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)
[X] 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	**33-0488566**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
26220 Enterprise Court, Lake Forest, CA	**92630**
(Address of principal executive offices)	(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 __X__ No ___

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

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.)

APRIA HEALTHCARE GROUP INC.

FORM 10-Q

For the period ended September 30, 2005

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS (unaudited)

APRIA HEALTHCARE GROUP INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited)

(dollars in thousands)	September 30, 2005	December 31, 2004
ASSETS		
CURRENT ASSETS		
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
TOTAL CURRENT ASSETS	346,183	348,311
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

	September 30,	December 31,
	$ 1,197,764	$ 1,107,664
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
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
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)		
STOCKHOLDERS EQUITY		
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)
	481,163	406,185
	$ 1,197,764	$ 1,107,664

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,	
(dollars in thousands, except per share data)	**2005**	**2004**	**2005**	**2004**
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
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

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

	Nine Months Ended September 30,	
(dollars in thousands)	**2005**	**2004**
OPERATING ACTIVITIES		
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)
NET CASH PROVIDED BY OPERATING ACTIVITIES	128,891	197,794
INVESTING ACTIVITIES		
Purchases of patient service equipment and property, equipment and improvements, exclusive of effects of acquisitions	(92,871)	(111,890)

	Nine Months Ended September 30,	
Proceeds from disposition of assets	685	159
Cash paid for acquisitions, including payments of deferred consideration	(101,907)	(116,121)
NET CASH USED IN INVESTING ACTIVITIES	(194,093)	(227,852)
FINANCING ACTIVITIES		
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
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	38,243	(91,637)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(26,959)	(121,695)
Cash and cash equivalents at beginning of period	39,399	160,553
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 12,440	$ 38,858

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.

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.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in thousands, except per share data)	**2005**	**2004**	**2005**	**2004**
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.

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,	
(dollars in thousands, except per share data)	**2005**	**2004**
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:

(dollars in thousands)		**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,	*(dollars in thousands)*
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:

	(dollars in thousands)
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
	$ 74,978

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 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 resolu