

**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 September 30, 2007**

**OR**

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

**FOR THE TRANSITION PERIOD FROM \_\_\_\_ TO \_\_\_\_**

*COMMISSION FILE NUMBER 1-11151*

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

(NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

NEVADA  
(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

76-0364866  
(I.R.S. EMPLOYER  
IDENTIFICATION NO.)

1300 WEST SAM HOUSTON PARKWAY SOUTH, SUITE 300,  
HOUSTON, TEXAS  
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

77042  
(ZIP CODE)

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

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

Yes       No

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

Large accelerated filer       Accelerated filer       Non-accelerated filer

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

Yes       No

As of November 8, 2007, the number of shares outstanding (issued less treasury stock) of the registrant's common stock, par value \$.01 per share, was: 11,828,455.

## **PART I - FINANCIAL INFORMATION**

Item 1.	Financial Statements.	
	Consolidated Balance Sheets as of September 30, 2007 and December 31, 2006	3
	Consolidated Statements of Net Income for the three and nine months ended September 30, 2007 and 2006	4
	Consolidated Statements of Cash Flows for the nine months ended September 30, 2007 and 2006	5
	Consolidated Statement of Shareholders' Equity for the nine months ended September 30, 2007	6
	Notes to Consolidated Financial Statements	7
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	18
Item 3.	Quantitative and Qualitative Disclosure About Market Risk	25
Item 4.	Controls and Procedures	25

## **PART II - OTHER INFORMATION**

Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	26
Item 6.	Exhibits	26
	Signatures	27
	Certifications	29-32

**ITEM 1. FINANCIAL STATEMENTS.**

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

	September 30, 2007 <u>(unaudited)</u>	December 31, 2006 <u></u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents.....	\$ 9,566	\$ 10,952
Marketable securities - available for sale.....	-	500
Patient accounts receivable, less allowance for doubtful accounts of \$1,950 and \$1,567, respectively.....	25,976	21,503
Accounts receivable - other.....	1,075	775
Other current assets.....	2,173	2,251
Total current assets.....	<u>38,790</u>	<u>35,981</u>
Fixed assets:		
Furniture and equipment.....	28,124	23,718
Leasehold improvements.....	17,325	15,226
	<u>45,449</u>	<u>38,944</u>
Less accumulated depreciation and amortization.....	28,373	25,573
	<u>17,076</u>	<u>13,371</u>
Goodwill.....	39,759	20,997
Other assets.....	2,777	1,108
	<u>\$ 98,402</u>	<u>\$ 71,457</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable - trade.....	\$ 1,212	\$ 1,601
Accrued expenses.....	9,535	7,007
Current portion of notes payable.....	854	562
Total current liabilities.....	<u>11,601</u>	<u>9,170</u>
Notes payable.....	1,084	797
Revolving line of credit.....	12,000	-
Deferred rent.....	1,171	1,273
Other long-term liabilities.....	615	829
Total liabilities.....	<u>26,471</u>	<u>12,069</u>
Minority interests in subsidiary limited partnerships.....	5,484	3,871
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, \$.01 par value, 500,000 shares authorized, no shares issued and outstanding.....	-	-
Common stock, \$.01 par value, 20,000,000 shares authorized, 14,043,192 and 13,681,849, shares issued, respectively.....	140	137
Additional paid-in capital.....	40,979	36,304
Retained earnings.....	56,956	50,704
Treasury stock at cost, 2,214,737 shares.....	(31,628)	(31,628)
Total shareholders' equity.....	<u>66,447</u>	<u>55,517</u>
	<u>\$ 98,402</u>	<u>\$ 71,457</u>

See notes to consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Net patient revenues.....	\$ 36,906	\$ 32,806	\$ 106,353	\$ 99,764
Management contract revenues.....	488	319	1,090	1,458
Other revenues.....	59	-	89	35
Net revenues.....	<u>37,453</u>	<u>33,125</u>	<u>107,532</u>	<u>101,257</u>
Clinic operating costs:				
Salaries and related costs.....	19,579	17,155	55,567	51,934
Rent, clinic supplies, contract labor and other.....	8,179	6,935	23,237	20,617
Provision for doubtful accounts.....	691	591	1,728	1,562
	<u>28,449</u>	<u>24,681</u>	<u>80,532</u>	<u>74,113</u>
Corporate office costs.....	<u>4,209</u>	<u>4,136</u>	<u>12,702</u>	<u>13,138</u>
Operating income from continuing operations.....	4,795	4,308	14,298	14,006
Interest and investment income.....	87	111	252	301
Interest expense.....	(84)	(9)	(135)	(32)
Loss in unconsolidated joint venture.....	-	-	-	(31)
Minority interests in subsidiary limited partnerships.....	<u>(1,369)</u>	<u>(1,377)</u>	<u>(4,151)</u>	<u>(4,355)</u>
Income before income taxes from continuing operations.....	3,429	3,033	10,264	9,889
Provision for income taxes.....	1,297	1,159	3,931	3,782
Net income from continuing operations.....	<u>2,132</u>	<u>1,874</u>	<u>6,333</u>	<u>6,107</u>
Discontinued operations:				
(Loss) income from discontinued operations.....	(17)	(2,089)	(127)	(3,013)
Tax benefit (expense) from discontinued operations.....	5	767	46	1,098
	<u>(12)</u>	<u>(1,322)</u>	<u>(81)</u>	<u>(1,915)</u>
Net income.....	<u>\$ 2,120</u>	<u>\$ 552</u>	<u>\$ 6,252</u>	<u>\$ 4,192</u>
Earnings per share:				
Basic - income from continuing operations.....	\$ 0.18	\$ 0.16	\$ 0.55	\$ 0.52
Basic - (loss) income from discontinued operations.....	-	(0.11)	(0.01)	(0.16)
Total basic earnings per common share.....	<u>\$ 0.18</u>	<u>\$ 0.05</u>	<u>\$ 0.54</u>	<u>\$ 0.36</u>
Diluted - income from continuing operations.....	\$ 0.18	\$ 0.16	\$ 0.54	\$ 0.51
Diluted - (loss) income from discontinued operations.....	-	(0.11)	-	(0.16)
Total diluted earnings per common share.....	<u>\$ 0.18</u>	<u>\$ 0.05</u>	<u>\$ 0.54</u>	<u>\$ 0.35</u>
Shares used in computation:				
Basic earnings per common share.....	<u>11,673</u>	<u>11,675</u>	<u>11,578</u>	<u>11,750</u>
Diluted earnings per common share.....	<u>11,738</u>	<u>11,801</u>	<u>11,657</u>	<u>11,901</u>

See notes to consolidated financial statements.

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

	Nine Months Ended September 30,	
	2007	2006
<b>OPERATING ACTIVITIES</b>		
Net income.....	\$ 6,252	\$ 4,192
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization.....	3,530	3,374
Minority interests in earnings of subsidiary limited partnerships.....	4,151	4,267
Provision for doubtful accounts.....	1,823	1,649
Equity-based awards compensation expense.....	936	737
Loss on sale or abandonment of assets.....	36	472
Tax benefit from exercise of stock options.....	(177)	(73)
Recognition of deferred rent subsidies.....	(351)	(306)
Deferred income taxes.....	(40)	(71)
Closure costs - write-off of goodwill.....	-	192
Changes in operating assets and liabilities:		
Increase in patient account receivable.....	(3,132)	(2,631)
(Increase) decrease in accounts receivable - other.....	(12)	287
(Increase) decrease in other assets.....	(368)	103
(Decrease) increase in accounts payable and accrued expenses.....	(430)	1,963
Increase in other liabilities.....	212	481
Net cash provided by operating activities.....	12,430	14,636
<b>INVESTING ACTIVITIES</b>		
Purchase of fixed assets.....	(2,847)	(3,920)
Purchase of business, net of cash acquired.....	(18,928)	(54)
Acquisitions of minority interest, included in goodwill.....	(512)	(1,207)
Purchase of marketable securities - available for sale.....	(2,040)	(100)
Proceeds on sale of marketable securities - available for sale.....	2,540	1,200
Proceeds on sale of fixed assets.....	37	38
Net cash used in investing activities.....	(21,750)	(4,043)
<b>FINANCING ACTIVITIES</b>		
Distributions to minority investors in subsidiary limited partnerships.....	(4,264)	(4,213)
Repurchase of common stock.....	-	(4,347)
Proceeds from revolving line of credit.....	12,000	-
Payment of notes payable.....	(421)	(203)
Excess tax benefit from stock options exercised.....	177	73
Proceeds from exercise of stock options.....	442	84
Net cash used in financing activities.....	7,934	(8,606)
Net increase (decrease) in cash and cash equivalents.....	(1,386)	1,987
Cash and cash equivalents - beginning of period.....	10,952	12,352
Cash and cash equivalents - end of period.....	\$ 9,566	\$ 14,339
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b>		
Cash paid during the period for :		
Income taxes.....	\$ 4,076	\$ 3,143
Interest.....	\$ 66	\$ 30
Purchase of business - seller financing portion.....	\$ 1,000	\$ -

See notes to consolidated financial statements.

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

	Common Stock		Additional Paid-In Capital	Retained Earnings	Treasury Stock		Total Shareholders' Equity
	Shares	Amount			Shares	Amount	
Balance December 31, 2006.....	13,682	\$ 137	\$ 36,304	\$ 50,704	(2,215)	\$ (31,628)	\$ 55,517
Issuance of common stock in connection with acquisition.....	228	2	3,121	-	-	-	3,123
Proceeds from exercise of stock options....	65	1	441	-	-	-	442
Tax benefit from exercise of stock options.....	-	-	177	-	-	-	177
Net activity in restricted stock.....	68	-	-	-	-	-	-
Amortization of restricted stock.....	-	-	192	-	-	-	192
Equity-based compensation expense.....	-	-	744	-	-	-	744
Net income.....	-	-	-	6,252	-	-	6,252
Balance September 30, 2007.....	<u>14,043</u>	<u>\$ 140</u>	<u>\$ 40,979</u>	<u>\$ 56,956</u>	<u>(2,215)</u>	<u>\$ (31,628)</u>	<u>\$ 66,447</u>

See notes to consolidated financial statements.

**U.S. PHYSICAL THERAPY, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2007**  
(unaudited)

**1. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES**

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

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

Effective September 1, 2007, the Company acquired a majority interest in STAR Physical Therapy, LP ("STAR"), a multi partner outpatient rehabilitation practice with operations in the southeast United States ("STAR Acquisition"). STAR owns and operates 51 outpatient physical and occupational therapy clinics and manages seven other facilities for third parties. During the nine months ended September 30, 2007, the Company opened 11 new clinics, of which 10 were Clinic Partnerships, and closed nine (one of which was part of STAR). Therefore, the Company ended September 2007 with 346 owned clinics.

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

The accompanying unaudited consolidated financial statements were prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and in accordance with the instructions for Form 10-Q. However, the statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. For further information regarding the Company's accounting policies, please read the audited financial statements included in the Company's Form 10-K for the year ended December 31, 2006.

The Company believes, and the Chief Executive Officer, Chief Financial Officer and Corporate Controller have certified, that the financial statements included in this report contain all necessary adjustments (consisting only of normal recurring adjustments) to present fairly, in all material respects, the Company's financial position, results of operations and cash flows for the interim periods presented.

Operating results for the nine months ended September 30, 2007 are not necessarily indicative of the results the Company expects for the entire year. Please also review the Risk Factors section included in our Form 10-K for the year ended December 31, 2006.

*Clinic Partnerships*

For Clinic Partnerships, the earnings and liabilities attributable to the minority limited partnership interest, typically owned by the managing therapist, are recorded within the balance sheets and income statements as minority interests in subsidiary limited partnerships.

*Wholly-Owned Facilities*

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

## **Significant Accounting Policies**

### **Cash Equivalents**

The Company considers all highly liquid investments with an original maturity or remaining maturity at the time of purchase of three months or less to be cash equivalents. Based upon its investment policy, the Company invests its cash primarily in deposits with major financial institutions, in highly rated commercial paper, short-term United States treasury obligations, United States and municipal government agency securities and United States government sponsored enterprises. The Company held approximately \$4.5 million and \$4.2 million in highly liquid investments included in cash and cash equivalents at September 30, 2007 and December 31, 2006, respectively.

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

### **Marketable Securities**

Management determines the appropriate classification of its investments at the time of purchase and reevaluates such determination at each balance sheet date. As of December 31, 2006, all marketable securities were classified as available for sale. Available-for-sale securities are carried at fair value, with unrealized holding gains and losses, net of tax, reported as a separate component of shareholders’ equity. Since the fair value of the marketable securities – available for sale equals the cost basis for such securities, there is no effect on comprehensive income for the periods reported.

### **Long-Lived Assets**

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

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

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

### **Goodwill**

Goodwill represents the excess of costs over the fair value of the acquired business assets. Historically, goodwill has been derived from acquisitions and from the purchase of some or all of a particular local management’s equity interest in an existing clinic.

The fair value of goodwill and other intangible assets with indefinite lives are tested for impairment annually and upon the occurrence of certain events, and are written down to fair value if considered impaired. The Company evaluates goodwill for impairment on an annual basis (in its third quarter) by comparing the fair value of each reporting unit to the carrying value of the reporting unit including related goodwill. A reporting unit refers to the acquired interest of a single clinic or group of clinics. Local management typically continues to manage the acquired clinic or group of clinics. For each clinic or group of clinics, the Company maintains discrete financial information and both corporate and local management regularly review the operating results. For each purchase of the equity interest, goodwill is assigned to the respective clinic or group of clinics, if deemed appropriate. The evaluation of goodwill in the third quarter of 2007 did not result in any goodwill amounts that were deemed impaired.

### **Revenue Recognition**

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



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

Since 1999, reimbursement for outpatient therapy services has been made according to a fee schedule published by the Department of Health and Human Services (“HHS”). Under the Balanced Budget Act of 1997, the total amount paid by Medicare in any one year for outpatient physical and/or occupational therapy (including speech-language pathology) to any one patient was initially limited to \$1,500 (the “Medicare Cap or Limit”), except for services provided in hospitals. After a three-year moratorium, this Medicare Limit on therapy services was implemented for services rendered on or after September 1, 2003 subject to an adjusted total of \$1,590 (the “Adjusted Medicare Limit”). Effective December 8, 2003, a moratorium was again placed on the Adjusted Medicare Limit for the remainder of 2003 and for years 2004 and 2005. Under the Medicare Prescription Drug, Improvement and Modernization Act of 2003, the Adjusted Medicare Limit was reinstated effective as of January 1, 2006. Outpatient therapy services rendered to Medicare beneficiaries by the Company's therapists are subject to the cap, except to the extent these services are rendered pursuant to certain management and professional services agreements with inpatient facilities, in which case the caps do not apply. The Medicare Limit for 2006 was \$1,740.

In 2006, Congress passed the Deficit Reduction Act (“DRA”), which allowed the Centers for Medicare and Medicaid Services (“CMS”) to grant exceptions to the Medicare Cap for services provided during the year, as long as those services met certain qualifications (as more fully defined in the February 15, 2006 Medicare Fact Sheet). The exception process allowed for automatic and manual exceptions to the Medicare Cap for medically necessary services. The exception process specified diagnosis that qualified for an automatic exception to the Medicare Cap if the condition or complexity has a direct and significant impact on the course of therapy being provided and the additional treatment was medically necessary. The exception process further provided that manual exceptions could be granted if the condition or complexity did not allow for an automatic exception, but was believed to require medically necessary services. This exception process adopted as part of the DRA was scheduled to expire on December 31, 2006.

In December 2006, Congress passed and the President signed the Tax Relief and Health Care Act of 2006, which extended the Medicare Cap exceptions process for 2007. The Medicare Cap continues to apply in 2007, and the Adjusted Medicare Limit for 2007 is \$1,780. After Congress extended the exceptions process for another year, CMS revised the exceptions procedures. These procedures eliminated the manual exceptions process and expanded the use of automatic exceptions. As of January 1, 2007, all services that require exceptions to the Medicare Cap are processed as automatic exceptions. While the basic procedure for obtaining an automatic exception remains the same, CMS expanded requirements for documentation related to the medical necessity of services provided above the cap.

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

Laws and regulations governing the Medicare program are complex and subject to interpretation. The Company believes that it is in compliance in all material respects with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing that would have a material effect on the Company's financial statements as of September 30, 2007. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as significant regulatory action including fines, penalties, and exclusion from the Medicare program.

### **Contractual Allowances**

Contractual allowances result from the differences between the rates charged for services performed and expected reimbursements by both insurance companies and government sponsored healthcare programs for such services. Medicare regulations and the various third party payors and managed care contracts are often complex and may include multiple reimbursement mechanisms payable for the services provided in Company clinics. The Company estimates contractual allowances based on its interpretation of the applicable regulations, payor contracts and historical calculations. Each month the Company estimates its contractual allowance for each clinic based on payor contracts and the historical collection experience of the clinic and applies an appropriate contractual allowance reserve percentage to the gross accounts receivable balances for each payor of the clinic. Based on the Company's historical experience, calculating the contractual allowance reserve percentage at the payor level is sufficient to allow us to provide the necessary detail and accuracy with its collectibility estimates. However, the services authorized and provided and related reimbursement are subject to interpretation that could result in payments that differ from our estimates. Payor terms are periodically revised necessitating continual review and assessment of the estimates made by management. The Company's billing systems may not capture the exact change in our contractual allowance reserve estimate from period to period in order to assess

the accuracy of our revenues and hence our contractual allowance reserves. Management regularly compares its cash collections to corresponding net revenues measured both in the aggregate and on a clinic-by-clinic basis. In the aggregate, historically the difference between net revenues and corresponding cash collections has generally been less than 1% of net revenues. Additionally, analysis of subsequent period's contractual write-offs on a payor basis shows a less than 1% difference between the actual aggregate contractual reserve percentage as compared to the estimated contractual allowance reserve percentage associated with the same period end balance. As a result, the Company believes that a reasonable likely change in the contractual allowance reserve estimate would not likely be more than 1% at September 30, 2007.

### **Income Taxes**

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

In June 2006, the FASB issued FIN 48, Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes a model for how a company is to recognize, measure, present and disclose in its financial statements uncertain positions that a company has taken or plans to take on a future tax return. Under FIN 48, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained upon examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on derecognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures. The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company did not have any unrecognized tax benefits for Federal, state and local tax jurisdictions. In addition, there was no effect on our financial condition or results of operations due to the implementation of FIN 48.

Estimated interest and penalties related to potential underpayment on any unrecognized tax benefits are to be classified as a component of tax expense in the Consolidated Statement of Operations. As of the date of adoption of FIN 48, the Company did not have any accrued interest or penalties associated with any unrecognized tax benefits, nor was any interest expense recognized during the nine months ended September 30, 2007.

The Company accrued state and federal income taxes at an effective tax rate of 37.8% and 38.2% for the three months ended September 30, 2007 and 2006, respectively. The Company accrued state and federal income taxes at an effective tax rate of 38.3% versus 38.2% for the nine months ended September 30, 2007 and 2006.

### **Fair Values of Financial Instruments**

The carrying amounts reported in the balance sheet for cash and cash equivalents, accounts receivable, accounts payable and notes payable approximate their fair values due to the short-term maturity of these financial instruments. The carrying amount of the revolving line of credits approximates its fair value. The interest rate on the revolving line of credit is set at various short-term intervals based on current market conditions. The carrying amounts for marketable securities – available for sale approximate the fair value on the respective balance sheet dates.

### **Segment Reporting**

Operating segments are components of an enterprise for which separate financial information is available that is evaluated regularly by chief operating decision makers in deciding how to allocate resources and in assessing performance. The Company identifies operating segments based on management responsibility and believes it meets the criteria for aggregating its operating segments into a single reporting segment.

### **Use of Estimates**

In preparing the Company's consolidated financial statements, management makes certain estimates and assumptions that affect the amounts reported in the consolidated financial statements and related disclosures. Actual results may differ from these estimates.

## Self-Insurance Program

The Company utilizes a self-insurance plan for its employee group health insurance coverage administered by a third party. Predetermined loss limits have been arranged with the insurance company to limit the Company's maximum liability and cash outlay. Accrued expenses include the estimated incurred but unreported costs to settle unpaid claims and estimated future claims.

## Reclassifications

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 154, "Accounting Changes and Error Corrections – A Replacement of APB Opinion No. 20 and FASB Statement No. 3", the prior period financial statements have been reclassified to conform with the current year presentation of reporting all earnings allocated to the minority limited partners within the line item in the balance sheets and income statements entitled – minority interests in subsidiary limited partnerships. The earnings allocated to the minority limited partners are shown as an adjustment to net income in the statements of cash flows. The payments of the distributions related to these allocated earnings are shown as a use of cash in the financing activities section of the statement of cash flows. In prior years, based upon an interpretation of the Emerging Issues Task Force issue 00-23, "Issues Related to the Accounting for Stock Compensation under APB No. 25 and FASB Interpretation No. 44", the Company reported the earnings allocated to minority limited partners for partnerships formed after January 18, 2001 as clinic costs – salaries and related expense. After a detailed review of our previous accounting policy and our Clinic Partnerships, management has determined that reporting such amounts in this line item was incorrect. The effect of reclassifying the prior period financial statements did not change total assets, shareholders' equity, net income or earnings per share. The minority interests previously recorded as expense in clinic costs – salaries and related, after reclassification, have the effect of increasing operating income from continuing operations by \$334,000 and \$926,000 for the three months and nine months ended September 30, 2006, respectively, and increasing minority interest in subsidiary limited partnerships by \$799,000 at September 30, 2006.

In accordance with current accounting literature, the results of operations and closure costs for the 31 clinics closed in 2006 and the results of operations for the clinic sold in 2006 are presented as discontinued operations for all periods presented, net of tax benefit.

The following table reconciles the amounts previously reported to the amounts reported in these financial statements by major line item for the statements of net income and cash flows for the three months and nine months ended September 30, 2006:

	Three Months Ended September 30, 2006			Nine Months Ended September 30, 2006		
	As Previously Reported (1)	Reclasses	As Reclassed	As Previously Reported (1)	Reclasses	As Reclassed
<b>Statement of Net Income</b>						
Net revenue.....	\$ 33,184	\$ (59) (2)	\$ 33,125	\$ 101,430	\$ (173) (2)	\$ 101,257
Clinic operating costs.....	25,058	(377) (3)	24,681	75,169	(1,056) (4)	74,113
Corporate office costs.....	4,136		4,136	13,138		13,138
Operating income from continuing operations.....	3,990		4,308	13,123		14,006
Interest and investment income, net.....	102		102	269		269
Loss in unconsolidated joint venture.....	-		-	(31)		(31)
Minority interest in subsidiary limited partnerships.....	(1,043)	(334)	(1,377)	(3,429)	(926)	(4,355)
Income before income taxes from continuing operations.....	3,049		3,033	9,932		9,889
Provision for income taxes.....	1,165	(6)	1,159	3,806	(24)	3,782
Net income from continuing operations.....	1,884		1,874	6,126		6,107
(Loss) income from discontinued operations, net of tax.....	(1,332)	10	(1,322)	(1,934)	19	(1,915)
Net income.....	\$ 552	\$ -	\$ 552	\$ 4,192	\$ -	\$ 4,192
<b>Statement of Cash Flows</b>						
Net cash provided by operating activities.....				\$ 13,944	\$ 692 (5)	\$ 14,636
Net cash used in investing activities.....				(4,043)	-	(4,043)
Net cash used in financing activities.....				(7,914)	(692) (6)	(8,606)
Net increase in cash and cash equivalents.....				1,987	-	1,987
Cash and cash equivalents - beginning of period.....				12,352		12,352
Cash and cash equivalents - end of period.....				\$ 14,339	\$ -	\$ 14,339

Footnotes on the following page.

- (1) As previously reported in the Company's Form 10Q for the quarterly period ended September 30, 2006.
- (2) Includes revenues related to clinic sold in the fourth quarter of 2006.
- (3) Includes minority interests in subsidiary limited partnerships previously reported as clinic operating costs - salaries and related costs of \$310,000 and costs related to Discontinued Operations of \$67,000.
- (4) Includes minority interests in subsidiary limited partnerships previously reported as clinic operating costs - salaries and related costs of \$897,000 and costs related to Discontinued Operations of \$159,000.
- (5) Includes increase in minority interests in subsidiary limited partnerships previously reported as clinic operating costs - salaries and related costs of \$897,000 offset by change in compensation liability of \$205,000. For clinic partnerships formed after January 18, 2001, earnings allocated to minority interests in subsidiary limited partnerships that were accrued and not paid were previously included in other liabilities and the net change was included in net cash provided by operating activities in the statement of cash flows.
- (6) Represents distribution paid to minority limited partners for Clinic Partnerships formed after January 18, 2001.

## Stock Options

Effective January 1, 2006, the Company adopted Statement No. 123R, "Shared-Based Payment" ("SFAS 123R"), which requires companies to measure and recognize compensation expense for all stock-based payments at fair value. SFAS 123R was applied on the modified prospective basis. Under the modified prospective approach, SFAS 123R applies to new awards and to awards that were outstanding on January 1, 2006 that are subsequently modified, repurchased or cancelled. Under the modified prospective approach, compensation cost recognized for 2006 includes compensation for all stock-based payments granted prior to, but not yet vested on January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123, and compensation cost for the stock-based payments granted subsequent to January 1, 2006, based on the grant-date fair value with the provisions of SFAS 123R. No stock options were granted during the nine months ended September 30, 2007.

The impact of adopting SFAS 123R on January 1, 2006 resulted in lowering net income and net income per diluted share for the three and nine months ended September 30, 2007 and 2006 as follows (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2007	2006	2007	2006
After tax effect of stock option compensation expense.....	\$ 158	\$ 170	\$ 459	\$ 445
Effect on diluted earnings per share.....	\$ 0.01	\$ 0.01	\$ 0.04	\$ 0.04

As of September 30, 2007, the future pre-tax expense of nonvested stock options is \$1.8 million to be recognized in the remainder of 2007 through 2010.

## Restricted Stock

In the first quarter of 2007, the Company granted 51,000 shares of restricted stock to employees pursuant to its 1999 Stock Incentive Plan, and during the second quarter of 2007, the Company granted 20,000 shares of restricted stock to non-employee directors pursuant to its 2003 Stock Incentive Plan. The restricted stock issued to employees is subject to continued employment and will vest in equal installments on the following five anniversaries of the date of grant. Compensation expense for grants of restricted stock will be recognized based on the fair value of \$14.43 per share on the date of grant. The 20,000 shares of restricted stock issued to non-employee directors will vest in equal monthly installments for the twelve months following the date of grant. The total compensation expense of \$1.0 million for the 71,000 total shares will be recognized in 2007 through early 2012. For the third quarter and first nine months of 2007, respectively, compensation expense for restricted stock grants, including shares of restricted stock granted in 2006, was \$102,000 and \$192,000, respectively. For the first nine months of 2006, compensation expense for restricted stock grants was \$16,000. There was no compensation expense related to restricted stock grants in the third quarter 2006.

## Recently Promulgated Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," ("SFAS 157") which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles ("GAAP"). As a result of SFAS 157, there is now a common definition of fair value to be used throughout GAAP. The FASB believes that the new standard will make the measurement of fair value more consistent and comparable and improve disclosures about those measures. SFAS 157 is effective for fiscal years beginning after November 15, 2007. Management is currently evaluating the impact of the statement on the Company and does not believe the adoption of SFAS 157 will have a material impact on the Company's consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115 ("SFAS 159")." SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value and is effective for fiscal years beginning after November 15, 2007 or January 1, 2008 for the Company. Early adoption is permitted as of the beginning of the previous fiscal year provided that the entity makes that choice in the first 120 days of that fiscal year and also elects to adopt the provisions of SFAS No. 157. Management is in the process of evaluating the impact of this pronouncement on its consolidated financial statements and does not believe the adoption of SFAS 159 will have a material impact on our consolidated financial statements.

## 2. EARNINGS PER SHARE

The computations of basic and diluted earnings per share for the Company are as follows (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Numerator:				
Net income from continuing operations.....	\$ 2,132	\$ 1,874	\$ 6,333	\$ 6,107
Net loss from discontinued operations.....	(12)	(1,322)	(81)	(1,915)
Net income.....	<u>\$ 2,120</u>	<u>\$ 552</u>	<u>\$ 6,252</u>	<u>\$ 4,192</u>
Denominator:				
Denominator for basic earnings per share - weighted-average shares.....	11,673	11,675	11,578	11,750
Effect of dilutive securities - Stock options.....	65	126	79	151
Denominator for diluted earnings per share - adjusted weighted-average shares and assumed conversions.....	<u>11,738</u>	<u>11,801</u>	<u>11,657</u>	<u>11,901</u>
Earnings per share:				
Basic - income from continuing operations.....	\$ 0.18	\$ 0.16	\$ 0.55	\$ 0.52
Basic - loss from discontinued operations.....	-	(0.11)	(0.01)	(0.16)
Total basic earnings per share.....	<u>\$ 0.18</u>	<u>\$ 0.05</u>	<u>\$ 0.54</u>	<u>\$ 0.36</u>
Diluted - income from continuing operations.....	\$ 0.18	\$ 0.16	\$ 0.54	\$ 0.51
Diluted - loss from discontinued operations.....	-	(0.11)	-	(0.16)
Total diluted earnings per share.....	<u>\$ 0.18</u>	<u>\$ 0.05</u>	<u>\$ 0.54</u>	<u>\$ 0.35</u>

Options to purchase 447,000 and 252,000 shares for the three months ended September 30, 2007 and 2006, respectively, and 447,000 and 173,000 shares for the nine months ended September 30, 2007 and 2006, respectively, were excluded from the diluted earnings per share calculations for the respective periods because the options' exercise prices were greater than the average market price of the common shares during the periods.

## 3. ACQUISITIONS

### Acquisition of Businesses

The STAR Acquisition closed on September 6, 2007. The Company acquired a 70% interest with the existing partners retaining a 30% interest. Pursuant to terms of the Reorganization and Securities Purchase Agreement among the Company and STAR, the limited partners of STAR and Regg E. Swanson, as Seller Representative and in his individual capacity ("Purchase Agreement"), the Company paid \$23.3 million (inclusive of certain capitalized acquisition costs)

including \$19.2 million in cash, promissory notes aggregating \$1.0 million and 227,618 in restricted shares of the Company's common stock representing an aggregate of \$3.1 million based on the market price of \$13.72 per share. The amount of the consideration was derived through arm's length negotiations. Funding for the STAR Acquisition was derived from \$9.2 million of existing cash and \$10.0 million of the proceeds from the Company's credit agreement, dated as of August 27, 2007 among the Company, as the Borrower, Bank of America, N. A., as Administrative Agent, Swing Line Lender and L/C Issuer ("Credit Agreement"). The results of operations of STAR have been included in the Company's consolidated financial statements since September 1, 2007, the effective date of the STAR Acquisition.

Because of the proximity of this transaction to quarter end, the purchase price was allocated to the fair value of the assets acquired and liabilities assumed based on the preliminary estimates of the fair values at the acquisition date, with the amount exceeding the estimated fair values being recorded as goodwill. The Company is in the process of completing its formal valuation analysis to identify and determine the fair values of tangible and intangible assets acquired and the liabilities assumed. The Company has 12 months from the closing date of the STAR Acquisition to finalize its valuations. Thus, the final allocation of the purchase price may differ from the preliminary estimates used at September 30, 2007 based on additional information obtained. Changes in the estimated valuation of the tangible and intangible assets acquired and the completion by the Company of the identification of any unrecorded pre-acquisition contingencies, where the liability is probable and the amount can be reasonably estimated, may result in adjustments to goodwill.

The preliminary purchase price allocation is as follows (in thousands):

Cash paid, net of cash acquired.....	\$	18,928
Seller notes.....		1,000
Fair value of common stock issued.....		3,123
Total consideration.....	\$	<u>23,051</u>
Estimated fair value of net tangible assets acquired:		
Patients accounts receivable.....	\$	3,164
Other accounts receivable.....		288
Other current assets.....		177
Fixed assets.....		4,400
Other assets.....		77
Current liabilities.....		(2,613)
Minority interest of limited partners of net tangible assets acquired.....		(1,726)
Net tangible assets acquired.....	\$	<u>3,767</u>
Referral relationships.....		580
Non compete, 5 year.....		410
Goodwill.....		18,294
	\$	<u>23,051</u>

Unaudited pro forma net revenue and net income from continuing operations for the three and nine months ended September 30, 2007 and 2006 for the Company as if the STAR Acquisition occurred as of January 1, 2006 is as follows (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2007	2006	2007	2006
Net revenue.....	\$ 42,850	\$ 40,217	\$ 128,535	\$ 121,271
Net income.....	2,173	2,316	7,429	7,070
Earnings per share:				
Basic - income from continuing operations.....	\$ 0.18	\$ 0.19	\$ 0.63	\$ 0.59
Diluted - income from continuing operations.....	\$ 0.18	\$ 0.19	\$ 0.63	\$ 0.58
Shares used in computation:				
Basic earnings per common share.....	<u>11,901</u>	<u>11,903</u>	<u>11,806</u>	<u>11,978</u>
Diluted earnings per common share.....	<u>11,966</u>	<u>12,029</u>	<u>11,885</u>	<u>12,129</u>

In the above proforma net revenue, revenue from management contracts constitute \$885,000 and \$851,000 for the three months ended September 30, 2007 and 2006, respectively, and \$2,643,000 and \$3,124,000 for the nine months ended September 30, 2007 and 2006, respectively.

On November 17, 2006, the Company acquired a majority interest in an eight-clinic practice located in Arizona (“Arizona Acquisition”). The Company acquired a 65% interest with the existing partner retaining a 35% interest. The Company paid \$5,959,000, consisting of a three-year note payable in the amount of \$877,500 and cash of \$5,081,500. In addition, the Company incurred \$70,000 of capitalized acquisition costs. The purchase agreement also provides for possible contingent consideration of up to \$1,500,000 based on the achievement of a certain designated level of operating results within a three-year period following the acquisition. Any contingent payments made will increase goodwill.

In 2006, the Arizona Acquisition resulted in approximately \$5.5 million of goodwill which is deductible for tax purposes. Other assets related to this acquisition included accounts receivable valued at \$546,000, furniture and equipment valued at \$78,000, prepaid rental valued at \$16,000 and a non-competition agreement valued at \$160,693, which amount is being amortized over five years. The Company also assumed certain employee benefits and other liabilities of approximately \$113,000 and recorded minority interests in subsidiary limited partnerships of approximately \$184,000.

The Company is permitted to make, and has occasionally made, changes to preliminary purchase price allocations during the first year after completing an acquisition.

Unaudited proforma consolidated financial information for the Arizona Acquisition has not been included as the results were not material to current operations.

**Acquisitions of Minority Interests**

During 2007, the Company has purchased the minority interest in several limited partnerships in separate transactions for an aggregate purchase price of \$544,000. The purchases yielded \$512,000 of goodwill related to two of the partnerships and the remaining \$32,000 represented payment of undistributed earnings to the minority limited partners.

During 2006, the Company purchased the 35% minority interest in three limited partnerships in separate transactions for an aggregate purchase price of \$1.1 million. Under two of the purchase agreements, the Company may be required to pay contingent consideration of up to \$284,000, in aggregate, based on the achievement of a certain designated level of operating results within a three-year period following the acquisitions. Any contingent payments made will increase goodwill.

For all minority interest purchases noted above, the Company paid or has agreed to pay to the minority limited partner any pro rata undistributed earnings earned through an agreed date prior to the purchase date.

The Company's minority interest purchases were accounted for as purchases and accordingly, the results of operations of the acquired minority interest percentage are included in the accompanying financial statements from the dates of purchase. In addition, the Company is permitted to make, and has occasionally made, changes to preliminary purchase price allocations during the first year after completing the purchase.

The changes in the carrying amount of goodwill consisted of the following (in thousands):

	Nine Months Ended September 30, 2007
Beginning balance.....	\$ 20,997
Goodwill acquired during the year.....	18,806
Adjustment.....	(44)
Ending balance.....	<u>\$ 39,759</u>

#### 4. CLOSURE COSTS AND DISCONTINUED OPERATIONS

After a thorough review of the Company's clinics, management decided to close 28 unprofitable clinics in the third quarter of 2006. Previously, during the second quarter of 2006, three clinics were closed. The operating results of these 31 locations have been reported as discontinued operations for all periods presented as required by SFAS 144. The following are the net revenues and pre-tax losses reported for these locations (in thousands):

	Quarter Ended September 30, 2006	Nine Months Ended September 30, 2006
Net revenues.....	\$ 639	\$ 2,921
Pre-tax loss.....	\$ (1,322)	\$ (1,915)

The accrual balance at December 31, 2006, which consisted of lease commitments for the closed clinics, and the accrual balance and activity for the nine months ended September 30, 2007 are as follows (in thousands):

<u>Type of Cost</u>	Dec 31, 2006		Sept 30, 2007	
	<u>Balance</u>	<u>Additions</u>	<u>Activity</u>	<u>Balance</u>
Lease obligations.....	\$ 829	\$ 26	\$ (725)	\$ 130

Lease commitments represent the future payments remaining under lease agreements adjusted for estimated early settlements. The cash flow impact of these 31 clinics is deemed immaterial for the consolidated statements of cash flows.

#### 5. NOTES PAYABLE

Notes payable as of September 30, 2007 and December 31, 2006 consist of the following (in thousands):

	<u>2007</u>	<u>2006</u>
Revolving credit agreement, average interest rate of 6.18%.....	\$ 12,000	\$ -
Various promissory notes payable in annual installments of an aggregate of \$333 plus accrued interest through September 6, 2010, interest accrues at 8.25% per annum.....	1,000	-
Promissory note payable in quarterly installments of \$73 plus accrued interest through November 17, 2009, interest accrues at 7.5% per annum.....	658	877
Promissory note payable in quarterly installments of \$42 plus accrued interest through May 18, 2008, interest accrues at 6% per annum.....	125	250
Promissory note payable in quarterly installments of \$26 plus accrued interest through December 19, 2008, interest accrues at 5.75% per annum.....	155	232
	<u>13,938</u>	<u>1,359</u>
Less current portion.....	(854)	(562)
	<u>\$ 13,084</u>	<u>\$ 797</u>

Effective August 27, 2007, the Company entered into the Credit Agreement with a commitment for a \$30,000,000 revolving credit agreement. The Credit Agreement can be increased to \$50,000,000 subject to certain terms and conditions. The Credit Agreement has a four year term, is unsecured and includes standard financial covenants. Proceeds from the Credit Agreement may be used to finance acquisitions, working capital, capital expenditures and for other corporate purposes. Interest expense on borrowings is based on a pricing grid tied to the Company's overall financial leverage with the applicable spread over LIBOR ranging from .5% to 1.5%. There are fees under the Credit Agreement including a closing fee of .25% and an unused commitment fee ranging from .1% to .35% depending on financial leverage and the amount of funds outstanding under the agreement.

In connection with the STAR Acquisition, the Company incurred notes payable in the aggregate totaling \$1,000,000 payable in equal annual installments of totaling \$333,333 beginning September 6, 2008 plus any accrued and unpaid interest. Interest accrues at a fixed rate of 8.25% per annum. The remaining principal and any accrued and unpaid interest then outstanding is due and payable on September 6, 2010. Any funds due to the Company related to the working capital adjustment pursuant to the Purchase Agreement will reduce the notes payable.



In connection with the Arizona Acquisition, the Company incurred a note payable in the amount of \$877,500, payable in equal quarterly principal installments of \$73,125 beginning March 1, 2007 plus any accrued and unpaid interest. Interest accrues at a fixed rate of 7.5% per annum. The remaining principal and any accrued and unpaid interest then outstanding is due and payable on November 17, 2009.

In connection with the acquisition of three physical and occupational therapy clinics located in New Jersey on May 18, 2005, the Company incurred a note payable in the amount of \$500,000, payable in equal quarterly principal installments of \$41,667 beginning September 1, 2005 plus any accrued and unpaid interest. Interest accrues at a fixed rate of 6% per annum. All outstanding principal and any accrued and unpaid interest then outstanding is due and payable on May 18, 2008.

In connection with the acquisition of two physical therapy clinics located in Alaska on December 19, 2005, the Company incurred a note payable in the amount of \$309,710, payable in equal quarterly principal installments of \$25,809 beginning April 1, 2006 plus any accrued and unpaid interest. Interest accrues at a fixed rate of 5.75% per annum. All outstanding principal and any accrued and unpaid interest then outstanding is due and payable on December 19, 2008.

Aggregate annual payments of principal pursuant to the above notes payable required subsequent to September 30, 2007 are as follows (in thousands):

During the twelve months ended September 30, 2007.....	\$	854
During the twelve months ended September 30, 2008.....		678
During the twelve months ended September 30, 2009.....		406
During the twelve months ended September 30, 2010.....		-
During the twelve months ended September 30, 2011.....		12,000
		<u>\$ 13,938</u>

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

### EXECUTIVE SUMMARY

#### Our Business

We operate outpatient physical and occupational therapy clinics that provide preventive, curative and post-operative care for a variety of orthopedic-related disorders and sports-related injuries, treatment for neurologically-related injuries and rehabilitation of injured workers. At September 30, 2007, we operated 346 outpatient physical and occupational therapy clinics in 42 states. Of these operating clinics, we have developed 276 and acquired 70. During the third quarter of 2007, we added two new clinics that we developed, acquired 52 clinics and closed six. To date, we have opened 369 facilities, acquired 71 clinics, sold seven clinics, closed 83 facilities and consolidated four clinics with other existing clinics. The average age of our clinics at September 30, 2007 was 5.5 years.

The results of operations of STAR have been included in our consolidated financial statements since September 1, 2007, the effective date of the STAR Acquisition.

In addition to our owned clinics, we also manage physical therapy facilities for third parties, primarily physicians, with 10 third-party facilities under management as of September 30, 2007.

#### Selected Operating and Financial Data

During 2006, we closed 31 unprofitable clinics. In accordance with current accounting literature, the results of operations and closure costs for these 31 clinics and the results of operations for one clinic sold in 2006 are presented as discontinued operations for all periods presented, net of the tax benefit. In addition, the prior period financial statements have been reclassified to conform with the current year presentation of reporting all earnings allocated to the minority interests limited partners within the line item in the statement of net income entitled – minority interests in subsidiary limited partnerships.

The following table reconciles the amounts previously reported to the amounts reported in these financial statements by major line item for the statements of net income and cash flows for the three and nine months ended September 30, 2006:

	Three Months Ended September 30, 2006			Nine Months Ended September 30, 2006		
	As Previously Reported (1)	Reclasses	As Reclassed	As Previously Reported (1)	Reclasses	As Reclassed
<b>Statement of Net Income</b>						
Net revenue.....	\$ 33,184	\$ (59) (2)	\$ 33,125	\$ 101,430	\$ (173) (2)	\$ 101,257
Clinic operating costs.....	25,058	(377) (3)	24,681	75,169	(1,056) (4)	74,113
Corporate office costs.....	4,136		4,136	13,138		13,138
Operating income from continuing operations.....	3,990		4,308	13,123		14,006
Interest and investment income, net.....	102		102	269		269
Loss in unconsolidated joint venture.....	-		-	(31)		(31)
Minority interest in subsidiary limited partnerships.....	(1,043)	(334)	(1,377)	(3,429)	(926)	(4,355)
Income before income taxes from continuing operations.....	3,049		3,033	9,932		9,889
Provision for income taxes.....	1,165	(6)	1,159	3,806	(24)	3,782
Net income from continuing operations.....	1,884		1,874	6,126		6,107
(Loss) income from discontinued operations, net of tax.....	(1,332)	10	(1,322)	(1,934)	19	(1,915)
Net income.....	\$ 552	\$ -	\$ 552	\$ 4,192	\$ -	\$ 4,192
<b>Statement of Cash Flows</b>						
Net cash provided by operating activities.....				\$ 13,944	\$ 692 (5)	\$ 14,636
Net cash used in investing activities.....				(4,043)	-	(4,043)
Net cash used in financing activities.....				(7,914)	(692) (6)	(8,606)
Net increase in cash and cash equivalents.....				1,987	-	1,987
Cash and cash equivalents - beginning of period.....				12,352		12,352
Cash and cash equivalents - end of period.....				\$ 14,339	\$ -	\$ 14,339

Footnotes on following page.

- (1) As previously reported in the Company's Form 10Q for the quarterly period ended September 30, 2006.
- (2) Includes revenues related to clinic sold in the fourth quarter of 2006.
- (3) Includes minority interests in subsidiary limited partnerships previously reported as clinic operating costs - salaries and related costs of \$310,000 and costs related to Discontinued Operations of \$67,000.
- (4) Includes minority interests in subsidiary limited partnerships previously reported as clinic operating costs - salaries and related costs of \$897,000 and costs related to Discontinued Operations of \$159,000.
- (5) Includes increase in minority interests in subsidiary limited partnerships previously reported as clinic operating costs - salaries and related costs of \$897,000 offset by change in compensation liability of \$205,000. For clinic partnerships formed after January 18, 2001, earnings allocated to minority interests in subsidiary limited partnerships that were accrued and not paid were previously included in other liabilities and the net change was included in net cash provided by operating activities in the statement of cash flows.
- (6) Represents distribution paid to minority limited partners for Clinic Partnerships formed after January 18, 2001.

The following table and discussion relates to continuing operations unless otherwise noted. Mature Clinics in the following discussion relates to clinics opened or acquired before October 1, 2006 and not closed in 2006.

The following table presents selected operating and financial data that we believe are key indicators of our operating performance.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2007	2006	2007	2006
Number of clinics, at the end of period.....	346	281	346	281
Working Days.....	63	63	191	191
Average visits per day per clinic.....	19.6	19.6	19.3	20.2
Total patient visits.....	381,452	340,335	1,108,252	1,029,244
Net patient revenue per visit.....	\$ 96.75	\$ 96.39	\$ 95.97	\$ 96.93
Statement of operations per visit:				
Net revenues.....	\$ 98.19	\$ 97.33	\$ 97.03	\$ 98.38
Salaries and related costs.....	51.33	50.40	50.14	50.46
Rent, clinic supplies, contract labor and other.....	21.44	20.38	20.97	20.03
Provision for doubtful accounts.....	1.81	1.74	1.56	1.52
Contribution from clinics.....	23.61	24.81	24.36	26.37
Corporate office costs.....	11.04	12.15	11.46	12.76
Operating income from continuing operations.....	\$ 12.57	\$ 12.66	\$ 12.90	\$ 13.61

## RESULTS OF OPERATIONS

### Three Months Ended September 30, 2007 Compared to the Three Months Ended September 30, 2006

- Net revenues increased to \$37.5 million for the three months ended September 30, 2007 (“2007 Third Quarter”) from \$33.1 million for the three months ended September 30, 2006 (“2006 Third Quarter”) due to a 13.1% increase in patient visits from 340,000 to 381,000 and a \$0.36 increase from \$96.39 to \$96.75 in net patient revenue per visit. The 2007 figures include one month of results for the STAR clinics acquired in September 2007.
- Net income, inclusive of discontinued operations, for the 2007 Third Quarter was \$2.1 million versus \$0.6 million for the same period last year. Net income, inclusive of discontinued operations, was \$0.18 per diluted share for the 2007 Third Quarter as compared to \$0.05 per diluted share for the 2006 Third Quarter. The 2007 Third Quarter includes a loss from discontinued operations of \$12,000, versus \$1.3 million, or \$0.11 per diluted share for the 2006 Third Quarter. Total diluted shares were 11.7 million for the 2007 Third Quarter and 11.8 million for the 2006 Third Quarter.

## **Net Patient Revenues**

- Net patient revenues increased to \$36.9 million for the 2007 Third Quarter from \$32.8 million for the 2006 Third Quarter, an increase of \$4.1 million, or 12.5%, due to a 12.1% increase in patient visits to 381,000 and a slight increase of \$0.36 in net patient revenues per visit to \$96.75 from \$96.39.
- Total patient visits increased 41,000, or 12.1%, to 381,000 for the 2007 Third Quarter from 340,000 for the 2006 Third Quarter. The growth in visits was attributable to an increase of approximately 43,000 visits in clinics opened or acquired between October 1, 2006 and September 30, 2007 ("New Clinics") offset by a slight decrease of 2,000 for Mature Clinics.
- The \$4.1 million net patient revenues increase for the 2007 Third Quarter included approximately \$4.3 million from New Clinics (of which \$3.4 million related to the clinics acquired in November 2006 and September 2007) offset by a decrease of \$0.2 million in net patient revenues from Mature Clinics. The \$0.2 million decrease for Mature Clinics included a \$1.2 million decrease for clinics opened prior to January 1, 2006 (excluding those clinics closed in 2006) which was offset by a \$1.0 million increase for clinics opened in the first nine months of 2006.

Net patient revenues are based on established billing rates less allowances and discounts for patients covered by contractual programs and workers' compensation. Net patient revenues are after contractual and other adjustments relating to patient discounts from certain payors. Payments received under these programs are based on predetermined rates and are generally less than the established billing rates of the clinics.

## **Clinic Operating Costs**

Clinic operating costs as a percent of net revenues were 76.0% for the 2007 Third Quarter and 74.5% for the 2006 Third Quarter. Without the results of the STAR clinics, clinic operating costs as a percent of net revenues were 75.1% for the 2007 Third Quarter.

### **Clinic Operating Costs - Salaries and Related Costs**

Salaries and related costs increased to \$19.6 million for the 2007 Third Quarter from \$17.1 million for the 2006 Third Quarter, an increase of \$2.4 million, or 14.1%. Of the \$2.4 million increase, costs of \$2.6 million were incurred at the New Clinics offset by a reduction of \$0.2 million at the Mature Clinics. Salaries and related costs as a percentage of net revenues were at 52.0% for the 2007 Third Quarter and 2006 Third Quarter.

### **Clinic Operating Costs - Rent, Clinic Supplies, Contract Labor and Other**

Rent, clinic supplies, contract labor and other increased to \$8.2 million for the 2007 Third Quarter from \$6.9 million for the 2006 Third Quarter, an increase of \$1.3 million, or 17.9%. Approximately \$1.1 million was incurred at the New Clinics and \$0.2 million was incurred at the Mature Clinics. Rent, clinic supplies, contract labor and other as a percentage of net revenues was 21.8% for the 2007 Third Quarter and 20.9% for the 2006 Third Quarter.

### **Clinic Operating Costs - Provision for Doubtful Accounts**

The provision for doubtful accounts was \$0.7 million for the 2007 Third Quarter and \$0.6 million for the 2006 Third Quarter. The provision for doubtful accounts as a percentage of net patient revenues was 1.8% for the 2007 and 2006 Third Quarter. Excluding the patient accounts receivable acquired in the STAR Acquisition, our allowance for bad debts as a percent of total patient accounts receivable was 7.9% at September 30, 2007, as compared to 6.8% at December 31, 2006. Our days sales outstanding was 56 days at September 30, 2007 and 55 days at December 31, 2006.

## **Corporate Office Costs**

Corporate office costs, consisting primarily of salaries and benefits of corporate office personnel, rent, insurance costs, depreciation and amortization, travel, legal, professional, and recruiting fees, were \$4.2 million, or 11.2% of net revenues, for the 2007 Third Quarter and \$4.1 million, or 12.5% of net revenues for the 2006 Third Quarter.

## **Interest and investment income**

Interest and investment income decreased to \$87,000 for the 2007 Third Quarter from \$111,000 for the 2006 Third Quarter primarily attributable to funds being used in September to fund the STAR Acquisition.

## **Interest expense**

Interest expense increased to \$84,000 for the 2007 Third Quarter from \$9,000 for the 2006 Third Quarter primarily due to the \$12.0 million in borrowings in September 2007 primarily in conjunction with the STAR Acquisition on its revolving credit agreement. See Liquidity and Capital Resources section below for a discussion of the terms of the Credit Agreement.

## **Minority Interests in Earnings of Subsidiary Limited Partnerships**

Minority interests in earnings of subsidiary limited partnerships remained at approximately \$1.4 million for the 2007 and 2006 Third Quarters. Minority interest as a percentage of operating income before corporate office costs decreased to 15.2% for the 2007 Third Quarter as compared to 16.3% for the 2006 Third Quarter.

## **Provision for Income Taxes**

The provision for income taxes increased to \$1.3 million for the 2007 Third Quarter from \$1.2 million for the 2006 Third Quarter. During the 2007 Third Quarter, we accrued state and federal income taxes at an effective tax rate of 37.8% versus 38.2% for the 2006 Third Quarter.

## **Loss from Discontinued Operations**

During 2006, we closed 31 clinics and sold one. For those clinics, we incurred \$12,000, net of tax benefit, in additional closure costs during the 2007 Third Quarter and incurred closure costs and loss from operations from those clinics of \$1.3 million, net of tax benefit, during the 2006 Third Quarter. The operating results of the nine clinics closed in 2007 were not material to our operations, and therefore, the results of these clinics were not classified and reported as discontinued operations.

## **Nine Months Ended September 30, 2007 Compared to the Nine Months Ended September 30, 2006**

- Net revenues increased to \$107.5 million for the nine months ended September 30, 2007 (“2007 Nine Months”) from \$101.3 million for the nine months ended September 30, 2006 (“2006 Nine Months”) due to a 7.7% increase in patient visits from 1,029,000 to 1,108,000 which was partially offset by a \$0.97 decrease from \$96.93 to \$95.96 in net patient revenue per visit. As previously noted, the 2007 figures include one month of results for the STAR clinics acquired in September 2007.
- Net income, inclusive of discontinued operations, for the 2007 Nine Months was \$6.3 million versus \$4.2 million for the 2006 Nine Months. Net income, inclusive of discontinued operations, was \$0.54 per diluted share for the 2007 Nine Months as compared to \$0.35 for the 2006 Nine Months. The net income for the 2007 Nine Months includes a loss from discontinued operations, net of tax benefit, of \$81,000, versus \$1.9 million, or \$0.16 per diluted share, for the 2006 Nine Months. Total diluted shares were 11.7 million for the 2007 Nine Months and 11.9 million for the 2006 Nine Months.

## **Net Patient Revenues**

- Net patient revenues increased to \$106.4 million for the 2007 Nine Months from \$99.8 million for the 2006 Nine Months, an increase of \$6.6 million, or 6.6%, due to a 7.7% increase in patient visits to 1,108,000 which was offset partially by a \$0.97 decrease in net patient revenues per visit to \$95.96 from \$96.93.
- Total patient visits increased 79,000, or 7.7%, to 1,108,000 for the 2007 Nine Months from 1,029,000 for the 2006 Nine Months. The growth in visits was attributable to an increase of approximately 75,000 visits in New Clinics and 4,000 for Mature Clinics. The visits for Mature Clinic were affected adversely due to weakness in the Michigan market as the rest of our operations achieved a 2.2% increase in same store visits.
- The \$6.6 million net patient revenues increase for the 2007 Nine Months included approximately \$7.6 million from New Clinics (of which \$6.1 million related to the clinics acquired in November 2006 and September 2007) offset by a decrease of \$1.0 million in net patient revenues from Mature Clinics. The \$1.0 million decrease for Mature Clinics included a \$5.0 million decrease related to clinics opened prior to January 1, 2006 (excluding those clinics closed in 2006) which was offset by a \$4.0 million increase related to clinics opened in the first nine months of 2006. This decrease is primarily due to the reduction in reimbursement rate by Medicare for outpatient rehabilitation and the weakness in the Michigan market during the first half of 2007.

Net patient revenues are based on established billing rates less allowances and discounts for patients covered by contractual programs and workers’ compensation. Net patient revenues are after contractual and other adjustments

relating to patient discounts from certain payors. Payments received under these programs are based on predetermined rates and are generally less than the established billing rates of the clinics.

### **Clinic Operating Costs**

Clinic operating costs as a percent of net revenues were 74.9% for the 2007 Nine Months and 73.2% for the 2006 Nine Months.

#### **Clinic Operating Costs - Salaries and Related Costs**

Salaries and related costs increased to \$55.6 million for the 2007 Nine Months from \$51.9 million for the 2006 Nine Months, an increase of \$3.6 million, or 7.0%. Of the \$3.6 million increase, costs of \$4.1 million were incurred at the New Clinics offset by a decrease of \$0.5 million at the Mature Clinics. Salaries and related costs as a percentage of net revenues were 51.7% for the 2007 Nine Months and 51.3% for 2006 Nine Months.

#### **Clinic Operating Costs - Rent, Clinic Supplies, Contract Labor and Other**

Rent, clinic supplies, contract labor and other increased to \$23.2 million for the 2007 Nine Months from \$20.6 million for the 2006 Nine Months, an increase of \$2.6 million, or 12.7%. Of the \$2.6 million increase, approximately \$2.0 million was incurred at the New Clinics and \$0.6 million was incurred at the Mature Clinics. Mature clinics opened in the first nine months of 2006 represented an increase of \$0.8 million whereas the Mature Clinics opened or acquired prior to January 1, 2006 experienced a decrease of \$0.2 million. Rent, clinic supplies, contract labor and other as a percentage of net revenues was 21.6% for the 2007 Nine Months and 20.4% for the 2006 Nine Months.

#### **Clinic Operating Costs - Provision for Doubtful Accounts**

The provision for doubtful accounts was \$1.7 million for the 2007 Nine Months and \$1.6 million for the 2006 Nine Months. The provision for doubtful accounts as a percentage of net patient revenues was 1.6% for the 2007 Nine Months and 1.5% for the 2006 Nine Months. Excluding the patient accounts receivable acquired in the STAR Acquisition, our allowance for bad debts as a percent of total patient accounts receivable was 7.9% at September 30, 2007, as compared to 6.8% at December 31, 2006. Our days sales outstanding was 56 days at September 30, 2007 and 55 days at December 31, 2006.

### **Corporate Office Costs**

Corporate office costs, consisting primarily of salaries and benefits of corporate office personnel, rent, insurance costs, depreciation and amortization, travel, legal, professional, and recruiting fees, were reduced to \$12.7 million, or 11.8% of net revenues, for the 2007 Nine Months from \$13.1 million, or 13.0% of net revenues, for the 2006 Nine Months. The \$0.4 million decrease is primarily due to lower salaries and related costs due to a reduction in workforce which occurred in the second half of 2006.

### **Interest and investment income**

Interest and investment income decreased to \$252,000 for the 2007 Nine Months from \$301,000 for the 2006 Nine Months primarily to funds being used in September to fund the STAR Acquisition.

### **Interest expense**

Interest expense increased to \$135,000 for the 2007 Nine Months from \$32,000 for the 2006 Nine Months primarily due to the \$12.0 million in borrowings in September 2007 on our revolving credit agreement. See Liquidity and Capital Resources section below for a discussion of the terms of the Credit Agreement.

## **Minority Interests in Earnings of Subsidiary Limited Partnerships**

Minority interests in earnings of subsidiary limited partnerships decreased to \$4.2 million for the 2007 Nine Months from \$4.4 million for the 2006 Nine Months. Minority interest as a percentage of operating income before corporate office costs decreased to 15.4% for the 2007 Nine Months as compared to 16.0% for the 2006 Nine Months. Subsequent to September 30, 2006, we purchased the limited partnership minority interest in nine Clinic Partnerships.

## **Provision for Income Taxes**

The provision for income taxes was \$3.9 million for the 2007 Nine Months and \$3.8 million for the 2006 Nine Months. During the 2007 Nine Months, we accrued state and federal income taxes at an effective tax rate of 38.3% versus 38.2% for the 2006 Nine Months.

## **Loss from Discontinued Operations**

During 2006, we closed 31 clinics and sold one. For those clinics, we incurred \$81,000, net of tax benefit, in additional closure costs during the 2007 Nine Months, which were primarily related to additional allowance for doubtful accounts. During the 2006 Nine Months, we incurred closure costs and loss from operations from those clinics of \$1.9 million, net of tax benefit. The operating results of the nine clinics closed in 2007 were not material to our operations, and therefore, the results of these clinics were not classified and reported as discontinued operations.

## **LIQUIDITY AND CAPITAL RESOURCES**

We believe that our business is generating sufficient cash flow from operating activities to allow us to meet our short-term and long-term cash requirements, other than with respect to future acquisitions. At September 30, 2007, we had \$9.6 million in cash and cash equivalents compared to \$11.5 million in cash, cash equivalents and marketable securities at December 31, 2006. Although the start-up costs associated with opening new clinics, and our planned capital expenditures are significant, we believe that our cash and cash equivalents and availability on our revolving credit agreement are sufficient to fund the working capital needs of our operating subsidiaries, payment of clinic closure costs accrued, future clinic development and investments through at least September 2008. Significant acquisitions would likely require financing. Included in cash and cash equivalents at September 30, 2007 were \$4.5 million in a money market fund.

Cash, cash equivalents and marketable securities decreased \$1.9 million from December 31, 2006 to September 30, 2007 due primarily to cash used for the STAR Acquisition (\$18.9 million). Other major uses of cash included: purchase of fixed assets (\$2.8 million), purchase of intangibles – limited partner interests (\$0.5 million), distributions to limited partners (\$4.3 million) and payment on notes payable (\$0.4 million). During the 2007 Nine Months cash of \$12.4 million was provided by operations and \$619,000 by proceeds from exercise of stock options.

Effective August 27, 2007, we entered into the Credit Agreement with a commitment for a \$30.0 million revolving credit agreement. The Credit Agreement can be increased to \$50.0 million subject to certain terms and conditions. The Credit Agreement has a four year term, is unsecured and includes standard financial covenants. Proceeds from the Credit Agreement may be used to finance acquisitions, working capital, capital expenditures and for other corporate purposes. Interest expense on borrowings is based on a pricing grid tied to our overall financial leverage with the applicable spread over LIBOR ranging from .5% to 1.5%. There are fees under the Credit Agreement including a closing fee of .25% and an unused commitment fee ranging from .1% to .35% depending on financial leverage and the amount of funds outstanding under the agreement. The prior credit agreement for \$15.0 million was terminated in September 2007.

Historically, we have generated sufficient cash from operations to fund our development activities and cover operational needs. We plan to continue developing new clinics and make additional acquisitions in select markets. We have from time to time purchased the minority interests of limited partners in our clinic partnerships. We may purchase additional minority interests in the future. Generally, any acquisition or purchase of minority interests is expected to be accomplished using a combination of cash and financing. Any large acquisition would likely require financing.

We makes reasonable and appropriate efforts to collect its accounts receivable, including applicable deductible and co-payment amounts, in a consistent manner for all payor types. Claims are submitted to payors daily, weekly or monthly in accordance with our policy or payor's requirements. When possible, we submit our claims electronically. The collection process is time consuming and typically involves the submission of claims to multiple payors whose payment of claims may be dependent upon the payment of another payor. Claims under litigation and vehicular incidents can take a year or longer to collect. Medicare and other payor claims relating to new clinics awaiting Medicare Rehab Agency status approval initially may not be submitted for six to 12 months. When all reasonable internal collection efforts have been exhausted, accounts are written off prior to sending them to outside collection firms. With managed care, commercial

health plans and self-pay payor type receivables, the write-off generally occurs after the account receivable has been outstanding for 120 days.

In connection with the STAR Acquisition, we incurred notes payable in the aggregate totaling \$1,000,000 payable in equal annual installments totaling \$333,333 beginning September 6, 2008 plus any accrued and unpaid interest. Interest accrues at a fixed rate of 8.25% per annum. The remaining principal and any accrued and unpaid interest then outstanding is due and payable on September 6, 2010. In addition, we assumed leases with remaining terms ranging from 2 months to 6 years for the operating facilities. Any funds due to us related to the working capital adjustment pursuant to the Purchase Agreement will be deducted from the notes payable.

In conjunction with the acquisition of an eight-clinic practice in Arizona in November 2006, we entered into a note payable with the sellers in the amount of \$877,500 payable in equal quarterly principal installments of \$73,125, beginning March 1, 2007, plus any accrued and unpaid interest. Interest accrues at a fixed rate of 7.5% per annum. The remaining principal and any accrued and unpaid interest then outstanding is due and payable on the third anniversary of the note, November 17, 2009. The purchase agreement also provides for possible contingent consideration of up to \$1,500,000 based on the achievement of a certain designated level of operating results within a three-year period following the acquisition. In addition, we assumed leases with remaining terms ranging from one to five years for six of the eight operating facilities. With respect to the two remaining leased facilities, one is being leased on a month-to-month basis and the other was renewed for three years effective February 1, 2007.

In conjunction with the acquisition of the two-clinic practice in Alaska in December 2005, we entered into a note payable with the sellers in the amount of \$309,710 payable in equal quarterly principal installments of \$25,809, beginning April 1, 2006, plus any accrued and unpaid interest. Interest accrues at a fixed rate of 5.75% per annum. All outstanding principal and any accrued and unpaid interest then outstanding is due and payable on the third anniversary of the note, December 19, 2008. The purchase agreement also provides for possible contingent consideration of up to \$325,000 based on the achievement of a certain designated level of operating results within a three-year period following the acquisition. In addition, we entered into a five-year lease for one of the facilities and assumed a lease expiring September 30, 2009 on the other facility.

In conjunction with the acquisition of the three-clinic practice in New Jersey in May 2005, we entered into a note payable with the sellers in the amount of \$500,000 payable in equal quarterly principal installments of \$41,667, beginning September 1, 2005, plus any accrued and unpaid interest. Interest accrues at a fixed rate of 6% per annum. All outstanding principal and any accrued and unpaid interest then outstanding is due and payable on the third anniversary of the note, May 18, 2008. The purchase agreement also provides for possible contingent consideration of up to \$650,000 based on the achievement of a certain designated level of operating results within a three-year period following the acquisition. In addition, we entered into a five-year lease for each of the three facilities. In July 2006, we paid \$90,000 additional consideration related to this acquisition upon achievement of the predefined operating results for the first year, and such amount was added to goodwill.

Since September 2001, the Board of Directors ("Board") has authorized us to purchase, in the open market or in privately negotiated transactions, up to 2,250,000 shares of its common stock. As of September 30, 2007, there were approximately 50,000 shares remaining that could be purchased under these programs. Since there is no expiration date for these share repurchase programs, additional shares may be purchased from time to time in the open market or private transactions depending on price, availability and our cash position. Shares purchased are held as treasury shares and may be used for such valid corporate purposes or retired as the Board considers advisable. We did not purchase any shares of our common stock during the 2007 Nine Months.

## **FACTORS AFFECTING FUTURE RESULTS**

### *Clinic Development*

As of September 30, 2007, we had 346 clinics in operation, two of which were opened in the 2007 Third Quarter and 51 of which were acquired in the 2007 Third Quarter. We expect to incur initial operating losses from new clinics opened in 2007. Generally, we experience losses during the initial period of a new clinic's operation. Operating margins for newly opened clinics tend to be lower than for more seasoned clinics because of start-up costs and lower patient visits and revenues. Patient visits and revenues typically gradually increase in the first year of operation, as patients and referral sources become aware of the new clinic. Revenues typically continue to increase during the two to three years following the first anniversary of a clinic opening. Based on the historical performance of our new clinics, generally the clinics opened in second half of 2006 would begin to favorably impact our results of operations beginning in late 2007.



## FORWARD LOOKING STATEMENTS

We make statements in this report that are considered to be forward-looking statements within the meaning under Section 21E of the Securities Exchange Act of 1934. These statements contain forward-looking information relating to the financial condition, results of operations, plans, objectives, future performance and business of our Company. These statements (often using words such as “believes”, “expects”, “intends”, “plans”, “appear”, “should” and similar words) involve risks and uncertainties that could cause actual results to differ materially from those we project. Included among such statements are those relating to opening new clinics, availability of personnel and the reimbursement environment. The forward-looking statements are based on our current views and assumptions and actual results could differ materially from those anticipated in such forward-looking statements as a result of certain risks, uncertainties, and factors, which include, but are not limited to:

- revenue and earnings expectations;
- general economic, business, and regulatory conditions including federal and state regulations;
- availability and cost of qualified physical and occupational therapists;
- personnel productivity;
- changes in Medicare guidelines and reimbursement or failure of our clinics to maintain their Medicare certification status;
- competitive and/or economic conditions in our markets which may require us to close certain clinics and thereby incur closure costs and losses including the possible write-down or write-off of goodwill;
- changes in reimbursement rates or payment methods from third party payors including governmental agencies and deductibles and co-pays owed by patients;
- maintaining adequate internal controls;
- availability, terms, and use of capital;
- acquisitions and the successful integration of the operations of the acquired businesses; and
- weather and other seasonal factors.

Many factors are beyond our control.

Given these uncertainties, you should not place undue reliance on our forward-looking statements. Please see our other periodic reports filed with the Securities and Exchange Commission (the "SEC") for more information on these factors. Our forward-looking statements represent our estimates and assumptions only as of the date of this report. Except as required by law, we are under no obligation to update any forward-looking statement, regardless of the reason the statement is no longer accurate.

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

We do not maintain any derivative instruments, interest rate swap arrangements, hedging contracts, futures contracts or the like. The Company's primary market risk exposure is the changes in interest rates obtainable on our revolving credit agreement. The interest on our revolving credit agreement is based on a variable rate. Based on the balance of the revolving credit facility at September 30, 2007, any change in the interest rate of 1% would yield a decrease or increase in annual interest expense of \$120,000.

### ITEM 4. CONTROLS AND PROCEDURES.

#### (a) Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, the Company's Management completed an evaluation, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures. Based on this evaluation, our principal executive officer and principal financial officer concluded (i) that our disclosure controls and procedures are designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 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 principal executive officer and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure (ii) that our disclosure controls and procedures are effective.

#### (b) Changes in Internal Control

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

## PART II - OTHER INFORMATION

### ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.

In connection with the STAR Acquisition, the Company issued 227,618 restricted shares of its common stock, representing an aggregate of \$3.1 million based on a price of \$13.72 per share determined on the closing price of its common stock 2 days before and following the announcement of the acquisition. The shares of the Company's common stock were issued in reliance upon exemptions from registration pursuant to Section 4(2) under the Securities Act of 1933, as amended (the "Securities Act").

### ITEM 6. EXHIBITS.

EXHIBIT NO.	DESCRIPTION
10.1	Reorganization and Securities Purchase Agreement dated as of September 6, 2007 between U.S. Physical Therapy, Ltd., STAR Physical Therapy, LP ("STAR LP"), the limited partners of STAR LP, and Regg Swanson as Seller Representative and in his individual capacity (Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on September 7, 2007)
10.2	Credit Agreement, dated as of August 27, 2007 among U. S. Physical Therapy, Inc., as the Borrower, Bank of America, N. A., as Administrative Agent, Swing Line Lender and L/C Issuer, and The Other Lenders Party Hereto (Incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K/A filed with the SEC on September 5, 2007)
31.1*	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
31.2*	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
31.3*	Rule 13a-14(a)/15d-14(a) Certification of Corporate Controller
32*	Certification Pursuant to 18 U.S.C 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* Filed herewith

## SIGNATURES

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

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

Date: November 9, 2007

By: /s/ LAWRANCE W. MCAFEE  
Lawrance W. McAfee  
Chief Financial Officer  
(duly authorized officer and principal financial  
and accounting officer)

By: /s/ JON C. BATES  
Jon C. Bates  
Vice President/Corporate Controller

## INDEX OF EXHIBITS

EXHIBIT NO. -----	DESCRIPTION -----
10.2	Reorganization and Securities Purchase Agreement dated as of September 6, 2007 between U.S. Physical Therapy, Ltd., STAR Physical Therapy, LP (“STAR LP”), the limited partners of STAR LP, and Regg Swanson as Seller Representative and in his individual capacity (Incorporated by reference to Exhibit 10.1 to the Company’s Current Report on Form 8-K filed with the SEC on September 7, 2007)
10.2	Credit Agreement, dated as of August 27, 2007 among U. S. Physical Therapy, Inc., as the Borrower, Bank of America, N. A., as Administrative Agent, Swing Line Lender and L/C Issuer, and The Other Lenders Party Hereto (Incorporated by reference to Exhibit 10.2 to the Company’s Current Report on Form 8-K/A filed with the SEC on September 5, 2007)
31.1*	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
31.2*	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
31.3*	Rule 13a-14(a)/15d-14(a) Certification of Corporate Controller
32*	Certification Pursuant to 18 U.S.C 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* Filed herewith

## EXHIBIT 31.1

### CERTIFICATION

I, Christopher Reading, certify that:

1. I have reviewed this quarterly report on Form 10-Q of U.S. Physical Therapy, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ CHRISTOPHER READING

-----  
Christopher Reading  
President and Chief Executive Officer  
(principal executive officer)

Date: November 9, 2007

## EXHIBIT 31.2

### CERTIFICATION

I, Lawrance W. McAfee, certify that:

1. I have reviewed this quarterly report on Form 10-Q of U.S. Physical Therapy, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ LAWRANCE W. MCAFEE

-----  
Lawrance W. McAfee  
Chief Financial Officer  
(principal financial and accounting officer)

Date: November 9, 2007

### EXHIBIT 31.3

#### CERTIFICATION

I, Jon C. Bates, certify that:

1. I have reviewed this quarterly report on Form 10-Q of U.S. Physical Therapy, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ JON C. BATES

-----  
Jon C. Bates  
Vice President/Corporate Controller

Date: November 9, 2007

**EXHIBIT 32**

**CERTIFICATION OF PERIODIC REPORT**

In connection with the Quarterly Report of U.S. Physical Therapy, Inc. (the "Company") on Form 10-Q for the quarterly period ended September 30, 2007, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Christopher J. Reading, President and Chief Executive Officer of the Company, Lawrance W. McAfee, Chief Financial Officer of the Company, and Jon C. Bates, Vice President and Corporate Controller of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

November 9, 2007

/s/ CHRISTOPHER J. READING

Christopher J. Reading  
Chief Executive Officer

/s/ LAWRANCE W. MCAFEE

Lawrance W. McAfee  
Chief Financial Officer

/s/ JON C. BATES

Jon C. Bates  
Vice President/Corporate Controller

This certification is made solely pursuant to the requirement of Section 1350 of 18 U.S.C., and is not for any other purpose. A signed original of this written statement required by Section 906 has been provided to U. S. Physical Therapy, Inc. and will be retained by U. S. Physical Therapy, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.