

Edgar Filing: FONAR CORP - Form 10-Q

FONAR CORP  
 Form 10-Q  
 November 09, 2006

FORM 10-Q  
 SECURITIES AND EXCHANGE COMMISSION  
 Washington, D.C. 20549

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)  
 OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended SEPTEMBER 30, 2006  
 -----

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-10248  
 -----

FONAR CORPORATION

-----  
 (Exact name of registrant as specified in its charter)

DELAWARE

11-2464137

-----  
 (State or other jurisdiction of (I.R.S. Employer Identification No.)  
 incorporation or organization)

110 Marcus Drive Melville, New York 11747

-----  
 (Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (631) 694-2929  
 -----

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 is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). YES X NO  
 --- ---

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the close of the latest practicable date.

Class	Outstanding at October 31, 2006
-----	-----
Common Stock, par value \$.0001	121,339,327
Class B Common Stock, par value \$.0001	3,953
Class C Common Stock, par value \$.0001	9,562,824
Class A Preferred Stock, par value \$.0001	7,836,287

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FONAR CORPORATION AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED BALANCE SHEETS  
 (000's OMITTED)

ASSETS	September 30, 2006 (UNAUDITED)	June 30 2006
Current Assets:	-----	-----
Cash and cash equivalents	\$ 4,108	\$ 4,557
Marketable securities	4,625	4,938
Accounts receivable - net	3,709	3,359
Accounts receivable - related parties -net	452	499
Medical receivables	5,248	6,053
Management fee receivable - related medical practices - net	7,415	7,323
Costs and estimated earnings in excess of billings on uncompleted contracts	56	2,958
Inventories	6,239	7,077
Investment in sales-type lease	232	279
Current portion of advances and notes to related medical practices	98	90
Current portion of note receivable less discount for below market interest	549	459
Prepaid expenses and other current assets	1,987	1,280
Total Current Assets	----- 34,718	----- 38,872
Property and equipment - net	6,310	6,667
Advances and notes to related medical practices - net	663	676
Notes receivable less discount for below market interest	5,558	5,719
Other intangible assets - net	5,097	4,930
Other assets	1,630	366
Total Assets	----- \$ 53,976 =====	----- \$57,230 =====

See accompanying notes to condensed consolidated financial statements (unaudited).

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(000's OMITTED)

LIABILITIES AND STOCKHOLDERS' EQUITY	September 30, 2006 (UNAUDITED)	June 30, 2006
Current Liabilities:		
Current portion of long-term debt and capital leases	\$ 239	\$ 234
Accounts payable	3,919	4,886
Other current liabilities	6,192	6,102
Unearned revenue on service contracts	4,070	4,238
Unearned revenue on service contracts - related parties	472	544
Customer advances	6,796	5,464
Customer advance - related party	42	42
Income taxes payable	-	8
Billings in excess of costs and estimated earnings on uncompleted contracts	2,102	2,979
Billings in excess of costs and estimated earnings on uncompleted contracts-related party	-	137
Total Current Liabilities	23,832	24,634
Long-Term Liabilities:		
Due to related medical practices	93	93
Long-term debt and capital leases, less current portion	1,122	1,172
Other liabilities	201	215
Total Long-Term Liabilities	1,416	1,480
Total Liabilities	25,248	26,114
Minority interest	686	697

See accompanying notes to condensed consolidated financial statements (unaudited).

FONAR CORPORATION AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(000's OMITTED, except share data)

LIABILITIES AND STOCKHOLDERS' EQUITY (continued)	September 30, 2006 (UNAUDITED)	June 30, 2006
STOCKHOLDERS' EQUITY:		
Class A non-voting preferred stock \$.0001 par value; 8,000,000 authorized, 7,836,287 issued and outstanding at September 30, 2006 and June 30, 2006	1	1
Common Stock \$.0001 par value; 150,000,000 shares authorized at September 30, 2006 and June 30, 2006, 121,630,391 issued at September 30, 2006 and 114,995,094 at June 30, 2006; 121,339,327 outstanding at September 30, 2006 and 114,704,030 at June 30, 2006	12	11

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Class B Common Stock \$ .0001 par value; 4,000,000 shares authorized, (10 votes per share), 3,953 issued and outstanding at September 30, 2006 and June 30, 2006	-	-	
Class C Common Stock \$.0001 par value; 10,000,000 shares authorized, (25 votes per share), 9,562,824 issued and outstanding at September 30, 2006 and June 30, 2006		1	1
Paid-in capital in excess of par value	172,016		168,412
Accumulated other comprehensive loss	( 160)		( 246)
Accumulated deficit	(142,438)		(136,333)
Notes receivable from employee stockholders	( 715)		( 752)
Treasury stock, at cost - 291,064 shares of common stock at September 30, 2006 and June 30, 2006	( 675)		( 675)
	-----		-----
Total Stockholders' Equity	28,042		30,419
	-----		-----
Total Liabilities and Stockholders' Equity	\$ 53,976		\$57,230
	=====		=====

See accompanying notes to condensed consolidated financial statements (unaudited).

FONAR CORPORATION AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)  
 (000's OMITTED, except per share data)

	FOR THE THREE MONTHS ENDED SEPTEMBER 30,	
	2006	2005
REVENUES	-----	-----
Product sales - net	\$ 2,317	\$ 4,011
Product sales - related parties - net	139	179
Service and repair fees - net	2,281	1,684
Service and repair fees - related parties - net	242	241
Management and other fees - net	-	648
Management and other fees - related medical practices - net	2,804	3,390
	-----	-----
Total Revenues - Net	7,783	10,153
	-----	-----
COSTS AND EXPENSES		
Costs related to product sales	2,442	3,886
Costs related to product sales - related parties	144	163
Costs related to service and repair fees	1,243	1,122
Costs related to service and repair fees - related parties	132	285
Costs related to management and other fees	-	528
Costs related to management and other fees - related medical practices	2,004	2,286
Research and development	1,432	1,840
Selling, general and administrative, inclusive of compensatory element of stock issuances of \$ 98 and \$ 524 for the three months ended September 30, 2006 and 2005, respectively	6,427	6,416
Provision for bad debts	50	25
Amortization of management agreements	-	37
Termination costs paid with common stock	-	1,600
	-----	-----
Total Costs and Expenses	13,874	18,188

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Loss From Operations	( 6,091)	( 8,035)
Interest Expense	( 71)	( 74)
Investment Income	199	173
Interest Income - Related Parties	11	4
Other Income (Expense)	39	( 104)
Minority Interest in Income of Partnerships	( 192)	( 281)
Loss Before Provision for Income Taxes	( 6,105)	( 8,317)
Provision for Income Taxes	-	-
NET LOSS	\$ ( 6,105)	\$ ( 8,317)
Net Loss Available to Common Stockholders	\$ ( 6,105)	\$ ( 8,317)
Basic Loss Per Common Share	\$ (.05)	\$ (.08)
Diluted Loss Per Common Share	\$ (.05)	\$ (.08)
Basic and Diluted Earnings Per Share-Common C	N/A	N/A

See accompanying notes to condensed consolidated financial statements (unaudited).

FONAR CORPORATION AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS  
 (UNAUDITED)  
 (000'S OMITTED)

	FOR THE THREE MONTHS ENDED SEPTEMBER 30,	
	2006	2005
Net loss	\$ (6,105)	\$ (8,317)
Other comprehensive income (loss) net of tax:		
Unrealized gains (losses) on securities, net of tax	86	( 20)
Total comprehensive loss	\$ (6,019)	\$ (8,337)

	FOR THE THREE MONTHS ENDED SEPTEMBER 30,	
	2006	2005
Cash Flows from Operating Activities		
Net loss	\$ ( 6,105)	\$ ( 8,317)
Adjustments to reconcile net loss to net cash used in operating activities:		
Minority interest in income of partnerships	192	281
Depreciation and amortization	656	844
Gain on sale of equipment	-	( 3)
Provision for bad debts	50	25
Compensatory element of stock issuances	98	524
Stock issued for costs and expenses	1,851	1,391
Termination costs paid with common stock	-	1,600
Amortization of unearned compensation	-	73
Loss from sale of physical medicine management business	-	144

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(Increase) decrease in operating assets, net:		
Accounts, management fee and medical receivable(s)	359	( 341)
Notes receivable	71	( 33)
Costs and estimated earnings in excess of billings on uncompleted contracts	2,902	1,258
Inventories	839	1,130
Principal payments received on sales type lease	47	41
Prepaid expenses and other current assets	( 707)	486
Other assets	( 30)	( 19)
Advances and notes to related medical practices	5	61
Increase (decrease) in operating liabilities, net:		
Accounts payable	( 967)	( 1,760)
Other current liabilities	( 149)	( 378)
Customer advances	1,332	( 177)
Billings in excess of costs and estimated earnings on uncompleted contracts	( 1,015)	241
Other liabilities	( 14)	( 11)
Due to related medical practices	-	8
Income taxes payable	( 8)	( 11)
	-----	-----
Net cash used in operating activities	( 593)	( 2,943)
	-----	-----

See accompanying notes to condensed consolidated financial statements (unaudited).

FONAR CORPORATION AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)  
(000'S OMITTED)

	FOR THE THREE MONTHS ENDED SEPTEMBER 30,	
	2006	2005
	-----	-----
Cash Flows from Investing Activities:		
Sales of marketable securities	398	2,388
Purchases of property and equipment	( 117)	( 426)
Costs of capitalized software development	( 184)	( 169)
Cost of patents and copyrights	( 165)	( 61)
Proceeds from sale of equipment	-	97
	-----	-----
Net cash (used in) provided by investing activities	( 68)	1,829
	-----	-----
Cash Flows from Financing Activities:		
Distributions to holders of minority interest	( 203)	( 180)
Repayment of borrowings and capital lease obligations	( 45)	( 91)
Net proceeds from exercise of stock options and warrants	50	400
Net proceeds from sale of stock	373	-
Repayment of notes receivable from employee stockholders	37	2
	-----	-----
Net cash provided by financing activities	212	131
	-----	-----
Net Decrease in Cash and Cash Equivalents	( 449)	( 983)
Cash and Cash Equivalents - Beginning of Period	4,557	5,517

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Cash and Cash Equivalents - End of Period	----- \$ 4,108 =====	----- \$ 4,534 =====
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See accompanying notes to condensed consolidated financial statements (unaudited).

FONAR CORPORATION AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2006  
(UNAUDITED)

### NOTE 1 - BASIS OF PRESENTATION & LIQUIDITY & CAPITAL RESOURCES

#### Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2007. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K filed on September 20, 2006 for the fiscal year ended June 30, 2006.

#### Liquidity and Capital Resources

The Company's principal source of liquidity has been cash flows provided by operations. The Company's management currently expects this to continue. At September 30, 2006, the Company had working capital of \$10.9 million. For the three months ended September 30, 2006, the Company incurred a net loss of \$6.1 million which included non-cash charges of \$2.7 million.

In order to conserve our capital resources the Company has and will continue to issue, from time to time, common stock and stock options to compensate employees and non-employees for goods and services. The Company is focusing on increased advertising and marketing campaigns and distribution programs to increase the demand for Fonar's products. Management anticipates that Fonar's capital resources will improve as Fonar's MRI scanner products gain wider market recognition and acceptance resulting in increased product sales. If the Company is not successful with its current marketing efforts to increase sales, then the Company could experience a shortfall in cash necessary to sustain operations at their current levels.

Given our September 30, 2006 cash and marketable securities balance of \$8.7 million and the Company's forecasted cash requirements, we anticipate that our existing capital resources, funds generated from operations and funds expected to be received from note repayments, will be sufficient to satisfy our cash flow requirements through at least September 30, 2007. Based on current results of operations, the Company believes it will either need to increase sales, reduce expenses or seek other sources of funds through the issuance of equity or debt financing in order to maintain sufficient funds available to operate subsequent to September 30, 2007.



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FONAR CORPORATION AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2006  
(UNAUDITED)

## NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Principles of Consolidation

The consolidated financial statements include the accounts of FONAR Corporation, its majority and wholly-owned subsidiaries and partnerships (collectively the "Company"). All significant intercompany accounts and transactions have been eliminated in consolidation.

### Earnings (Loss) Per Share

Basic earnings (loss) per share ("EPS") is computed based on weighted average shares outstanding and excludes any potential dilution. In accordance with EITF 03-6, "Participating Securities and the Two-Class method under FASB Statement No. 128" ("EITF 03-6"), the Company's participating convertible securities, which include Class B common stock and Class C common stock, are not included in the computation of basic EPS for three months ended September 30, 2006 and 2005, because the participating securities do not have a contractual obligation to share in the losses of the Company.

Diluted EPS reflects the potential dilution from the exercise or conversion of all dilutive securities into common stock based on the average market price of common shares outstanding during the period. The number of common shares potentially issuable upon the exercise of certain options and warrants or conversion of the participating

### Earnings (Loss) Per Share (Continued)

convertible securities that were excluded from the diluted EPS calculation was approximately 7,014,000 and 7,028,000 because they are antidilutive as a result of a net loss for the three months ended September 30, 2006 and 2005, respectively.

### Stock Options and Warrants and Similar Equity Instruments

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" SFAS 123R. SFAS 123R requires the compensation cost relating to stock-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued on the grant date of such instruments, and will be recognized over the period during which an individual is required to provide service in exchange for the award (typically the vesting period). SFAS 123R covers a wide range of stock-based compensation arrangements including stock options, restricted stock plans, performance-based awards, stock appreciation rights, and employee stock purchase plans. SFAS 123R replaces SFAS 123 and supersedes APB Opinion 25.

On July 1, 2005, the Company adopted SFAS 123R using the modified prospective method, in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123R for all share-based payments granted after the effective date and (b) based on the fair value as measured under SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123R that remain unvested on the effective date.

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FONAR CORPORATION AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2006  
(UNAUDITED)

### NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### Stock Options and Warrants and Similar Equity Instruments (Continued)

Accordingly, the adoption of SFAS 123R's fair value method did not have a significant impact on our result of operations. SFAS 123R requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. It is unlikely that the Company will have near term benefits from tax deductions. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. The Company cannot estimate what those amounts will be in the future because of various factors, including but not limited to the timing of employee exercises and whether the Company will be in a taxable position. At this time, there would be no tax impact related to the prior periods since the Company has a net loss.

#### Recent Accounting Pronouncements

In February 2006, the FASB issued SFAS NO. 155, Accounting for Certain Hybrid Financial Instruments-An Amendment of FASB No. 133 and 140. The purpose of SFAS statement No. 155 is to simplify the accounting for certain hybrid financial instruments by permitting fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. SFAS No. 155 also eliminates the restriction on passive derivative instruments that a qualifying special-purpose entity may hold. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of any entity's first fiscal year beginning after September 15, 2006. We believe that the adoption of this standard on July 1, 2007 will not have a material effect on our consolidated financial statements.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets, an Amendment of SFAS No. 140. SFAS No. 156 requires separate recognition of a servicing asset and a servicing liability each time an entity undertakes and obligation to service a financial asset by entering into a servicing contract. This statement also requires that servicing assets and liabilities be initially recorded at fair value and subsequently adjusted to the fair value at the end of each reporting period. This statement is effective in fiscal years beginning after September 15, 2006. We believe that the adoption of this standard on July 1, 2007 will not have a material effect on our consolidated financial statements.

In June, 2006, the FASB issued Interpretation No. 48, "Accounting of Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109". This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This Interpretation is effective for fiscal years beginning after December 31, 2006.

The Company is assessing the impact of this Interpretation on its consolidated financial statements, but does not expect it to have a material effect.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2006  
(UNAUDITED)

### NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### Recent Accounting Pronouncements (Continued)

In September, 2006, the FASB issued SFAS No. 157, "Fair Value Measurements", which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This standard applies under other accounting pronouncements that require or permit fair value measurements, but does not require any new fair value measurements. SFAS No. 157 will become effective for us in 2009. We are currently assessing the impact of SFAS No. 157; however, we do not believe the adoption of this standard will have a material effect on our consolidated financial statements.

In September, 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans", which requires us to recognize the funded status of our defined benefit plans in the consolidated balance sheets and changes in the funded status in comprehensive income. This standard also requires us to recognize the gains/losses, prior year service costs and transition assets/obligations as a component of other comprehensive income upon adoption, and provide additional annual disclosure. SFAS No. 158 does not affect the computation of benefit expense recognized in our consolidated statements of operations. The recognition and disclosure provisions are effective in 2007. In addition, SFAS No. 158 requires us to measure plan assets and benefit obligations as of the year-end balance sheet date effective in 2009. We are required to apply the provisions of this standard prospectively. We are currently assessing the impact of SFAS No. 158 on our consolidated financial statements.

In September, 2006, the SEC staff issued Staff Accounting Bulletin ("SAB") No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements". This guidance indicates that the materiality of a misstatement must be evaluated using both the rollover and iron curtain approaches. The iron curtain approach quantifies a misstatement based on the amount of the error originating in the current year income statement. SAB No. 108 is effective for our 2007 annual consolidated financial statements. We are currently assessing the impact of SAB No. 108; however, we do not believe the adoption of this standard will have a material effect on our consolidated financial statements.

#### Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation. The reclassifications did not have any effect on reported net losses for any periods presented.

FONAR CORPORATION AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2006  
(UNAUDITED)

### NOTE 3 - MEDICAL RECEIVABLES, ACCOUNTS RECEIVABLE AND MANAGEMENT FEE RECEIVABLE

#### Medical Receivables

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The Company was assigned medical receivables valued at \$11,775,000, in connection with the satisfaction of the management fees and termination fees related to a Termination and Replacement Agreement dated May 23, 2005. The balance of the medical receivables as of September 30, 2006 was \$5,248,000.

Accounts Receivable and Management Fee Receivable

Receivables, net is comprised of the following at September 30, 2006: ]

	(000's Omitted)	
	Gross Receivable -----	Allowance for doubtful accounts -----  Net -----
Receivables from equipment sales and service contracts	\$ 4,353 =====	\$ 644 =====
Receivables from equipment sales and service contracts-related parties	\$ 1,098 =====	\$ 646 =====
Management fee receivables from related medical practices ("PC's")	\$10,518 =====	\$ 3,103 =====

The Company's customers are concentrated in the healthcare industry.

The Company's receivables from the related PC's consist substantially of fees outstanding under management agreements, service contracts and lease agreements. Payment of the outstanding fees is based on collection by the PC's of fees from third party medical reimbursement organizations, principally insurance companies and health management organizations.

Collection by the Company of its accounts receivable may be impaired by the uncollectibility of the PC's medical fees from third party payors, particularly insurance carriers covering automobile no-fault and workers compensation claims due to longer payment cycles and rigorous informational requirements and certain other disallowed claims. Approximately 42% and 47% of the PC's net revenues for both the three months ended September 30, 2006 and 2005, respectively, were derived from no-fault and personal injury protection claims. The Company considers the aging of its accounts receivable in determining the amount of allowance for doubtful accounts and contractual allowances. The Company generally takes all legally available steps to collect its receivables. Credit losses associated with the receivables are provided for in the condensed consolidated financial statements and have historically been within management's expectations.

FONAR CORPORATION AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2006  
(UNAUDITED)

NOTE 3 - MEDICAL RECEIVABLES, ACCOUNTS RECEIVABLE AND MANAGEMENT FEE RECEIVABLE  
(Continued)

Accounts Receivable and Management Fee Receivable (Continued)

Certain no-fault insurers have raised issues concerning whether the Company's

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clients the "P.C.'s" are in compliance with certain laws, including, but not limited to, laws governing their corporate structure and/or licensing, their entitlement or standing to seek and/or obtain no-fault benefits, and/or laws prohibiting the corporate practice of medicine, fee-splitting and/or physician self referrals. To the extent any claims are asserted against the P.C.'s, the settlement of such claims could result in the P.C.'s waiving their rights to collect certain of their insurance claims. Management believes that the company and the P.C.'s are not in violation of any of the above mentioned laws. Since the resolution or settlement of these claims with the insurance companies could have a material impact on the collection of management fees by the Company from its P.C.'s, the Company has provided reserves for uncollectable fees related to this matter.

On February 8, 2006, the Deficit Reduction Act of 2005 ("DRA") was signed into law by President George W. Bush. The DRA would result in caps on Medicare and Medicaid payment rates for most imaging services, including MRI and CT, furnished in physicians' offices and other non-hospital based settings. Under the cap, payments for these imaging services could not exceed the hospital outpatient payment rates for those services. This change is to apply to services furnished by the P.C.'s on or after January 1, 2007. Although the professional corporations managed by HCMA bill for scans on a "global" basis, which means a single fee per scan, the limitation is applicable only to the technical component of the services, which is the payment or portion of the payment attributable to the non-professional services. If the fee for the technical component of the service (without including geographic adjustments) exceeds the hospital outpatient payment amount for the service (also without including geographic adjustments), under the Physician Fee Schedule, then the payment would be limited to the Physician Fee Schedule rate. The implementation of this reimbursement reduction contained in the DRA may have an indirect but significant effect on HMCA's results of operations and, ultimately, its financial condition, but they are presently pending before both houses of Congress bills known as the "Access to Medicare Imaging Act of 2006" which would delay reductions for two years. If the DRA reductions are implemented, however, then we believe that the Upright MRI(TM) is uniquely designed to facilitate increased volumes to compensate for the reductions. The Upright MRI(TM) with multiple positions is dynamic MRI as compared with the static conventional recumbent-only single position MRI.

Net revenues from management and other fees charged to the related P.C.'s accounted for approximately 36.0% and 33.4% of the consolidated net revenues for the three months ended September 30, 2006 and 2005, respectively. Product sales and service repair fees from related parties amounted to approximately 4.9% and 4.1% of consolidated net revenues for the three months ended September 30, 2006 and 2005, respectively.

FONAR CORPORATION AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2006  
(UNAUDITED)

NOTE 3 - MEDICAL RECEIVABLES, ACCOUNTS RECEIVABLE AND MANAGEMENT FEE RECEIVABLE  
(Continued)

Unaudited Financial Information of Unconsolidated Managed Medical Practices

Summarized income statement data related to the unconsolidated medical practices managed by the Company is as follows:

(000's omitted) (Income Tax-Cash Basis)

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For the three months ended September 30,

	2006 -----	2005 -----
Patient Revenue - Net	\$ 4,762 =====	\$ 4,326 =====
Income from Operations	\$ 183 =====	\$ 2 =====
Net Loss	\$ (59) =====	\$ (211) =====

## NOTE 4 - INVENTORIES

Inventories included in the accompanying condensed consolidated balance sheet at September 30, 2006 consist of:

(000's omitted)	
Purchased parts, components and supplies	\$ 4,175
Work-in-process	2,064 -----
	\$ 6,239 =====

## NOTE 5 - COSTS AND ESTIMATED EARNINGS ON UNCOMPLETED CONTRACTS AND CUSTOMER ADVANCES

1) Information relating to uncompleted contracts as of September 30, 2006 is as follows:

(000's omitted)	
Costs incurred on uncompleted Contracts	\$ 7,075
Estimated earnings	4,319 -----
	11,394
Less: Billings to date	13,440 -----
	\$ (2,046) =====

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## NOTE 5 - COSTS AND ESTIMATED EARNINGS ON UNCOMPLETED CONTRACTS AND CUSTOMER ADVANCES (Continued)

Included in the accompanying condensed consolidated balance sheet at September 30, 2006 under the following captions:

Costs and estimated earnings in excess of	
billings on uncompleted contracts	\$ 56
Less: billings in excess of costs and estimated earnings on uncompleted contracts	2,102 -----
	\$ (2,046)

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=====

2) Customer advances consist of the following as of September 30, 2006:

	Total	Related Party	Other
	-----	-----	-----
Total Advances	\$ 20,278	\$ 42	\$ 20,236
Less: Advances			
on contracts under construction	13,440	--	13,440
	-----	-----	-----
	\$ 6,838	\$ 42	\$ 6,796
	=====	=====	=====

NOTE 6 -STOCKHOLDERS' EQUITY

Common Stock

During the three months ended September 30, 2006:

- a) The Company issued 50,749 shares of common stock to employees as compensation valued at \$19,199 under stock bonus plans.
- b) The Company issued 175,000 shares of common stock to consultants and others valued at \$78,200.
- c) The Company issued 5,227,548 shares of common stock for costs and expenses of \$1,850,969.
- d) The Company issued 92,000 shares of common stock upon the exercise of stock options resulting in proceeds of \$49,680.
- e) The Company issued 1,090,000 shares of common stock resulting in proceeds of \$372,760.

The Company pays premiums for life insurance on its Chief Executive Officer. The insurance policies were owned by a life insurance trust. The cash surrender value of the life insurance policies, in the approximate amount of \$1.2 million, was contributed to capital during the first quarter of 2007 pursuant to a split dollar agreement.

FONAR CORPORATION AND SUBSIDIARIES  
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NOTE 7 - OTHER CURRENT LIABILITIES

Other current liabilities in the accompanying condensed consolidated balance sheet consist of the following:

(000's omitted)

	September 30, 2006	June 30, 2006
	-----	-----
Royalties	\$ 661	\$ 716
Accrued salaries, commissions and payroll taxes	1,415	1,146
Accrued interest	535	535

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Litigation judgements	193	193
Sales tax payable	2,243	2,181
Other	1,145	1,331
	-----	-----
	\$ 6,192	\$ 6,102
	=====	=====

### NOTE 8 -SALE OF PHYSICAL MEDICINE MANAGEMENT BUSINESS

On July 28, 2005 Fonar, HMCA and Dynamic entered into an Asset Purchase Agreement with Health Plus Management Services, L.L.C. ("Health Plus"), pursuant to which HMCA and its subsidiary Dynamic sold to Health Plus the portion of their business which was engaged in the business of managing physical therapy and rehabilitation facilities, together with the assets used in the conduct of such business.

The assets sold consisted principally of the management agreements with the physical therapy and rehabilitation facility management business, the physical therapy equipment, a portion of the accounts receivable and furniture and fixtures the Company provided to the physical therapy and rehabilitation facilities.

The purchase price under the Asset Purchase Agreement was \$6.6 million, payable pursuant to a promissory note (the "note") in 120 monthly installments commencing on August 28, 2005. The first twelve installments are interest only and the remaining 108 payments will consist of equal installments of principal and interest in the amount of \$76,014 each. The note is secured by a first lien on all of the assets of Health Plus, including its accounts receivable. The Note is subject to prepayment provisions to the extent Health Plus resells all or part of the assets and business or utilizes the assets sold as collateral in any debt financing. The note provides for interest at 5% per annum. The fair value assigned to the note was \$6,078,068 reflecting a discount of \$521,932 for the below market interest rate. The Company recorded a loss of \$143,598 on this transaction during the year ended June 30, 2006.

FONAR CORPORATION AND SUBSIDIARIES  
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### NOTE 8 -SALE OF PHYSICAL MEDICINE MANAGEMENT BUSINESS (Continued)

The two principals of Health Plus were employed by HMCA and Dynamic up to the time of the closing of the business. In consideration for the termination of their employment agreement, these two individuals each became entitled to receive \$800,000. In addition, each became entitled to receive \$200,000 for collection services to be provided on behalf of HMCA and Dynamic with respect to a portion of the accounts receivable of certain physical therapy and rehabilitation facilities which arose during the period when HMCA was engaged in the management of those facilities. The \$1,000,000 payable to each of these individuals was satisfied in shares of Fonar common stock. During the year ended June 30, 2006 the Company issued 1,871,490 shares totaling \$1,995,675. The remaining balance under this obligation at September 30, 2006 is \$4,325 which was included in other current liabilities. The Company capitalized \$400,000 with respect to collection services. During the year ended June 30, 2006, \$400,000 was charged to compensatory element of stock.

For accounting purposes in accordance with accounting principles generally



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accepted in the United States of America, the Company determined that the classification of the disposed business described above as discontinued operations would not be appropriate. Accordingly, the operating results of the disposed business have been included in continuing operations in the accompanying consolidated financial statements.

### NOTE 9 - SALE OF SUBSIDIARY

On January 31, 2006, the Company sold 100% of the stock of Tallahassee Magnetic Resonance Imaging, P.A. to Raymond V. Damadian for a diminimus amount since the liabilities exceed the assets. No gain or loss was recognized on this sale. Revenue recognized from this entity totaled \$265,017 for the three months ended September 30, 2005.

### NOTE 10 - SEGMENT AND RELATED INFORMATION

The Company operates in two industry segments - manufacturing and the servicing of medical equipment and management of physician practices, including diagnostic imaging services.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies as disclosed in the Company's 10-K as of June 30, 2006. All inter-segment sales are market-based. The Company evaluates performance based on income or loss from operations.

FONAR CORPORATION AND SUBSIDIARIES  
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### NOTE 10 - SEGMENT AND RELATED INFORMATION (Continued)

Summarized financial information concerning the Company's reportable segments is shown in the following table:

(000's omitted)

	Medical Equipment	Physician Management and Diagnostic Imaging Services	Totals
	-----	-----	-----
For the three months ended Sept. 30, 2006:			
Net revenues from external customers	\$ 4,979	\$ 2,804	\$ 7,783
Inter-segment net revenues	\$ 183	\$ -	\$ 183
Loss from operations	\$ (5,577)	\$ (514)	\$ (6,091)
Depreciation and amortization	\$ 383	\$ 273	\$ 656
Compensatory element of stock issuances	\$ 93	\$ 5	\$ 98
Capital expenditures	\$ 434	\$ 32	\$ 466
Identifiable assets	\$ 28,917	\$ 25,059	\$ 53,976

For the three months ended Sept. 30, 2005:

Net revenues from external customers	\$ 6,115	\$ 4,038	\$ 10,153
Inter-segment net revenues	\$ 136	\$ -	\$ 136
Loss from operations	\$ (5,801)	\$ (2,234)	\$ (8,035)

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Depreciation and amortization	\$	494	\$	350	\$	844
Compensatory element of stock issuances	\$	211	\$	313	\$	524
Termination Costs paid with Common Stock	\$	-	\$	1,600	\$	1,600
Capital expenditures	\$	241	\$	415	\$	656
Identifiable Assets - June 30, 2006	\$	31,264	\$	25,965	\$	57,229

### NOTE 11 - SUPPLEMENTAL CASH FLOW INFORMATION

During the three months ended September 30, 2006 and September 30, 2005, the Company paid \$71,000 and \$74,000 for interest, respectively.

Non-Cash Transaction.

During the three months ended September 30, 2006:

- a) The Company recorded the cash surrender value of the split dollar life insurance policies of \$1,234,000 to additional paid in capital.

FONAR CORPORATION AND SUBSIDIARIES  
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### NOTE 12 - POTENTIAL DELISTING OF THE COMPANY'S COMMON STOCK

The Company received written notification from The Nasdaq Stock Market on December 22, 2005 that the bid price of its common stock for the last 30 consecutive trading days had closed below the minimum \$1.00 per share required for continued listing under Nasdaq Marketplace Rule 4310(c)(4) (the "Rule"). Pursuant to Nasdaq Marketplace Rule 4310(c)(8)(D), the Company has been provided an initial period of 180 calendar days, or until June 20, 2006, to regain compliance. The notice states that the Company has achieved compliance with the Rule if at any time before June 20, 2006 the bid price of the Company's common stock closes at \$1.00 per share or more for a minimum of 10 consecutive business days. The Company has been granted an extension to achieve compliance until December 18, 2006.

If the Company cannot demonstrate compliance with the bid price rule by December 18, 2006, than the Staff will provide written notice that the Company's securities will be delisted. At that time, the Company may appeal the Staff's determination to delist its securities to a Listing Qualification Panel.

### FONAR CORPORATION AND SUBSIDIARIES

#### Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

For the three month period ended September 30, 2006, we reported a net loss of \$6.1 million on revenues of \$7.8 million as compared to net loss of \$8.3 million on revenues of \$10.2 million for the first three months of fiscal 2006.

Sales of our Upright MRI(TM) scanners were negatively affected primarily by marketing and advertising pressure from our competitors attempting to minimize the unique medical benefits of Upright MRI(TM). These companies may not make Upright MRI(TM) scanners because of Fonar's patents. Our losses were also due to a brief interruption in Fonar's advertising campaigns, and prospective customers

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continue to have concerns relating to increased difficulty in obtaining insurance reimbursements. We have resumed and are continuing our national advertising campaign to bring the benefits of weight-bearing MRI, and its necessity in the proper evaluation of back pain, to the attention of the consumer and ultimately, referring physicians, hospitals, insurers and other third party payors. The national advertising campaign has had a positive effect on Fonar's overall sales activity and should result in increasing numbers of sales of Fonar Upright MRI's.

In addition, sales of our scanners may have been adversely affected by the Deficit Reduction Act of 2005 (DRA) which would result in caps on Medicare and Medicaid payment rates for most imaging services, including MRI, furnished in physicians' offices and other non-hospital based settings. Under the cap, payments for the "technical" (non-professional services) component of these scans could not exceed the hospital outpatient amount under a Physician Fee Schedule. We believe, however, the Upright MRI(TM) scanners should not be adversely affected but benefit from increased volumes because the Upright MRI(TM) with multiple positions is dynamic MRI as compared with the static conventional recumbent-only single position MRI. The principal reason for the decline in revenues of our wholly owned subsidiary, Health Management Corporation of America, was the sale of its physical therapy and rehabilitation management business in July, 2005. We also refer to Health Management Corporation of America as "HMCA".

In addition, we are planning to expand our sales force, both in terms of hiring more sales personnel and establishing a network of domestic distributors (we already use distributors for foreign sales) under the direction of our internal sales force.

We also are monitoring the performance of our existing users and plan to establish teams to assist underperforming customers improve their scan volume. In addition, we have held seminars to assist customers in their marketing efforts.

Notwithstanding the disappointing MRI scanner sales revenues, the number of units sold increased from one during the first quarter of fiscal 2006 to three units during the first quarter of fiscal 2007.

Importantly, we believe that our efforts to penetrate the hospital market are beginning to show greater results. For the 2006 fiscal year, two Fonar Upright MRI(TM) scanners were sold to hospitals, one of which is a member of a chain of hospitals. In the first quarter of fiscal 2007, we sold one Fonar Upright(TM) MRI scanner to a hospital. The Fonar Upright MRI(TM) scanner is the only scanner which enables weight-bearing scans of the spine, which is critical in making a correct diagnosis of spine diseases such as low back pain and therefore the key to performing the correct surgery of the spine. There are approximately 916,000 surgical procedures performed on the spine each year as compared to approximately 950,000 cardiac surgeries annually in the United States (including, stents, bypasses, angioplasties, valve replacements, heart transplants and the like).

### Forward Looking Statements

Certain statements made in this Quarterly Report on Form 10-Q are "forward-looking statements" (within the meaning of the Private Securities Litigation Reform Act of 1995) regarding the plans and objectives of Management for future operations. Such statements involve known and unknown risks, uncertainties and other factors that may cause actual results, performance or achievements of the Company to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. The forward-looking statements included herein are based on current expectations that involve numerous risks and uncertainties. The Company's plans

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and objectives are based, in part, on assumptions involving the expansion of business. Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, competitive and market conditions and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond the control of the Company. Although the Company believes that its assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Report will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statement included herein, the inclusion of such information should not be regarded as a representation by the Company or any other person that the objectives and plans of the Company will be achieved.

### Results of Operations

The Company operates in two industry segments: the manufacture and servicing of medical (MRI) equipment, the Company's traditional business which is conducted directly by Fonar, and diagnostic facilities management services, which is conducted through Fonar's wholly-owned subsidiary, HMCA. During July 2005 HMCA sold the portion of its business engaged in the management of physical therapy and rehabilitation facilities.

Trends in the first quarter of fiscal 2007 include a decrease in product sales revenues. Sales orders for Upright(TM) MRI scanners, however, increased from one in the first fiscal quarter of fiscal 2006 to three in the first fiscal quarter of 2007. The Company will continue to focus on increased advertising and marketing efforts, including adding additional sales personnel and distributors, to improve sales performance in fiscal 2007.

For the three month period ended September 30, 2006, as compared to the three month period ended September 30, 2005, overall revenues from MRI product sales decreased 41.4% (\$2.5 million compared to \$4.2 million). Unrelated party scanner sales (\$2.3 million compared to \$4.0 million) decreased at a rate of 42.2% and related party scanner sales (\$139,000 compared to \$179,000) decreased 22.3%. Service revenues, however, increased by 31% (\$2.5 million compared to \$1.9 million) because of customers entering into service agreements with Fonar for their scanners following the expiration of the warranty period on their equipment. Overall, for the first quarter of fiscal 2007, revenues for the medical equipment segment decreased by 18.6% to \$5.0 million from \$6.1 million for the first quarter of fiscal 2006. The revenues generated by HMCA also decreased, by 30.6% to \$2.8 million for the first quarter of fiscal 2007 as compared to \$4.0 million for the first quarter of fiscal 2006. The decrease in revenues recognized by HMCA resulted primarily from the sale of HMCA's business of managing physical therapy and rehabilitation centers during July 2005.

There were approximately \$259,000 in foreign revenues for the first three months of fiscal 2007 as compared to approximately \$553,000 in foreign revenues for the first three months of fiscal 2006, representing a decrease in foreign revenues of 53.2%.

We recognize MRI scanner sales revenues on the "percentage of completion" basis, which means the revenues are recognized as the scanner is manufactured. Revenues recognized in a particular quarter do not necessarily reflect new orders or progress payments made by customers in that quarter. We build the scanner as the customer meets certain benchmarks in its site preparation in order to minimize the time lag between incurring costs of manufacturing and our receipt of the cash progress payments from the customer which are due upon delivery. Consequently, there can be a disparity between the revenues recognized in a fiscal period and the number of product sales. Generally, the recognized revenue results from revenues from a scanner sale being recognized in a fiscal quarter or quarters following the quarter in which the sale was made. Illustrating this point, the revenue from product sales for the first three

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months of fiscal 2007 decreased 41.4% from the first three months of fiscal 2006 (\$2.5 million compared to \$4.2 million). We received, however, orders for three Upright(TM) MRI scanners during the first three months of fiscal 2007 as compared to an order for one Upright(TM) MRI scanner during the first three months of fiscal 2006, reflecting an increase of 200% in scanner orders.

We believe the decrease in product sales revenues reflect the large variation in sales revenue that is typical of the sale of high unit cost capital equipment, which variation is characteristic of Fonar's 28 year experience selling MRI scanning systems.

Service and repair revenues increased by 31.0%, from \$1.9 million for the first quarter of fiscal 2006 to \$2.5 million for the first quarter of fiscal 2007.

The increases in service and repair revenues are occurring because after the warranty on the MRI scanner expires, the owner will ordinarily enter into a service contract with us to assure continued coverage. We anticipate that for this reason there will continue to be increases in service revenues as warranties on installed scanners expire over time.

Costs related to product sales decreased by 36.1% from \$4.0 million in the first quarter of fiscal 2006 to \$2.6 million in the first quarter of 2007, reflecting the corresponding decrease in product sales revenues. Costs related to providing service remained constant at \$1.4 million in the first quarter of fiscal 2006 and in the first quarter of 2007, notwithstanding the increase in service revenues.

In brief, costs are incurred concurrently with revenues in accordance with the percentage of completion method.

Service and repair revenues increased at a materially higher rate than the costs related to providing service and repairs. Service contract prices are fixed for the term of the contract, which are usually for a term of one year. We believe that an important factor in keeping service costs down is our ability to monitor the performance of customers' scanners from our facilities in Melville on a daily basis and to detect and repair any irregularities before more serious problems result. We also believe the low cost of providing service reflects the high quality of our products.

Overall, our operating loss for our medical equipment segment was \$5.5 million for the first three months of fiscal 2007 as compared to operating loss of \$5.8 million for the first three months of fiscal 2006.

HMCA revenues decreased in the first quarter of fiscal 2007, by 30.6% to \$2.8 million from \$4.0 million for the first quarter of fiscal 2006. HMCA is seeking to increase revenues from the MRI facilities by continuing its program of replacing older scanners at the sites we manage with Upright(TM) MRI scanners. We now manage ten sites, as compared to eight sites at September 30, 2005, equipped with Upright(TM) MRI scanners. HMCA experienced an operating loss of \$513,000 for the first three months of fiscal 2007 compared to operating loss of \$2.2 million for the first three months of fiscal 2006. The greater loss in the first quarter of fiscal 2006 was principally the result of a payment of \$1.6 million for the termination of two employment agreements in connection with the sale by HMCA of its physical therapy and rehabilitation facility management business and the loss of revenues resulting from the sale of that business during the first quarter of fiscal 2006.

HMCA cost of revenues for the first quarter of fiscal 2007 decreased to \$2.0 million as compared to \$2.8 million for the first quarter of fiscal 2006, which is also principally the result of HMCA's sale of its physical therapy and rehabilitation facility management business during fiscal 2006.

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On February 8, 2006, the Deficit Reduction Act of 2005 ("DRA") was signed into law by President George W. Bush. The DRA would result in caps on Medicare and Medicaid payment rates for most imaging services, including MRI and CT, furnished in physicians' offices and other non-hospital based settings. Under the cap, payments for these imaging services could not exceed the hospital outpatient payment rates for those services. This change would apply to services furnished by the professional corporations managed by HMCA on or after January 1, 2007. Although the professional corporations managed by HCMA bill for scans on a "global" basis, which means a single fee per scan, the limitation is applicable only to the technical component of the services, which is the payment or portion of the payment attributable to the non-professional services. If the fee for the technical component of the service (without including geographic adjustments) exceeds the hospital outpatient payment amount for the service (also without including geographic adjustments), under the Physician Fee Schedule, then the payment would be limited to the Physician Fee Schedule rate. The implementation of this reimbursement reduction contained in the DRA may have an indirect but significant effect on HMCA's results of operations and, ultimately, its financial condition, but there are presently pending before both houses of Congress bills known as the "Access to Medicare Imaging Act of 2006" which would delay reductions for two years. If the DRA reductions are implemented, however, then we believe that the Upright MRI(TM) is uniquely designed to facilitate increased volumes to compensate for the reductions. The Upright MRI(TM) with multiple positions is dynamic MRI as compared with the static conventional recumbent-only single position MRI.

### Sale of Physical Therapy and Rehabilitation Facility Management Business

Notwithstanding our continuing efforts to increase revenues from the management of MRI scanning facilities, HMCA's revenues declined because of the sale of its business of managing physical therapy and rehabilitation practices. The sale was completed in fiscal 2006 on July 28, 2005. This sale was made in connection with HMCA's decision to focus on the management of diagnostic imaging facilities.

The sale was made pursuant to an asset purchase agreement to Health Plus Management Services, L.L.C. There is no material relationship between Health Plus and Fonar, HMCA, or any of their respective subsidiaries, directors or officers, or associates of any such person. The two principals of Health Plus were employed by HMCA up to the time of the closing of the transaction. In consideration for the termination of their employment agreements, these two individuals each became entitled to receive \$800,000. In addition, each became entitled to receive \$200,000 for billing and collection services to be provided on behalf of HMCA with respect to a portion of the accounts receivable of certain physical therapy and rehabilitation facilities which arose during the period when we were engaged in the management of those facilities. The \$1,000,000 payable to each of these individuals was payable at our option in shares of Fonar common stock.

The purchase price under the asset purchase agreement was \$6.6 million, payable pursuant to a promissory note in 120 monthly installments commencing on August 28, 2005. The first twelve installments are interest only and the remaining 108 payments will consist of equal installments of principal and interest in the amount of \$76,014 each. The note is subject to prepayment provisions to the extent Health Plus resells all or part of the assets and business or utilizes the assets sold as collateral in any debt financing. A loss from the sale of \$143,598 has been recorded during the quarter ended September 30, 2005. The note provides for interest at 5% per annum. The \$6.6 million note was valued at \$6,078,068 as a result of a discount for the below market interest rate.

As our consolidated revenues decreased by 23.3% to \$7.8 million for the

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first quarter of fiscal 2007 from \$10.2 million for the first quarter of fiscal 2006, the total costs and expenses decreased by 23.7% to \$13.9 million for the first quarter of fiscal 2007 from \$18.2 million for the first quarter of fiscal 2006.

Selling, general and administrative expenses remained constant at \$6.4 million in the first three months of fiscal 2006 and in the first three months of fiscal 2007. The compensatory element of stock issuances decreased by 81.3% from \$524,000 in the first three months of fiscal 2006 to \$98,000 in the first three months of fiscal 2007 which is now included in selling general and administrative expenses. This primarily reflected a lesser use of Fonar's stock in lieu of cash to pay employees, consultants and professionals for services.

Research and development expenses decreased by 22.2 % to \$1.4 million for the first three months of fiscal 2007 as compared to \$1.8 million for the first three months of fiscal 2006.

Interest expense in the first three months of fiscal 2007 decreased by 4.0% to \$71,000 from \$74,000 for the first three months of fiscal 2006.

Inventories decreased by 11.8% to \$6.2 million at September 30, 2006 as compared to \$7.1 million at June 30, 2006 as the Company's product sales revenues decreased and we decreased our purchase of raw materials and components.

Costs and estimated earnings in excess of billings on uncompleted contracts decreased by 98.1% to \$56,000 at September 30, 2006 from \$3.0 million at June 30, 2006. This decrease resulted from our receipt of installment payments upon delivery to customers whose sites were prepared to receive deliveries.

Management fee and medical receivables and accounts receivable decreased by 2.4% to \$16.8 million at September 30, 2006 from \$17.2 million at June 30, 2006, primarily due to collections on the Company's medical receivables offset by an increase in accounts receivable from the medical segment.

Our operating loss and net loss were \$6.1 million for the first three months of fiscal 2007 as compared to operating and net losses of \$8.0 million and \$8.3 million, respectively, for the first three months of fiscal 2006.

The overall trends reflected in the results of operations for the first three months of fiscal 2007 are a decrease in revenues from product sales, as compared to the first three months of fiscal 2006 (\$2.5 million for the first three months of fiscal 2007 as compared to \$4.2 million for the first three months of fiscal 2006), and a decrease in MRI equipment segment revenues relative to HMCA revenues (\$5.0 million or 64% from the MRI equipment segment as compared to \$2.8 million or 36% from HMCA, for the first three months of fiscal 2007, as compared to \$6.1 million or 60% from the MRI equipment segment and \$4.0 million or 40%, from HMCA, for the first three months of fiscal 2006). In addition, we experienced a decrease in unrelated party sales relative to related party sales in our medical equipment product sales (\$4.6 million or 92% to unrelated parties and \$381,000 or 8% to related parties for the first three months of fiscal 2007 as compared to \$5.7 million, or 93% to unrelated parties and \$420,000 or 7% to related parties for the first three months of fiscal 2006).

We are committed to reversing the trends we have experienced in the first three months in fiscal 2007. Nevertheless, factors beyond our control, such as the timing and rate of market growth which depend on economic conditions, payor reimbursement rates and policies, and unexpected expenditures or the timing of such expenditures, make it impossible to forecast future operating results. We believe we are pursuing the correct policies which should prove successful in improving the Company's operating results.

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The Company's Upright MRI(TM), and Fonar-360(TM) MRI scanners, together with the Company's works-in-progress, are intended to significantly improve the Company's competitive position.

The Company's Upright MRI(TM) scanner, which operates at 6000 gauss (.6 Tesla) field strength, allows patients to be scanned while standing or reclining. As a result, for the first time, MRI is able to be used to show abnormalities and injuries under full weight-bearing conditions, particularly the spine and joints. A floor-recessed elevator brings the patient to the height appropriate for the targeted image region. A custom-built adjustable bed will allow patients to sit or lie on their backs, sides or stomachs at any angle. Full-range-of-motion studies of the joints in virtually any direction will be possible, an especially promising feature for sports injuries.

The Upright MRI(TM) will also be useful for MRI directed neuro-surgical procedures as the surgeon would have unhindered access to the patient's head when the patient is supine with no restrictions in the vertical direction. This easy-entry, mid-field-strength scanner should be ideal for trauma centers where a quick MRI-screening within the first critical hour of treatment will greatly improve patients' chances for survival and optimize the extent of recovery.

The Fonar 360(TM) is an enlarged room sized magnet in which the floor, ceiling and walls of the scan room are part of the magnet frame. This is made possible by Fonar's patented Iron-Frame(TM) technology which allows the Company's engineers to control, contour and direct the magnet's lines of flux in the patient gap where wanted and almost none outside of the steel of the magnet where not wanted. Consequently, this scanner allows surgeons and other interventional physicians to walk inside the magnet and achieve 360 degree access to the patient to perform interventional procedures.

The Fonar 360(TM) is presently marketed as a diagnostic scanner and is sometimes referred to as the Open Sky(TM) MRI. In its Open Sky(TM) version, the Fonar 360(TM) serves as an open patient friendly scanner which allows 360 degree access to the patient on the scanner bed. To optimize the patient-friendly character of the Open Sky(TM) MRI, the walls, floor, ceiling and magnet poles are decorated with landscape murals. The patient gap is twenty inches and the magnetic field strength, like that of FONAR's Upright MRI(TM), is 0.6 Tesla.

In the future, we expect the Fonar 360(TM) to function as an interventional MRI. The enlarged room sized magnet and 360 access to the patient afforded by the Fonar 360(TM) would permit surgeons to walk into the magnet and perform interventions on the patient inside the magnet. Most importantly the exceptional quality of the MRI image and its capacity to exhibit tissue detail on the image, can then be obtained real time during the procedure to guide the interventionalist. Thus surgical instruments, needles, catheters, endoscopes and the like could be introduced directly into the human body and guided to the malignant lesion by means of the MRI image. The number of inoperable lesions should be greatly reduced by the availability of this new capability. Most importantly treatment can be carried directly to the target tissue. The interventional features of the Fonar 360(TM) are expected to be implemented by Oxford Nuffield Orthopedic Center in Oxford U.K. in the near future. A full range of MRI compatible surgical instruments using ceramic cutting tools and beryllium-copper materials are available commercially.

The Company expects marked demand for its most commanding MRI products, the Upright MRI(TM) and the Fonar 360(TM), first for their exceptional features in patient diagnosis and treatment. These scanners additionally provide improved image quality and higher imaging speed because of their higher field strength of .6 Tesla. The geometry of the Upright MRI(TM) as compared to a single coil, or multiple coils on only one axis and its transverse magnetic field enables the use of two detector rf coils operating in quadrature which increases the Upright



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MRI(TM) signal to noise ratio by 40%, providing a signal to noise ratio equal to a .84T recumbent only MRI scanner.

### Liquidity and Capital Resources

Cash, cash equivalents and marketable securities decreased from \$9.5 million at June 30, 2006 to \$8.7 million at September 30, 2006. Principal uses of cash during the first three months of fiscal 2007 included capital expenditures for property and equipment of \$117,000, repayment of long-term debt and capital lease obligations in the amount of \$45,000, capitalized software development costs of \$184,000 and capitalized patent and copyright costs of \$165,000, and a decrease in accounts payable of \$967,000.

Marketable securities approximated \$4.6 million as at September 30, 2006, as compared to \$4.9 million at June 30, 2006. This reduction represents the maturation of marketable securities which have not been reinvested and the proceeds of which are available to fund operations if needed. At September 30, 2006, our investments in U.S. Government obligations were \$2.4 million, our investments in corporate and government agency bonds were \$1.9 million and our investments in certificates of deposit and deposit notes were \$400,000. The investments made have had the intended effect of maintaining a stable investment portfolio.

Cash used in operating activities for the first three months of fiscal 2007 approximated \$593,000. Cash used in operating activities was attributable primarily to the net loss of \$6.1 million and the decrease in accounts payable of \$967,000, which were offset by a decrease in costs and estimated earnings in excess of billings on uncompleted contracts of \$2.9 million, a decrease in inventories of \$839,000 and the issuance of stock for compensation, costs and expenses in lieu of cash in the amount of \$1.9 million.

Cash used in investing activities for the first three months of fiscal 2007 approximated \$68,000. The principal source of cash from investing activities during the first three months of fiscal 2007 consisted of the sale of marketable securities of \$398,000, offset by expenditures for property and equipment of approximately \$117,000 and capitalized software and patent costs of approximately \$349,000.

Cash provided by financing activities for the first three months of fiscal 2007 approximated \$212,000. The sources of cash from financing activities were net proceeds from exercises of stock options and warrants of \$50,000, repayment of notes receivable from employee stockholders of \$37,000, and net proceeds from the sale of stock of \$373,000. The principal uses of cash in financing activities during the first three months of fiscal 2007 consisted of repayment of principal on long-term debt and capital lease obligations of approximately \$45,000 and distributions to holders of minority interests of \$203,000.

The Company's obligations and the periods in which they are scheduled to become due are set forth in the following table:

(000's OMITTED)

Obligation	Total	Due in			
		Less than 1 year	Due in 1-3 years	Due in 4-5 years	Due after 5 years
Long-term debt	\$ 555	\$ --	\$ --	\$ --	\$ 555
Capital lease Obligation	806	239	388	179	--

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Operating Leases	8,760	2,399	3,742	1,143	1,476
	-----	-----	-----	-----	-----
Total cash Obligations	\$ 10,121	\$ 2,638	\$ 4,130	\$ 1,322	\$ 2,031
	=====	=====	=====	=====	=====

Total liabilities decreased by 3.3% to \$25.2 million at September 30, 2006 from \$26.1 million at June 30, 2006.

We experienced a decrease in long-term debt from \$1.2 million at June 30, 2006 to \$1.1 million at September 30, 2006, a decrease in unearned revenue on service contracts from \$4.8 million to \$4.5 million at June 30, 2006 to September 30, 2006, a decrease in billings in excess of costs and estimated earnings on uncompleted contracts from \$3.1 million at June 30, 2006 to \$2.1 million at September 30, 2006, a decrease in accounts payable from \$4.9 million at June 30, 2006 to \$3.9 million at September 30, 2006, an increase in customer advances from \$5.5 million at June 30, 2006 to \$6.8 at September 30, 2006.

As of September 30, 2006, the total of \$6.2 million in other current liabilities included primarily accrued salaries and payroll taxes of \$1.4 million, accrued royalties of \$661,000 and excise and sales taxes of \$2.2 million.

Our working capital approximated \$10.9 million as of September 30, 2006, as compared to working capital of \$14.2 million as of June 30, 2006, decreasing by 23.5%. This resulted principally from a decrease in accounts receivable of \$410,000 (\$17.2 million at June 30, 2006 as compared to \$16.8 million at September 30, 2006), a decrease of cost and estimated earnings in excess of billings on uncompleted contracts of \$2.9 million (\$3.0 million at June 30, 2006 as compared to \$56,000 at September 30, 2006) along with a decrease in inventories of \$838,000 (\$7.1 million at June 30, 2006 as compared to \$6.2 million at September 30, 2006).

With respect to current liabilities, the current portion of long-term debt increased from \$234,000 at June 30, 2006 to \$239,000 at September 30, 2006, and billings in excess of costs and estimated earnings on uncompleted contracts decreased from \$3.1 million at June 30, 2006 to \$2.1 million at September 30, 2006. Customer advances increased from \$5.5 million at June 30, 2006 to \$6.8 million at September 30, 2006 and accounts payable decreased from \$4.9 million at June 30, 2006 to \$3.9 million at September 30, 2006.

In order to conserve our capital resources, we have issued common stock under our stock bonus and stock option plans to compensate employees and non-employees for services rendered. In the first three months of fiscal 2007, the compensatory element of stock issuances was \$98,000 as compared to \$524,000 for the first three months of fiscal 2006. Utilization of equity in lieu of cash compensation has improved our liquidity since it increases cash available for other expenditures. In addition, we used stock to pay \$ 1.6 million for the termination of two employment agreements terminated in connection with the sale of HMCA's physical therapy and rehabilitation facility management business in the first three months of fiscal 2006.

Fonar's capital resources are expected to improve as Fonar's MRI scanner products gain wider market recognition and acceptance and produce increased product sales. The Company is focusing on increased advertising and marketing to increase demand for its products.

Inventories decreased by \$900,000 (\$7.1 million at June 30, 2006 as compared to \$6.2 million at September 30, 2006) resulting from a decrease in the purchasing of raw materials and components and in filling our backlog of orders.

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Fonar has not committed to making additional capital expenditures in the 2007 fiscal year other than its intention to continue research and development expenditures at current levels.

Our business plan calls for a continuing emphasis on providing our customers with enhanced equipment service and maintenance capabilities and delivering state-of-the-art, innovative and high quality equipment upgrades at competitive prices.

Our principal source of liquidity has been cash flows provided by operations. We currently expect this to continue. At September 30, 2006, we had working capital of \$10.9 million. For the three months ended September 30, 2006, we incurred a net loss of \$6.1 million which included non-cash charges of \$2.7 million.

In order to conserve our capital resources we have and will continue to issue, from time to time, common stock and stock options to compensate employees and non-employees for services rendered. The Company is focusing on increased advertising and marketing campaigns and distribution programs to increase the demand for Fonar's products. Management anticipates that Fonar's capital resources will improve as Fonar's MRI scanner products gain wider market recognition and acceptance resulting in increased product sales. If we are not successful with our current marketing efforts to increase sales, then we could experience a shortfall in the cash necessary to sustain operations at their current levels.

Given our September 30, 2006 cash and marketable securities balance of \$8.7 million and our forecasted cash requirements, we anticipate that our existing capital resources, funds generated from operations and funds expected to be received from note repayments, will be sufficient to satisfy our cash flow requirements through at least September 30, 2007. Based upon current results of operations, we believe we will either need to increase sales, reduce expenses or seek other sources of funds through the issuance of equity or debt financing in order to maintain sufficient funds available to operate subsequent to September 30, 2007.

The Company received written notification from The Nasdaq Stock Market on December 22, 2005 that the bid price of its common stock for the last 30 consecutive trading days had closed below the minimum \$1.00 per share required for continued listing under Nasdaq Marketplace Rule 4310(c)(4) (the "Rule"). Pursuant to Nasdaq Marketplace Rule 4310(c)(8)(D), the Company had been provided an initial period of 180 calendar days, or until June 20, 2006, to regain compliance but since Fonar was then in compliance with NASDAQ's other listing requirements, an extension to December 18, 2006 was granted.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our investments are in fixed rate instruments. Below is a tabular presentation of the maturity profile of the fixed rate instruments held by us at September 30, 2006.

INTEREST RATE SENSITIVITY  
PRINCIPAL AMOUNT BY EXPECTED MATURITY  
WEIGHTED AVERAGE INTEREST RATE

Year of Maturity	Investments in Fixed Rate Instruments	Weighted Average Interest Rate
-----	-----	-----
9/30/07	\$ 100,000	4.25%
9/30/08	1,650,000	3.93%

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9/30/09	1,945,687	4.07%
9/30/10	998,812	2.98%
9/30/11	100,000	4.54%
	-----	
Total:	\$ 4,794,499	
	=====	
	Fair Value	
	at 9/30/06\$	4,539,857
	=====	

All of our revenue, expense and capital purchasing activities are transacted in United States dollars.

See Note 13 to the consolidated Financial Statements in our Form 10-K as of and for the year ended June 30, 2006 for information on long-term debt.

### Item 4. Controls and Procedures

#### (a) Evaluation of disclosure controls and procedures.

The Company maintains controls and procedures designed to ensure that information required to be disclosed in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those controls and procedures performed as of the end of the period covered by this report, the principal executive and acting principal financial officer of the Company concluded that disclosure controls and procedures were effective.

#### (b) Change in internal controls.

The Company continues to enhance its controls and procedures related to the financial reporting process, improvements that were established during the latter part of fiscal 2005. This included hiring an outside consultant to assist with technical accounting and reporting issues, developing more standardized closing procedures and implementing a more formal process for documenting the weekly management meetings to review operating performance and results.

There have been no changes in our internal control over financial reporting that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

Item 1 - Legal Proceedings: There were no material changes in litigation for the first three months of fiscal 2007.

Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds: None

Item 3 - Defaults Upon Senior Securities: None

Item 4 - Submission of Matters to a Vote of Security Holders: None

Item 5 - Other Information: None

Item 6 - Exhibits and Reports on Form 8-K: Exhibit 31.1 Certification See Exhibits Exhibit 32.1 Certification See Exhibits 8-K (earnings press release) filed on September 15, 2006

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FONAR CORPORATION AND SUBSIDIARIES

### SIGNATURES

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

FONAR CORPORATION  
(Registrant)

By: /s/ Raymond V. Damadian  
Raymond V. Damadian  
President & Chairman

Dated: November 9, 2006