds the aggregate distributions made with respect to a share of Class C Common Stock divided by (y) the fair market value used in determining the conversion factor for the Class B Common Stock (the "Anti-Dilution Option"). The aggregate number of shares of Class C Common Stock so converted by any holder shall not exceed a number equal to (a) the number of shares of Class C Common Stock held by such holder immediately prior to such conversion plus the number of shares of Class C Common Stock previously converted in Class A Common Stock by such holder multiplied by (b) a fraction, the numerator of which is the number of shares of Class B Common Stock converted at the lower price and the denominator of which is the aggregate number of shares of Class B Common Stock issued at the closing of the 2004 Mergers. As of September 30, 2006 and 2005, respectively, each share of Class C Common Stock was convertible into 13.7500000 and 8.4615384 shares of Class A Common Stock under the anti-dilution provision.

Subject to the terms of any preferred stock or any other class of stock having any preference or priority over the Class A Common Stock, Class B Common Stock and Class C Common Stock that the Company may issue in the future, all dividends and other distributions will be made to the holders of Class A Common Stock, Class B Common Stock and Class C Common Stock in the following order of priority:

- First, the holders of the shares of Class B Common Stock (other than shares concurrently being converted into Class A Common Stock), as a single and separate class, are entitled to receive all distributions until there has been paid with respect to each such share from amounts then and previously distributed an amount equal to $1.15 plus an amount equal to nine percent (9%) per annum on such amount, without compounding, from the date the Class B Common Stock was first issued.

- Second, the holders of the shares of Class C Common Stock (other than shares concurrently being converted into Class A Common Stock), as a single and separate class, are entitled to receive all distributions until there has been paid with respect to each such share from amounts then and previously distributed an amount equal to $3.30. After the full required distributions have been made to the holders of shares of Class C Common Stock (other than shares concurrently being converted into Class A Common Stock) as described in the previous sentence, each share of Class C Common Stock then outstanding will be retired and will not be reissued.

- Third, after the full distributions have been made to the holders of the shares of Class B Common Stock and Class C Common Stock as described above, all holders of the shares of Class A Common Stock and Class B Common Stock, as a single class, shall thereafter be entitled to receive all remaining distributions pro rata based on the number of outstanding shares of Class A Common Stock or Class B Common Stock held by each holder, provided that for purposes of such remaining distributions, each share of Class B Common Stock will be deemed to have been converted into one share of Class A Common Stock (subject to adjustment to account for stock splits, stock dividends, combinations or other similar events affecting the Class A Common Stock).

NOTE 8. EMPLOYEE STOCK-BASED COMPENSATION

At September 30, 2006, the Company had two stock-based employee compensation plans. Prior to January 1, 2006, the Company accounted for grants for these plans under Accounting Principals Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees" ("APB 25") and related interpretations, and applied SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure," for disclosure purposes only. Under APB 25, stock-based compensation cost related to stock options was not recognized in net income since the options underlying those plans had exercise prices greater than or equal to the market value of the underlying stock on the date of the grant. The Company grants options at or above the market price of its common stock at the date of each grant.

On June 17, 2005, the Company granted 1,357,000 stock options to certain employees, officers, directors and former directors of the Company under the Company's 2004 Incentive Plan, as amended. In the third quarter of 2005, stock options totaling 360,000 to certain employees were cancelled as a result of staff reductions related to the consolidation of corporate functions duplicated at the Company's Houston, Texas and Roswell, Georgia facilities. On May 12, 2006, the Company granted 102,000 stock options to certain employees and directors of the Company under the Company's 2004 Incentive Plan, as amended.

On August 31, 2005, the Company granted 650,000 restricted stock units to certain officers of the Company under the Company's 2004 Incentive Plan, as amended. No restricted stock units have been granted in 2006.

Effective January 1, 2006, the company adopted SFAS No. 123 (revised 2004), "Share Based Payment," ("SFAS No. 123(R)") which revises SFAS No. 123 and supersedes APB 25. SFAS No. 123(R) requires that all share-based payments to employees be recognized in the financial statements based on their fair values at the date of grant. The calculated fair value is recognized as expense (net of any capitalization) over the requisite service period, net of estimated forfeitures, using the straight-line method under SFAS No. 123(R). The Company considers many factors when estimated expected forfeitures, including types of awards, employee class and historical experience. The statement was adopted using the modified prospective method of application which requires compensation expense to be recognized in the financial statements for all unvested stock options beginning in the quarter of adoption. No adjustments to prior periods have been made as a result of adopting SFAS No. 123(R). Under this transition method, compensation expense for share-based awards granted prior to January 1, 2006, but not yet vested as of January 1, 2006, will be recognized in the Company's financial statements over their remaining service period. The cost was based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123. As required by SFAS No. 123(R), compensation expense recognized in future periods for share-based compensation granted prior to adoption of the standard will be adjusted for the effects of estimated forfeitures.

For the three months and nine months ended September 30, 2006, the impact of adopting SFAS No. 123(R) on the Company's consolidated condensed statements of operations was an increase in salaries and benefits expense of $49,642 and $97,713, respectively, with a corresponding decrease in the Company's income from continuing operations, income before provision for income taxes and net income resulting from the recognition of compensation expense associated with employee stock options. There was no material impact on the Company's basic and diluted net income per share as a result of the adoption of SFAS No. 123(R).

The adoption of SFAS No. 123(R) has no effect on net cash flow. Since the Company is not presently a taxpayer and has provided a valuation allowance against deferred income tax assets net of liabilities, there is also no effect on the Company's consolidated statement of cash flows. Had the Company been a taxpayer, the Company would have recognized cash flow resulting from tax deductions in excess of recognized compensation cost as a financing cash flow.



The following table illustrates the pro forma net income and earnings per share that would have resulted in the three months and nine months ended September 30, 2005 from recognizing compensation expense associated with accounting for employee stock-based awards under the provisions of SFAS No. 123(R). The reported and pro forma net income and earnings per share for the three months and nine months ended September 30, 2006 are provided for comparative purposes only, since stock-based compensation expense is recognized in the financial statements under the provisions of SFAS No.123(R).

| | THREE MONTHS ENDED SEPTEMBER 30, | | NI |
|---|---|---|---|
| | 2006 | 2005 | |
| Net income (loss) - as reported | $ (487,706) | $ (6,082,287) | $ |
| Add: Stock-based employee compensation included in net income (loss) | 49,642 | -- | |
| Deduct: Total stock-based employee compensation (expense determined under the fair value-based method for all awards), net of tax effect | (49,642) | (45,831) | |
| Net loss - pro forma | $ (487,705) | $ (6,128,118) | $ |
| Net loss per share: | | | |
| Basic - as reported | $ (0.04) | $ (0.53) | $ |
| Basic - pro forma | $ (0.04) | $ (0.53) | $ |
| Diluted - as reported | $ (0.04) | $ (0.53) | $ |
| Diluted - pro forma | $ (0.04) | $ (0.53) | $ |

NOTE 9. DISCONTINUED OPERATIONS

BELLAIRE SURGICARE. As of the Closing, the Company's management expected the case volumes at Bellaire SurgiCare to improve in 2005. However, by the end of February 2005, it was determined that the expected case volume increases were not going to be realized. On March 1, 2005, the Company closed Bellaire SurgiCare and consolidated its operations with the operations of Memorial Village. The Company tested the identifiable intangible assets and goodwill related to the surgery center business using the present value of cash flows method. As a result of the decision to close Bellaire SurgiCare and the resulting impairment of the joint venture interest and management contracts related to the surgery centers, the Company recorded a charge for impairment of intangible assets of $4,090,555 for the year ended December 31, 2004. The Company also recorded a loss on disposal of this discontinued component (in addition to the charge for impairment of intangible assets) of $163,049 for the quarter ended March 31, 2005. The operations of this component are reflected in the Company's consolidated condensed statements of operations as `loss from operations of discontinued components' for the three months and nine months ended September 30, 2005. There were no operations for this component after March 31, 2005.

The following table contains selected financial statement data related to Bellaire SurgiCare as of and for the three months and nine months ended September 30, 2005:

| | THREE MONTHS ENDED SEPTEMBER 30, 2005 | NINE MONTHS ENDED SEPTEMBER 30, 200 |
|---|---|---|
| Income statement data: | | |
| Net operating revenues | $ -- | $ 161,679 |
| Operating expenses | -- | 350,097 |
| Net loss | $ -- | $ (188,418) |
| Balance sheet data: | | |
| Current assets | $ -- | $ -- |
| Other assets | -- | -- |
| Total assets | $ -- | $ -- |
| Current liabilities | $ -- | $ -- |
| Other liabilities | -- | -- |
| Total liabilities | $ -- | $ -- |



CARDC. On April 1, 2005, IPS entered into the CARDC Settlement with Dr. Bradley E. Chipps, M.D. and CARDC to settle disputes as to the existence and enforceability of certain contractual obligations. As part of the CARDC Settlement, Dr. Chipps, CARDC, and IPS agreed that CARDC would purchase the assets owned by IPS and used in connection with CARDC, in exchange for termination of the MSA between IPS and CARDC. Additionally, among other provisions, after April 1, 2005, Dr. Chipps, CARDC and IPS have been released from any further obligation to each other arising from any previous agreement. As a result of the CARDC dispute, the Company recorded a charge for impairment of intangible assets related to CARDC of $704,927 for the year ended December 31, 2004. The Company also recorded a gain on disposal of this discontinued component (in addition to the charge for impairment of intangible assets) of $506,625 for the quarter ended March 31, 2005. For the quarter ended June 30, 2005, the Company reduced the gain on disposal of this discontinued component by $238,333 as the result of post-settlement adjustments related to the reconciliation of balance sheet accounts. The operations of this component are reflected in the Company's consolidated condensed statements of operations as `loss from operations of discontinued components' for the three months and nine months ended September 30, 2005. There were no operations for this component in the Company's financial statements after March 31, 2005.

| | THREE MONTHS ENDED SEPTEMBER 30, 2005 | NINE MONTHS ENDED SEPTEMBER 30, 200 |
|---|---|---|
| Income statement data: | | |
| Net operating revenues | $ -- | $ 848,373 |
| Operating expenses | -- | 809,673 |
| Net loss | $ -- | $ 38,700 |
| Balance sheet data: | | |
| Current assets | $ -- | $ -- |
| Other assets | -- | -- |
| Total assets | $ -- | $ -- |
| Current liabilities | $ -- | $ -- |
| Other liabilities | -- | -- |
| Total liabilities | $ -- | $ -- |

INTEGRIMED. On June 7, 2005, as described in Note 1. General - Description of Business - Integrated Physician Solutions, IPS executed an Asset Purchase Agreement with eClinicalWeb to sell substantially all of the assets of IntegriMED. As a result of this transaction, the Company recorded a loss on disposal of this discontinued component of $47,101 for the quarter ended June 30, 2005. The operations of this component are reflected in the Company's consolidated condensed statements of operations as `loss from operations of discontinued components' for the three months and nine months ended September 30, 2005. There were no operations for this component in the Company's financial statements after June 30, 2005.

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

| | THREE MONTHS ENDED SEPTEMBER 30, 2005 | NINE MONTHS ENDED SEPTEMBER 30, 200 |
|---|---|---|
| Income statement data: | | |

| | | |
|---|---|---|
| Net operating revenues | $ -- | $ 191,771 |
| Operating expenses | -- | 899,667 |
| Net loss | $ -- | $ (707,896) |
| Balance sheet data: | | |
| Current assets | $ -- | $ -- |
| Other assets | -- | -- |
| Total assets | $ -- | $ -- |
| Current liabilities | $ -- | $ -- |
| Other liabilities | -- | -- |
| Total liabilities | $ -- | $ -- |

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TASC AND TOM. On June 13, 2005, the Company announced that it had accepted an offer to purchase its interests in TASC and TOM in Dover, Ohio. These transactions, which were consummated on September 30, 2005, were deemed to be effective as of October 1, 2005, and are described in greater detail in Note 1. General - Description of Business - Ambulatory Surgery Center Business. As a result of these transactions, as well as the uncertainty of future cash flows related to the Company's surgery center business, the Company determined that the joint venture interests associated with TASC and TOM were impaired and recorded a charge for impairment of intangible assets related to TASC and TOM of $2,122,445 for the three months ended June 30, 2005. As a result of these transactions, the Company recorded a gain on disposal of this discontinued component (in addition to the charge for impairment of intangible assets) of $1,357,712 for the quarter ended December 31, 2005. The Company allocated the goodwill recorded as part of the IPS Merger to each of the surgery center reporting units and recorded a loss on the write-down of goodwill related to TASC and TOM totaling $789,173 for the quarter ended December 31, 2005, which reduced the gain on disposal. The operations of this component are reflected in the Company's consolidated condensed statements of operations as `loss from operations of discontinued components' for the three months and nine months ended September 30, 2005. There were no operations for this component in the Company's financial statements after September 30, 2005.

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

| | THREE MONTHS ENDED SEPTEMBER 30, 2005 | NINE MONTHS ENDED SEPTEMBER 30, 2005 |
|---|---|---|
| Income statement data: | | |
| Net operating revenues | $ 737,355 | $ 2,408,156 |
| Operating expenses | 827,429 | 2,467,111 |
| Net loss | $ (90,074) | $ (58,956) |

| | | |
|---|---|---|
| Balance sheet data: | | |
| Current assets | $ 641,172 | $ 641,172 |
| Other assets | 1,398,449 | 1,398,449 |
| Total assets | $ 2,039,621 | $ 2,039,621 |
| Current liabilities | $ 617,186 | $ 617,186 |
| Other liabilities | 828,312 | 828,312 |
| Total liabilities | $ 1,445,498 | $ 1,445,498 |

SUTTER. On October 31, 2005, IPS executed the Sutter Settlement with Dr. Sutter to settle disputes that had arisen between IPS and Dr. Sutter and to avoid the risk and expense of litigation. As part of the Sutter Settlement, Dr. Sutter and IPS agreed that Dr. Sutter would purchase the assets owned by IPS and used in connection with Dr. Sutter's practice, in exchange for termination of the MSA between IPS and Dr. Sutter. Additionally, among other provisions, after October 31, 2005, Dr. Sutter and IPS have been released from any further obligation to each other arising from any previous agreement. As a result of this transaction, the Company recorded a loss on disposal of this discontinued component (in addition to the charge for impairment of intangible assets of $38,440 recorded in the fourth quarter of 2005) of $279 for the quarter ended December 31, 2005. The operations of this component are reflected in the Company's consolidated condensed statements of operations as `loss from operations of discontinued components' for the three months and nine months ended September 30, 2005. There were no operations for this component in the Company's financial statements after October 31, 2005.

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

| | THREE MONTHS ENDED SEPTEMBER 30, 2005 | NINE MONTHS ENDED SEPTEMBER 30, 2005 |
|---|---|---|
| Income statement data: | | |
| Net operating revenues | $106,151 | $322,470 |
| Operating expenses | 103,440 | 314,049 |
| Net income | $ 2,711 | $ 8,421 |
| Balance sheet data: | | |
| Current assets | $102,924 | $102,924 |
| Other assets | 14,066 | 14,066 |
| Total assets | $116,990 | $116,990 |
| Current liabilities | $ 21,778 | $ 21,778 |
| Other liabilities | -- | -- |
| Total liabilities | $ 21,778 | $ 21,778 |

MEMORIAL VILLAGE. As a result of the uncertainty of future cash flows related to our surgery center business as well as the transactions related to TASC and TOM, the Company determined that the joint venture interest associated with Memorial Village was impaired and recorded a charge for impairment of intangible assets related to Memorial Village of $3,229,462 for the three months ended June 30, 2005. In November 2005, the Company decided that, as a result of ongoing losses at Memorial Village, it would need to either find a buyer for the Company's equity interests in Memorial Village or close the facility. In preparation for this pending transaction, the Company tested the identifiable intangible assets and goodwill related to the surgery center business using the present value of cash flows method. As a result of the decision to sell or close Memorial Village, as well as the uncertainty of cash flows related to the Company's surgery center business, the Company recorded an additional charge for impairment of intangible assets of $1,348,085 for the three months ended September 30, 2005. As described in Note 1. General - Description of Business - Ambulatory Surgery Center Business, effective January 31, 2006, the Company executed an Asset Purchase Agreement to sell substantially all of the assets of Memorial Village. As a result of this transaction, the Company recorded a gain on the disposal of this discontinued component (in addition to the charge for impairment of intangible assets) of $574,321 for the quarter ended March 31, 2006. The Company allocated the goodwill recorded as part of the IPS Merger to each of the surgery center reporting units and recorded a loss on the write-down of goodwill related to Memorial Village totaling $2,005,383 for the quarter ended December 31, 2005. The operations of this component are reflected in the Company's consolidated statements of operations as 'loss from operations of discontinued components' for the three months and nine months ended September 30, 2006 and 2005, respectively.

The following table contains selected financial statement data related to Memorial Village as of and for the three months and nine months ended September 30, 2006 and 2005, respectively:

| | THREE MONTHS ENDED | | N |
|---|---|---|---|
| | SEPTEMBER 30, 2006 | SEPTEMBER 30, 2005 | SEPTEMBER 3 |
| Income statement data: | | | |
| Net operating revenues | $ -- | $ 61,046 | $ 17,249 |
| Operating expenses | -- | 817,575 | 170,285 |
| Net loss | $ -- | $(756,529) | $(153,036) |
| Balance sheet data: | | | |
| Current assets | $ -- | $ 414,255 | $ -- |
| Other assets | -- | 552,107 | -- |
| Total assets | $ -- | $ 966,362 | $ -- |
| Current liabilities | $ -- | $ 940,149 | $ -- |
| Other liabilities | 52,546 | 52,546 | |
| Total liabilities | $ -- | $ 992,695 | $ -- |

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SAN JACINTO. As described in Note 1. General - Description of Business - Ambulatory Surgery Center Business, effective March 1, 2006, the Company executed an Asset Purchase Agreements to sell substantially all of the assets of San Jacinto, which is 10% owned by Baytown SurgiCare, Inc., a wholly owned subsidiary of the Company and is not consolidated in the Company's financial statements. As a result of this transaction, the Company recorded a gain on disposal of this discontinued operation of $94,066 for the quarter ended March 31, 2006. As a result of the uncertainty of future cash flows related to the surgery center business, and in conjunction with the transactions related to TASC and TOM, the Company determined that the joint venture interest associated with San Jacinto was impaired and recorded a charge for impairment of intangible assets related to San Jacinto of $734,522 for the three months ended June 30, 2005. The Company also recorded an additional $2,113,262 charge for impairment of intangible assets for the three months ended September 30, 2005 related to the management contracts with San Jacinto. The Company allocated the goodwill recorded as part of the IPS Merger to each of the surgery center reporting units and recorded a loss on the write-down of goodwill related to San Jacinto totaling $694,499 for the quarter ended December 31, 2005. There were no operations for this component in our financial statements after March 31, 2006.



ORION. Prior to the divestiture of the Company's ambulatory surgery center business, the Company recorded management fee revenue, which was eliminated in the consolidation of the Company's financial statements, for Bellaire SurgiCare, TASC and TOM and Memorial Village. The management fee revenue for San Jacinto was not eliminated in consolidation. The management fee revenue associated with the discontinued operations in the surgery center business totaled $0 and $61,039, respectively, for the three months and nine months ended September 30, 2006. For the three months and nine months ended September 30, 2005, the Company generated management fee revenue of $101,662 and $320,069, respectively, and net minority interest losses totaling $24,823 and $67,588, respectively. For the quarters ended June 30, 2005 and December 31, 2005, the Company recorded a charge for impairment of intangible assets of $276,420 and $142,377, respectively, related to trained work force and non-compete agreements affected by the surgery center operations the Company discontinued in 2005 and early 2006.

The following table summarizes the components of income (loss) from operations of discontinued components:

| | THREE MONTHS ENDED | | NINE |
|---|---|---|---|
| | SEPTEMBER 30, 2006 | SEPTEMBER 30, 2005 | SEPTEMBER 30 |
| Bellaire SurgiCare | | | |
| Net loss | $-- | $ -- | $ -- |
| Loss on disposal | -- | -- | -- |
| CARDC | | | |
| Net income | -- | -- | -- |
| Gain on disposal | -- | -- | -- |
| IntegriMED | | | |
| Net loss | -- | -- | -- |
| Loss on disposal | -- | -- | -- |
| TASC and TOM | | | |

| | | | |
|---|---|---|---|
| Net loss | -- | (90,074) | -- |
| Loss on disposal | -- | -- | -- |
| Sutter | | | |
| Net income | -- | 2,711 | -- |
| Memorial Village | | | |
| Net loss | -- | (756,529) | (153,036 |
| Gain (loss) on disposal | -- | (1,348,085) | 574,321 |
| San Jacinto | | | |
| Gain (loss) on disposal | -- | (2,113,262) | 94,066 |
| Orion | | | |
| Net income | -- | 76,835 | 61,039 |
| Total income (loss) from operations of discontinued components, including net gain (loss) on disposal | $-- | $(4,228,403) | $ 576,390 |



NOTE 10. LONG-TERM DEBT

Long-term debt is as follows:

| | SEPTEMBER 30, 2006 | D |
|---|---|---|
| Promissory note due to sellers of MBS, bearing interest at 8%, interest payable monthly or on demand, matures December 15, 2007 | $ 1,714,336 | |
| Working capital due to sellers of MBS, due on demand | -- | |
| Term loan with a financial institution, non-interest bearing, matures November 15, 2010, net of accretion of $654,010 and $641,467, respectively | 3,096,134 | |
| Revolving line of credit with a financial institution, bearing interest at 6.5%, interest payable monthly or on demand (1) | -- | |
| $2,300,000 revolving line of credit, bearing interest at prime (8.25% at September 30, 2006) plus 6%, interest payable monthly, matures December 14, 2006 (2) | 1,008,282 | |
| Convertible notes, bearing interest at 18%, interest payable monthly, convertible on demand | 50,000 | |
| Note payable due to a related party, bearing interest at 6%, interest payable monthly, due on demand | -- | |
| Insurance financing note payable, bearing interest at 5.25%, interest payable monthly | 168,156 | |
| Convertible promissory notes due to a related party, bearing interest at 9%, mature November 30, 2006 | 1,250,000 | |
| Total long-term debt | 7,286,908 | |
| Less: current portion of long-term debt | (3,491,527) | |

| | |
|---|---|
| Long-term debt, net of current portion | $ 3,795,381 |

(1) As of March 13, 2006, the Company had retired approximately $778,000 of debt at a discounted price of $112,500.

(2) As part of the Loan and Security Agreement, the Company is required to comply with certain financial covenants, measured on a quarterly basis. The financial covenants include maintaining a required debt service coverage ratio and meeting a minimum operating income level for the surgery and diagnostic centers before corporate overhead allocations. At September 30, 2006, the Company was out of compliance with both of these financial covenants and has notified the lender as such. Under the terms of the Loan and Security Agreement, failure to meet the required financial covenants constitutes an event of default. Under an event of default, the lender may (i) accelerate and declare the obligations under the credit facility to be immediately due and payable; (ii) withhold or cease to make advances under the credit facility; (iii) terminate the credit facility; (iv) take possession of the collateral pledged as part of the Loan and Security Agreement; (v) reduce or modify the revolving loan commitment; and/or (vi) take necessary action under the Guaranties. The full amount of the loan as of September 30, 2006 is recorded as a current liability. In December 2005, the Company received notification from CIT stating that (i) certain events of default under the Loan and Security Agreement had occurred as a result of the Company being out of compliance with two financial covenants relating to its debt service coverage ratio and its minimum operating income level, (ii) as a result of the events of default, CIT raised the interest rate for monies borrowed under the Loan and Security Agreement to the provided "Default Rate" of prime rate plus 6%, (iii) the amount available under the revolving credit facility was reduced to $2,300,000 and (iv) CIT reserved all additional rights and remedies available to it as a result of these events of default. The Company is currently in negotiations with CIT to obtain, among other provisions, a waiver of the events of default. In the event CIT declares the obligations under the Loan and Security Agreement to be immediately due and payable or exercises its other rights described above, the Company would not be able to meet its obligations to CIT or its other creditors. As a result, such action would have a material adverse effect on the Company's ability to continue as a going concern.



## NOTE 11. LITIGATION

On January 1, 1999, IPS acquired Children's Advanced Medical Institutes, Inc. ("CAMI") in a merger transaction. On that same date, IPS began providing management services to the Children's Advanced Medical Institutes, P.A. (the "P.A."), an entity owned by the physicians affiliated with CAMI. The parties' rights and obligations were memorialized in a merger agreement, a management services agreement and certain other agreements. On February 7, 2000, the P.A., certain physicians affiliated with the P.A., and the former shareholders of CAMI filed suit against IPS in the U.S. District Court for the Northern District of Texas, Dallas Division, Civil Action File No. 3-00-CV-0536-L. On May 9, 2001, IPS (which was formerly known as Pediatric Physician Alliance, Inc.) filed suit against the P.A., certain physicians who were members of the P.A., and Patrick Solomon as Escrow Agent of CAMI. The case was filed in the U.S. District Court for the Northern District of Texas, Dallas Division, Civil Action File No. 3-01CV0877-L. In their complaint, the P.A., the former shareholders of CAMI and the physicians seek a claim against IPS for approximately $500,000 (which includes interest and attorneys' fees). IPS asserted a claim against the physicians for over $5,000,000 due to the overpayments and their alleged breach of the agreements. An arbitration hearing was held on the claim filed by the former shareholders of CAMI in January 2004, and the Arbitrator issued an award against IPS. The U.S. District Court confirmed the award in the amount of $548,884 and judgment was entered. IPS has accrued approximately $540,000 for possible losses related to this claim. On June 1, 2005, IPS and the physicians executed a settlement agreement under which $300,000 of the judgment was paid to the physicians with the remaining amount of the judgment being returned to IPS. All claims asserted in the lawsuit and arbitration were dismissed with prejudice.

On October 5, 2004, Orion's predecessor, SurgiCare, was named as a defendant in a suit entitled Shirley Browne and Bellaire Anesthesia Management Consultants, Inc. ("BAMC") v. SurgiCare, Inc., Bellaire SurgiCare, Inc., Sherman Nagler, Jeffrey Penso, and Michael Mineo, in the 152nd Judicial District Court of Harris County, Texas, Cause No. 2004-55688. The dispute arises out of the for cause termination of BAMC's exclusive contract to provide anesthesia services to Bellaire SurgiCare, Inc. Ms. Browne had filed a charge of discrimination with the EEOC on February 6, 2004, claiming that she was terminated in retaliation for having previously complained about discriminatory treatment and a hostile work environment. She claimed she had been discriminated against based on her sex, female, and retaliated against in violation of Title VII. The Company denied Ms. Browne's allegations of wrongdoing. The EEOC declined to institute an action and issued a right to sue letter, which prompted the lawsuit. The parties have reached a final settlement, which was accrued for as of September 30, 2005 and paid on December 27, 2005, on all matters for dismissal of all claims.

On July 12, 2005, the Company was named as a defendant in a suit entitled American International Industries, Inc. ("AII") vs. Orion HealthCorp, Inc. (previously known as SurgiCare, Inc.), Keith G. LeBlanc, Paul Cascio, Brantley Capital Corporation, Brantley Venture Partners III, L.P., Brantley Partners IV, L.P. (collectively, "the Named Defendants") and UHY Mann Frankfort Stein & Lipp CPAs, LLP ("UHY Mann") in the 80th Judicial District Court of Harris County, Texas, Cause No. 2005-44326. The case involved allegations that the Company made material and intentional misrepresentations regarding the financial condition of the parties to the acquisition and restructuring transactions effected on December 15, 2004 for the purpose of inducing AII to convert its SurgiCare Class AA convertible preferred stock into shares of the Company's Class A Common Stock. AII asserted that the value of its Class A Common Stock of Orion had fallen as a direct result of the alleged material misrepresentations by the Company. AII was seeking an aggregate of $7,600,000 in damages (actual damages of $3,800,000 and punitive damages of $3,800,000), and rescission of the agreement to convert the SurgiCare Class AA convertible preferred stock into Class A Common Stock. On September 8, 2006, the Company entered into a Settlement Agreement with a Joint and Mutual Release and Indemnity Agreement (the "AII Settlement Agreement") in which the claims by AII against the Named Defendants were fully settled as to all claims, with complete mutual releases for all of the Named Defendants and AII. Under the terms of the AII Settlement Agreement, AII will receive $750,000, paid primarily by various insurance carriers of the Named Defendants, on or before 45 days from the execution of the AII Settlement Agreement. As part of the AII Settlement Agreement, the Named Defendants vigorously denied any liability and AII acknowledged the highly disputed nature of its claims against the Named Defendants. Both the Named Defendants and AII acknowledged that the AII Settlement Agreement was made as a compromise to avoid further expense and to terminate for all time the controversy underlying the lawsuit.

In addition, the Company is involved in various other legal proceedings and claims arising in the ordinary course of business. The Company's management believes that the disposition of these additional matters, individually or in the aggregate, is not expected to have a materially adverse effect on the Company's financial condition. However, depending on the amount and timing of such disposition, an unfavorable resolution of some or all of these matters could materially affect the Company's future results of operations or cash flows in a particular period.

NOTE 12. SUBSEQUENT EVENTS

On October 15, 2006, Brantley IV and the Company executed the First and Second Note Third Amendment, which extends the First Note Maturity Date and Second Note Maturity Date to November 30, 2006. (See Note 2. Going Concern).

On November 1, 2006, the Company issued 125,000 shares of Class A Common Stock to Keith LeBlanc, former president of the Company, in connection with restricted stock units that were granted to him on August 31, 2005. Per the terms of Mr. LeBlanc's separation agreement, 125,000 of the 250,000 restricted stock units vested on January 1, 2006 and the remaining 125,000 units will vest on January 1, 2007. In the separation agreement, Mr. LeBlanc agreed to refrain from trading any of the restricted stock units for a period of one year commencing on November 1, 2005.



On November 9, 2006, the Company filed a definitive proxy statement with the SEC on Form DEF14A with respect to the transactions contemplated by the Rand Stock Purchase Agreement, the Online Stock Purchase Agreement, the Private Placement Agreements and the Purchase Agreement, which are described in Note 2. Going Concern, and set a special stockholders meeting date of November 27, 2006 for approval of certain changes in corporate structure which will enable the Company to consummate the aforementioned transactions.



EXHIBIT INDEX

| EXHIBIT NO. | DESCRIPTION |
|---|---|
| Exhibit 31.1 | Rule 13a-14(a)/15d-14(a) Certification |
| Exhibit 31.2 | Rule 13a-14(a)/15d-14(a) Certification |
| Exhibit 32.1 | Section 1350 Certification |
| Exhibit 32.2 | Section 1350 Certification |