

APRIA HEALTHCARE GROUP INC  
Form 10-Q  
November 09, 2005

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**Form 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2005

OR

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

Commission File Number: 1-14316

**APRIA HEALTHCARE GROUP INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**33-0488566**  
(I.R.S. Employer  
Identification Number)

**26220 Enterprise Court, Lake Forest, CA**  
(Address of principal executive offices)

**92630**  
(Zip Code)

Registrant's telephone number: (949) 639-2000

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of November 4, 2005 there were outstanding 49,564,090 shares of the Registrant's common stock, par value \$.001, which is the only class of common stock of the Registrant (not including 9,627,659 shares held in treasury.)

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**APRIA HEALTHCARE GROUP INC.**

**FORM 10-Q**

**For the period ended September 30, 2005**

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**PART I FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS (unaudited)**

**APRIA HEALTHCARE GROUP INC.**

**CONDENSED CONSOLIDATED BALANCE SHEETS**  
 (unaudited)

<i>(dollars in thousands)</i>	<b>September 30, 2005</b>	<b>December 31, 2004</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 12,440	\$ 39,399
Accounts receivable, less allowance for doubtful accounts of \$48,677 and \$45,064 at September 30, 2005 and December 31, 2004, respectively	233,586	219,365
Inventories, net	40,415	40,295
Deferred income taxes	32,792	29,126
Refundable and prepaid income taxes	3,570	-
Prepaid expenses and other current assets	23,380	20,126
	<hr/>	<hr/>
<b>TOTAL CURRENT ASSETS</b>	<b>346,183</b>	<b>348,311</b>
PATIENT SERVICE EQUIPMENT, less accumulated depreciation of \$442,340 and \$420,714 at September 30, 2005 and December 31, 2004, respectively	232,784	224,801
PROPERTY, EQUIPMENT AND IMPROVEMENTS, net	46,579	51,012
DEFERRED INCOME TAXES	6,974	5,024
GOODWILL	538,196	455,623
INTANGIBLE ASSETS, less accumulated amortization of \$7,982 and \$6,425 at September 30, 2005 and December 31, 2004, respectively	12,071	9,907
DEFERRED DEBT ISSUANCE COSTS, net	5,680	6,962
OTHER ASSETS	9,297	6,024
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	September 30, \$ 1,197,764	December 31, \$ 1,107,664
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 59,743	\$ 63,601
Accrued payroll and related taxes and benefits	41,129	47,620
Accrued insurance	10,895	8,991
Income taxes payable	11,789	19,208
Other accrued liabilities	31,589	34,014
Current portion of long-term debt	6,342	4,901
	<hr/>	<hr/>
TOTAL CURRENT LIABILITIES	161,487	178,335
LONG-TERM DEBT, exclusive of current portion	506,126	475,957
DEFERRED INCOME TAXES	39,830	42,136
OTHER NON-CURRENT LIABILITIES	9,158	5,051
COMMITMENTS AND CONTINGENCIES (Note G)		
<b>STOCKHOLDERS EQUITY</b>		
Preferred stock, \$.001 par value: 10,000,000 shares authorized, none issued	-	-
Common stock, \$.001 par value: 150,000,000 shares authorized; 59,182,649 and 58,236,364 shares issued at September 30, 2005 and December 31, 2004, respectively; 49,554,990 and 48,608,705 shares outstanding at September 30, 2005 and December 31, 2004, respectively	59	58
Additional paid-in capital	466,754	439,544
Treasury stock, at cost; 9,627,659 shares at September 30, 2005 and December 31, 2004	(254,432)	(254,432)
Retained earnings	268,482	221,041
Accumulated other comprehensive income (loss)	300	(26)
	<hr/>	<hr/>
	481,163	406,185
	<hr/>	<hr/>
	\$ 1,197,764	\$ 1,107,664
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See notes to condensed consolidated financial statements.

**APRIA HEALTHCARE GROUP INC.**

**CONDENSED CONSOLIDATED INCOME STATEMENTS**  
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
<i>(dollars in thousands, except per share data)</i>				
Net revenues	\$ 367,615	\$ 364,569	\$ 1,114,409	\$ 1,075,012
Costs and expenses:				
Cost of net revenues:				
Product and supply costs	76,062	67,645	231,535	197,488
Patient service equipment depreciation	28,050	30,497	83,153	90,364
Nursing services	169	193	521	634
Other	3,617	3,641	10,814	11,331
	<hr/>	<hr/>	<hr/>	<hr/>
TOTAL COST OF NET REVENUES	107,898	101,976	326,023	299,817
Provision for doubtful accounts	12,160	12,268	39,410	38,548

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	Three Months Ended September 30,		Nine Months Ended September 30,	
Selling, distribution and administrative	212,150	200,619	628,083	582,496
<i>Qui tam</i> settlement and related costs (Note G)	-	-	20,000	-
Amortization of intangible assets	2,047	1,854	5,176	4,639
<b>TOTAL COSTS AND EXPENSES</b>	<b>334,255</b>	<b>316,717</b>	<b>1,018,692</b>	<b>925,500</b>
<b>OPERATING INCOME</b>	<b>33,360</b>	<b>47,852</b>	<b>95,717</b>	<b>149,512</b>
Interest expense, net	5,262	5,210	14,894	15,119
<b>INCOME BEFORE TAXES</b>	<b>28,098</b>	<b>42,642</b>	<b>80,823</b>	<b>134,393</b>
Income tax expense	8,843	12,807	33,382	47,652
<b>NET INCOME</b>	<b>\$ 19,255</b>	<b>\$ 29,835</b>	<b>\$ 47,441</b>	<b>\$ 86,741</b>
Basic net income per common share	\$ 0.39	\$ 0.61	\$ 0.97	\$ 1.75
Diluted net income per common share	\$ 0.38	\$ 0.60	\$ 0.95	\$ 1.72

See notes to condensed consolidated financial statements.

APRIA HEALTHCARE GROUP INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(unaudited)

<i>(dollars in thousands)</i>	Nine Months Ended September 30,	
	2005	2004
<b>OPERATING ACTIVITIES</b>		
Net income	\$ 47,441	\$ 86,741
Items included in net income not requiring cash:		
Provision for doubtful accounts	39,410	38,548
Depreciation and amortization	104,999	110,962
Amortization of deferred debt issuance costs	1,297	1,890
Deferred income taxes	(8,144)	19,977
Stock-based compensation	2,643	2,537
Loss (gain) on disposition of assets	50	(26)
Changes in operating assets and liabilities, exclusive of effects of acquisitions:		
Accounts receivable	(53,769)	(65,062)
Inventories, net	1,484	(2,578)
Prepaid expenses and other assets	(2,952)	(3,398)
Accounts payable, exclusive of outstanding checks	2,918	5,039
Accrued payroll and related taxes and benefits	(6,491)	8,262
Income taxes payable	(3,341)	1,286
Accrued expenses	3,346	(6,384)
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>128,891</b>	<b>197,794</b>
<b>INVESTING ACTIVITIES</b>		
Purchases of patient service equipment and property, equipment and improvements, exclusive of effects of acquisitions	(92,871)	(111,890)

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	<b>Nine Months Ended September 30,</b>	
Proceeds from disposition of assets	685	159
Cash paid for acquisitions, including payments of deferred consideration	(101,907)	(116,121)
	<u>          </u>	<u>          </u>
NET CASH USED IN INVESTING ACTIVITIES	(194,093)	(227,852)
<b>FINANCING ACTIVITIES</b>		
Proceeds from revolving credit facilities	41,250	20,000
Payments on revolving credit facilities	(11,000)	-
Payments on term loans	-	(19,313)
Payments on other long-term debt	(5,706)	(6,382)
Outstanding checks included in accounts payable	(6,776)	(1,689)
Capitalized debt issuance costs	(15)	(37)
Repurchases of common stock	-	(100,000)
Issuances of common stock	20,490	15,784
	<u>          </u>	<u>          </u>
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	38,243	(91,637)
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>		
Cash and cash equivalents at beginning of period	(26,959)	(121,695)
	<u>          </u>	<u>          </u>
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 12,440	\$ 38,858
	<u>          </u>	<u>          </u>

See notes to condensed consolidated financial statements.

**APRIA HEALTHCARE GROUP INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE A CERTAIN SIGNIFICANT ACCOUNTING POLICIES**

*Basis of Presentation:* The accompanying unaudited condensed consolidated financial statements include the accounts of Apria Healthcare Group Inc. ( Apria or the company ) and its subsidiaries. Intercompany transactions and accounts have been eliminated.

All adjustments, consisting of normal recurring accruals necessary for a fair presentation of the results of operations for the interim periods presented, have been reflected herein. The unaudited results of operations for interim periods are not necessarily indicative of the results to be expected for the entire year. For further information, refer to the consolidated financial statements and footnotes thereto included in the company s Annual Report on Form 10-K for the fiscal year ended December 31, 2004.

Certain amounts from prior periods have been reclassified to conform to the current period presentation.

*Use of Accounting Estimates:* The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

*Revenue Recognition and Concentration of Credit Risk:* Revenues are recognized on the date services and related products are provided to patients and are recorded at amounts expected to be received under reimbursement arrangements with third-party payors, including private insurers, prepaid health plans, Medicare and Medicaid. Approximately 39% of the company s revenues are reimbursed under arrangements with Medicare and Medicaid. No other third-party payor group represents more than 8% of the company s revenues. The majority of the company s revenues are derived from fees charged for patient care under fee-for-service arrangements. Revenues derived from capitation arrangements represent 10% or less of total net revenues.

Due to the nature of the industry and the reimbursement environment in which Apria operates, certain estimates are required to record net revenues and accounts receivable at their net realizable values. Inherent in these estimates is the risk that they will have to be revised or updated as additional information becomes available. Specifically, the complexity of many third-party billing arrangements and the uncertainty of reimbursement amounts for certain services from certain payors may result in adjustments to amounts originally recorded. Such adjustments are typically identified and recorded at the point of cash application, claim denial or account review.

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Management performs periodic analyses to evaluate accounts receivable balances to ensure that recorded amounts reflect estimated net realizable value. Specifically, management considers historical realization data, accounts receivable aging trends, other operating trends and the extent of contracted business and business combinations. Also considered are relevant business conditions such as governmental and managed care payor claims processing procedures and system changes. Management also performs focused reviews of certain large and/or slow-paying payors. Due to continuing changes in the healthcare industry and with third-party reimbursement, it is possible that estimates could change in the near term, which could have an impact on operations and cash flows.

Accounts receivable are reduced by an allowance for doubtful accounts which provides for those accounts from which payment is not expected to be received, although services were provided and revenue was earned. Upon determination that an account is uncollectible, it is written-off and charged to the allowance.

*Distribution Expenses:* Distribution expenses, totaling \$43,004,000 and \$127,912,000 for the three and nine-month periods ended September 30, 2005, are included in selling, distribution and administrative expenses. For the corresponding periods in 2004, distribution expenses were \$40,720,000 and 115,840,000, respectively.

*Stock-based Compensation:* The company accounts for its stock-based compensation plans under the recognition and measurement principles of Accounting Principles Board ( APB ) Opinion No. 25, and related interpretations. Apria has adopted the disclosure provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123. For the nine-month period ended September 30, 2005, net income reflects compensation expense for restricted stock awards and restricted stock purchase rights accounted for in accordance with APB Opinion No. 25. Had compensation expense for all of the company's stock-based compensation awards been recognized based on the fair value recognition provisions of SFAS No. 123, Apria's net income and per share amounts would have been adjusted to the pro forma amounts indicated below.

<i>(in thousands, except per share data)</i>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Net income as reported	\$ 19,255	\$ 29,835	\$ 47,441	\$ 86,741
Add: stock-based compensation expense included in reported net income, net of related tax effects	247	237	1,585	1,572
Deduct: total stock-based compensation expense determined for all awards under fair value-based method, net of related tax effects	(1,627)	(2,673)	(6,515)	(7,978)
Pro forma net income	\$ 17,875	\$ 27,399	\$ 42,511	\$ 80,335
Basic net income per share:				
As reported	\$ 0.39	\$ 0.61	\$ 0.97	\$ 1.75
Pro forma	\$ 0.36	\$ 0.56	\$ 0.87	\$ 1.62
Diluted income per share:				
As reported	\$ 0.38	\$ 0.60	\$ 0.95	\$ 1.72
Pro forma	\$ 0.35	\$ 0.55	\$ 0.85	\$ 1.60

For purposes of the pro forma disclosure, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model and employing the following weighted-average assumptions for grants in the nine-month periods ended September 30, 2005 and 2004: risk-free interest rates of 3.78% and 3.02%, respectively; dividend yield of 0% for all periods; expected lives of 4.13 and 4.83 years, respectively; and volatility of 32% and 47%, respectively.

*Recent Accounting Pronouncements:* In November 2004, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 151, Inventory Costs, which amends and clarifies previous guidance on the accounting for abnormal amounts of idle facility expense, freight, handling costs and spoilage. Abnormal amounts of these costs should be recognized as current period charges rather than as a portion of inventory cost. Additionally, SFAS No. 151 requires that the allocation of fixed production overhead be based on the normal capacity of the production facilities, which refers to a range of production levels within which ordinary variations are expected. The statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Apria does not expect the adoption of SFAS No. 151 to have a material effect on the company's consolidated financial statements.

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In December 2004, the FASB issued SFAS No. 123R, Share-Based Payment. This statement replaces SFAS No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS No. 123R requires a company to measure the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. The cost will be recognized over the period during which the employee is required to provide service in exchange for the award (usually the vesting period). Adoption of SFAS No. 123R was initially required as of the beginning of the first interim or annual reporting period beginning after June 15, 2005. The Securities and Exchange Commission subsequently amended Rule 4-01(a) of Regulation S-X to amend the required compliance date for SFAS No. 123R to the first interim or annual reporting period for the first fiscal year beginning on or after June 15, 2005. Accordingly, Apria will adopt the statement January 1, 2006. Management is currently evaluating the statement and its transition provisions. The impact of adoption on the results of operations cannot be estimated at this time as it is dependent on the level of future share-based awards. However, had SFAS No. 123R been adopted in prior periods, the effect would have approximated the SFAS No. 123 pro forma disclosures presented above.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions. This statement eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets and replaces it with an exception for exchanges that do not have commercial substance. If the future cash flows of the entity are not expected to change significantly as a result of the transaction, then the exchange shall be measured based on the recorded amount of the nonmonetary assets relinquished, rather than on the fair values of the exchanged assets. The statement is effective for nonmonetary asset exchanges beginning after June 15, 2005. The adoption of SFAS No. 153 did not have a material effect on the company's consolidated financial statements.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, which replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements. SFAS No. 154 changes the accounting for and the reporting of a change in accounting principle. The statement also defines and requires retrospective application of a change in accounting principle to prior periods' financial statements unless impracticable. If retrospective application is impracticable, the new accounting principle must be applied to the asset and liability balances as of the beginning of the earliest period practicable and a corresponding adjustment to the opening balance of retained earnings for the same period, rather than being reported in the income statement. Additionally, SFAS No. 154 addresses a change in accounting estimate effected by a change in accounting principle and redefines restatement as a revision to reflect the correction of an error. The statement is effective for accounting changes and error corrections made in fiscal years beginning after December 15, 2005. Accordingly, Apria will adopt the statement January 1, 2006.

### NOTE B BUSINESS COMBINATIONS

Apria periodically makes acquisitions of complementary businesses in specific geographic markets. The results of operations of the acquired companies are included in the accompanying consolidated income statements from the dates of acquisition. During the nine-month period ended September 30, 2005, cash paid for acquisitions was \$101,907,000, which included deferred payments of \$8,501,000 that were related to acquisitions completed prior to 2005. At September 30, 2005, deferred consideration payable totaled \$5,795,000 and is included on the consolidated balance sheet in other accrued liabilities.

During the nine-month period ended September 30, 2005, Apria acquired 19 companies, each with revenues that are primarily attributable to the respiratory therapy line of business. Pending receipt of additional valuation information, amounts preliminarily allocated to goodwill, other intangible assets and patient service equipment were \$83,332,000, \$7,435,000 and \$6,958,000, respectively. This allocation is inclusive of amounts not yet paid.

The following supplemental unaudited pro forma information presents the combined operating results of Apria and the businesses that were acquired by Apria during the nine-month period ended September 30, 2005, as if the acquisitions had occurred at the beginning of the earliest period presented. The pro forma information is based on the historical financial statements of Apria and the acquired businesses. Amounts are not necessarily indicative of the results that may have been achieved had the acquired businesses been integrated at the beginning of the earliest period presented or that may be achieved in the future.

	Nine Months Ended September 30,	
	2005	2004
<i>(dollars in thousands, except per share data)</i>		
Net revenues	\$ 1,138,966	\$ 1,125,493
Net income	\$ 47,221	\$ 85,420
Basic net income per common share	\$ 0.96	\$ 1.72
Diluted net income per common share	\$ 0.94	\$ 1.69

**NOTE C GOODWILL AND INTANGIBLE ASSETS**

Apria accounts for intangible assets and goodwill under the initial recognition provisions of SFAS No. 141, Business Combinations, and the financial accounting and reporting provisions of SFAS No. 142, Goodwill and Other Intangible Assets. Goodwill and other intangible assets with indefinite lives are not amortized but are tested for impairment annually, or more frequently if circumstances indicate that impairment might exist. If the carrying value of goodwill or an intangible asset exceeds its fair value, an impairment loss is recognized.

The net change in the carrying amount of goodwill of \$82,573,000 for the nine months ended September 30, 2005, is the result of business combinations. Substantially all of the goodwill recorded in conjunction with the business combinations completed during the periods presented is expected to be deductible for tax purposes.

Intangible assets, all of which are subject to amortization, consist of the following:

<i>(dollars in thousands)</i>	September 30, 2005			December 31, 2004			
	Average Life in Years	Gross Carrying Amount	Accumulated Amortization	Net Book Value	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Covenants not to compete	4.9	\$ 16,457	\$ (5,795)	\$ 10,662	\$ 11,947	\$ (4,060)	\$ 7,887
Trade names	2.0	628	(361)	267	1,695	(870)	825
Customer lists	< 1	2,968	(1,826)	1,142	2,690	(1,495)	1,195
		\$ 20,053	\$ (7,982)	\$ 12,071	\$ 16,332	\$ (6,425)	\$ 9,907

Amortization expense was \$5,176,000 for the nine-month period ended September 30, 2005. Estimated amortization expense for the current year and each of the next five fiscal years ending December 31 is presented below:

Year Ending December 31,	<i>(dollars in thousands)</i>
2005	\$ 6,915
2006	3,591
2007	2,716
2008	2,226
2009	1,416
2010	383

**NOTE D LONG-TERM DEBT**

*Revolving Credit Facility:* At September 30, 2005, Apria's borrowings under its revolving credit facility were \$255,000,000; outstanding letters of credit totaled \$3,855,000; and credit available under the revolving facility was \$241,145,000. Apria was in compliance with all of the financial covenants required by the related credit agreement.

*Convertible Senior Notes:* At September 30, 2005, the fair value of the \$250,000,000 in convertible senior notes was \$263,750,000, as determined by reference to quoted market prices.

*Hedging Activities:* Apria utilizes interest rate swap agreements to moderate its exposure to interest rate fluctuations on its underlying variable rate long-term debt. Apria does not use derivative financial instruments for trading or other speculative purposes. Apria currently has two interest rate swap agreements in effect that have terms of three and four years and a notional amount of \$25,000,000 each. The interest rate swap agreements fix an equivalent amount of the company's variable rate debt at interest rates of 3.04% and 3.42%. During the second quarter of 2005, Apria entered into two new interest rate swap agreements. The forward-starting contracts, each with a notional amount of \$25,000,000, become effective in January 2006. Both agreements have a three-year term with fixed rates of 4.38% and 4.44%.

The interest rate swap agreements are being accounted for as cash flow hedges under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. Accordingly, the difference between the interest received and interest paid is reflected as an adjustment to interest expense. For the nine months ended September 30, 2005 and 2004, Apria paid net settlement amounts of \$68,000 and \$1,175,000, respectively. At September 30, 2005, the aggregate fair value of the swap agreements was an asset of \$506,000, which is reflected in the accompanying



consolidated balance sheet in other assets.

Unrealized gains and losses on the fair value of the swap agreements are reflected, net of taxes, in accumulated other comprehensive income. (See Note E Stockholders Equity. ) In the event of counterparty non-performance, Apria's exposure to credit loss under the swap agreements is limited to the interest rate spread.

## NOTE E STOCKHOLDERS EQUITY

For the nine months ended September 30, 2005, changes to stockholders' equity are comprised of the following amounts:

	<i>(dollars in thousands)</i>
Net income	\$ 47,441
Proceeds from the exercise of stock options	20,490
Tax benefit related to the exercise of stock options	4,078
Stock-based compensation	2,643
Other comprehensive income, net of taxes	326
	<hr/>
	\$ 74,978
	<hr/>

Net income and total comprehensive income differ by unrealized gains or losses related to interest rate swap agreements, net of taxes. For the nine months ended September 30, 2005 and 2004, total comprehensive income was \$47,767,000 and \$87,392,000, respectively.

## NOTE F INCOME TAXES

Income taxes for the nine months ended September 30, 2005 have been provided at a higher effective rate than is expected to be applicable for the entire year. The higher rate is due to a permanent difference resulting from the portion of the settlement of two *qui tam* lawsuits that is non-deductible for tax purposes. (See Note G Commitments and Contingencies. ) This higher rate was partially offset by a decrease in the valuation allowance and corresponding reduction of the tax provision that was recorded in the first quarter of 2005. Such adjustment resulted from state net operating loss carryforwards that became realizable based on a change in estimate of expected future earnings.

Income taxes for the nine-month period ended September 30, 2004 were provided at the effective tax rate that was expected to be applicable for that year.

At September 30, 2005, the company had various apportioned state net operating loss carryforwards which resulted in a deferred tax asset of \$9,670,000, net of federal tax benefit.

Apria utilized \$5,017,000 of federal net operating loss carryforwards in 2004. The remaining \$7,106,000 of federal net operating loss carryforwards expired unused on December 31, 2004.

## NOTE G COMMITMENTS AND CONTINGENCIES

*Disposition of Federal Investigation and Qui Tam Lawsuits.* As previously reported, Apria was the subject of an investigation commenced in mid-1998 by the U.S. Attorney's office in Los Angeles and the U.S. Department of Health and Human Services. The investigation concerned the documentation supporting Apria's billing for services provided to patients whose healthcare costs were paid by Medicare and other federal programs. The investigation related to two civil *qui tam* lawsuits against Apria filed by individuals suing on behalf of the government. These lawsuits, both pending in the United States District Court for the Central District of California, are *United States of America ex rel. Cynthia Costa and Ken Kostanecki v. Apria Healthcare Group, Inc.*, Case No. SACV-98-230-MMM(RCx) and *United States of America ex rel. Catherine Wickern v. Apria Healthcare Group, Inc.*, Case No. SACV-001263-MMM(RCx).

As previously reported, Apria and representatives of the government and the individual plaintiffs reached a preliminary agreement in early August 2005 to settle these lawsuits for the aggregate sum of \$17.6 million, without any admission of wrongdoing by Apria. The settlement was finalized in a definitive agreement that was fully executed and became effective on September 30, 2005, and Apria paid the settlement amount on that date.

The government informed Apria on October 4, 2005 that a third civil *qui tam* lawsuit (of which the government apprised Apria in July 2005) had been dismissed at the government's request by the district court in which the action was pending. That lawsuit, which is still under seal, alleged improper billing similar to that alleged in the above-described actions, but was limited to several specific locations during 2002-2004. The time

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period in which the plaintiff could appeal the district court's decision has not yet elapsed.

Apria is also engaged in the defense of certain claims and lawsuits arising out of the ordinary course and conduct of its business, the outcomes of which are not determinable at this time. Apria has insurance policies covering such potential losses where such coverage is cost effective. In the opinion of management, any liability that might be incurred by Apria upon the resolution of these claims and lawsuits will not, in the aggregate, have a material adverse effect on Apria's results of operations or financial condition.

**NOTE H PER SHARE AMOUNTS**

The following table sets forth the computation of basic and diluted per share amounts:

<i>(in thousands, except per share data)</i>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
<b>Numerator:</b>				
Net income	\$ 19,255	\$ 29,835	\$ 47,441	\$ 86,741
Numerator for basic and diluted per share amounts income available to common stockholders	\$ 19,255	\$ 29,835	\$ 47,441	\$ 86,741
<b>Denominator:</b>				
Denominator for basic per share amounts weighted average shares	49,495	49,146	49,145	49,649
Effect of dilutive securities:				
Employee stock options dilutive potential common shares	970	646	966	787
Denominator for diluted per share amounts adjusted weighted average shares	50,465	49,792	50,111	50,436
Basic net income per common share	\$ 0.39	\$ 0.61	\$ 0.97	\$ 1.75
Diluted net income per common share	\$ 0.38	\$ 0.60	\$ 0.95	\$ 1.72
Employee stock options excluded from the computation of diluted per share amounts:				
Shares for which exercise price exceeds average market price of common stock	15	870	595	1,012
Average exercise price per share that exceeds average market price of common stock	\$ 34.59	\$ 30.40	\$ 33.43	\$ 30.10

**Cautionary statement for purposes of the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995:** Apria's business is subject to a number of risks which are partly or entirely beyond the company's control. The company has described certain of those risks in its Annual Report on Form 10-K for the fiscal year ended December 31, 2004, as filed with the Securities and Exchange Commission on March 16, 2005. This report may be used for purposes of the Private Securities Litigation Reform Act of 1995 as a readily available document containing meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in any forward-looking statements the company may make from time to time. Key factors that may have an impact on Apria include the following:

trends and developments affecting the collectibility of accounts receivable;  
government legislative and budget developments that could continue to affect reimbursement levels;  
the effectiveness of the Apria's operating systems and controls;  
healthcare reform and the effect of federal and state healthcare regulations;  
pricing pressures from large payors;  
the successful implementation of the company's acquisition strategy and integration of acquired businesses; and  
other factors described in Apria's filings with the Securities and Exchange Commission.

In addition, the military and national security activities in which the United States is currently engaged, and the federal government's financial commitments to disaster recovery efforts, have and could continue to have significant impacts on the economy and government spending priorities. Deficit spending by the government as the result of adverse developments in the economy and the continuing costs of military and national security activities and disaster assistance will most likely increase pressure to reduce government expenditures for other purposes, including government-funded programs such as Medicare and Medicaid.

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

Apria operates in the home healthcare segment of the healthcare industry and provides services in the home respiratory therapy, home infusion therapy and home medical equipment areas. In all three lines, Apria provides patients with a variety of clinical services and related products and supplies, most of which are prescribed by a physician as part of a care plan. Apria provides these services to patients in the home throughout the United States through approximately 500 branch locations.

**Critical Accounting Policies.** Apria's management considers the accounting policies that govern revenue recognition and the determination of the net realizable value of accounts receivable to be the most critical in relation to the company's consolidated financial statements. These policies require management's most complex and subjective judgments. Additionally, the accounting policies related to goodwill, long-lived assets and income taxes require significant judgment. These policies are presented in detail in the Management's Discussion and Analysis of Financial Condition and Results of Operations section in Apria's Annual Report on Form 10-K for the fiscal year ended December 31, 2004.

### Results of Operations

**Net Revenues.** Net revenues were \$367.6 million in the third quarter of 2005, compared to \$364.6 million for the corresponding period in 2004. For the nine-month period ended September 30, 2005, net revenues were \$1,114 million, up 3.7% from \$1,075 million in the same period of 2004. Respiratory medication revenues for the first nine months of 2004, were reduced by \$11.5 million due to Medicare reimbursement reductions that went into effect January 1, 2004. Additional Medicare pricing reductions became effective January 1, 2005, for respiratory medications and certain equipment items, which further eroded revenue growth. Expected Medicare reimbursement reductions on oxygen and oxygen equipment were delayed until April 8, 2005, when the revised 2005 fee schedule was implemented. Management estimates that the 2005 Medicare reimbursement reductions resulted in approximately \$8.9 million and \$21.9 million of net revenue reductions for the three and nine months ended September 30, 2005, respectively.

Apria chose not to renew its contract with Gentiva CareCentrix (Gentiva) upon its expiration on January 1, 2004. The company continued to service Gentiva patients as usual for the first few months in 2004 and then began the transition to other providers. Such transition was effectively complete by the end of the second quarter in 2004. When comparing the nine-month periods in 2005 and 2004, the revenue reduction in 2005 related to this contract exit represented 1.5% of prior year revenues. The impact to the third quarter was less than one percent.

Revenue growth, after consideration of the Medicare and Gentiva revenue reductions, was due almost entirely to acquisitions of complementary businesses. Apria's acquisition strategy generally results in the rapid integration of acquired businesses into existing operating locations. This rapid integration limits Apria's ability to separately track the amount of revenue generated by an acquired business. Therefore, estimating the net revenue contribution from acquisitions requires certain assumptions. Apria estimates that approximately \$56 million of the net revenue growth between the nine-month periods in 2004 and 2005 was derived from acquisitions.

After adjusting for Medicare reimbursement cuts, the loss of Gentiva business and acquisition activity, organic revenue declined 0.7% for the third quarter of 2005 compared to 2004 and grew 2.1% for the nine-month period in 2005 as compared to 2004.

The company is experiencing increased pricing pressure from its managed care customers as these organizations seek to lower costs by obtaining more favorable pricing from providers such as Apria. Managed care organizations are also evaluating alternative delivery models for certain products and services, which include those provided by Apria. This trend may cause Apria to provide reduced levels of certain products and services in the future, resulting in a corresponding reduction in revenue. The company recently signed a new three-year contract with CIGNA HealthCare, effective February 2006, which is expected to accelerate the company's revenue growth. Apria had previously serviced CIGNA members under a subcontracting arrangement with Gentiva prior to 2004.

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The following table sets forth a summary of net revenues by service line:

<i>(dollars in thousands)</i>	Three Months Ended September 30,				Nine Months Ended September 30,			
	2005		2004		2005		2004	
	\$	%	\$	%	\$	%	\$	%
Respiratory therapy	\$ 249,847	68.0%	\$ 245,958	67.5%	\$ 763,248	68.5%	\$ 735,035	68.4%
Infusion therapy	65,893	17.9%	63,639	17.5%	192,158	17.2%	182,751	17.0%
Home medical equipment/other	51,875	14.1%	54,972	15.0%	159,003	14.3%	157,226	14.6%
Total net revenues	\$ 367,615	100.0%	\$ 364,569	100.0%	\$ 1,114,409	100.0%	\$ 1,075,012	100.0%

**Respiratory Therapy.** Respiratory therapy revenues are derived primarily from the provision of oxygen systems, home ventilators, sleep apnea equipment, nebulizers, respiratory medications and related services. Net revenues in the respiratory therapy service line increased 1.6% in the third quarter of 2005 and 3.8% in the nine months ended September 30, 2005, as compared to the corresponding periods in 2004. This growth was primarily attributable to acquisitions of respiratory therapy businesses. The Medicare reimbursement reductions caused a decline of 3.3% and 2.7% in revenue growth for the three and nine-month periods ended September 30, 2005. The year over year growth in the respiratory service line was also reduced by the exit from the Gentiva contract, representing approximately 1.8% of 2004 respiratory revenues. Additionally, third quarter revenues for oxygen and oxygen-related products decreased 1.6% when compared to the same period in 2004. Declines in respiratory medications had the greatest impact on the respiratory revenue line with a 15.9% decrease in the third quarter and a 13.6% decrease in the nine-month period ended September 30, 2005, as compared to the corresponding periods in 2004. Conversely, the positive air pressure device product line exhibited strong growth of 16.6% quarter to quarter and 15.0% year to year, when comparing 2005 to 2004.

**Infusion Therapy.** The infusion therapy service line involves the administration of a drug or nutrient directly into the body intravenously through a needle or catheter. Infusion therapy services also include administering enteral nutrients directly into the gastrointestinal tract through a feeding tube. Infusion therapy revenues increased 3.5% and 5.1% in the three and nine months ended September 30, 2005, respectively. Enteral nutrition, which makes up approximately 43% of the revenue in the infusion service line, was the main driver of the infusion growth with increases of 6.5% and 8.0% in the third quarter and nine months ended September 30, 2005, respectively, when compared to the corresponding periods in 2004. Excluding enteral nutrition, infusion growth rates were 1.5% quarter to quarter and 3.1% year to year, when comparing 2005 to 2004.

**Home Medical Equipment/Other.** Home medical equipment/other revenues are derived from the provision of equipment to assist patients with ambulation, safety and general care in and around the home. Home medical equipment/other revenues decreased 5.6% in the third quarter of 2005 and increased slightly to 1.1% for the nine months ended September 30, 2005 when compared to the corresponding periods in 2004. Diabetic supplies grew 55.8% in the nine months ended September 30, 2005 when compared to the same period in 2004. This growth is directly attributable to the March 2004 acquisition of a company that entered the diabetic supply market just prior to being acquired by Apria. Excluding the growth in diabetic supplies, home medical equipment/other revenue experienced a 5.5% decline for the third quarter and a 1.0% decrease for the nine months ended September 30, 2005, respectively, when compared to the same periods in 2004. Medicare reimbursement reductions implemented in 2005 that impact this line of business represent 1.4% of home medical equipment/other revenues for the third quarter of 2005 and 1.5% for the first nine months of 2005 compared to the corresponding periods in 2004. Additionally, hospital utilization rates were down in the third quarter with many of the company's managed care contractors, which served to further depress growth in home medical equipment/other revenues, as evidenced by an 11.1% decline in bed-related revenues and a 9.7% decrease in wheelchair revenues for the current quarter, as compared to 2004.

**Revenue Recognition and Certain Concentrations.** Revenues are recognized on the date services and related products are provided to patients and are recorded at amounts estimated to be received under reimbursement arrangements with third-party payors, including private insurers, prepaid health plans, Medicare and Medicaid. Due to the nature of the industry and the reimbursement environment in which Apria operates, certain estimates are required to record net revenues and accounts receivable at their net realizable values. Inherent in these estimates is the risk that they will have to be revised or updated as additional information becomes available, which could have an impact on the consolidated financial statements.

In 2005, approximately 39% of Apria's revenues are being reimbursed under arrangements with Medicare and Medicaid. No other third-party payor represents more than 8% of the company's revenues. The majority of the company's revenues are derived from fees charged for patient care under fee-for-service arrangements. Revenues derived from capitation arrangements represent 10% or less of total net revenues for all periods presented.

Medicare Reimbursement. In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003, which is herein referred to as the Medicare Modernization Act, became law. The Medicare Modernization Act includes a number of provisions that affect Medicare Part B reimbursement policies for items and services provided by Apria, the most significant of which are:

A freeze on annual payment increases for durable medical equipment The freeze commenced in 2004 and will continue through 2008.

Reimbursement reductions for five durable medical equipment categories, including oxygen Reimbursement for most of these categories is based on the median price paid for such items on behalf of beneficiaries of federal employee health benefit plans, or FEHBP. The new fee schedules for most products went into effect January 1, 2005. The revised pricing for oxygen and oxygen equipment was implemented on April 8, 2005. Any 2005 claims for oxygen and oxygen equipment that had been submitted prior to the implementation of the new fee schedule were paid based on 2004 pricing schedules and were not retroactively adjusted.

Reimbursement reduction for inhalation drugs The previous reimbursement rate of 95% of the average wholesale price was reduced to 80% of the average wholesale price, effective January 1, 2004. Beginning in January 2005, reimbursement for these drugs was further reduced through a shift to the manufacturer-reported average sales price (subject to adjustment each quarter) plus 6%, plus a separate dispensing fee per patient episode. The dispensing fees for 2005 are \$57.00 for a 30-day supply of medications and \$80.00 for a 90-day supply. In its final 2006 physician fee schedule released on November 2, 2005, the Centers for Medicare and Medicaid Services, or CMS, established an initial dispensing fee of \$57.00 for a 30-day supply for a new patient, and \$33.00 for each 30-day supply thereafter. The 90-day dispensing fee will be lowered to \$66.00.

Additionally, the manufacturer-reported average sales price, which is subject to adjustment each quarter, was adjusted downward in the third quarter of 2005, resulting in a further decline in revenue of approximately \$1.1 million in the third quarter when compared to the second quarter.

Establishment of a competitive bidding program Such a program would require that suppliers wishing to provide certain items to beneficiaries submit bids to Medicare. The program, for as yet unspecified durable medical equipment items and services, is to be transitioned into (i) 10 of the largest metropolitan statistical areas in 2007; (ii) 80 of the largest metropolitan statistical areas in 2009; and (iii) additional areas after 2009. The legislation contains special provisions for rural areas.

Incentives for expansion of Medicare Part C The Medicare Modernization Act includes financial incentives for managed care plans to expand their provision of Medicare Advantage plans in 2006 in a stated effort to attract more Medicare beneficiaries to managed care models. The company maintains contracts to provide respiratory, infusion and medical equipment and related services to a significant number of managed care plans nationwide, and believes that the Medicare Advantage expansion represents a growth opportunity starting in 2006.

Reimbursement for home infusion therapy under Medicare Part D Currently, a limited number of infusion therapies, supplies and equipment are covered by Medicare Part B. The Medicare Modernization Act provides expanded coverage for home infusion drugs. The industry is currently working with CMS to further define the coverage and payment policies that will govern the administration of this benefit, which takes effect in 2006.

Apria's management estimates that the revision to inhalation drug reimbursement in 2004 resulted in a revenue reduction of approximately \$15 million from 2003 levels. Management further estimates that 2005 pretax income will be reduced from 2004 levels by nearly \$40 million as a result of the lower Medicare pricing implemented in 2005 and a related product pricing increase. (See Results of Operations Gross Profit. ) The impact of the competitive bidding program and the Medicare Part C and D programs cannot be estimated at this time.

The Balanced Budget Act of 1997 contained several provisions that lowered Apria's Medicare reimbursement levels. Subsequent legislation, the Medicare Balanced Budget Refinement Act of 1999 and the Medicare, Medicaid and SCHIP Benefits Improvement and Protection Act of 2000, mitigated some of the effects of the original legislation. The Medicare Modernization Act also addressed some of the issues pending from the earlier legislation. However, still pending from the 1997 Legislation is the streamlined authority granted to the Secretary of the U.S. Department of Health and Human Services, or HHS, to increase or reduce the reimbursement for home medical equipment, including oxygen, by up to 15% each year under an inherent reasonableness authority. In December 2002, CMS issued an interim final rule that establishes a process by which such adjustments may be made. The rule applies to all Medicare Part B services except those paid under a physician fee schedule, a prospective payment system, or a competitive bidding program. As of this date, neither CMS nor the durable medical equipment regional carriers have used the expedited authority.

Medicaid Reimbursement. Since 2001, some states have adopted alternative pricing methodologies for certain drugs and biologicals under the Medicaid program. In at least 22 states, these changes have reduced the level of reimbursement received by Apria without a corresponding offset or increase to compensate for the service costs incurred. In several of those states, Apria has elected to stop accepting new Medicaid patient referrals for the affected drugs and biologicals. Apria is continuing to provide services to patients already on service, and for those who receive other Medicaid-covered respiratory, home medical equipment or infusion therapies, if the reimbursement levels for those services remain

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adequate. Further, some states are considering other reductions in Medicaid reimbursement as they work through their respective state's budget process. Apria management cannot predict the outcome of such budget negotiations and whether other states will consider reductions as well.

**Senate Reconciliation Bill.** The U.S. Senate is currently considering a budget reconciliation bill that includes savings targeted from both Medicare and Medicaid. The bill proposes to change the current capped rental period from 15 months to 13 months for certain durable medical equipment items covered by Medicare. This provision would apply to patients who begin their first rental month in January 2006. The bill also proposes to eliminate the service and maintenance fee that providers may bill in six-month intervals after the equipment is considered capped and instead provides for a repair/maintenance fee that would be billed when patient-owned equipment is serviced. If these provisions survive the budget reconciliation process, they would not have an impact on revenues until early 2007.

**Gross Profit.** Gross margins were 70.6% and 72.0% for the third quarters of 2005 and 2004, respectively. For the nine-month periods ended September 30, 2005 and 2004, the margins were 70.7% and 72.1%, respectively. The decline is primarily due to the Medicare reimbursement reductions and the effects of the non-renewal of the Gentiva contract in 2004. Further eroding the gross margin is a manufacturer's price increase for a particular respiratory drug, effected concurrently with higher government reimbursement for that drug in 2005. This price increase is estimated to have a \$4.7 million negative impact on Apria's gross margin for the nine-month period ended September 30, 2005. Favorably impacting gross profit is a decrease in depreciation expense, which is due to the decrease in patient service equipment expenditures.

**Provision for Doubtful Accounts.** The provision for doubtful accounts results from management's estimate of the net realizable value of accounts receivable after considering actual write-offs of specific receivables. The provision was 3.3% of net revenues for the third quarter of 2005 and 3.4% for the same period last year. For the year-to-date periods of 2005 and 2004, the provision was 3.5% and 3.6%, respectively. The improvement in 2005 when compared to 2004 is partially due to strong cash collections and a focused effort to increase cash applications. (See Liquidity and Capital Resources - Accounts Receivable. )

**Selling, Distribution and Administrative.** Selling, distribution and administrative expenses are comprised of expenses incurred in support of operations and those associated with administrative functions. Expenses incurred by the operating locations include salaries and other expenses in the following functional areas: selling, distribution, clinical, intake, reimbursement, warehousing and repair. Many of these operating costs are variable with revenue growth patterns. Certain expenses, such as facility lease and fuel costs, are very sensitive to market-driven price fluctuations. Administrative expenses include overhead costs incurred by the operating locations and corporate support functions. These expenses do not vary as closely with revenue growth as do the operating costs.

Selling, distribution and administrative expenses were 57.7% of net revenues in the third quarter of 2005, up from 55.0% in the third quarter of 2004. For the nine-month period ending September 30, 2005, selling, distribution and administrative expenses were 58.2% of net revenues compared to 54.2% for the same period last year. The percentage increase between the quarter and year-to-date periods is primarily attributable to the lower revenues resulting from Medicare pricing changes without a corresponding reduction in the company's actual cost of providing those products and services. Higher fuel prices and vehicle maintenance expenditures, rising medical benefit costs and outsourced collection fees also factored into the increases. Advertising costs related to the company's diabetic supply business are also higher year to year because this business was not acquired until late in the first quarter of 2004. Other incremental costs include severance charges related to the departure of two executives and a reduction in workforce at the Corporate office in the first quarter of 2005.

**Qui Tam Settlement and Related Costs.** A \$20 million accrual was recorded in the second quarter in connection with a preliminary agreement to settle the previously disclosed civil *qui tam* lawsuits. Such accrual was comprised of a \$17.6 million settlement and \$2.4 million in legal fees and other related costs. The settlement was paid to the government in the third quarter subsequent to finalizing the settlement agreement. (See Liquidity and Capital Resources - Federal Investigation. )

**Amortization of Intangible Assets.** For the quarter and nine months ended September 30, 2005, amortization expense was \$2.0 million and \$5.2 million, respectively. This compares to \$1.9 million and \$4.6 million for the similar periods last year. The year over year increase is due to ongoing acquisition activity and the valuation of certain customer relationships acquired in business combinations. (See Liquidity and Capital Resources - Business Combinations. )

**Interest Expense.** Interest expense was \$5.3 million for the third quarter of 2005, as compared to \$5.2 million in the third quarter of 2004. For the year-to-date periods in 2005 and 2004, interest expense was \$14.9 million and \$15.1 million, respectively. (See Liquidity and Capital Resources - Long-term Debt. )

**Income Taxes.** Income taxes for the nine months ended September 30, 2005 have been provided at a higher effective rate than is expected to be applicable for the entire year. The higher rate is due to a permanent difference resulting from the portion of the settlement of two *qui tam* lawsuits that is non-deductible for tax purposes. (See Note G - Commitments and Contingencies. ) This higher rate was partially offset by a decrease in the valuation allowance and corresponding reduction of the tax provision that was recorded in the first quarter of 2005. Such adjustment resulted from state net operating loss carryforwards that became realizable based on a change in estimate of expected future earnings.

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Income taxes for the nine-month period ended September 30, 2004 were provided at the effective tax rate that was expected to be applicable for that year.

At September 30, 2005, the company had various apportioned state net operating loss carryforwards which resulted in a deferred tax asset of \$9.7 million, net of federal tax benefit.

Apria utilized \$5.0 million of federal net operating loss carryforwards in 2004. The remaining \$7.1 million of federal net operating loss carryforwards expired unused on December 31, 2004.

### Liquidity and Capital Resources

Apria's principal source of liquidity is its operating cash flow, which is supplemented by a \$500.0 million revolving credit facility. Apria's ability to generate operating cash flows in excess of its operating needs has afforded it the ability, among other things, to pursue its acquisition strategy and fund patient service equipment expenditures to support revenue growth. Management believes that its operating cash flow and revolving credit line will continue to be sufficient to fund its operations and growth strategies. However, sustaining current cash flow levels is dependent on many factors, some of which are not within Apria's control, such as government reimbursement levels and the financial health of its payors.

**Cash Flow.** Cash provided by operating activities was \$128.9 million in the first nine months of 2005 compared with \$197.8 million in the corresponding period in 2004. The decrease in operating cash flow between the two periods can be primarily attributed to the Medicare reimbursement changes which negatively impacted net income for the first nine months of 2005. Also reducing operating cash flow was a \$21.9 million increase in income tax payments between the two periods and a \$17.6 million payment made to the government in the third quarter of 2005 related to the *qui tam* lawsuits.

Cash used in investing activities decreased to \$194.1 million for the first nine months of 2005 compared to \$227.9 million during the same period last year. The decrease is primarily attributable to lower expenditures for acquisitions in 2005 and a decrease in expenditures for patient service equipment when compared to the corresponding period in 2004.

Cash provided by financing activities was \$38.2 million during the first nine months of 2005 compared to cash used in financing activities of \$91.6 million for the first nine months of 2004. In 2005, the \$41.3 million in net proceeds from the revolving credit facility was the primary source of cash. Cash used in 2004 primarily relates to the \$100.0 million repurchase of the company's common stock.

**Contractual Cash Obligations.** The following table summarizes Apria's long-term cash payment obligations to which the company is contractually bound. The years presented below represent 12-month rolling periods ending September 30.

<i>(dollars in millions)</i>	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6+	Totals
Revolving loan	\$ -	\$ -	\$ -	\$ -	\$ 255	\$ -	\$ 255
Convertible senior notes	-	-	-	-	-	250	250
Capital lease obligations	2	1	-	-	-	-	3
Other debt	4	-	-	-	-	-	4
Operating leases	56	43	30	21	13	15	178
Deferred acquisition payments	6	-	-	-	-	-	6
<b>Total contractual cash obligations</b>	<b>\$ 68</b>	<b>\$ 44</b>	<b>\$ 30</b>	<b>\$ 21</b>	<b>\$ 268</b>	<b>\$ 265</b>	<b>\$ 696</b>

The holders of the convertible senior notes will first have the option to require Apria to repurchase all or a portion of their notes in September 2008.

**Accounts Receivable.** Accounts receivable before allowance for doubtful accounts increased to \$282.3 million at September 30, 2005 from \$264.4 million at December 31, 2004, which is primarily attributable to an increase in unbilled receivables related to acquisitions. Days sales outstanding (calculated as of each period end by dividing accounts receivable, less allowance for doubtful accounts, by the 90-day rolling average of net revenues) were 57 at September 30, 2005, 55 at September 30, 2004 and 52 at December 31, 2004. The increase in days sales outstanding at the end of the third quarter of 2005 is primarily due to an increase in unbilled receivables from acquisitions. The time-consuming processes of converting patient files onto Apria's systems and obtaining provider numbers from government payors routinely delay billing of the newly acquired business. Consequently, the related cash receipts are delayed, causing a temporary increase in accounts receivable and days sales

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outstanding. Additionally, a decline in organic revenue adversely impacted the 90-day rolling average of net revenue, which also factored into the increase in days sales outstanding.

Accounts aged in excess of 180 days of total receivables for certain major payor categories, and in total, are as follows:

	September 30, 2005	December 31, 2004
Total	21.5%	21.3%
Medicare	20.6%	18.7%
Medicaid	28.2%	24.9%
Self pay	39.5%	32.8%
Managed care/other	21.3%	20.6%

**Evaluation of Net Realizable Value.** Management performs various analyses to evaluate accounts receivable balances to ensure that recorded amounts reflect estimated net realizable value. Management applies specific percentages to the accounts receivable aging to estimate the amount that will ultimately be uncollectible and therefore should be reserved. The percentages are increased as the accounts age. Accounts aged in excess of 360 days are reserved at 100%. Management establishes and monitors these percentages through analyses of historical realization data, accounts receivable aging trends, other operating trends, the extent of contracted business and business combinations. Also considered are relevant business conditions, such as governmental and managed care payor claims processing procedures and system changes. If indicated by such analyses, management may periodically adjust the uncollectible estimate and corresponding percentages. Additionally, focused reviews of certain large and/or problematic payors are performed to determine if their respective reserve levels are appropriate.

**Unbilled Receivables.** Included in accounts receivable are earned but unbilled receivables of \$49.1 million and \$36.3 million at September 30, 2005 and at December 31, 2004, respectively. Delays ranging from one day up to several weeks between the dates of service and billing can occur due to delays in obtaining certain required payor-specific documentation from internal and external sources. Earned but unbilled receivables are aged from date of service and are considered in Apria's analysis of historical performance and collectibility. The increase in unbilled receivables at September 30, 2005 is largely due to acquisitions completed during 2005, as discussed above.

**Inventories and Patient Service Equipment.** Inventories consist primarily of pharmaceuticals and disposable products used in conjunction with patient service equipment. Patient service equipment consists of respiratory and home medical equipment that is provided to in-home patients for the course of their care plan, normally on a rental basis and subsequently returned to Apria for redistribution after cleaning and maintenance is performed.

The branch locations serve as the primary point from which inventories and patient service equipment are delivered to the patient. The branches are supplied with inventory and equipment from the regional warehouses, which coordinate purchasing with the corporate office. The regions are also responsible for repairs and scheduled maintenance of patient service equipment, which adds to the frequent movement of equipment between the region and branch locations. Further, the majority of Apria's patient service equipment is located in patients' homes. While the utilization varies widely between equipment types, on the average, approximately 80% of the equipment is on rent at any given time. Inherent in this asset flow is the fact that losses will occur. Management has successfully instituted a number of controls over the company's inventories and patient service equipment to minimize such losses. The company performs physical inventories on an annual or quarterly basis, depending on the product type, and adjusts the related balances accordingly. Inventory and patient service equipment losses for the nine months ended September 30, 2005 and 2004 were \$1.4 million and \$2.0 million, respectively.

**Long-Term Debt. Revolving Credit Facility.** At September 30, 2005, borrowings under Apria's revolving credit facility were \$255.0 million; outstanding letters of credit totaled \$3.9 million; and credit available under the revolving facility was \$241.1 million. The company continues to be in compliance with all of the financial covenants required by the credit agreement.

**Convertible Senior Notes.** At September 30, 2005, the fair value of the \$250.0 million in convertible senior notes was \$263.8 million, as determined by reference to quoted market prices.

**Hedging Activities.** Apria is exposed to interest rate fluctuations on its underlying variable rate long-term debt. Apria's policy for managing interest rate risk is to evaluate and monitor all available relevant information, including but not limited to, the structure of its interest-bearing assets and liabilities, historical interest rate trends and interest rate forecasts published by major financial institutions. The tools Apria may utilize to moderate its exposure to fluctuations in the relevant interest rate indices include, but are not limited to: (i) strategic determination of repricing periods and related principal amounts, and (ii) derivative financial instruments such as interest rate swap agreements, caps or collars.



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Apria does not use derivative financial instruments for trading or other speculative purposes.

At September 30, 2005, Apria had two interest rate swap agreements in effect to fix its LIBOR-based variable rate debt. The terms of such agreements are as follows: a three-year agreement with a notional amount of \$25.0 million and a fixed rate of 3.04%, expiring December 2005; and a four-year agreement with a notional amount of \$25.0 million and a fixed rate of 3.42%, expiring December 2006.

During the second quarter of 2005, Apria entered into two new interest rate swap agreements. The forward-starting contracts, each with a notional amount of \$25.0 million, become effective in January 2006. Both agreements have a three-year term with fixed rates of 4.38% and 4.44%.

The interest rate swap agreements are being accounted for as cash flow hedges under SFAS No. 133, *Accounting for Derivative and Hedging Activities*. Accordingly, the difference between the interest received and interest paid is reflected as an adjustment to interest expense. For the nine months ended September 30, 2005 and 2004, Apria paid net settlement amounts of \$68,000 and \$1.2 million, respectively. Unrealized gains and losses on the fair value of the swap agreements are reflected, net of taxes, in other comprehensive income. At September 30, 2005, the aggregate fair value of the swap agreements was an asset of \$506,000. In the event of counterparty non-performance, Apria's exposure to credit loss under the swap agreements is limited to the interest rate spread.

**Treasury Stock.** In October 2005, Apria's Board of Directors authorized the company to repurchase up to \$250 million worth of its outstanding common stock. On November 7, 2005, Apria purchased 7,337,526 shares of its common stock at an initial share price of \$23.83 through an accelerated share repurchase program. The price of the shares is subject to a future adjustment based on the volume weighted average price of the company's common stock over a period of up to five months. The adjustment can be paid in cash or shares, at Apria's election. Depending on market and other considerations, the company plans to purchase the remaining \$75 million worth of its common stock in open market or privately negotiated transactions over the next five fiscal quarters.

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**Business Combinations.** Pursuant to one of its primary growth strategies, Apria periodically acquires complementary businesses in specific geographic markets. The results of operations of the acquired companies are included in the accompanying condensed consolidated income statements from the dates of acquisition. Covenants not to compete are being amortized over the life of the respective agreements. Trade names and customer lists are being amortized over the period of their expected benefit.

The aggregate consideration for acquisitions that closed during the first nine months of 2005 was \$99.5 million. Pending receipt of additional valuation information, the preliminary allocation of this amount includes \$83.3 million to goodwill, \$7.4 million to other intangible assets and \$7.0 million to patient service equipment.

Cash paid for acquisitions, which includes amounts deferred from prior year acquisitions, totaled \$101.9 million and \$116.1 million in the first nine months of 2005 and 2004, respectively.

The success of Apria's acquisition strategy is directly dependent on Apria's ability to maintain and/or generate sufficient liquidity to fund such acquisitions and on the company's ability to successfully integrate the acquired operations.

**HIPAA.** The Health Insurance Portability and Accountability Act of 1996, or HIPAA, is comprised of a number of components. Pursuant to the administrative simplification section of HIPAA, HHS has issued multiple regulations, each with its own compliance date. For those regulations with a compliance date that has already passed, Apria was materially compliant by the date required. Remaining regulation under HIPAA that may have a material effect on Apria govern the following:

standards for unique national health identifier for healthcare providers for use in connection with standard transactions compliance date: May 23, 2007 Apria expects to be materially compliant with these regulations by the compliance date; and

the first installment of an interim enforcement rule, when issued in full, will address both substantive and procedural requirements for the imposition of civil monetary penalties.

Apria faces potential criminal or civil sanctions if it does not comply with existing or new laws and regulations related to patient health information, use of standard transaction and code sets and use of standard identifiers. New health information standards, whether implemented pursuant to HIPAA or otherwise, could have a significant effect on the manner in which Apria handles healthcare related data and communicates with payors.

**Disposition of Federal Investigation and Qui Tam Lawsuits.** As previously reported, Apria was the subject of an investigation commenced in mid-1998 by the U.S. Attorney's office in Los Angeles and the U.S. Department of Health and Human Services. The investigation concerned the documentation supporting Apria's billing for services provided to patients whose healthcare costs were paid by Medicare and other federal

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programs. The investigation related to two civil *qui tam* lawsuits against Apria filed by individuals suing on behalf of the government. These lawsuits, both pending in the United States District Court for the Central District of California, are *United States of America ex rel. Cynthia Costa and Ken Kostanecki v. Apria Healthcare Group, Inc.*, Case No. SACV-98-230-MMM(RCx) and *United States of America ex rel. Catherine Wickern v. Apria Healthcare Group, Inc.*, Case No. SACV-001263-MMM(RCx).

As previously reported, Apria and representatives of the government and the individual plaintiffs reached a preliminary agreement in early August 2005 to settle these lawsuits for the aggregate sum of \$17.6 million, without any admission of wrongdoing by Apria. The settlement was finalized in a definitive agreement that was fully executed and became effective on September 30, 2005, and Apria paid the settlement amount on that date.

The government informed Apria on October 4, 2005 that a third civil *qui tam* lawsuit (of which the government apprised Apria in July 2005) had been dismissed at the government's request by the district court in which the action was pending. That lawsuit, which is still under seal, alleged improper billing similar to that alleged in the above-described actions, but was limited to several specific locations during 2002-2004. The time period in which the plaintiff could appeal the district court's decision has not yet elapsed.

### Off-Balance Sheet Arrangements

Apria is not a party to off-balance sheet arrangements as defined by the Securities and Exchange Commission. However, from time to time the company enters into certain types of contracts that contingently require the company to indemnify parties against third-party claims. The contracts primarily relate to: (i) certain asset purchase agreements, under which the company may provide customary indemnification to the seller of the business being acquired; (ii) certain real estate leases, under which the company may be required to indemnify property owners for environmental and other liabilities, and other claims arising from the company's use of the applicable premises; and (iii) certain agreements with the company's officers, directors and employees, under which the company may be required to indemnify such persons for liabilities arising out of their employment relationship.

The terms of such obligations vary by contract and in most instances a specific or maximum dollar amount is not explicitly stated therein. Generally, amounts under these contracts cannot be reasonably estimated until a specific claim is asserted. Consequently, no liabilities have been recorded for these obligations on the company's balance sheets for any of the periods presented.

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

Apria is exposed to interest rate fluctuations on its underlying variable rate long-term debt. Apria utilizes interest rate swap agreements to moderate such exposure. Apria does not use derivative financial instruments for trading or other speculative purposes.

At September 30, 2005, Apria's revolving credit facility borrowings totaled \$255.0 million. The bank credit agreement provides interest rate options based on the following indices: Federal Funds Rate, Prime Rate or the London Interbank Offered Rate (LIBOR). All such interest rate options are subject to the application of an interest margin as specified in the bank credit agreement. At September 30, 2005, all of Apria's outstanding revolving debt was tied to LIBOR.

At September 30, 2005, Apria had a three-year interest rate swap agreement with a notional amount of \$25.0 million and a fixed rate of 3.04% and a four-year interest rate swap agreement with a notional amount of \$25.0 million and a fixed rate of 3.42%.

During the second quarter of 2005, Apria entered into two new interest rate swap agreements. The forward-starting contracts, each with a notional amount of \$25.0 million, become effective in January 2006. Both agreements have a three-year term with fixed rates of 4.38% and 4.44%.

Based on the revolving debt outstanding and the swap agreements in effect at September 30, 2005, a 100 basis point change in the applicable interest rates would increase or decrease Apria's annual cash flow and pretax earnings by approximately \$2.1 million. (See Management's Discussion and Analysis of Financial Condition and Results of Operations - Long-term Debt Hedging Activities.)

### ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, the company carried out an evaluation as required by Rules 13a-15(b) and 15d-15(b) of the Securities Exchange Act of 1934, as amended, under the supervision and with the participation of the company's management, including the company's principal executive officer and principal financial officer, of the effectiveness of the design and operation of the company's disclosure controls and procedures. Based upon that evaluation, the principal executive officer and principal financial officer concluded that the company's disclosure controls and procedures are effective in timely alerting them to material information relating to the company that is required to be

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included in the company's periodic Securities and Exchange Commission filings.

As required by Rule 13a-15(d) and 15d-15(d) of the Securities Exchange Act of 1934, as amended, the company carried out an evaluation of the company's internal control over financial reporting to determine whether, during the period covered by this report, there have been changes to the company's internal control over financial reporting or in other factors that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting. Based on that evaluation, there have been no such changes during the period covered by this report.

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### PART II OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

As previously reported, Apria was the subject of an investigation commenced in mid-1998 by the U.S. Attorney's office in Los Angeles and the U.S. Department of Health and Human Services. The investigation concerned the documentation supporting Apria's billing for services provided to patients whose healthcare costs were paid by Medicare and other federal programs. The investigation related to two civil *qui tam* lawsuits against Apria filed by individuals suing on behalf of the government. These lawsuits, both pending in the United States District Court for the Central District of California, are *United States of America ex rel. Cynthia Costa and Ken Kostanecki v. Apria Healthcare Group, Inc.*, Case No. SACV-98-230-MMM(RCx) and *United States of America ex rel. Catherine Wickern v. Apria Healthcare Group, Inc.*, Case No. SACV-001263-MMM(RCx).

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The government informed Apria on October 4, 2005 that a third civil *qui tam* lawsuit (of which the government apprised Apria in July 2005) had been dismissed at the government's request by the district court in which the action was pending. That lawsuit, which is still under seal, alleged improper billing similar to that alleged in the above-described actions, but was limited to several specific locations during 2002-2004. The time period in which the plaintiff could appeal the district court's decision has not yet elapsed.

Apria is also engaged in the defense of certain claims and lawsuits arising out of the ordinary course and conduct of its business, the outcomes of which are not determinable at this time. Apria has insurance policies covering such potential losses where such coverage is cost effective. In the opinion of management, any liability that might be incurred by Apria upon the resolution of these claims and lawsuits will not, in the aggregate, have a material adverse effect on Apria's results of operations or financial condition.

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#### ITEM 6. EXHIBITS

<u>Exhibit Number</u>	<u>Reference</u>
10.1	Amended and Restated Employment Agreement dated October 20, 2005, between Registrant and Lawrence A. Mastrovich.
10.2	Letter Agreement with respect to the Accelerated Share Repurchase transaction dated November 7, 2005, between Registrant and Citibank, N.A., acting through Citigroup Global Markets Inc., as agent.
31.1	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rule 13a-14(a).
31.2	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rule 13a-14(a).
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350.

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### SIGNATURES

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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.

APRIA HEALTHCARE GROUP INC.  
Registrant

November 9, 2005

/s/ AMIN I. KHALIFA  
Amin I. Khalifa  
Executive Vice President and Chief Financial Officer  
(Principal Financial Officer)