U S PHYSICAL THERAPY INC /NV
Form 10-Q
November 04, 2010

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**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**WASHINGTON, D.C. 20549**
**FORM 10-Q**

(MARK ONE)

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

**FOR THE QUARTERLY PERIOD ENDED September 30, 2010**

**OR**

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**FOR THE TRANSITION PERIOD FROM _____TO_____**

***COMMISSION FILE NUMBER 1-11151***

**U.S. PHYSICAL THERAPY, INC.**

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

| NEVADA | 76-0364866 |
|---|---|
| (STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION) | (I.R.S. EMPLOYER IDENTIFICATION NO.) |
| 1300 WEST SAM HOUSTON PARKWAY SOUTH, SUITE 300, HOUSTON, TEXAS | 77042 |
| (ADDRESS OF PRINCIPAL EXECUTIVE OFFICES) | (ZIP CODE) |

**REGISTRANT S TELEPHONE NUMBER, INCLUDING AREA CODE: (713) 297-7000**

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.

þ Yes o No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

o Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check One):

| Large accelerated filer o | Accelerated filer þ | Non-accelerated filer o<br>(Do not check if a smaller reporting company) | Smaller reporting company o |
|---|---|---|---|

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

o Yes þ No

As of November 3, 2010, the number of shares outstanding (issued less treasury stock) of the registrant s common stock, par value $.01 per share, was: 11,641,288.

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**PART I FINANCIAL INFORMATION**

Item 1. Financial Statements.

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## ITEM 1. FINANCIAL STATEMENTS.

### U. S. PHYSICAL THERAPY, INC. AND SUBSIDIARIES
### CONSOLIDATED BALANCE SHEETS
### (IN THOUSANDS, EXCEPT SHARE DATA)

| | September 30, 2010 (unaudited) | December 31, 2009 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash | $ 9,720 | $ 6,429 |
| Patient accounts receivable, less allowance for doubtful accounts of $2,226 and $1,830, respectively | 23,900 | 22,300 |
| Accounts receivable other, less allowance for doubtful accounts of $81 and $42, respectively | 1,500 | 1,331 |
| Other current assets | 2,944 | 2,959 |
| Total current assets | 38,064 | 33,019 |
| Fixed assets: | | |
| Furniture and equipment | 32,491 | 31,973 |
| Leasehold improvements | 19,240 | 19,012 |
| | 51,731 | 50,985 |
| Less accumulated depreciation and amortization | 38,546 | 36,646 |
| | 13,185 | 14,339 |
| Goodwill | 67,327 | 57,247 |
| Other intangible assets, net | 7,448 | 5,955 |
| Other assets | 930 | 869 |
| | $ 126,954 | $ 111,429 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable trade | $ 1,224 | $ 1,292 |
| Accrued expenses | 13,450 | 12,459 |
| Current portion of notes payable | 379 | 1,013 |
| Total current liabilities | 15,053 | 14,764 |
| Notes payable | 100 | |
| Revolving line of credit | | 400 |
| Deferred rent | 900 | 1,027 |
| Other long-term liabilities | 4,387 | 3,013 |

| | | |
|---|---|---|
| Total liabilities | 20,440 | 19,204 |
| Commitments and contingencies | | |
| Shareholders equity: | | |
| U. S. Physical Therapy, Inc. shareholders equity: | | |
| Preferred stock, $.01 par value, 500,000 shares authorized, no shares issued and outstanding | | |
| Common stock, $.01 par value, 20,000,000 shares authorized, 13,856,025 and 13,828,470 shares issued, respectively | 139 | 138 |
| Additional paid-in capital | 44,114 | 43,210 |
| Retained earnings | 85,729 | 75,632 |
| Treasury stock at cost, 2,214,737 shares | (31,628) | (31,628) |
| Total U. S. Physical Therapy, Inc. shareholders equity | 98,354 | 87,352 |
| Noncontrolling interests | 8,160 | 4,873 |
| Total equity | 106,514 | 92,225 |
| | $ 126,954 | $ 111,429 |

See notes to consolidated financial statements.

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**U. S. PHYSICAL THERAPY, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF NET INCOME**
**(IN THOUSANDS, EXCEPT PER SHARE DATA)**
**(unaudited)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| Net patient revenues | $ 51,748 | $ 49,578 | $ 152,823 | $ 146,533 |
| Management contract revenues and other revenues | 1,650 | 1,459 | 5,083 | 4,460 |
| Net revenues | 53,398 | 51,037 | 157,906 | 150,993 |
| Clinic operating costs: | | | | |
| Salaries and related costs | 27,991 | 26,823 | 82,406 | 78,656 |
| Rent, clinic supplies, contract labor and other | 10,162 | 10,179 | 30,500 | 30,490 |
| Provision for doubtful accounts | 695 | 1,001 | 2,463 | 2,576 |
| Closure costs | 19 | 49 | 34 | 83 |
| Total clinic operating costs | 38,867 | 38,052 | 115,403 | 111,805 |
| Corporate office costs | 5,798 | 5,790 | 17,114 | 17,049 |
| Operating income | 8,733 | 7,195 | 25,389 | 22,139 |
| Interest and other income, net | 1 | 2 | 583 | 7 |
| Interest expense | (50) | (93) | (195) | (294) |
| Income before taxes | 8,684 | 7,104 | 25,777 | 21,852 |
| Provision for income taxes | 2,507 | 1,964 | 7,435 | 6,085 |
| Net income including noncontrolling interests | 6,177 | 5,140 | 18,342 | 15,767 |
| Less: net income attributable to noncontrolling interests | (2,302) | (2,039) | (6,844) | (6,290) |
| Net income attributable to common shareholders | $ 3,875 | $ 3,101 | $ 11,498 | $ 9,477 |
| Earnings per share attributable to common shareholders: | | | | |
| Basic | $ 0.33 | $ 0.27 | $ 0.99 | $ 0.81 |
| Diluted | $ 0.33 | $ 0.26 | $ 0.97 | $ 0.80 |

| | | | | |
|---|---|---|---|---|
| Shares used in computation: | | | | |
| Basic | 11,667 | 11,570 | 11,634 | 11,734 |
| Diluted | 11,889 | 11,748 | 11,862 | 11,781 |

See notes to consolidated financial statements.

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**U. S. PHYSICAL THERAPY, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(IN THOUSANDS)**
**(unaudited)**

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2010 | 2009 |
| **OPERATING ACTIVITIES** | | |
| Net income including noncontrolling interests | $ 18,342 | $ 15,767 |
| Adjustments to reconcile net income including noncontrolling interests to net cash provided by operating activities: | | |
| Depreciation and amortization | 4,276 | 4,439 |
| Provision for doubtful accounts | 2,463 | 2,576 |
| Equity-based awards compensation expense | 919 | 1,213 |
| (Gain) loss on sale of business and sale or abandonment of assets, net | (350) | 103 |
| Deferred income tax | 1,104 | 190 |
| Other | (175) | (406) |
| Changes in operating assets and liabilities: | | |
| Increase in patient accounts receivable | (3,616) | (513) |
| (Increase) decrease in accounts receivable other | (169) | 192 |
| Decrease (increase) in other assets | 95 | (32) |
| Increase in accounts payable and accrued expenses | 664 | 1,534 |
| Increase (decrease) in other liabilities | 229 | (546) |
| Net cash provided by operating activities | 23,782 | 24,517 |
| **INVESTING ACTIVITIES** | | |
| Purchase of fixed assets | (2,670) | (3,282) |
| Purchase of businesses, net of cash acquired | (8,846) | |
| Acquisitions of noncontrolling interests | (553) | (135) |
| Net proceeds on sale of fixed assets and business | 897 | 53 |
| Net cash used in investing activities | (11,172) | (3,364) |
| **FINANCING ACTIVITIES** | | |
| Distributions to noncontrolling interests | (7,236) | (7,429) |
| Purchase and retirement of common stock | (1,401) | (5,586) |
| Proceeds from revolving line of credit | 36,800 | 17,450 |
| Payments on revolving line of credit | (37,200) | (25,450) |
| Payment of notes payable | (734) | (1,026) |
| Excess tax benefit from stock options exercised | 48 | 44 |
| Proceeds from exercise of stock options | 404 | 57 |
| Net cash used in financing activities | (9,319) | (21,940) |
| Net increase (decrease) in cash | 3,291 | (787) |
| Cash beginning of period | 6,429 | 10,113 |

| | | | | |
|---|---|---|---|---|
| Cash end of period | $ | 9,720 | $ | 9,326 |

| | | | | |
|---|---|---|---|---|
| **SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION** | | | | |
| Cash paid during the period for: | | | | |
| Income taxes | $ | 6,168 | $ | 6,946 |
| Interest | $ | 139 | $ | 268 |
| Non-cash investing and financing transactions during the period: | | | | |
| Purchase of business seller financing portion | $ | 275 | $ | |

See notes to consolidated financial statements.

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**U. S. PHYSICAL THERAPY, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY**
**(IN THOUSANDS)**
**(unaudited)**

| | U. S. Physical Therapy, Inc. | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Common Stock | | Additional Paid-In | Retained | Treasury Stock | | Total Shareholders | Noncontrolling | |
| | Shares | Amount | Capital | Earnings | Shares | Amount | Equity | Interests | Total |
| Balance December 31, 2009 | 13,829 | $ 138 | $ 43,210 | $ 75,632 | (2,215) | $ (31,628) | $ 87,352 | $ 4,873 | $ 92,225 |
| Issuance of restricted stock | 93 | | | | | | | | |
| Cancellation of restricted stock | (10) | | | | | | | | |
| Proceeds from exercise of stock options | 31 | 1 | 403 | | | | 404 | | 404 |
| Tax benefit from exercise of stock options | | | 48 | | | | 48 | | 48 |
| Compensation expense restricted stock | | | 872 | | | | 872 | | 872 |
| Compensation expense stock options | | | 47 | | | | 47 | | 47 |
| Purchase of business | | | | | | | | 3,858 | 3,858 |
| Sale of business | | | | | | | | (92) | (92) |
| Purchase and retirement of treasury shares | (87) | | | (1,401) | | | (1,401) | | (1,401) |
| Purchase of noncontrolling interests | | | (466) | | | | (466) | (87) | (553) |
| Distributions to noncontrolling interest partners | | | | | | | | (7,236) | (7,236) |
| Net income | | | | 11,498 | | | 11,498 | 6,844 | 18,342 |
| Balance September 30, 2010 | 13,856 | $ 139 | $ 44,114 | $ 85,729 | (2,215) | $ (31,628) | $ 98,354 | $ 8,160 | $ 106,514 |

See notes to consolidated financial statements.

**U.S. PHYSICAL THERAPY, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**September 30, 2010**
(unaudited)

## 1. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements include the accounts of U.S. Physical Therapy, Inc. and its subsidiaries. All significant intercompany transactions and balances have been eliminated. The Company primarily operates through subsidiary clinic partnerships, in which the Company generally owns a 1% general partnership interest and a 64% limited partnership interest. The managing therapist of each clinic owns, directly or indirectly, the remaining limited partnership interest in the majority of the clinics (hereinafter referred to as Clinic Partnership ). To a lesser extent, the Company operates some clinics, through wholly-owned subsidiaries, under profit sharing arrangements with therapists (hereinafter referred to as Wholly-Owned Facilities ).

The Company continues to seek to attract physical and occupational therapists who have established relationships with patients and physicians by offering therapists a competitive salary and a share of the profits of the clinic operated by that therapist. The Company has developed satellite clinic facilities of existing clinics, with the result that many clinic groups operate more than one clinic location. In addition, the Company has acquired a majority interest in a number of clinics through acquisitions.

During the three months ended September 30, 2010, the Company opened five new clinics as satellites of existing clinics and closed two clinics. During the nine months ended September 30, 2010, the Company opened 13 new clinics, acquired five, sold five and closed nine. Of the 13 clinics opened, three were new Clinic Partnerships and the remaining ten were satellites of existing clinics. On February 26, 2010, the Company acquired a 70% interest in five clinics in the northeast and, on March 31, 2010, the Company sold its 51% interest in a five clinic joint venture in Texas. The Company ended September 2010 with 372 clinics.

The Company intends to continue to focus on developing new clinics and on opening satellite clinics where deemed appropriate. The Company will also continue to evaluate acquisition opportunities.

The accompanying unaudited consolidated financial statements were prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and in accordance with the instructions for Form 10-Q. However, the statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. Management believes this report contains all necessary adjustments (consisting only of normal recurring adjustments) to present fairly, in all material respects, the Company s financial position, results of operations and cash flows for the interim periods presented. For further information regarding the Company s accounting policies, please read the audited financial statements included in the Company s Form 10-K for the year ended December 31, 2009.

The Company believes, and the Chief Executive Officer, Chief Financial Officer and Corporate Controller have certified, that the financial statements included in this report present fairly, in all material respects, the Company s financial position, results of operations and cash flows for the interim periods presented.

Operating results for the three months and nine months ended September 30, 2010 are not necessarily indicative of the results the Company expects for the entire year. Please also review the Risk Factors section included in our Form 10-K for the year ended December 31, 2009 and Item 1A. Risk Factors included in this report.

*Clinic Partnerships*

For Clinic Partnerships, the earnings and liabilities attributable to the noncontrolling interests, typically owned by the managing therapist, directly or indirectly, are recorded within the balance sheets and income statements as noncontrolling interests.

*Wholly-Owned Facilities*

For Wholly-Owned Facilities with profit sharing arrangements, an appropriate accrual is recorded for the amount of profit sharing due to the profit sharing therapists. The amount is expensed as compensation and included in clinic operating costs salaries and related costs. The respective liability is included in current liabilities accrued expenses on the balance sheet.

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**Significant Accounting Policies**

**Cash**

The Company maintains its cash at financial institutions. The combined account balances at several institutions may exceed the Federal Deposit Insurance Corporation ( FDIC ) insurance coverage and, as a result, there is a concentration of credit risk related to amounts on deposit in excess of FDIC insurance coverage. Management believes that this risk is not significant.

**Long-Lived Assets**

Fixed assets are stated at cost. Depreciation is computed on the straight-line method over the estimated useful lives of the related assets. Estimated useful lives for furniture and equipment range from three to eight years and for software purchased from three to seven years. Leasehold improvements are amortized over the shorter of the related lease term or estimated useful lives of the assets, which is generally three to five years.

**Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of**

The Company reviews property and equipment and intangible assets with finite lives for impairment upon the occurrence of certain events or circumstances which indicate that the related amounts may be impaired. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

**Goodwill**

For 2010 acquisitions, goodwill represents the excess of the amount paid and fair value of the noncontrolling interests over the fair value of the acquired business assets, which include certain intangible assets. Historically, goodwill has been derived from acquisitions and, prior to 2009, from the purchase of some or all of a particular local management s equity interest in an existing clinic. Effective January 1, 2009, if the purchase price of a noncontrolling interest by the Company exceeds or is less than the book value at the time of purchase, any excess or shortfall is recognized as an adjustment to additional paid-in capital.

The fair value of goodwill and other intangible assets with indefinite lives are tested for impairment annually and upon the occurrence of certain events, and are written down to fair value if considered impaired. The Company evaluates goodwill for impairment on at least an annual basis (in its third quarter) by comparing the fair value of each reporting unit to the carrying value of the reporting unit including related goodwill. The Company operates a one segment business which is made up of various clinics within partnerships. A reporting unit refers to the acquired interest of a single clinic or group of clinics. Local management typically continues to manage the acquired clinic or group of clinics. For each clinic or group of clinics, the Company maintains discrete financial information and both corporate and local management regularly review the operating results. The Company did not combine any of the reporting units for impairment testing in any year presented because they did not meet the criteria for aggregation. For each purchase of the equity interest, goodwill, if any, is assigned to the respective clinic or group of clinics, if deemed appropriate. The evaluation of goodwill in 2010 and 2009 did not result in any goodwill amounts that were deemed impaired.

An impairment loss generally would be recognized when the carrying amount of the net assets of the reporting unit, inclusive of goodwill and other intangible assets, exceed the estimated fair value of the reporting unit. The estimated fair value of a reporting unit is determined using two factors: (i) earnings prior to taxes, depreciation and amortization for the reporting unit multiplied by a price/earnings ratio used in the industry and (ii) a discounted cash flow analysis. A weight is assigned to each factor and the sum of each weight times the factor is considered the estimated fair value. The price/earnings ratio, discount rate and residual capitalization rate factors were updated to reflect current market conditions for the third quarter of 2010 goodwill impairment test.

**Noncontrolling interests**

The Company recognizes noncontrolling interests as equity in the consolidated financial statements separate from the parent entity s equity. The amount of net income attributable to noncontrolling interests is included in consolidated net income on the face of the income statement. Changes in a parent entity s ownership interest in a subsidiary that do not result in deconsolidation are treated as equity transactions if the parent entity retains its controlling financial interest. The Company recognizes a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss is measured using the fair value of the noncontrolling equity investment on the deconsolidation date.

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When the purchase price of a noncontrolling interest by the Company exceeds or is less than the book value at the time of purchase, any excess or shortfall is recognized as an adjustment to additional paid-in capital. Additionally, operating losses are allocated to noncontrolling interests even when such allocation creates a deficit balance for the noncontrolling interest partner.

**Revenue Recognition**

Revenues are recognized in the period in which services are rendered. Net patient revenues (patient revenues less estimated contractual adjustments) are reported at the estimated net realizable amounts from third-party payors, patients and others for services rendered. The Company has agreements with third-party payors that provide for payments to the Company at amounts different from its established rates. The allowance for estimated contractual adjustments is based on terms of payor contracts and historical collection and write-off experience.

The Company determines allowances for doubtful accounts based on the specific agings and payor classifications at each clinic. The provision for doubtful accounts is included in clinic operating costs in the statement of net income. Net accounts receivable, which are stated at the historical carrying amount net of contractual allowances, write-offs and allowance for doubtful accounts, includes only those amounts the Company estimates to be collectible.

Since 1999, reimbursement for outpatient therapy services provided to Medicare beneficiaries has been made according to a Medicare Physician Fee Schedule ( MPFS ) published by the Department of Health and Human Services ( HHS ). Under the Balanced Budget Act of 1997, the total amount paid by Medicare in any one year for outpatient physical therapy or occupational therapy (including speech-language pathology) to any one patient is subjected to a stated dollar amount (the Medicare Cap or Limit ), except for services provided by hospitals. Outpatient therapy services rendered to Medicare beneficiaries by the Company s therapists are subject to the Medicare Cap, except to the extent these services are rendered pursuant to certain management and professional services agreements with inpatient facilities. In 2006, Congress passed the Deficit Reduction Act ( DRA ), which allowed the Centers for Medicare & Medicaid Services ( CMS ) to grant exceptions to the Medicare Cap for services provided during the year, as long as those services met certain qualifications. The exception process initially allowed for automatic and manual exceptions to the Medicare Cap for medically necessary services. CMS subsequently revised the exceptions procedures and eliminated the manual exceptions process. Beginning January 1, 2008, all services that required exceptions to the Medicare Cap were processed as automatic exceptions. While the basic procedure for obtaining an automatic exception remained the same, CMS expanded requirements for documentation related to the medical necessity of services provided above the cap. Under the Medicare Improvements for Patients and Providers Act ( MIPPA ) as passed July 16, 2008, the extension process remained through December 31, 2009. The Temporary Extension Act of 2010, enacted on March 2, 2010, extended the therapy cap exceptions process through March 31, 2010, retroactive to January 1, 2010. With respect to the MPFS, in April, the Continuing Extension Act of 2010 was signed into law which extended the zero percent update through May 31, 2010.

On March 23, 2010, the President signed into law the Patient Protection and Affordable Care Act ( PPACA ), which extended the exceptions process for the outpatient therapy Medicare Cap. Outpatient therapy service providers may continue to submit claims when an exception is appropriate beyond the allotted Medicare Cap for services furnished on or after January 1, 2010 through December 31, 2010. For physical therapy and speech language pathology service combined, and for occupational therapy services, the Medicare Cap for 2010 is $1,860.

On June 25, 2010, the President signed into law the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act ( PACMBPRA ). The legislation increases reimbursement to providers of outpatient physical therapy for Medicare patients by 2.2% effective June 1, 2010 through November 30, 2010.

Since the Medicare Cap was implemented, patients who have been impacted by the cap and those who do not qualify for an exception may choose to pay for services in excess of the cap themselves; however, it is assumed that the Medicare Cap will continue to result in some lower revenues to the Company.

On November 2, 2010 CMS released a final ruling on the Multiple Procedure Payment Reduction (MPPR) that includes changes to the reimbursement for Medicare related therapy services that will become effective January 1, 2011. Under MPPR, the practice expense of second and subsequent therapy codes billed in a single day will be reduced by 25%. This reduction will result in an estimated 7% rate reduction for therapy services provided in calendar year 2011 for Medicare. In addition, CMS will make changes to the Relative Value Units (RVUs) and the Geographic

Practice Costs Index (GPCI) to the Resource Based Relative Value System (RBRVS) that would potentially mitigate the 7% rate reduction, assuming that Congress acts with regard to the pending Sustainable Growth Rate (SGR) Physician Fee Schedule reduction.



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Laws and regulations governing the Medicare program are complex and subject to interpretation. The Company believes that it is in compliance in all material respects with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing that would have a material effect on the Company s financial statements as of September 30, 2010. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as significant regulatory action including fines, penalties, and exclusion from the Medicare program.

Management contract revenues are derived from contractual arrangements whereby the Company manages a clinic for third party owners. The Company does not have any ownership interest in these clinics. Typically, revenues are determined based on the number of visits conducted at the clinic and recognized when services are performed.

**Contractual Allowances**

Contractual allowances result from the differences between the rates charged for services performed and expected reimbursements for such services by both insurance companies and government sponsored healthcare programs. Medicare regulations and the various third party payors and managed care contracts are often complex and may include multiple reimbursement mechanisms payable for the services provided in Company clinics. The Company estimates contractual allowances based on its interpretation of the applicable regulations, payor contracts and historical calculations. Each month the Company estimates its contractual allowance for each clinic based on payor contracts and the historical collection experience of the clinic and applies an appropriate contractual allowance reserve percentage to the gross accounts receivable balances for each payor of the clinic. Based on the Company s historical experience, calculating the contractual allowance reserve percentage at the payor level is sufficient to allow us to provide the necessary detail and accuracy with its collectibility estimates. However, the services authorized and provided and related reimbursement are subject to interpretation that could result in payments that differ from the Company s estimates. Payor terms are periodically revised necessitating continual review and assessment of the estimates made by management. The Company s billing systems may not capture the exact change in our contractual allowance reserve estimate from period to period in order to assess the accuracy of our revenues, and hence, our contractual allowance reserves. Management regularly compares its cash collections to corresponding net revenues measured both in the aggregate and on a clinic-by-clinic basis. In the aggregate, historically the difference between net revenues and corresponding cash collections has generally reflected a difference within approximately 1% of net revenues. Additionally, analysis of subsequent period s contractual write-offs on a payor basis shows a less than 1% difference between the actual aggregate contractual reserve percentage as compared to the estimated contractual allowance reserve percentage associated with the same period end balance. As a result, the Company believes that a change in the contractual allowance reserve estimate would not likely be more than 1% at September 30, 2010.

**Income Taxes**

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

The Company recognizes the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount to be recognized in the financial statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority.

The Company recognizes accrued interest expense and penalties associated with unrecognized tax benefits as income tax expense. The Company did not have any accrued interest or penalties associated with any unrecognized tax benefits nor was any interest expense recognized during the nine months ended September 30, 2010 and 2009.

**Fair Value of Financial Instruments**

The carrying amounts reported in the balance sheet for cash and cash equivalents, accounts receivable, accounts payable and notes payable approximate their fair values due to the short-term maturity of these financial instruments. The carrying amount of the revolving line of credit approximates its fair value. The interest rate on the revolving line

of credit, which is tied to the Eurodollar Rate, is set at various short-term intervals as detailed in the credit agreement.



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**Segment Reporting**

Operating segments are components of an enterprise for which separate financial information is available that is evaluated regularly by chief operating decision makers in deciding how to allocate