ORION HEALTHCORP INC
Form 10QSB
August 12, 2005

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

FORM 10-QSB

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2005

Commission File No. 001-16587

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

Delaware (STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	**58-1597246** (IRS EMPLOYER IDENTIFICATION NO.)
1805 Old Alabama Road **Suite 350, Roswell GA** (ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)	**30076** (ZIP CODE)

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

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

TITLE OF EACH CLASS	NAME OF EACH EXCHANGE ON WHICH REGISTERED
Class A Common Stock, $0.001 par value per share	**The American Stock Exchange**

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

As of August 11, 2005, 11,321,265 shares of the Registrant's Class A Common Stock, par value $0.001, were outstanding, 10,642,306 shares of the Registrant’s Class B Common Stock, par value $0.001, were outstanding and 1,555,137 shares of the Registrant’s Class C Common Stock, par value $0.001, were outstanding.

ORION HEALTHCORP, INC.
Quarterly Report on Form 10-QSB
For the Quarterly Period Ended June 30, 2005

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NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

The forward-looking statements in this report are based on current beliefs, estimates and assumptions concerning the operations, future results, and prospects of Orion HealthCorp, Inc. (formerly known as SurgiCare, Inc. "SurgiCare") ("Orion" or the "Company") and its affiliated companies described herein. As actual operations and results may materially differ from those assumed in forward-looking statements, there is no assurance that forward-looking statements will prove to be accurate. Forward-looking statements are subject to the safe harbors created in the Acts. Any number of factors could affect future operations and results, including, without limitation, changes in federal or state healthcare laws and regulations and third party payer requirements, changes in costs of supplies, labor and employee benefits, increases in interest rates on the Company's indebtedness as well as general market conditions, competition and pricing. The Company undertakes no obligation to update publicly any forward-looking statements, whether as a result of new information or future events.

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

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

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

Certain Recent Developments

Acquisition and Restructuring Transactions

On November 18, 2003, the Company entered into an agreement and plan of merger with Integrated Physician Solutions, Inc. ("IPS"), which was amended and restated on February 9, 2004, and further amended on July 16, 2004 and on September 9, 2004 (the "IPS Merger Agreement"), relating to the Company's acquisition of IPS (the "IPS Merger"). On February 9, 2004, the Company entered into an agreement and plan of merger with Dennis Cain Physician Solutions, Ltd. ("DCPS") and Medical Billing Services, Inc. ("MBS"), which was amended and restated on July 16, 2004, and further amended on September 9, 2004 and on December 15, 2004 (the "DCPS/MBS Merger Agreement"), relating to the Company's acquisition of DCPS and MBS (the "DCPS/MBS Transaction" and together with the IPS Merger, the "Acquisitions"). The Company completed the IPS Merger and the DCPS/MBS Transaction on December 15, 2004. As a result of the IPS Merger and the DCPS/MBS Transaction, IPS, MBS and DCPS became wholly-owned subsidiaries of the Company.

On December 15, 2004, and simultaneous with the consummation of the IPS Merger and DCPS/MBS Transaction, the Company consummated its previously disclosed restructuring transactions (the “Closing”), which included issuances of new equity securities for cash and contribution of outstanding debt, and the restructuring of its debt facilities. The Company also completed a one-for-ten reverse stock split (the “Reverse Stock Split”), created three new classes of common stock (Class A, Class B and Class C Common Stock) and changed its name. SurgiCare common stock was converted to shares of Orion’s Class A Common Stock (the “Reclassification”).

Also on December 15, 2004, the Company issued 11,482,261 shares of its Class B Common Stock (the “Investment Transaction”) to various investors for $13,200,000 in cash plus cash in the amount of $128,350, which amount equaled the accrued but unpaid interest immediately prior to the Closing owed to a subsidiary of Brantley Partners IV, L.P. (“Brantley IV”) by SurgiCare and IPS on amounts advanced prior to October 24, 2003 (the “Base Bridge Interest Amount”). At the Closing, Orion used $5,908,761 to pay off the debt owed to the subsidiary of Brantley IV. The Company also granted to Brantley IV the right to purchase shares of Class A Common Stock for cash in an amount up to an aggregate of $3,000,000 after the Closing (the “Purchase Right”). Brantley IV may exercise the Purchase Right at any time after December 15, 2004. Each additional investment will be: (i) subject to the approval of a majority of the members of the board of directors of the Company that are not affiliated with Brantley IV, (ii) consummated on a date mutually agreed by the Company and Brantley IV, and (iii) accomplished with documentation reasonably satisfactory to the Company and Brantley IV. Pursuant to the terms of the Purchase Right, the purchase price per share of the Class A Common Stock will be equal to the lesser of (a) $1.25, and (b) 70% multiplied by the average of the daily average of the high and low price per share of the Class A Common Stock on the American Stock Exchange (“AMEX”) or a similar system on which the Class A Common Stock shall be listed at the time, for the twenty trading days immediately preceding the date of the closing of the exercise of the Purchase Right.

Holders of shares of Class B Common Stock have the option to convert their shares of Class B Common Stock into shares of Class A Common Stock at any time based on a conversion factor in effect at the time of the conversion. The conversion factor is designed to yield one share of Class A Common Stock per share of Class B Common Stock converted, plus such additional shares of Class A Common Stock, or portions thereof, necessary to approximate the unpaid portion of the return of the original purchase price for the Class B Common Stock less the Base Bridge Interest Amount, plus an amount equal to nine percent (9%) per annum on the amount of the original purchase price less the Base Bridge Interest Amount, without compounding, from the date the Class B Common Stock was first issued to the date of conversion. The conversion factor is calculated based on a number equal to one plus the quotient of $1.15 plus 9% per annum (not compounded), divided by the fair market value of the Class A Common Stock (which is determined by reference to the prices at which Class A Common Stock trades immediately prior to the conversion). Therefore, so long as the Class B Common Stock has not yet received a full return of its purchase price less the Base Bridge Interest Amount and a 9% rate of return, if the market value of a share of Class A Common Stock increases, a share of Class B Common Stock will convert into fewer shares of Class A Common Stock, and if the market value of Class A Common Stock shares decreases, a share of Class B Common Stock will convert into more shares of Class A Common Stock. The initial conversion factor was approximately 1.28 (one share of Class B Common Stock converts into approximately 1.28 shares of Class A Common Stock). As of June 30, 2005, the conversion factor was approximately 2.435549575995 shares (one share of Class B Common Stock converts into approximately 2.435549575995 shares of Class A Common Stock). The holders of Class B Common Stock vote together with the holders of Class A Common Stock and Class C Common Stock, as a single class, generally, with each holder of Class A Common Stock entitled to one vote per share of Class A Common Stock held by such holder; with each holder of Class B Common Stock entitled to one vote per share of Class B Common Stock held by such holder; and with each holder of Class C Common Stock entitled to one vote per share of Class C Common Stock held by such holder.

Additionally, the Company used $3,683,492 of the proceeds of the Investment Transaction to repay a portion of the indebtedness to unaffiliated third parties and restructured additional existing indebtedness.

New Line of Credit and Debt Restructuring

In connection with the Closing, Orion also entered into a new secured two-year revolving credit facility pursuant to the Loan and Security Agreement (the "Loan and Security Agreement"), dated December 15, 2004, by and among Orion, certain of its affiliates and subsidiaries, and Healthcare Business Credit Corporation ("HBCC"). Under this facility, up to $4,000,000 of loans may be made available to Orion, subject to a borrowing base. Orion borrowed $1,600,000 under this facility concurrently with the Closing. The interest rate under this facility is equal to the prime rate plus 3%. Upon an event of default, HBCC can accelerate the loans or call the guaranties described below. In connection with entering into this new facility, Orion also restructured its previously-existing debt facilities, which resulted in a decrease in aggregate debt owed to DVI Business Credit Corporation and DVI Financial Services (collectively, "DVI") from approximately $10.1 million to a combined principal amount of approximately $6.5 million, of which approximately $2 million was paid at the Closing.

Pursuant to the Guaranty Agreement (the "Brantley IV Guaranty"), dated as of December 15, 2004, provided by Brantley IV to HBCC, Brantley IV agreed to provide a deficiency guaranty in the amount of $3,272,727. Pursuant to the Guaranty Agreement (the "Brantley Capital Guaranty"; and together with the Brantley IV Guaranty, collectively, the "Guaranties"), dated as of December 15, 2004, provided by Brantley Capital Corporation ("Brantley Capital") to HBCC, Brantley Capital agreed to provide a deficiency guaranty in the amount of $727,273. In consideration for the Guaranties, Orion issued warrants to purchase 20,455 shares of Class A Common Stock, at an exercise price of $0.01 per share, to Brantley IV, and issued warrants to purchase 4,545 shares of Class A Common Stock, at an exercise price of $0.01 per share, to Brantley Capital.

Post-Restructuring Loan Transactions

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

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

Additionally, in connection with the First Loan and the Second Loan, the Company entered into a First Amendment to the Loan and Security Agreement (the “First Amendment”), dated March 22, 2005, with certain of the Company’s affiliates and subsidiaries, and HBCC, whereby its $4,000,000 secured two-year revolving credit facility has been reduced by the amount of the loans from Brantley IV to $2,750,000. As a result of the First Amendment, the Brantley IV Guaranty was amended by the Amended and Restated Guaranty Agreement (the “Amended Brantley IV Guaranty”), dated March 22, 2005, which reduces the deficiency guaranty provided by Brantley IV by the amount of the First Loan to $2,247,727. Also as a result of the First Amendment, the Brantley Capital Guaranty was amended by the Amended and Restated Guaranty Agreement (the “Amended Brantley Capital Guaranty”), dated March 22, 2005, which reduces the deficiency guaranty provided by Brantley Capital by the amount of the Second Loan to $502,273.

Post-Restructuring Transactions Involving Subsidiaries

On June 7, 2005, InPhySys, Inc. (f/k/a IntegriMED, Inc.) (“IntegriMED”), a wholly-owned subsidiary of IPS, executed an Asset Purchase Agreement (the “Agreement”) with eClinicalWeb, LLC (“eClinicalWeb”) to sell substantially all of the assets of IntegriMED. The Agreement was deemed to be effective as of midnight on June 6, 2005. The property sold by IntegriMED to eClinicalWeb (hereinafter collectively referred to as the “Acquired Assets”) includes the machinery, equipment, supplies, materials, computers, software, software licenses, and other personal property owned by IntegriMED and used exclusively in the operation of IntegriMED's business, IntegriMED's goodwill and all of the business conducted under the name "IntegriMED" and "InPhySys", sales and customer lists, account lists, records, manuals, and telephone numbers used exclusively in the operation of IntegriMED's business, and all of IntegriMED's rights and interests in all contracts, open customer purchase orders, quotations or similar agreements to the extent entered into by IntegriMED or assigned to IntegriMED. Additionally, eClinicalWeb agreed to assume and to thereafter perform and pay when due all liabilities related to the Acquired Assets but only to the extent such liabilities arise from and after the Closing Date (as defined below). eClinicalWeb also agreed to sublease certain space from IPS that was occupied by employees of IntegriMED as of the Closing Date. As consideration for the purchase of the Acquired Assets, eClinicalWeb issued to IntegriMED the following: (i) a two percent (2%) ownership interest in eClinicalWeb; and (ii) $69,033.90, for the payoff of certain leases and purchase of certain software, via wire transfer at the closing of the transfer and delivery of all documents and instruments necessary to consummate the transactions contemplated by the Agreement (the "Closing Date"), which occurred concurrently with the execution of the Agreement. In addition to the consideration listed above, IntegriMED retained the following assets related to IntegriMED's business: (i) all cash and cash equivalents relating to IntegriMED's business as of the Closing Date; (ii) all accounts receivable relating to IntegriMED's business as of the Closing Date; and (iii) other assets of IntegriMED

not used exclusively in IntegriMED's business.

On June 13, 2005, the Company announced that it has accepted an offer to purchase its interests in the ambulatory surgery center and the magnetic resonance imaging ("MRI") facility in Dover, Ohio. Under the terms of the offer letter, the Company's interests in these facilities would be sold to a local hospital for cash and assumption of debt. In addition, the Company would continue to operate the facilities under a long-term management agreement. This transaction has not yet closed.

2004 Incentive Plan

On June 1, 2005, the Company executed Amendment No. 1 (the "First Plan Amendment") to the Orion HealthCorp, Inc. 2004 Incentive Plan ("the Plan"), which was adopted in December 2004. The First Plan Amendment amends the Plan to allow the grant of restricted stock units, as well as restricted stock (which was allowed under the Plan) and is attached hereto as Exhibit 10.6.

On June 17, 2005, the Company granted 1,357,000 stock options to certain employees, officers, directors and former directors of the Company pursuant to the Plan, which allows for a maximum of 2.2 million shares of Class A Common Stock to be delivered in satisfaction of awards made under the Plan. The Form of Orion HealthCorp, Inc. Stock Option Agreement (Incentive Stock Option), dated as of June 17, 2005, is attached hereto as Exhibit 10.7.

American Stock Exchange Compliance

On July 8, 2005, the Company received a letter from AMEX stating that the Company had evidenced compliance with the requirements necessary for continued listing on AMEX. This letter was a result of the Company's notification by AMEX on March 7, 2005, that it was not in compliance with the AMEX Company Guide in connection with two issuances of common stock in 2003 and 2004 without advance shareholder approval. After submission of and acceptance by the AMEX of a plan of correction, which included the Company's obtaining such shareholder approval at its May 31, 2005 Annual Meeting of Shareholders, the Company has now regained compliance. The results of the 2005 Annual Meeting of Shareholders are described under the caption "Part II, Item 4. Submission of Matters to a Vote of Security Holders."

Critical Accounting Policies and Estimates

The preparation of Orion's financial statements is in conformity with accounting principles generally accepted in the United States of America, which require management to make estimates and assumptions that affect the amounts reported in the financial statements and footnotes. Orion management bases these estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments that are not readily apparent from other sources. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Changes in the facts or circumstances underlying these estimates could result in material changes and actual results could differ from these estimates. Orion believes the following critical accounting policies affect the most significant areas involving management's judgments and estimates.

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

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

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

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

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

Revenue Recognition. The Company recognizes revenue from its surgery and diagnostic center business on the date the procedures are performed, and accounts receivable are recorded at that time. Revenues are reported at the estimated realizable amounts from patients and third-party payers. If such third-party payers were to change their reimbursement policies, the effect on revenue could be significant. Earnings are charged with a provision for contractual adjustments and doubtful accounts based on such factors as historical trends of billing and cash collections, established fee schedules, accounts receivable agings and contractual relationships with third-party payers. Contractual allowances are estimated primarily using each surgery center's collection experience. Contractual rates and fee schedules are also helpful in this process. On a rolling average basis, the Company tracks collections as a percentage of related billed charges. This percentage, which is adjusted on a quarterly basis, has proved to be the best indicator of expected realizable amounts from patients and third-party payers. Contractual adjustments and accounts deemed uncollectible are applied against the allowance account. The Company is not aware of any material claims, disputes or unsettled matters with third-party payers and there have been no material settlements with third party payers for the three months and six months ended June 30, 2005.

IPS records revenue based on patient services provided by its affiliated medical groups. Net patient service revenue is impacted by billing rates, changes in current procedural terminology code reimbursement and collection trends. IPS reviews billing rates at each of its affiliated medical groups on at least an annual basis and adjusts those rates based on each insurer's current reimbursement practices. Amounts collected by IPS for treatment by its affiliated medical groups of patients covered by Medicaid and other contractual reimbursement programs, which may be based on cost of services provided or predetermined rates, are generally less than the established billing rates of IPS' affiliated medical groups. IPS estimates the amount of these contractual allowances and records a reserve against accounts receivable based on historical collection percentages for each of the affiliated medical groups, which include various payer categories. When payments are received, the contractual adjustment is written off against the established reserve for contractual allowances. The historical collection percentages are adjusted quarterly based on actual payments received, with any differences charged against net revenue for the quarter. Additionally, IPS tracks cash collection percentages for each medical group on a monthly basis, setting quarterly and annual goals for cash collections, bad debt write-offs and aging of accounts receivable. IPS is not aware of any material claims, disputes or unsettled matters with third party payers and there have been no material settlements with third party payers for the three months and six months ended June 30, 2005 and 2004.

MBS earns revenues based on the collection of MBS's customers' receivables. Revenues are recognized during the period in which collections were received.

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

MBS records uncollectible accounts receivable using the direct write-off method of accounting for bad debts. Historically, MBS has experienced minimal credit losses and has not written-off any material accounts during 2005 or 2004.

Investment in Limited Partnerships. The investments in limited partnerships are accounted for by the equity method. Under the equity method, the investment is initially recorded at cost and is subsequently increased to reflect the Company's share of the income of the investee and reduced to reflect the share of the losses of the investee or distributions from the investee.

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

Goodwill and Other Intangible Assets. Goodwill represents the excess of cost over the fair value of net assets of companies acquired in business combinations accounted for using the purchase method. In July 2001, the FASB issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 eliminates pooling-of-interest accounting and requires that all business combinations initiated after June 30, 2001, be accounted for using the purchase method. SFAS No. 142 eliminates the amortization of goodwill and certain other intangible assets and requires the Company to evaluate goodwill for impairment on an annual basis by applying

a fair value test. SFAS No. 142 also requires that an identifiable intangible asset that is determined to have an indefinite useful economic life not be amortized, but separately tested for impairment using a fair value-based approach at least annually. The Company evaluates its goodwill and other intangible assets in the fourth quarter of each fiscal year.

Overview

Surgery and Diagnostic Center Business

The Company was incorporated in Delaware on February 24, 1984 as Technical Coatings Incorporated. On September 10, 1984, its name was changed to Technical Coatings, Inc. Immediately prior to July 1999, the Company was an inactive company. On July 11, 1999, the Company changed its name to SurgiCare, Inc., and at that time changed its business strategy to developing, acquiring and operating freestanding ambulatory surgery centers ("ASCs"). On July 21, 1999, the Company acquired all of the issued and outstanding shares of common stock of Bellaire SurgiCare, Inc. ("Bellaire SurgiCare"), in exchange for the issuance of 9.86 million shares of common stock (now 986,000 shares of Class A Common Stock after giving effect to the Reverse Stock Split and Reclassification), and 1.35 million shares of Series A Redeemable preferred stock, par value $.001 per share, to the holders of Bellaire SurgiCare's common stock. For accounting purposes, this reverse acquisition was effective July 1, 1999. On December 15, 2004, the Company changed its name to Orion HealthCorp, Inc.

As of June 30, 2005, the Company owned a majority interest in two surgery centers and a minority interest as general partner in one additional center. Two of the centers are located in Texas and one is located in Ohio. In limited circumstances, the Company, or its subsidiaries, may also furnish anesthesia services in support of the activities of the surgery centers. The Company's ASCs perform various types of procedures including: orthopedic surgery; colonoscopy; ophthalmic laser surgery; pain injections; and various pediatric surgeries. The most common procedures performed in the Company's ASCs include knee arthroscopy, lumbar nerve block and sacral injection, colonoscopy, hammertoe correction, sinus endoscopic biopsy, cataract removal, breast biopsy, Mitchell procedures and cystourethroscopy. The Company also owns a 41% interest in an open MRI center in Ohio, which opened in July 2004. The open MRI center performs diagnostic procedures using MRI technology. On June 13, 2005, the Company announced that it has accepted an offer to purchase its interests in the ambulatory surgery center and the MRI center. Under the terms of the offer letter, the Company's interests in these facilities would be sold to a local hospital for cash and assumption of debt. In addition, the Company would continue to operate the facilities under a long-term management agreement. This transaction has not yet closed.

The following table sets forth information related to Orion's surgical and diagnostic centers in operation as of June 30, 2005:

Name	Location	Acquisition Date	Orion Ownership
SurgiCare Memorial Village	Houston, Texas	Oct. 2000	60%
San Jacinto Surgery Center	Baytown, Texas	Oct. 2000	10%
Tuscarawas Ambulatory Surgery Center	Dover, Ohio	June 2002	51%
Tuscarawas Open MRI	Dover, Ohio	July 2004	41%

Integrated Physician Solutions

IPS, a Delaware corporation, was founded in 1996 as a business development company to provide physician practice management services to general and subspecialty pediatric practices. IPS commenced its business activities upon consummation of several medical group business combinations effective January 1, 1999. The Pediatric Physician Alliance ("PPA") division of IPS manages pediatric medical clinics. On June 7, 2005, IntegriMED, a wholly-owned subsidiary of IPS, executed an Asset Purchase Agreement with eClinicalWeb, LLC to sell substantially all of the assets of IntegriMED. The Agreement was deemed to be effective as of midnight on June 6, 2005. (See ""Part I, Item 2. Management's Discussion and Analysis or Plan of Operations - Certain Recent Developments - Post-Restructuring Transactions Involving Subsidiaries."

PPA is an experienced and innovative provider of healthcare management services dedicated to the practice of pediatrics. As of June 30, 2005, PPA managed 10 practice sites, representing six medical groups in Illinois, Ohio and New Jersey. PPA provides business management and administrative services to the affiliated medical groups. These services include human resources management, accounting, group purchasing, public relations, marketing, information technology, and general day-to-day business operations management services. The affiliated physicians, who are all employed by separate corporations, provide all clinical and patient care related services. There is a standard forty-year contract between PPA and the various affiliated medical groups whereby the physicians are compensated after all practice expenses and a management fee is paid to PPA.

IPS owns all the assets used in the operation of the medical groups and the physicians, who were equity owners in IPS, and, as a result of the IPS Merger, are now equity owners in Orion. IPS manages the day-to-day business operations of each medical group and provides the assets for the physicians to use in their practice, for a fixed fee or

percentage of the net operating income of the medical group. All revenues are collected by IPS, the fixed fee or percentage payment to IPS is taken from the net operating income of the medical group and the remainder of the net operating income of the medical group is paid to the physicians as a salary and treated as an expense on IPS's accounting records.

Medical Billing Services

MBS is based in Houston, Texas and was incorporated in Texas on October 16, 1985. DCPS is based in Houston, Texas and was organized as a Texas limited liability company on September 16, 1998. DCPS reorganized as a Texas limited partnership on August 31, 2003. The Company acquired MBS and DCPS in the DCPS/MBS Transaction. Subsequent to the DCPS/MBS Transaction, DCPS has operated as a wholly-owned subsidiary of MBS. MBS and DCPS provide practice management, billing and collection, managed care consulting and coding/reimbursement services to hospital-based physicians and clinics. The discussion of MBS below includes the operations of DCPS.

- *Medical Practice Management Services.* MBS provides a wide range of management services to medical practices, including accounting and bookkeeping services, evaluation of staffing needs, and billing and reimbursement analysis. These management services help create a more efficient medical practice and provide assistance with the business aspects associated with operating a medical practice.

- *Billing and Collection Services.* MBS provides billing and collection services to its clients. These include coding, reimbursement services, charge entry, claim submission, collection activities, and financial reporting services.

- *Managed Care Consulting Services.* MBS provides consulting services aimed at assisting clients with navigating and interacting with managed care organizations.

MBS provides services to approximately 58 customers throughout Texas. These customers include anesthesiologists, pathologists, radiologists, imaging centers, comprehensive breast centers, hospital labs, cardio-thoracic surgeons and ASCs.

Results of Operations

As part of the Acquisitions and restructuring transactions, which closed on December 15, 2004, the IPS Merger has been treated as a reverse acquisition, meaning that the purchase price, comprised of the fair value of the outstanding shares of the Company prior to the transaction, plus applicable transaction costs, has been allocated to the fair value of the Company's tangible and intangible assets and liabilities prior to the transaction, with any excess being considered goodwill. IPS is being treated as the continuing reporting entity, and thus IPS's historical results have become those of the combined company. Orion's results include the results of IPS for the three months and six months ended June 30, 2004 and the results of IPS, the Company's surgery and diagnostic center business and MBS (which includes DCPS) for the three months and six months ended June 30, 2005. The descriptions of the business and results of operations of MBS set forth in this report include the business and results of operations of DCPS.

The following table sets forth selected unaudited consolidated condensed statements of operations data expressed as a percentage of Orion's net operating revenues for the three months and six months ended June 30, 2005 and 2004, respectively. Orion's historical results and period-to-period comparisons are not necessarily indicative of the results for any future period.

	Three Months Ended		**Six Months Ended**	
	June 30, 2005 *(Unaudited)*	**June 30, 2004** *(Unaudited)*	**June 30, 2005** *(Unaudited)*	**June 30, 2004** *(Unaudited)*
Net operating revenues	100.0%	100.0%	100.0%	100.0%
Direct cost of revenues				