HOVNANIAN ENTERPRISES INC
Form 10-Q
March 08, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

[X] Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended JANUARY 31, 2017

OR

[ ] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission file number 1-8551

Hovnanian Enterprises, Inc. (Exact Name of Registrant as Specified in Its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)

22-1851059 (I.R.S. Employer Identification No.)

110 West Front Street, P.O. Box 500, Red Bank, NJ 07701 (Address of Principal Executive Offices)

732-747-7800 (Registrant's Telephone Number, Including Area Code)

N/A (Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

Yes [X] No [ ]

Indicate by check mark whether the registrant 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 (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes [X] 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.

Large Accelerated Filer [ ] Accelerated Filer [X]

Non-Accelerated Filer [ ] (Do not check if smaller reporting company) Smaller Reporting Company [ ]

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. 132,110,001 shares of Class A Common Stock and 15,251,061 shares of Class B Common Stock were outstanding as of March 3, 2017.

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HOVNANIAN ENTERPRISES, INC.

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HOVNANIAN ENTERPRISES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In Thousands)

	January 31, 2017 (Unaudited)	October 31, 2016 (1)
ASSETS		
Homebuilding:		
Cash and cash equivalents	$195,830	$339,773
Restricted cash and cash equivalents	1,786	3,914
Inventories:		
Sold and unsold homes and lots under development	945,153	899,082
Land and land options held for future development or sale	176,701	175,301
Consolidated inventory not owned	171,572	208,701
Total inventories	1,293,426	1,283,084
Investments in and advances to unconsolidated joint ventures	111,351	100,502
Receivables, deposits and notes, net	45,982	49,726
Property, plant and equipment, net	49,998	50,332
Prepaid expenses and other assets	50,352	46,762
Total homebuilding	1,748,725	1,874,093
Financial services	113,249	197,230
Income taxes receivable – including net deferred tax benefits	283,322	283,633
Total assets	$2,145,296	$2,354,956
LIABILITIES AND EQUITY		
Homebuilding:		
Nonrecourse mortgages secured by inventory, net of debt issuance costs	$73,528	$82,115
Accounts payable and other liabilities	319,661	369,228
Customers’ deposits	35,953	37,429
Nonrecourse mortgages secured by operating properties	13,997	14,312
Liabilities from inventory not owned, net of debt issuance costs	124,394	150,179
Revolving credit facility	52,000	52,000
Notes payable and term loan, net of discount and debt issuance costs	1,567,673	1,605,758
Total homebuilding	2,187,206	2,311,021
Financial services	86,370	172,445
Total liabilities	2,273,576	2,483,466
Stockholders’ equity deficit:		

Preferred stock, $0.01 par value - authorized 100,000 shares; issued and outstanding 5,600 shares with a liquidation preference of $140,000 at January 31, 2017 and at October 31, 2016	135,299	135,299
Common stock, Class A, $0.01 par value – authorized 400,000,000 shares; issued 143,870,764 shares at January 31, 2017 and 143,806,775 shares at October 31, 2016	1,439	1,438
Common stock, Class B, $0.01 par value (convertible to Class A at time of sale) – authorized 60,000,000 shares; issued 15,942,809 shares at January 31, 2017 and 15,942,809 shares at October 31, 2016	159	159
Paid in capital – common stock	706,509	706,137
Accumulated deficit	(856,326)	(856,183)
Treasury stock – at cost - 11,760,763 shares of Class A common stock and 691,748 shares of Class B common stock at January 31, 2017 and October 31, 2016	(115,360)	(115,360)
Total stockholders’ equity deficit	(128,280)	(128,510)
Total liabilities and equity	$2,145,296	$2,354,956

(1) Derived from the audited balance sheet as of October 31, 2016.

See notes to condensed consolidated financial statements (unaudited).

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HOVNANIAN ENTERPRISES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In Thousands Except Share and Per Share Data)

(Unaudited)

	Three Months Ended January 31,	
	2017	2016
Revenues:		
Homebuilding:		
Sale of homes	$531,415	$556,775
Land sales and other revenues	7,745	604
Total homebuilding	539,160	557,379
Financial services	12,849	18,226
Total revenues	552,009	575,605
Expenses:		
Homebuilding:		
Cost of sales, excluding interest	445,027	464,146
Cost of sales interest	18,322	16,843
Inventory impairment loss and land option write-offs	3,184	11,681
Total cost of sales	466,533	492,670
Selling, general and administrative	44,408	47,504
Total homebuilding expenses	510,941	540,174
Financial services	6,855	8,215
Corporate general and administrative	15,656	16,321
Other interest	22,627	21,225
Other operations	1,587	1,384
Total expenses	557,666	587,319
Gain on extinguishment of debt	7,646	-
Loss from unconsolidated joint ventures	(1,666)	(1,480)
Income (loss) before income taxes	323	(13,194)
State and federal income tax (benefit) provision:		
State	(18)	4,319
Federal	484	(1,340)
Total income taxes	466	2,979
Net loss	$(143)	$(16,173)
Per share data:		
Basic:		
Loss per common share	$0.00	$(0.11)

Weighted-average number of common shares outstanding	147,535	147,139
Assuming dilution:		
Loss per common share	$0.00	$(0.11)
Weighted-average number of common shares outstanding	147,535	147,139

See notes to condensed consolidated financial statements (unaudited).

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HOVNANIAN ENTERPRISES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF EQUITY

(In Thousands Except Share Amounts)

(Unaudited)

	A Common Stock Shares Issued and Outstanding	Amount	B Common Stock Shares Issued and Outstanding	Amount	Preferred Stock Shares Issued and Outstanding	Amount	Paid-In Capital	Accumulated Deficit	Treasury Stock
Balance, October 31, 2016	132,046,012	$1,438	15,251,061	$159	5,600	$135,299	$706,137	$(856,183)	$(115,360)
Stock options, amortization and issuances							138		
Restricted stock amortization, issuances and forfeitures	63,989	1					234		
Net loss								(143)	
Balance, January 31, 2017	132,110,001	$1,439	15,251,061	$159	5,600	$135,299	$706,509	$(856,326)	$(115,360)

See notes to condensed consolidated financial statements (unaudited).

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HOVNANIAN ENTERPRISES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)

(Unaudited)

	Three Months Ended January 31,	
	2017	2016
Cash flows from operating activities:		
Net loss	$(143)	$(16,173)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation	1,013	865
Compensation from stock options and awards	452	1,545
Amortization of bond discounts and deferred financing costs	4,129	2,971
Gain on sale and retirement of property and assets	(56)	(81)
Loss from unconsolidated joint ventures	1,666	1,480
Distributions of earnings from unconsolidated joint ventures	185	-
Gain on extinguishment of debt	(7,646)	-
Inventory impairment and land option write-offs	3,184	11,681
Deferred income tax provision	20	2,616
(Increase) decrease in assets:		
Origination of mortgage loans	(229,537)	(275,617)
Sale of mortgage loans	312,027	240,976
Restricted cash, receivables, prepaids, deposits and other assets	4,833	(2,877)
Inventories	(13,526)	(19,089)
Increase (decrease) in liabilities:		
State income tax payable	291	275
Customers’ deposits	(1,476)	(1,785)
Accounts payable, accrued interest and other accrued liabilities	(49,500)	(11,868)
Net cash provided by (used in) operating activities	25,916	(65,081)
Cash flows from investing activities:		
Proceeds from sale of property and assets	60	93
Purchase of property, equipment and other fixed assets and acquisitions	(560)	(1,253)
Increase in restricted cash related to mortgage company	(2,324)	(81)
(Increase) decrease in restricted cash related to letters of credit	(1)	52
Investments in and advances to unconsolidated joint ventures	(14,639)	(11,497)
Distributions of capital from unconsolidated joint ventures	1,939	2,132
Net cash used in investing activities	(15,525)	(10,554)
Cash flows from financing activities:		
Proceeds from mortgages and notes	54,396	57,592
Payments related to mortgages and notes	(63,307)	(72,985)

Proceeds from model sale leaseback financing programs	747	9,339
Payments related to model sale leaseback financing programs	(4,268)	(7,110)
Proceeds from land bank financing programs	4,788	138,314
Payments related to land bank financing programs	(27,650)	(3,240)
Payments for senior notes and senior amortizing notes	(33,086)	(175,040)
Net proceeds (payments) related to mortgage warehouse lines of credit	(86,058)	31,481
Deferred financing cost from land bank financing program and note issuances	(938)	(3,883)
Net cash (used in) financing activities	(155,376)	(25,532)
Net decrease in cash and cash equivalents	(144,985)	(101,167)
Cash and cash equivalents balance, beginning of period	346,765	253,745
Cash and cash equivalents balance, end of period	$201,780	$152,578

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HOVNANIAN ENTERPRISES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands - Unaudited)

(Continued)

	Three Months Ended	
	January 31,	
	2017	2016
Supplemental disclosure of cash flow:		
Cash paid during the period for:		
Interest, net of capitalized interest (see Note 3 to the Condensed Consolidated Financial Statements)	$24,019	$33,000
Income taxes	$154	$88

See notes to condensed consolidated financial statements (unaudited).

HOVNANIAN ENTERPRISES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED

1. Basis of Presentation

Hovnanian Enterprises, Inc. and Subsidiaries (the "Company", "we", "us" or "our") has reportable segments consisting of six Homebuilding segments (Northeast, Mid-Atlantic, Midwest, Southeast, Southwest and West) and the Financial Services segment (see Note 16).

The accompanying unaudited Condensed Consolidated Financial Statements include our accounts and those of all wholly-owned subsidiaries after elimination of all significant intercompany balances and transactions.

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X and should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended October 31, 2016. In the opinion of management, all adjustments for interim periods presented have been made, which include normal recurring accruals and deferrals necessary for a fair presentation of our condensed consolidated financial position, results of operations and cash flows. The preparation of Condensed Consolidated Financial Statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates, and these differences could have a significant impact on the Condensed Consolidated Financial Statements. Results for interim periods are not necessarily indicative of the results which might be expected for a full year. The balance sheet at October 31, 2016 has been derived from the audited Consolidated Financial Statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements.

Reclassifications

In November 2016, we adopted Accounting Standards Update ("ASU") 2015-03, "Interest - Imputation of Interest," which changes the presentation of debt issuance costs in the balance sheet from an asset to a direct reduction of the carrying amount of the related debt. The adoption of this guidance resulted in the reclassification of applicable unamortized debt issuance costs from "Prepaid expenses and other assets" of $24.5 million to "Nonrecourse mortgages secured by inventory" of $1.3 million, "Liabilities from inventory not owned" of $3.0 million and "Notes payable and term loan" of

$20.2 million (as discussed in Note 11) on our Condensed Consolidated Balance Sheets. We applied the new guidance retrospectively to all prior periods presented in the financial statements to conform to the fiscal 2017 presentation. Additionally, in November 2016, we adopted ASU 2015-15 “Interest – Imputation of Interest (Subtopic 835-30)” (“ASU 2015-15”), which was issued as a follow-up to ASU 2015-03. ASU 2015-15 allows an entity to defer and present debt issuance costs for line-of-credit arrangements as an asset and subsequently amortize the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. Therefore, there was no change to the presentation of our “Revolving credit facility” on the Condensed Consolidated Balance Sheets for any of the periods presented.

2. Stock Compensation

The Company’s total stock-based compensation expense was $0.5 million and $1.5 million for the three months ended January 31, 2017 and 2016, respectively. Included in this total stock-based compensation expense was the vesting of stock options of $0.1 million for both the three months ended January 31, 2017 and 2016.

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3. Interest

Interest costs incurred, expensed and capitalized were:

	Three Months Ended January 31,	
(In thousands)	2017	2016
Interest capitalized at beginning of period	$96,688	$123,898
Plus interest incurred(1)	38,699	41,959
Less cost of sales interest expensed	18,322	16,843
Less other interest expensed(2)(3)	22,627	21,225
Less interest transferred to unconsolidated joint venture(4)	-	10,676
Interest capitalized at end of period(5)	$94,438	$117,113

(1) Data does not include interest incurred by our mortgage and finance subsidiaries.

(2) Other interest expensed includes interest that does not qualify for interest capitalization because our assets that qualify for interest capitalization (inventory under development) do not exceed our debt. Also includes interest on

(3) completed homes and land in planning, which does not qualify for capitalization, and therefore is expensed. Cash paid for interest, net of capitalized interest, is the sum of other interest expensed, as defined above, and interest paid by our mortgage and finance subsidiaries adjusted for the change in accrued interest on notes payable, which is calculated as follows:

	Three Months Ended January 31,	
(In thousands)	2017	2016
Other interest expensed	$22,627	$21,225
Interest paid by our mortgage and finance subsidiaries	629	559
Decrease in accrued interest	763	11,216
Cash paid for interest, net of capitalized interest	$24,019	$33,000

(4) Represents capitalized interest which was included as part of the assets transferred to the joint venture the Company entered into in November 2015, as discussed in Note 17. There was no impact to the Condensed Consolidated Statement of Operations as a result of this transaction.

(5) Capitalized interest amounts are shown gross before allocating any portion of impairments, if any, to capitalized interest.

4. Reduction of Inventory to Fair Value

We record impairment losses on inventories related to communities under development and held for future development when events and circumstances indicate that they may be impaired and the undiscounted cash flows estimated to be generated by those assets are less than their related carrying amounts. If the expected undiscounted cash flows are less than the carrying amount, then the community is written down to its fair value. We estimate the fair value of each impaired community by determining the present value of the estimated future cash flows at a discount rate commensurate with the risk of the respective community. In the first quarter of fiscal 2017, our discount rate used for impairments recorded ranged from 18.3% to 19.8%. In the first quarter of fiscal 2016, no discount rate was used as the six communities impaired during the quarter were land held for sale for which purchase offer prices were used to determine the fair value. Should the estimates or expectations used in determining cash flows or fair value decrease or differ from current estimates in the future, we may need to recognize additional impairments.

During the three months ended January 31, 2017 and 2016, we evaluated inventories of all 390 and 512 communities under development and held for future development or sale, respectively, for impairment indicators through preparation and review of detailed budgets or other market indicators of impairment. We performed detailed impairment calculations during the three months ended January 31, 2017 and 2016 for six and eleven of those communities (i.e., those with a projected operating loss or other impairment indicators), respectively, with an aggregate carrying value of $13.8 million and $46.2 million, respectively. Of those communities tested for impairment during the three months ended January 31, 2017 and 2016, one and four communities with an aggregate carrying value of $1.2 million and $17.3 million, respectively, had undiscounted future cash flow that only exceeded the carrying amount by less than 20%. As a result of our impairment analysis, we recorded impairment losses for the three months ended January 31, 2017 and 2016, which are included in the Condensed Consolidated Statement of Operations on the line entitled “Homebuilding: Inventory impairment loss and land option write-offs” and deducted from inventory, of $2.7 million for five communities, with a pre-impairment value of $12.6 million, and $9.7 million for six communities which were held for sale mainly in the Midwest, with a pre-impairment value of $28.7 million, respectively. The pre-impairment value represents the carrying value, net of prior period impairments, if any, at the time of recording the impairment.

The Condensed Consolidated Statement of Operations line entitled “Homebuilding: Inventory impairment loss and land option write-offs” also includes write-offs of options and approval, engineering and capitalized interest costs that we record when we redesign communities and/or abandon certain engineering costs and we do not exercise options in various locations because the communities' pro forma profitability is not projected to produce adequate returns on investment commensurate with the risk. Total aggregate write-offs related to these items were $0.5 million and $2.0 million for the three months ended January 31, 2017 and 2016, respectively. Occasionally, these write-offs are offset by recovered deposits (sometimes through legal action) that had been written off in a prior period as walk-away costs. Historically, these recoveries have not been significant in comparison to the total costs written off. The number of lots walked away from during the three months ended January 31, 2017 and 2016 were 1,061 and 1,256, respectively. The walk-aways were located in all segments except the Southwest and West in the first quarter of fiscal 2017, and in all segments except the West, with the majority in the Southeast, Mid-Atlantic and Northeast, in the first quarter of fiscal 2016.

We decide to mothball (or stop development on) certain communities when we determine that the current performance does not justify further investment at the time. When we decide to mothball a community, the inventory is reclassified on our Condensed Consolidated Balance Sheets from “Sold and unsold homes and lots under development” to “Land and land options held for future development or sale.” During the first quarter of fiscal 2017, we did not mothball any additional communities, or re-activate any previously mothballed communities, but we sold one previously mothballed community. As of January 31, 2017 and October 31, 2016, the net book value associated with our 28 and 29 total mothballed communities was $69.3 million and $74.4 million, respectively, which was net of impairment charges recorded in prior periods of $268.0 million and $296.3 million, respectively.

From time to time we enter into option agreements that include specific performance requirements, whereby we are required to purchase a minimum number of lots. Because of our obligation to purchase these lots, for accounting purposes in accordance with Accounting Standards Codification (“ASC”) 360-20-40-38, we are required to record this inventory on our Condensed Consolidated Balance Sheets. As of January 31, 2017 and October 31, 2016, we had no specific performance options.

We sell and lease back certain of our model homes with the right to participate in the potential profit when each home is sold to a third party at the end of the respective lease. As a result of our continued involvement, for accounting purposes in accordance with ASC 360-20-40-38, these sale and leaseback transactions are considered a financing rather than a sale. Therefore, for purposes of our Condensed Consolidated Balance Sheets, at January 31, 2017 and October 31, 2016, inventory of $75.5 million and $79.2 million, respectively, was recorded to “Consolidated inventory not owned,” with a corresponding amount of $66.3 million and $69.7 million (net of debt issuance costs), respectively, recorded to “Liabilities from inventory not owned” for the amount of net cash received from the transactions.

We have land banking arrangements, whereby we sell our land parcels to the land bankers and they provide us an option to purchase back finished lots on a predetermined schedule. Because of our options to repurchase these parcels, for accounting purposes, in accordance with ASC 360-20-40-38, these transactions are considered a financing rather than a sale. For purposes of our Condensed Consolidated Balance Sheets, at January 31, 2017 and October 31, 2016, inventory of $96.1 million and $129.5 million, respectively, was recorded to “Consolidated inventory not owned,” with a corresponding amount of $58.1 million and $80.5 million (net of debt issuance costs), respectively, recorded to “Liabilities from inventory not owned” for the amount of net cash received from the transactions.

5. Variable Interest Entities

The Company enters into land and lot option purchase contracts to procure land or lots for the construction of homes. Under these contracts, the Company will fund a stated deposit in consideration for the right, but not the obligation, to purchase land or lots at a future point in time with predetermined terms. Under the terms of the option purchase contracts, many of the option deposits are not refundable at the Company's discretion. Under the requirements of ASC 810, certain option purchase contracts may result in the creation of a variable interest in the entity (“VIE”) that owns the land parcel under option.

In compliance with ASC 810, the Company analyzes its option purchase contracts to determine whether the corresponding land sellers are VIEs and, if so, whether the Company is the primary beneficiary. Although the Company does not have legal title to the underlying land, ASC 810 requires the Company to consolidate a VIE if the Company is determined to be the primary beneficiary. In determining whether it is the primary beneficiary, the Company considers, among other things, whether it has the power to direct the activities of the VIE that most significantly impact the VIE's economic performance. Such activities would include, among other things, determining or limiting the scope or purpose of the VIE, selling or transferring property owned or controlled by the VIE, or arranging financing for the VIE. The Company also considers whether it has the obligation to absorb losses of the VIE or the right to receive benefits from the VIE. As a result of its analyses, the Company determined that as of January 31, 2017 and October 31, 2016, it was not the primary beneficiary of any VIEs from which it is purchasing land under option purchase contracts.

We will continue to secure land and lots using options, some of which are with VIEs. Including deposits on our unconsolidated VIEs, at January 31, 2017, we had total cash deposits amounting to $52.5 million to purchase land and lots with a total purchase price of $914.1 million. The maximum exposure to loss with respect to our land and lot options is limited to the deposits plus any pre-development costs invested in the property, although some deposits are refundable at our request or refundable if certain conditions are not met.

6. Warranty Costs

General liability insurance for homebuilding companies and their suppliers and subcontractors is very difficult to obtain. The availability of general liability insurance is limited due to a decreased number of insurance companies willing to underwrite for the industry. In addition, those few insurers willing to underwrite liability insurance have significantly increased the premium costs. To date, we have been able to obtain general liability insurance but at higher premium costs with higher deductibles. Our subcontractors and suppliers have advised us that they have also had difficulty obtaining insurance that also provides us coverage. As a result, we have an owner controlled insurance program for certain of our subcontractors whereby the subcontractors pay us an insurance premium (through a reduction of amounts we would otherwise owe such subcontractors for their work on our homes) based on the risk type of the trade. We absorb the liability associated with their work on our homes as part of our overall general liability insurance at no additional cost to us because our existing general liability and construction defect insurance policy and related reserves for amounts under our deductible covers construction defects regardless of whether we or our subcontractors are responsible for the defect. For the three months ended January 31, 2017 and 2016, we received $0.9 million and $1.0 million, respectively, from subcontractors related to the owner controlled insurance program, which we accounted for as a reduction to inventory.

We accrue for warranty costs that are covered under our existing general liability and construction defect policy as part of our general liability insurance deductible. This accrual is expensed as selling, general and administrative costs. For homes delivered in fiscal 2017 and 2016, our deductible under our general liability insurance is a $20 million aggregate for construction defect and warranty claims. For bodily injury claims, our deductible per occurrence in fiscal 2017 and 2016 is $0.25 million, up to a $5 million limit. Our aggregate retention in fiscal 2017 and 2016 is $21 million for construction defect, warranty and bodily injury claims. In addition, we establish a warranty accrual for lower cost related issues to cover home repairs, community amenities and land development infrastructure that are not covered under our general liability and construction defect policy. We accrue an estimate for these warranty costs as part of cost of sales at the time each home is closed and title and possession have been transferred to the homebuyer. Additions and charges in the warranty reserve and general liability reserve for the three months ended January 2017 and 2016 were as follows:

	Three Months Ended	
	January 31,	
(In thousands)	2017	2016
Balance, beginning of period	$121,144	$135,053
Additions – Selling, general and administrative	2,908	4,623
Additions – Cost of sales	3,487	3,382
Charges incurred during the period	(9,526)	(9,669)
Changes to pre-existing reserves	-	-
Balance, end of period	$118,013	$133,389

Warranty accruals are based upon historical experience. We engage a third-party actuary that uses our historical warranty and construction defect data to assist our management in estimating our unpaid claims, claim adjustment expenses and incurred but not reported claims reserves for the risks that we are assuming under the general liability and construction defect programs. The estimates include provisions for inflation, claims handling and legal fees.

Insurance claims paid by our insurance carriers, excluding insurance deductibles paid, were less than $0.1 million and $3.2 million for the three months ended January 2017 and 2016, respectively, for prior year deliveries. In the first quarter of fiscal 2016 we settled two construction defect claims relating to the Northeast segment which made up the majority of the payments.

7. Commitments and Contingent Liabilities

We are involved in litigation arising in the ordinary course of business, none of which is expected to have a material adverse effect on our financial position, results of operations or cash flows, and we are subject to extensive and complex laws and regulations that affect the development of land and home building, sales and customer financing processes, including zoning, density, building standards and mortgage financing. These laws and regulations often provide broad discretion to the administering governmental authorities. This can delay or increase the cost of development or homebuilding.

We also are subject to a variety of local, state, federal and foreign laws and regulations concerning protection of health and the environment, including those regulating the emission or discharge of materials into the environment, the management of stormwater runoff at construction sites, the handling, use, storage and disposal of hazardous substances, impacts to wetlands and other sensitive environments, and the remediation of contamination at properties that we have owned or developed or currently own or are developing (“environmental laws”). The particular environmental laws that apply to any given community vary greatly according to the community site, the site’s environmental conditions and the present and former uses of the site. These environmental laws may result in delays, may cause us to incur substantial compliance, remediation and/or other costs, and can prohibit or severely restrict development and homebuilding activity. In addition, noncompliance with these laws and regulations could result in fines and penalties, obligations to remediate, permit revocations or other sanctions; and contamination or other environmental conditions at or in the vicinity of our developments may result in claims against us for personal injury, property damage or other losses.

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In March 2013, we received a letter from the Environmental Protection Agency ("EPA") requesting information about our involvement in a housing redevelopment project in Newark, New Jersey that a Company entity undertook during the 1990s. We understand that the development is in the vicinity of a former lead smelter and that recent tests on soil samples from properties within the development conducted by the EPA show elevated levels of lead. We also understand that the smelter ceased operations many years before the Company entity involved acquired the properties in the area and carried out the re-development project. We responded to the EPA's request. In August 2013, we were notified that the EPA considers us a potentially responsible party (or "PRP") with respect to the site, that the EPA will clean up the site, and that the EPA is proposing that we fund and/or contribute towards the cleanup of the contamination at the site. We began preliminary discussions with the EPA concerning a possible resolution but do not know the scope or extent of the Company's obligations, if any, that may arise from the site and therefore cannot provide any assurance that this matter will not have a material impact on the Company. The EPA requested additional information in April 2014 and the Company has responded to its information request.

We anticipate that increasingly stringent requirements will be imposed on developers and homebuilders in the future. Although we cannot reliably predict the extent of any effect these requirements may have on us, they could result in time-consuming and expensive compliance programs and in substantial expenditures, which could cause delays and increase our cost of operations. In addition, our ability to obtain or renew permits or approvals and the continued effectiveness of permits already granted or approvals already obtained is dependent upon many factors, some of which are beyond our control, such as changes in policies, rules and regulations and their interpretations and application.

8. Restricted Cash and Deposits

Cash represents cash deposited in checking accounts. Cash equivalents include certificates of deposit, Treasury bills and government money–market funds with maturities of 90 days or less when purchased. Our cash balances are held at a few financial institutions and may, at times, exceed insurable amounts. We believe we help to mitigate this risk by depositing our cash in major financial institutions. At January 31, 2017 and October 31, 2016, $6.9 million and $9.4 million, respectively, of the total cash and cash equivalents was in cash equivalents, the book value of which approximates fair value.

Restricted cash and cash equivalents on the Condensed Consolidated Balance Sheets totaled $24.2 million and $22.9 million as of January 31, 2017 and October 31, 2016, respectively, which included cash collateralizing our letter of credit agreements and facilities as discussed in Note 10. Also included in this balance were (1) homebuilding and financial services customers' deposits of $0.1 million and $20.4 million at January 31, 2017, respectively, and $2.2 million and $15.1 million as of October 31, 2016, respectively, which are restricted from use by us, and (2) $2.0 million at January 31, 2017 and $3.9 million at October 31, 2016, respectively, of restricted cash under the terms of our mortgage warehouse lines of credit.

Total Homebuilding Customers' deposits are shown as a liability on the Condensed Consolidated Balance Sheets. These liabilities are significantly more than the applicable periods' restricted cash balances because, in some states, the deposits are not restricted from use and, in other states, we are able to release the majority of these customer deposits to cash by pledging letters of credit and surety bonds.

9. Mortgage Loans Held for Sale

Our mortgage banking subsidiary originates mortgage loans, primarily from the sale of our homes. Such mortgage loans are sold in the secondary mortgage market within a short period of time of origination. Mortgage loans held for sale consist primarily of single-family residential loans collateralized by the underlying property. We have elected the fair value option to record loans held for sale and therefore these loans are recorded at fair value with the changes in the value recognized in the Condensed Consolidated Statements of Operations in "Revenues: Financial services." We currently use forward sales of mortgage-backed securities ("MBS"), interest rate commitments from borrowers and mandatory and/or best efforts forward commitments to sell loans to third-party purchasers to protect us from interest rate fluctuations. These short-term instruments, which do not require any payments to be made to the counterparty or purchaser in connection with the execution of the commitments, are recorded at fair value. Gains and losses on changes in the fair value are recognized in the Condensed Consolidated Statements of Operations in "Revenues: Financial services."

At January 31, 2017 and October 31, 2016, \$65.2 million and \$147.4 million, respectively, of mortgages held for sale were pledged against our mortgage warehouse lines of credit (see Note 10). We may incur losses with respect to mortgages that were previously sold that are delinquent and which had underwriting defects, but only to the extent the losses are not covered by mortgage insurance or resale value of the home. The reserves for these estimated losses are included in the "Financial services" balances on the Condensed Consolidated Balance Sheets. As of January 31, 2017 and 2016, we had reserves specifically for 93 and 131 identified mortgage loans, respectively, as well as reserves for an estimate for future losses on mortgages sold but not yet identified to us.

The activity in our loan origination reserves during the three months ended January 31, 2017 and 2016 was as follows:

	Three Months Ended January 31,	
(In thousands)	2017	2016
Loan origination reserves, beginning of period	$8,137	$8,025
Provisions for losses during the period	34	41
Adjustments to pre-existing provisions for losses from changes in estimates	(3,094)	(38)
Loan origination reserves, end of period	$5,077	$8,028

10. Mortgages and Notes Payable

We have nonrecourse mortgage loans for certain communities totaling $73.5 million and $82.1 million (net of debt issuance costs) at January 31, 2017 and October 31, 2016, respectively, which are secured by the related real property, including any improvements, with an aggregate book value of $195.8 million and $201.8 million, respectively. The weighted-average interest rate on these obligations was 5.1% and 4.9% at January 31, 2017 and October 31, 2016, respectively, and the mortgage loan payments on each community primarily correspond to home deliveries. We also have nonrecourse mortgage loans on our corporate headquarters totaling $14.0 million and $14.3 million at January 31, 2017 and October 31, 2016, respectively. These loans had a weighted-average interest rate of 8.8% at both January 31, 2017 and October 31, 2016, respectively. As of January 31, 2017, these loans had installment obligations with annual principal maturities in the years ending October 31 of: $1.0 million in 2017, $1.4 million in 2018, $1.5 million in 2019, $1.7 million in 2020, $1.8 million in 2021 and $6.6 million after 2021.

In June 2013, K. Hovnanian Enterprises, Inc. (“K. Hovnanian”), as borrower, and we and certain of our subsidiaries, as guarantors, entered into a five-year, $75.0 million unsecured revolving credit facility (the “Credit Facility”) with Citicorp USA, Inc., as administrative agent and issuing bank, and Citibank, N.A., as a lender. The Credit Facility is available for both letters of credit and general corporate purposes. The Credit Facility does not contain any financial maintenance covenants, but does contain certain restrictive covenants that track those contained in our indenture governing the 8.0% Senior Notes due 2019, which are described in Note 11. The Credit Facility also contains certain customary events of default which would permit the administrative agent at the request of the required lenders to, among other things, declare all loans then outstanding to be immediately due and payable if such default is not cured within applicable grace periods, including the failure to make timely payments of amounts payable under the Credit Facility or other material indebtedness or the acceleration of other material indebtedness, the failure to comply with agreements and covenants or for representations or warranties to be correct in all material respects when made, specified events of bankruptcy and insolvency, and the entry of a material judgment against a loan party. Outstanding borrowings under the Credit Facility accrue interest at an annual rate equal to either, as selected by K. Hovnanian, (i) the alternate base rate plus the applicable spread determined on the date of such borrowing or (ii) an adjusted London Interbank Offered Rate (“LIBOR”) rate plus the applicable spread determined as of the date two business days prior to the first day of the interest period for such borrowing. As of January 31, 2017 there were $52.0 million of borrowings and $16.0 million of letters of credit outstanding under the Credit Facility. As of October 31, 2016, there were $52.0 million of borrowings and $17.9 million of letters of credit outstanding under the Credit Facility. As of January 31, 2017, we believe we were in compliance with the covenants under the Credit Facility.

In addition to the Credit Facility, we have certain stand–alone cash collateralized letter of credit agreements and facilities under which there was a total of $1.7 million letters of credit outstanding at both January 31, 2017 and October 31, 2016, respectively. These agreements and facilities require us to maintain specified amounts of cash as collateral in segregated accounts to support the letters of credit issued thereunder, which will affect the amount of cash we have available for other uses. As of both January 31, 2017 and October 31, 2016, the amount of cash collateral in these segregated accounts was $1.7 million, respectively, which is reflected in “Restricted cash and cash equivalents” on the Condensed Consolidated Balance Sheets.

Our wholly owned mortgage banking subsidiary, K. Hovnanian American Mortgage, LLC (“K. Hovnanian Mortgage”), originates mortgage loans primarily from the sale of our homes. Such mortgage loans and related servicing rights are sold in the secondary mortgage market within a short period of time. In certain instances, we retain the servicing rights for a small amount of loans. Our secured Master Repurchase Agreement with JPMorgan Chase Bank, N.A. (“Chase Master Repurchase Agreement”), which was amended on January 31, 2017 to extend the maturity to January 30, 2018, is a short-term borrowing facility that provides up to $50.0 million through maturity. The loan is secured by the mortgages held for sale and is repaid when we sell the underlying mortgage loans to permanent investors. Interest is payable monthly on outstanding advances at an adjusted LIBOR rate, which was 0.78% at January 31, 2017, plus the applicable margin of 2.5% or 2.63% based upon type of loan. As of January 31, 2017 and October 31, 2016, the aggregate principal amount of all borrowings outstanding under the Chase Master Repurchase Agreement was $25.7 million and $44.1 million, respectively.

K. Hovnanian Mortgage has another secured Master Repurchase Agreement with Customers Bank ("Customers Master Repurchase Agreement"), which was amended on February 17, 2017, that is a short-term borrowing facility that provides up to $50.0 million through its maturity on February 16, 2018. The loan is secured by the mortgages held for sale and is repaid when we sell the underlying mortgage loans to permanent investors. Interest is payable daily or as loans are sold to permanent investors on outstanding advances at the current LIBOR rate, plus the applicable margin ranging from 2.5% to 5.25% based on the type of loan and the number of days outstanding on the warehouse line. As of January 31, 2017 and October 31, 2016, the aggregate principal amount of all borrowings outstanding under the Customers Master Repurchase Agreement was $19.1 million and $38.8 million, respectively.

K. Hovnanian Mortgage has a third secured Master Repurchase Agreement with Credit Suisse First Boston Mortgage Capital LLC ("Credit Suisse Master Repurchase Agreement"), which was amended on February 23, 2016, that is a short-term borrowing facility that provides up to $50.0 million through its maturity on February 21, 2017. The loan is secured by the mortgages held for sale and is repaid when we sell the underlying mortgage loans to permanent investors. Interest is payable monthly on outstanding advances at the Credit Suisse Base Rate (as defined in the loan documents), which was 1.37% at January 31, 2017, plus the applicable margin of 2.25% to 2.5%. There were no outstanding borrowings under the Credit Suisse Master Repurchase Agreement as of January 31, 2017. As of October 31, 2016 the aggregate principal amount of all borrowings outstanding was $32.9 million.

In February 2014, K. Hovnanian Mortgage executed a secured Master Repurchase Agreement with Comerica Bank ("Comerica Master Repurchase Agreement"), which was amended on December 23, 2016 to extend the maturity date to December 22, 2017. The Comerica Master Repurchase Agreement is a short-term borrowing facility that provides up to $50.0 million through maturity. The loan is secured by the mortgages held for sale and is repaid when we sell the underlying mortgage loans to permanent investors. Interest is payable monthly at the current LIBOR rate, subject to a floor of 0.25%, plus the applicable margin of 2.5%. As of January 31, 2017 and October 31, 2016, the aggregate principal amount of all borrowings outstanding under the Comerica Master Repurchase Agreement was $14.7 million and $29.8 million, respectively.

The Chase Master Repurchase Agreement, Customers Master Repurchase Agreement, Credit Suisse Master Repurchase Agreement and Comerica Master Repurchase Agreement (together, the "Master Repurchase Agreements") require K. Hovnanian Mortgage to satisfy and maintain specified financial ratios and other financial condition tests. Because of the extremely short period of time mortgages are held by K. Hovnanian Mortgage before the mortgages are sold to investors (generally a period of a few weeks), the immateriality to us on a consolidated basis of the size of the Master Repurchase Agreements, the levels required by these financial covenants, our ability based on our immediately available resources to contribute sufficient capital to cure any default, were such conditions to occur, and our right to cure any conditions of default based on the terms of the applicable agreement, we do not consider any of these covenants to be substantive or material. As of January 31, 2017, we believe we were in compliance with the covenants under the Master Repurchase Agreements.

11. Senior Notes and Term Loan

Senior Notes and Term Loan balances as of January 31, 2017 and October 31, 2016, were as follows:

	January 31,	**October 31,**
(In thousands)	**2017(1)(2)**	**2016(1)(2)**
Senior Secured Term Loan, net of debt issuance costs	$72,623	$72,646
Senior Secured Notes:		
7.25% Senior Secured First Lien Notes due October 15, 2020	$570,101	$569,641
10.0% Senior Secured Second Lien Notes due October 15, 2018 (net of discount)	69,372	68,951
9.125% Senior Secured Second Lien Notes due November 15, 2020	143,439	143,337
9.5% Senior Secured Notes due November 15, 2020	74,192	74,140
2.0% Senior Secured Notes due November 1, 2021 (net of discount)	53,031	53,022
5.0% Senior Secured Notes due November 1, 2021 (net of discount)	132,425	131,998
Total Senior Secured Notes, net of debt issuance costs	$1,042,560	$1,041,089
Senior Notes:		
7.0% Senior Notes due January 15, 2019	$131,603	$148,800
8.0% Senior Notes due November 1, 2019	233,667	247,348
Total Senior Notes, net of debt issuance costs	$365,270	$396,148
11.0% Senior Amortizing Notes due December 1, 2017, net of debt issuance costs	$3,911	$6,152
Senior Exchangeable Notes due December 1, 2017, net of debt issuance costs	$51,647	$57,298

(1) "Notes payable and term loan" on our Condensed Consolidated Balance Sheets as of January 31, 2017 and October 31, 2016 consists of the total senior secured, senior, senior amortizing and senior exchangeable notes and senior secured term loan shown above, as well as accrued interest of $31.7 million and $32.4 million, respectively.

(2) As discussed in Note 1, we adopted ASU 2015-03 in January 2017. We applied the new guidance retrospectively to all prior periods presented in the financial statements to conform to the fiscal 2017 presentation. As a result, $20.2 million of debt issuance costs at October 31, 2016, were reclassified from prepaids and other assets to a reduction in our senior secured term loan, senior secured, senior, senior amortizing and senior exchangeable notes. Debt issuance costs at January 31, 2017 were $18.6 million.

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General

Except for K. Hovnanian, the issuer of the notes, our home mortgage subsidiaries, joint ventures and subsidiaries holding interests in our joint ventures and certain of our title insurance subsidiaries, we and each of our subsidiaries are guarantors of the senior secured term loan and senior secured, senior, senior amortizing and senior exchangeable notes outstanding at January 31, 2017 (collectively, the “Notes Guarantors”). In addition to the Notes Guarantors, the 5.0% Senior Secured Notes due 2021 (the “5.0% 2021 Notes”), the 2.0% Senior Secured Notes due 2021 (the “2.0% 2021 Notes” and together with the 5.0% 2021 Notes, the “2021 Notes”) and the 9.5% Senior Secured Notes due 2020 (collectively with the 2021 Notes, the “JV Holdings Secured Group Notes”) are guaranteed by K. Hovnanian JV Holdings, L.L.C. and its subsidiaries except for certain joint ventures and joint venture holding companies (collectively, the “JV Holdings Secured Group”). Members of the JV Holdings Secured Group do not guarantee K. Hovnanian's other indebtedness.

The Term Loan Credit Agreement (defined below) and the indentures governing the notes outstanding at January 31, 2017 do not contain any financial maintenance covenants, but do contain restrictive covenants that limit, among other things, the Company’s ability and that of certain of its subsidiaries, including K. Hovnanian, to incur additional indebtedness (other than certain permitted indebtedness and refinancing indebtedness, under the Term Loan and certain of the senior secured notes, any new or refinancing indebtedness may not be scheduled to mature earlier than January 15, 2021 (so long as no member of the JV Holdings Secured Group is an obligor thereon), or February 15, 2021 (if otherwise), and nonrecourse indebtedness), pay dividends and make distributions on common and preferred stock, repurchase subordinated indebtedness (with respect to the Term Loan and certain of the senior secured and senior notes) and common and preferred stock, make other restricted payments, make investments, sell certain assets (including in certain land banking transactions), incur liens, consolidate, merge, sell or otherwise dispose of all or substantially all assets and enter into certain transactions with affiliates. The Term Loan Credit Agreement and the indentures also contain events of default which would permit the lenders/holders thereof to exercise remedies with respect to the collateral (as applicable), declare the loans made under the Term Loan Facility (defined below) (the “Term Loans”)/notes to be immediately due and payable if not cured within applicable grace periods, including the failure to make timely payments on the Term Loans/notes or other material indebtedness, cross default to other material indebtedness, the failure to comply with agreements and covenants and specified events of bankruptcy and insolvency, with respect to the Term Loans, material inaccuracy of representations and warranties and a change of control, and, with respect to the indentures governing the Term Loans and senior secured notes, the failure of the documents granting security for the Term Loans and senior secured notes to be in full force and effect, and the failure of the liens on any material portion of the collateral securing the Term Loans and senior secured notes to be valid and perfected. As of January 31, 2017, we believe we were in compliance with the covenants of the Term Loan Facility and the indentures governing our outstanding notes.

Under the terms of our debt agreements, we have the right to make certain redemptions and prepayments and, depending on market conditions and covenant restrictions, may do so from time to time. We also continue to evaluate our capital structure and may also continue to make debt purchases and/or exchanges for debt or equity from time to time through tender offers, open market purchases, private transactions, or otherwise, or seek to raise additional debt or equity capital, depending on market conditions and covenant restrictions.

If our consolidated fixed charge coverage ratio, as defined in the agreements governing our debt instruments (other than the senior exchangeable notes discussed below), is less than 2.0 to 1.0, we are restricted from making certain payments, including dividends, and from incurring indebtedness other than certain permitted indebtedness, refinancing indebtedness and nonrecourse indebtedness. As a result of this ratio restriction, we are currently restricted from paying dividends, which are not cumulative, on our 7.625% Series A Preferred Stock. We anticipate that we will continue to be restricted from paying dividends for the foreseeable future. Our inability to pay dividends is in accordance with covenant restrictions and will not result in a default under our debt instruments or otherwise affect compliance with any of the covenants contained in our debt instruments.

As a result of our evaluation of our geographic operating footprint as it relates to our strategic objectives, we decided to exit the Minneapolis, MN and Raleigh, NC markets, and in the third quarter of fiscal 2016, we completed the sale of our land portfolios in those markets. We have also decided to wind down our operations in the San Francisco Bay area in Northern California and in Tampa, FL by building and delivering homes to sell through our existing land position.

Any other liquidity-enhancing transaction will depend on identifying counterparties, negotiation of documentation and applicable closing conditions and any required approvals. Due to covenant restrictions in our debt instruments, we are currently limited in the amount of debt we can incur that does not qualify as refinancing indebtedness with certain maturity requirements as discussed above (a limitation that we expect to continue for the foreseeable future), even if market conditions would otherwise be favorable, which could also impact our ability to grow our business.

Fiscal 2017

During the three months ended January 31, 2017, we repurchased in open market transactions $17.5 million aggregate principal amount of 7.0% Senior Notes due 2019, $14.0 million aggregate principal amount of 8.0% Senior Notes due 2019 and 6,925 Units (defined below under "Units") representing $6.9 million stated amount of Units. The aggregate purchase price for these transactions was $30.8 million, plus accrued and unpaid interest. These transactions resulted in a gain on extinguishment of debt of $7.8 million, which is included as “Gain on Extinguishment of Debt” on the Condensed Consolidated Statement of Operations.

Secured Obligations

Our $75.0 million senior secured term loan facility (the “Term Loan Facility”) has a maturity of August 1, 2019 (provided that if any of K. Hovnanian’s 7.0% Senior Notes due 2019 (the “7.0% Notes”) remain outstanding on October 15, 2018, the maturity date of the Term Loan Facility will be October 15, 2018, or if any refinancing indebtedness with respect to the 7.0% Notes has a maturity date prior to January 15, 2021, the maturity date of the Term Loan Facility will be October 15, 2018) and bears interest at a rate equal to LIBOR plus an applicable margin of 7.0% or, at K. Hovnanian’s option, a base rate plus an applicable margin of 6.0%, payable monthly. At any time from and after September 8, 2018, K. Hovnanian may voluntarily repay outstanding Term Loans, provided that voluntary prepayments of Eurodollar loans made on a date other than the last day of an interest period applicable thereto are subject to customary breakage costs and voluntary prepayments made prior to February 1, 2019 are subject to a premium equal to 1.0% of the aggregate principal amount of the Term Loans so prepaid (any prepayment of the Term Loans made on or after February 1, 2019 are without any prepayment premium).

Our 10.0% Senior Secured Second Lien Notes (the “10.0% Second Lien Notes”) have a maturity of October 15, 2018, and bear interest at a rate of 10.0% per annum, payable semi-annually on February 15 and August 15 of each year, commencing February 15, 2017, to holders of record at the close of business on February 1 and August 1, as the case may be, immediately preceding such interest payment dates. The 10.0% Second Lien Notes are redeemable in whole or in part at our option at any time prior to July 15, 2018 at 100% of their principal amount plus an applicable “Make-Whole Amount.” At any time and from time to time on or after July 15, 2018, K. Hovnanian may also redeem some or all of the 10.0% Second Lien Notes at a redemption price equal to 100% of their principal amount. In addition, we may also redeem up to 35% of the aggregate principal amount of the 10.0% Second Lien Notes prior to

July 15, 2018 with the net cash proceeds from certain equity offerings at 110.00% of principal.

Our 9.5% Senior Secured Notes (the “9.5% Secured Notes”) have a maturity of November 15, 2020, and bear interest at a rate of 9.50% per annum, payable semi-annually on February 15 and August 15 of each year, commencing February 15, 2017, to holders of record at the close of business on February 1 and August 1, as the case may be, immediately preceding such interest payment dates. The 9.5% Notes are redeemable in whole or in part at our option at any time prior to November 15, 2018 at 100% of their principal amount plus an applicable “Make-Whole Amount.” At any time and from time to time on or after November 15, 2018, K. Hovnanian may also redeem some or all of the 9.5% Notes at a redemption price equal to 100% of their principal amount. In addition, we may also redeem up to 35% of the aggregate principal amount of the 9.5% Notes prior to November 15, 2018 with the net cash proceeds from certain equity offerings at 109.50% of principal.

All of K. Hovnanian’s obligations under the Term Loan Facility and the 10.0% Second Lien Notes are guaranteed by the Notes Guarantors. The Term Loan Facility and the guarantees thereof are secured on a first lien super priority basis relative to K. Hovnanian’s First Lien Notes (defined below), the 9.125% Second Lien Notes (defined below) and the 10.0% Second Lien Notes, and the 10.0% Second Lien Notes and the guarantees thereof are secured on a pari passu second lien basis with K. Hovnanian’s 9.125% Second Lien Notes, by substantially all of the assets owned by K. Hovnanian and the Notes Guarantors, in each case subject to permitted liens and certain exceptions. The 9.5% Notes are guaranteed by the Notes Guarantors and the members of the JV Holdings Secured Group. The 9.5% Notes are secured on a pari passu first lien basis with K. Hovnanian’s 2021 Notes, by substantially all of the assets of the members of the JV Holdings Secured Group, subject to permitted liens and certain exceptions.

The 5.0% 2021 Notes and the 2.0% 2021 Notes were issued as separate series under an indenture, but have substantially the same terms other than with respect to interest rate and related redemption provisions, and vote together as a single class. The 2021 Notes are redeemable in whole or in part at our option at any time, at 100.0% of the principal amount plus the greater of 1% of the principal amount and an applicable “Make-Whole Amount.”

The guarantees of the JV Holdings Secured Group with respect to the 2021 Notes and the 9.5% Notes are secured, subject to permitted liens and other exceptions, by a first-priority lien on substantially all of the assets of the members of the JV Holdings Secured Group. As of January 31, 2017, the collateral securing the guarantees included (1) $57.4 million of cash and cash equivalents (subsequent to such date, fluctuations as a result of cash uses include general business operations and real estate and other investments along with cash inflow primarily from deliveries); (2) $140.0 million aggregate book value of real property of the JV Holdings Secured Group, which does not include the impact of inventory investments, home deliveries or impairments thereafter and which may differ from the value if it were appraised; and (3) equity interests in guarantors that are members of the JV Holdings Secured Group. Members of the JV Holdings Secured Group also own equity in joint ventures, either directly or indirectly through ownership of joint venture holding companies, with a book value of $97.1 million as of January 31, 2017; this equity is not pledged to secure, and is not collateral for, the 2021 Notes. Members of the JV Holdings Secured Group are “unrestricted subsidiaries” under K. Hovnanian's other senior secured notes and senior notes and the Term Loan Facility, and thus have not guaranteed such indebtedness.

K. Hovnanian also has outstanding 7.25% Senior Secured First Lien Notes due 2020 (the "First Lien Notes") and 9.125% Senior Secured Second Lien Notes due 2020 (the "9.125% Second Lien Notes" and, together with the First Lien Notes, the "2020 Secured Notes"). We may redeem some or all of the First Lien Notes at 103.625% of principal commencing October 15, 2016, at 101.813% of principal commencing October 15, 2017 and 100% of principal commencing October 15, 2018. We may redeem some or all of the 9.125% Second Lien Notes at 104.563% of principal commencing November 15, 2016, at 102.281% of principal commencing November 15, 2017 and 100% of principal commencing November 15, 2018. The First Lien Notes are secured by a first-priority lien and the 9.125% Second Lien Notes and the 10.0% Second Lien Notes are secured by a second-priority lien, in each case, subject to permitted liens and other exceptions, on substantially all the assets owned by K. Hovnanian and the Notes Guarantors.

At January 31, 2017, the aggregate book value of the real property that constituted collateral securing the Term Loan Facility, the 2020 Secured Notes and the 10.0% Second Lien Notes was $587.8 million, which does not include the impact of inventory investments, home deliveries or impairments thereafter and which may differ from the value if it were appraised. In addition, cash and cash equivalents collateral that secured the Term Loan Facility, the 2020 Secured Notes and the 10.0% Second Lien Notes was $140.1 million as of January 31, 2017, which included $1.7 million of restricted cash collateralizing certain letters of credit. Subsequent to such date, fluctuations as a result of cash uses include general business operations and real estate and other investments along with cash inflow primarily from deliveries.

Senior Notes

K. Hovnanian’s 7.0% Senior Notes due 2019 are redeemable in whole or in part at our option at any time prior to July 15, 2016 at 100% of their principal amount plus an applicable “Make-Whole Amount.” We may also redeem some or all of the notes at 103.5% of principal commencing July 15, 2016, at 101.75% of principal commencing January 15, 2017 and 100% of principal commencing January 15, 2018.

K. Hovnanian's 8.0% Senior Notes due 2019 are redeemable in whole or in part at K. Hovnanian's option at any time prior to August 1, 2019 at a redemption price equal to 100% of their principal amount plus an applicable "Make-Whole Amount." At any time and from time to time on or after August 1, 2019, K. Hovnanian may also redeem some or all of the notes at a redemption price equal to 100% of their principal amount.

Units

On October 2, 2012, the Company and K. Hovnanian issued $100,000,000 aggregate stated amount of 6.0% Exchangeable Note Units (the "Units") (equivalent to 100,000 Units). Each $1,000 stated amount of Units initially consists of (1) a zero coupon senior exchangeable note due December 1, 2017 (a "Senior Exchangeable Note") issued by K. Hovnanian, which bears no cash interest and has an initial principal amount of $768.51 per Senior Exchangeable Note, and that will accrete to $1,000 at maturity and (2) a senior amortizing note due December 1, 2017 (a "Senior Amortizing Note") issued by K. Hovnanian, which has an initial principal amount of $231.49 per Senior Amortizing Note, bears interest at a rate of 11.0% per annum, and has a final installment payment date of December 1, 2017. Each Unit may be separated into its constituent Senior Exchangeable Note and Senior Amortizing Note after the initial issuance date of the Units, and the separate components may be combined to create a Unit.

Each Senior Exchangeable Note had an initial principal amount of $768.51 (which will accrete to $1,000 over the term of the Senior Exchangeable Note at an annual rate of 5.17% from the date of issuance, calculated on a semi-annual bond equivalent yield basis). Holders may exchange their Senior Exchangeable Notes at their option at any time prior to 5:00 p.m., New York City time, on the business day immediately preceding December 1, 2017. Each Senior Exchangeable Note will be exchangeable for shares of Class A Common Stock at an initial exchange rate of 185.5288 shares of Class A Common Stock per Senior Exchangeable Note (equivalent to an initial exchange price, based on $1,000 principal amount at maturity, of approximately $5.39 per share of Class A Common Stock). The exchange rate will be subject to adjustment in certain events. If certain corporate events occur prior to the maturity date, the Company will increase the applicable exchange rate for any holder who elects to exchange its Senior Exchangeable Notes in connection with such corporate event. In addition, holders of Senior Exchangeable Notes will also have the right to require K. Hovnanian to repurchase such holders' Senior Exchangeable Notes upon the occurrence of certain of these corporate events. As of January 31, 2017, 18,305 Senior Exchangeable Notes have been converted into 3.4 million shares of our Class A Common Stock, all of which were converted during the first quarter of fiscal 2013. In September 2016, K. Hovnanian purchased a total of 20,823 Units for an aggregate purchase price of $20.6 million, and in November 2016, K. Hovnanian purchased a total of 6,925 Units for an aggregate purchase price of $6.9 million.

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On each June 1 and December 1 (each, an “installment payment date”), K. Hovnanian will pay holders of Senior Amortizing Notes equal semi-annual cash installments of $30.00 per Senior Amortizing Note (except for the June 1, 2013 installment payment, which was $39.83 per Senior Amortizing Note), which cash payment in the aggregate will be equivalent to 6.0% per year with respect to each $1,000 stated amount of Units. Each installment will constitute a payment of interest (at a rate of 11.0% per annum) and a partial repayment of principal on the Senior Amortizing Note. Following certain corporate events that occur prior to the maturity date, holders of the Senior Amortizing Notes will have the right to require K. Hovnanian to repurchase such holders’ Senior Amortizing Notes.

12. Per Share Calculation

Basic earnings per share is computed by dividing net income (loss) (the “numerator”) by the weighted-average number of common shares outstanding, adjusted for nonvested shares of restricted stock (the “denominator”) for the period. Computing diluted earnings per share is similar to computing basic earnings per share, except that the denominator is increased to include the dilutive effects of options and nonvested shares of restricted stock, as well as common shares issuable upon exchange of our Senior Exchangeable Notes issued as part of our 6.0% Exchangeable Note Units. Any options that have an exercise price greater than the average market price are considered to be anti-dilutive and are excluded from the diluted earnings per share calculation.

All outstanding nonvested shares that contain nonforfeitable rights to dividends or dividend equivalents that participate in undistributed earnings with common stock are considered participating securities and are included in computing earnings per share pursuant to the two-class method. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating securities according to dividends or dividend equivalents and participation rights in undistributed earnings in periods when we have net income. The Company’s restricted common stock (“nonvested shares”) are considered participating securities.

There were no incremental shares attributed to nonvested stock and outstanding options to purchase common stock for the three months ended January 31, 2017 and 2016. Also, for the three months ended January 31, 2017 and 2016, 10.0 million and 15.2 million shares, respectively, of common stock issuable upon the exchange of our senior exchangeable notes (which were issued in fiscal 2012) were excluded from the computation of diluted earnings per share because we had a net loss for the period.

In addition, shares related to out-of-the money stock options that could potentially dilute basic earnings per share in the future that were not included in the computation of diluted earnings per share were 4.8 million and 6.4 million for the three months ended January 31, 2017 and 2016, respectively, because to do so would have been anti-dilutive for the periods presented.

13. Preferred Stock

On July 12, 2005, we issued 5,600 shares of 7.625% Series A Preferred Stock, with a liquidation preference of $25,000 per share. Dividends on the Series A Preferred Stock are not cumulative and are payable at an annual rate of 7.625%. The Series A Preferred Stock is not convertible into the Company's common stock and is redeemable in whole or in part at our option at the liquidation preference of the shares. The Series A Preferred Stock is traded as depositary shares, with each depositary share representing 1/1000th of a share of Series A Preferred Stock. The depositary shares are listed on the NASDAQ Global Market under the symbol "HOVNP." During the three months ended January 31, 2017 and 2016, we did not pay any dividends on the Series A Preferred Stock due to covenant restrictions in our debt instruments. We anticipate that we will continue to be restricted from paying dividends, which are not cumulative, for the foreseeable future.

14. Common Stock

Each share of Class A Common Stock entitles its holder to one vote per share, and each share of Class B Common Stock generally entitles its holder to ten votes per share. The amount of any regular cash dividend payable on a share of Class A Common Stock will be an amount equal to 110% of the corresponding regular cash dividend payable on a share of Class B Common Stock. If a shareholder desires to sell shares of Class B Common Stock, such stock must be converted into shares of Class A Common Stock at a one to one conversion rate.

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On August 4, 2008, our Board of Directors adopted a shareholder rights plan (the “Rights Plan”) designed to preserve shareholder value and the value of certain tax assets primarily associated with net operating loss (NOL) carryforwards and built-in losses under Section 382 of the Internal Revenue Code. Our ability to use NOLs and built-in losses would be limited if there was an “ownership change” under Section 382. This would occur if shareholders owning (or deemed under Section 382 to own) 5% or more of our stock increase their collective ownership of the aggregate amount of our outstanding shares by more than 50 percentage points over a defined period of time. The Rights Plan was adopted to reduce the likelihood of an “ownership change” occurring as defined by Section 382. Under the Rights Plan, one right was distributed for each share of Class A Common Stock and Class B Common Stock outstanding as of the close of business on August 15, 2008. Effective August 15, 2008, if any person or group acquires 4.9% or more of the outstanding shares of Class A Common Stock without the approval of the Board of Directors, there would be a triggering event causing significant dilution in the voting power of such person or group. However, existing stockholders who owned, at the time of the Rights Plan’s adoption, 4.9% or more of the outstanding shares of Class A Common Stock will trigger a dilutive event only if they acquire additional shares. The approval of the Board of Directors’ decision to adopt the Rights Plan may be terminated by the Board of Directors at any time, prior to the Rights being triggered. The Rights Plan will continue in effect until August 15, 2018, unless it expires earlier in accordance with its terms. The approval of the Board of Directors’ decision to adopt the Rights Plan was submitted to a stockholder vote and approved at a special meeting of stockholders held on December 5, 2008. Also at the Special Meeting on December 5, 2008, our stockholders approved an amendment to our Certificate of Incorporation to restrict certain transfers of Class A Common Stock in order to preserve the tax treatment of our NOLs and built-in losses under Section 382 of the Internal Revenue Code. Subject to certain exceptions pertaining to pre-existing 5% stockholders and Class B stockholders, the transfer restrictions in the amended Certificate of Incorporation generally restrict any direct or indirect transfer (such as transfers of our stock that result from the transfer of interests in other entities that own our stock) if the effect would be to (i) increase the direct or indirect ownership of our stock by any person (or public group) from less than 5% to 5% or more of our common stock; (ii) increase the percentage of our common stock owned directly or indirectly by a person (or public group) owning or deemed to own 5% or more of our common stock; or (iii) create a new public group. Transfers included under the transfer restrictions include sales to persons (or public groups) whose resulting percentage ownership (direct or indirect) of common stock would exceed the 5% thresholds discussed above, or to persons whose direct or indirect ownership of common stock would by attribution cause another person (or public group) to exceed such threshold.

On July 3, 2001, our Board of Directors authorized a stock repurchase program to purchase up to 4 million shares of Class A Common Stock. There were no shares purchased during the three months ended January 31, 2017. As of January 31, 2017, the maximum number of shares of Class A Common Stock that may yet be purchased under this program is 0.5 million.

15. Income Taxes

The total income tax expense of $0.5 million recognized for the three months ended January 31, 2017 was primarily related to the impact of permanent differences between book income and taxable income and the conversion of deductible charitable contributions to net operating losses, which increased the Company’s valuation allowances. The total income tax expense of $3.0 million recognized for the three months ended January 31, 2016 was primarily due to the impact of permanent differences between book income and taxable income as a result of the issuance of shares under a deferred compensation plan that were expensed during vesting at significantly higher value than the value at the time of issuance as well as state tax expenses and state tax reserves for uncertain tax positions.

Deferred federal and state income tax assets primarily represent the deferred tax benefits arising from temporary differences between book and tax income which will be recognized in future years as an offset against future taxable income. If the combination of future years' income (or loss) and the reversal of the timing differences results in a loss, such losses can be carried forward to future years. In accordance with ASC 740, we evaluate our deferred tax assets quarterly to determine if valuation allowances are required. ASC 740 requires that companies assess whether valuation allowances should be established based on the consideration of all available evidence using a "more likely than not" standard.

As of October 31, 2014, we concluded that it was more likely than not that a substantial amount of our deferred tax assets ("DTA") would be utilized. This conclusion was based on a detailed evaluation of all relevant evidence available at that time, both positive and negative. The positive evidence included factors such as the expectation of earnings going forward over the long term and evidence of a sustained recovery in the housing markets in which we operate. Economic data affirmed the housing market recovery with housing starts, homebuilding volume and prices all increasing and forecasted to continue to increase. Historically low mortgage rates, affordable home prices, reduced foreclosures and a favorable home ownership to rental comparison are key factors in the recovery. As a result of this conclusion, our valuation allowance for our DTA was reduced in the fourth quarter of fiscal 2014.

As expected at the time of that conclusion, our earnings have continued to improve such that we have not been and are currently not in a three-year cumulative loss position as of January 31, 2017. As per ASC 740, cumulative losses are one of the most objectively verifiable forms of negative evidence; we no longer have this negative evidence that we had when the full valuation allowance was recorded and we expect to be profitable going forward over the long term. Our recent three years cumulative performance and our expectations for the coming years based on our current backlog, community count and recent sales contracts provide evidence that reaffirms our conclusion that a full valuation allowance was not necessary and that the current valuation allowance for deferred taxes of $628.1 million as of January 31, 2017 is appropriate.

16. Operating and Reporting Segments

Our operating segments are components of our business for which discrete financial information is available and reviewed regularly by the chief operating decision maker, our Chief Executive Officer, to evaluate performance and make operating decisions. Based on this criteria, each of our communities qualifies as an operating segment, and therefore, it is impractical to provide segment disclosures for this many segments. As such, we have aggregated the homebuilding operating segments into six reportable segments.

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Our homebuilding operating segments are aggregated into reportable segments based primarily upon geographic proximity, similar regulatory environments, land acquisition characteristics and similar methods used to construct and sell homes. Our reportable segments consist of the following six homebuilding segments and a financial services segment noted below. During fiscal 2016, we decided to exit the Minneapolis, MN and Raleigh, NC markets and in the third quarter of fiscal 2016, we completed the sale of our portfolios in those markets.

Homebuilding:

(1) Northeast (New Jersey and Pennsylvania)
(2) Mid-Atlantic (Delaware, Maryland, Virginia, Washington D.C. and West Virginia)
(3) Midwest (Illinois and Ohio)
(4) Southeast (Florida, Georgia and South Carolina)
(5) Southwest (Arizona and Texas)
(6) West (California)

Financial Services

Operations of the Company’s Homebuilding segments primarily include the sale and construction of single-family attached and detached homes, attached townhomes and condominiums, urban infill and active lifestyle homes in planned residential developments. In addition, from time to time, operations of the homebuilding segments include sales of land. Operations of the Company’s Financial Services segment include mortgage banking and title services provided to the homebuilding operations’ customers. We do not typically retain or service mortgages that we originate but rather sell the mortgages and related servicing rights to investors.

Corporate and unallocated primarily represents operations at our headquarters in Red Bank, New Jersey. This includes our executive offices, information services, human resources, corporate accounting, training, treasury, process redesign, internal audit, construction services, and administration of insurance, quality and safety. It also includes interest income and interest expense resulting from interest incurred that cannot be capitalized in inventory in the Homebuilding segments, as well as the gains or losses on extinguishment of debt from any debt repurchases or exchanges.

Evaluation of segment performance is based primarily on operating earnings from continuing operations before provision for income taxes (“Income (loss) before income taxes”). Income (loss) before income taxes for the Homebuilding segments consist of revenues generated from the sales of homes and land, income (loss) from unconsolidated entities, management fees and other income, less the cost of homes and land sold, selling, general and administrative expenses and interest expense. Income before income taxes for the Financial Services segment consist of revenues generated from mortgage financing, title insurance and closing services, less the cost of such services and selling, general and administrative expenses incurred by the Financial Services segment.

Operational results of each segment are not necessarily indicative of the results that would have occurred had the segment been an independent stand-alone entity during the periods presented.

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Financial information relating to the Company's segment operations was as follows:

(In thousands)	Three Months Ended January 31, 2017	2016
Revenues:		
Northeast	$58,575	$72,504
Mid-Atlantic	100,226	93,820
Midwest	43,702	91,920
Southeast	56,584	39,252
Southwest	183,409	204,325
West	96,531	55,578
Total homebuilding	539,027	557,399
Financial services	12,849	18,226
Corporate and unallocated	133	(20)
Total revenues	$552,009	$575,605
Income (loss) before income taxes:		
Northeast	$906	$2,734
Mid-Atlantic	3,882	2,622
Midwest	712	(5,559)
Southeast	(294)	(1,834)
Southwest	11,923	16,369
West	(754)	(5,968)
Homebuilding income before income taxes	16,375	8,364
Financial services	5,994	10,011
Corporate and unallocated	(22,046)	(31,569)
Income (loss) before income taxes	$323	$(13,194)

(In thousands)	January 31, 2017	October 31, 2016
Assets:		
Northeast	$211,610	$219,363
Mid-Atlantic	292,866	292,899
Midwest	107,213	111,596
Southeast	235,600	226,124
Southwest	371,940	341,472
West	254,379	269,400

Total homebuilding	1,473,608	1,460,854
Financial services	113,249	197,230
Corporate and unallocated (1)	558,439	696,872
Total assets	$2,145,296	$2,354,956

(1) Includes $283.3 million and $283.6 million of income taxes receivable, including deferred tax assets, as of January 31, 2017 and October 31, 2016, respectively.

17. Investments in Unconsolidated Homebuilding and Land Development Joint Ventures

We enter into homebuilding and land development joint ventures from time to time as a means of accessing lot positions, expanding our market opportunities, establishing strategic alliances, managing our risk profile, leveraging our capital base and enhancing returns on capital. Our homebuilding joint ventures are generally entered into with third-party investors to develop land and construct homes that are sold directly to third-party home buyers. Our land development joint ventures include those entered into with developers and other homebuilders as well as financial investors to develop finished lots for sale to the joint venture's members or other third parties.

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In November 2015, the Company entered into a new joint venture to which the Company contributed a land parcel that had been mothballed by the Company, but on which construction by the joint venture has now begun. Upon formation of the joint venture, the Company received $25.7 million of cash proceeds for the transferred land. In addition, during the third quarter of fiscal 2016, we entered into a new joint venture by transferring eight communities we owned and our option to buy one community to the joint venture. As a result of the formation of the joint venture, the Company received $29.8 million of cash in return for the land and option transfers. During the first quarter of fiscal 2017, we expanded this joint venture by transferring one community we owned and our option to buy three communities to the joint venture, resulting in our receiving $11.2 million of net cash.

The tables set forth below summarize the combined financial information related to our unconsolidated homebuilding and land development joint ventures that are accounted for under the equity method.

(Dollars in thousands)	January 31, 2017		
	Homebuilding	Land Development	Total
Assets:			
Cash and cash equivalents	$39,100	$446	$39,546
Inventories	594,106	11,199	605,305
Other assets	29,202	-	29,202
Total assets	$662,408	$11,645	$674,053
Liabilities and equity:			
Accounts payable and accrued liabilities	$84,920	$943	$85,863
Notes payable	265,561	2,159	267,720
Total liabilities	350,481	3,102	353,583
Equity of:			
Hovnanian Enterprises, Inc.	97,074	3,330	100,404
Others	214,853	5,213	220,066
Total equity	311,927	8,543	320,470
Total liabilities and equity	$662,408	$11,645	$674,053
Debt to capitalization ratio	46 %	20 %	46 %

(Dollars in thousands)	October 31, 2016		
	Homebuilding	Land Development	Total
Assets:			
Cash and cash equivalents	$48,542	$1,478	$50,020
Inventories	516,947	11,010	527,957
Other assets	25,865	-	25,865
Total assets	$591,354	$12,488	$603,842

Liabilities and equity:				
Accounts payable and accrued liabilities	$72,302	$1,812	$74,114	
Notes payable	214,911	2,261	217,172	
Total liabilities	287,213	4,073	291,286	
Equity of:				
Hovnanian Enterprises, Inc.	88,379	3,220	91,599	
Others	215,762	5,195	220,957	
Total equity	304,141	8,415	312,556	
Total liabilities and equity	$591,354	$12,488	12,782	6,186

Prepaid expenses and other current assets	3,082	3,686
Other receivables	3,323	8,983
Total current assets	90,054	80,512
Equipment, at cost	727,232	752,128
Less accumulated depreciation	(373,721)	(393,179)
Equipment, net	353,511	358,949
Goodwill	122,992	154,656
Other intangible assets, net of accumulated amortization of $17,538 in 2004 and $20,701in 2005	28,249	39,071
Deferred financing costs, net of accumulated amortization of $6,289 in 2004 and $8,492 in 2005	9,264	8,236
Other assets	18,128	33,918
Total assets	$ 622,198	$ 675,342
LIABILITIES AND STOCKHOLDERS DEFICIT		
Current liabilities:		
Accounts payable	$ 20,518	$ 23,672
Accrued compensation and related expenses	15,661	14,088
Accrued interest payable	717	4,561
Income taxes payable	865	87
Other accrued liabilities	22,177	29,064
Current portion of long-term debt	9,390	7,781
Total current liabilities	69,328	79,253
Long-term debt, net of current portion	412,733	418,260
Senior subordinated notes	153,541	153,541
Minority interests and other liabilities	4,164	4,400
Deferred income taxes	49,960	60,144
Total liabilities	689,726	715,598
Commitments and Contingencies (Note 10)		
Stockholders deficit:		
Preferred stock, $0.01 par value; 1,000,000 shares authorized and no shares issued and outstanding		
Common stock, $0.01 par value; 100,000,000 shares authorized; shares issued and outstanding - 49,024,596 at December 31, 2004 and 49,572,206 at December 31, 2005	490	496
Additional paid-in deficit	(15,798)	(11,876)
Accumulated comprehensive (loss) income	(278)	3,217
Accumulated deficit	(51,942)	(32,093)
Total stockholders deficit	(67,528)	(40,256)
Total liabilities and stockholders deficit	$ 622,198	$ 675,342

See accompanying notes.

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

	Year Ended December 31, 2003	2004	2005
Revenues	$ 413,553	$ 432,080	$ 430,788
Costs and expenses:			
Costs of revenues, excluding depreciation and amortization	198,456	217,605	226,294
Selling, general and administrative expenses	47,472	48,142	48,077
Employment agreement costs	2,446	2,064	366
Severance and related costs	2,246	1,223	826
Loss on early reitrement of debt		44,393	
Impairment charges	73,225		
Depreciation expense	77,675	80,488	82,505
Amortization expense	2,897	3,522	3,954
Interest expense, net of interest income of $201 in 2003, $215 in 2004 and $608 in 2005	43,589	44,039	37,491
Other (income) and expense, net	(200)	(484)	(399)
Total costs and expenses	447,806	440,992	399,114
(Loss) income before income taxes, minority interest expense and earnings from unconsolidated investees	(34,253)	(8,912)	31,674
Income tax (benefit) expense	(1,680)	(6,770)	13,450
Minority interest expense	1,686	2,373	1,718
Earnings from unconsolidated investees	(2,649)	(4,029)	(3,343)
Net (loss) income	$ (31,610)	$ (486)	$ 19,849
Comprehensive (loss) income, net of taxes:			
Net (loss) income	$ (31,610)	$ (486)	$ 19,849
Unrealized (loss) gain on hedging transactions, net of related tax effects of $186 in 2004 and $2,318 in 2005		(278)	3,495
Comprehensive (loss) income	$ (31,610)	$ (764)	$ 23,344
(Loss) earnings per common share:			
Basic	$ (0.66)	$ (0.01)	$ 0.40
Diluted	$ (0.66)	$ (0.01)	$ 0.39
Weighted average number of shares of common stock and common stock equivalents:			
Basic	47,872	48,350	49,378
Diluted	47,872	48,350	50,262

See accompanying notes.

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ALLIANCE IMAGING, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(dollars in thousands)

	Year Ended December 31, 2003	2004	2005
Operating activities:			
Net (loss) income	$ (31,610)	$ (486)	$ 19,849
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Provision for doubtful accounts	2,843	809	2,638
Non-cash stock-based compensation	1,672	322	278
Impairment charges	73,225		
Depreciation and amortization	80,572	84,010	86,459
Amortization of deferred financing costs	3,021	3,039	2,203
Loss on early retirement of debt		44,393	
Distributions less than equity in undistributed income of investee	(104)	(1,359)	(478)
Deferred income taxes	(4,167)	1,106	12,814
Gain on sale of assets	(231)	(483)	(400)
Changes in operating assets and liabilities, net of acquisitions:			
Accounts receivable	2,417	(5,679)	3,062
Prepaid expenses and other current assets	278	(364)	(583)
Other receivables	(499)	(348)	(5,586)
Other assets	(1,596)	(1,056)	(1,390)
Accounts payable	2,990	4,525	1,716
Accrued compensation and related expenses	(1,023)	5,829	(1,768)
Accrued interest payable	(325)	(6,359)	3,844
Income taxes payable	289	(9,272)	(778)
Other accrued liabilities	733	2,117	4,983
Minority interests and other liabilities	522	154	211
Net cash provided by operating activities	129,007	120,898	127,074
Investing activities:			
Equipment purchases	(90,245)	(85,676)	(76,460)
(Increase) decrease in deposits on equipment	(7,281)	7,004	(9,652)
Acquisitions, net of cash received	(10,981)		(50,207)
Investment in unconsolidated joint ventures		(3,145)	
Proceeds from sale of assets	2,136	6,259	1,882
Net cash used in investing activities	(106,371)	(75,558)	(134,437)
Financing activities:			
Principal payments on equipment debt	(6,602)	(6,050)	(7,004)
Proceeds from equipment debt		4,176	1,450
Principal payments on term loan facility	(26,875)	(51,250)	(25,000)
Proceeds from term loan facility		154,000	
Principal payments on revolving loan facility	(20,000)		(39,500)
Proceeds from revolving loan facility	20,000		69,000
Principal payments on senior subordinated notes		(256,459)	
Proceeds from senior subordinated notes		150,000	
Payments of debt issuance costs	(220)	(8,327)	(1,175)
Payments of debt retirement costs		(35,532)	
Proceeds from exercise of employee stock options	231	3,842	2,292
Net proceeds from issuance of common stock	348	50	
Net cash (used in) provided by financing activities	(33,118)	(45,550)	63
Net decrease in cash and cash equivalents	(10,482)	(210)	(7,300)
Cash and cash equivalents, beginning of year	31,413	20,931	20,721
Cash and cash equivalents, end of year	$ 20,931	$ 20,721	$ 13,421
Supplemental disclosure of cash flow information:			
Interest paid	$ 41,102	$ 47,573	$ 32,052
Income taxes paid, net of refunds	3,200	395	1,356
Supplemental disclosure of non-cash investing and financing activities:			
Net book value of assets exchanged	$ 2,090	$ 261	$ 9,261
Capital lease obligations assumed for the purchase of equipment	7,001		3,924
Capital lease obligation transferred for the sale of equipment	(1,139)		
Comprehensive (loss) income from hedging transactions, net of taxes		(278)	3,495

See accompanying notes.

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ALLIANCE IMAGING, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS DEFICIT
(dollars in thousands)

	Common Stock Shares	Amount	Additional Paid-In (Deficit)	Accumulated Comprehensive (Loss) Income	Accumulated Deficit	Total Stockholders Deficit
Balance at December 31, 2002	47,682,576	$ 477	$ (22,940)	$	$ (19,846)	$ (42,309)
Exercise of common stock options	210,000	2	229			231
Issuance of common stock to officer	66,411	1	347			348
Non-cash stock-based compensation			1,672			1,672
Stock option income tax benefit			870			870
Net loss					(31,610)	(31,610)
Balance at December 31, 2003	47,958,987	480	(19,822)		(51,456)	(70,798)
Exercise of common stock options	1,033,850	10	3,832			3,842
Issuance of common stock to officer	11,933		50			50
Issuance of common stock under directors deferred compensation plan	19,826		124			124
Non-cash stock-based compensation			322			322
Stock option income tax benefit adjustment			(304)			(304)
Unrealized loss on hedging transaction, net of tax				(278)		(278)
Net loss					(486)	(486)
Balance at December 31, 2004	49,024,596	490	(15,798)	(278)	(51,942)	(67,528)
Exercise of common stock options	547,610	6	2,286			2,292
Non-cash stock-based compensation			278			278
Stock option income tax benefit			1,358			1,358
Unrealized gain on hedging transaction, net of tax				3,495		3,495
Net income					19,849	19,849
Balance at December 31, 2005	49,572,206	$ 496	$ (11,876)	$ 3,217	$ (32,093)	$ (40,256)

See accompanying notes.

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ALLIANCE IMAGING, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2005
(dollars in thousands, excepts per share amounts)

1. Description of the Company and Basis of Financial Statement Presentation

Description of the Company Alliance Imaging, Inc. and its subsidiaries (the Company) provides diagnostic imaging services primarily to hospitals and other healthcare providers on a shared and full-time service basis, in addition to operating a growing number of fixed-site imaging centers primarily in partnerships with hospitals or health systems. The Company s services normally include the use of their imaging systems, technologists to operate the systems, equipment maintenance and upgrades and management of day-to-day operations. The Company also offers ancillary services including marketing support, education and training and billing assistance. The Company operates entirely within the United States and is one of the largest providers of shared service and fixed-site magnetic resonance imaging (MRI) and positron emission tomography and positron emission tomography/computed tomography (PET and PET/CT) services in the country. For the fiscal year ended December 31, 2005, MRI services and PET and PET/CT services generated 68% and 23% of the Company s revenue, respectively.

Principles of Consolidation and Basis of Financial Statement Presentation The accompanying 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. We record minority interest expense related to our consolidated subsidiaries which are not wholly owned. Investments in non-consolidated investees are accounted for under the equity method. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America.

2. Summary of Significant Accounting Policies

Cash and Cash Equivalents The Company classifies short-term investments with original maturities of three months or less as cash equivalents.

Accounts Receivable The Company provides shared and single-user diagnostic imaging equipment and technical support services to the healthcare industry and directly to patients on an outpatient basis. Substanitally all of the Company s accounts receivables are due from hospitals, other healthcare providers and health insurance providers located throughout the United States. A substantial portion of the Company s services are provided pursuant to long-term contracts with hospitals and other healthcare providers or directly to patients. Receivables generally are collected within industry norms for third-party payors. Estimated credit losses are provided for in the consolidated financial statements and losses experienced have been within management s expectations.

Concentration of Credit Risk Financial instruments which potentially subject the Company to a concentration of credit risk principally consists of cash, cash equivalents and trade receivables. The Company invests available cash in money market securities of high-credit-quality financial institutions. The Company had cash and cash equivalents in the amount of $19,854 and $12,305 as of December 31, 2004 and 2005, respectively, in excess of federally insured limits. At December 31, 2004 and 2005, the Company s accounts receivable were primarily from clients in the healthcare industry. To reduce credit risk, the Company performs periodic credit evaluations of its clients, but does not generally require advance payments or collateral. Credit losses to clients in the healthcare industry have not been material. The provision for doubtful accounts was 0.7%, 0.2%, and 0.6% of revenues in 2003, 2004 and 2005, respectively.

Equipment Equipment is stated at cost and is depreciated using the straight-line method over an initial estimated life of three to seven years to an estimated residual value, between five and ten percent of original cost. If the Company continues to operate the equipment beyond its initial estimated life, the residual value is then depreciated to a nominal salvage value over three years.

Routine maintenance and repairs are charged to expense as incurred. Major repairs and purchased software and hardware upgrades, which extend the life of or add value to the equipment, are capitalized and depreciated over the remaining useful life.

With the exception of a relatively small dollar amount of office furniture, office equipment, computer equipment, software and leasehold improvements, substantially all of the property owned by the Company relates to diagnostic imaging equipment, power units and mobile trailers used in the business.

Goodwill and Intangible Assets Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets (SFAS 142) requires that goodwill and intangible assets with indefinite useful lives not be amortized, but instead be tested for impairment at least annually. In accordance with SFAS 142, the Company has selected to perform an annual impairment test for goodwill based on the financial information for the twelve months ended September 30, 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 are its geographical regions. SFAS 142 requires the Company to compare the fair value of the reporting unit to its carrying amount on an annual basis to determine if there is potential impairment. If the fair value of the reporting unit is less than its carrying value, an impairment loss is recorded to the extent that the implied fair value of the goodwill within the reporting unit is less than the carrying value. The fair value of the reporting unit is determined based on discounted cash flows, market multiples or appraised values as appropriate. In 2003, based on the factors described in Note 4, management performed an interim valuation analysis in accordance with SFAS 142 and recognized a goodwill impairment charge in three of its reporting units. In 2004 and 2005, management performed an interim valuation analysis and concluded that the fair value of each reporting unit exceeds its carrying value, indicating no goodwill impairment was present. No triggering events have occurred during the fourth quarters of 2004 and 2005 which would require an additional impairment test as of December 31, 2004 and 2005. SFAS 142 also requires intangible assets with definite useful lives to be amortized over their respective estimated useful lives to their estimated residual values and reviewed for impairment in accordance with Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long Lived-Assets (SFAS 144).

Impairment of Long-Lived Assets The Company accounts for long-lived assets in accordance with the provisions of SFAS 144. SFAS 144 requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to undiscounted future net cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. During 2003, as discussed in Note 4, the Company evaluated the recoverability of the carrying amount of certain long-lived assets and recognized an impairment charge to reduce these assets to their fair value.

Revenue Recognition The majority of the Company s revenues are derived directly from healthcare providers and are primarily for imaging services. To a lesser extent, revenues are generated from direct billings to third-party payors or patients which are recorded net of contractual discounts and other arrangements for providing services at less than established patient billing rates. Revenues from billings to third-party payors and patients amounted to approximately 12%, 13% and 13% of revenues in the years ended December 31, 2003, 2004 and 2005, respectively. No single customer accounted for more than 3% of consolidated revenues in each of the three years in the period ended December 31, 2005. The Company

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recognizes revenue in accordance with Staff Accounting Bulletin No. 104, Revenue Recognition (SAB 104). As the price is predetermined, all revenues are recognized at the time the delivery of imaging service has occurred and collectibility is reasonably assured which is based upon contract terms with healthcare providers and negotiated rates with third party payors and patients. The Company also records revenue from management services that it performs based upon management service contracts with predetermined pricing. Revenues from these services amounted to approximately 6%, 7% and 9% of total revenue in the years ended December 31, 2003, 2004 and 2005, respectively. These revenues are recorded in the period in which the service is performed and collections of the billed amounts are reasonably assured in accordance with SAB 104.

Stock-Based Compensation The Company accounts for stock based compensation awards using the intrinsic value method prescribed under APB Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25), and its related interpretations. For the years ended December 31, 2003, 2004 and 2005 the Company recorded non-cash stock-based compensation of $72, $48 and $24, respectively, for options issued with exercise prices below the fair value of the common stock. All other employee stock-based awards were granted with an exercise price equal to the market value of the underlying common stock on the date of grant and no compensation cost is reflected in the Company s operating results for those awards. For the years ended December 31, 2003, 2004, and 2005 the Company recorded non-cash stock-based compensation of $1,600, $274 and $228, respectively, as a result of amending certain stock option agreements in June 2001 and May 2004 to reduce performance targets. In 2005 the Company created an advisory committee of industry and medical consultants. Non-employee stock-based awards are granted to the members of the advisory committee with an exercise price equal to the market value of the underlying common stock on the date of grant. For the year ended December 31, 2005 the Company recorded non-cash stock-based compensation of $27, as a result of granting stock options to these non-employees.

Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123), requires presentation of pro forma information regarding net (loss) income and (loss) earnings per share determined as if the Company has accounted for its employee stock options granted subsequent to December 31, 1994 under the fair value method of that Statement. The fair value for these options was estimated as of the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions for 2003, 2004 and 2005, respectively: risk-free interest rates of 3.25%, 3.32% and 3.88%; no dividend yield; volatility factors of the expected market price of the Company s common stock of 78.0%, 53.3% and 51.69%; and a weighted average expected life of the options of 6.22, 5.69 and 5.66 years. The weighted average fair value of options granted during 2003, 2004 and 2005 is $3.32 per share, $2.02 per share and $5.57 per share, respectively.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options expected vesting period. Had compensation cost for the Company s stock option plan been determined based on the estimated fair value at the grant dates for awards under the plan consistent with the fair value method of SFAS No. 123 utilizing the Black-Scholes option-pricing model, the Company s net (loss) income and basic and diluted (loss) earnings per share for the years ended December 31, would have approximated the pro forma amounts indicated below:

	2003	2004	2005
Net (loss) income:			
As reported	$ (31,610)	$ (486)	$ 19,849
Add: Stock-based compensation expense included in reported net (loss) income, net of related tax effects	978	190	167
Deduct: Stock-based compensation expense determined under fair value based method, net of related tax effects	(248)	(951)	(1,370)
Pro forma net (loss) income	$ (30,880)	$ (1,247)	$ 18,646
Basic (loss) earnings per share:			
As reported	$ (0.66)	$ (0.01)	$ 0.40
Pro forma	$ (0.65)	$ (0.03)	$ 0.38
Diluted (loss) earnings per share:			
As reported	$ (0.66)	$ (0.01)	$ 0.39
Pro forma	$ (0.65)	$ (0.03)	$ 0.37

Employment Agreement Costs The Company recorded employment agreement costs of $2,446 for the year ended December 31, 2003, related to payments under an amendment to an employment agreement (amended agreement) with its former chairman of the board. The Company recorded employment agreement costs of $2,064 for the year ended December 31, 2004, related to an employment agreement with its former chief financial officer and payments under the amended agreement with their former chairman of the board. The Company recorded employment agreement costs of $366 for the year ended December 31, 2005, related to the amended agreement with its former chairman of the board. The Company does not expect to incur any further costs relating to the amended agreement with its former chairman of the board.

Derivatives The Company accounts for derivative instruments and hedging activities in accordance with the provisions of SFAS 133, Accounting for Derivative Instruments and Hedging Actvities (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 designates the derivative as a hedge of the identified exposure. The Company does not enter into derivative instruments that do not qualify as cash flow hedges as described in SFAS 133 and SFAS 138. 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 (loss) income, net of tax.

Income Taxes The provision for income taxes is determined in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. Deferred tax assets and liabilities are determined based on the temporary differences between the financial reporting and tax bases of assets and liabilities, applying enacted statutory tax rates in effect for the year in which the differences are expected to reverse. Future income tax benefits are recognized only to the extent that the realization of such benefits is considered to be more likely than not. The Company regularly reviews its deferred tax assets for recoverability and establishes a valuation allowance, when it is more likely than not that such deferred tax assets will not be recoverable, based on historical taxable income, projected future taxable income, and the expected timing of the reversals of existing temporary differences.

Fair Values of Financial Instruments The carrying amount reported in the balance sheet for cash and cash equivalents approximates fair value based on the short-term maturity of these instruments. The carrying amounts reported in the balance sheet for accounts receivable and accounts payable approximate fair value based on the short-term nature of these accounts. The carrying amount reported in the balance sheet for long-term debt under our Credit Agreement approximates fair value, as these borrowings have variable rates that reflect currently available terms and conditions for similar debt. The fair value of the Company s senior subordinated notes and its equipment loans was $168,357 and $141,243 compared to the carrying amount reported on the balance sheet of $165,357 and $165,207 as of December 31, 2004 and 2005, respectively. The fair value of the Company s senior subordinated notes was based upon the bond trading prices at December 31, 2004 and 2005, respectively. The fair value of the equipment loans was estimated using discounted cash flow analyses, based on the Company s current incremental rates for similar types of equipment loans.

Use of Estimates The preparation of 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 financial statements and accompanying notes. Actual results could differ from those estimates.

Comprehensive (Loss) Income For the year ended December 31, 2003, the Company did not have any components of comprehensive income as defined in Statement of Financial Accounting Standards No. 130, Reporting Comprehensive Income (SFAS 130). During the years ended December 31, 2004 and 2005, the Company entered into interest rate swap agreements and interest rate collar agreements, as discussed in Note 9, for which unrealized gains and losses are classified as a component of comprehensive (loss) income as defined in SFAS 130.

Segment Reporting The chief operating decision maker reviews the operating results of the Company s geographic regions for the purpose of making operating decisions and assessing performance. Based on the aggregation criteria in Statement of Financial Accounting Standards No. 131, Disclosures about Segments of an Enterprise and Related Information, the Company has aggregated the results of its geographic regions into one reportable segment.

Recent Accounting Pronouncements In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS 153, Exchanges of Nonmonetary Assets (SFAS 153), which is an amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions, (APB 29). This statement addresses the measurement of exchanges of nonmonetary assets, and eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets as defined in paragraph 21(b) of APB 29, and replaces it with an exception for exchanges that do not have commercial substance. This statement specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS 153 did not have a material impact on the Company s consolidated financial position or results of operations.

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In December 2004, the FASB issued SFAS 123(R) (revised December 2004), Share-Based Payment (SFAS 123(R)), which is a revision of SFAS 123 and supersedes APB No. 25. This statement requires that the fair value at the grant date resulting from all share-based payment transactions be recognized in the financial statements. Further, SFAS 123(R) requires entities to apply a fair-value based measurement method in accounting for these transactions. This value is recorded over the vesting period. This statement is effective for the first fiscal year beginning after June 15, 2005. The Company will adopt SFAS 123(R) for the fiscal year beginning January 1, 2006. The Company will use the modified prospective application transition method and estimates that the adoption of SFAS 123(R) for share-based awards issued to employees will reduce the Company s 2006 net income by approximately $1.5 million to $2.5 million. This estimate is based upon various assumptions, including an estimate of the number of share-based awards that will be granted, cancelled or expired during 2006, as well as the Company s future stock prices. These assumptions are highly subjective and changes in these assumptions would materially affect the Company s estimates. In addition, the Company s net income will continue to be reduced by compensation expense for share-based awards to non-employees.

In March 2005, the FASB issued FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations (FIN 47), an interpretation of SFAS 143, Accounting for Conditional Asset Retirement Obligations. This interpretation clarifies that an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability s fair value can be reasonably estimated. This interpretation also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. This statement is effective no later than the end of fiscal years ending after December 15, 2005. The adoption of FIN 47 did not have a material impact on the Company s consolidated financial position or results of operations.

In May 2005, the FASB issued SFAS 154, Accounting for Changes and Error Corrections (SFAS 154), which is a replacement of APB Opinion No. 20, Accounting Changes, and SFAS 3, Reporting Accounting Changes in Interim Financial Statements. This statement changes the requirements for the accounting for and reporting of all voluntary changes in accounting principle and in the instance that a pronouncement does not include specific transition provisions. This statement requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company believes the adoption of SFAS 154 will not have a material impact on its consolidated financial position or results of operations.

In June 2005, the FASB issued Emerging Issues Task Force Issue No. 04-05, Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights (EITF 04-05). EITF 04-05 clarifies how general partners in a limited partnership should determine whether they control a limited partnership. A general partner of a limited partnership is presumed to control the limited partnership unless the limited partners have substantive kick-out rights or participating rights. For general partners of all new limited partnerships formed and for existing limited partnerships for which the partnership agreements are modified, EITF 04-05 is effective after June 29, 2005. For general partners in all other limited partnerships, EITF 04-05 is effective for the first period in fiscal years beginning after December 15, 2005. The Company believes the adoption of EITF 04-05 will not have a material impact on its consolidated financial position or results of operations.

In June 2005, the FASB issued EITF 05-06, Determining the Amortization Period for Leasehold Improvements (EITF 05-06). EITF 05-06 defines the useful life for leasehold improvements acquired in a business combination, or purchased significantly after, and not contemplated at the beginning of the lease term. EITF 05-06 is effective for leasehold improvements purchased or acquired in reporting periods after June 29, 2005. The adoption of EITF 05-06 did not have a material impact on the Company s consolidated financial position or results of operations.

3. Transactions

On March 30, 2003, the Company entered into a joint venture agreement with GE Capital Corporation to form Affordable Imaging Rentals, LLC (AIR), subsequently renamed to Mobile Interim Solutions (MIS). MIS owns and operates a diagnostic imaging rental fleet of approximately 50 systems, primarily used by hospital and other healthcare clients for short-term, unstaffed MRI and CT rental needs. The Company has a 50% equity interest in MIS for which it paid $8,700 in cash. This equity interest is an investment in a non-consolidated investee, because the Company does not possess control, and is being accounted for under the equity method. The Company also entered into a long-term management agreement with MIS to provide logistics and related services for the rental fleet.

Effective September 1, 2005, the Company acquired certain assets associated with nine multi-modality fixed-site diagnostic imaging centers. The multi-modality fixed-site diagnostic imaging centers include one MRI system, six CT systems, and 29 other modality systems. The purchase price consisted of $7,650 in cash and $826 in assumed liabilities and transaction costs. The acquisition was financed using the Company s internally generated funds. As a result of this acquisition, the Company recorded goodwill and intangible assets of $2,246 and $2,400, respectively. The intangible assets were recorded at fair value at the acquisition date. All recorded goodwill is deductible for tax purposes and will be amortized over 15 years for tax purposes. The acquisition also includes $246 of contingent payment due to the shareholders of the centers if certain performance targets are met over a three year period. When the contingency is resolved and consideration is distributable, the Company will record the fair value of the consideration as additional purchase price to goodwill. Adjustments to goodwill may occur in future periods as a result of changes in the original valuation of assets and liabilities acquired. The year ended December 31, 2005 includes four months of operations from this acquisition. The Company has not included pro forma information as this acquisition did not have a material impact on the Company s consolidated financial position or results of operations.

Effective October 1, 2005, the Company acquired 100% of the outstanding stock of PET Scans of America Corp. (PSA), a mobile provider of PET and PET/CT services primarily to hospitals in 13 states. The purchase price consisted of $36,596 in cash and $3,692 in assumed liabilities and transaction costs. The acquisition was financed using the Company s revolving line of credit, internally generated funds, and capital leases. As a result of this acquisition the Company acquired intangible assets of $11,400, of which $9,100 was assigned to PSA customer contracts, which will be amortized over 10 years, and $2,100 was assigned to certificates of need held by PSA, which have indefinite useful lives and are not subject to amortization. These assets were recorded at fair value at the acquisition date. The Company recorded total goodwill of $22,472, which includes $3,007 of goodwill related to income tax timing differences as a result of the acquisition. None of the goodwill recorded is deductible for tax purposes. Adjustments to goodwill may occur in future periods as a result of changes in the original valuation of assets and liabilities acquired. The year ended December 31, 2005 includes three months of operations from this acquisition. The Company has not included pro forma information as this acquisition did not have a material impact on the Company s consolidated financial position or results of operations.

In late December 2005, the Company purchased an additional equity interest in a joint venture the Company formed in 2004 with the University of Pittsburgh Medical Center. The joint venture, Alliance Oncology (AO), is designed to partner with hospitals to build and operate radiation oncology centers, with an emphasis on intensity modulated radiation therapy and image guided radiation therapy. The purchase price for the additional equity interest was $8,000, which was financed through the Company s revolving line of credit. The Company now owns 80% of AO. As a result of this acquisition the Company recorded goodwill of $6,946, which is deductible for tax purposes and will be amortized over 15 years for tax purposes. Adjustments to goodwill may occur in future periods as a result of changes in the original valuation of assets and liabilities acquired. The year ended December 31, 2005 did not include any consolidated results of operations from this acquisition due to the small number of days between the acquisition date and the fiscal year end. During the year the Company recorded earnings in unconsolidated investees for the Company s share of AO s previously unconsolidated earnings. The Company has not included pro forma information as this acquisition did not have a material impact on the Company s consolidated financial position or results of operations.

4. Impairment Charges

In 2003, the Company saw an increase in the competitive climate in the MRI industry, resulting in an increase in activity by original equipment manufacturers selling systems directly to certain of the Company s clients. This has caused an increase in the number of the Company s clients deciding not to renew its contracts, and as a result, the Company s MRI revenues have declined and they continue to decline through 2005. These events triggered an acceleration of the review of the recoverability of the carrying value of certain equipment, goodwill, and other intangible assets according to the provisions of SFAS 144 and SFAS 142. Due to the factors noted above, in 2003 the Company recognized a non-cash impairment charge totaling $73,225 associated with goodwill and other intangible assets and certain equipment in accordance with the provisions of SFAS 142 and 144, and an impairment of an investment in a joint venture, the components of which are described in more detail below.

In 2003, as discussed in Note 5, the Company recorded an impairment charge of $41,916 under SFAS 142 related to goodwill and an impairment charge of $802 under SFAS 144 related to certain customer contract intangible assets.

The Company evaluated the recoverability of the carrying amount of certain long-lived assets, specifically its 1.0 Tesla and 0.2 Tesla MRI systems, as a result of the decline in client demand for these systems. An impairment is assessed when the undiscounted expected future cash flows derived from the asset are less than its carrying amount. The Company used its best judgment based upon the most current facts and circumstances when applying these impairment rules. Based upon the analysis performed on the 1.0 Tesla and 0.2 Tesla MRI systems, an impairment charge of $22,793 was recognized to reduce certain of these assets to their fair market value as of September 30, 2003. Fair market value was based upon quoted market prices. The Company revised its estimate of residual values on all of its MRI equipment from 20% to 10%. In addition, the Company also changed its estimate of useful lives of 1.5 Tesla MRI systems from 8 years to 7 years. Both of these changes in estimates are being recognized on a prospective basis.

In 2003, the Company recognized a $7,714 impairment charge relating to an other than temporary decline in the fair value of the Company s investment in a joint venture. The Company concluded that its investment was other than temporarily impaired because the Company s carrying value of the investment exceeded the calculated fair value of the investment and the prospects for recovery are still considered weak. The fair value of the investment was based upon the Company s best estimate of the expected discounted future cash flows of the joint venture.

5. Goodwill and Intangible Assets

Changes in the carrying amount of goodwill are as follows:

Balance at December 31, 2004	$ 122,992
Goodwill acquired during the year (see Note 3)	31,664
Balance at December 31, 2005	$ 154,656

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Intangible assets consisted of the following:

	December 31, 2004 Gross Carrying Amount	Accumulated Amortization	Intangible Assets, net	December 31, 2005 Gross Carrying Amount	Accumulated Amortization	Intangible Assets, net
Amortizing intangible assets:						
Customer contracts	$ 40,426	$ (15,528)	$ 24,898	$ 51,063	$ (18,791)	$ 32,272
Other	3,272	(2,010)	1,262	4,467	(1,910)	2,557
Total amortizing intangible assets	$ 43,698	$ (17,538)	$ 26,160	$ 55,530	$ (20,701)	$ 34,829
Intangible assets not subject to amortization			$ 2,089			$ 4,242
Total other intangible assets, net			$ 28,249			$ 39,071

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.

In 2003, the Company recognized a goodwill impairment charge of $41,916 in three of its reporting units to reduce these assets to their fair value as of September 30, 2003. The implied fair value for goodwill is determined based on the fair value of assets and liabilities of the respective reporting units, in accordance with SFAS 142, based on discounted cash flows, market multiples, or appraised values as appropriate.

Also in the third quarter of 2003 in accordance with SFAS 144, the Company determined that certain intangible assets acquired in May 1998 were impaired, and the Company recorded a charge of $802 to two of its reporting units in order to record these assets at fair value. Fair market value was determined based upon discounted cash flows.

Based upon the SFAS 144 study performed, the Company changed its estimate for the amortization period of certain customer contracts from a weighted average useful life of 19 years to 15 years in the third quarter of 2003. This change in estimate has been recognized on a prospective basis. Other intangible assets subject to amortization were determined to have a weighted average useful life of four years. Amortization expense for intangible assets subject to amortization was $2,897, $3,522 and $3,954 for the years ended December 31, 2003, 2004 and 2005, 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:

2006	$ 4,871
2007	4,655
2008	4,441
2009	4,120
2010	4,032

6. Other Accrued Liabilities

Other accrued liabilities consisted of the following:

	December 31, 2004	2005
Accrued systems rental and maintenance costs	$ 3,058	$ 5,801
Accrued site rental fees	1,796	1,242
Accrued property and sales taxes payable	8,061	10,569
Accrued self-insurance expense	4,789	5,725
Other accrued expenses	4,473	5,727
Total	$ 22,177	$ 29,064

7. Long-Term Debt and Senior Subordinated Credit Facility

Long-term debt consisted of the following:

	December 31, 2004	2005
Term loan facility	$ 409,875	$ 384,875
Revolving loan facility		29,500
Senior subordinated notes	153,541	153,541
Equipment debt	12,248	11,666
Long-term debt, including current portion	575,664	579,582
Less current portion	9,390	7,781
Long-term debt	$ 566,274	$ 571,801

Bank Credit Facilities On November 2, 1999, the Company entered into a $616,000 Credit Agreement (the Credit Agreement) consisting of a $131,000 Tranche A Term Loan Facility, a $150,000 Tranche B Term Facility, a $185,000 Tranche C Term Loan Facilty, and a Revolving Loan Facilty. On June 11, 2002, the Company entered into a second amendment to its Credit Agreement in order to complete a $286,000 refinancing of its Tranche B and C term loan facility. Under the terms of the amended term loan facility, the Company received proceeds of $286,000 from a new Tranche C term loan facility, and used the entire amount of the proceeds to retire $145,500 and $140,500 owed under Tranche B and C of its existing term loan facility, respectively. The new Tranche C borrowing rate was decreased to the London InterBank Offered Rate (LIBOR) plus 2.375%. The borrowing rate under the previously applicable Tranche B borrowing rate had been LIBOR plus 2.750% and the previously applicable Tranche C borrowing rate had been LIBOR plus 3.000%.

On December 29, 2004, the Company entered into a third amendment to its Credit Agreement which revised the Tranche C term loan facility (Tranche C1) resulting in incremental borrowings of $154,000 and decreased the maximum amount of availability under the existing revolving loan facility from $150,000 to $70,000. The proceeds from the amendment were used to complete a cash tender offer to retire $256,459 of the $260,000 10 3⁄8% Senior Subordinated Notes due 2011, as discussed below. The Tranche C1 borrowing rate decreased to LIBOR plus 2.250%. On December 19, 2005 the Company entered into a fourth amendment to its Credit Agreement which revised the Company s maximum consolidated leverage ratio covenant to a level not to exceed 4.00 to 1.00 as of the last day of any fiscal quarter until the expiration of the agreement. Prior to the fourth amendment, the Company s maximum consolidated leverage ratio covenant was 3.75 to 1.00 as of the last day of any fiscal quarter beginning March 31, 2006 to the expiration of the agreement. The fourth amendment also requires the Company to maintain a maximum consolidated senior leverage ratio covenant at a level not to exceed 3.00 to 1.00 as of the last day

of any fiscal quarter. The amendment increased the Tranche C1 LIBOR margin from an annual rate of 2.250% to 2.500%. In connection with the amendment, the Company incurred an amendment fee of $594.

At December 31, 2005, the Company had $29,500 in borrowings outstanding under the revolving loan facility and $34,879 in available borrowings under the revolving loan facility. The Company s Credit Agreement, as amended, will govern the Tranche C1 and the revolving loan facility with the same security provisions and the revised restrictive covenants which, among other things, limit the incurrence of additional indebtedness, dividends, transactions with affiliates, asset sales, acquisitions, mergers and consolidations, liens and encumbrances, and restrictive payments. As of December 31, 2005, the Company was in compliance with all covenants under the Credit Agreement. As noted in the maturities schedule, principal payments are required in 2006 and on various dates through 2011 for the Tranche C1 and revolving loan facility. Voluntary prepayments are permitted in whole or in part without premium or penalty. Interest under Tranche C1 and the revolving loan facility is variable based on the Company s leverage ratio and changes in specified published rates and the bank s prime lending rate.

The weighted average interest rates on Tranche A and the Tranche C1 term loan facilities at December 31, 2004 were 3.500% and 4.690%, respectively. The remaining principal balance of Tranche A was paid during 2005. The weighted average interest rates on Tranche C1 and the revolving loan facility at December 31, 2005 were 6.282% and 5.875%, respectively. The Company pays a commitment fee equal to 0.50% per annum on the undrawn portion available under the revolving loan facility. The Company also pays variable per annum fees in respect of outstanding letters of credit. The Credit Agreement is collateralized by the Company s equity interests in its majority owned subsidiaries, partnerships and limited liability companies and its unencumbered assets, which include accounts receivable, inventory, equipment, and intellectual property.

10⅜% Senior Subordinated Notes In December 2004 the Company completed a cash tender offer (the Tender Offer) for any and all of its outstanding 10⅜% Notes. The Company redeemed substantially all of the 10⅜% Notes at a redemption price equal to 113.856% of the principal amount, together with the accrued interest to the redemption date. The Company incurred a loss on early retirement of debt of $44,393 for the tender offer which represents the tender premium and consent payment to redeem the 10⅜% Notes, write off of unamortized debt issuance costs related to the retired debt, and fees and expenses related to the redemption of the 10⅜% Notes. The Company used the remaining proceeds from Tranche C1, proceeds from the sale of the 7¼% Notes described below, and existing cash to settle the tender premium and consent payment. At December 31, 2005, the Company had $3,541 remaining of the original $260,000 10⅜% Notes. As of December 31, 2005, the Company was in compliance with all covenants contained in our 10⅜% Notes.

7¼% Senior Subordinated Notes On December 29, 2004, the Company issued $150,000 of its 7¼% Senior Subordinated Notes due 2012 (the 7¼% Notes) in a transaction exempt from the registration requirements of the Securities Act of 1933, as amended, and used the proceeds to repay a portion of its 10⅜% Notes. The 7¼% Notes contain restrictive covenants which, among other things, limit the incurrence of additional indebtedness, dividends, transactions with affiliates, asset sales, acquisitions, mergers and consolidations, liens and encumbrances, and restrictive payments. The 7¼% Notes are unsecured senior subordinated obligations and are subordinated in right of payment to all existing and future senior debt, including bank debt, and all obligations of its subsidiaries. As of December 31, 2005, the Company was in compliance with all covenants contained in the 7¼% Notes.

The maturities of long-term debt as of December 31, 2005 are as follows:

	Bank Credit Facilities Tranche C1	Revolver	Subordinated Notes	Equipment Loans	Total
Year ending December 31:					
2006	$ 3,900	$	$	$ 3,881	$ 7,781
2007	3,900			3,022	6,922
2008	3,900			2,255	6,155
2009	3,900			1,681	5,581
2010	3,900	29,500		827	34,227
Thereafter	365,375		153,541		518,916
	$ 384,875	$ 29,500	$ 153,541	$ 11,666	$ 579,582

Of the Company s total indebtedness at December 31, 2005, $570,877 is an obligation of the Company and $8,705 is an obligation of the Company s consolidated subsidiaries.

8. Stockholders Deficit

(Loss) Earnings Per Common Share The following table sets forth the computation of basic and diluted (loss) earnings per share (amounts in thousands, except per share amounts):

	Year Ended December 31, 2003	2004	2005
Numerator:			
Net (loss) income	$ (31,610)	$ (486)	$ 19,849
Denominator:			
Weighted-average shares basic	47,872	48,350	49,378
Effect of dilutive securities:			
Employee stock options			884
Weighted-average shares diluted	47,872	48,350	50,262
(Loss) earnings per common share:			
Basic	$ (0.66)	$ (0.01)	$ 0.40
Diluted	$ (0.66)	$ (0.01)	$ 0.39
Stock options excluded from the computation of diluted per share amounts:			
Weighted-average shares for which the exercise price exceeds average market price of common stock	4,149	1,291	1,279
Average exercise price per share that exceeds average market price of common stock	$ 6.31	$ 8.19	$ 11.60

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Stock Options and Awards In December 1997, the Company adopted an employee stock option plan (1997 Equity Plan) pursuant to which options with respect to a total of 4,685,450 shares of the Company s common stock were available for grant. Options were granted at their fair value at the date of grant. All options have 10-year terms. On November 2, 1999, in connection with the 1999 Recapitalization Merger, all options under the 1997 Equity Plan became fully vested.

In connection with the Company s acquisition of all of the outstanding common stock of Three Rivers Holding Corporation (Three Rivers), the parent corporation of SMT Health Services, Inc., in 1999, outstanding employee stock options under the 1997 Three Rivers Stock Option Plan were converted into options to acquire shares of the Company s common stock. The Three Rivers stock option plan allowed for options with respect to a total of 2,825,200 shares of the Company s common stock to be available for grant. Options were granted at their fair value at the date of grant. All options have 10-year terms. 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 1999 Recapitalization Merger), all options under the 1997 Three Rivers Stock Option Plan became fully vested.

In connection with the 1999 Recapitalization Merger, the Company adopted an employee stock option plan (the 1999 Equity Plan) pursuant to which options with respect to a total of 6,325,000 shares of the Company s common stock will be available for grant. 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). In November 2000, the Company granted 865,000 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 December 31, 2005. The exercise price 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. For the years ended December 31, 2003, 2004 and 2005 the Company recorded non-cash stock-based compensation of $72, $48 and $24, respectively, with an offset to additional paid-in deficit.

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. Management estimates that the Company could incur an additional $200 to $500 in the aggregate of these non-cash stock-based compensation charges over the next 3½ years. These charges, however, may not be evenly distributed over each of those three years or over the four quarters in any one year, depending upon the timing of employee turnover and the number of shares subject to the options held by departing employees. For the year ended December 31, 2003, 2004 and 2005, the Company recorded $1,600, $274 and $228, respectively, in non-cash stock-based compensation as a result of the amendment.

In 2005, the Company created an advisory committee of industry and medical consultants. Non-employee stock-based awards are granted to the members of the advisory committee with an exercise price equal to the market value of the underlying common stock on the date of grant. For the year ended December 31, 2005 the Company recorded non-cash stock-based compensation of $27, as a result of granting stock options to these non-employees.

The following table summarizes the Company s stock option activity:

	Shares	Weighted Average Exercise Price
Outstanding at December 31, 2002	5,429,300	$ 4.35
Granted	2,511,000	4.77
Exercised	(210,000)	1.10
Canceled	(2,909,420)	4.10
Outstanding at December 31, 2003	4,820,880	4.86
Granted	987,500	3.92
Exercised	(1,033,850)	3.72
Canceled	(1,085,420)	5.75
Outstanding at December 31, 2004	3,689,110	4.67
Granted	1,078,500	10.88
Exercised	(547,610)	4.19
Canceled	(648,725)	6.71
Outstanding at December 31, 2005	3,571,275	$ 6.25

The following table summarizes information about all stock options outstanding at December 31, 2005:

Options Outstanding	Exercise Price	Weighted Average Remaining Contractual Life	Options Exercisable	Exercise Price
9,000	$ 2.04	1.8	9,000	$ 2.04
62,500	2.20	3.2	62,500	2.20
214,450	5.60	3.8	214,450	5.60
35,000	5.60	4.8	35,000	5.60
27,400	13.00	5.6	21,920	13.00
10,000	13.00	5.6	8,000	13.00
35,000	10.65	6.0	24,500	10.65
1,000,000	5.27	7.0	500,000	5.27
246,000	5.19	7.0	84,000	5.19
400,000	2.95	7.3	200,000	2.95
53,000	4.95	7.4	26,500	4.95
48,000	3.55	7.7	19,200	3.55
359,425	3.67	8.0	19,771	3.67
70,000	4.04	8.4	21,000	4.04
40,000	4.06	8.4	12,000	4.06
35,000	4.19	8.6	35,000	4.19
20,000	7.20	8.8	4,000	7.20
15,000	6.94	8.8	5,000	6.94
2,500	10.98	9.0	833	10.98
574,500	12.35	9.0	9,250	12.35
80,000	9.60	9.2	8,000	9.60
15,000	9.17	9.2	1,500	9.17
10,000	10.41	9.3	1,000	10.41
50,000	10.71	9.4	5,000	10.71
2,500	8.62	9.7		8.62
150,000	5.56	9.9		5.56
6,000	7.75	9.8		7.75
1,000	5.62	10.0		5.62
3,571,275	$ 6.25	7.5	1,327,424	$ 5.09

Directors Deferred Compensation Plan Effective January 1, 2000, the Company established a Directors Deferred Compensation Plan (the Director Plan) for all non-employee directors. Each of the non-employee directors has elected to participate in the Director Plan and have their annual fee of $25 deferred into a stock account and converted quarterly into Phantom Shares. Upon retirement, separation from the Board of Directors, or the occurrence of a change of control, each director has the option of being paid cash or issued common stock for their Phantom Shares. For the years ended December 31, 2003, 2004 and 2005 the Company recorded additional director fees of zero, $299, and ($220) respectively, with an increase (decrease) to other accrued liabilities for the difference between the current fair market value and the original issuance price of the Phantom Shares. At December 31, 2004 and 2005, $946 and $668, respectively was included in other accrued liabilities relating to the Director Plan.

9. 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 hedge the future cash interest payments associated with a

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portion of the Company s variable rate bank debt. These agreements are three years in length and mature in 2007. As of December 31, 2004, and 2005 the fair value of the Company s interest rate swap agreements was an accumulated loss of $464 and an accumulated income of $2,824, 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 of the hedges 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 years ended December 31, 2004 and 2005, the Company recorded a net settlement amount of $1,020, and $756, respectively. The Company has designated these swaps as cash flow hedges of variable future cash flows associated with its long-term debt. For the years ended December 31, 2004 and 2005, the Company recognized a comprehensive loss, net of tax, of $278, and a comprehensive income, net of tax, of $1,980, based on the change in fair value of these instruments. The Company will continue to record subsequent changes in the fair value of the swaps through comprehensive (loss) income during the period these instruments are designated as hedges.

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 December 31, 2005, the fair value of the Company s interest rate collar agreements was an accumulated income of $2,525. For the year ended December 31, 2005, the Company did not record any net settlement amount. The Company has designated these collars as cash flow hedges of variable future cash flows associated with its long-term debt. For the year ended December 31, 2005, the Company recognized a comprehensive income, net of tax, of $1,515 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 (loss) income during the period these instruments are designated as hedges.

10. Commitments and Contingencies

The Company has maintenance contracts with its equipment vendors for substantially all of its diagnostic imaging equipment. The contracts are between one and five years from inception and extend through the year 2008, but may be canceled by the Company under certain circumstances. The Company s total contract payments for the years ended December 31, 2003, 2004 and 2005 were $33,598, $35,214 and $35,972, respectively. At December 31, 2005, the Company had binding equipment purchase commitments totaling $24,744.

The Company leases office and warehouse space and certain equipment under non-cancelable operating leases. The office and warehouse leases generally call for minimum monthly payments plus maintenance and inflationary increases. The future minimum payments under such leases are as follows:

Year ending December 31:	
2006	$ 6,439
2007	5,903
2008	4,492
2009	3,073
2010	2,307
Thereafter	2,908
	$ 25,122

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The Company s total rental expense, which includes short-term equipment rentals, for the years ended December 31, 2003, 2004 and 2005 was $8,852, $8,722 and $9,518 respectively.

The Company has applied the disclosure provisions of FASB Interpretation No. 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 December 31, 2005 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 $191 at December 31, 2005. 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 allege 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 has not yet responded to the second amended complaint and anticipates filing a demurrer and/or motion to strike the new claim and plea. A hearing for any such challenge to the second amended complaint has been scheduled for May 4, 2006. No date for the filing or hearing of a motion for class certification has been set and no trial date has been set. The Company is currently evaluating the allegations of the second amended complaint and are unable to predict the likely timing or outcome of the lawsuit.

The Company from time to time is also involved in other 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. 401(k) Savings Plan

The Company established a 401(k) Savings Plan (the Plan) in January 1990. Effective August 1, 1998, the Plan was amended and restated in its entirety. Currently, all employees who are over 21 years of age are eligible to participate after attaining three months of service. Employees may contribute between 1% and 25% of their annual compensation. The Company matches 50 cents for every dollar of employee contributions up to 5% of their annual compensation, subject to the limitations imposed by the Internal Revenue Code. Employees vest in employer contributions 25% per year, over 4 years. The Company may also make discretionary contributions depending on profitability. No discretionary contributions were made in 2003, 2004 or 2005. The Company incurred and charged to expense $1,454, $1,468 and $1,421 during 2003, 2004 and 2005, respectively, related to the Plan.

12. Income Taxes

The (benefit) provision for income taxes shown in the consolidated statements of operations consists of the following:

	Year Ended December 31, 2003	2004	2005
Current:			
Federal	$ (100)	$ (5,099)	$ 649
State	1,302	732	9
Total current	1,202	(4,367)	658
Deferred:			
Federal	(1,635)	(1,566)	10,321
State	(1,247)	(837)	2,471
Total deferred	(2,882)	(2,403)	12,792
Total (benefit) provision for income taxes	$ (1,680)	$ (6,770)	$ 13,450

Significant components of the Company s net deferred tax assets (liabilities) at December 31 are as follows:

	2004	2005
Basis differences in equipment	$ (93,985)	$ (87,601)
Basis differences in intangible assets	(5,621)	(11,315)
Net operating losses	71,932	60,345
Accounts receivable	3,027	2,248
State income taxes	3,117	4,065
Accruals not currently deductible for income tax purposes	2,739	5,485
Basis differences associated with acquired investments	(2,228)	(6,097)
Other	1,954	(2,975)
Total deferred taxes	(19,065)	(35,845)
Valuation allowance	(18,113)	(18,113)
Net deferred taxes	$ (37,178)	$ (53,958)
Current deferred tax asset	$ 12,782	$ 6,186
Noncurrent deferred tax liability	(49,960)	(60,144)
Net deferred taxes	$ (37,178)	$ (53,958)

A reconciliation of the expected total (benefit) provision for income taxes, computed using the federal statutory rate on income (loss) is as follows:

	Year Ended December 31, 2003	2004	2005
U.S. Federal tax (benefit) expense at statutory rate	$ (11,989)	$ (3,119)	$ 11,086
State income taxes, net of federal benefit	454	(68)	1,752
Amortization or write-off of non-deductible goodwill	8,132		
Performance based stock options		569	
Minority interest expense	(589)	(830)	(601)
Earnings from unconsolidated investees	927	1,410	1,170
Tax settlement		(5,095)	
Other	1,385	363	43
(Benefit) provision for income taxes	$ (1,680)	$ (6,770)	$ 13,450

As of December 31, 2005, the Company had net operating loss carryforwards of approximately $163,840 and $40,063 for federal and state income tax purposes, respectively. The utilization of the majority of these net operating loss carryforwards may be subject to limitation under Section 382 of the Internal Revenue Code. These loss carryforwards will expire at various dates from 2006 through 2025. As of December 31, 2005, the Company also had alternative minimum tax credit carryforwards of $1,223 with no expiration date.

The Company maintains a valuation allowance to reduce certain deferred tax assets to amounts that are, in management s estimation, more likely than not to be realized. This allowance primarily relates to the deferred tax assets established for certain state net operating loss carryforwards, as well as net operating loss carryforwards from the acquisition of Mobil Technology, Inc. (MTI) in 1998 which are subject to limitation. Any reductions in the valuation allowance resulting from realization of the MTI net operating loss carryforwards will result in a reduction of goodwill.

During 2004, the Company recorded a higher than statutory income tax benefit primarily due to the reversal of income tax reserves of $5,095 primarily related to the favorable outcome of examinations of its 1998 and 1999 federal income tax returns and a favorable final IRS determination related to the treatment of an income item in a federal income tax return of one of its subsidiaries.

At December 31, 2005, approximately $1,200 of tax contingency accruals remain as the Company feels it is probable that a liability has been incurred and the amount of the contingency can be reasonably estimated based on specific events.

13. Related-Party Transactions

The Company recorded management fees payable to Kohlberg Kravis Roberts & Co (KKR) of $650 in 2003, 2004 and 2005, and will continue to receive financial advisory services from KKR on an ongoing basis. At December 31, 2004 and 2005, the Company has accrued $163 related to these services.

Revenue from management agreements with unconsolidated equity investees was $9,028, $11,508 and $11,873 during 2003, 2004 and 2005, respectively.

14. Investments in Unconsolidated Investees

The Company has direct ownership in five unconsolidated investees at December 31, 2005. The Company owns between 30 percent and 50 percent of these investees, and provides management services under agreements with three of these investees, expiring at various dates through 2023. As discussed in Note 3, in late December 2005 the Company purchased an additional equity interest in AO, a joint venture

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formed in 2004, which was an unconsolidated investee prior to purchase of the additional equity interest. AO was included in the total unconsolidated investee count of six at December 31, 2004. The Company s earnings in unconsolidated investees for the years ended December 31, 2004 and December 31, 2005 include the Company s percentage of AO s earnings for these periods. At December 31, 2005 the Company also has ownership in an unconsolidated investee of AO. 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):

	Decmber 31, 2004	**2005**
Combined Balance Sheet Data:		
Current assets	$ 15,342	$ 11,232
Noncurrent assets.	24,740	31,958
Current liabilities	9,136	12,230
Noncurrent liabilities	11,763	12,779

	Years Ended December 31, 2003	**2004**	**2005**
Combined Operating Results:			
Revenues	$ 34,921	$ 30,799	$ 34,709
Expenses	29,279	22,061	25,332
Net income	5,642	8,738	9,377
Equity in earnings of unconsolidated investees	2,649	4,029	3,343

15. Quarterly Financial Data (Unaudited)

The following table sets forth selected unaudited quarterly information for the Company s last eight fiscal quarters. This information has been prepared on the same basis as the Consolidated Financial Statements and all necessary adjustments (which consisted only of normal recurring adjustments) have been included in the amounts stated below to present fairly the results of such periods when read in conjunction with the Consolidated Financial Statements and related notes included elsewhere herein.

	Quarter Ended Mar. 31, 2004	**Jun. 30, 2004**	**Sep. 30, 2004**	**Dec. 31, 2004**
Revenues	$ 105,646	$ 109,481	$ 109,760	$ 107,193
Income (loss) before income taxes, minority interest expense and earnings from unconsolidated investees	7,538	10,656	11,041	(38,147)
Net income (loss)	4,540	11,723	6,966	(23,715)
Earnings (loss) per common share:				
Basic	$ 0.09	$ 0.24	$ 0.14	$ (0.49)
Diluted	$ 0.09	$ 0.24	$ 0.14	$ (0.49)

	Quarter Ended Mar. 31, 2005	Jun. 30, 2005	Sep. 30, 2005	Dec. 31, 2005
Revenues	$ 105,964	$ 108,434	$ 106,198	$ 110,192
Income before income taxes, minority interest expense and earnings from unconsolidated investees	9,995	9,956	8,055	3,668
Net income	6,135	6,155	5,011	2,548
Earnings per common share:				
Basic	$ 0.12	$ 0.12	$ 0.10	$ 0.05
Diluted	$ 0.12	$ 0.12	$ 0.10	$ 0.05

The Company experiences seasonality in the revenues and margins generated for its 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. During the fourth quarter of 2005, the expected slight decrease in revenue due to seasonality issues was offset by an increase in revenue as a result of the Company s acquisition activity in the third and fourth quarters of 2005, as discussed in Note 3. The variability in margins is higher than the variability in revenues due to the fixed nature of the Company s costs.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

Item 9A. 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 period 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.

There has been no change in our internal controls over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

Management s Report on Internal Control Over Financial Reporting

Internal control over financial reporting refers to the process designed by, or under the supervision of, our Chief Executive Officer and Chief Financial Officer, and effected by our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles, and includes those policies and procedures that:

(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of managements and directors of the Company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company s assets that could have a material effect on the financial statements.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk. Management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company.

Management has used the framework set forth in the report entitled Internal Control Integrated Framework published by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission to evaluate the effectiveness of the Company s internal control over financial reporting. Management has concluded that the Company s internal control over financial reporting was effective as of December 31, 2005. Deloitte & Touche LLP has issued an attestation report on management s assessment of the Company s internal control over financial reporting.

Paul S. Viviano, Chief Executive Officer
Howard K. Aihara, Chief Financial Officer

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Alliance Imaging, Inc.
Anaheim, California

We have audited management s assessment, included in the accompanying Management s Report on Internal Control Over Financial Reporting, that Alliance Imaging, Inc. and subsidiaries (the Company) maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed by, or under the supervision of, the company s principal executive and principal financial officers, or persons performing similar functions, and effected by the company s board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that the Company maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedule as of and for the year ended December 31, 2005 of the Company and our report dated March 16, 2005 expressed an unqualified opinion on those financial statements and financial statement schedule.

DELOITTE & TOUCHE LLP

Costa Mesa, California
March 16, 2006

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Item 9B. Other Information

None

PART III

Item 10. Directors and Executive Officers of the Registrant.

The information required by Item 10 of Form 10-K with respect to identification of our directors is incorporated by reference from the information contained in the section captioned Nominees and Other Members of the Board of Directors in our 2006 definitive proxy statement.

The information required by Item 10 of Form 10-K with respect to compliance with Section 16 (a) of the Securities Exchange Act, as amended, is incorporated by reference from the information contained in the section captioned Section 16(a) Beneficial Reporting Compliance in our 2006 definitive proxy statement.

The information required by Item 10 of Form 10-K with respect to our Code of Business Conduct and Ethics that applies to our senior financial officers is incorporated by reference from the section captioned Availability of Certain Documents in our 2006 definitive proxy statement.

The information required by Item 10 of Form 10-K with respect to audit committees and audit committee financial experts is incorporated by reference from the information contained in the section captioned Corporate Governance and Board Committees in our 2006 definitive proxy statement.

Item 11. Executive Compensation.

The information required by Item 11 of Form 10-K is incorporated by reference from the information contained in the sections captioned Directors Compensation , Summary Compensation Table , Option Grants in Last Fiscal Year , Aggregated Option Exercises in Last Fiscal Year and Fiscal Year End Option Values , Employment and Change of Control Arrangements , Stock Performance Graph , Report of the Compensation Committee on Executive Compensation , and Compensation Committee Interlocks and Insider Participation in our 2006 definitive proxy statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

The information required by Item 12 of Form 10-K with respect to security ownership of certain beneficial owners and management is incorporated by reference from the information contained in the section captioned Ownership of Alliance Common Stock in our 2006 definitive proxy statement.

The information required by Item 12 of Form 10-K with respect to securities authorized for issuance under equity compensation plans is incorporated by reference from the information contained in Item 5 of Part II of this Form 10-K.

Item 13. Certain Relationships and Related Transactions.

The information required by Item 13 of Form 10-K is incorporated by reference from the information contained in the section captioned Certain Relationships and Related Party Transactions in our 2006 definitive proxy statement.

Item 14. Principal Accountant Fees and Services.

The information required by Item 14 of Form 10-K with respect to principal accountant fees and services is incorporated by reference from the section captioned Ratification of the Appointment of Deloitte & Touche LLP as Independent Auditors in our 2006 definitive proxy statement.

PART IV

Item 15. Exhibits, Financial Statement Schedules

(a) The following documents are filed as part of this Form 10-K:

1. Financial Statements:

A listing of the Consolidated Financial Statements of Alliance Imaging, Inc., related notes and Report of Independent Registered Public Accounting Firm is set forth in Item 8 of this report on Form 10-K.

The consolidated balance sheets of Alliance-HNI L.L.C. and Subsidiaries as of December 31, 2005 and 2004, the Consolidated Statements of Operations and Comprehensive Income, Changes in Members Capital, and Cash Flows for each of the three years in the period ended December 31, 2005, related notes and the Report of Independent Registered Public Accounting Firm are set forth in Exhibit 99.1 to this Form 10-K.

2. Financial Statement Schedules:

The following Financial Statement Schedule for the years ended December 31, 2005, 2004 and 2003 is set forth on page 87 of this report on Form 10-K:

Schedule II Valuation and Qualifying Accounts

All other schedules have been omitted because the required information is not present or is not present in amounts sufficient to require submission of the schedule, or because the information required is included in the Consolidated Financial Statements and related notes for the year ended December 31, 2005.

3. Index to Exhibits:

Exhibit No.	**Description**
3.1	Amended and Restated Certificate of Incorporation of Alliance.(7)
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 10⅜% Senior Subordinated Notes due 2011.(5)
4.2	Credit Agreement dated as of November 2, 1999, as amended.(5)
4.3	Specimen certificate for shares of common stock, $.01 par value, of Alliance.(7)
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 7¼% Senior Subordinated Notes due 2012 and 7¼% Series B Senior Subordinated Notes due 2012.(13)
4.6	Supplemental Indenture dated as of December 14, 2004 by and between Registrant and the Bank of New York with respect to 10⅜% Senior Subordinated Notes due 2011. (13)
4.7	Third Amendment dated as of December 29, 2004 to Credit Agreement.(13)
4.8	Fourth Amendment dated as of December 19, 2005 to Credit Agreement.(16)
10.1	The 1999 Equity Plan for Employees of Alliance and Subsidiaries including the forms of option agreements used thereunder, as amended.(5)

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10.2	The Alliance 1997 Stock Option Plan, including form of option agreement used thereunder, as amended.(5)
10.3	The Three Rivers Holding Corp. 1997 Stock Option Plan, as amended.(5)
10.4	Alliance Directors Deferred Compensation Plan, as amended.(6)
10.5	2003 Incentive Plan(9)
10.6	Employment Agreement dated as of July 23, 1997 between Alliance and Richard N. Zehner.(1)
10.7	Agreement Not to Compete dated as of July 23, 1999 between Alliance and Richard N. Zehner.(1)
10.8	Amendment to Employment Agreement dated as of July 23, 1997 between Alliance and Richard N. Zehner.(2)
10.9	Amendment to Employment Agreement dated as of December 31, 1997 between Alliance and Richard N. Zehner.(3)
10.10	Second Amendment to Employment Agreement dated as of February 5, 1998 between Alliance and Richard N. Zehner.(3)
10.11	Employment Agreement dated as of January 19, 1998 between Alliance and Kenneth S. Ord.(4)
10.12	Agreement Not to Compete dated as of January 19, 1998 between Alliance and Kenneth S. Ord.(4)
10.15	Employment Agreement dated as of April 29, 1998 between Alliance and Russell D. Phillips, Jr.(3)
10.16	Agreement Not to Compete dated as of April 29, 1998 between Alliance and Russell D. Phillips, Jr.(3)
10.17	Employment Agreement dated as of January 1, 2003 between Alliance and Paul S. Viviano.(9)
10.18	Agreement Not to Compete dated as of January 1, 2003 between Alliance and Paul S. Viviano.(9)
10.19	Stock Subscription Agreement dated as of January 2, 2003 between Alliance and Paul S. Viviano.(9)
10.20	Stock Subscription Agreement dated as of February 3, 2003 between Alliance and Paul S. Viviano.(9)
10.21	Form of Stockholder s Agreement.(5)
10.23	Registration Rights Agreement dated as of November 2, 1999.(5)
10.24	Management Agreement, dated as of November 2, 1999, between Alliance and Kohlberg Kravis Roberts & Co., LLP.(5)
10.25	Amendment No. 1 to Management Agreement, effective as of January 1, 2000, between Alliance and Kohlberg Kravis Roberts & Co., LLP.(5)
10.26	Form of Indemnification Agreement.(6)
10.27	Amendment to Employment Agreement, Non-Qualified Stock Option Agreement and Non-Compete Agreement, dated as of May 21, 2003, between Alliance and Richard N. Zehner.(10)

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10.29	Amendment to Employment Agreement and Stockholders Agreement, dated March 29, 2004 by and between Alliance, Viewer Holdings, LLC and Kenneth S. Ord.(12)
10.30	Amended and Restated Employment Agreement dated as of May 9, 2005 between Alliance and Paul S. Vivano.(15)
10.31	Agreement Not to Compete dated as of May 9, 2005 between Alliance and Paul S. Vivano.(15)
10.32	Employment Agreement dated as of May 9, 2005 between Alliance and Andrew P. Hayek.(15)
10.33	Agreement Not to Compete dated as of May 9, 2005 between Alliance and Andrew P. Hayek.(15)
10.34	Employment Agreement dated as of December 1, 2005 between Alliance and Howard K. Aihara.(17)
10.35	Agreement Not to Compete dated as of December 1, 2005 between Alliance and Howard K. Aihara.(17)
21.1	List of subsidiaries.(17)
23.1	Consent of Independent Registered Public Accounting Firm.(17)
23.2	Consent of Independent Registered Public Accounting Firm.(17)
31	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.(17)
32	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.(17)
99.1	Alliane-HNI L.L.C. and Subsidiaries Consolidated Balance Sheets as of December 31, 2005 and 2004 and the Consolidated Statements of Operations and Comprehensive Income, Changes in Members Capital, and Cash Flows for each of the Three Years in the Period Ended December 31, 2005 and Report of Independent Registered Public Accounting Firm.(17)

(1) Incorporated by reference to exhibits filed with the Company s Registration Statement on Form S-2, No. 333-33817.

(2) Incorporated by reference herein to the indicated Exhibit in response to Item 14(a)(3), Exhibits of the Company s Annual Report on Form 10-K for the year ended December 31, 1997 (File No. 000-16334).

(3) Incorporated by reference herein to the indicated Exhibit in response to Item 14(a)(3), Exhibits of the Company s Annual Report on Form 10-K for the year ended December 31, 1998 (File No. 000-16334).

(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 March 31, 1998 (File No. 000-16334).

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

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

(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 June 30, 2001 (File No. 001-16609).

(8) 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).

(9) 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).

(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 June 30, 2003 (File No. 001-16609).

(11) 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, 2003 (File No. 001-16609).

(12) 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, 2004 (File No. 001-16609).

(13) 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).

(14) 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, 2004 (File No. 001-16609).

(15) 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).

(16) 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).

(17) Filed herewith

SIGNATURES

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

	ALLIANCE IMAGING, INC.	
March 16, 2006	By:	/s/ PAUL S. VIVIANO Paul S. Viviano, *Chairman of the Board and Chief Executive Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 16, 2006.

Signature	Title
/s/ PAUL S. VIVIANO Paul S. Viviano	Chairman of the Board and Chief Executive Officer (Principal Executive Officer)
/s/ HOWARD K. AIHARA Howard K. Aihara	Executive Vice President and Chief Financial Officer (Principal Financial Officer)
/s/ NICHOLAS A. POAN Nicholas A. Poan	Vice President and Corporate Controller (Principal Accounting Officer)
/s/ NEIL F. DIMICK Neil F. Dimick	Director
/s/ ANTHONY B. HELFET Anthony B. Helfet	Director
/s/ KENNETH W. FREEMAN Kenneth W. Freeman	Director
/s/ MICHAEL W. MICHELSON Michael W. Michelson	Director
/s/ JAMES C. MOMTAZEE James C. Momtazee	Director
/s/ EDWARD L. SAMEK Edward L. Samek	Director
/s/ JAMES H. GREENE James H. Greene, Jr.	Director

ALLIANCE IMAGING, INC. AND SUBSIDIARIES
SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS
(Dollars in thousands)

	Balance at Beginning of Period	Additions Charged to Expense	Deductions (Bad Debt Write-offs, net of Recoveries)	Balance at End of Period
Year ended December 31, 2005				
Allowance for Doubtful Accounts	$ 7,376	$ 2,638	$ (4,156)	$ 5,858
Year ended December 31, 2004				
Allowance for Doubtful Accounts	$ 8,376	$ 809	$ (1,809)	$ 7,376
Year ended December 31, 2003				
Allowance for Doubtful Accounts	$ 9,187	$ 2,843	$ (3,654)	$ 8,376

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