

ALLIANCE IMAGING INC /DE/  
Form 10-Q/A  
August 01, 2007

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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## FORM 10-Q/A

(Amendment No. 1)

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

For Quarter Ended: March 31, 2007

Commission File Number: 1-16609

## ALLIANCE IMAGING, INC.

(Exact name of registrant as specified in its charter)

**DELAWARE**

(State or other jurisdiction of  
incorporation or organization)

**33-0239910**

(IRS Employer Identification Number)

**1900 South State College Boulevard  
Suite 600  
Anaheim, California 92806**

(Address of principal executive office)

**(714) 688-7100**

(Registrant's telephone number, including area code)

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

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

Large accelerated filer  Accelerated Filer  Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of April 30, 2007:

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Common Stock, \$.01 par value, 50,221,262 shares

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**ALLIANCE IMAGING, INC.**

**FORM 10-Q/A**

**For the Fiscal Quarter Ended March 31, 2007**

**Explanatory Note**

Alliance Imaging, Inc. (the Company) is filing this Amendment No. 1 to its Quarterly Report on Form 10-Q for the quarter ended March 31, 2007 (the 10-Q), originally filed on May 10, 2007, to restate its condensed consolidated balance sheet as of March 31, 2007 and its condensed consolidated statements of operations and comprehensive income and condensed consolidated statements of cash flows for the quarters ended March 31, 2007 and 2006, and related disclosures. Please refer to Note 13 to the accompanying condensed consolidated financial statements for additional information.

Subsequent to the filing of the 10-Q, the Company identified an error with respect to the accounting for interest rate swap agreements. The swap agreements were executed in 2004 and mature at various dates in 2007. Since inception the Company had recorded the unrealized gains and losses in fair value of the swap agreements through other comprehensive income (loss). The Company has determined that these transactions do not meet the requirements for hedge accounting treatment and any unrealized gains or losses should have been recognized through earnings.

This Amendment No. 1 does not result in a change in the Company's previously reported revenues, cash flow from operations or total cash and cash equivalents shown in its condensed consolidated financial statements. Furthermore, the Company has not modified or updated disclosures presented in this Form 10-Q/A, except as required to reflect the effects of the items discussed above. Accordingly, this Form 10-Q/A does not reflect events occurring after the filing of the 10-Q or modify or update those disclosures affected by subsequent events or discoveries. Information not affected by these restatements is unchanged and reflects the disclosures made at the time of the original filing of the 10-Q on May 10, 2007.

The following items have been amended as a result of the restatements described above:

Part I Item 1 Financial Statements

Part I Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations

Part I Item 3 Quantitative and Qualitative Disclosures About Market Risk

Part I Item 4 Controls and Procedures

**ALLIANCE IMAGING, INC.**  
**FORM 10-Q/A**  
**March 31, 2007**  
**Index**

|   | <b>Page</b> |
|---|-------------|
| <u>PART I FINANCIAL INFORMATION</u>   |             |
| <u>Item 1 Financial Statements:</u>   |             |
| <u>Condensed Consolidated Balance Sheets (Unaudited)</u>  |             |
| <u>December 31, 2006 and March 31, 2007 (as restated)</u>   | 3           |
| <u>Condensed Consolidated Statements of Operations and Comprehensive Income (Unaudited) Quarter ended March 31, 2006 and 2007 (as restated)</u> | 4           |
| <u>Condensed Consolidated Statements of Cash Flows (Unaudited)</u>  |             |
| <u>Quarter ended March 31, 2006 and 2007 (as restated)</u>  | 5           |
| <u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>   | 6           |
| <u>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u>   | 19          |
| <u>Item 3 Quantitative and Qualitative Disclosures about Market Risk</u>  | 26          |
| <u>Item 4 Controls and Procedures</u>   | 27          |
| <u>PART II OTHER INFORMATION</u>  |             |
| <u>Item 1 Legal Proceedings</u>   | 29          |
| <u>Item 1A Risk Factors</u>   | 29          |
| <u>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</u>   | 30          |
| <u>Item 3 Defaults Upon Senior Securities</u>   | 30          |
| <u>Item 4 Submission of Matters to a Vote of Security Holders</u>   | 30          |
| <u>Item 5 Other Information</u>   | 30          |
| <u>Item 6 Exhibits</u>  | 31          |
| <u>SIGNATURES</u>   | 34          |

## PART I FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

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

|   | December 31,<br>2006 | March 31,<br>2007<br>(as restated,<br>see Note 13) |
|---|----------------------|--|
| <b>ASSETS</b>   |                      |  |
| Current assets:   |                      |  |
| Cash and cash equivalents                                   | \$ 16,440            | \$ 30,581  |
| Accounts receivable, net of allowance for doubtful accounts | 51,569               | 54,044   |
| Deferred income taxes                                       | 20,199               | 23,473   |
| Prepaid expenses and other current assets                   | 4,211                | 3,747  |
| Other receivables   | 8,096                | 9,927  |
| Total current assets  | 100,515              | 121,772  |
| Equipment, at cost  | 769,967              | 771,743  |
| Less accumulated depreciation                               | (425,790 )           | (424,675 )   |
| Equipment, net  | 344,177              | 347,068  |
| Goodwill  | 150,069              | 150,069  |
| Other intangible assets, net                                | 35,782               | 34,572   |
| Deferred financing costs, net                               | 6,947                | 6,677  |
| Other assets  | 27,036               | 17,887   |
| Total assets  | \$ 664,526           | \$ 678,045   |
| <b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>                 |                      |  |
| Current liabilities:  |                      |  |
| Accounts payable  | \$ 14,525            | \$ 14,174  |
| Accrued compensation and related expenses                   | 16,993               | 15,733   |
| Accrued interest payable                                    | 4,320                | 6,977  |
| Income taxes payable  | 637                  |  |
| Other accrued liabilities                                   | 32,331               | 32,645   |
| Current portion of long-term debt                           | 2,858                | 2,704  |
| Total current liabilities                                   | 71,664               | 72,333   |
| Long-term debt, net of current portion                      | 373,026              | 371,863  |
| Senior subordinated notes                                   | 153,541              | 153,541  |
| Minority interests and other liabilities                    | 4,376                | 5,675  |
| Deferred income taxes                                       | 78,893               | 84,578   |
| Total liabilities   | 681,500              | 687,890  |
| Commitments and contingencies (Note 10)                     |                      |  |
| Stockholders' deficit:                                      |                      |  |
| Common stock  | 499                  | 501  |
| Additional paid-in deficit                                  | (7,070 )             | (5,345 )   |
| Accumulated comprehensive income                            | 1,356                | 1,087  |
| Accumulated deficit   | (11,759 )            | (6,088 )   |
| Total stockholders' deficit                                 | (16,974 )            | (9,845 )   |
| Total liabilities and stockholders' deficit                 | \$ 664,526           | \$ 678,045   |

See accompanying notes.

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

|  | <b>Quarter Ended</b><br><b>March 31,</b><br><b>2006</b><br><b>(as restated,</b><br><b>see Note 13)</b> | <b>2007</b><br><b>(as restated,</b><br><b>see Note 13)</b> |
|--|--|--|
| Revenues   | \$ 115,343   | \$ 109,406   |
| Costs and expenses:  |  |  |
| Cost of revenues, excluding depreciation and amortization  | 59,867   | 56,177   |
| Selling, general and administrative expenses   | 13,756   | 14,728   |
| Severance and related costs  | 489  | 76   |
| Depreciation expense   | 21,001   | 20,801   |
| Amortization expense   | 1,244  | 1,210  |
| Interest expense, net of interest income   | 9,774  | 10,074   |
| Other (income) and expense, net  | 728  | (320 )   |
| Total costs and expenses   | 106,859  | 102,746  |
| Income before income taxes, minority interest expense and earnings from unconsolidated investees | 8,484  | 6,660  |
| Income tax expense   | 3,651  | 3,952  |
| Minority interest expense  | 540  | 521  |
| Earnings from unconsolidated investees   | (1,040 )   | (3,484 )   |
| Net income   | \$ 5,333   | \$ 5,671   |
| Comprehensive income, net of taxes:  |  |  |
| Net income   | \$ 5,333   | \$ 5,671   |
| Unrealized gain (loss) on hedging transactions, net of taxes                                     | 552  | (269 )   |
| Comprehensive income   | \$ 5,885   | \$ 5,402   |
| Earnings per common share:   |  |  |
| Basic  | \$ 0.11  | \$ 0.11  |
| Diluted  | \$ 0.11  | \$ 0.11  |
| Weighted average number of shares of common stock and common stock equivalents:                  |  |  |
| Basic  | 49,608   | 49,955   |
| Diluted  | 49,974   | 51,088   |

*See accompanying notes.*

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

|   | <b>Quarter Ended<br/>March 31,<br/>2006<br/>(as restated,<br/>see Note 13)</b> | <b>2007<br/>(as restated,<br/>see Note 13)</b> |
|---|--|--|
| <b>Operating activities:</b>  |  |  |
| Net income  | \$ 5,333   | \$ 5,671                                       |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |  |
| Provision for doubtful accounts   | 761  | 832  |
| Share-based payment   | 715  | 898  |
| Depreciation and amortization   | 22,245   | 22,011   |
| Amortization of deferred financing costs  | 396  | 397  |
| Adjustment of swaps to fair value   | (442 )   | 672  |
| Distributions less than than equity in undistributed income of investees          | (489 )   | (421 )   |
| Deferred income taxes   | 3,419  | 2,844  |
| Excess tax benefit from share-based payment arrangements                          |  | (254 )   |
| Loss (gain) on sale of assets   | 728  | (320 )   |
| Changes in operating assets and liabilities:                                      |  |  |
| Accounts receivable   | (5,439 )   | (3,307 )                                       |
| Prepaid expenses and other current assets   | 850  | 464  |
| Other receivables   | (2,003 )   | (1,831 )                                       |
| Other assets  | (306 )   | (1,128 )                                       |
| Accounts payable  | (9,718 )   | (4,228 )                                       |
| Accrued compensation and related expenses   | 121  | (1,260 )                                       |
| Accrued interest payable  | 2,996  | 2,657  |
| Income taxes payable  | 151  | (637 )   |
| Other accrued liabilities   | 339  | 333  |
| Minority interests and other liabilities  | (168 )   | 1,299  |
| Net cash provided by operating activities   | 19,489   | 24,692   |
| <b>Investing activities:</b>  |  |  |
| Equipment purchases   | (24,331 )  | (24,764 )                                      |
| Decrease in deposits on equipment   | 5,734  | 13,455   |
| Proceeds from sale of assets  | 427  | 1,392  |
| Net cash used in investing activities   | (18,170 )  | (9,917 )                                       |
| <b>Financing activities:</b>  |  |  |
| Principal payments on equipment debt  | (1,129 )   | (855 )   |
| Proceeds from equipment debt  |  | 138  |
| Principal payments on term loan facility  |  | (600 )   |
| Principal payments on revolving loan facility                                     | (12,500 )  | (7,000 )                                       |
| Proceeds from revolving loan facility   | 8,500  | 7,000  |
| Payments of debt issuance costs   | (137 )   | (127 )   |
| Proceeds from exercise of employee stock options                                  | 270  | 556  |
| Excess tax benefit from share-based payment arrangements                          |  | 254  |
| Net cash used in financing activities   | (4,996 )   | (634 )   |
| Net (decrease) increase in cash and cash equivalents                              | (3,677 )   | 14,141   |
| Cash and cash equivalents, beginning of period                                    | 13,421   | 16,440   |
| Cash and cash equivalents, end of period  | \$ 9,744   | \$ 30,581                                      |
| <b>Supplemental disclosure of cash flow information:</b>                          |  |  |
| Interest paid   | \$ 6,977   | \$ 6,587                                       |
| Income taxes paid, net of refunds   | 128  | 937  |
| <b>Supplemental disclosure of non-cash investing and financing activities:</b>    |  |  |
| Net book value of assets exchanged  | \$ 4,442   | \$ 938   |
| Capital lease obligations assumed for the purchase of equipment debt              | 1,839  |  |
| Equipment debt transferred to unconsolidated investee                             | (2,379 )   |  |
| Comprehensive income from hedging transactions, net of taxes                      | 552  | (269 )   |

See accompanying notes.





**ALLIANCE IMAGING, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**March 31, 2007**

**(Unaudited)**

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

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

**Basis of Presentation** The accompanying unaudited condensed consolidated financial statements have been prepared by Alliance Imaging, Inc. (the Company) in accordance with accounting principles generally accepted in the United States of America and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (including normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter ended March 31, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes to the consolidated financial statements for the year ended December 31, 2006.

**Principles of Consolidation** The accompanying unaudited condensed consolidated financial statements of the Company include the assets, liabilities, revenues and expenses of all majority owned subsidiaries over which the Company exercises control. Intercompany transactions have been eliminated. The Company records minority interest expense related to its consolidated subsidiaries which are not owned. Investments in non-consolidated investees are accounted for under the equity method. At March 31, 2006 and 2007, the Company had \$229 and \$3,877, respectively, in accounts payable related to deposits on equipment.

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

**2. Share-Based Compensation**

The Company adopted Statement of Financial Accounting Standards No. 123(R) (revised December 2004), Share-Based Payment (SFAS 123(R)), in the fiscal year beginning January 1, 2006, using the modified prospective application transition method. Under SFAS 123(R), the Company now records in its consolidated statements of operations (i) compensation cost for options granted, modified, repurchased or cancelled on or after January 1, 2006 under the provisions of SFAS 123(R) and (ii) compensation cost for the unvested portion of options granted prior to January 1, 2006 over their remaining vesting periods using the amounts previously measured under SFAS 123 for pro forma disclosure purposes.

In November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position FAS123R-3, Transition Election to Accounting for the Tax Effects of Share-Based Payment Awards (FSP). The Company has elected to follow the alternative transition method as described in the FSP for computing its additional paid-in capital pool. In addition, the Company treats the tax deductions from stock options as being realized when they reduce taxes payable in accordance with the principles and timing under the relevant tax law.

**Stock Option Plans and Awards**

On November 2, 1999, in connection with a series of transactions contemplated by an Agreement and Plan of Merger between Viewer Acquisition Corp and the Company in November 1999, the Company adopted an employee stock option plan (the 1999 Equity Plan ) pursuant to which options and awards with respect to a total of 6,325,000 shares of the Company's common stock became available for grant. As of March 31, 2007, a total of 548,740 shares are available for grant under the 1999 Equity Plan (excluding certain restricted stock awards granted during the first quarter of 2007, the effectiveness of which are conditioned on shareholder approval of an increase in the number of shares of common stock that may be issued under the 1999 Equity Plan at the Annual Meeting of Stockholders on May 30, 2007 (the Annual Meeting )). Options are granted with exercise prices equal to fair value of the Company's common stock at the date of grant, except as noted below. All options have 10-year terms. A portion of the options vest in equal increments over five years and a portion vest after eight years (subject to acceleration if certain financial performance targets are achieved). The Company settles stock option exercises with newly issued shares of common stock.

The Company is using the Black-Scholes option pricing model to value the compensation expense associated with stock-based awards. The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model that uses the assumptions noted in the table below. In addition, forfeitures are estimated when recognizing compensation expense, and the estimate of forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized through a cumulative catch-up adjustment in the period of change and will also impact the amount of compensation expense to be recognized in future periods. The Company records non-cash share-based compensation for stock options granted with exercise prices below the fair value of the Company's common stock at the date of grant and for certain stock options subject to amended performance targets under the 1999 Equity Plan, as discussed below.

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

|                                  | Quarter Ended |        |
|----------------------------------|---------------|--------|
|                                  | March 31,     |        |
|                                  | 2006          | 2007   |
| Risk free interest rate          | 4.55 %        | 4.74 % |
| Expected dividend yield          | 0.00 %        | 0.00 % |
| Expected stock price volatility  | 56.7 %        | 60.4 % |
| Average expected life (in years) | 6.69          | 6.61   |

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

In November 2000, the Company granted stock options to certain employees at exercise prices below the fair value of the Company's common stock, of which 35,000 options were outstanding at March 31, 2007. The exercise prices of these options and the fair value of the Company's common stock on the grant date were \$5.60 and \$9.52 per share, respectively.

Under the 1999 Equity Plan, a portion of the options granted are performance options. These options vest on the eighth anniversary of the grant date if the option holder is still an employee, but the

vesting accelerates if the Company meets the operating performance targets specified in the option agreements. On June 20, 2001, the Company's compensation committee authorized the Company to amend the option agreements under its 1999 Equity Plan to reduce the performance targets for 1,899,600 performance options out of the 2,284,222 performance options outstanding. On May 18, 2004, the Company's compensation committee authorized the Company to make a second amendment to the option agreements under its 1999 Equity Plan to further reduce the performance targets for all of the 1,914,500 performance options outstanding. As a result of the amendment, if the Company achieves the reduced performance targets but does not achieve the original performance targets, and an option holder terminates employment prior to the eighth anniversary of the option grant date, the Company would be required to record a non-cash stock-based compensation charge equal to the amount by which the actual value of the shares subject to the performance option on the date of the amendment exceeded the option's exercise price.

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

|   | Number of Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value |
|---|------------------|---------------------------------|---|---------------------------|
| Outstanding at December 31, 2006                            | 4,094,325        | \$ 5.93                         |   |                           |
| Granted   | 655,500          | 7.28                            |   |                           |
| Exercised   | (168,670 )       | 3.28                            |   |                           |
| Canceled  | (378,075 )       | 5.64                            |   |                           |
| Outstanding at March 31, 2007                               | 4,203,080        | \$ 6.27                         | 7.43  | \$ 10,336                 |
| Vested and expected to vest in the future at March 31, 2007 | 3,657,973        | \$ 6.21                         | 7.25  | \$ 9,217                  |
| Exercisable at March 31, 2007                               | 1,613,998        | \$ 5.71                         | 5.86  | \$ 4,877                  |

The weighted average grant-date fair value of options granted during the quarters ended March 31, 2006 and 2007 was \$2.58 per share and \$4.57 per share, respectively. The total intrinsic value of options exercised during the quarters ended March 31, 2006 and 2007 was \$91 and \$668, respectively. The total cash received from employees as a result of stock option exercises was \$270 and \$556 for the quarters ended March 31, 2006 and 2007, respectively.

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

|                               | Shares     | Weighted Average Grant Date Fair Value |
|-------------------------------|------------|--|
| Unvested at December 31, 2006 | 2,830,441  | \$ 3.54                                |
| Granted                       | 655,500    | 4.57                                   |
| Vested                        | (525,709 ) | 3.69                                   |
| Canceled                      | (371,150 ) | 3.20                                   |
| Unvested at March 31, 2007    | 2,589,082  | \$ 3.82                                |

At March 31, 2007, the total unrecognized fair value compensation cost related to unvested stock options granted to both employees and non-employees was \$6,005, which is expected to be recognized over a remaining weighted-average period of 3.63 years. The valuation model applied in this calculation utilizes highly subjective assumptions that could potentially change over time, including the expected forfeiture rate and performance targets. Therefore the amount of unrecognized compensation expense noted above does not necessarily represent the value that will ultimately be realized by the Company in the statements

of operations. The total fair value of shares vested during the quarters ended March 31, 2006 and 2007 was \$857, and \$1,941, respectively.

**Restricted Stock Awards**

The 1999 Equity Plan, as amended and restated, permits the award of restricted stock, restricted stock units, stock bonus awards and performance-based awards. During 2007, the Company granted 625,000 restricted stock awards ( award ) to certain employees of the Company, with an effective grant date of January 1, 2007. These awards cliff vest after three years, provided that the employee remains continuously employed through the issuance date. The effectiveness of these awards is conditioned on shareholder approval of an increase in the number of shares of common stock that may be issued under the 1999 Equity Plan at the Annual Meeting. For the quarter ended March 31, 2007 the Company recorded non-cash share-based compensation expense related to these grants of \$246.

The weighted average grant-date fair value of restricted stock granted during the quarter ended March 31, 2007 was \$6.65 per share.

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

|                               | Shares  | Weighted<br>Average<br>Grant Date<br>Fair Value |
|-------------------------------|---------|---|
| Unvested at December 31, 2006 |         |   |
| Granted                       | 625,000 | \$ 6.65   |
| Vested                        |         |   |
| Canceled                      |         |   |
| Unvested at March 31, 2007    | 625,000 | \$ 6.65   |

At March 31, 2007, the total unrecognized fair value compensation cost related to restricted stock awards granted to employees was \$2,784, which is expected to be recognized over a remaining weighted-average period of 2.68 years. The valuation model applied in this calculation utilizes highly subjective assumptions that could potentially change over time, including the expected forfeiture rate. Therefore the amount of unrecognized compensation expense noted above does not necessarily represent the value that will ultimately be realized by the Company in the statements of operations.

**Stock Bonus Award**

During 2006 and 2007, the Company granted stock bonus awards ( award ) to certain employees of the Company. On the issuance date, the Company shall issue a number of shares of the Company's common stock ( shares ), equal to the bonus award divided by the fair market value of the shares at that time, provided that the employee remains continuously employed through the issuance date. For the quarters ended March 31, 2006 and 2007 the Company recorded non-cash share based compensation expense related to these grants of \$125 and \$167, respectively.

At March 31, 2007, the total unrecognized fair value compensation cost related to the stock bonus awards granted to employees was \$1,208, which is expected to be recognized over a remaining weighted-average period of 1.98 years. The valuation model applied in this calculation utilizes highly subjective assumptions that could potentially change over time, including the expected forfeiture rate. Therefore the amount of unrecognized compensation expense noted above does not necessarily represent the value that will ultimately be realized by the Company in the statements of operations.

### 3. Recent Accounting Pronouncements

**Uncertainty in Income Taxes** In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, ( FIN 48 ), an interpretation of FASB Statement No. 109, Accounting for Income Taxes, ( FASB 109 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB 109. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effect, if any, of applying FIN 48 is to be reported as an adjustment to the opening balance of retained earnings in the year of adoption. The impact of the Company's reassessment of its tax positions in accordance with FIN 48 did not have a material effect on the results of operations, financial condition or liquidity. See further discussion of FIN 48 at Note 8.

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

**Fair Value Option for Financial Assets and Liabilities** In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115 ( SFAS 159 ), which permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the Board's long-term measurement objectives for accounting for financial instruments. SFAS 159 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently evaluating the provisions of SFAS 159 and the impact on our consolidated financial position and results of operations. The Company will adopt SFAS 159 for the fiscal year beginning January 1, 2008.

### 4. Goodwill and Intangible Assets

Changes in the carrying amount of goodwill are as follows:

|   |            |
|---|------------|
| Balance at December 31, 2006            | \$ 150,069 |
| Additions to goodwill during the period |            |
| Balance at March 31, 2007               | \$ 150,069 |

Intangible assets consisted of the following:

|   | December 31, 2006 |              | Intangible  | March 31, 2007 |              | Intangible  |
|---|-------------------|--------------|-------------|----------------|--------------|-------------|
|   | Gross Carrying    | Accumulated  | Assets, net | Gross Carrying | Accumulated  | Assets, net |
|   | Amount            | Amortization |             | Amount         | Amortization |             |
| <b>Amortizing intangible assets:</b>          |                   |              |             |                |              |             |
| Customer contracts                            | \$ 51,063         | \$ (22,909 ) | \$ 28,154   | \$ 51,063      | \$ (23,930 ) | \$ 27,133   |
| Other   | 7,175             | (2,726 )     | 4,449       | 6,905          | (2,915 )     | 3,990       |
| Total amortizing intangible assets            | \$ 58,238         | \$ (25,635 ) | \$ 32,603   | \$ 57,968      | \$ (26,845 ) | \$ 31,123   |
| Intangible assets not subject to amortization |                   |              | \$ 3,179    |                |              |             |
| Total other intangible assets                 |                   |              | \$ 35,782   |                |              |             |

The Company reviews the recoverability of the carrying value of goodwill on an annual basis or more frequently when an event occurs or circumstances change to indicate an impairment of these assets has possibly occurred. Goodwill is allocated to the Company's various reporting units which represent the Company's geographical regions. The Company compares the fair value of the reporting unit to its carrying amount to determine if there is potential impairment.

Amortization expense for intangible assets subject to amortization was \$1,244 and \$1,210 for the quarters ended March 31, 2006 and 2007, respectively. The intangible assets not subject to amortization represent certificates of need and regulatory authority rights which have indefinite useful lives.

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

|      |          |
|------|----------|
| 2007 | \$ 4,680 |
| 2008 | 4,466    |
| 2009 | 4,145    |
| 2010 | 4,076    |
| 2011 | 3,934    |

## 5. Other Accrued Liabilities

Other accrued liabilities consisted of the following:

|  | December 31,<br>2006 | March 31,<br>2007 |
|--|----------------------|-------------------|
| Accrued systems rental and maintenance costs | \$ 2,596             | \$ 2,107          |
| Accrued site rental fees                     | 1,507                | 1,642             |
| Accrued property and sales taxes payable     | 12,055               | 12,561            |
| Accrued self-insurance expense               | 6,915                | 7,120             |
| Other accrued expenses                       | 9,258                | 9,215             |
| Total  | \$ 32,331            | \$ 32,645         |

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

Long-term debt consisted of the following:

|   | <b>December 31,<br/>2006</b> | <b>March 31,<br/>2007</b> |
|---|------------------------------|---------------------------|
| Term loan facility                        | \$ 367,200                   | \$ 366,600                |
| Senior subordinated notes                 | 153,541                      | 153,541                   |
| Equipment debt                            | 8,684                        | 7,967                     |
| Long-term debt, including current portion | 529,425                      | 528,108                   |
| Less current portion                      | 2,858                        | 2,704                     |
| Long-term debt                            | \$ 526,567                   | \$ 525,404                |

In April 2007, the Company entered into a fifth amendment to its Credit Agreement which granted consent to the sale of a significant interest in the Company. See Note 11 for further information regarding this transaction.

**7. Derivatives**

In the second quarter of 2004, the Company entered into interest rate swap agreements, with notional amounts of \$56,813, \$46,813 and \$48,438 to manage the future cash interest payments associated with a portion of the Company's variable rate bank debt. These agreements are three years in length and mature in the second and fourth quarters of 2007. As of March 31, 2006 and 2007, the fair value of the Company's interest rate swap agreements was \$3,266 and \$1,055, respectively. Under these arrangements, the Company receives three-month London Interbank Offered Rate (LIBOR) and pays a fixed rate of 3.15%, 3.89% and 3.69%, respectively. The net effect is to record interest expense at fixed rates of 5.65%, 6.39% and 6.19%, respectively, as the debt incurs interest based on three-month LIBOR plus 2.50%. For the quarter ended March 31, 2006 the Company paid a net settlement amount of \$306. For the quarter ended March 31, 2007, the Company received a net settlement amount of \$704. Changes in the fair value of the swap agreements are recorded in interest expense each period, as these transactions do not qualify for hedge accounting treatment. For the quarters ended March 31, 2006 and 2007, the Company recognized interest expense of \$672 and a reduction to interest expense of \$442, based on the change in fair value of these instruments, respectively. The Company will continue to record subsequent changes in the fair value of the swaps through interest expense.

In the first quarter of 2005, the Company entered into multiple interest rate collar agreements for its variable rate bank debt. The total underlying notional amount of the debt was \$178,000. Under these arrangements the Company has purchased a cap on the interest rate of 4.00% and has sold a floor of 2.25%. The Company paid a net purchase price of \$1,462 for these collars. These agreements are two and three years in length and mature at various dates between January 2007 and January 2008. As of March 31, 2006 and 2007, the fair value of the Company's interest rate collar agreements was \$3,446 and \$1,810, respectively. For the quarters ended March 31, 2006 and 2007, the Company received a net settlement amount of \$68 and \$629, respectively. The Company has designated these collars as cash flow hedges of variable future cash flows associated with its long-term debt. For the quarters ended March 31, 2006 and 2007 the Company recognized \$552 and (\$269), net of tax, respectively, in other comprehensive income (loss) based on the change in fair value of these instruments. The Company will record subsequent changes in the fair value of the collars through comprehensive income during the period these instruments are designated as hedges.

The Company accounts for derivative instruments and hedging activities in accordance with the provisions of SFAS 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133) and SFAS 138, Accounting for Certain Derivative Instruments and Hedging Activities (SFAS 138), an

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

## 8. Income Taxes

For the quarter ended March 31, 2006 and 2007, the Company recorded a provision for income taxes of \$3,651 and \$3,952, or 40.6% and 41.1% of the Company's pretax income, respectively. The Company's effective tax rates were higher than the federal statutory rates primarily as a result of state income taxes.

FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB 109. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effect, if any, of applying FIN 48 is to be reported as an adjustment to the opening balance of retained earnings in the year of adoption. The impact of the Company's reassessment of its tax positions in accordance with FIN 48 did not have a material effect on the results of operations, financial condition or liquidity.

As of January 1, 2007, the Company has recorded a liability of \$1,495 for unrecognized tax benefits related to various federal and state income tax matters. This entire amount would reduce the Company's effective income tax rate if recognized.

The Company recognizes accrued interest and penalties related to unrecognized tax benefits in income tax expense. As of January 1, 2007, the Company had approximately \$176 in accrued interest and penalties which is included as a component of the \$1,495 unrecognized tax benefit noted above. The liability for the payment of interest and penalties did not materially change as of March 31, 2007.

Alliance Imaging, Inc. and its subsidiaries are subject to U.S. federal income tax as well as income tax of multiple state tax jurisdictions. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service for the years ending December 31, 2003 through 2006. The Company and its subsidiaries state income tax returns are open to audit under the statute of limitations for the years ending December 31, 2002 through 2006. The Company does not anticipate a significant change to the total amount of unrecognized tax benefits within the next 12 months.



## 9. Earnings Per Common Share

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

|   | <b>Quarter Ended</b> |             |
|---|----------------------|-------------|
|   | <b>March 31,</b>     |             |
|   | <b>2006</b>          | <b>2007</b> |
| <b>Numerator:</b>   |                      |             |
| Net income  | \$ 5,333             | \$ 5,671    |
| <b>Denominator:</b>   |                      |             |
| Denominator for basic earnings per share weighted-average shares                                  | 49,608               | 49,955      |
| <b>Effect of dilutive securities:</b>   |                      |             |
| Employee stock options  | 366                  | 1,133       |
| Denominator for diluted earnings per share adjusted weighted-average shares                       | 49,974               | 51,088      |
| <b>Earnings per common share:</b>   |                      |             |
| Basic   | \$ 0.11              | \$ 0.11     |
| Diluted   | \$ 0.11              | \$ 0.11     |
| <b>Stock options excluded from the computation of diluted per share amounts:</b>                  |                      |             |
| Weighted-average shares for which the exercise price exceeds average market price of common stock | 1,130                | 1,030       |
| Average exercise price per share that exceeds average market price of common stock                | \$ 11.76             | \$ 9.91     |

## 10. Commitments and Contingencies

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

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

It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Historically, payments made related to these

indemnifications have been immaterial. At March 31, 2007 the Company has determined that no liability is necessary related to these guarantees and indemnities.

The Company guarantees a portion of a loan on behalf of an unconsolidated investee under an agreement executed prior to 2002. The maximum potential future payment under this financial guarantee is \$99 at March 31, 2007. The Company has not recorded an obligation for this guarantee.

On May 5, 2005, Alliance Imaging, Inc. was served with a complaint filed in Alameda County Superior Court alleging wage and hour claims on behalf of a putative class of approximately 400 former and current California employees of the Company. On August 19, 2005, the plaintiffs filed an amended complaint, which the Company answered on September 23, 2005. In this suit, captioned Linda S. Jones, et al. v. Alliance Imaging, Inc., et al., the plaintiffs alleged violations of California's wage, meal period, and break time laws and regulations. Plaintiffs sought recovery of unspecified economic damages, statutory penalties, attorneys' fees, and costs of suit. The parties are currently taking discovery to develop facts relevant to the named plaintiffs' expected motion for certification of one or more classes. On or about March 10, 2006, plaintiffs filed a second amended complaint adding a cause of action for conversion and a plea for punitive damages. The Company filed a demurrer seeking to strike the new claim and plea. On July 19, 2006, the Company and the Plaintiffs entered into a tentative settlement of the Class Action Complaint pursuant to which the Company agreed to pay \$2,500 in exchange for dismissal with prejudice of all claims brought on behalf of the putative class under the Class Action Complaint. On September 8, 2006, the settlement was preliminarily approved by the court and a conditional class was certified for purposes of seeking class approval of the settlement. On October 2, 2006, notice was mailed to the conditional class members outlining the terms of the settlement and providing all class members with an opportunity to opt out of the settlement prior to the final approval hearing scheduled for November 27, 2006. Two putative class members opted out of the class, and there were no objections submitted. The final approval hearing was held on November 27, 2006 as scheduled, and the Court granted final approval of the settlement. The settlement amount was distributed by the class settlement administrator on February 16, 2007. The case will be dismissed upon the parties' compliance with the settlement agreement. The Court scheduled a hearing for a final accounting of the settlement distribution on June 25, 2007.

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

#### **11. Related-Party Transactions**

The Company recorded management fees payable to Kohlberg Kravis Roberts & Co ( KKR ) of \$163 for the quarters ended March 31, 2006 and 2007. At March 31, 2006 and 2007, the Company has accrued \$163 related to these services. The Company will pay \$30 for financial advisory services from KKR through April 16, 2007. KKR will no longer provide financial advisory services after April 16, 2007.

On April 16, 2007, funds managed by Oaktree Capital Management, LLC ( Oaktree ) and MTS Health Investors, LLC ( MTS ) purchased approximately 24,829,005 shares of the Company's common stock from a fund managed by an affiliate of KKR. Upon completion of the transaction, funds managed by Oaktree and MTS owned in the aggregate approximately 49.4% and KKR owned less than 3% of the outstanding shares of common stock of the Company.

Revenue from management agreements with unconsolidated equity investees was \$4,356 and \$3,955 for the quarters ended March 31, 2006 and 2007, respectively.

**12. Investments in Unconsolidated Investees**

The Company has direct ownership in four unconsolidated investees at March 31, 2007. The Company owns between 33.3 percent and 50 percent of these investees, expiring at various dates through 2023. At March 31, 2007 the Company also has ownership in an unconsolidated investee of Alliance Oncology ( AO ), a consolidated joint venture of the Company. AO owns 50% of this investee and provides management services under an agreement which expires in 2025. All of these investees are accounted for under the equity method since the Company does not exercise control over the operations of these investees.

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

|                                     | December 31,<br>2006 | March 31,<br>2007 |
|-------------------------------------|----------------------|-------------------|
| <b>Combined Balance Sheet Data:</b> |                      |                   |
| Current assets                      | \$ 10,033            | \$ 10,929         |
| Noncurrent assets                   | 26,182               | 24,834            |
| Current liabilities                 | 7,741                | 7,795             |
| Noncurrent liabilities              | 11,822               | 10,467            |

|  | Quarters Ended<br>March 31, |          |
|--|-----------------------------|----------|
|  | 2006                        | 2007     |
| <b>Combined Operating Results:</b>             |                             |          |
| Revenues                                       | \$ 10,281                   | \$ 9,157 |
| Expenses                                       | 7,999                       | 6,178    |
| Net income                                     | 2,283                       | 2,979    |
| Equity in earnings of unconsolidated investees | 1,040                       | 3,484    |

**13. Restatement of Previously Issued Financial Statements**

Subsequent to the filing of its Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2007, the Company identified an error with respect to the accounting for interest rate swap agreements. As discussed in Note 7, the swap agreements were executed in 2004 and mature at various dates in 2007. Since inception, the Company had recorded the unrealized gains and losses in fair value of the swap agreements as a component of other comprehensive income (loss). The Company has determined that these transactions do not meet the requirements for hedge accounting treatment and any unrealized gains or losses should have been recognized in the results of operations as interest expense.

*Effects of Restatement*

To correct this error, the Company has restated the accompanying condensed consolidated balance sheet as of March 31, 2007, and its condensed consolidated statements of operations and comprehensive income and its condensed consolidated statements of cash flows for the quarters ended March 31, 2007 and 2006, and the notes to the condensed consolidated financial statements for such periods as appropriate. The Company corrected the accompanying Condensed Consolidated Balance Sheet as of December 31, 2006 in its Annual Report on Form 10-K/A filed on August 1, 2007.

The following is a summary of the corrections described above:

**NET INCOME, COMPREHENSIVE INCOME, AND EARNINGS PER COMMON SHARE**  
(in thousands, except per share amounts)

|  | <b>Quarter Ended</b> |             |
|--|----------------------|-------------|
|  | <b>March 31,</b>     |             |
|  | <b>2006</b>          | <b>2007</b> |
| Net income as previously reported  | \$ 5,068             | \$ 6,074    |
| Adjustments:   |                      |             |
| Interest expense, net of related tax effects                               | 265                  | (403 )      |
| Net income as restated   | \$ 5,333             | \$ 5,671    |
| Comprehensive income as previously reported:                               | \$ 5,885             | \$ 5,402    |
| Adjustments:   |                      |             |
| Adjustments to net income as restated                                      | 265                  | (403 )      |
| Unrealized (loss) gain on hedging transactions, net of related tax effects | (265 )               | 403         |
| Comprehensive income as restated   | \$ 5,885             | \$ 5,402    |
| Earnings per common share as previously reported:                          |                      |             |
| Basic  | \$ 0.10              | \$ 0.12     |
| Diluted  | \$ 0.10              | \$ 0.12     |
| Earnings per common share as restated:                                     |                      |             |
| Basic  | \$ 0.11              | \$ 0.11     |
| Diluted  | \$ 0.11              | \$ 0.11     |

**CONDENSED CONSOLIDATED BALANCE SHEET**  
(in thousands)

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|                                  | As previously<br>reported | Adjustments | As<br>restated |
|----------------------------------|---------------------------|-------------|----------------|
| <i>As of March 31, 2007</i>      |                           |             |                |
| Accumulated comprehensive income | \$ 1,730                  | \$ (643 )   | \$ 1,087       |
| Accumulated deficit              | (6,731 )                  | 643         | \$ (6,088 )    |

17

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**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND  
COMPREHENSIVE (LOSS) INCOME**  
(in thousands, except per share amounts)

|   | As previously<br>reported | Adjustments | As<br>restated |
|---|---------------------------|-------------|----------------|
| <b><i>Quarter Ended March 31, 2007</i></b>  |                           |             |                |
| Interest expense, net of interest income  | \$ 9,402                  | \$ 672      | \$ 10,074      |
| Total costs and expenses  | 102,074                   | 672         | 102,746        |
| Income before income taxes, minority interest expense, and earnings from unconsolidated investees | 7,332                     | (672 )      | 6,660          |
| Income tax expense  | 4,221                     | (269 )      | 3,952          |
| Net income  | 6,074                     | (403 )      | 5,671          |
| Unrealized (loss) gain on hedging transactions, net of taxes                                      | (672 )                    | 403         | (269 )         |
| Earnings per common share:  |                           |             |                |
| Basic   | 0.12                      | (0.01 )     | 0.11           |
| Diluted   | 0.12                      | (0.01 )     | 0.11           |
| <b><i>Quarter Ended March 31, 2006</i></b>  |                           |             |                |
| Interest expense, net of interest income  | \$ 10,216                 | \$ (442 )   | \$ 9,774       |
| Total costs and expenses  | 107,301                   | (442 )      | 106,859        |
| Income before income taxes, minority interest expense, and earnings from unconsolidated investees | 8,042                     | 442         | 8,484          |
| Income tax expense  | 3,474                     | 177         | 3,651          |
| Net income  | 5,068                     | 265         | 5,333          |
| Unrealized gain (loss) on hedging transactions, net of taxes                                      | 817                       | (265 )      | 552            |
| Earnings per common share:  |                           |             |                |
| Basic   | 0.10                      | 0.01        | 0.11           |
| Diluted   | 0.10                      | 0.01        | 0.11           |

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

|   | As previously<br>reported | Adjustments | As<br>restated |
|---|---------------------------|-------------|----------------|
| <b><i>Quarter Ended March 31, 2007</i></b>                              |                           |             |                |
| Net income  | \$ 6,074                  | \$ (403 )   | \$ 5,671       |
| Adjustment of swaps to fair value                                       |                           | 672         | 672            |
| Deferred income taxes   | 3,113                     | (269 )      | 2,844          |
| Supplemental disclosure of non-cash investing and financing activities: |                           |             |                |
| Comprehensive loss from hedging transactions, net of taxes              | (672 )                    | 403         | (269 )         |
| <b><i>Quarter Ended March 31, 2006</i></b>                              |                           |             |                |
| Net income  | \$ 5,068                  | \$ 265      | \$ 5,333       |
| Adjustment of swaps to fair value                                       |                           | (442 )      | (442 )         |
| Deferred income taxes   | 3,242                     | 177         | 3,419          |
| Supplemental disclosure of non-cash investing and financing activities: |                           |             |                |
| Comprehensive income from hedging transactions, net of taxes            | 817                       | (265 )      | 552            |

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

**Overview**

We are a leading national provider of shared-service and fixed-site diagnostic imaging and therapeutic services, based upon annual revenue and number of diagnostic imaging systems deployed. Our principal sources of revenue are derived from magnetic resonance imaging (MRI) and positron emission tomography and positron emission tomography/computed tomography (PET and PET/CT). We provide imaging and therapeutic services primarily to hospitals and other healthcare providers on a shared and full-time service basis. We also provide services through a growing number of fixed sites primarily to hospitals or health systems. Our services normally include the use of our imaging systems, technologists to operate the systems, equipment maintenance and upgrades and management of day-to-day shared-service and fixed-site diagnostic imaging operations. We also provide non scan-based services, which includes only the use of our imaging systems under a short-term contract. For the quarter ended March 31, 2007, MRI services and PET and PET/CT services generated 60% and 31% of our revenue, respectively. The remaining revenue was comprised of other modality diagnostic imaging services revenue, primarily computed tomography (CT), and management contract revenue. We had 494 diagnostic imaging systems, including 326 MRI systems and 77 PET or PET/CT systems and served over 1,000 clients in 43 states at March 31, 2007. Of these 494 diagnostic imaging systems, 72 were located in fixed-sites, which constitutes systems installed in hospitals or other buildings on hospital campuses, including modular buildings, systems installed inside medical groups' offices, or medical buildings, and free-standing fixed-sites, which includes systems installed in a medical office building, ambulatory surgical center, or other retail space. Of these 72 fixed-sites, 61 were MRI fixed sites, four were PET or PET/CT fixed-sites and seven were other modality fixed sites.

Approximately 90% of our revenues for the quarter ended March 31, 2007 were generated by providing services to hospitals and other healthcare providers, which we refer to as wholesale revenues. Our wholesale revenues are typically generated from contracts that require our clients to pay us based on the number of scans we perform on patients on our clients' behalf, although some pay us a flat fee for a period of time regardless of the number of scans we perform. These payments are due to us independent of our clients' receipt of reimbursement from third-party payors. We typically deliver our services for a set number of days per week through exclusive, long-term contracts with hospitals and other healthcare providers. The initial terms of these contracts average approximately three years in length for mobile services and approximately five to 10 years in length for fixed-site arrangements. These contracts often contain automatic renewal provisions and certain contracts have cancellation clauses if the hospital or other healthcare provider purchases their own system. We price our contracts based on the type of system used, the scan volume, and the number of ancillary services provided. Pricing is also affected by competitive pressures.

Approximately 10% of our revenues for the quarter ended March 31, 2007 were generated by providing services directly to patients from our sites located at or near hospitals or other healthcare provider facilities, which we refer to as retail revenue. Our revenue from these sites is generated from direct billings to patients or their third-party payors, including Medicare, which are recorded net of contractual discounts and other arrangements for providing services at discounted prices. We typically charge a higher price per scan under retail billing than we do under wholesale billing.

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

On February 8, 2006, the Deficit Reduction Act of 2005 ( DRA ) was signed into law by President George W. Bush. The DRA imposes caps on Medicare payment rates for certain imaging services, including MRI and PET, furnished in physician's offices and other non-hospital based settings. Under the

cap, payments for specified imaging services cannot exceed the hospital outpatient payment rates for those services. This change applies to services furnished on or after January 1, 2007. The limitation is applicable to the technical components of the services only, which is the payment we receive for the services for which we bill directly under the Medicare Physician Fee Schedule. The technical reimbursement under the Physician Fee Schedule generally allows for higher reimbursement than under the hospital outpatient prospective payment system, or HOPPS. The implementation of this reimbursement reduction contained in the DRA will have a significant effect on our financial condition and results of operations in 2007.

On July 18, 2006, the U.S. House of Representatives Energy and Commerce Committee's Subcommittee on Health conducted a hearing regarding quality and utilization of imaging services and the provisions of the DRA that directly effect Medicare payment for imaging services. Many members of Congress have expressed concern about the impact of the DRA, and both the U.S. House of Representatives and the U.S. Senate introduced bills that would have delayed the effective date of the DRA for two years. The bills were not passed and therefore, they did not become law. The DRA provisions as currently structured became effective January 1, 2007.

On November 1, 2006, the Centers for Medicare and Medicaid Services, or CMS, issued a final determination of Medicare Part B HOPPS reimbursement rates for PET and PET/CT imaging procedures, effective January 1, 2007. For 2007, the national rate for PET scans was reduced from the rate of \$1,150 per scan in 2006 to \$855 per scan. In addition, for 2007, the national rate for PET/CT scans was reduced from the rate of \$1,250 per scan in 2006 to \$950 per scan.

For full year 2006, we estimate that approximately 5.6% of our revenue was billed directly to the Medicare program. If the DRA had been in effect for full year 2006, we estimate the reduction in Medicare revenue due to the DRA reimbursement rate decrease would have reduced revenue by approximately \$9.7 million. Additionally, the PET and PET/CT Medicare HOPPS reduction would have reduced revenue by approximately \$2.8 million. Combined, the DRA and PET and PET/CT Medicare HOPPS rate reductions would have negatively impacted our 2006 revenue and will negatively impact our 2007 revenue by a total of \$12.5 million and \$14 million, respectively. We expect that the entire 2007 revenue decrease will directly negatively affect revenue and earnings.

As a result of the 2007 reductions in Medicare reimbursement rates resulting from the implementation of the DRA and revised PET and PET/CT reimbursements under HOPPS, the Company may face increased PET and PET/CT wholesale pricing pressure.

In addition, the DRA also codifies the reduction in reimbursement for multiple images on contiguous body parts. The DRA mandates payment at 100% of the technical component of the higher-priced imaging procedure and 50% for the technical component of each additional imaging procedure for multiple images of contiguous body parts within a family of codes performed in the same session. Initially, CMS announced that it would phase in this reimbursement reduction over a two-year period, resulting in a 25% reduction for each additional imaging procedure on contiguous body parts in 2006 and an additional 25% reduction in 2007. On November 1, 2006, however, CMS announced that it would not implement the additional 25% reduction in 2007. The implementation of this reimbursement reduction did not have a material impact on our consolidated financial position or results of operations for the year ended December 31, 2006 or the first quarter of 2007. We continue to believe that the implementation of this reimbursement reduction will not have a material impact on our consolidated financial position or results of operations in the future.

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



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

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

In 2006 and 2007, the growth rate of MRI industry wide scan volumes has slowed in part due to weak hospital volumes as reported by several investor-owned hospital companies, a growing number of medical groups adding imaging capacity within their practice setting, the increasing trend of third-party payors intensifying their utilization management efforts to control MRI scan volume growth rate and additional patient-related cost-sharing programs. We expect that this trend will continue throughout 2007.

In recent years, we began to see an increase in the competitive climate in the MRI industry, resulting in an increase in activity by original equipment manufacturers, or OEMs, selling systems directly to certain of our clients. Typically, OEMs target our higher scan volume clients. This increase in activity by OEMs has resulted in overcapacity of systems in the marketplace, especially related to medical groups adding imaging capacity within their practice setting. This has caused an increase in the number of our higher scan volume clients deciding not to renew their contracts. We replace these higher volume scan clients typically with lower volume clients. In the first quarter of 2007, our MRI revenues declined compared to 2006 levels and we believe that MRI revenues will continue to decline in future years.

### **Seasonality**

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

### **Results of Operations**

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The discussion and analysis set forth below has been amended to reflect the restatement as described in the Explanatory Note to the amended Quarterly Report on Form 10 Q/A and in Note 13 of the Notes to the Condensed Consolidated Financial Statements included elsewhere in this Quarterly Report. For this reason, the data set forth in this section may not be comparable to discussions and data in our previously filed Quarterly Report.

21

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The following table shows our consolidated statements of income as a percentage of revenues for each of the quarters ended March 31:

|  | 2006    | 2007    |
|--|---------|---------|
| Revenues   | 100.0 % | 100.0 % |
| Costs and expenses:  |         |         |
| Cost of revenues, excluding depreciation and amortization  | 51.9    | 51.3    |
| Selling, general and administrative expenses   | 11.9    | 13.5    |
| Severance and related costs  | 0.4     | 0.1     |
| Depreciation expense   | 18.2    | 19.0    |
| Amortization expense   | 1.1     | 1.1     |
| Interest expense, net of interest income   | 8.5     | 9.2     |
| Other (income) and expense, net  | 0.6     | (0.3 )  |
| Total costs and expenses   | 92.6    | 93.9    |
| Income before income taxes, minority interest expense and earnings from unconsolidated investees | 7.4     | 6.1     |
| Income tax expense   | 3.2     | 3.6     |
| Minority interest expense  | 0.5     | 0.5     |
| Earnings from unconsolidated investees   | (0.9 )  | (3.2 )  |
| Net income   | 4.6 %   | 5.2 %   |

The table below provides MRI statistical information for each of the quarters ended March 31:

|   | 2006      | 2007      |
|---|-----------|-----------|
| MRI statistics                                |           |           |
| Average number of total systems               | 328.1     | 310.6     |
| Average number of scan-based systems          | 279.7     | 256.6     |
| Scans per system per day (scan-based systems) | 9.36      | 9.12      |
| Total number of scan-based MRI scans          | 182,422   | 162,800   |
| Price per scan                                | \$ 358.60 | \$ 360.69 |

The table below provides PET and PET/CT statistical information for each of the quarters ended March 31:

|                                      | 2006     | 2007     |
|--------------------------------------|----------|----------|
| PET and PET/CT statistics            |          |          |
| Average number of systems            | 67.1     | 69.9     |
| Scans per system per day             | 5.82     | 6.29     |
| Total number of PET and PET/CT scans | 24,464   | 27,713   |
| Price per scan                       | \$ 1,312 | \$ 1,221 |

Following are the components of revenue (in millions):

|                                    | 2006     | 2007     |
|------------------------------------|----------|----------|
| Total MRI revenue                  | \$ 71.9  | \$ 65.5  |
| PET and PET/CT revenue             | 32.3     | 34.2     |
| Other modalities and other revenue | 11.1     | 9.7      |
| Total                              | \$ 115.3 | \$ 109.4 |

|  | 2006    | 2007    |
|--|---------|---------|
| Total fixed-revenue (in millions) for each of the quarters ended March 31: | \$ 17.8 | \$ 18.1 |



***Quarter Ended March 31, 2007 Compared to Quarter Ended March 31, 2006***

Revenue decreased \$5.9 million, or 5.1%, to \$109.4 million in the first quarter of 2007 compared to \$115.3 million in the first quarter of 2006 primarily due to a decrease in MRI revenue and other modalities and other revenue, offset by an increase in PET and PET/CT revenues. Scan-based MRI revenue decreased \$6.7 million in the first quarter of 2007, or 10.2%, compared to the first quarter of 2006, from \$65.4 million in the first quarter of 2006 to \$58.7 million in the first quarter of 2007. This decrease is primarily a result of a 10.8% decrease in our scan-based MRI scan volume. Scan-based MRI scan volume decreased to 162,800 scans in the first quarter of 2007 from 182,422 scans in the first quarter of 2006, primarily due to a decrease in the average number of scan-based systems in service due to lower client demand. Scan-based systems in service decreased to 256.6 systems in the first quarter of 2007 from 279.7 systems in the first quarter of 2006 to adjust to modestly declining scan volumes and to increase the efficiency of our mobile MRI systems. Average scans per system per day also decreased by 2.6% to 9.12 in first quarter of 2007 from 9.36 in first quarter of 2006. These decreases were partially offset by a 0.6% increase in the average price per MRI scan to \$360.69 per scan in first quarter of 2007 compared to \$358.60 per scan in first quarter of 2006 and an increase in non-scan based MRI revenue of \$0.3 million in the first quarter of 2007 over the same period in 2006. Other modalities and other revenue decreased \$1.4 million, or 12.3%, to \$9.7 million in the first quarter of 2007 compared to \$11.1 million in the first quarter of 2006 primarily due to a decrease in other fixed-site modality revenue, primarily related to the Company's decision to close 11 unprofitable fixed-sites, a decrease in management contract revenue from our management agreements and a decrease in reimbursement of expenses from unconsolidated investees. PET and PET/CT revenue in the first quarter of 2007 increased \$1.9 million, or 5.7%, compared to the first quarter of 2006. Total PET and PET/CT scan volumes increased 13.3% to 27,713 scans in the first quarter of 2007 from 24,464 scans in the first quarter of 2006, primarily as a result of growth in our core PET business. The average number of PET and PET/CT systems in service increased to 69.9 systems in the first quarter of 2007 from 67.1 systems in the first quarter of 2006. Scans per system per day increased 8.1%, to 6.29 scans per system per day in the first quarter of 2007 from 5.82 scans per system per day in the first quarter of 2006. These PET and PET/CT increases were partially offset by a 6.9% decline in the average price per PET and PET/CT scan, to \$1,221 per scan in the first quarter of 2007 compared to \$1,312 per scan in the first quarter of 2006. The decline in PET and PET/CT average price per scan is primarily due to the impact of the DRA and HOPPS reimbursement rate reductions which became effective January 1, 2007.

We had 326 MRI systems at March 31, 2007 compared to 345 MRI systems at March 31, 2006. We had 77 PET and PET/CT systems at March 31, 2007 compared to 74 PET and PET/CT systems at March 31, 2006. We operated 72 fixed sites at March 31, 2007, compared to 73 fixed sites at March 31, 2006.

Cost of revenues, excluding depreciation and amortization, decreased \$3.7 million, or 6.2%, to \$56.2 million in the first quarter of 2007 compared to \$59.9 million in the first quarter of 2006. Compensation and related employee expenses decreased \$1.8 million, or 6.3%, primarily as a result of labor efficiencies and a lower average headcount of MRI technologists as a result of a decrease in the average number of MRI systems in use. Outside medical services decreased \$0.7 million, or 26.6%, primarily as a result of a decrease in radiologist service costs associated with lower MRI scan volume and lower scans per system per day. Equipment rental expense decreased \$0.6 million, or 39.0%, primarily due to a lower number of rental systems in use to support current clients as a result of improved route efficiency. Medical supplies decreased \$0.5 million, or 8.0%, primarily as a result of a decrease in film costs related to lower MRI scan volume. Radiopharmaceutical costs, which are used as a component of a PET and PET/CT scan, also decreased due to sourcing discounts, partially offset by an increase in radiopharmaceutical costs due to an increase in the number of PET and PET/CT scans. Management contract expenses decreased \$0.3 million, or 10.7%, primarily as a result of a decrease in expenses incurred on behalf of unconsolidated investees. Fuel expenses decreased \$0.2 million, or 15.0%, primarily due to

improved route efficiency. Maintenance and related costs increased \$0.9 million, or 8.2%, primarily due to an increase in the number of PET/CT systems in service, which have a higher average service cost per system than MRI systems, offset by a decrease in cryogen expense as a result of a decrease in the number of MRI systems in service. All other cost of revenues, excluding depreciation and amortization, decreased \$0.5 million, or 8.8%. Cost of revenues, as a percentage of revenue, decreased to 51.3% in the first quarter of 2007 from 51.9% in the first quarter of 2006 as a result of the factors described above.

Selling, general and administrative expenses increased \$1.0 million, or 7.1%, to \$14.7 million in the first quarter of 2007 compared to \$13.7 million in the first quarter of 2006. Professional services increased \$1.0 million, or 71.7%, due to an increase in legal costs and consulting services. Non-cash share-based compensation increased \$0.2 million in the first quarter of 2007 from the first quarter of 2006 due to new share-based payment grants during the first quarter of 2007. All other selling, general and administrative expenses decreased \$0.2 million, or 1.4%. Selling, general and administrative expenses as a percentage of revenue were 13.5% and 11.9% in the first quarter of 2007.

We recorded severance and related costs of \$0.1 million in the first quarter of 2007 and \$0.5 million in the first quarter of 2006 primarily for severance costs associated with reductions-in-force due to our consolidation of five geographic regions to four geographic regions in the first quarter of 2006.

Depreciation expense decreased \$0.2 million, or 1.0%, to \$20.8 million in the first quarter of 2007 compared to \$21.0 million in the first quarter of 2006.

Amortization expense was \$1.2 million in both the first quarter of 2007 and the first quarter of 2006.

Interest expense, net, increased \$0.3 million, or 3.1%, to \$10.1 million in the first quarter of 2007 compared to \$9.8 million in the first quarter of 2006. Variability in the fair value of our interest rate swaps executed in 2004 accounted for a \$1.1 million increase in interest expense. This increase was off by a decrease in interest expense due to higher average debt balances during 2006 as a result of the pay down of debt in the second half of 2006. These decreases were partially offset by higher average interest rates in the first quarter of 2007 on our variable rate term loans. The increase in interest rates on our variable rate term loans was partially offset by the execution of various interest rate swap and collar agreements in 2004 and 2005 to manage against future interest rate increases on a portion of our variable rate term loans.

Income tax expense was \$4.0 million and \$3.7 million in the first quarter of 2007 and 2006, respectively, resulting in effective tax rates of 41.1% and 40.6% in the first quarter of 2007 and 2006, respectively. Our effective tax rates were higher than the federal statutory rates principally as a result of state income taxes.

Minority interest expense was \$0.5 million in the first quarter of 2007 and 2006.

Earnings from unconsolidated investees increased by \$2.4 million, or 235.1%, to \$3.5 million in the first quarter of 2007 compared to \$1.0 million in the first quarter of 2006, primarily due to a \$2.0 million gain on sale from a sale/leaseback transaction in one of the Company's unconsolidated investees as well as an increase in earnings of unconsolidated investees.

Our net income was \$5.7 million, or \$0.11 per share on a diluted basis, in the first quarter of 2007 compared to \$5.3 million, or \$0.11 per share on a diluted basis, in the first quarter of 2006.

### **Liquidity and Capital Resources**

Our primary source of liquidity is cash provided by operating activities. We generated \$24.7 million and \$19.5 million of cash flow from operating activities in the first quarters of 2007 and 2006, respectively. Our ability to generate cash flow is affected by numerous factors, including demand for MRI, PET and other diagnostic imaging services. Our ability to generate cash flow from operating activities is also dependent upon the collections of our accounts receivable. The provision for doubtful accounts increased

by \$0.1 million in the first quarter of 2007 compared to the first quarter of 2006. Our number of days of revenue outstanding for our accounts receivable was 49 days and 46 days as of March 31, 2007 and 2006, which we believe is among the more favorable in the healthcare service industry. In addition, as of March 31, 2007, we had \$64.1 million of available borrowings under our revolving line of credit.

Our primary use of capital resources is to fund capital expenditures. We used cash of \$9.9 million and \$18.2 million for investing activities in the quarters ended March 31, 2007 and 2006, respectively. We incur capital expenditures for the purposes of:

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

Capital expenditures totaled \$24.8 million and \$24.3 million in the quarters ended March 31, 2007 and 2006, respectively. During the first quarter of 2007, we purchased 7 MRI systems, 7 PET/CT systems and 3 CT systems. We traded-in or sold 1 MRI system and 3 PET systems for the quarter ended March 31, 2007. Our decision to purchase a new system is typically predicated on obtaining new or extending existing client contracts, which serve as the basis of demand for the new system. We expect to purchase additional systems in 2007 and finance substantially all of these purchases with our available cash, cash from operating activities, our revolving line of credit, and equipment leases. Based upon the client demand described above, which dictates the type of equipment purchased, we expect capital expenditures to total approximately \$75 to \$85 million in 2007.

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

#### **Recent Accounting Pronouncements**

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, ( *FIN 48* ), an interpretation of FASB Statement No. 109, *Accounting for Income Taxes*, ( *FASB 109* ). *FIN 48* clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB 109. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. *FIN 48* also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. *FIN 48* is effective for fiscal years beginning after December 15, 2006. The cumulative effect, if any, of applying *FIN 48* is to be reported as an adjustment to the opening balance of retained earnings in the year of adoption. The impact of our reassessment of tax positions in accordance with *FIN 48* did not have a material effect on our results of operations, financial condition or liquidity.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, ( *SFAS 157* ), which enhances the existing guidance for measuring assets and liabilities using fair value. This statement provides a single definition of fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. *SFAS 157* emphasizes fair value as a market-based measurement instead of an entity-specific measurement. The statement sets out a fair value hierarchy with the highest priority being quoted prices in active markets. *SFAS 157* is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently evaluating the provisions of *SFAS 157* and the impact on our consolidated financial position and results of operations. We will adopt *SFAS 157* for the fiscal year beginning January 1, 2008.

February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115 ( SFAS 159 ), which permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the Board's long-term measurement objectives for accounting for financial instruments. SFAS 159 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently evaluating the provisions of SFAS 159 and the impact on our consolidated financial position and results of operations. We will adopt SFAS 159 for the fiscal year beginning January 1, 2008.

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

Certain statements contained in Management's Discussion and Analysis of Financial Condition and Results of Operations, particularly in the section entitled "Liquidity and Capital Resources", and elsewhere in this quarterly report on Form 10-Q/A, are forward-looking statements, within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Statements which address activities, events or developments that we expect or anticipate will or may occur in the future, including such things as results of operations and financial condition, capital expenditures, the consummation of acquisitions and financing transactions and the effect of such transactions on our business and our plans and objectives for future operations and expansion are examples of forward-looking statements. In some cases you can identify these statements by forward-looking words like "may", "will", "should", "expect", "anticipate", "believe", "estimate", "predict", "continue" or similar words. Forward-looking statements are subject to risks and uncertainties which could cause actual outcomes and results to differ materially from our expectations, forecasts and assumptions. These risks and uncertainties include factors affecting our leverage, including fluctuations in interest rates, the risk that the counter-parties to our interest rate swap agreements fail to satisfy their obligations under these agreements, our ability to incur financing, the effect of operating and financial restrictions in our debt instruments, the accuracy of our estimates regarding our capital requirements, the effect of intense levels of competition in our industry, changes in the rates or methods of third party reimbursements for diagnostic imaging services, changes in the healthcare regulatory environment, our ability to keep pace with technological developments within our industry, and other risks and uncertainties, including those enumerated and described under "Risk Factors" in our Form 10-K/A, as filed with the Securities and Exchange Commission, for the fiscal year ended December 31, 2006. The foregoing should not be construed as an exhaustive list of all factors which could cause actual results to differ materially from those expressed in forward-looking statements made by us.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

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

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



During 2004 we entered into swap agreements which have notional amounts of \$56.8 million, \$46.8 million and \$48.4 million at March 31, 2007. Under the terms of these agreements, we receive three-month LIBOR and pay a fixed rate of 3.15%, 3.89%, and 3.69%, respectively. The net effect is to record interest expense at fixed rates of 5.65%, 6.39% and 6.19% respectively, as the debt incurs interest based on three-month LIBOR plus 2.50%. Changes in the fair value of the swap agreements are recorded in interest expense each period. For the quarter ended March 31, 2007, we received a net settlement amount of \$0.7 million. For the quarter ended March 31, 2006 we paid a net settlement amount of \$0.3 million. The swap agreements mature during the second and fourth quarters of 2007.

During 2005 we entered into multiple interest rate collar agreements which have a notional amount of \$178.0 million. Under the terms of these agreements, we have purchased a cap on the interest rate of 4.00% and have sold a floor of 2.25%. For the quarters ended March 31, 2007 and 2006 we received a net settlement amount of \$0.6 million and \$0.1 million, respectively, on these collar agreements. The collar agreements mature at various dates between January 2007 and January 2008.

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

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

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

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

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

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

In connection with the restatement and the filing of this Form 10-Q/A, we, with the participation of management, including our Chief Executive Officer and our Chief Financial Officer, re-evaluated our disclosure controls and procedures. In performing the re-evaluation, we considered the effects of the restatement that resulted from the error in the accounting for interest rate swap agreements. Based on the foregoing re-evaluation of our disclosure controls and procedures as of the end of the quarter covered by this report, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

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

**PART II OTHER INFORMATION**

**ITEM 1.      LEGAL PROCEEDINGS**

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On May 5, 2005, Alliance Imaging, Inc. was served with a complaint filed in Alameda County Superior Court alleging wage and hour claims on behalf of a putative class of approximately 400 former and current California employees of our company. On August 19, 2005, the plaintiffs filed an amended complaint, which we answered on September 23, 2005. In this suit, captioned Linda S. Jones, et al. v. Alliance Imaging, Inc., et al., the plaintiffs alleged violations of California's wage, meal period, and break time laws and regulations. Plaintiffs sought recovery of unspecified economic damages, statutory penalties, attorneys' fees, and costs of suit. On or about March 10, 2006, plaintiffs filed a second amended complaint (later further amended by a third amended complaint) adding a cause of action for conversion and a plea for punitive damages. We filed a demurrer and motion to strike seeking to dismiss the new claim and plea. On July 19, 2006, we and the Plaintiffs entered into a tentative settlement of the class action complaint pursuant to which we agreed to pay \$2.5 million in exchange for a dismissal with prejudice of all claims brought on behalf of the putative class under the class action complaint. On September 8, 2006, the settlement was preliminarily approved by the court and a conditional class was certified for purposes of seeking class approval of the settlement. On October 2, 2006, notice was mailed to the conditional class members outlining the terms of the settlement and providing all class members with an opportunity to opt out of the settlement prior to the final approval hearing scheduled for November 27, 2006. Two putative class members opted out of the class, and there were no objections submitted. The final approval hearing was held on November 27, 2006 as scheduled, and the Court granted final approval of the settlement. The settlement amount was distributed by the class settlement administrator on February 16, 2007. The case will be dismissed upon the parties' compliance with the settlement agreement. The Court scheduled a hearing for a final accounting of the settlement distribution on June 25, 2007.

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

### **ITEM 1A. RISK FACTORS**

We have included in Part I, Item 1A of our Annual Report on Form 10-K/A for the year ended December 31, 2006, a description of certain risks and uncertainties that could affect our business, future performance or financial condition. Among these risk factors are risk factors entitled:

- Loss of key executives and failure to attract qualified managers and sales persons could limit our growth and negatively impact our operations ; and
- We are controlled by a single stockholder who will be able to exert significant influence over matters requiring stockholder approval, including change of control transactions .

These two risk factors are amended and superseded by the risk factors set forth below. The other risk factors disclosed in our Form 10-K/A shall remain in full force and affect.

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

We depend upon our management team to a substantial extent. In particular, we depend upon Mr. Viviano, our Chief Executive Officer and the Chairman of our Board of Directors for his skills, experience and knowledge of our company and industry contacts. Effective April 16, 2007, Mr. Viviano entered into an amendment to his employment agreement which extends its term to April 16, 2010, subject to automatic extensions on a quarterly basis after the initial term has been completed. Mr. Viviano can prevent a quarterly extension by giving notice of a desire to modify or terminate the agreement at least thirty days prior to the quarterly extension date. In addition, we do not have key employee insurance

policies covering any of our management team. The loss of Mr. Viviano or other members of our management team could have a material adverse effect on our business, results of operations or financial condition.

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

**Two of our stockholders and their affiliates beneficially own almost half of our outstanding shares of common stock and have the contractual right to designate members of our board of directors and board committees, and will therefore be able to exert significant influence over us, including with respect to change of control transactions.**

On April 16, 2007, OCM Principal Opportunities Fund IV, L.P., MTS Health Investors II, L.P., and affiliated funds, which we refer to as the Oaktree Parties, acquired approximately 49% of our outstanding shares of common stock from a fund controlled by an affiliate of Kohlberg Kravis Roberts & Co., L.P. Following the acquisition, the Oaktree Parties beneficially own approximately 49.4% of our outstanding shares of common stock. In connection with the acquisition, the Oaktree Parties obtained the right to designate three of the seven members of our board of directors, two of the four members of our Compensation Committee (including the chairperson), two of the four members of our Nominating and Corporate Governance Committee, and one of the three members of our Finance Committee.

As a result of the arrangements described above, the Oaktree Parties have the ability to exert significant influence of our management and operations, as well as matters requiring stockholder approval, including approving mergers, consolidations or sales of all or substantially all of our assets. This concentration of ownership may also delay or prevent a change of control of our company or reduce the price investors might be willing to pay for our common stock. The interests of the Oaktree Parties may conflict with the interests of other holders of our common stock.

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

Not applicable.

**ITEM 3.        DEFAULTS UPON SENIOR SECURITIES**



Not applicable.

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

Not applicable.

**ITEM 5. OTHER INFORMATION**

Not applicable.

30

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**ITEM 6. EXHIBITS**

(a) Exhibits

| Exhibit No. | Description   |
|-------------|---|
| 3.1         | Amended and Restated Certificate of Incorporation of Alliance.(3)   |
| 3.2         | Amended and Restated By-laws of Alliance.(7)  |
| 4.1         | Indenture dated as of April 10, 2001 by and between the Registrant and the Bank of New York with respect to \$260 million aggregate principal amount of 103/8% Senior Subordinated Notes due 2011.(1)   |
| 4.2         | Credit Agreement dated as of November 2, 1999, as amended.(1)   |
| 4.3         | Specimen certificate for shares of common stock, \$.01 par value, of Alliance.(3)   |
| 4.4         | Second Amendment dated as of June 10, 2002 to Credit Agreement.(8)  |
| 4.5         | Indenture dated as of December 29, 2004 by and between the Registrant and the Bank of New York with respect to \$150 million aggregate principal amount of 7 1/4% Senior Subordinated Notes due 2012 and 7 1/4% Series B Senior Subordinated Notes due 2012.(6) |
| 4.6         | Supplemental Indenture dated as of December 14, 2004 by and between Registrant and the Bank of New York with respect to 103/8% Senior Subordinated Notes due 2011.(6)   |
| 4.7         | Third Amendment dated as of December 29, 2004 to Credit Agreement.(6)   |
| 4.8         | Fourth Amendment dated as of December 19, 2005 to Credit Agreement.(8)  |
| 4.9         | Fifth Amendment dated as of April 16, 2007 to Credit Agreement.(17)   |
| 10.1        | The 1999 Equity Plan for Employees of Alliance and Subsidiaries.(11)  |
| 10.2        | Forms of option agreements under the 1999 Equity Plan for Employees of Alliance and Subsidiaries.(1)  |
| 10.3        | Alliance Directors' Deferred Compensation Plan, as amended.(2)  |
| 10.4        | Employment Agreement dated as of January 1, 2003 between Alliance and Paul S. Viviano.(5)   |
| 10.5        | Agreement Not to Compete dated as of January 1, 2003 between Alliance and Paul S. Viviano.(5)   |
| 10.6        | Stock Subscription Agreement dated as of January 2, 2003 between Alliance and Paul S. Viviano.(5)   |
| 10.7        | Stock Subscription Agreement dated as of February 3, 2003 between Alliance and Paul S. Viviano.(5)  |
| 10.8        | Form of Stockholder's Agreement.(1)   |
| 10.9        | Registration Rights Agreement dated as of November 2, 1999.(1)  |
| 10.10       | Management Agreement, dated as of November 2, 1999, between Alliance and Kohlberg Kravis Roberts & Co., LLP.(1)   |
| 10.11       | Amendment No. 1 to Management Agreement, effective as of January 1, 2000, between Alliance and Kohlberg Kravis Roberts & Co., LLP.(1)   |
| 10.12       | Form of Indemnification Agreement.(2)   |
| 10.13       | Amended and Restated Employment Agreement dated as of May 9, 2005 between Alliance and Paul S. Vivano.(7)   |
| 10.14       | Agreement Not to Compete dated as of May 9, 2005 between Alliance and Paul S. Vivano.(7)  |
| 10.15       | Employment Agreement dated as of May 9, 2005 between Alliance and Andrew P. Hayek.(7)   |
| 10.16       | Agreement Not to Compete dated as of May 9, 2005 between Alliance and Andrew P. Hayek.(7)   |
| 10.17       | Employment Agreement dated as of December 1, 2005 between Alliance and Howard K. Aihara.(9)   |

31

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| 10.18 | Agreement Not to Compete dated as of December 1, 2005 between Alliance and Howard K. Aihara.(9)  |
| 10.19 | 2006 Executive Incentive Plan (10)   |
| 10.20 | Summary of compensation award to Nicholas A. Poan(12)  |
| 10.21 | Forms of Restricted Stock Award Agreement under the 1999 Equity Plan for Employees of Alliance and Subsidiaries, as amended and Restated(15)   |
| 10.22 | Form of Stock Bonus Award Agreement under the 1999 Equity Plan for Employees of Alliance and Subsidiaries, as amended and Restated(15)   |
| 10.23 | Summary of compensation award to Michael F. Frisch(13)   |
| 10.24 | Summary of compensation award to Eli Glovinsky(15)   |
| 10.25 | Schedule of Executive Officer Compensation(15)   |
| 10.26 | Schedule of Non-Employee Director Compensation(15)   |
| 10.27 | Underwriting Agreement, dated November 20, 2006, by and among Alliance Imaging, Inc., the selling stockholder named therein and Citigroup Global Markets Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, as representatives of the several underwriters named therein(14) |
| 10.28 | Governance and Standstill Agreement, dated as of March 16, 2007, among Alliance Imaging, Inc., OCM Principal Opportunities Fund IV, LP., and MTS Health Investors II, L.P.(16)   |
| 10.29 | Form of Executive Severance Agreement(16)  |
| 10.30 | Assignment, dated as of April 16, 2007, to Registration Rights Agreement, dated as of November 2, 1999.(17)  |
| 10.31 | Amendment No. 2 to Management Agreement, dated as of April 16, 2007, between Alliance and Kohlberg, Kravis Roberts & Co., LLP.(17)   |
| 10.32 | Amendment of Employment Agreement, dated as of April 16, 2007, between Paul S. Viviano and Alliance Imaging, Inc.(17)  |
| 10.33 | Amendment of Employment Agreement, dated as of April 16, 2007, between Howard K. Aihara and Alliance Imaging, Inc.(17)   |
| 21.1  | List of subsidiaries.(15)  |
| 31    | Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.(18)   |
| 32    | Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.(18)   |

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

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

(3) Incorporated by reference to exhibits filed in response to Item 6, Exhibits of the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2001 (File No. 001-16609).

(4) Incorporated by reference to exhibits filed in response to Item 6, Exhibits of the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002 (File No. 001-16609).

(5) Incorporated by reference herein to the indicated Exhibit response in Item 15(a)(3), Exhibits of the Company's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 001-16609).

(6) Incorporated by reference to exhibits filed in response to Item 9.01(c), Exhibits of the Company's Current Report on Form 8-K, dated December 29, 2004 (File No. 001-16609).

- (7) Incorporated by reference to exhibits filed in response to Item 6, Exhibits of the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005 (File No. 001-16609).
- (8) Incorporated by reference to exhibits filed in response to Item 9.01(d), Exhibits of the Company's Current Report on Form 8-K, dated December 22, 2005 (File No. 001-16609).
- (9) Incorporated by reference herein to the indicated Exhibit response in Item 15(a)(1), Exhibits of the Company's Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 001-16609).
- (10) Incorporated by reference to exhibits filed in response to Item 6, Exhibits of the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 (File No. 001-16609).
- (11) Incorporated by reference to Appendix A to the Company's Proxy Statement on Schedule 14A relating to its 2006 Annual Meeting (File No. 001-16609).
- (12) Incorporated by reference to Item 1.01, of the Company's Current Report on Form 8-K, dated October 17, 2006 (File No. 001-16609).
- (13) Incorporated by reference to Item 5.02(c) of the Company's Current Report on Form 8-K, dated November 13, 2006 (File No. 001-16609)
- (14) Incorporated by reference to Exhibit 1.1 of the Company's Current Report on Form 8-K, dated November 22, 2006 (File No. 001-16609)
- (15) Incorporated by reference herein to the indicated Exhibit response in Item 15(a)(3), Exhibits of the Company's Annual Report on Form 10-K for the year ended December 31, 2006 (File No. 001-16609).
- (16) Incorporated by reference to Item 9.01(d), Exhibits, of the Company's Current Report on Form 8-K, dated March 16, 2007 (File No. 001-16609)
- (17) Incorporated by reference to Item 9.01(d), Exhibits, of the Company's Current Report on Form 8-K, dated April 16, 2007 (File No. 001-16609)
- (18) Filed herewith

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

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

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| August 1, 2007 | <b>ALLIANCE, IMAGING, INC.</b><br>By: /s/ PAUL S. VIVIANO<br>Paul S. Viviano<br><i>Chairman of the Board and Chief Executive Officer<br/>(Principal Executive Officer)</i>      |
| August 1, 2007 | By: /s/ HOWARD K. AIHARA<br>Howard K. Aihara<br><i>Executive Vice President and Chief Financial Officer<br/>(Principal Financial Officer)</i>                                   |
| August 1, 2007 | By: /s/ NICHOLAS A. POAN<br>Nicholas A. Poan<br><i>Senior Vice President, Finance, Corporate<br/>Controller and Chief Accounting Officer<br/>(Principal Accounting Officer)</i> |