# FORM 10–Q

## HANGER ORTHOPEDIC GROUP INC – HGR

**Filed: May 09, 2007 (period: March 31, 2007)**

Quarterly report which provides a continuing view of a company's financial position

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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 March 31, 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 1−10670

HANGER ORTHOPEDIC GROUP, INC.

(Exact name of registrant as specified in its charter)

| Delaware | 84−0904275 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |
| Two Bethesda Metro Center, Suite 1200, Bethesda, MD | 20814 |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code: (301) 986−0701

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

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

Indicate by check mark whether the registrant 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 |X| 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 |X|

As of May 4, 2007, 22,352,152 shares of common stock, $.01 par value per share, were outstanding.

Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

HANGER ORTHOPEDIC GROUP, INC.

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**HANGER ORTHOPEDIC GROUP, INC.**
**CONSOLIDATED BALANCE SHEETS**
**(Dollars in thousands, except share and per share amounts)**
**(Unaudited)**

| | March 31, 2007 | December 31, 2006 |
|---|---|---|
| **ASSETS** | | |
| **CURRENT ASSETS** | | |
| Cash and cash equivalents | $ 19,454 | $ 23,139 |
| Accounts receivable, less allowance for doubtful accounts of $3,484 and $3,369 in 2007 and 2006, respectively | 93,315 | 99,403 |
| Inventories | 75,524 | 75,803 |
| Prepaid expenses, other assets and income taxes receivable | 13,706 | 8,805 |
| Deferred income taxes | 8,069 | 7,962 |
| Total current assets | 210,068 | 215,112 |
| **PROPERTY, PLANT AND EQUIPMENT** | | |
| Land | 1,065 | 1,065 |
| Buildings | 5,287 | 5,287 |
| Furniture and fixtures | 12,364 | 12,283 |
| Machinery and equipment | 27,007 | 26,323 |
| Leasehold improvements | 35,137 | 33,811 |
| Computer and software | 51,644 | 49,750 |
| Total property, plant and equipment, gross | 132,504 | 128,519 |
| Less accumulated depreciation and amortization | 89,629 | 86,225 |
| Total property, plant and equipment, net | 42,875 | 42,294 |
| **INTANGIBLE ASSETS** | | |
| Excess cost over net assets acquired | 446,616 | 446,371 |
| Patents and other intangible assets, net | 2,732 | 2,935 |
| Total intangible assets, net | 449,348 | 449,306 |
| **OTHER ASSETS** | | |
| Debt issuance costs, net | 10,643 | 10,853 |
| Other assets | 1,600 | 1,557 |
| Total other assets | 12,243 | 12,410 |
| **TOTAL ASSETS** | $ 714,534 | $ 719,122 |

**The accompanying notes are an integral part of the consolidated financial statements.**



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

**HANGER ORTHOPEDIC GROUP, INC.**
**CONSOLIDATED BALANCE SHEETS**
**(Dollars in thousands, except share and per share amounts)**
**(Unaudited)**

| | March 31, 2007 | December 31, 2006 |
|---|---|---|
| **LIABILITIES, CONVERTIBLE PREFERRED STOCK AND SHAREHOLDERS' EQUITY** | | |
| **CURRENT LIABILITIES** | | |
| Current portion of long–term debt | $ 5,436 | $ 5,386 |
| Accounts payable | 17,408 | 19,093 |
| Accrued expenses | 9,201 | 10,862 |
| Accrued interest payable | 6,128 | 1,803 |
| Accrued compensation related costs | 11,149 | 20,760 |
| Total current liabilities | 49,322 | 57,904 |
| **LONG–TERM LIABILITIES** | | |
| Long–term debt, less current portion | 404,072 | 405,238 |
| Deferred income taxes | 29,800 | 30,741 |
| Other liabilities | 13,608 | 9,908 |
| Total liabilities | 496,802 | 503,791 |
| **COMMITMENTS AND CONTINGENCIES (Note H)** | | |
| **PREFERRED STOCK** | | |
| Series A Convertible Preferred stock, liquidation preference of $1,000 per share, 50,000 shares authorized, issued and outstanding in 2007 | 47,654 | 47,654 |
| **SHAREHOLDERS' EQUITY** | | |
| Common stock, $.01 par value; 60,000,000 shares authorized, 22,522,410 shares and 22,377,551 shares issued and outstanding in 2007 and 2006, respectively | 225 | 224 |
| Additional paid–in capital | 157,750 | 156,480 |
| Retained earnings | 12,759 | 11,629 |
| | 170,734 | 168,333 |
| Treasury stock at cost (141,154 shares) | (656) | (656) |
| Total shareholders' equity | 170,078 | 167,677 |
| **TOTAL LIABILITIES, CONVERTIBLE PREFERRED STOCK AND SHAREHOLDERS' EQUITY** | $ 714,534 | $ 719,122 |

**The accompanying notes are an integral part of the consolidated financial statements.**



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

**HANGER ORTHOPEDIC GROUP, INC.**
**CONSOLIDATED STATEMENTS OF OPERATIONS**
**For the Three Months Ended March 31,**
**(Dollars in thousands, except share and per share amounts)**
**(Unaudited)**

| | 2007 | 2006 |
|---|---|---|
| Net sales | $ 143,850 | $ 140,445 |
| Cost of goods sold (exclusive of depreciation and amortization) | 72,549 | 70,215 |
| Selling, general and administrative | 55,157 | 55,627 |
| Depreciation and amortization | 3,748 | 3,688 |
| Income from operations | 12,396 | 10,915 |
| Interest expense | 9,340 | 9,500 |
| Income before taxes | 3,056 | 1,415 |
| Provision for income taxes | 1,272 | 586 |
| Net income | 1,784 | 829 |
| Preferred stock dividend and accretion–7% Redeemable Preferred Stock | –– | 1,565 |
| Preferred stock dividend–Series A Convertible Preferred Stock | 416 | –– |
| Net income (loss) applicable to common stock | $ 1,368 | $ (736) |
| Basic Per Common Share Data | | |
| Net income (loss) | $ 0.06 | $ (0.03) |
| Shares used to compute basic per common share amounts | 22,191,920 | 21,837,069 |
| Diluted Per Common Share Data | | |
| Net income (loss) | $ 0.06 | $ (0.03) |
| Shares used to compute diluted per common share amounts | 23,368,871 | 21,837,069 |

**The accompanying notes are an integral part of the consolidated financial statements.**



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

**HANGER ORTHOPEDIC GROUP, INC.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**For the Three Months Ended March 31,**
**(Dollars in thousands)**
**(Unaudited)**

| | 2007 | 2006 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 1,784 | $ 829 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Gain on disposal of assets | (81) | (57) |
| Provision for bad debt | 4,061 | 4,125 |
| Provision for deferred income taxes | 698 | 505 |
| Depreciation and amortization | 3,748 | 3,688 |
| Amortization of debt issuance costs | 447 | 589 |
| Compensation expense on stock options and restricted stock | 695 | 349 |
| Amortization of terminated interest rate swaps | –– | (127) |
| Changes in assets and liabilities, net of effects of acquired companies: | | |
| Accounts receivable | 2,031 | 3,523 |
| Inventories | 437 | (1,558) |
| Prepaid expenses, other assets, and income taxes receivable | (6,205) | (9,001) |
| Other assets | 8 | 44 |
| Accounts payable | (1,539) | (2,268) |
| Accrued expenses, accrued interest payable, and income taxes payable | 2,026 | (5,143) |
| Accrued compensation related costs | (9,611) | (8,850) |
| Other liabilities | 3,656 | 581 |
| Net cash provided by (used in) operating activities | 2,155 | (12,771) |
| Cash flows from investing activities: | | |
| Purchase of property, plant and equipment (net of acquisitions) | (4,125) | (2,617) |
| Acquisitions and earnouts (net of cash acquired) | (498) | (154) |
| Proceeds from sale of property, plant and equipment | 158 | 57 |
| Net cash used in investing activities | (4,465) | (2,714) |
| Cash flows from financing activities: | | |
| Borrowings under revolving credit agreement | –– | 19,000 |
| Repayments under revolving credit agreement | –– | (5,000) |
| Repayment of term loan | (577) | (375) |
| Scheduled repayment of long–term debt | (719) | (646) |
| Increase in debt issue costs | (238) | (95) |
| Proceeds from issuance of Common Stock | 575 | 141 |
| Change in book overdraft | –– | 711 |
| Series A Convertible Preferred Stock dividend payment | (416) | –– |
| Net cash (used in) provided by financing activities | (1,375) | 13,736 |
| Decrease in cash and cash equivalents | (3,685) | (1,749) |
| Cash and cash equivalents, at beginning of period | 23,139 | 7,921 |
| Cash and cash equivalents, at end of period | $ 19,454 | $ 6,172 |

**The accompanying notes are an integral part of the consolidated financial statements.**



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

**NOTE A – BASIS OF PRESENTATION**

The unaudited interim consolidated financial statements as of and for the three months ended March 31, 2007 and 2006 have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC") for interim financial reporting. These consolidated statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary for a fair statement for the periods presented. The year−end consolidated data was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America ("GAAP").

These consolidated financial statements should be read in conjunction with the consolidated financial statements of Hanger Orthopedic Group, Inc. (the "Company") and notes thereto included in the Annual Report on Form 10−K for the year ended December 31, 2006, filed by the Company with the SEC.

**NOTE B – SIGNIFICANT ACCOUNTING POLICIES**

*Principles of Consolidation*

The consolidated financial statements include the accounts of the Company and its wholly−owned subsidiaries. All intercompany transactions and balances have been eliminated.

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, 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.

*Stock−Based Compensation*

The Company issues options and restricted shares of common stock under two active share−based compensation plans, one for employees and the other for the Board of Directors. At March 31, 2007, 4.7 million shares of common stock are authorized for issuance under the Company's share−based compensation plans. Shares of common stock issued under the share−based compensation plans are released from the Company's authorized shares. Stock option and restricted share awards are granted at the fair market value of the Company's common stock on the date immediately preceding the date of grant. Stock option awards vest over a period determined by the compensation plan, ranging from one to three years, and generally have a maximum term of ten



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

*Stock−Based Compensation (continued)*

years. Restricted shares of common stock vest over a period of time determined by the Compensation Committee of the Board of Directors ranging from one to four years.

The Company follows the provisions of Statement of Financial Accounting Standards ("SFAS") 123R, *Share−Based Payment* ("SFAS 123R"), which require companies to measure and recognize compensation expense for all share−based payments at fair value. For the three month period ended March 31, 2007 and 2006, the Company recognized $0.7 million and $0.3 million in compensation expense, of which approximately $0.02 million and $0.1 million related to options, respectively. The Company calculates the fair value of stock options using the Black−Scholes model. The total value of the stock option awards is expensed ratably over the requisite service period of the employees receiving the awards.

*Segment Information*

The Company applies a "management" approach to disclosure of segment information. The management approach designates the internal organization that is used by management for making operating decisions and assessing performance as the basis of the Company's reportable segments. The description of the Company's reportable segments and the disclosure of segment information are presented in Note N.

*Restructuring*

During 2001 and 2004 the Company recorded certain restructuring charges. As of March 31, 2007, the remaining liability approximates $0.1 million and relates to lease termination and other exit costs to be paid through 2012.

*New Accounting Standards*

We adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, "Accounting for Uncertainty in Income Taxes", on January 1, 2007. As a result of adoption, we recognized a debit of approximately $0.2 million to the January 1, 2007 retained earnings balance. As of the adoption date, we had gross tax affected unrecognized tax benefits of $3.3 million of which $1.1 million, if recognized, would affect the effective tax rate. Also as of the adoption date, we had accrued interest expense and penalties related to the unrecognized tax benefits of $0.4 million and $0.4 million, respectively. We recognize interest accrued and penalties related to unrecognized tax benefits as a component of income tax expense. Total penalties and interest accrued as of March 31, 2007 was $0.9 million.

The Company files numerous consolidated and separate income tax returns in the United States Federal jurisdiction and in many state jurisdictions. With few exceptions, the Company is no



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

longer subject to US Federal income tax examinations for years before 2003 and is no longer subject to state and local income tax examinations by tax authorities for years before 2002.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements* (“SFAS 157”). SFAS 157 provides guidance on the application of fair value measurement objectives required in existing GAAP literature to ensure consistency and comparability. Additionally, SFAS 157 requires additional disclosures on the fair value measurements used. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company believes the adoption of SFAS 157 will not have a material impact on its financial statements.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities Fair Value* Measurements (“SFAS 159”). SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 does not affect any existing accounting literature that requires certain assets and liabilities to be carried at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of adopting SFAS No. 159 on our financial statements.

**NOTE C — SUPPLEMENTAL CASH FLOW FINANCIAL INFORMATION**

The supplemental disclosure requirements for the statements of cash flows are as follows:

| *(In thousands)* | Three Months Ended March 31, 2007 | Three Months Ended March 31, 2006 |
|---|---|---|
| Cash paid during the period for: | | |
| Interest | $ 4,837 | $ 13,939 |
| Income taxes | 1,709 | 3,251 |
| Non−cash financing and investing activities: | | |
| Preferred stock dividends declared and accretion | $ 416 | $ 1,565 |
| Issuance of notes in connection with acquisitions | 180 | −− |
| Cancellation of restricted shares of common stock | (9) | (32) |

**NOTE D — GOODWILL AND OTHER INTANGIBLE ASSETS**

The Company completed its annual goodwill impairment analysis in October 2006, which did not result in an impairment. In completing the analysis, the Company determined that it had two reporting units, which were the same as its reportable segments: (i) patient−care centers and (ii) distribution. The fair value of the Company’s reporting units was primarily determined based on the income approach and considers the market and cost approach.



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

**NOTE D — GOODWILL AND OTHER INTANGIBLE ASSETS (CONTINUED)**

The activity related to goodwill for the three month period ended March 31, 2007 is as follows:

| *(In thousands)* | Patient−Care Centers | Distribution | Total |
|---|---|---|---|
| Balance at December 31, 2006 | $ 417,988 | $ 28,383 | $ 446,371 |
| Additions due to acquisitions | 245 | −− | 245 |
| Balance at March 31, 2007 | $ 418,233 | $ 28,383 | $ 446,616 |

All goodwill additions for the three months ended March 31, 2007 were allocated to the patient−care centers segment.

**NOTE E – ACQUISITIONS**

The Company acquired the assets of a footwear company during the three month period ended March 31, 2007, for which it paid an aggregate purchase price of $0.5 million, consisting of $0.3 million in cash, a $0.2 million promissory note and other transaction costs. The Company did not have any acquisitions during the three month period ended March 31, 2006.

The Company accounts for its acquisitions using the purchase method of accounting. The results of operations for these acquisitions are included in the Company’s results of operations from their date of acquisition. Pro forma results would not be materially different.

In connection with acquisitions, the Company occasionally agrees to make earnout payments if cash collection targets are reached that verify the value of the target negotiated at acquisition. Earnouts are defined in the purchase agreement and are accrued based on attainment of earnout targets. In connection with these agreements, the Company paid $0.2 during each of the three month periods ended March 31, 2007 and 2006. The Company has accounted for these amounts as additional purchase price, resulting in an increase in excess cost over net assets acquired. The Company estimates that it may pay up to a total of $1.3 million related to earnout provisions in future periods.



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

**NOTE F – INVENTORY**

Inventories, which are recorded at the lower of cost or market using the first–in, first–out method were as follows:

| (In thousands) | March 31, 2007 | December 31, 2006 |
|---|---|---|
| Raw materials | $ 27,570 | $ 29,032 |
| Work–in–process | 29,284 | 27,279 |
| Finished goods | 18,670 | 19,492 |
| | $ 75,524 | $ 75,803 |

**NOTE G – LONG TERM DEBT**

Long–term debt consists of the following:

| (In thousands) | March 31, 2007 | December 31, 2006 |
|---|---|---|
| Term Loan | $ 228,275 | $ 228,852 |
| 10 1/4% Senior Notes due 2014 | 175,000 | 175,000 |
| Subordinated seller notes, non–collateralized, net of unamortized discount with principal and interest payable in either monthly, quarterly or annual installments at effective interest rates ranging from 5.0% to 10.8%, maturing through December 2011 | 6,233 | 6,772 |
| | 409,508 | 410,624 |
| Less current portion | (5,436) | (5,386) |
| | $ 404,072 | $ 405,238 |

*Revolving Credit Facility*

The $75.0 million Revolving Credit Facility matures on May 26, 2011 and bears interest, at the Company's option, of LIBOR plus 2.75% or a Base Rate (as defined in the credit agreement) plus 1.75%. The obligations under the Revolving Credit Facility are guaranteed by the Company's subsidiaries and are secured by a first priority perfected interest in the Company's subsidiaries' shares, all of the Company's assets and all the assets of the Company's subsidiaries. The Revolving Credit Facility requires compliance with various covenants including but not limited to a maximum total leverage ratio and a maximum annual capital expenditures limit. As of March 31, 2007, the Company has not made draws on the Revolving Credit Facility and has $72.0 million available under that facility. Availability under the Company's Revolving Credit Facility is net of standby letters of credit of approximately $3.0 million.



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

*Term Loan*

The $230.0 million Term Loan matures on May 26, 2013 and requires quarterly payments commencing September 30, 2006. From time to time, mandatory payments may be required as a result of capital stock issuances, additional debt incurrences, asset sales or other events as defined in the credit agreement. The Term Loan bears interest, at the Company's option, of LIBOR plus 2.50% or a Base Rate (as defined in the credit agreement) plus 1.50%. At March 31, 2007, the interest rate on the Term Loan was 7.60%. The obligations under the Term Loan are guaranteed by the Company's subsidiaries and are secured by a first priority perfected interest in the Company's subsidiaries' shares, all of the Company's assets and all the assets of the Company's subsidiaries. The Term Loan is subject to covenants that mirror those of the Revolving Credit Facility. Effective March 12, 2007, the Company secured certain amendments to its existing Senior Secured Credit Facility that includes reducing the margin over LIBOR that the Company pays as interest under the existing Term Loan to 2.25%.

*10 ¼% Senior Notes*

The 10 ¼% Senior Notes mature June 1, 2014, are senior indebtness and are guaranteed on a senior unsecured basis by all of the Company's current and future domestic subsidiaries. Interest is payable semi–annually on June 1 and December 1, commencing December 1, 2006.

On or prior to June 1, 2009, the Company may redeem up to 35% of the aggregate principal amount of the notes at a redemption price of 110.250% of the principal amount thereof, plus accrued and unpaid interest and additional interest, if any, with the net cash proceeds of an equity offering; provided that (i) at least 65% of the aggregate principal amount of the notes remains outstanding immediately after the redemption (excluding notes held by the Company and its subsidiaries); and (ii) the redemption occurs within 90 days of the date of the closing of the equity offering.

Except as discussed above, the notes are not redeemable at the Company's option prior to June 1, 2010. On or after June 1, 2010, the Company may redeem all or part of the notes upon not less than 30 days and no more than 60 days' notice, for the twelve–month period beginning on June 1 of the following years; at (i) 105.125% during 2010; (ii) 102.563% during 2011; and (iii) 100.0% during 2012 and thereafter.



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

*General*

The terms of the Senior Notes and the Revolving Credit Facility limit the Company's ability to, among other things, incur additional indebtedness, create liens, pay dividends on or redeem capital stock, make certain investments, make restricted payments, make certain dispositions of assets, engage in transactions with affiliates, engage in certain business activities and engage in mergers, consolidations and certain sales of assets. At March 31, 2007, the Company is in compliance with all covenants under these debt agreements.

**NOTE H – COMMITMENTS AND CONTINGENT LIABILITIES**

*Commitments*

The Company's wholly−owned subsidiary, Innovative Neurotronics, Inc. ("IN, Inc."), is party to a non−binding purchase agreement under which it agrees to purchase assembled WalkAide System kits. As of March 31, 2007, IN, Inc. had outstanding purchase commitments of approximately $0.4 million.

*Contingencies*

Regulatory Inquiry

On June 15, 2004, the Company announced that an employee at its patient−care center in West Hempstead, New York alleged in a television news story aired on June 14, 2004 that there were instances of billing discrepancies at that facility.

On June 18, 2004, the Company announced that on June 17, 2004, the Audit Committee of the Company's Board of Directors had engaged a law firm to serve as independent counsel to the Audit Committee and to conduct an independent investigation of the allegations. The scope of that independent investigation was expanded to cover certain of the Company's other patient−care centers and included consideration of some of the allegations made in the Amended Complaint filed in the class actions discussed below. On June 17, 2004, the U.S. Attorney's Office for the Eastern District of New York subpoenaed records of the Company regarding various billing activities and locations. In addition, the Company also announced on June 18, 2004 that the Securities and Exchange Commission had commenced an informal inquiry into the matter. The Company is cooperating with the regulatory authorities. The Audit Committee's investigation will not be complete until all regulatory authorities have indicated that their inquiries are complete.

Management believes that any billing discrepancies are likely to be primarily at the West Hempstead patient−care center. Furthermore, management does not believe the resolution of the matters raised by the allegations will have a materially adverse effect on the Company's financial statements. The West Hempstead facility generated $0.1 million and $0.2 million in net sales during the quarters ended March 31, 2007 and 2006, respectively, or less than 0.2% of the Company's net sales, for each period. It should be noted that additional regulatory inquiries may be raised relating to the Company's billing activities at other locations. No assurance can be given that the final results of the regulatory agencies' inquiries will be consistent with the results to date or that any discrepancies identified during the ongoing regulatory review will not have a material adverse effect on the Company's financial statements.



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

Consolidated Class Action

Between June 22, 2004 and July 1, 2004, five putative securities class action complaints were filed against the Company, four in the Eastern District of New York, Twist Partners v. Hanger Orthopedic Group, Inc., et al., No. 1:04–cv–02585 (filed 06/22/2004, E.D.N.Y); Shapiro v. Hanger Orthopedic Group, Inc., et al., No. 1:04–cv–02681 (filed 06/28/2004, E.D.N.Y.); Imperato v. Hanger Orthopedic Group, Inc., No. 1:04–cv–02736 (filed 06/30/2004, E.D.N.Y.); Walters v. Hanger Orthopedic Group, Inc., et al., No. 1:04–cv–02826 (filed 07/01/2004, E.D.N.Y.); and one in the Eastern District of Virginia, Browne v. Hanger Orthopedic Group, Inc., et al., No. 1:04–cv–715 (filed 06/23/2004, E.D. Va.). The complaints asserted that the Company's reported revenues were inflated through certain billing improprieties at one of the Company's facilities. The plaintiffs in Browne subsequently dismissed their complaint without prejudice, and the four remaining cases were consolidated into a single action in the Eastern District of New York encaptioned In re Hanger Orthopedic Group, Inc. Securities Litigation, No. 1:04–cv–2585 (the "Consolidated Securities Class Action"). On February 28, 2006, the court granted the Company's motion to transfer the Consolidated Securities Class Action to the District of Maryland. On June 12, 2006, a Second Consolidated Amended Class Action Complaint was filed against the Company in the District of Maryland, In re Hanger Orthopedic Group, Inc. Securities Litigation, No. 8:06–cv–00579–AW (the "Second Amended Complaint"). The Second Amended Complaint asserted that the Company's reported revenues were inflated through certain billing improprieties at some of the Company's facilities. In addition, the Second Amended Complaint asserted that the Company violated the federal securities laws in connection with a restatement announced by the Company on August 16, 2004, restating certain of the Company's financial statements during 2001 through the first quarter of 2004. The Second Amended Complaint purported to allege violations of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b–5 promulgated thereunder, as well as violations of Section 20(a) of the Exchange Act by certain of the Company's executives as "controlling persons" of the Company. On September 1, 2006, the Company filed a motion to dismiss the Second Amended Complaint and oral argument took place on February 21, 2007. On March 16, 2007, the United States District Court for the District of Maryland Southern Division dismissed the Second Amended Complaint with prejudice. The following thirty–day period during which the plaintiffs were permitted to file an appeal or motion for reconsideration passed without the filing of any such appeal or motion, resulting in a final judgment in favor of the Company.

Derivative Action

On September 8, 2005, a derivative action was filed against the Company and certain of its current and former directors in the United States District Court for the Eastern District of New York. The lawsuit, which is encaptioned *Green Meadows Partners, LLP v. Ivan R. Sabel, et al*, No. CV 05 4259 (E.D.N.Y.), also largely repeats the allegations made in the consolidated amended complaint filed by the plaintiffs in *In re Hanger Orthopedic Group, Inc. Securities Litigation*, discussed above. On that basis, the *Green Meadows Partners* complaint purports to assert claims against the individual defendants, on behalf of the Company, for contribution in connection with the *In re Hanger Orthopedic Group, Inc. Securities Litigation* matter; forfeiture of certain bonuses and other incentive–based or equity–based compensation pursuant to Section 304; breach of fiduciary duty; unjust enrichment; and "abuse of control." The Complaint seeks unspecified compensatory damages, restitution and disgorgement, injunctive relief, and award of attorneys' fees and costs. The defendants have not yet filed their response to the *Green Meadows Partners* Complaint. After the transfer of the Consolidated Securities Class Action to the District of Maryland, the parties agreed to the transfer of the *Green Meadows Partners* case to the District of Maryland and to stay the case pending the outcome of the defendants' motion to

dismiss the Consolidated Securities Class Action case. As discussed above, the Consolidated Securities Class Action was dismissed with prejudice by the District Court of Maryland Southern Division on March 16, 2007, and the thirty–day period during which the plaintiffs were permitted to file an appeal or motion for reconsideration passed without the filing of any such appeal or motion, resulting in a final judgment in favor of the Company. The Company intends to seek a dismissal of the *Green Meadows Partners* case.

Other Proceedings

The Company is also party to various legal proceedings that are ordinary and incidental to its business. Management does not expect that any legal proceedings currently pending will have a material adverse impact on the Company’s financial statements.

*Guarantees and Indemnifications*

In the ordinary course of its business, the Company may enter into service agreements with service providers in which it agrees to indemnify or limit the service provider against certain losses and liabilities arising from the service provider’s performance of the agreement. The Company has reviewed its existing contracts containing indemnification or clauses of guarantees and does not believe that its liability under such agreements will result in any material liability.

**NOTE I — REDEEMABLE CONVERTIBLE PREFERRED STOCK**

In May 2006, in connection with its debt refinancing, the Company redeemed 37,881 shares of its 7% Redeemable Preferred Stock for $64.7 million and issued 50,000 shares of Series A Convertible Preferred Stock (“Series A Preferred”) with a stated value of $1,000 per share. The Company incurred $0.3 million of fees in connection with the redemption of the 7% Redeemable Preferred Stock and $2.3 million of costs to issue the Series A Preferred shares. The Series A Preferred provides for cumulative dividends at a rate of 3.33% per annum, payable quarterly in arrears. The Company may elect to defer the payment of dividends. The Series A Preferred may be converted into common shares at $7.56 per share at the option of the holders after a required holding period of 61 days which has since passed or at the option of the Company upon satisfaction of certain conditions. In addition, the initial holders of the Series A Preferred are entitled to have representation on the board of directors of the Company and are entitled to vote on all matters on which the holders of the Company’s common stock are entitled to vote.



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

**NOTE J – NET INCOME (LOSS) PER COMMON SHARE**

Basic per common share amounts are computed using the weighted average number of common shares outstanding during the period. Diluted per common share amounts are computed using the weighted average number of common shares outstanding during the period and dilutive potential common shares. Dilutive potential common shares consist of stock options and restricted shares and are calculated using the treasury stock method.

| *(In thousands, except share and per share data)* | Three Months Ended March 31, 2007 | Three Months Ended March 31, 2006 |
|---|---|---|
| Net income | $ 1,784 | $ 829 |
| Less: Preferred stock dividends declared and accretion–7% Redeemable Preferred Stock (1) | –– | 1,565 |
| Less: Preferred stock dividend declared–Series A Convertible Preferred Stock (1) | 416 | –– |
| Net income (loss) applicable to common stock | $ 1,368 | $ (736) |
| Shares of common stock outstanding used to compute basic per common share amounts | 22,191,920 | 21,837,069 |
| Effect of dilutive options | 1,176,951 | –– |
| Shares used to compute dilutive per common share amounts (1) | 23,368,871 | 21,837,069 |
| Basic income (loss) per share applicable to common stock | $ 0.06 | $ (0.03) |
| Diluted income (loss) per share applicable to common stock | 0.06 | (0.03) |

(1) For 2007 and 2006, excludes the effect of the conversion of the Preferred Stock as it is considered anti–dilutive. For 2007 and 2006, options to purchase 1,555,815 and 1,687,065 shares of common stock, respectively, are not included in the computation of diluted income per share as these options are anti–dilutive.



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

**NOTE K – SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN**

The Company's unfunded noncontributory defined benefit plan (the "Plan") covers certain senior executives, is administered by the Company and calls for annual payments upon retirement based on years of service and final average salary. Net periodic benefit expense is actuarially determined.

The change in the Plan's net benefit obligation is as follows:

| | *(In thousands)* |
|---|---|
| Net benefit cost at December 31, 2006 | $ 5,851 |
| Service cost | 521 |
| Interest cost | 84 |
| Amortization of (gain) loss | –– |
| Net benefit cost at March 31, 2007 | $ 6,456 |

At March 31, 2007, the Company has accrued approximately $6.5 million in benefit obligations related to the Plan.

**NOTE L — STOCK–BASED COMPENSATION**

*Restricted Shares of Common Stock*

A summary of the activity of restricted shares of common stock for the three months ended March 31, 2007 is as follows:

| | Employee Plans | | Director Plans | |
|---|---|---|---|---|
| | **Shares** | **Weighted Average Grant Date Fair Value** | **Shares** | **Weighted Average Grant Date Fair Value** |
| Nonvested at December 31, 2006 | 993,375 | $ 7.91 | 79,135 | $ 7.52 |
| Granted | –– | –– | –– | –– |
| Vested | (66,125) | 6.60 | –– | –– |
| Forfeited | (7,250) | 7.87 | –– | –– |
| Nonvested at March 31, 2007 | 920,000 | $ 8.01 | 79,135 | $ 7.52 |

During the three month period ended March 31, 2007, 66,125 restricted shares of common stock, with an intrinsic value of $0.4 million, became fully vested. As of March 31, 2007, total unrecognized compensation cost related to restricted shares of common stock was approximately $6.2 million and the related weighted–average period over which it is expected to be recognized is approximately 2.8 years. The aggregate granted shares have vesting dates through June 2010.



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

*Options*

Employee Plans

Under the Company's 2002 Stock Option Plan, 1.5 million shares of common stock were authorized for issuance. Options may only be granted at an exercise price that is not less than the fair market value of the common stock on the date of grant and may expire no later than ten years after grant. Vesting and expiration periods are established by the Compensation Committee of the Board of Directors, generally with vesting of four years following grant and generally with expirations of ten years after grant. During 2003, the 2002 Stock Option Plan was amended to permit the grant of restricted shares of common stock awards in addition to stock options and to change the name of the plan to the 2002 Stock Incentive Plan. During May 2006, an additional 2.7 million shares of common stock were authorized for issuance. During the three months ended March 31, 2007, no shares were cancelled under the 2002 Stock Option Plan. At March 31, 2007, 3,041,002 shares of common stock were available for issuance.

Director Plans

During April and May 2003, the Compensation Committee of the Board of Directors and the shareholders of the Company, respectively, approved the 2003 Non–Employee Directors' Stock Incentive Plan ("2003 Directors' Plan") which replaced the Company's 1993 Non–Employee Director Stock Option Plan ("Director Plan"). The 2003 Directors' Plan authorized 500,000 shares of common stock for grant and permits the issuance of stock options and restricted shares of common stock. The 2003 Directors' Plan also provides for the automatic annual grant of 8,500 shares of restricted shares of common stock to each director and permits the grant of an additional restricted stock grant in the event the director elects to receive his or her annual director fee in restricted shares of common stock rather than cash. Options may only be granted at an exercise price that is not less than the fair market value of the common stock on the date of grant and may expire no later than ten years after grant. Vesting and expiration periods are established by the Compensation Committee of the Board of Directors, generally with vesting of three years following grant and generally with expirations of ten years after grant. During the three months ended March 31, 2007, no shares were cancelled under the 2003 Directors' Plan. At March 31, 2007, 380,461 shares of common stock were available for issuance.

Non–qualified Options

Under an employment agreement, in October 2001, the Company issued to its Chief Financial Officer a non–qualified option to purchase 75,000 shares of its common stock at an exercise price of $5.50 per share. Similarly, under an employment agreement, in January 2002, the Company issued to its President and Chief Operating Officer a non–qualified option to purchase 350,000 shares of its common stock at an exercise price of $6.02 per share. In addition, the Company has issued to other employees non–qualified options to purchase an aggregate of 80,000 shares of its common stock at a weighted average exercise price of $8.73 per share. These options were granted at fair market value of the underlying common stock on the date of grant. During the three months ended March 31, 2007, none of the above options were exercised. During the three months ended March 31, 2007, no options to exercise shares were cancelled. At March 31, 2007, 406,000 non–qualified options were exercisable.



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

*Options (continued)*

The summary of option activity and weighted average exercise prices are as follows:

| *(In thousands, except per share and weighted average price amounts)* | Employee Plans | | Director Plans | | Non–Qualified Awards | |
|---|---|---|---|---|---|---|
| | **Shares** | **Weighted Average Price** | **Shares** | **Weighted Average Price** | **Shares** | **Weighted Average Price** |
| Outstanding at December 31, 2006 | 2,388,983 | $ 10.70 | 188,411 | $ 10.04 | 406,000 | $ 5.95 |
| Granted | –– | –– | –– | –– | –– | –– |
| Terminated | (14,750) | –– | –– | –– | –– | –– |
| Exercised | (121,109) | 3.68 | (25,000) | 5.20 | –– | –– |
| Outstanding at March 31, 2007 | 2,253,124 | $ 11.04 | 163,411 | $ 10.79 | 406,000 | $ 5.95 |
| Aggregate intrinsic value at March 31, 2007 | $ 24,877,010 | | $ 1,761,896 | | $ 2,415,000 | |
| Weighted average remaining contractual term (years) | 2.9 | | 5.5 | | 3.0 | |

The intrinsic value of options exercised during the three months ended March 31, 2007 was $0.6 million. Options exercisable under the Company's share–based compensation plans at March 31, 2007 were 2.8 million shares with a weighted average exercise price of $10.33, an average remaining contractual term of 3.0 years, and an aggregate intrinsic value of $28.8 million. Cash received by the Company related to the exercise of options during the three months ended March 31, 2007 amounted to $0.3 million. As of March 31, 2007, total unrecognized compensation cost related to stock option awards was approximately $0.03 million and the related weighted–average period over which it is expected to be recognized is approximately 3.0 years.

Information concerning outstanding and exercisable options as of March 31, 2007 is as follows:

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| | | Weighted Average | | | |
| **Range of Exercise Prices** | **Shares** | **Remaining Life (Years)** | **Exercise Price** | **Shares** | **Weighted Average Exercise Price** |
| $ 1.64 to $ 1.65 | 403,065 | 2.2 | $ 1.64 | 403,065 | $ 1.64 |
| 4.63 to 6.02 | 758,655 | 2.4 | 5.37 | 731,380 | 5.38 |
| 8.08 to 12.10 | 167,105 | 5.7 | 9.30 | 167,105 | 9.30 |
| 12.96 to 18.63 | 1,388,710 | 3.4 | 14.71 | 1,379,755 | 14.70 |
| 22.13 to 22.50 | 105,000 | 1.7 | 22.31 | 105,000 | 22.31 |
| | 2,822,535 | 3.0 | $ 10.29 | 2,786,305 | $ 10.33 |



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

**NOTE N – SEGMENT AND RELATED INFORMATION**

The Company has identified two reportable segments in which it operates based on the products and services it provides. The Company evaluates segment performance and allocates resources based on the segments' income from operations.

The reportable segments are: (i) patient–care centers and (ii) distribution. The reportable segments are described further below:

*Patient–Care Centers* – This segment consists of the Company's owned and operated patient–care centers and fabrication centers of O&P components. The patient–care centers provide services to design and fit O&P devices to patients. These centers also instruct patients in the use, care and maintenance of the devices. Fabrication centers are involved in the fabrication of O&P components for both the O&P industry and the Company's own patient–care centers.

*Distribution* – This segment distributes O&P products and components to both the O&P industry and the Company's own patient–care practices.

*Other* – This segment consists of Hanger corporate, IN, Inc. and Linkia. IN, Inc. specializes in bringing emerging MyoOrthotics Technologies® to the O&P market. MyoOrthotics Technologies represents the merging of orthotic technologies with electrical stimulation. Linkia is a national managed–care agent for O&P services and a patient referral clearing house.

The accounting policies of the segments are the same as those described in the summary of "Significant Accounting Policies" in Note B to the condensed consolidated financial statements.



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

**NOTE N – SEGMENT AND RELATED INFORMATION (CONTINUED)**

Summarized financial information concerning the Company's reportable segments is shown in the following table. Intersegment sales mainly include sales of O&P components from the distribution segment to the patient–care centers segment and were made at prices which approximate market values.

| *(In thousands)* | Patient–Care Centers | Distribution | Other | Consolidating Adjustments | Total |
|---|---|---|---|---|---|
| **Three Months Ended March 31, 2007** | | | | | |
| Net sales | | | | | |
| Customers | $ 130,609 | $ 13,047 | $ 194 | $ –– | $ 143,850 |
| Intersegments | –– | 28,840 | 426 | (29,266) | –– |
| Depreciation and amortization | 3,004 | 82 | 662 | –– | 3,748 |
| Income from operations | 19,153 | 3,619 | (10,712) | 336 | 12,396 |
| Interest (income) expense | (1,628) | 1,733 | 9,235 | –– | 9,340 |
| Income (loss) before taxes and extraordinary items | 20,781 | 1,886 | (19,947) | 336 | 3,056 |
| Total assets | 613,239 | 92,179 | 9,116 | –– | 714,534 |
| Capital expenditures | 1,777 | 127 | 2,221 | –– | 4,125 |
| **Three Months Ended March 31, 2006** | | | | | |
| Net sales | | | | | |
| Customers | $ 127,140 | $ 13,185 | $ 120 | $ –– | $ 140,445 |
| Intersegments | –– | 24,223 | –– | (24,223) | –– |
| Depreciation and amortization | 3,104 | 76 | 508 | –– | 3,688 |
| Income from operations | 15,787 | 4,667 | (9,539) | –– | 10,915 |
| Interest (income) expense | (1,575) | 1,727 | 9,348 | –– | 9,500 |
| Income (loss) before taxes and extraordinary items | 17,362 | 2,940 | (18,887) | –– | 1,415 |
| Total assets | 587,166 | 79,941 | 37,311 | –– | 704,418 |
| Capital expenditures | 2,186 | 32 | 399 | –– | 2,617 |

The Company's foreign and export sales and assets located outside of the United States of America are not significant. Additionally, no single customer accounted for more than 10% of revenues for three months ended March 31, 2007 and the same period in the prior year.

**NOTE O – CONSOLIDATING FINANCIAL INFORMATION**

The Company's Revolving Credit Facility, Senior Notes, and Term Loan are guaranteed fully, jointly and severally, and unconditionally by all of the Company's current and future domestic subsidiaries. The following are summarized Consolidating Balance Sheets as of March 31, 2007 and December 31, 2006, Statements of Operations for the three month periods ended March 31, 2007 and 2006 and Cash Flows for the three month periods ended March 31, 2007 and 2006 of the Company, segregating the parent company (Hanger Orthopedic Group, Inc.) and its guarantor subsidiaries, as each of the Company's subsidiaries is wholly–owned.



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

## NOTE O – CONSOLIDATING FINANCIAL INFORMATION (CONTINUED)

| BALANCE SHEET – March 31, 2007 | Hanger Orthopedic Group (Parent Company) | Guarantor Subsidiaries | Consolidating Adjustments | Consolidated Totals |
|---|---|---|---|---|
| *(In thousands)* | | | | |
| ASSETS | | | | |
| Cash and cash equivalents | $ 13,299 | $ 6,155 | $ –– | $ 19,454 |
| Accounts receivable | –– | 93,315 | –– | 93,315 |
| Inventories | –– | 75,524 | –– | 75,524 |
| Prepaid expenses, other assets and income taxes receivable | 5,088 | 8,618 | –– | 13,706 |
| Intercompany receivable | 315,495 | –– | (315,495) | –– |
| Deferred income taxes | 8,069 | –– | –– | 8,069 |
| Total current assets | 341,951 | 183,612 | (315,495) | 210,068 |
| Property, plant and equipment, net | 8,567 | 34,308 | –– | 42,875 |
| Excess cost over net assets acquired | –– | 446,616 | –– | 446,616 |
| Patents and other intangible assets,net | –– | 2,732 | –– | 2,732 |
| Investment in subsidiaries | 324,027 | –– | (324,027) | –– |
| Other assets | 10,906 | 1,337 | –– | 12,243 |
| Total assets | $ 685,451 | $ 668,605 | $ (639,522) | $ 714,534 |
| LIABILITIES, CONVERTIBLE PREFERRED STOCK AND SHAREHOLDERS' EQUITY | | | | |
| Current portion of long–term debt | $ 2,300 | $ 3,136 | $ –– | $ 5,436 |
| Accounts payable | 728 | 16,680 | –– | 17,408 |
| Accrued expenses | 10,671 | (1,470) | –– | 9,201 |
| Accrued interest payable | 6,078 | 50 | –– | 6,128 |
| Accrued compensation related costs | 3,292 | 7,857 | –– | 11,149 |
| Total current liabilities | 23,069 | 26,253 | –– | 49,322 |
| Long–term debt, less current portion | 400,975 | 3,097 | –– | 404,072 |
| Deferred income taxes | 34,662 | (4,862) | –– | 29,800 |
| Intercompany payable | –– | 315,495 | (315,495) | –– |
| Other liabilities | 9,013 | 4,595 | –– | 13,608 |
| Total liabilities | 467,719 | 344,578 | (315,495) | 496,802 |
| Convertible preferred stock | 47,654 | –– | –– | 47,654 |
| Common stock | 225 | 36 | (36) | 225 |
| Additional paid–in capital | 157,750 | 7,461 | (7,461) | 157,750 |
| Retained earnings | 12,759 | 317,070 | (317,070) | 12,759 |
| Treasury stock | (656) | (540) | 540 | (656) |
| Total shareholders' equity | 170,078 | 324,027 | (324,027) | 170,078 |
| Total liabilities, convertible preferred stock and shareholders' equity | $ 685,451 | $ 668,605 | $ (639,522) | $ 714,534 |



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

## NOTE O – CONSOLIDATING FINANCIAL INFORMATION (CONTINUED)

| BALANCE SHEET – December 31, 2006 | Hanger Orthopedic Group (Parent Company) | Guarantor Subsidiaries | Consolidating Adjustments | Consolidated Totals |
|---|---|---|---|---|
| *(In thousands)* | | | | |
| ASSETS | | | | |
| Cash and cash equivalents | $ 18,925 | $ 4,214 | $ –– | $ 23,139 |
| Accounts receivable | –– | 99,403 | –– | 99,403 |
| Inventories | –– | 75,803 | –– | 75,803 |
| Prepaid expenses, other assets and income taxes receivable | 2,036 | 6,769 | –– | 8,805 |
| Intercompany receivable | 327,944 | –– | (327,944) | –– |
| Deferred income taxes | 7,962 | –– | –– | 7,962 |
| Total current assets | 356,867 | 186,189 | (327,944) | 215,112 |
| Property, plant and equipment, net | 7,447 | 34,847 | –– | 42,294 |
| Excess cost over net assets acquired | –– | 446,371 | –– | 446,371 |
| Patents and other intangible assets, net | –– | 2,935 | –– | 2,935 |
| Investment in subsidiaries | 302,845 | –– | (302,845) | –– |
| Other assets | 11,113 | 1,297 | –– | 12,410 |
| Total assets | $ 678,272 | $ 671,639 | $ (630,789) | $ 719,122 |
| LIABILITIES, CONVERTIBLE PREFERRED STOCK AND SHAREHOLDERS' EQUITY | | | | |
| Current portion of long–term debt | $ 2,300 | $ 3,086 | $ –– | $ 5,386 |
| Accounts payable | 1,295 | 17,798 | –– | 19,093 |
| Accrued expenses | 11,460 | (598) | –– | 10,862 |
| Accrued interest payable | 1,759 | 44 | –– | 1,803 |
| Accrued compensation related costs | 3,503 | 17,257 | –– | 20,760 |
| Total current liabilities | 20,317 | 37,587 | –– | 57,904 |
| Long–term debt, less current portion | 401,551 | 3,687 | –– | 405,238 |
| Deferred income taxes | 35,603 | (4,862) | –– | 30,741 |
| Intercompany payable | –– | 327,944 | (327,944) | –– |
| Other liabilities | 5,470 | 4,438 | –– | 9,908 |
| Total liabilities | 462,941 | 368,794 | (327,944) | 503,791 |
| Convertible preferred stock | 47,654 | –– | –– | 47,654 |
| Common stock | 224 | 35 | (35) | 224 |
| Additional paid–in capital | 156,480 | 7,462 | (7,462) | 156,480 |
| Retained earnings | 11,629 | 295,888 | (295,888) | 11,629 |
| Treasury stock | (656) | (540) | 540 | (656) |
| Total shareholders' equity | 167,677 | 302,845 | (302,845) | 167,677 |
| Total liabilities, convertible preferred stock and shareholders' equity | $ 678,272 | $ 671,639 | $ (630,789) | $ 719,122 |



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

## NOTE O – CONSOLIDATING FINANCIAL INFORMATION (CONTINUED)

| **STATEMENT OF OPERATIONS**<br>**Three Months Ended March 31, 2007**<br>***(In thousands)*** | **Hanger Orthopedic Group (Parent Company)** | **Guarantor Subsidiaries** | **Consolidating Adjustments** | **Consolidated Totals** |
|---|---|---|---|---|
| Net sales | $ –– | $ 143,850 | $ –– | $ 143,850 |
| Cost of goods sold (exclusive of depreciation and amortization) | –– | 72,549 | –– | 72,549 |
| Selling, general and administrative | 8,361 | 46,796 | –– | 55,157 |
| Depreciation and amortization | 528 | 3,220 | –– | 3,748 |
| Income (loss) from operations | (8,889) | 21,285 | –– | 12,396 |
| Interest expense, net | 9,235 | 105 | –– | 9,340 |
| Equity in earnings of subsidiaries | 21,180 | –– | (21,180) | –– |
| Income (loss) before taxes | 3,056 | 21,180 | (21,180) | 3,056 |
| Provision for income taxes | 1,272 | –– | –– | 1,272 |
| Net income | $ 1,784 | $ 21,180 | $ (21,180) | $ 1,784 |

| **STATEMENT OF OPERATIONS**<br>**Three Months Ended March 31, 2006**<br>***(In thousands)*** | **Hanger Orthopedic Group (Parent Company)** | **Guarantor Subsidiaries** | **Consolidating Adjustments** | **Consolidated Totals** |
|---|---|---|---|---|
| Net sales | $ –– | $ 140,445 | $ –– | $ 140,445 |
| Cost of goods sold (exclusive of depreciation and amortization) | –– | 70,215 | –– | 70,215 |
| Selling, general and administrative | 7,328 | 48,299 | –– | 55,627 |
| Depreciation and amortization | 414 | 3,274 | –– | 3,688 |
| Income (loss) from operations | (7,742) | 18,657 | –– | 10,915 |
| Interest expense, net | 9,348 | 152 | –– | 9,500 |
| Equity in earnings of subsidiaries | 18,505 | –– | (18,505) | –– |
| Income (loss) before taxes | 1,415 | 18,505 | (18,505) | 1,415 |
| Provision for income taxes | 586 | –– | –– | 586 |
| Net income | $ 829 | $ 18,505 | $ (18,505) | $ 829 |



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

## NOTE O – CONSOLIDATING FINANCIAL INFORMATION (CONTINUED)

| **STATEMENTS OF CASH FLOWS**<br>**Three Months Ended March 31, 2007**<br>***(In thousands)*** | **Hanger Orthopedic Group (Parent Company)** | **Guarantor Subsidiaries** | **Consolidating Adjustments** | **Consolidated Totals** |
|---|---|---|---|---|
| Cash flows from operating activities: | | | | |
| Net cash (used in) provided by operating activities | $ (3,325) | $ 5,480 | $ –– | $ 2,155 |
| Cash flows from investing activities: | | | | |
| Purchase of property, plant and equipment | (1,649) | (2,476) | –– | (4,125) |
| Acquisitions and earnouts | –– | (498) | –– | (498) |
| Proceeds from sale of property, plant and equipment | –– | 158 | –– | 158 |
| Net cash used in investing activities | (1,649) | (2,816) | –– | (4,465) |
| Cash flows from financing activities: | | | | |
| Borrowings under revolving credit agreement | –– | –– | –– | –– |
| Repayments under revolving credit agreement | –– | –– | –– | –– |
| Repayments under term loan | (577) | –– | –– | (577) |
| Scheduled repayment of long–term debt | –– | (719) | –– | (719) |
| Decrease in financing costs | (238) | –– | –– | (238) |
| Proceeds from issuance of Common Stock | 575 | –– | –– | 575 |
| Preferrd stock dividend paid | (416) | –– | –– | (416) |
| Net cash used in financing activities | (656) | (719) | –– | (1,375) |
| Net decrease in cash and cash equivalents | (5,630) | 1,945 | –– | (3,685) |
| Cash and cash equivalents, at beginning of period | 18,925 | 4,214 | –– | 23,139 |
| Cash and cash equivalents, at end of period | $ 13,295 | $ 6,159 | $ –– | $ 19,454 |

| **STATEMENTS OF CASH FLOWS**<br>**Three Months Ended March 31, 2006**<br>***(In thousands)*** | **Hanger Orthopedic Group (Parent Company)** | **Guarantor Subsidiaries** | **Consolidating Adjustments** | **Consolidated Totals** |
|---|---|---|---|---|
| Cash flows from operating activities: | | | | |
| Net cash (used in) provided by operating activities | $ (15,108) | $ 2,337 | $ –– | $ (12,771) |
| Cash flows from investing activities: | | | | |
| Purchase of property, plant and equipment | (399) | (2,218) | –– | (2,617) |
| Acquisitions and earnouts | –– | (154) | –– | (154) |
| Proceeds from sale of property, plant and equipment | –– | 57 | –– | 57 |
| Net cash used in investing activities | (399) | (2,315) | –– | (2,714) |
| Cash flows from financing activities: | | | | |
| Borrowings under revolving credit agreement | 19,000 | –– | –– | 19,000 |
| Repayments under revolving credit agreement | (5,000) | –– | –– | (5,000) |
| Repayments under term loan | (375) | –– | –– | (375) |
| Scheduled repayment of long–term debt | –– | (646) | –– | (646) |
| Increase in financing costs | (95) | –– | –– | (95) |
| Proceeds from issuance of Common Stock | 141 | –– | –– | 141 |
| Change in book overdraft | 711 | –– | –– | 711 |
| Net cash provided by (used in) financing activities | 14,382 | (646) | –– | 13,736 |
| Net decrease in cash and cash equivalents | (1,125) | (624) | –– | (1,749) |
| Cash and cash equivalents, at beginning of period | 3,120 | 4,801 | –– | 7,921 |
| Cash and cash equivalents, at end of period | $ 1,995 | $ 4,177 | $ –– | $ 6,172 |



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

**ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

**Overview**

*The following is a discussion of our results of operations and financial position for the periods described below. This discussion should be read in conjunction with the Consolidated Financial Statements included in this report. Our discussion of our results of operations and financial condition includes various forward−looking statements about our markets, the demand for our products and services and our future results. These statements are based on our current expectations, which are inherently subject to risks and uncertainties. Our actual results and the timing of certain events may differ materially from those indicated in the forward looking statements.*

**Business Overview**

*General*

We are the largest owner and operator of orthotic and prosthetic ("O&P") patient−care centers ("patient−care centers"), accounting for approximately 22% of the $2.5 billion O&P patient−care market, in the United States. In addition, through our wholly−owned subsidiary, Southern Prosthetic Supply, Inc. ("SPS"), we are the largest distributor of branded and private label O&P devices and components in the United States, all of which are manufactured by third parties. We also create products, through our wholly−owned subsidiary, Innovative Neurotronics, Inc. ("IN, Inc."), for sale in our patient−care centers and through a sales force, to patients who have had a loss of mobility due to strokes, multiple sclerosis or other similar conditions. Another subsidiary, Linkia, LLC ("Linkia"), develops programs to manage all aspects of O&P patient care for large private payors.

For the quarter ended March 31, 2007, our net sales were $143.9 million and we recorded net income of $1.8 million.

We conduct our operations in two segments – patient−care centers and distribution. For the quarter ended March 31, 2007, net sales attributable to our patient−care services segment and distribution segment were $130.6 million and $13.0 million, respectively. See Note N to our consolidated financial statements contained herein for further information related to our segments.

*Patient Care Services*

At March 31, 2007, we operated 619 O&P patient−care centers in 45 states and the District of Columbia and employed in excess of 1,000 revenue−generating O&P practitioners ("practitioners").

In our orthotics business, we design, fabricate, fit and maintain a wide range of standard and custom−made braces and other devices (such as spinal, knee and sports−medicine braces) that provide external support to patients suffering from musculoskeletal disorders, such as ailments of the back, extremities or joints and injuries from sports or other activities. In our prosthetics business, we design, fabricate, fit and maintain custom−made artificial limbs for patients who are without one or more limbs as a result of traumatic injuries, vascular diseases, diabetes, cancer or congenital disorders. O&P devices are increasingly technologically advanced and are custom−designed to add functionality and comfort to patients' lives, shorten the rehabilitation process and lower the cost of rehabilitation.



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

Patients are referred to our local patient−care centers directly by physicians as a result of our reputation with them or through our agreements with managed care providers. Practitioners, technicians and office administrators staff our patient−care centers. Our practitioners generally design and fit patients with, and the technicians fabricate, O&P devices as prescribed by the referring physician. Following the initial design, fabrication and fitting of our O&P devices, our technicians conduct regular, periodic maintenance of O&P devices as needed.

Our practitioners are also responsible for managing and operating our patient−care centers and are compensated, in part, based on their success in managing costs and collecting accounts receivable. We provide centralized administrative, marketing and materials management services to take advantage of economies of scale and to increase the time practitioners have to provide patient care. In areas where we have multiple patient−care centers, we also utilize shared fabrication facilities where technicians fabricate devices for practitioners in that region.

*Distribution*

Our distribution segment, SPS, is the largest distributor in the O&P market with a dedicated sales force and three distribution sites in the United States. SPS purchases and distributes O&P products to our patient−care centers as well as independent O&P providers.

*Product Development*

In 2004, we formed a new subsidiary, IN, Inc. Specializing in the field of functional electrical stimulation, IN, Inc. identifies emerging MyoOrthotics Technologies® developed at research centers and universities throughout the world that use neuromuscular stimulation to improve the functionality of an impaired limb. MyoOrthotics Technologies represents the merging of orthotic technologies with electrical stimulation. Working with the inventors, IN, Inc. advances the design and manufacturing, the regulatory and clinical aspects of the technology and then introduces the devices to the marketplace through a variety of distribution channels. IN, Inc.'s first product, the WalkAide System, has received U.S. Food and Drug Administration ("FDA") approval and was released for sale through our patient−care centers on May 1, 2006. In November 2006, we received ISO 13485 certification as well as the European CE Mark which are widely accepted quality management standards for medical devices and related services. During 2007 we anticipate developing additional distribution channels for the WalkAide, including cultivating international distributors and development of a direct sales force.

*Provider Network Management*

Linkia is the first provider network management service company dedicated solely to serving the O&P market. Linkia was created in 2003 and is dedicated to managing the O&P services of national insurance companies. Linkia partners with healthcare insurance companies by securing national and regional contracts to manage the O&P networks. In 2004, Linkia entered into its first contract and in September 2005, Linkia signed an agreement with CIGNA HealthCare that covers over nine million beneficiaries. We will continue the deployment of the Linkia network and although it is too early to assess the overall success of this effort, we expect the Linkia contracts to positively impact patient−care center sales, as the CIGNA contract is phased in.

**Industry Overview**

We estimate that the O&P patient care market in the United States is approximately $2.5 billion, of which we account for approximately 22%. The O&P patient care services market is highly fragmented and is characterized by local, independent O&P businesses, with the majority generally having a single facility with annual revenues of less than $1.0 million. We do not believe that any of our patient care competitors account for a market share of more than 2% of the country's total estimated O&P patient care services revenue.

The care of O&P patients is part of a continuum of rehabilitation services including diagnosis, treatment and prevention of future injury. This continuum involves the integration of several medical disciplines that begins with the attending physician's diagnosis. A patient's course of treatment is generally determined by an orthopedic surgeon, vascular surgeon or physiatrist, who writes a prescription and refers the patient to an O&P patient care services provider for treatment. A practitioner then, using the prescription, consults with both the referring physician and the patient to formulate the design of an orthotic or prosthetic device to meet the patient's needs.

The O&P industry is characterized by stable, recurring revenues, primarily resulting from the need for periodic replacement and modification of O&P devices. Based on our experience, the average replacement time for orthotic devices is one to three years, while the average replacement time for prosthetic devices is three to five years. There is also an attendant need for continuing O&P patient care services. In addition to the inherent need for periodic replacement and modification of O&P devices and continuing care, we expect the demand for O&P services will continue to grow as a result of several key trends, including:

*Aging U.S. Population.* The growth rate of the over−65 age group is nearly triple that of the under−65 age group. There is a direct correlation between age and the onset of diabetes and vascular disease, which is the leading cause of amputations. With broader medical insurance coverage, increasing disposable income, longer life expectancy, greater mobility expectations and improved technology of O&P devices, we believe the elderly will increasingly seek orthopedic rehabilitation services and products.

*Growing Physical Health Consciousness.* The emphasis on physical fitness, leisure sports and conditioning, such as running and aerobics, is growing, which has led to increased injuries requiring orthopedic rehabilitative services and products. These trends are evidenced by the increasing demand for new devices that provide support for injuries, prevent further or new injuries or enhance physical performance.



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

*Increased Efforts to Reduce Healthcare Costs.* O&P services and devices have enabled patients to become ambulatory more quickly after receiving medical treatment in the hospital. We believe that significant cost savings can be achieved through the early use of O&P services and products. The provision of O&P services and products in many cases reduces the need for more expensive treatments, thus representing a cost savings to third–party payors.

*Advancing Technology.* The range and effectiveness of treatment options for patients requiring O&P services have increased in connection with the technological sophistication of O&P devices. Advances in design technology and lighter, stronger and more cosmetically acceptable materials have enabled patients to replace older O&P devices with new O&P products that provide greater comfort, protection and patient acceptability. As a result, treatment can be more effective or of shorter duration, giving the patient greater mobility and a more active lifestyle. Advancing technology has also increased the prevalence and visibility of O&P devices in many sports, including skiing, running and tennis.

**Competitive Strengths**

The combination of the following competitive strengths will help us in growing our business through an increase in our net sales, net income and market share:

- Leading market position, with an approximate 22% share of total industry revenues and operations in 45 states and the District of Columbia, in an otherwise fragmented industry;

- National scale of operations, which has better enabled us to:
  - establish our brand name and generate economies of scale;
  - implement best practices throughout the country;
  - utilize shared fabrication facilities;
  - contract with national and regional managed care entities;
  - identify, test and deploy emerging technology; and
  - increase our influence on, and input into, regulatory trends;
- Distribution of, and purchasing power for, O&P components and finished O&P products, which enables us to:
  - negotiate greater purchasing discounts from manufacturers and freight providers;
  - reduce patient–care center inventory levels and improve inventory turns through centralized purchasing control;



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

- quickly access prefabricated and finished O&P products;
- promote the usage by our patient−care centers of clinically appropriate products that also enhance our profit margins;
- engage in co−marketing and O&P product development programs with suppliers; and
- expand the non−Hanger client base of our distribution segment;

- Development of leading−edge technology for sale in our practices and through distributors;
- Full O&P product offering, with a balanced mix between orthotics services and products and prosthetics services and products;
- Practitioner compensation plans that financially reward practitioners for their efficient management of accounts receivable collections, labor, materials, and other costs, and encourages cooperation among our practitioners within the same local market area;
- Proven ability to rapidly incorporate technological advances in the fitting and fabrication of O&P devices;
- History of successful integration of small and medium−sized O&P business acquisitions, including 56 O&P businesses since 1997, representing over 150 patient−care centers;
- Highly trained practitioners, whom we provide with the highest level of continuing education and training through programs designed to inform them of the latest technological developments in the O&P industry, and our certification program located at the University of Connecticut; and
- Experienced and committed management team.

**Business Strategy**

Our goal is to continue to provide superior patient care and to be the most cost−efficient, full service, national O&P operator. The key elements of our strategy to achieve this goal are to:

- Improve our performance by:

  - developing and deploying new processes to improve the productivity of our practitioners;
  - continuing periodic patient evaluations to gauge patients’ device and service satisfaction;
  - improving the utilization and efficiency of administrative and corporate support services;



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

– enhancing margins through continued consolidation of vendors and product offering; and

– leveraging our market share to increase sales and enter into more competitive payor contracts;

- Increase our market share and net sales by:

– continued marketing of Linkia to regional and national providers and contracting with national and regional managed care providers who we believe select us as a preferred O&P provider because of our reputation, national reach, density of our patient–care centers in certain markets and our ability to help reduce administrative expenses;

– increasing our volume of business through enhanced comprehensive marketing programs aimed at referring physicians and patients, such as our Patient Evaluation Clinics program, which reminds patients to have their devices serviced or replaced and informs them of technological improvements of which they can take advantage; and our "People in Motion" program which introduces potential patients to the latest O&P technology;

– expanding the breadth of products being offered out of our patient–care centers; and

– increasing the number of practitioners through our residency program;

- Develop businesses that provide services and products to the broader rehabilitation and post–surgical healthcare areas as demonstrated by our emerging venture called TotalCare;

- Continue to create, license or patent and market devices based on new cutting edge technology. We anticipate bringing new technology to the market through our IN, Inc. product line. The first new product, the WalkAide System, was released for sale on May 1, 2006;

- Selectively acquire small and medium–sized O&P patient care service businesses and open satellite patient–care centers primarily to expand our presence within an existing market and secondarily to enter into new markets; and

- Provide our practitioners with:

– the training necessary to utilize existing technology for different patient service facets, such as the use of our Insignia scanning system for burns and cranial helmets;

– career development and increased compensation opportunities;

– a wide array of O&P products from which to choose;



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

– administrative and corporate support services that enable them to focus their time on providing superior patient care; and

– selective application of new technology to improve patient care.

**Results and Outlook**

Net sales for the three months ended March 31, 2007 increased by $3.5 million, or 2.5%, to $143.9 million from $140.4 million in the prior year's first quarter. The sales increase was principally the result of a $3.3 million, or 2.6%, increase in same–center sales in our patient care business. Cost of goods sold for the quarter increased by $2.3 million to $72.5 million, or 50.4% of net sales, compared to $70.2 million, or 50.0% of net sales, in the prior quarter principally due to the increase in sales and a $1.2 million decrease in labor, offset by a $3.5 million increase in cost of materials as compared to 2006.

Income from operations increased by $1.5 million for the three months ended March 31, 2007, to $12.4 million from $10.9 million in the same period of the prior year due principally to the sales increase and a decrease in selling, general and administrative expenses, offset by an increase in cost of goods sold. Selling, general and administrative expenses decreased by $0.5 million due to a $0.2 million increase in personnel costs offset by a $0.7 million decrease in other variable operating expense. The increase in cost of goods sold as a percentage of sales was due to sales increases, the mix of products sold, and inflationary factors; offset by lower employee costs.

We continue to improve upon our cash collections. Day's sales outstanding ("DSO"), which is the number of days between the billing for our O&P services and the date of our receipt of payment, decreased to 56 days as of March 31, 2007 compared to 59 days at March 31, 2006. The decrease in DSO is due to continued efforts at the patient–care centers to target collections as well as other work flow enhancements.

We expect to continue to see an increase in our sales volume over the next year as a result of the increase in Medicare reimbursement, continued roll out of Linkia national contracts, sales from IN, Inc.'s WalkAide and growth from our distribution segment. We will also continue our efforts to counter the cyclical trends and challenges present in our market by undertaking several specific initiatives:

- continued marketing of the Linkia model to national and large regional insurance carriers;
- the utilization of our centralized billing system, OPS, to analyze related O&P procedures in an effort to provide comprehensive services;
- the rollout of the "People in Motion" program, which introduces potential patients to new O&P technology;
- the introduction of new products by entering into exclusive distribution contracts with O&P product manufacturers; and
- continuing discussions with rehabilitation providers to enable us to provide more comprehensive O&P services.



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

**Critical Accounting Policies & Estimates**

Our analysis and discussion of our financial condition and results of operations are based upon our Consolidated Financial Statements that have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. GAAP provides the framework from which to make these estimates, assumptions, and disclosures. We have chosen accounting policies within GAAP that management believes are appropriate to accurately and fairly report our operating results and financial position in a consistent manner. Management regularly assesses these policies in light of current and forecasted economic conditions. Our accounting policies are stated in Note B to the Consolidated Financial Statements in our Annual Report on Form 10−K for the year ended December 31, 2006. We believe the following accounting policies are critical to understanding the results of operations and affect the more significant judgments and estimates used in the preparation of the Consolidated Financial Statements.

- *Revenue Recognition:* Revenues on the sale of orthotic and prosthetic devices and associated services to patients are recorded when the device is accepted by the patient, provided that (i) delivery has occurred or services have been rendered; (ii) persuasive evidence of an arrangement exists; (iii) the sales price is fixed or determinable; and (iv) collectibility is reasonably assured. Revenues on the sale of orthotic and prosthetic devices to customers by our distribution segment are recorded upon the shipment of products, in accordance with the terms of the invoice, net of merchandise returns received and the amount established for anticipated returns. Discounted sales are recorded at net realizable value. Deferred revenue represents prepaid tuition and fees received from students enrolled in our practitioner education program.

  Revenue at our patient−care centers segment is recorded net of all governmental adjustments, contractual adjustments and discounts. We employ a systematic process to ensure that our sales are recorded at net realizable value and that any required adjustments are recorded on a timely basis. The contracting module of our centralized, computerized billing system is designed to record revenue at net realizable value based on our contract with the patient's insurance company. Updated billing information is received periodically from payors and is uploaded into our centralized contract module and then disseminated to all patient−care centers electronically.



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

The following represents the composition of our patient−care segment's accounts receivable balance by payor:

| **March 31, 2007**<br>*(In thousands)* | **0−60 days** | **61−120 days** | **Over 120 days** | **Total** |
|---|---|---|---|---|
| Commercial and other | $ 26,622 | $ 10,168 | $ 11,212 | $ 48,002 |
| Private pay | 3,212 | 1,184 | 1,551 | 5,947 |
| Medicaid | 4,874 | 2,778 | 3,157 | 10,809 |
| Medicare | 14,416 | 4,113 | 3,730 | 22,259 |
| VA | 780 | 290 | 222 | 1,292 |
| | $ 49,904 | $ 18,533 | $ 19,872 | $ 88,309 |

| **December 31, 2006**<br>*(In thousands)* | **0−60 days** | **61−120 days** | **Over 120 days** | **Total** |
|---|---|---|---|---|
| Commercial and other | $ 27,957 | $ 15,730 | $ 9,866 | $ 53,553 |
| Private pay | 3,111 | 1,310 | 1,222 | 5,643 |
| Medicaid | 4,639 | 3,686 | 2,778 | 11,103 |
| Medicare | 13,796 | 5,908 | 2,978 | 22,682 |
| VA | 833 | 435 | 177 | 1,445 |
| | $ 50,336 | $ 27,069 | $ 17,021 | $ 94,426 |

Disallowed sales generally relate to billings to payors with whom we do not have a formal contract. In these situations we record the sale at usual and customary ratesand simultaneously record a disallowed sale to reduce the sale to net value, based on our historical experience with the payor in question. Disallowed sales may also result if the payor rejects or adjusts certain billing codes. Billing codes are frequently updated within our industry. As soon as updates are received, we reflect the change in our centralized billing system.

As part of our preauthorization process with payors, we validate our ability to bill the payor for the service we are providing before we deliver the device. Subsequent to billing for our devices and services, there may be problems with pre−authorization or with other insurance coverage issues with payors. If there has been a lapse in coverage, the patient is financially responsible for the charges related to the devices and services received. If we do not collect from the patient, we record bad debt expense. Occasionally, a portion of a bill is rejected by a payor due to a coding error on our part and we are prevented from pursuing payment from the patient due to the terms of our contract with the insurance company. We appeal these types of decisions and are generally successful. This activity is factored into our methodology to determine the estimate for the allowance for doubtful accounts. We immediately record, as a reduction of sales, a disallowed sale for any claims that we know we will not recover and adjust our future estimates accordingly.



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

Certain accounts receivable may be uncollectible, even if properly pre−authorized and billed. Regardless of the balance, accounts receivable amounts are periodically evaluated to assess collectibility. In addition to the actual bad debt expense recognized during collection activities, we estimate the amount of potential bad debt expense that may occur in the future. This estimate is based upon our historical experience as well as a review of our receivable balances. On a quarterly basis, we evaluate cash collections, accounts receivable balances and write−off activity to assess the adequacy of our allowance for doubtful accounts. Additionally, a company−wide evaluation of collectibility of receivable balances older than 180 days is performed at least semi−annually, the results of which are used in the next allowance analysis. In these detailed reviews, the account's net realizable value is estimated after considering the customer's payment history, past efforts to collect on the balance and the outstanding balance, and a specific reserve is recorded if needed. From time to time, the Company may outsource the collection of such accounts to outsourced agencies after internal collection efforts are exhausted. In the cases when valid accounts receivable cannot be collected, the uncollectible account is written off to bad debt expense.

- *Inventories:* Inventories, which consist principally of raw materials, work−in−process and finished goods, are stated at the lower of cost or market using the first−in, first−out method. At our patient−care centers segment, we calculate cost of goods sold in accordance with the gross profit method for all reporting periods. We base the estimates used in applying the gross profit method on the actual results of the most recently completed fiscal year and other factors, such as sales mix and purchasing trends among other factors, affecting cost of goods sold during the current reporting periods. Cost of goods sold during the period is adjusted when the annual physical inventory is taken. We treat these adjustments as changes in accounting estimates. At our distribution segment, a perpetual inventory is maintained. Management adjusts our reserve for inventory obsolescence whenever the facts and circumstances indicate that the carrying cost of certain inventory items is in excess of its market price. Shipping and handling costs are included in cost of goods sold.

- *Property, Plant and Equipment:* We record property, plant and equipment at cost. Equipment acquired under capital leases is recorded at the lower of fair market value or the present value of the future lease payments. The cost and related accumulated depreciation of assets sold, retired or otherwise disposed of are removed from the respective accounts, and any resulting gains or losses are included in the Consolidated Statements of Operations. Depreciation is computed for financial reporting purposes using the straight−line method over the estimated useful lives of the related assets as follows:

| | |
|---|---|
| Furniture and fixtures | 5 years |
| Machinery and equipment | 5 years |
| Computers and software | 5 years |
| Buildings | 10 to 40 years |
| Assets under capital leases | Shorter of asset life or term of lease |
| Leasehold improvements | Shorter of asset life or term of lease |



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

We capitalize internally developed computer software costs incurred during the application development stage in accordance with Statement of Position 98−1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*.

- *Goodwill and Other Intangible Assets*: Excess cost over net assets acquired ("Goodwill") represents the excess of purchase price over the value assigned to net identifiable assets of purchased businesses. We assess goodwill for impairment when events or circumstances indicate that the carrying value may not be recoverable, or, at a minimum, annually. Any impairment would be recognized by a charge to operating results and a reduction in the carrying value of the intangible asset. Our annual impairment test primarily utilizes the income approach and considers the market approach and the cost approach in determining the value of our reporting units. As of October 1, 2006, our test did not result in an impairment charge.

  Non−compete agreements are recorded based on agreements entered into by us and are amortized, using the straight−line method, over their terms ranging from five to seven years. Other definite−lived intangible assets are recorded at cost and are amortized, using the straight−line method, over their estimated useful lives of up to 16 years. Whenever the facts and circumstances indicate that the carrying amounts of these intangibles may not be recoverable, management reviews and assesses the future cash flows expected to be generated from the related intangible for possible impairment. Any impairment would be recognized as a charge to operating results and a reduction in the carrying value of the intangible asset.

- *Deferred Tax Assets (Liabilities).* We account for certain income and expense items differently for financial accounting purposes than for income tax purposes. Deferred income tax assets or liabilities are provided in recognition of these temporary differences. We recognize deferred tax assets if it is more likely than not the assets will be realized in future years. We are required to estimate our income taxes in each of the jurisdictions in which we operate. This process requires us to estimate our actual current tax exposure and assess the temporary differences resulting from differing treatment of items, such as the deductibility of certain intangible assets, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income. To the extent we believe the recovery is not likely, we must establish a valuation allowance, which will continually be assessed. After having determined that we will be able to begin utilizing a significant portion of the deferred tax assets, the valuation allowance may be reversed, resulting in a benefit to the statement of operations in some future period.

- *Stock−Based Compensation.* Stock−based compensation is accounted for using the grant−date fair value method. Compensation expense is recognized ratably over the service period. We estimate a 0% forfeiture rate for unvested options, as they relate to director awards and we do not forsee any director terminations prior to vesting. Based on the history of restricted stock forfeitures, we do not believe future forfeitures will have a material impact on future compensation expense or earnings per share.



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

- *Supplemental Executive Retirement Plan.* Benefit costs and liabilities balances are calculated based on certain assumptions including benefits earned, discount rates, interest costs, mortality rates and other factors. Actual results that differ from the assumptions are accumulated and amortized over future periods, affecting the recorded obligation and expense in future periods. The following assumptions were used in the calculation of the net benefit cost and obligation at March 31, 2007:

| | |
|---|---|
| Discount rate | 5.75% |
| Average rate of increase in compensation | 3.00% |

We believe the assumptions used are appropriate, however, changes in assumptions or differences in actual experience may affect our benefit obligation and future expenses.

**New Accounting Guidance**

We adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, "Accounting for Uncertainty in Income Taxes", on January 1, 2007. As a result of adoption, we recognized a debit of approximately $0.2 million to the January 1, 2007 retained earnings balance. As of the adoption date, we had gross tax affected unrecognized tax benefits of $3.3 million of which $1.1 million, if recognized, would affect the effective tax rate. Also as of the adoption date, we had accrued interest expense and penalties related to the unrecognized tax benefits of $0.4 million and $0.4 million, respectively. We recognize interest accrued and penalties related to unrecognized tax benefits as a component of income tax expense. Total penalties and interest accrued as of March 31, 2007 was $0.9 million.

The Company files numerous consolidated and separate income tax returns in the United States Federal jurisdiction and in many state jurisdictions. With few exceptions, the Company is no longer subject to US Federal income tax examinations for years before 2003 and is no longer subject to state and local income tax examinations by tax authorities for years before 2002.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements* ("SFAS 157"). SFAS 157 provides guidance on the application of fair value measurement objectives required in existing GAAP literature to ensure consistency and comparability. Additionally, SFAS 157 requires additional disclosures on the fair value measurements used. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company believes the adoption of SFAS 157 will not have a material impact on its financial statements.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities Fair Value Measurements* ("SFAS 159"). SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 does not affect any existing accounting literature that requires certain assets and liabilities to be carried at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of adopting SFAS No. 159 on our financial statements.



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

**Results of Operations**

The following table sets forth for the periods indicated certain items from our Consolidated Statements of Operations as a percentage of our net sales:

| | Three Months Ended March 31, 2007 | Three Months Ended March 31, 2006 |
|---|---|---|
| Net sales | 100.0 % | 100.0 % |
| Cost of goods sold | 50.4 | 50.0 |
| Selling, general and administrative | 38.4 | 39.6 |
| Depreciation and amortization | 2.6 | 2.6 |
| Income from operations | 8.6 | 7.8 |
| Interest expense, net | 6.5 | 6.8 |
| Income before taxes | 2.1 | 1.0 |
| Provision for income taxes | 0.9 | 0.4 |
| Net income | 1.2 | 0.6 |

***Three Months Ended March 31, 2007 Compared to the Three Months Ended March 31, 2006***

*Net Sales.* Net sales for the three months ended March 31, 2007 were $143.9 million, an increase of $3.5 million, or 2.5%, versus net sales of $140.4 million for the three months ended March 31, 2006. The sales increase was principally the result of a $3.3 million, or 2.6%, same–center sales growth.

*Cost of Goods Sold.* Cost of goods sold for the three months ended March 31, 2007 was $72.5 million, or 50.4% of net sales, compared to $70.2 million, or 50.0% of net sales, for the three months ended March 31, 2006. The increase in cost of goods sold as a percentage of sales was due to sales increases, the mix of products sold, and inflationary factors; offset by lower employee costs.

*Selling, General and Administrative.* Selling, general and administrative expenses for the three months ended March 31, 2007 decreased by $0.5 million to $55.2 million, or 38.4% of net sales from $55.6 million, or 39.6% of net sales, for the three months ended March 31, 2006. The decrease resulted from a $0.2 million increase in personnel costs offset by a $0.7 million decrease in other variable operating expense.

*Depreciation and Amortization.* Depreciation and amortization for each of the three months ended March 31, 2007 and 2006 was $3.7 million.



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

*Income from Operations.*Principally due to an increase in net sales, income from operations for the three months ended March 31, 2007 was $12.4 million compared to $10.9 million for the three months ended March 31, 2006. Income from operations, as a percentage of net sales, increased to 8.6% for the three months ended March 31, 2007 versus 7.8% for the prior year's comparable period.

*Interest Expense.* Interest expense in the three months ended March 31, 2007 decreased to $9.3 million compared to $9.5 million in the three months ended March 31, 2006 due to amendments to our existing Senior Secured Credit Facility that includes reducing the margin over LIBOR that the Company pays as interest under the existing Term Loan to 2.25%.

*Income Taxes.* Income tax provision of $1.3 million was recognized for the three months ended March 31, 2007 compared to $0.6 million for the same period of the prior year. The change in the income tax provision was primarily the result of higher income from operations. The effective tax rate for the three months ended March 31, 2007 was 41.6% compared to 41.4% for the three months ended March 31, 2006. The effective tax rate for the three month periods ended March 31, 2007 and 2006 consists principally of the federal statutory tax rate of 35.0% and state income taxes.

*Net Income.* As a result of the above, we recorded net income of $1.8 million for the three months ended March 31, 2007, compared to net income of $0.8 million for the same period in the prior year.

*Net Income (Loss) Applicable to Common Stock.* Preferred stock dividends amounted to $0.4 million in the first quarter of 2007 compared to preferred stock dividends and accretion of $1.6 million in the first quarter of 2006. As a result, net income applicable to common stock of $1.4 million, or $0.06 per share, was recorded in the first quarter of 2007, compared to a net loss attributable to common stock of $0.7 million, or $0.03 per share, in the prior year's first quarter.

**Financial Condition, Liquidity, and Capital Resources**

*Cash Flows*

Our working capital at March 31, 2007 was $160.7 million compared to $157.2 million at December 31, 2006. Working capital increased principally as a result of continued strong cash collections as evidenced by the decrease in accounts receivable offset by decreases in accounts payable and payment of year end incentive compensation. These factors combined with a change in interest payment dates resulted in operating cash flows of $2.2 million for the three months ended March 31, 2007, which compared favorably to $12.8 million of cash used by operations in the prior year. Days sales outstanding ("DSO"), which is the number of days between the billing for our O&P services and the date of our receipt of payment thereof, for the three months ended March 31, 2007, decreased to 56 days, compared to 59 days for the same period last year. The decrease in DSO is due to a continued effort at our patient−care centers to target collections. At March 31, 2007 the company's availability under its Revolving Credit Facility was $72.0 million, net of $3.0 million of standby letters of credit.



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

Net cash used in investing activities was $4.5 million for the three months ended March 31, 2007, versus $2.7 million for the same period in the prior year. Cash used in investing activities was principally related to the purchase of computer related assets and leasehold improvements and the acquisition of a footwear company for approximately $0.5 million.

Net cash used in financing activities was $1.4 million for the three months ended March 31, 2007, compared to net cash provided by financing activities of $13.7 million for the three months ended March 31, 2006. Improved cash flows from operations for the three months ended March 31, 2007 eliminated the need for the company to borrow funds under its Revolving Credit Facility. For the three months ended March 31, 2006 the company borrowed $14.0 million under the Revolving Credit Facility which were used primarily to fund the payout of incentive compensation and the purchases of fixed assets.

*Debt*

The following summarizes our debt balance at:

| *(In thousands)* | March 31, 2007 | December 31, 2006 |
|---|---|---|
| Term Loan | $ 228,275 | $ 228,852 |
| 10 1/4% Senior Notes due 2014 | 175,000 | 175,000 |
| Subordinated seller notes, non–collateralized, net of unamortized discount with principal and interest payable in either monthly, quarterly or annual installments at effective interest rates ranging from 5.0% to 10.8%, maturing through December 2011 | 6,233 | 6,772 |
| | 409,508 | 410,624 |
| Less current portion | (5,436) | (5,386) |
| | $ 404,072 | $ 405,238 |

*Revolving Credit Facility*

The $75.0 million Revolving Credit Facility matures on May 26, 2011 and bears interest, at the Company's option, of LIBOR plus 2.75% or a Base Rate (as defined in the credit agreement) plus 1.75%. The obligations under the Revolving Credit Facility are guaranteed by the Company's subsidiaries and are secured by a first priority perfected interest in the Company's subsidiaries' shares, all of the Company's assets and all the assets of the Company's subsidiaries. The Revolving Credit Facility requires compliance with various covenants including but not limited to a maximum total leverage ratio and a maximum annual capital expenditures limit. As of March 31, 2007, the Company has not made draws on the Revolving Credit Facility and has $72.0 million available under that facility. Availability under the Company's Revolving Credit Facility is net of standby letters of credit of approximately $3.0 million.



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

*Term Loan*

The $230.0 million Term Loan matures on May 26, 2013 and requires quarterly payments commencing September 30, 2006. From time to time, mandatory payments may be required as a result of capital stock issuances, additional debt incurrences, asset sales or other events as defined in the credit agreement. The Term Loan bears interest, at the Company's option, of LIBOR plus 2.50% or a Base Rate (as defined in the credit agreement) plus 1.50%. At March 31, 2007, the interest rate on the Term Loan was 7.60%. The obligations under the Term Loan are guaranteed by the Company's subsidiaries and are secured by a first priority perfected interest in the Company's subsidiaries' shares, all of the Company's assets and all the assets of the Company's subsidiaries. The Term Loan is subject to covenants that mirror those of the Revolving Credit Facility. Effective March 12, 2007, the Company secured certain amendments to its existing Senior Secured Credit Facility that includes reducing the margin over LIBOR that the Company pays as interest under the existing Term Loan to 2.25%. On April 30, 2007, the Company received a rating upgrade from Moody's Investors Service. This upgrade combined with achievement of other thresholds defined in the Term Loan agreement will result in a 25 basis point reduction in the interest rate margin from the present rate of 2.25% above LIBOR.

*10 ¼% Senior Notes*

The 10 ¼% Senior Notes mature June 1, 2014, are senior indebtedness and are guaranteed on a senior unsecured basis by all of the Company's current and future domestic subsidiaries. Interest is payable semi−annually on June 1 and December 1, commencing December 1, 2006.

On or prior to June 1, 2009, the Company may redeem up to 35% of the aggregate principal amount of the notes at a redemption price of 110.250% of the principal amount thereof, plus accrued and unpaid interest and additional interest, if any, with the net cash proceeds of an equity offering; provided that (i) at least 65% of the aggregate principal amount of the notes remains outstanding immediately after the redemption (excluding notes held by the Company and its subsidiaries); and (ii) the redemption occurs within 90 days of the date of the closing of the equity offering.

Except as discussed above, the notes are not redeemable at the Company's option prior to June 1, 2010. On or after June 1, 2010, the Company may redeem all or part of the notes upon not less than 30 days and no more than 60 days' notice, for the twelve−month period beginning on June 1 of the following years; at (i) 105.125% during 2010; (ii) 102.563% during 2011; and (iii) 100.0% during 2012 and thereafter.

*General*

We believe that, based on current levels of operations and anticipated growth, cash generated from operations, together with other available sources of liquidity, including borrowings available under the Revolving Credit Facility, will be sufficient for at least twelve months to fund anticipated capital expenditures and make required payments of principal and interest on our debt, including payments due on our outstanding debt. In addition, we will continue to evaluate potential acquisitions and expect to fund such acquisitions from our available sources of liquidity, as discussed above. We are limited to $50.0 million in acquisitions annually by the terms of the Revolving Credit Facility agreement. At March 31, 2007, we are in compliance with all covenants under these debt agreements.



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

**Obligations and Commercial Commitments**

The following table sets forth our contractual obligations and commercial commitments as of March 31, 2007:

| | Payments Due by Period | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2007 | 2008 | 2009 | 2010 | 2011 | Thereafter | Total |
| *(In thousands)* | | | | | | | |
| Long−term debt | $ 4,190 | $ 4,676 | $ 3,185 | $ 2,546 | $ 2,520 | $ 392,391 | $ 409,508 |
| Interest payments on long−term debt | 31,187 | 35,273 | 34,978 | 34,767 | 34,579 | 66,353 | 237,137 |
| Operating leases | 28,898 | 23,694 | 18,052 | 10,878 | 5,998 | 3,888 | 91,408 |
| Capital leases | 123 | 87 | 35 | 2 | −− | −− | 247 |
| Other long−term obligations (1) | 539 | 245 | 336 | 16,650 | 1,843 | 780 | 20,393 |
| Total contractual cash obligations | $ 64,937 | $ 63,975 | $ 56,586 | $ 64,843 | $ 44,940 | $ 463,412 | $ 758,693 |

(1) Other long−term obligations consist primarily of amounts related to our Supplemental Executive Retirement Plan, earnout payments and payments under the restructuring plans.

*Dividends.*

The Series A Convertible Preferred Stock are entitled to cumulative dividends, accruing at an annual rate of 3.33%, or $1.7 million, payable quarterly in arrears. We may elect to defer the payment of dividends otherwise payable on a dividend payment date. In such event, the amount of deferred dividends will be added to the stated value. Accrued but unpaid dividends will be payable upon our liquidation in cash and upon a Holder Conversion, (as defined in the Amended and Restated Preferred Stock Purchase Agreement) at the option of the Holder, either in cash (to the extent permitted under applicable law and the terms of our indebtedness) or in additional shares of our common stock. Immediately prior to the occurrence of an acceleration event prior to the fifth anniversary of the original issue date, the stated value of each share of Series A Convertible Preferred Stock will be increased by an amount per share equal to all dividends that would otherwise be payable on a share of Series A Convertible Preferred Stock on each dividend payment date on and after the occurrence of such acceleration event and prior to and including the fifth anniversary of the original issuance date.

**Off−Balance Sheet Arrangements**

The Company's wholly−owned subsidiary, Innovative Neurotronics, Inc. (“IN, Inc.”), is party to a non−binding purchase agreement under which it agrees to purchase assembled WalkAide System kits. As of March 31, 2007, IN, Inc. had outstanding purchase commitments of approximately $0.4 million.



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

**Market Risk**

We are exposed to the market risk that is associated with changes in interest rates. At March 31, 2007, all our outstanding debt, with the exception of the Revolving Credit Facility and the Term Loan, is subject to a fixed interest rate. (See Item 3 below.)

**Forward Looking Statements**

This report contains forward–looking statements setting forth our beliefs or expectations relating to future revenues, contracts and operations, as well as the results of an internal investigation and certain legal proceedings. Actual results may differ materially from projected or expected results due to changes in the demand for our O&P products and services, uncertainties relating to the results of operations or recently acquired O&P patient–care centers, our ability to enter into and derive benefits from managed–care contracts, our ability to successfully attract and retain qualified O&P practitioners, federal laws governing the health–care industry, uncertainties inherent in incomplete investigations and legal proceedings, governmental policies affecting O&P operations and other risks and uncertainties generally affecting the health–care industry. Readers are cautioned not to put undue reliance on forward–looking statements. We disclaim any intent or obligation to publicly update these forward–looking statements, whether as a result of new information, future events or otherwise.

**ITEM 3. Quantitative and Qualitative Disclosures about Market Risk**

We have existing obligations relating to our 10 ¼ % Senior Notes, Term Loan, Subordinated Seller Notes, and Series A Convertible Preferred Stock. As of March 31, 2007, we have cash flow exposure to the changing interest rate on the Term Loan and Revolving Credit Facility. The other obligations have fixed interest or dividend rates.

We have a $75.0 million revolving credit facility, with no outstanding balance at March 31, 2007, as discussed in Note G to our Condensed Consolidated Financial Statements. The rates at which interest accrues under the entire outstanding balance are variable.

In addition, in the normal course of business, we are exposed to fluctuations in interest rates. From time to time, we execute LIBOR contracts to fix interest rate exposure for specific periods of time. At March 31, 2007, we had one contract outstanding which fixed LIBOR at 7.60% and expiring on June 29, 2007.

Presented below is an analysis of our financial instruments as of March 31, 2007 that are sensitive to changes in interest rates. The table demonstrates the change in estimated annual cash flow related to the outstanding balance under the Term Loan and the Revolving Credit Facility (the revolving Credit Facility did not have an outstanding balance at March 31, 2007), calculated for an instantaneous parallel shift in interest rates, plus or minus 50 basis points ("BPS"), 100 BPS, and 150 BPS.



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

| Cash Flow Risk | Annual Interest Expense Given an Interest Rate Decrease of X Basis Points | | | No Change in Interest Rates | Annual Interest Expense Given an Interest Rate Increase of X Basis Points | | |
|---|---|---|---|---|---|---|---|
| | (150 BPS) | (100 BPS) | (50 BPS) | | 50 BPS | 100 BPS | 150 BPS |
| *(In thousands)* | | | | | | | |
| Term Loan | $ 13,925 | $ 15,066 | $ 16,208 | $ 17,349 | $ 18,490 | $ 19,632 | $ 20,773 |
| Revolving Credit Facility | –– | –– | –– | –– | –– | –– | –– |
| | $ 13,925 | $ 15,066 | $ 16,208 | $ 17,349 | $ 18,490 | $ 19,632 | $ 20,773 |

**ITEM 4. Controls and Procedures**

***Disclosure Controls and Procedures***

The Company’s disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed by it in its periodic reports filed with the Securities and Exchange Commission is recorded, processed, summarized and reported, within the time periods specified in the Commission’s rules and forms. Based on an evaluation of the Company’s disclosure controls and procedures conducted by the Company’s Chief Executive Officer and Chief Financial Officer, such officers concluded that the Company’s disclosure controls and procedures were effective as of March 31, 2007 to ensure that information required to be disclosed in the reports filed with the Exchange Act was accumulated and communicated to management, including the Company’s Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosures.

***Change in Internal Control Over Financial Reporting***

In accordance with Rule 13a–15(d) under the Securities Exchange Act of 1934, management, with the participation of the Company’s Chief Executive Officer and Chief Financial Officer, determined that there was no change in the Company’s internal control over financial reporting that occurred during the first quarter ended March 31, 2007, that has materially effected, or is reasonably likely to materially effect, the Company’s internal control over financial reporting.

**Part II. Other Information**

**ITEM 1. LEGAL PROCEEDINGS.**

**Regulatory Inquiry**



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

On June 15, 2004, the Company announced that an employee at its patient–care center in West Hempstead, New York alleged in a television news story aired on June 14, 2004 that there were instances of billing discrepancies at that facility.

On June 18, 2004, the Company announced that on June 17, 2004, the Audit Committee of the Company's Board of Directors had engaged a law firm to serve as independent counsel to the Audit Committee and to conduct an independent investigation of the allegations. The scope of that independent investigation was expanded to cover certain of the Company's other patient–care centers and included consideration of some of the allegations made in the Amended Complaint filed in the class actions discussed below. On June 17, 2004, the U.S. Attorney's Office for the Eastern District of New York subpoenaed records of the Company regarding various billing activities and locations. In addition, the Company also announced on June 18, 2004 that the Securities and Exchange Commission had commenced an informal inquiry into the matter. The Company is cooperating with the regulatory authorities. The Audit Committee's investigation will not be complete until all regulatory authorities have indicated that their inquiries are complete.

Management believes that any billing discrepancies are likely to be primarily at the West Hempstead patient–care center. Furthermore, management does not believe the resolution of the matters raised by the allegations will have a materially adverse effect on the Company's financial statements. The West Hempstead facility generated $0.1 million and $0.2 million in net sales during the quarters ended March 31, 2007 and 2006, respectively, or less than 0.2% of the Company's net sales, for each period.

It should be noted that additional regulatory inquiries may be raised relating to the Company's billing activities at other locations. No assurance can be given that the final results of the regulatory agencies' inquiries will be consistent with the results to date or that any discrepancies identified during the ongoing regulatory review will not have a material adverse effect on the Company's financial statements.

**Consolidated Class Action**

Between June 22, 2004 and July 1, 2004, five putative securities class action complaints were filed against the Company, four in the Eastern District of New York, Twist Partners v. Hanger Orthopedic Group, Inc., et al., No. 1:04–cv–02585 (filed 06/22/2004, E.D.N.Y); Shapiro v. Hanger Orthopedic Group, Inc., et al., No. 1:04–cv–02681 (filed 06/28/2004, E.D.N.Y.); Imperato v. Hanger Orthopedic Group, Inc., No. 1:04–cv–02736 (filed 06/30/2004, E.D.N.Y.); Walters v. Hanger Orthopedic Group, Inc., et al., No. 1:04–cv–02826 (filed 07/01/2004, E.D.N.Y.); and one in the Eastern District of Virginia, Browne v. Hanger Orthopedic Group, Inc., et al., No. 1:04–cv–7 15 (filed 06/23/2004, E.D. Va.). The complaints asserted that the Company's reported revenues were inflated through certain billing improprieties at one of the Company's facilities. The plaintiffs in Browne subsequently dismissed their complaint without prejudice, and the four remaining cases were consolidated into a single action in the Eastern District of New York encaptioned In re Hanger Orthopedic Group, Inc. Securities Litigation, No. 1:04–cv–2585 (the "Consolidated Securities Class Action"). On February 28, 2006, the court granted the Company's motion to transfer the Consolidated Securities Class Action to the District of Maryland. On June 12, 2006, a Second Consolidated Amended Class Action Complaint was filed against the Company in the District of Maryland, In re Hanger Orthopedic Group, Inc. Securities Litigation, No. 8:06–cv–00579–AW (the "Second Amended Complaint"). The Second Amended Complaint asserted that the Company's reported revenues were inflated through certain billing improprieties at some of the Company's facilities. In addition, the Second Amended Complaint asserted that the Company violated the federal securities laws in connection with a restatement announced by the Company on August 16, 2004, restating certain of the Company's financial statements during 2001 through the first quarter of 2004. The Second Amended Complaint purported to allege violations of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b–5 promulgated thereunder, as well as violations of Section 20(a) of the Exchange Act by certain of the Company's executives as "controlling persons" of the Company. On September 1, 2006, the Company filed a motion to dismiss the Second Amended Complaint and oral argument took place on February 21, 2007. On March 16, 2007, the United States District Court for the District of Maryland Southern Division dismissed the Second Amended Complaint with prejudice. The following thirty–day period during which the plaintiffs were permitted to file an appeal or motion for reconsideration passed without the filing of any such appeal or motion, resulting in a final judgment in favor of the Company.



Source: HANGER ORTHOPEDIC GR, 10–Q, May 09, 2007

**Derivative Action**

On September 8, 2005, a derivative action was filed against the Company and certain of its current and former directors in the United States District Court for the Eastern District of New York. The lawsuit, which is encaptioned *Green Meadows Partners, LLP v. Ivan R. Sabel, et al*, No. CV 05 4259 (E.D.N.Y.), also largely repeats the allegations made in the consolidated amended complaint filed by the plaintiffs in *In re Hanger Orthopedic Group, Inc. Securities Litigation*, discussed above. On that basis, the *Green Meadows Partners* complaint purports to assert claims against the individual defendants, on behalf of the Company, for contribution in connection with the *In re Hanger Orthopedic Group, Inc. Securities Litigation* matter; forfeiture of certain bonuses and other incentive−based or equity−based compensation pursuant to Section 304; breach of fiduciary duty; unjust enrichment; and "abuse of control." The Complaint seeks unspecified compensatory damages, restitution and disgorgement, injunctive relief, and award of attorneys' fees and costs. The defendants have not yet filed their response to the *Green Meadows Partners* Complaint. After the transfer of the Consolidated Securities Class Action to the District of Maryland, the parties agreed to the transfer of the *Green Meadows Partners* case to the District of Maryland and to stay the case pending the outcome of the defendants' motion to dismiss the Consolidated Securities Class Action case. As discussed above, the Consolidated Securities Class Action was dismissed with prejudice by the District Court of Maryland Southern Division on March 16, 2007, and the thirty−day period during which the plaintiffs were permitted to file an appeal or motion for reconsideration passed without the filing of any such appeal or motion, resulting in a final judgment in favor of the Company. The Company intends to seek a dismissal of the *Green Meadows Partners* case.



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

**Other Proceedings**

The Company is also party to various legal proceedings that are ordinary and incidental to its business. Management does not expect that any legal proceedings currently pending will have a material adverse impact on the Company's financial statements.

**ITEM 1A. Risk Factors**

Item 1A ("Risk Factors") of the Company's Annual Report on Form 10−K for the year ended December 31, 2006 sets forth information relating to important risks and uncertainties that could materially adversely affect the Company's business, financial condition or operating results. Those risk factors continue to be relevant to an understanding of the Company's business, financial condition and operating results. Certain of those risk factors have been updated in this Form 10−Q to provide updated information, as set forth below. References to "we," "our" and "us" in these risk factors refer to the Company.

***We incurred net losses for the years ended December 31, 2004 and could incur net losses in the future.***

We incurred a net loss of $23.4 million for the year ended December 31, 2004 primarily as a result of the recognition of $45.8 million in non−cash charges related to goodwill impairment. For the three months ended March 31, 2007 and the year ended December 31, 2006, we generated net income of $1.8 million and $3.4 million, respectively. We cannot assure that we will not incur net losses in the future.

***Changes in government reimbursement levels could adversely affect our net sales, cash flows and profitability.***

We derived 40.3% and 41.5% of our net sales for the three months ended March 31, 2007 and 2006, respectively, from reimbursements for O&P services and products from programs administered by Medicare, Medicaid and the U.S. Veterans Administration. Each of these programs sets maximum reimbursement levels for O&P services and products. If these agencies reduce reimbursement levels for O&P services and products in the future, our net sales could substantially decline. In addition, the percentage of our net sales derived from these sources may increase as the portion of the U.S. population over age 65 continues to grow, making us more vulnerable to maximum reimbursement level reductions by these organizations. Reduced government reimbursement levels could result in reduced private payor reimbursement levels because fee schedules of certain third−party payors are indexed to Medicare. Furthermore, the healthcare industry is experiencing a trend towards cost containment as government and other third−party payors seek to impose lower reimbursement rates and negotiate reduced contract rates with service providers. This trend could adversely affect our net sales. Medicare provides for reimbursement for O&P products and services based on prices set forth in fee schedules for ten regional service areas. In November 2003, Congress legislated a three−year freeze on Medicare reimbursement levels which ended December 31, 2006 on all O&P services. The effect of this legislation was a downward pressure on our income from operations. During 2006, Congress enacted legislation that increased Medicare reimbursement levels by approximately 4.3% effective January 1, 2007. If the U.S. Congress were to legislate additional modifications to the Medicare fee schedules, our net sales from Medicare and other payors could be adversely and materially affected. We cannot predict whether any such modifications to the fee schedules will be enacted or what the final form of any modifications might be.



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

On April 24, 2006, the Centers for Medicare & Medicaid Services announced a proposed rule that would call for a competitive bidding program for certain covered prosthetic and orthotic equipment as required by the Medicare Modernization Act of 2003. We cannot now identify the impact of such proposed rule on us.

***If we cannot collect our accounts receivable and effectively manage our inventory, our business, results of operations, financial condition and ability to satisfy our obligations under our indebtedness could be adversely affected.***

As of March 31, 2007 and December 31, 2006, our accounts receivable over 120 days represented approximately 17.6% and 16.3% of total accounts receivable outstanding in each period, respectively. If we cannot collect our accounts receivable, our business, results of operations, financial condition and ability to satisfy our obligations under our indebtedness could be adversely affected. In addition, our principal means of control with respect to accounting for inventory and costs of goods sold is a physical inventory conducted on an annual basis. This accepted method of accounting controls and procedures may result in an understatement or overstatement, as the case may be, of inventory between our annual physical inventories. In conjunction with our physical inventory performed on October 1, 2006, we recorded a $4.4 million decrease to inventory. Adjustments to inventory during interim periods following our physical inventory could adversely affect our results of operations and financial condition.

**ITEM 6. Exhibits**

(a) Exhibits. The following exhibits are filed herewith:

| Exhibit No. | Document |
|---|---|
| 31.1 | Written Statement of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes−Oxley Act of 2002. |
| 31.2 | Written Statement of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes−Oxley Act of 2002. |
| 32 | Written Statement of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes−Oxley Act of 2002. |



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

**SIGNATURES**

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

HANGER ORTHOPEDIC GROUP, INC.

| | |
|---|---|
| Dated: May 9, 2007 | /s/ Ivan R. Sabel<br>Ivan R. Sabel, CPO<br>Chairman and Chief Executive Officer<br>(Principal Executive Officer) |
| Dated: May 9, 2007 | /s/ George E. McHenry<br>George E. McHenry<br>Executive Vice President and<br>Chief Financial Officer<br>(Principal Financial Officer) |
| Dated: May 9, 2007 | /s/ Thomas C. Hofmeister<br>Thomas C. Hofmeister<br>Vice President of Finance<br>(Chief Accounting Officer) |



Source: HANGER ORTHOPEDIC GR, 10−Q, May 09, 2007

**Exhibit 31.1**

**Certification of Chief Executive Officer**
**Pursuant to Section 302 of the Sarbanes–Oxley Act and Rule 13a–14(a)**
**or 15d–14(a) under the Securities Exchange Act of 1934**

I, Ivan R. Sabel, certify that:

1. I have reviewed this quarterly report on Form 10–Q of Hanger Orthopedic Group, 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 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 disclosure 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 first fiscal quarter 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 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 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.

Date: May 9, 2007

/s/ Ivan R. Sabel
Ivan R. Sabel, CPO
Chairman and Chief Executive Officer

**Exhibit 31.2**

**Certification of Chief Financial Officer**
**Pursuant to Section 302 of the Sarbanes–Oxley Act and Rule 13a–14(a)**
**or 15d–14(a) under the Securities Exchange Act of 1934**

I, George E. McHenry, certify that:

1. I have reviewed this quarterly report on Form 10–Q of Hanger Orthopedic Group, 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 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 disclosure 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 first fiscal quarter 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 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 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.

Date: May 9, 2007

/s/ George E. McHenry
George E. McHenry
Executive Vice President and
Chief Financial Officer

**Exhibit 32**

**Written Statement of the Chief Executive Officer and Chief Financial Officer**
**Pursuant to 18 U.S.C. Section 1350, as adopted**
**Pursuant to Section 906 of the Sarbanes−Oxley Act of 2002**

Solely for the purposes of complying with 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes−Oxley Act of 2002, the undersigned Chief Executive Officer and Chief Financial Officer of Hanger Orthopedic Group, Inc. (the "Company"), hereby certify, based on our knowledge, that the Quarterly Report on Form 10−Q of the Company for the three months ended March 31, 2007 (the "Report") fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and that information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Ivan R. Sabel
Ivan R. Sabel
Chairman and Chief Executive Officer

/s/ George E. McHenry
George E. McHenry
Executive Vice President and
Chief Financial Officer

May 9, 2007

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