

ORTHODONTIC CENTERS OF AMERICA INC /DE/  
Form 10-Q  
August 14, 2002

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2002, 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 No.: 001-13457

ORTHODONTIC CENTERS OF AMERICA, INC.  
(Exact name of registrant as specified in its charter)

Delaware	72-1278948
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

3850 N. CAUSEWAY BOULEVARD, SUITE 800  
METAIRIE, LOUISIANA 70002  
(504) 834-4392

(Address, including zip code, of principal executive offices and Registrant's telephone number, including area code)

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(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

As of August 13, 2002, there were approximately 51,307,000 outstanding shares of the Registrant's Common Stock, \$.01 par value per share.

ORTHODONTIC CENTERS OF AMERICA, INC.

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FORWARD-LOOKING STATEMENTS

Certain statements contained in this Report may not be based on historical facts and are "forward looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements may be identified by reference to a future period(s) or by the use of forward looking terminology, such as "anticipate," "estimate," "believe," "expect," "foresee," "may," "would," "could" or "will." These forward-looking statements include, without limitation, statements regarding the Company's future growth, deferred tax asset, liquidity, capital resources, amendments to existing service agreements, stock repurchases, pending litigation against OrthAlliance, financial merits of the OrthAlliance merger, advances to affiliated practices, repayment or replacement of outstanding indebtedness and impairment of goodwill. We caution you not to place undue reliance on these forward-looking statements, in that they involve certain risks and uncertainties that could cause actual results to differ materially from anticipated results. These risks and uncertainties include potential adverse changes in the Company's financial results and conditions, disruption of the Company's relationships with its affiliated practices or loss of a significant number of the Company's affiliated practices, failure or delay in integrating OrthAlliance's affiliated practices, adverse outcomes of litigation pending against the Company and OrthAlliance, competition, failure or delay in obtaining lender approval of the stock repurchase program, failure to consummate proposed developments or acquisitions, inability to effectively manage an increasing number of affiliated practices, changes in the general economy of the United States and the specific markets in which the Company operates, risks relating to the Company's foreign operations, changes in the Company's operating or expansion strategy, inability of the Company to attract and retain qualified personnel, and affiliated practitioners, inability of the Company to effectively market its services and those of its affiliated practices, changes in regulations affecting the Company's business, inability to obtain alternative financing or to obtain financing on acceptable terms, and other factors identified in the Company's Annual Report on Form 10-K for the year ended December 31, 2001 and from time to time in other filings with the Securities and Exchange Commission or in other public announcements by the Company. We undertake no obligation to update these forward-looking statements to reflect events or circumstances that occur after the date of this Report.

PART I. FINANCIAL INFORMATION
ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

Orthodontic Centers of America, Inc.
Condensed Consolidated Balance Sheets

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June 30,  
2002

(Unaudited)  
(dollars in thousands)

ASSETS:

Current assets:

Cash and cash equivalents .....	\$ 12,825
Service fees receivable, net of allowance for uncollectible amounts .....	79,901
Deferred income taxes .....	5,150
Advances to affiliated practices, net .....	14,690
Supplies inventory .....	8,503
Prepaid expenses and other assets .....	7,775
<b>Total current assets .....</b>	<b>128,844</b>
Property, equipment and improvements, net .....	93,004
Advances to affiliated practices, less current portion, net .....	11,737
Deferred income taxes, less current portion .....	56,791
Intangible assets, net .....	224,395
Goodwill .....	75,572
Other assets .....	7,384
<b>Total assets .....</b>	<b>\$ 597,727</b>

LIABILITIES AND STOCKHOLDERS' EQUITY:

Current liabilities:

Accounts payable .....	\$ 4,725
Accrued salaries and other accrued liabilities .....	13,945
Deferred revenue .....	2,038
Income taxes payable .....	19,611
Service fee prepayments .....	12,693
Amounts payable to affiliated practices .....	1,724
Current portion of notes payable to affiliated practices .....	2,565
<b>Total current liabilities .....</b>	<b>57,301</b>
Notes payable to affiliated practices, less current portion .....	10,264
Long-term debt .....	108,030
Non-controlling interest in subsidiary .....	25

Stockholders' equity:

Preferred stock, \$.01 par value; 10,000,000 shares authorized; no shares outstanding .....	-
Common stock, \$.01 par value per share; 100,000,000 shares authorized; 51,217,000 shares outstanding at June 30, 2002 and 50,914,000 shares outstanding at December 31, 2001 .....	512
Additional paid-in capital .....	211,838
Retained earnings .....	213,291
Accumulated other comprehensive loss .....	(2,802)
Due from key employees for stock purchase program .....	(488)
Capital contribution receivable from stockholders .....	(244)
<b>Total stockholders' equity .....</b>	<b>422,107</b>
<b>Total liabilities and stockholders' equity .....</b>	<b>\$ 597,727</b>

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(1) The consolidated balance sheet at December 31, 2001 has been derived from the Company's audited consolidated financial statements at that date, but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

See notes to condensed consolidated financial statements.

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Orthodontic Centers of America, Inc.  
Condensed Consolidated Statements of Income

	Three months ended June 30,		Six
	2002	2001	2002
	(Unaudited) (in thousands, except per share)		
Fee revenue .....	\$ 113,432	\$ 82,228	\$ 224,75
Direct expenses:			
Employee costs .....	32,079	23,309	63,90
Orthodontic supplies .....	9,550	6,456	19,12
Rent .....	10,064	7,079	20,13
Marketing and advertising .....	7,964	6,457	16,91
Total direct expenses .....	59,657	43,301	120,08
General and administrative .....	14,770	9,150	29,17
Non-recurring recruiting expense .....	12,772	--	12,77
Depreciation and amortization .....	5,839	4,624	11,29
Operating profit .....	20,394	25,153	51,42
Interest income (expense), net .....	(992)	(1,148)	(2,34)
Non-controlling interest in subsidiary .....	7	(190)	3
Income before income taxes .....	19,409	23,815	49,11
Provision for income taxes .....	7,327	8,989	18,54
Net income .....	\$ 12,082	\$ 14,826	\$ 30,57
Net income per share:			
Basic .....	\$ 0.24	\$ 0.30	\$ 0.6
Diluted .....	\$ 0.23	\$ 0.30	\$ 0.5
Average shares outstanding:			
Basic .....	51,188	48,837	51,36
Diluted .....	51,999	50,218	52,17

See notes to condensed consolidated financial statements.

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Orthodontic Centers of America, Inc.  
Condensed Consolidated Statements of Cash Flows

	Six m J ----- 2002 ----- ( (in
Operating activities:	
Net income .....	\$ 30,576
Adjustments to reconcile net income to net cash provided by operating activities:	
Provision for bad debt expense .....	2,271
Depreciation and amortization .....	11,294
Deferred income taxes .....	(873)
Non-recurring recruiting expense .....	4,771
Non-controlling interest in subsidiary .....	(31)
Changes in operating assets and liabilities:	
Service fee receivables and prepayments .....	(22,970)
Supplies inventory .....	340
Prepaid expenses and other .....	(2,021)
Amounts payable to affiliated practices .....	(1,394)
Accounts payable and other current liabilities .....	7,565
Net cash provided by operating activities .....	29,528
Investing activities:	
Purchases of property, equipment and improvements .....	(7,069)
Intangible assets acquired .....	(5,276)
Proceeds from available-for-sale investments .....	--
Payments received on management agreements .....	1,284
Advances to affiliated practices, net .....	(8,149)
Net cash used in investing activities .....	(19,210)
Financing activities:	
Repayment of notes payable to affiliated practices .....	(2,774)
Repayment of long-term debt .....	(10,000)
Proceeds from long-term debt .....	--
Issuance of common stock .....	2,892
Net cash (used in) provided by financing activities .....	(9,882)
Effect of exchange rate changes on cash and cash equivalents .....	(1,783)
Change in cash and cash equivalents .....	(1,347)
Cash and cash equivalents at beginning of period .....	14,172
Cash and cash equivalents at end of period .....	\$ 12,825
Supplemental cash flow information: Cash paid during period for:	
Interest .....	\$ 1,955
Income taxes .....	\$ 233

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Supplemental disclosures of non-cash investing and financing activities:

Notes payable and common stock issued  
to obtain Service Agreements .....

\$ 835  
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See notes to condensed consolidated financial statements.

Orthodontic Centers of America, Inc.

Notes to Condensed Consolidated Financial Statements (Unaudited)

June 30, 2002

1. DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Orthodontic Centers of America, Inc. (the "Company") provides integrated business services to orthodontic and pediatric dental practices throughout the United States and in Japan, Mexico, Puerto Rico and Spain.

The Company provides business operations, financial, marketing and administrative services to orthodontic practices and pediatric dental practices. These services are provided under service, management service and consulting agreements (hereinafter referred to as "Service Agreements") with orthodontists or pediatric dentists and/or their wholly-owned professional entities (hereafter referred to as "Affiliated Practices"). Because the Company does not control the Affiliated Practices, it does not consolidate their financial results.

The Company's consolidated financial statements include service fees earned under the Service Agreements and the expenses of providing the Company's services, which generally includes all expenses of the Affiliated Practices except for the practitioners' compensation and certain expenses directly related to the Affiliated Practices, such as professional insurance coverage.

Certain reclassifications have been made to the prior period's financial statements in order to conform to the current period's presentation.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. Operating results for the three- and six-month periods ended June 30, 2002 are not necessarily indicative of the results that may be expected for the year ending December 31, 2002. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2001.

2. REVENUE RECOGNITION

Fee revenue consists of service fees earned by the Company under the Service Agreements. Effective January 1, 2000, the Company changed its method of revenue recognition for service fees earned under its Service Agreements. Fee revenue is generally recognized as service fees are contractually due under the Company's Service Agreements, except that recognition of a portion of the service fees is deferred because patient contract revenue is calculated on a straight-line basis

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over the term of the patient contracts (which, for orthodontic patients, average about 26 months), and are reduced by amounts retained or to be retained by Affiliated Practices.

Amounts retained or to be retained by an Affiliated Practice equal the Affiliated Practice's proportionate share of the portion of that straight-line allocation of patient contract revenue that is collected during the relevant period, and the patient receivables that represent the uncollected portion of that straight-line allocation of patient contract revenue. Amounts retained or to be retained are reduced by any operating losses, depreciation, interest on outstanding loans, bad debt or other expenses that the Company has incurred but for which it has not been reimbursed by the Affiliated Practice; however, these unreimbursed expenses reduce amounts retained by an Affiliated Practice only up to the amounts that would otherwise be retained by the Affiliated Practice. Any remaining unreimbursed expenses would reduce amounts retained or to be retained

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by the Affiliated Practice in subsequent periods. For the Company's general form of Service Agreements (under which service fees are generally determined, at least in part, based upon a percentage of practice operating profit), the amounts retained or to be retained by an Affiliated Practice are estimated using the percentage of practice operating profits that may be retained by the Affiliated Practice under the Service Agreement. For Service Agreements of OrthAlliance, Inc. ("OrthAlliance"), which was acquired by the Company in November 2001, under which service fees are generally determined, at least in part, based upon a percentage of practice revenue and reimbursement of practice related expenses, amounts retained or to be retained by an Affiliated Practice are estimated using the percentage of practice revenue that may be retained by the Affiliated Practice under the terms of the Service Agreement, minus the estimated amount of practice related expenses for which OrthAlliance may be reimbursed under the Service Agreement.

Many of OrthAlliance's Affiliated Practices require that their patients pay a down payment of approximately 25% of the total treatment fee at the commencement of treatment. This results in the Company receiving cash in advance of incurring certain practice related expenses and recognizing certain service fees as fee revenue, which are deferred and recorded as service fee prepayments. Service fee prepayments represent cash received in excess of service fees that have been recognized as fee revenue, less an estimate of the portion of that cash that the applicable Affiliated Practice is to retain and practice related expenses that have not yet been incurred.

Most of the Affiliated Practices pledge their billed and unbilled patient fees receivable to the Company as collateral for the Company's service fees. The Company is generally responsible for billing and collection of the patient fees receivable, which are conducted in the name of the applicable Affiliated Practice. Collections from patient fees receivable are generally deposited into depository bank accounts that the Company establishes and maintains.

The Company generally collects its service fees receivable from funds that are collected from patient fees receivable and deposited into depository bank accounts. This results in deferral of collection of a portion of the Company's service fees receivable until the related patient fees receivable that have been pledged to the Company are collected and the funds are deposited into a depository bank account. This deferral is generally for a period that averages less than 90 days, as patient fees receivable are generally collected within that period of time. The Company does not generally charge Affiliated Practices any interest on these deferred balances of service fees receivable. For newly-developed centers (which typically generate operating losses during their

first 12 months of operations), the Company generally defers payment of a portion of its service fees relating to unreimbursed expenses over a five-year period that generally commences in the second year of the center's operations, and charges the Affiliated Practices interest on those deferred amounts at market rates. Under the Company's revenue recognition policy, those unreimbursed expenses are not recognized as revenue or recorded as service fees receivable until such revenue is collateralized by patient fees receivable pledged by Affiliated Practices. Pledged patient fees receivable which prove to be uncollectible have the effect of reducing the amount of service fees receivable collected by the Company.

In some cases, the Company assists Affiliated Practices in obtaining financing for their share of operating expenses by providing a guaranty of loans from a third-party lender. Information about amounts guaranteed by the Company is provided in "ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS - LIQUIDITY AND CAPITAL RESOURCES."

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3. INTANGIBLE ASSETS

The Company generally affiliates with an existing orthodontic or pediatric dental practice by acquiring substantially all of the non-professional assets of the practice, either directly or indirectly through a stock purchase, and entering into a Service Agreement with the orthodontist or pediatric dentist and/or his or her professional corporation or other entity (the "Affiliated Practice"). The acquired assets generally consist of equipment, furniture, fixtures and leasehold interests. The Company records these acquired tangible assets at their fair value as of the date of acquisition, and depreciates or amortizes the acquired assets using the straight-line method over their useful lives. The remainder of the purchase price is allocated to an intangible asset, which represent the costs of obtaining the Service Agreement through which the Company obtains the exclusive right to provide business operations, financial, marketing and administrative services to the Affiliated Practice during the term of the Service Agreement. The Service Agreements generally provide that the professional corporation or entity is responsible for providing orthodontic or pediatric dental services and for employing all orthodontists or pediatric dentists. The terms of the Service Agreements range from 20 to 40 years, with most ranging from 20 to 25 years. In many cases, the Affiliated Practice has the option to terminate the Service Agreement, upon written notice, after a certain length of time as prescribed in the Service Agreement. In the event the Affiliated Practice terminates its affiliation with the Company, it generally is required to purchase all of the related assets, including the unamortized portion of intangible assets, at the current book value or sell its interests in the practice to another licensed orthodontist or pediatric dentist who agrees to assume the obligations under the Service Agreement.

Subsequent to affiliation, an Affiliated Practice may acquire an existing practice, center or patient base, and the Company may pay consideration to the Affiliated Practice to amend its Service Agreement to extend the Company's affiliation to such newly acquired practice, center or patient base, which provides the Company with the opportunity to earn additional service fees. This consideration is also allocated to an intangible asset.

Service Agreements are amortized on a straight-line basis over the shorter of their term or 25 years. Amortization expense was \$2.7 million and \$5.4 million, respectively, for the three- and six-month periods ended June 30, 2002, compared to \$2.0 million and \$4.1 million, respectively, for the three- and six-month periods ended June 30, 2001. Accumulated amortization was \$37.5 million and \$24.8 million as of June 30, 2002 and 2001, respectively. Intangible assets and



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the related accumulated amortization are written off when fully amortized.

### 4. EARNINGS PER SHARE

Basic and diluted earnings per share are based on the weighted average number of shares of common stock and common stock equivalents (e.g., stock options) outstanding during the period.

### 5. ACCOUNTING CHANGE

On January 1, 2002, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets," which requires that goodwill and intangible assets with indefinite lives, including such assets recorded in past business combinations, no longer be amortized, but instead be tested for impairment by measuring the reporting unit at fair value with the initial impairment test performed within six months from the beginning of the year in which the standard is adopted. SFAS No. 142 also requires that the impairment test be performed at least annually thereafter, with interim testing required if circumstances warrant. Intangible assets with finite lives will continue to be amortized over their useful lives and reviewed for impairment. In the quarter ended June 30, 2002, the Company completed its initial evaluation of goodwill impairment as required with the adoption of SFAS No. 142 and determined that the existing goodwill balance was not impaired. However, no assurances can be given regarding future impairment.

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SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," requires the Company to evaluate whether events or circumstances have occurred that indicate all or a portion of the carrying amount of the Company's intangible assets may not be recoverable. The recoverability takes into account whether these intangibles should be completely or partially written off or the amortization period accelerated based on management's estimate of future operating income over the remaining term of the Service Agreement. If the intangible assets is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the intangibles exceeds its fair value using estimated discounted cash flows. The Company adopted SFAS No. 144 on January 1, 2002, which did not impact the Company's financial position or results of operations. For the quarter ended June 30, 2002, the Company performed valuations on the carrying amount of the Company's intangibles and determined that impairment did not exist at June 30, 2002.

### 6. BUSINESS COMBINATION WITH ORTHALLIANCE

On November 9, 2001, a newly-formed subsidiary of the Company merged with and into OrthAlliance. As a result of the merger, OrthAlliance became a wholly-owned subsidiary of the Company. OrthAlliance provides management and consulting services to orthodontic and pediatric dental practices throughout the United States.

The merger was accounted for using the purchase method of accounting. The results of operations of OrthAlliance subsequent to November 9, 2001 have been included in the Company's consolidated statements of income. The results of OrthAlliance do not include results of operations relating to Service Agreements with certain affiliated practices that are parties to litigation pending against OrthAlliance and have ceased remitting service fees to OrthAlliance (the "Excluded OrthAlliance Affiliated Practices"). The purchase price has been allocated to the acquired assets, including identifiable intangible assets, and liabilities assumed based on their estimated fair values as of November 9, 2001 with an amount of \$71.8 million recorded in goodwill. The Company has begun its

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assessment of recoverability for certain assets acquired as part of its initiative to finalize its purchase accounting for the merger and has determined that collectibility of these amounts is uncertain and has, therefore, adjusted goodwill for the amount that the Company believes will not be recovered. Additional adjustments may be required as the Company completes its assessment of recoverability. Also, during April 2002, the Company received proceeds from an OrthAlliance Affiliated Practice to terminate its Service Agreement and, accordingly, the Company adjusted the goodwill balance recorded in connection with the merger to reflect the consideration received. The goodwill balance at June 30, 2002 was \$75.6 million. These purchase price allocations are preliminary and, therefore, subject to change as the Company obtains more information and as certain pre-acquisition contingencies, particularly those related to litigation, are resolved.

Following the announcement of the merger agreement with OrthAlliance, a number of OrthAlliance's affiliated practices commenced litigation against OrthAlliance, alleging, among other things, that OrthAlliance breached the terms of their Service Agreements by failing to provide certain services and/or that certain provisions of their Service Agreements may be unenforceable. In determining the purchase price allocation, the Company has assigned no value to advances to affiliated practices, property, equipment and improvements, notes receivable, and Service Agreements relating to the Excluded OrthAlliance Affiliated Practices because of the inherent uncertainties of the litigation process, the relatively early stages of these lawsuits and the recentness of the merger, all of which create uncertainties with respect to the recoverability of these assets. Also, the allocation does not reflect any proceeds that may be received by OrthAlliance from these Affiliated Practices in consideration for certain assets or termination of their Service Agreements. Therefore, the estimated values are preliminary and may change as more facts become known. The assignment of no value to assets related to these Affiliated Practices does not reflect a belief by management that these lawsuits have merit or that the plaintiffs will ultimately prevail in these actions. In connection with the OrthAlliance merger, the Company assumed a liability for certain estimated additional merger-related costs that may be incurred by the Company, including estimated attorneys fees and legal expenses anticipated to be incurred in connection with these lawsuits.

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Intangible assets associated with OrthAlliance's Service Agreements are being amortized on a straight-line basis over the terms of the Service Agreements (up to 25 years), with a weighted-average life of approximately 20 years. A portion of the amortization expense generated with respect to these intangible assets is not deductible for federal income tax purposes.

OrthAlliance's Service Agreements are with a professional corporation or other entity owned by an orthodontist or pediatric dentist. OrthAlliance's Service Agreements generally provide that the professional corporation or other entity is responsible for providing orthodontic or pediatric dental services and for hiring orthodontists or pediatric dentists. These Service Agreements also generally provide that OrthAlliance services are feasible only if the professional entity operates an active orthodontic or pediatric dental practice to which it and each orthodontist associated with the professional entity devotes their full time and attention. These Service Agreements also generally require that the professional entity enter into an employment agreement with the owner of the professional entity and other practitioners providing services in the respective practice. These employment agreements are generally for a term of five years, which generally automatically renew for one year terms unless earlier terminated. Under these employment agreements, the orthodontist or pediatric dentist may generally terminate their employment (subject to a

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covenant not to compete) following the initial term of the agreement by giving at least one year's prior written notice. Approximately five of OrthAlliance's affiliated practitioners formerly affiliated with New Image Orthodontic Group, Inc. ("New Image") (not including nine of the Excluded OrthAlliance Affiliated Practices) may terminate their employment agreement prior to expiration of their term by giving at least one year's prior written notice and by paying a termination fee ranging from \$300,000 to \$1,000,000.

In connection with the OrthAlliance merger, the Company assumed liabilities for estimated employee severance and for operating lease agreements expected to be terminated. The severance accrual relates to approximately 30 OrthAlliance corporate employees. The operating lease payment accrual relates to facility leases assumed by the Company for facilities that are being vacated. Amounts accrued represent management's estimates of the cost to exit these leases.

Components and activity for the liabilities assumed are as follows:

	December 31, 2001	Charges and adjustments	June 30, 2002
	-----	-----	-----
	(in thousands)		
Accrued severance liability .....	\$2,579	\$ 988	\$1,591
Accrued operating facility leases .....	1,203	277	926
	-----	-----	-----
	\$3,782	\$1,265	\$2,517
	=====	=====	=====

### 7. INCOME TAXES

As of June 30, 2002, the Company has approximately \$56.8 million of deferred tax assets resulting from its change in method for recognizing fee revenue effective January 2000. In April 2002, the Company filed an application with the Internal Revenue Service ("IRS") to change the Company's tax accounting method of recognizing revenue. The Company has not made any estimated federal income tax payments during 2002 based on the expectation that the authorized change in accounting will at least alleviate the Company's tax liability for the first two quarterly estimated federal income tax installments and, accordingly, has recorded such estimated payments as income taxes payable. To the extent the IRS approves the change in accounting, the deferred tax assets will be used to reduce the income tax payable for 2002.

### 8. NON-RECURRING RECRUITING EXPENSE

On April 30, 2002, the Company and a former employee reached agreement on the number of affiliated orthodontists that the former employee was credited with recruiting and the amount payable to the former

employee in consideration for his prior services in recruiting these affiliated orthodontists. These amounts had been disputed by the parties and were the subject of a lawsuit pending between the parties, which was commenced on October 17, 2000. On May 10, 2002, that lawsuit was dismissed, and the Company paid the former employee approximately \$8.0 million in cash and forgave approximately

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\$4.8 million of indebtedness owed by the former employee to the Company. These amounts have been included in the Company's Condensed Consolidated Statements of Income for the three and six months ended June 30, 2002 as a non-recurring recruiting expense. The Company does not have similar recruiting arrangements with any other employee or affiliated practitioner.

### 9. COMMITMENTS AND CONTINGENCIES

The Company and its subsidiaries are parties to other pending litigation, as disclosed in footnote 12 of the Company's Annual Report on Form 10-K for the year ended December 31, 2001. Except as previously disclosed, there has not been any material changes to such litigation.

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

The following discussion summarizes the financial position of Orthodontic Centers of America, Inc. ("we," "our," "OCA" or the "Company") at June 30, 2002, and the results of operations for the three and six months ended June 30, 2002, and should be read in conjunction with the condensed consolidated financial statements and related notes included elsewhere in this Report.

### GENERAL

Our business was established in 1985. At June 30, 2002, we provided business services to 370 orthodontic and pediatric dental practices operating in 869 orthodontic and pediatric dental centers in which 626 orthodontists, pediatric dentists and general dentists were practicing as of June 30, 2002. These amounts do not include the Excluded OrthAlliance Affiliated Practices, which are 49 orthodontists and pediatric dentists, as of June 30, 2002, that are involved in litigation with OrthAlliance, Inc. ("OrthAlliance"), which we acquired in November 2001, and have ceased paying service fees to OrthAlliance.

Generally, when we develop a new center, all patients treated at the center are new patients and, in the first several months after commencing operations, the center is open only for a limited number of days each month as new patients are added. Our affiliated centers have generally become increasingly more productive and profitable as more new patients are added and existing patients return for monthly follow-up visits. After approximately 26 months of operations, a center's growth in patient base has typically begun to stabilize as the initial patients complete treatment. At that point, a center can increase the number of patients treated by improving the efficiency of its clinical staff, increasing patient treatment intervals and adding operating days or practitioners. Our affiliated centers may also increase revenue by implementing periodic price increases. Established practices with which we have affiliated have typically increased their revenue by applying our operating strategies and systems.

### APPLICATION OF CRITICAL ACCOUNTING POLICIES

We provide integrated business services to orthodontic and pediatric dental practices, and our consolidated financial statements include service fees earned under our service and consulting agreements and the expenses of providing these services. We do not consolidate the patient revenue and other operations and accounts of our affiliated practices. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and

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liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

During the six months ended June 30, 2002, there were no material changes to or in the application of our critical accounting policies presented in our Annual Report on Form 10-K for the year ended December 31, 2001.

For further discussion of our accounting policies, see Note 2 to our Condensed Consolidated Financial Statements included elsewhere in this Report, primarily related to revenue recognition.

### REVENUE RECOGNITION

We recognize fee revenue based on a straight-line allocation of patient contract revenue over the terms of our affiliated practices' patient contracts (which, for orthodontic patients, average about 26 months), minus the portion of that straight-line allocation retained or to be retained by our affiliated practices. Amounts retained or to be retained by an affiliated practice equal the practice's proportionate share of the portion of that straight-line allocation of patient contract revenue that is collected during the relevant period, and the patient

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receivables that represent the uncollected portion of that straight-line allocation of patient contract revenue. Amounts retained or to be retained are reduced by any operating losses, depreciation, interest on outstanding loans, bad debt or other expenses that we have incurred but for which we have not been reimbursed by the practice; however, these unreimbursed expenses reduce amounts retained by an affiliated practice only up to the amounts that would otherwise be retained by the practice. Any remaining unreimbursed expenses would reduce amounts retained or to be retained by the practice in subsequent periods. For OCA's general form of service and consulting agreements (under which service fees are generally determined, at least in part, based upon a percentage of practice operating profit), the amounts retained or to be retained by an affiliated practice are estimated using the percentage of practice operating profits that may be retained by the practice under the service or consulting agreement. For OrthAlliance's service, management service and consulting agreements (under which service fees are generally determined, at least in part, based upon a percentage of practice revenue and reimbursement of practice related expenses), amounts retained or to be retained by an affiliated practice are estimated using the percentage of practice revenue that may be retained by the practice under the terms of the service, management service or consulting agreement, minus the estimated amount of practice related expenses for which OrthAlliance may be reimbursed under that agreement.

Many of OrthAlliance's affiliated practices require that their patients pay a down payment of approximately 25% of the total treatment fee at the commencement of treatment. This results in us receiving cash in advance of incurring certain practice related expenses and recognizing certain service fees as fee revenue, which are deferred and recorded as service fee prepayments. Service fee prepayments represent cash received in excess of service fees that have been recognized as fee revenue, less an estimate of the portion of that cash that the applicable affiliated practice is to retain and practice related expenses that have not yet been incurred.

### EXPENSES

Operating expenses of our affiliated centers are our expenses and are recognized

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as incurred. Employee costs consist of wages, salaries and benefits paid to all of our employees, including orthodontic assistants, business staff and management personnel. General and administrative expenses consist of, among other things, provision for losses on service fees receivable, professional fees, maintenance and utility costs, office supply expense, telephone expense, taxes, license fees, printing expense and shipping expense.

### OVERVIEW OF SERVICE AND CONSULTING AGREEMENTS

We provide a wide range of services to our affiliated practices, including marketing and advertising, management information systems, staffing, supplies and inventory, scheduling, billing, financial reporting, accounting and other administrative and business services. These services are provided under long-term agreements with affiliated orthodontists and pediatric dentists and/or their wholly-owned professional corporation or other entity, with terms that generally range from 20 to 40 years (with most ranging from 20 to 25 years).

The specific form of agreement is based upon the dental regulatory provisions of the particular state in which an affiliated practice is located. In most states, we use a form of service agreement, with some minor variations from state to state. In a small number of states with particularly stringent laws relating to the practice of dentistry, we use a consulting agreement, which also varies somewhat from state to state. OrthAlliance and its affiliated practices are parties to service, management service and consulting agreements that differ in some respects from the service and consulting agreements that OCA has historically used.

**OCA SERVICE AGREEMENTS.** Under OCA's general form of service agreement, we provide affiliated practices with a wide range of business services in exchange for monthly service fees. The monthly service fees under these service agreements are generally computed based upon 24% of new patient contract balances in the first month of treatment plus the balance of the patient contract balances allocated equally over the remaining terms of the patient contracts (which average about 26 months), minus amounts retained by the affiliated practice. The amounts retained by an affiliated practice are based on a percentage of the operating

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profits of the practice on a cash basis, generally cash collections minus expenses during the period (in some cases, after reduction for any hourly-based service fees or hourly-based amounts retained by the affiliated practice), plus, in some cases, certain hourly-based amounts. These service fees generally represent reimbursement for direct and indirect expenses that we incur in providing services to an affiliated practice (including employee costs, marketing and advertising costs, office rent, utilities expense, supply costs and general and administrative expenses), a portion of the operating profits of the affiliated practice on a cash basis and, in some cases, hourly-based service fees. Excluding reimbursement of direct and indirect expenses and any hourly-based service fees, service fees based on the operating profits of the affiliated practice generally range from 40% to 50% of a mature practice's cash operating profits (in some cases, after reduction for any hourly-based service fees or hourly-based amounts retained by an affiliated practice).

**OCA CONSULTING AGREEMENTS.** Under OCA's general form of consulting agreement, the types of services we provide to affiliated practices are generally similar to the services we provide under our general form of service agreement. Fees paid to us under the consulting agreements generally are a combination of, depending on the service being performed, cost-based types of fees, flat monthly fees and hourly fees.

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### ORTHALLIANCE SERVICE, MANAGEMENT SERVICE AND CONSULTING AGREEMENTS.

Under OrthAlliance's general form of service agreements, OrthAlliance generally must provide or arrange for certain services for its affiliated practices, and advise and assist the practices with respect to certain other services. These services are generally similar to those provided under OCA's service agreements. OrthAlliance is generally responsible for paying certain practice expenses, for which it is to be reimbursed by the affiliated practice. If the practice's collections are insufficient to fund the practice's current practice expenses, then OrthAlliance is generally obligated to advance funds for those expenses. Under these service agreements, OrthAlliance generally receives service fees based on either (1) a percentage of adjusted practice revenue (generally about 17%), which is to be earned by OrthAlliance on an accrual basis of accounting and received on a cash basis, subject, in some cases, to a minimum dollar amount of annual service fees during the first five years of the agreement, (2) a percentage of adjusted practice revenue (generally about 17%), which is to be earned by OrthAlliance on an accrual basis of accounting, and received on a cash basis, subject to annual adjustments based upon improvements in the affiliated practice's operating margin, and, in some cases, subject to a minimum dollar amount of annual service fees during the first five years of the agreement, or (3) a flat monthly fee with annual fixed-dollar increases.

Under OrthAlliance's general form of consulting agreements, OrthAlliance must provide certain specified services to its affiliated practices, provide other services at the request of the practices and consult with or advise the affiliated practices with respect to other services. These services are generally similar to those provided under OCA's service agreements. Under these agreements, OrthAlliance receives a consulting fee based on one of the three fee structures described above with respect to OrthAlliance's service agreements.

Under OrthAlliance's general form of management service agreements, which are used for practices that were affiliated with New Image Orthodontic Group, Inc. prior to OrthAlliance's acquisition of those agreements in March 2000, OrthAlliance is to provide and remit payment for a wide range of services for its affiliated practices, including providing facilities, equipment, support personnel, utilities, supplies, bookkeeping, marketing and billing and collections services. These management service agreements generally provide for a service fee that varies from month to month depending on the particular practice's practice revenue and operating expenses. Service fees are calculated based on two grids set forth in the management service agreement that determine the portion of practice revenue, on a cash basis, that is to be retained by the affiliated practice. One grid determines a percentage of practice revenue, on a cash basis, to be retained by the affiliated practice based on the amount of such practice revenue during the prior calendar quarter. Pursuant to this grid, OrthAlliance's service fees generally increase if the affiliated practice's practice revenue increases and the service fees generally decrease if the affiliated practice's practice revenue decreases. The other grid determines an offsetting or additional percentage of such practice revenue to be retained by the affiliated practice, based on the practice's operating expenses during the prior calendar quarter. Pursuant to this grid, OrthAlliance's service fees generally decrease if the affiliated practice's operating expenses increase and the

service fees generally increase if the affiliated practice's operating expenses decrease. The management service agreements generally provide for maximum service fees of 19.5% of the practice's practice revenue on a cash basis. A few of OrthAlliance's management service agreements provide for a fixed percentage service fee.

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### SEASONALITY

Our affiliated practices have experienced their highest volume of new cases in the summer and other periods when schools are not typically in session. During these periods, children have a greater opportunity to visit an orthodontist or pediatric dentist to commence treatment. Consequently, our affiliated practices have experienced higher revenue during the first and third quarters of the year as a result of increased patient starts. During the Thanksgiving and Christmas seasons, our affiliated practices have experienced reduced volume and fourth quarter revenue for our affiliated practices has been generally lower as compared to other periods. Seasonality in recent periods has been mitigated by the impact of additional affiliated practices.

### EMERGING ISSUES TASK FORCE ISSUE NO. 97-2

We do not have a controlling financial interest in our affiliated practices. In accordance with guidance in Emerging Issues Task Force Issue No. 97-2, we do not consolidate the patient revenue and other operations and accounts of our affiliated practices within our financial statements.

### BUSINESS COMBINATION WITH ORTHALLIANCE

OrthAlliance became our wholly-owned subsidiary in a stock-for-stock merger in November 2001. The OrthAlliance merger was accounted for using the purchase method of accounting, and the results of operations of OrthAlliance have been included in our consolidated financial statements for the period from November 9, 2001 through December 31, 2001 and the six months ended June 30, 2002. However, our condensed consolidated financial statements for the three- and six-month periods ended June 30, 2002 do not include any results of operations associated with the Excluded OrthAlliance Affiliated Practices, which are engaged in litigation with OrthAlliance and have ceased paying service fees to OrthAlliance.

We believe that the OrthAlliance merger is a strategically important transaction, which we believe will provide opportunities for growth in our fee revenue and increases in our operating margin. Our objective is to build sound, long-term business relationships with OrthAlliance's affiliated practices, and to increase the number of these practices that use our suite of integrated business systems and services. Since entering into a merger agreement with OrthAlliance in May 2001, we have devoted substantial resources to attempting to integrate OrthAlliance's affiliated practices into our network of other affiliated practices. Some of OrthAlliance's affiliated practices began using part of our computer and business systems prior to the merger, under a license that we granted to OrthAlliance in October 2001. In addition, approximately 70 of OrthAlliance's affiliated practices (not including six of the Excluded OrthAlliance Affiliated Practices) have agreed, in amendments to their service, management service or consulting agreements with OrthAlliance, to use our proprietary computer software and business systems in their practices. We continue to implement our business systems for these practices. We also continue to inform other OrthAlliance affiliated practices about the quality and benefits of our systems and services, which we hope will persuade additional practices to use a wide range of these systems and services.

Before we entered into the merger agreement with OrthAlliance, we anticipated that some portion of OrthAlliance's affiliated practices would oppose such a merger because of, among other things, disappointment with the market price of OrthAlliance's common stock (which many practices received in connection with their affiliation with OrthAlliance), unwillingness to affiliate with a competitor of OrthAlliance or perceived differences in the companies' cultures and operating strategies. Accordingly, we factored the likelihood of a number of dissident practices into our analysis of the economic merits of the merger, and



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into the structure of the merger agreement and merger consideration (which was based on the

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number of practices that entered into amendments to their employment agreements and service, management service and consulting agreements with OrthAlliance prior to the merger). Following the announcement of the merger agreement with OrthAlliance in May 2001, a number of OrthAlliance's affiliated practices did, in fact, file lawsuits against OrthAlliance and/or notify OrthAlliance that it was in default under their service, management service and consulting agreements, in response to which OrthAlliance engaged outside counsel to represent its interests. We believe that, despite these lawsuits, the OrthAlliance merger has financial merit and was a positive development for our company.

OrthAlliance intends to defend each of these lawsuits vigorously, and to continue to demand that these practices honor their commitments under their agreements with OrthAlliance. We believe that the plaintiffs' claims in these actions lack merit, and that OrthAlliance has meritorious claims against each of these plaintiffs. Based on our prior experience and discussions with some of these litigating practices or their representatives, we currently believe that some of these practices will settle their lawsuits by paying us an amount of cash in exchange for termination or modification of their service, management service and consulting agreements with OrthAlliance, depending upon the parties' ability to reach an agreement as to the amount to be paid. We cannot assure you that such an agreement or settlement will be reached in any of these lawsuits. We also cannot, at this time, predict the outcome of these lawsuits or assure you that we will prevail in any of them, nor can we estimate at this time the amount of damages that we might incur or receive in these actions. Due to the uncertainty of this litigation, we have currently assigned no value to service, management service and consulting agreements with the Excluded OrthAlliance Affiliated Practices, which were engaged in litigation with OrthAlliance and which had ceased to pay service fees to OrthAlliance as of June 30, 2002, for purposes of allocating the purchase price that we paid in the OrthAlliance merger.

### RESULTS OF OPERATIONS

The following table provides information about the percentage of fee revenue represented by some of the items in our condensed consolidated statements of income. These amounts exclude the Excluded OrthAlliance Affiliated Practices.

	Three months ended June 30,	
	2002	2001
Fee revenue .....	100.0%	100.0%
Direct expenses:		
Employee costs .....	28.3	28.3
Orthodontic supplies .....	8.4	7.9
Rent .....	8.9	8.6
Marketing and advertising .....	7.0	7.9

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Total direct expenses .....	52.6	52.7
General and administrative .....	13.0	11.1
Non-recurring recruiting expense .....	11.3	--
Depreciation and amortization .....	5.1	5.6
Operating profit .....	18.0	30.6
Interest (income) expense .....	0.9	1.4
Non-controlling interest in subsidiary .....	0.0	0.2
Income before income taxes .....	17.1	29.0
Provision for income taxes .....	6.5	10.9
Net income .....	10.6%	18.0%

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OVERVIEW. Our net income decreased \$2.7 million and increased \$1.9 million for the three and six months ended June 30, 2002, respectively, compared to the same periods in 2001. During the three months ended June 30, 2002, we recorded a non-recurring recruiting expense of \$12.8 million (\$8.0 million, net of income tax benefit) for amounts paid to a former employee for his past recruiting services in accordance with the our accounting policies for such costs. Excluding the impact of this non-recurring expense, net income increased \$5.2 million and \$9.9 million for the three and six months ended June 30, 2002, respectively, compared to the same periods in 2001. These increases were primarily due to significant growth in fee revenue from centers opened since June 30, 2001, including increases in fee revenue resulting from our merger with OrthAlliance in November 2001. Fee revenue increased \$31.0 million and \$65.0 million for the three and six months ended June 30, 2002, respectively, compared to the same periods in 2001. Our operating margin (or operating profits as a percentage of fee revenue) for the three months ended June 30, 2002 was \$20.4 million, or 18.0%, compared to \$25.2 million, or 30.6%, for the three months ended June 30, 2001. Operating margin for the six months ended June 30, 2002 was \$51.4 million, or 22.9%, compared to \$48.4 million, or 30.3%, for the six months ended June 30, 2001. Excluding the impact of the non-recurring expense, operating margin was \$33.2 million, or 29.2%, for the three months ended June 30, 2002 and \$64.2 million, or 28.9%, for the six months ended June 30, 2002. The factors affecting our net income are discussed below.

FEE REVENUE. Fee revenue during the three months ended June 30, 2002 was \$113.4 million, an increase of 37.9% from \$82.2 million for the same period in 2001. We attribute \$14.2 million of this increase to the growth in fee revenue of centers open throughout both periods and \$17.0 million of this increase to centers opened since June 30, 2001 or added through our acquisition of OrthAlliance in November 2001. For the six months ended June 30, 2002, fee revenue was \$224.8 million, an increase of 40.7% from \$159.7 million for the comparable period in 2001 or added through our acquisition of OrthAlliance in November 2001. We attribute \$28.3 million of this increase to the growth in fee revenue of centers open throughout both periods and \$36.8 million of this increase to centers opened since June 30, 2001. The increase in fee revenue during 2002 was also due to an increase in the number of patients being treated by our affiliated practices and an increase in the average amount of fees that patients were charged for treatment. During the six months ended June 30, 2002, our affiliated practices initiated treatment of about 59,800 patients, an

increase of 27.7% from about 46,800 patients during the same period in 2001. This represents new patient contract balances of \$194.1 million at June 30, 2002, compared to \$149.7 million at June 30, 2001. At June 30, 2002, our affiliated practitioners were treating a total of 515,300 patients, an increase of 35.9% from approximately 379,100 patients at June 30, 2001.

We adopted a change in accounting for revenue effective January 1, 2000 and recorded a cumulative effect of change in accounting principles of \$50.6 million, net of an income tax benefit, in 2000. During the three and six months ended June 30, 2001, we recognized revenue of \$7.4 million and \$16.9 million, respectively, that was included in the cumulative effect of change in accounting principles.

**EMPLOYEE COSTS.** Employee costs was \$32.1 million for the three months ended June 30, 2002, an increase of 37.6% from \$23.3 million for the comparable period in 2001. For the six months ended June 30, 2002, employee costs was \$63.9 million, an increase of 40.0% from \$45.7 million for the comparable period in 2001. These increases primarily resulted from the addition of employees in connection with the OrthAlliance merger in November 2001. As a percentage of fee revenue, employee costs was 28.3% and 28.4% for the three and six months ended June 30, 2002, respectively, compared to 28.6% and 28.6%, respectively, for the same periods in 2001. As a result of developments in orthodontic technology, a patient may be seen every six to eight weeks, rather than the traditional four weeks, without compromising quality of care and without extending the patient's total term of treatment. Consistent with industry trends, our affiliated orthodontists have begun increasing the intervals between patient treatments. During the six months ended June 30, 2002, patients in our affiliated orthodontic centers averaged 46.9 days between office visits, compared to an average of 45.6 days during the comparable period in 2001. This increase in patient treatment interval reduces the number of office visits during the term of a patient's treatment, which continues to average about 26 months, and results in lower employee costs per patient. The increased interval does not, however, reduce the amount of treatment fees per patient. Therefore, the increased interval reduces the employee costs incurred with respect to an individual patient relative to the patient's treatment fee.

**ORTHODONTIC SUPPLIES.** Orthodontic supplies was \$9.6 million for the three months ended June 30, 2002, an increase of 47.9% from \$6.5 million for the comparable period in 2001. For the six months ended June 30, 2002, orthodontic supplies was \$19.1 million, an increase of 50.7% from \$12.7 million for the comparable period in 2001. As a percentage of fee revenue, orthodontic supplies increased to 8.4% and 8.5% for the three and six months ended June 30, 2002, respectively, from 7.9% for each of the same periods in 2001. These increases were primarily due to increases in prices charged for orthodontic supplies by certain of our vendors beginning in the fourth quarter of 2001.

**RENT.** Rent expense was \$10.1 million for the three months ended June 30, 2002, an increase of 42.2% from \$7.1 million for the comparable period in 2001. For the six months ended June 30, 2002, rent expense was \$20.1 million, an increase of 45.0% from \$13.9 million for the comparable period in 2001. These increases were primarily due to centers acquired, affiliated, opened or relocated after June 30, 2001, including OrthAlliance affiliated practices. As a percentage of fee revenue, rent expense increased to 8.9% for the three months ended June 30, 2002 from 8.6% for the comparable period in 2001, and increased to 9.0% for the six months ended June 30, 2002 from 8.7% for the comparable period in 2001. These increases were primarily attributable to rent increases in certain markets and to an overall increase in common area maintenance charges incurred during the six months ended June 30, 2002, compared to the same period in 2001.

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MARKETING AND ADVERTISING. Marketing and advertising expense was \$8.0 million for the three months ended June 30, 2002, an increase of 23.3% from \$6.5 million for the comparable period in 2001. For the six months ended June 30, 2002, marketing and advertising expense was \$16.9 million, an increase of 33.2% from \$12.7 million for the comparable period in 2001. The increase in this expense primarily resulted from increases in marketing and advertising related to growth in fee revenue for existing centers as well as marketing and advertising for centers added after June 30, 2001. As a percentage of fee revenue, marketing and advertising decreased to 7.0% and 7.5% for the three and six months ended June 30, 2002, respectively,

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from 7.9% and 8.0%, respectively, for the same periods in 2001. These decreases were primarily due to OrthAlliance affiliated practices generally advertising less than other OCA affiliated practices.

GENERAL AND ADMINISTRATIVE. General and administrative expense was \$14.8 million for the three months ended June 30, 2002, an increase of 61.4% from \$9.2 million for the comparable period in 2001. For the six months ended June 30, 2002, general and administrative was \$29.2 million, an increase of 67.5% from \$17.4 million for the comparable period in 2001. As a percentage of fee revenue, general and administrative expense increased to 13.0% for the three and six months ended June 30, 2002 from 11.1% and 10.9%, respectively, for the same periods in 2001. These increases were primarily due to our recording of an allowance of \$1.9 million for uncollectible advances to affiliated practitioners in the second quarter of 2002 based on our assessment of the recoverability of these advances. The impact of OrthAlliance affiliated practices on our general and administrative expense and an increase in office supplies expense contributed to the increase for the three and six months ended June 30, 2002 compared to the same periods in 2001. The increase in office supplies expense was primarily attributable to price increases by certain vendors beginning in the fourth quarter of 2001 and an increase in office supplies use due to an increased number of patients and affiliated practices during the six months ended June 30, 2002. For the three and six months ended June 30, 2001, we incurred several non-recurring accounting and legal expenses.

NON-RECURRING RECRUITING EXPENSE. During the three months ended June 30, 2002, we recorded a non-recurring charge of \$12.8 million (\$8.0 million, net of income tax benefit) for amounts paid to a former employee for past recruiting services. We reached an agreement during this quarter with the former employee regarding the previously disputed amounts and, in accordance with our accounting policies for such costs, the amounts paid to the former employee were treated as a non-recurring recruiting expense.

DEPRECIATION AND AMORTIZATION. Depreciation and amortization was \$5.8 million for the three months ended June 30, 2002, an increase of 26.3% from \$4.6 million for the comparable period in 2001. For the six months ended June 30, 2002, depreciation and amortization was \$11.3 million, an increase of 25.3% from \$9.0 million for the comparable period in 2001. The increase in this expense is a result of the fixed assets acquired and service agreements entered into for centers developed, acquired or relocated after 2001. As a percentage of fee revenue, depreciation and amortization decreased to 5.1% and 5.0% for the three and six months ended June 30, 2002, respectively, from 5.6% for each of the same periods in 2001, primarily due to an increase in fee revenue at centers affiliated with OrthAlliance and at centers open throughout both periods, which required significantly less investment in additional fixed assets or service agreements than new centers. There was no amortization of the goodwill amount recorded in connection with the OrthAlliance acquisition.

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INTEREST. Net interest expense for the three months ended June 30, 2002 was \$0.9 million, a decrease of 13.6% from \$1.2 million for the comparable period in 2001. For the six months ended June 30, 2002, net interest expense was \$2.3 million, an increase of 4.2% from \$2.2 million for the comparable period in 2001. As a percentage of fee revenue, interest expense decreased to 0.9% and 1.0% for the three and six months ended June 30, 2002, respectively, from 1.4% for each of the comparable periods in 2001.

PROVISION FOR INCOME TAXES. Our effective income tax rate was 37.8% for each of the three and six months ended June 30, 2002 and 2001.

NET INCOME. Net income for the three months ended June 30, 2002 was \$12.1 million, a decrease of 18.5% from \$14.8 million for the three months ended June 30, 2001. Excluding the non-recurring recruiting expense of \$8.0 million (net of income tax benefit), net income for the three months ended June 30, 2002 was \$20.0 million, an increase of \$5.2 million, or 35.1%, compared to the three months ended June 30, 2001. Net income for the six months ended June 30, 2002 was \$30.6 million, a decrease of 6.7% from \$28.7 million for the six months ended June 30, 2001. Excluding the non-recurring recruiting expense, net income for the six months ended June 30, 2002 was \$38.5 million, an increase of \$9.8 million, or 34.1%, compared to the six months ended June 30, 2001.

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### LIQUIDITY AND CAPITAL RESOURCES

#### CASH FLOW

The following table summarizes cash flow information for the six months ended June 30, 2002 and 2001:

	Six months ended June 30,	
	2002	2001
	(in thousands)	
Net cash provided by operating activities.....	\$ 29,528	\$ 23,613
Net cash used in investing activities.....	(19,210)	(23,097)
Net cash provided by (used in) financing activities.....	(9,882)	2,119

OPERATING ACTIVITIES. Net cash provided by operating activities was \$29.5 million for the six months ended June 30, 2002, an increase of 25% from \$23.6 million for the six months ended June 30, 2001. This increase was primarily due to increases in service fees receivable and prepayments of \$13.9 million and in amounts payable to affiliated practices of \$2.3 million during the six months ended June 30, 2002, as compared to the same period in 2001, which were partially offset by increases in certain noncash items of \$9.0 million and in accounts payable and other current liabilities of \$13.0 million during the six months ended June 30, 2002, as compared to the same period in 2001.

- o Noncash items. As discussed above in "--RESULTS OF OPERATIONS," we

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recorded \$12.8 million in non-recurring recruiting expense during the second quarter of 2002 related to amounts paid to a former employee for his past recruiting services. Of this amount, \$8.0 million was paid in cash and the remaining amount of \$4.8 million, which is included in the \$9.0 million of noncash items, relates to forgiven debt owed by the former employee. The remaining noncash items are due to an increase in provision for bad debt expense of \$2.0 million and in depreciation and amortization of \$2.3 million during the six months ended June 30, 2002, as compared to the same period in 2001.

- o Accounts payable and other current liabilities. The increase in accounts payable and other current liabilities during the six months ended June 30, 2002, as compared to the same period in 2001, was primarily due to an increase in our income taxes payable. In April 2002, we filed an application with Internal Revenue Service ("IRS") to change our tax accounting method of recognizing revenue. We have not made any estimated federal income tax payments during 2002 based on our expectation that the authorized change in accounting will at least alleviate any liability for the first two quarterly estimated federal income tax installments and, accordingly, we have recorded such estimated payments as income taxes payable. To the extent the IRS approves the change in tax accounting method, the deferred tax assets of approximately \$56.8 million will be used to reduce the income tax payable for 2002.
- o Service fees receivables and prepayments. The increase in service fees receivable and prepayments during the six months ended June 30, 2002, as compared to the same period in 2001, was primarily attributable to an increase in the number of patients being treated by our affiliated practices. At June 30, 2002, our affiliated practices were treating approximately 515,000 patients compared to 379,000 at June 30, 2001.

Our working capital at June 30, 2002 was \$71.5 million, including cash and cash equivalents of \$12.8 million, compared to working capital at December 31, 2001 of \$52.9 million, including cash and cash equivalents of \$14.2 million. The increase of \$18.6 million in working capital during the six months ended June 30, 2002 was primarily due to an increase of \$21.3 million in service fees receivables. An increase in income taxes payable during the six months ended June 30, 2002 was mostly offset by an aggregate decrease in all other current liabilities.

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INVESTING ACTIVITIES. Net cash used in investing activities was \$19.2 million for the six months ended June 30, 2002, a decrease of 18.6% from \$23.6 million for the six months ended June 30, 2001. This decrease was primarily due to the use of \$6.2 million less cash to acquire service or consulting agreements and \$2.9 million less cash to purchase property, equipment and improvement during the six months ended June 30, 2002, as compared to the same period of 2001. In addition, a purchase accounting adjustment of \$1.3 million to goodwill, which was recorded during the second quarter of 2002, reduced the amount of cash used for investing activities during the six months ended June 30, 2002. Partially offsetting the overall decrease in cash used was an increase of \$5.5 million in advances to affiliated practices during the six months ended June 30, 2002, compared to the same period in 2001.

- o Intangible assets acquired. We paid \$5.3 million during the six months ended June 30, 2002, compared to \$11.4 million during the six months ended June 30, 2001, to acquire and amend service or consulting agreements, pursuant to which we obtain the exclusive right to provide

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operations, financial, marketing and administrative services to the practice during the term of the service agreement. We may from time to time, provide consideration to existing practices in return for the practices amending their service agreements. Subsequent to affiliation, an affiliated practice may acquire an existing practice, center or patient base. We may amend the service agreement to include these newly acquired practice, center or patient base as they may potentially provide earnings leverage to us. Of the \$5.3 million paid for intangibles during the six months ended June 30, 2002, approximately 93.5% related to new affiliations and 6.5% related to existing affiliated practices.

- o Purchases of property, equipment and improvement. We purchased \$7.3 million and \$10.0 million in property, equipment and improvement for the six months ended June 30, 2002 and 2001, respectively. The following table provides information about the composition of these purchases during the six months ended June 30, 2002 (in millions):

Center additions.....	\$ 1.9
Remodeling of existing centers.....	1.6
Additional capital expenditures at existing centers.....	0.8
International development.....	2.8
	-----
Total.....	\$ 7.1
	=====

- o Advances to affiliated practices. We advanced to affiliated practices \$8.1 million during the six months ended June 30, 2002, compared to \$2.7 million for the six months ended June 30, 2001.
- o Payments received on management agreements. In April 2002, we received proceeds from an OrthAlliance affiliated practice to terminate its service agreement and, accordingly, we reduced the goodwill recorded in connection with the OrthAlliance merger to reflect the consideration received.

FINANCING ACTIVITIES. Net cash used in financing activities for the six months ended June 30, 2002 was \$9.9 million, compared to \$2.1 million provided by financing activities during the six months ended June 30, 2001. The increase in net cash used during the six months ended June 30, 2002 was primarily due to increased repayments of \$7.9 million of indebtedness outstanding under our revolving and bridge credit facilities and increased repayments of \$4.9 million of notes payable to affiliated practices during the six months ended June 30, 2002, as compared to the six months ended June 30, 2001.

USES OF CAPITAL

CAPITAL EXPENDITURES. Our capital expenditures consist primarily of the costs associated with expenditures to facilitate growth and development in existing centers, maintenance expenditures to sustain current levels of business activity at existing centers, acquisitions of the fixed assets of newly affiliated

practices and development of de novo centers in the United States and abroad. The average cost of developing a new orthodontic center in the United States is

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about \$325,000, including the cost of equipment, leasehold improvements, working capital and start-up losses associated with the initial operations of the orthodontic center. These costs are shared by us and the particular affiliated practice. We generally bear an affiliated practice's share of these costs until we are reimbursed by the practice. In some cases, we assist our practices in obtaining financing for their share of these costs by providing a guaranty of loans from our primary lender. At each of June 30, 2002 and December 31, 2001, the outstanding balance of these amounts that we guaranteed was approximately \$2.0 million.

During the stages of rapid growth in the number of our affiliated practices in the 1990's, we expended a disproportionately high amount of our capital investment on de novo centers relative to expenditures on our existing centers. During recent years, however, our capital expenditures have been increasingly directed toward remodeling, improving and expanding our existing affiliated centers to facilitate internal growth. During recent years, we also invested significantly in computer systems infrastructure and other technology for our affiliated centers, such as advanced digital cameras or DSL data delivery capability. In addition, we continue to invest in the foundational infrastructure of our international operations.

OTHER USES OF CAPITAL. Newly-developed affiliated practices and existing affiliated practices that expand their capacity by adding additional centers or practitioners typically experience cash flow needs until they begin generating sufficient operating profits at the newly-developed or newly-expanded centers. We may advance funds to affiliated practices to assist them in maintaining affiliated practitioner compensation during the start up or expansion phase of their practices, as an advance against future service fees, as part of our role to facilitate growth of our affiliated practices while reducing the financial stress associated with that growth so that our affiliated practitioners can focus on patient care. These advances are interest free, unsecured loans to the affiliated practices. The affiliated practice generally begins to repay the advances once the practice or center becomes profitable, generally at the beginning of the second year that the practice or center is open. We intend to fund these advances and any continued financing through a combination of bank borrowings and cash from operations.

On August 6, 2002, our Board of Directors approved a common stock repurchase program. Under the program, we may repurchase up to 2.0 million shares of our common stock from time to time in the open market at prevailing market prices or in privately-negotiated transactions during the 18 months following approval of the repurchase program, subject to approval by our lenders. The extent and timing of any repurchases would depend on market conditions, lender approval and other corporate considerations. Repurchased shares may be held in treasury stock, and may be available for use in connection our stock option plans, stock programs and acquisitions, or for other corporate purposes as determined by us. As of the filing of this Report, we had not yet repurchased any shares under this program.

### CAPITAL RESOURCES

We maintain a \$100.0 million revolving line of credit, of which \$68.0 million was outstanding at June 30, 2002, with a lending group that consists of Wachovia Bank, N.A., Bank of America FSB, Bank One, N.A., and Hibernia National Bank. The revolving line of credit, which expires in October 2003, provides funding for our general working capital and expansion of the number of affiliated centers, and bears interest at varying rates above the lender's prime rate or LIBOR. Amounts borrowed under the line of credit are secured by a security interest in



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our ownership interests in our operating subsidiaries.

In November 2001, we obtained a \$50.0 million bridge credit facility from Bank of America FSB, of which \$40.0 million was outstanding at June 30, 2002. Borrowings under this bridge credit facility bear interest at varying rates above the lender's prime rate or LIBOR. Under the bridge credit facility, we have the right, upon written notice at least 30 days prior to November 9, 2002, to extend the bridge credit facility to October 7, 2003. We anticipate that we will further repay a portion of the bridge credit facility through cash flow from operations, enter into a new long-term financing arrangement to replace the bridge credit facility or extend the term of the bridge credit facility to October 2003. We are currently reviewing our projections for cash needs and the possibility of obtaining a new long-term financing arrangement providing more favorable interest rates and terms.

Our revolving line of credit and our bridge credit facility require that we maintain certain financial and nonfinancial covenants under the terms of the credit agreements, including a maximum leverage ratio, minimum fixed charge coverage ratio and minimum consolidated net worth ratio. These credit agreements also impose restrictions on our acquisitions, investments, dividends, stock repurchases and other aspects of our business. If we do not comply with these covenants and restrictions, the lenders could demand immediate payment of all amounts borrowed under both the revolving line of credit and the bridge credit facility, and terminate our ability to borrow funds under those credit facilities. At June 30, 2002, we were in compliance with these covenants and restrictions.

We believe that our cash needs will primarily relate to development of additional centers and affiliation with additional practices in the United States and other countries, capital expenditures for our affiliated centers and computer systems, repayment of amounts owing under our bridge credit facility and other indebtedness, payment of income taxes, potential acquisitions of other companies or assets and general corporate purposes. Our cash needs could vary significantly depending upon our growth, results of operations and ability to affiliate with additional centers and practices, as well as the outcome of pending litigation and other contingencies. We expect to fund these cash needs through a combination of cash flow from our operations and funds available under our revolving line of credit, as well as a replacement or extension of our bridge credit facility. We currently believe that we will be able to meet our anticipated funding requirements for at least the next 12 months; however, our ability to meet these funding needs could be adversely affected if we were to suffer adverse results from our operations or lose a material portion of our affiliated practices, if our affiliated practices were to suffer adverse results of operations or a material loss of patients, if we suffer adverse outcomes from pending litigation and other contingencies, if we are unable to replace our bridge credit facility on favorable terms or if we violate the covenants and restrictions to which we are subject under our revolving line of credit and bridge credit facility.

### NEW ACCOUNTING PRONOUNCEMENTS

On January 1, 2002, we adopted Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets," which requires that goodwill and intangible assets with indefinite lives, including such assets recorded in past business combinations, no longer be amortized, but instead be tested for impairment by measuring the reporting unit at fair value with the initial impairment test performed within six months from the beginning of the year in which the standard is adopted. SFAS No. 142 also requires that the impairment test be performed at least annually thereafter, with interim testing required if circumstances

warrant. Intangible assets with finite lives will continue to be amortized over their useful lives and reviewed for impairment. On June 12, 2002, we completed our initial evaluation of goodwill impairment as required with the adoption of SFAS No. 142 and determined that the existing goodwill balance was not impaired. However, no assurances can be given regarding future impairment.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

During the six months ended June 30, 2002, there were no material changes to the quantitative and qualitative disclosures about market risks presented in our Annual Report on Form 10-K for the year ended December 31, 2001.

PART II. OTHER INFORMATION

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

In June 2002, pursuant to exemptions from registration provided in Section 4(2) of the Securities Act of 1933 (the "Securities Act") and Rule 506 under the Securities Act, we offered certain OrthAlliance affiliated practitioners the opportunity to participate in two incentive programs under which participants may be issued shares of our common stock or a promissory note in the future depending in part upon the future financial performance of the affiliated practitioners' respective practices. Offers to participate in the incentive program were made on a private basis to a limited number of individuals who had a pre-existing relationship with our subsidiary, OrthAlliance. To participate in the incentive programs, participants must, among several other prerequisites to participation, enter into amendments to their service, consulting or management service agreements with OrthAlliance and to their employment agreements with their professional entities, or enter into our general form of business services agreement. As of the date of the filing of this Report, 44 OrthAlliance affiliated practitioners (including 40 practitioners who had previously entered into other amendments to their agreements in connection with the OrthAlliance merger) were participating in the incentive programs and no shares of our common stock or promissory notes have been issued under these incentive programs. No underwriters are involved with these incentive programs.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The annual meeting of our stockholders was held on May 17, 2002. At this meeting, the following matters were voted upon by our stockholders:

(a) Election of Class II Directors

Ashton J. Ryan, Jr., W. Dennis Summers and Edward J. Walters, Jr. were elected to serve as Class II directors until the annual meeting of stockholders in 2005 or until their successors are elected and qualified. The vote was as follows:

Name	Votes Cast In Favor	Votes Cast Against or Withheld	Abstention Non Vote
----	-----	-----	-----
Ashton J. Ryan, Jr.....	46,730,145	1,117,261	3,692,59

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W. Dennis Summers.....	45,970,121	1,877,285	3,692,59
Edward J. Walters, Jr.....	46,722,399	1,125,007	3,692,59

The terms of the following directors continued following the meeting:

Name -----	Term Expires -----
Bartholomew F. Palmisano, Sr.....	2003
Hector M. Bush, D.M.D.....	2003
Jack P. Devereux, Jr., D.D.S., M.S.....	2003
Dennis J.L. Buchman, D.M.D., M.S.....	2004
John J. Sheridan, D.D.S., M.S.D.....	2004
David W. Vignes.....	2004

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(b) Amendment and Restatement of 1994 Incentive Stock Plan

Our stockholders approved the amendment and restatement of our 1994 Incentive Stock Plan by the following vote:

Votes Cast In Favor -----	Votes Cast Against or Withheld -----	Abstentions/ Non Votes -----
44,309,871	3,443,236	3,786,893

(c) Selection of Independent Auditors

Our stockholders ratified the appointment of Ernst & Young LLP as our independent auditors for the fiscal year ending December 31, 2002 by the following vote:

Votes Cast In Favor -----	Votes Cast Against or Withheld -----	Abstentions/ Non Votes -----
46,212,729	1,595,702	3,731,569

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) EXHIBITS

Exhibit number	Description
3.1	Bylaws of the Registrant (incorporated by reference to

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exhibits filed with the Registrant's Registration Statement on Form S-1, Registration Statement No. 33-85326)

- 3.2 Restated Certificate of Incorporation of the Registrant (incorporated by reference to exhibits filed with the Registrant's Registration Statement on Form S-1, Registration Statement No. 33-85326)
- 4 Specimen Stock Certificate (incorporated by reference to exhibits filed with the Registrant's Registration Statement on Form S-1, Registration Statement No. 33-85326)

(b) REPORTS ON FORM 8-K

During the three months ended June 30, 2002, we did not file any current reports on Form 8-K (excluding a current report on Form 8-K filed on May 9, 2002 reporting information under "Item 9. Regulation FD Disclosure").

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SIGNATURES

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

Orthodontic Centers of America, Inc.  
-----  
(Registrant)

Date: August 14, 2002

/s/ Bartholomew F. Palmisano, Sr.  
-----  
Bartholomew F. Palmisano, Sr.  
Chairman of the Board, President  
and Chief Executive Officer

/s/ John C. Glover  
-----  
John C. Glover  
Chief Financial Officer

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EXHIBIT INDEX

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(incorporated by reference to exhibits filed with the  
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- 4 Specimen Stock Certificate (incorporated by reference to  
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