

APRIA HEALTHCARE GROUP INC
Form 10-Q
May 10, 2007

**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 March 31, 2007

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

As of May 7, 2007 there were outstanding 43,645,375 shares of the Registrant's common stock, par value \$.001 per share, which is the only class of common stock of the Registrant (not including 16,999,072 shares held in treasury).

APRIA HEALTHCARE GROUP INC.

FORM 10-Q

For the period ended March 31, 2007

PART I. FINANCIAL INFORMATION

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EXHIBITS

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, 2006, as filed with the Securities and Exchange Commission on March 1, 2007. That 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;
potential reductions in reimbursement rates by government and third-party payors;
the effectiveness of Apria's operating systems and controls;
healthcare reform and the effect of federal and state healthcare regulations;
economic and political events, international conflicts and natural disasters;
acquisition-related risks; and
other factors described in Apria's filings with the Securities and Exchange Commission.

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

APRIA HEALTHCARE GROUP INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

| <i>(dollars in thousands)</i> | March 31, 2007 | December 31, 2006 |
|---|-------------------|----------------------|
| ASSETS | | |
| | (unaudited) | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 16,543 | \$ 14,657 |
| Accounts receivable, less allowance for doubtful accounts of \$26,066 and \$27,342 at March 31, 2007 and December 31, 2006, respectively | 212,325 | 211,097 |
| Inventories, net | 42,760 | 40,681 |
| Deferred income taxes | 36,733 | 36,648 |
| Deferred expenses | 22,584 | 22,712 |
| Prepaid expenses and other current assets | 18,315 | 19,142 |
| | <hr/> | <hr/> |
| TOTAL CURRENT ASSETS | 349,260 | 344,937 |
| PATIENT SERVICE EQUIPMENT, less accumulated depreciation of \$443,764 and \$445,608 at March 31, 2007 and December 31, 2006, respectively | 207,165 | 212,068 |
| PROPERTY, EQUIPMENT AND IMPROVEMENTS, net | 54,291 | 52,975 |
| GOODWILL | 539,182 | 539,187 |
| INTANGIBLE ASSETS, less accumulated amortization of \$7,793 and \$8,238 at March 31, 2007 and December 31, 2006, respectively | 5,560 | 6,551 |
| DEFERRED DEBT ISSUANCE COSTS, net | 4,168 | 4,612 |
| OTHER ASSETS | 8,129 | 8,166 |
| | <hr/> | <hr/> |
| | \$ 1,167,755 | \$ 1,168,496 |
| | <hr/> | <hr/> |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| CURRENT LIABILITIES | | |
| Accounts payable | \$ 65,118 | \$ 66,969 |
| Accrued payroll and related taxes and benefits | 36,803 | 46,532 |
| Accrued insurance | 12,401 | 10,977 |
| Income taxes payable | - | 10,793 |
| Other accrued liabilities | 26,106 | 33,827 |
| Deferred revenue | 32,942 | 32,280 |
| Current portion of long-term debt | 540 | 2,145 |
| | <hr/> | <hr/> |
| TOTAL CURRENT LIABILITIES | 173,910 | 203,523 |
| LONG-TERM DEBT, net of current portion | 460,000 | 485,000 |
| DEFERRED INCOME TAXES | 65,038 | 60,815 |
| INCOME TAXES PAYABLE AND OTHER NON-CURRENT LIABILITIES | 26,286 | 8,727 |
| | <hr/> | <hr/> |
| TOTAL LIABILITIES | 725,234 | 758,065 |
| COMMITMENTS AND CONTINGENCIES (Note J) | | |
| STOCKHOLDERS EQUITY | | |
| Preferred stock, \$.001 par value: 10,000,000 shares authorized; none issued | - | - |
| Common stock, \$.001 par value: 150,000,000 shares authorized; 60,516,782 and 59,762,307 shares issued at March 31, 2007 and December 31, 2006, respectively; 43,517,710 and 42,789,450 shares outstanding at March 31, 2007 and December 31, 2006, respectively | 61 | 60 |

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| | March 31, | December 31, |
|--|--------------|--------------|
| Additional paid-in capital | 500,180 | 482,123 |
| Treasury stock, at cost; 16,999,072 and 16,972,857 shares at March 31, 2007 and December 31, 2006, respectively | (430,408) | (429,573) |
| Retained earnings | 372,382 | 357,470 |
| Accumulated other comprehensive income | 306 | 351 |
| | <hr/> | <hr/> |
| TOTAL STOCKHOLDER S EQUITY | 442,521 | 410,431 |
| | <hr/> | <hr/> |
| | \$ 1,167,755 | \$ 1,168,496 |
| | <hr/> | <hr/> |

See notes to condensed consolidated financial statements.

APRIA HEALTHCARE GROUP INC.

CONDENSED CONSOLIDATED INCOME STATEMENTS

(unaudited)

| | Three Months Ended March 31, | |
|--|---------------------------------|------------|
| | 2007 | 2006 |
| <hr/> | | |
| <i>(dollars in thousands, except per share data)</i> | | |
| Net revenues: | | |
| Fee for service/product arrangements | \$ 348,006 | \$ 328,891 |
| Capitation arrangements | 41,284 | 39,165 |
| | <hr/> | <hr/> |
| TOTAL NET REVENUES | 389,290 | 368,056 |
| | <hr/> | <hr/> |
| Costs and expenses: | | |
| Cost of net revenues: | | |
| Product and supply costs | 91,070 | 83,169 |
| Patient service equipment depreciation | 28,010 | 28,721 |
| Respiratory therapy services | 9,338 | 9,419 |
| Nursing services | 2,104 | 2,245 |
| Other | 4,274 | 3,420 |
| | <hr/> | <hr/> |
| TOTAL COST OF NET REVENUES | 134,796 | 126,974 |
| | <hr/> | <hr/> |
| Provision for doubtful accounts | 9,698 | 10,168 |
| Selling, distribution and administrative | 206,579 | 197,693 |
| Amortization of intangible assets | 992 | 1,277 |
| | <hr/> | <hr/> |
| TOTAL COSTS AND EXPENSES | 352,065 | 336,112 |
| | <hr/> | <hr/> |
| OPERATING INCOME | 37,225 | 31,944 |
| Interest expense | 6,320 | 8,259 |
| Interest income | (494) | (972) |
| | <hr/> | <hr/> |
| INCOME BEFORE TAXES | 31,399 | 24,657 |
| Income tax expense | 12,255 | 8,534 |
| | <hr/> | <hr/> |
| NET INCOME | \$ 19,144 | \$ 16,123 |
| | <hr/> | <hr/> |

| | Three Months Ended March 31, | |
|-------------------------------------|---|-------------|
| | \$ 0.44 | \$ 0.38 |
| Basic net income per common share | <u>0.44</u> | <u>0.38</u> |
| Diluted net income per common share | <u>0.44</u> | <u>0.38</u> |

See notes to condensed consolidated financial statements.

APRIA HEALTHCARE GROUP INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

| <i>(dollars in thousands)</i> | Three Months Ended March 31, | |
|---|---|-----------------|
| | 2007 | 2006 |
| OPERATING ACTIVITIES | | |
| Net income | \$ 19,144 | \$ 16,123 |
| Items included in net income not requiring cash: | | |
| Provision for doubtful accounts | 9,698 | 10,168 |
| Depreciation and amortization | 33,955 | 35,241 |
| Amortization of deferred debt issuance costs | 445 | 432 |
| Deferred income taxes | 4,663 | 1,883 |
| Share-based compensation | 1,436 | 1,069 |
| (Gain) loss on disposition of assets and other | (64) | 263 |
| Changes in operating assets and liabilities, exclusive of effects of acquisitions: | | |
| Accounts receivable | (10,926) | (13,239) |
| Inventories, net | (2,074) | (1,568) |
| Prepaid expenses and other assets | 863 | 1,025 |
| Accounts payable, exclusive of book-cash overdraft | 1,846 | 1,067 |
| Accrued payroll and related taxes and benefits | (10,564) | (15,761) |
| Income taxes payable | 4,701 | 6,258 |
| Deferred revenue | 662 | - |
| Deferred expenses | 128 | - |
| Accrued expenses | (5,660) | (4,798) |
| Excess tax benefits from share-based compensation | (3,364) | - |
| | <u>44,889</u> | <u>38,163</u> |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | | |
| INVESTING ACTIVITIES | | |
| Purchases of patient service equipment and property, equipment and improvements, exclusive of effects of acquisitions | (32,672) | (38,834) |
| Proceeds from disposition of assets | 26 | 555 |
| Cash paid for acquisitions, including payments of deferred consideration | - | (4,063) |
| | <u>(32,646)</u> | <u>(42,342)</u> |
| NET CASH USED IN INVESTING ACTIVITIES | | |
| FINANCING ACTIVITIES | | |
| Proceeds from revolving credit facilities | - | 12,900 |
| Payments on revolving credit facilities | (25,000) | (17,900) |
| Payments on other long-term debt | (1,605) | (2,169) |
| Change in book-cash overdraft included in accounts payable | (413) | (858) |
| Excess tax benefits from share-based compensation | 3,364 | - |

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| | Three Months Ended March 31, | |
|---|---|------------------|
| Issuances of common stock | 13,297 | 2,802 |
| NET CASH USED IN FINANCING ACTIVITIES | (10,357) | (5,225) |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 1,886 | (9,404) |
| Cash and cash equivalents at beginning of period | 14,657 | 23,304 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 16,543 | \$ 13,900 |

SUPPLEMENTAL DISCLOSURES See Note E and Note H for cash paid for interest and income taxes, respectively.

NON-CASH TRANSACTIONS See Note F for tax benefit from stock option exercises and non-cash treasury stock transaction.

Purchases of patient service equipment and property, equipment and improvements exclude purchases that remain unpaid at the end of the respective quarter. Such amounts are then included in the following period's purchases. Unpaid purchases were \$4,868 and \$8,152 at March 31, 2007 and December 31, 2006, respectively.

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 in consolidation.

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, 2006.

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 materially 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. For the three-month periods ended March 31, 2007 and 2006, approximately 35% and 38% of the company's revenues were reimbursed under arrangements with Medicare and Medicaid. No other third-party payor group represented more than 9% of the company's revenues for either period presented. The majority of the company's revenues are derived from fees charged for patient care under fee-for-service/product arrangements.

Approximately half of Apria's net revenues are derived from rental arrangements to provide respiratory and other home medical equipment to patients in the home. Apria bills for these services on a monthly basis. The initial billing and revenue recognition is generated upon proper qualification of the patient and confirmation of delivery. Subsequent billings are processed monthly until the period of medical necessity ends. As a matter of process, Apria generates the subsequent billings in 30-day cycles so that each month's billing falls on approximately the same day of the month as the initial billing. At a given period-end, some percentage of the billed amounts are considered unearned as a portion of the rental period falls into the subsequent period. Such amounts are deferred and recognized as revenue in the subsequent period when the remaining portion of the rental period has elapsed. Corresponding expenses are deferred as well.

Due to the nature of the industry and the reimbursement environment in which Apria operates, certain estimates are required to record net revenues and to record accounts receivable at their net realizable values. Inherent in these estimates is the risk that they will have to be revised or

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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.

Clinical Expenses: Respiratory therapy and infusion therapy nursing expenses included in selling, distribution and administrative expenses totaled \$5,887,000 and \$4,952,000 for the three-month periods ended March 31, 2007 and 2006, respectively.

Distribution Expenses: Distribution expenses, totaling \$43,717,000 and \$44,080,000 for the three-month periods ended March 31, 2007 and 2006, respectively, are included in selling, distribution and administrative expenses.

Sales and Certain Other Taxes: In its consolidated financial statements, Apria accounts for taxes imposed on revenue-producing transactions by government authorities on a net basis, and accordingly, excluded from net revenues. Such taxes include, but are not limited to sales, use, privilege and excise taxes.

NOTE B RECENT ACCOUNTING PRONOUNCEMENTS

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 155, Accounting for Certain Hybrid Financial Instruments. The statement amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. The statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. Accordingly, the company adopted SFAS No. 155 on January 1, 2007. Such adoption did not have a material effect on the company's consolidated financial statements.

In June 2006, the FASB issued Interpretation No. 48 (FIN No. 48), Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, Accounting for Income Taxes. This standard creates a comprehensive model to address accounting for uncertainty in tax positions. FIN No. 48, clarifies the accounting for income taxes, by prescribing a minimum recognition threshold a tax position is required to meet before being recognized for financial statements. FIN No. 48 also provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

The company adopted FIN No. 48 as of January 1, 2007 and increased its liability for unrecognized tax benefits by recording a cumulative effect adjustment of \$4,232,000. This cumulative effect adjustment was recorded as a reduction to opening retained earnings.

In June 2006, the Emerging Issues Task Force (EITF) reached a consensus on EITF No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (EITF No. 06-3) which became effective for the Company as of January 1, 2007. EITF No. 06-3 provides that taxes imposed by a governmental authority on a revenue producing transaction between a seller and a customer should be shown in the income statement on either a gross or a net basis, based on the entity's accounting policy, which should be disclosed pursuant to Accounting Principles Board (APB) Opinion No. 22, Disclosure of Accounting Policies. The company will continue to present taxes within the scope of EITF No. 06-3 on a net basis. As such, the adoption of EITF No. 06-3 did not have a material effect on Apria's consolidated financial statements.

In September 2006, The FASB issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Management is currently evaluating the statement to determine what, if any, impact the statement will have on the company's consolidated financial statements.

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In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 (SFAS No. 159). SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Entities that elect the fair value option will report unrealized gains and losses in earnings at each subsequent reporting date. The fair value option may be elected on an instrument-by-instrument basis, with few exceptions. SFAS No. 159 also establishes presentation and disclosure requirements to facilitate comparisons between companies that choose different measurement attributes for similar assets and liabilities. The requirements of SFAS No. 159 are effective for fiscal years beginning after November 15, 2007. Management is currently evaluating the statement to determine what, if any, impact the statement will have on the company's consolidated financial statements.

NOTE C 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 condensed consolidated income statements from the dates of acquisition. No acquisitions were effected during the three months ended March 31, 2007. For the three months ended March 31, 2006 cash paid for acquisitions was \$4,063,000, which included deferred payments of \$3,001,000 related to prior periods. For the periods ended March 31, 2007 and 2006 deferred consideration payable totaled \$108,000 and \$2,625,000, respectively, and is included in the condensed consolidated balance sheets in other accrued liabilities.

NOTE D 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.

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

| <i>(dollars in thousands)</i> | March 31, 2007 | | | December 31, 2006 | | | |
|-------------------------------|-----------------------------|-----------------------------|-----------------------------|----------------------|-----------------------------|-----------------------------|----------------------|
| | Average Life in Years | Gross Carrying Amount | Accumulated Amortization | Net Book Value | Gross Carrying Amount | Accumulated Amortization | Net Book Value |
| Covenants not to compete | 5.0 | \$ 13,145 | \$ (7,631) | \$ 5,514 | \$ 13,506 | \$ (7,313) | \$ 6,193 |
| Customer lists | 0.8 | 208 | (162) | 46 | 1,283 | (925) | 358 |
| | 4.6 | \$ 13,353 | \$ (7,793) | \$ 5,560 | \$ 14,789 | \$ (8,238) | \$ 6,551 |

Estimated future amortization expense is presented below:

| Year Ending December 31, | <i>(dollars in thousands)</i> |
|--------------------------|-------------------------------|
| 2007 | \$ 2,916 |
| 2008 | 2,066 |
| 2009 | 1,254 |
| 2010 | 315 |
| | \$ 6,551 |

NOTE E LONG-TERM DEBT

Revolving Credit Facility: At March 31, 2007, borrowings under the revolving credit facility were \$210,000,000; outstanding letters of credit totaled \$3,855,000; credit available under the revolving facility was \$286,145,000; and Apria was in compliance with all covenants required by the credit agreement.

Convertible Senior Notes: At March 31, 2007, the fair value of the \$250,000,000 in convertible senior notes was \$275,000,000, as determined by reference to quoted market prices.

NOTE E LONG-TERM DEBT

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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. At March 31, 2007, Apria had one interest rate swap agreement in effect which will expire in January 2009 and has a notional amount of \$25,000,000 with a fixed rate of 4.44%. Apria also had an interest swap agreement which expired in December 2006 that had a notional amount of \$25,000,000 with a fixed rate of 3.42%.

The swap agreements are being accounted for under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. The difference between the interest received and interest paid is reflected as an adjustment to interest expense. Apria paid a net settlement amount of \$58,000 for the three-month period ended March 31, 2007 and \$84,000 for the same three-month period in 2006. The aggregate fair value of the swap agreement was an asset of \$264,000 and \$356,000 at March 31, 2007 and December 31, 2006, respectively, and is reflected in the accompanying condensed consolidated balance sheets in other assets. Unrealized gains and losses on the fair value of the swap agreements are reflected, net of taxes, in operating income, as the transactions no longer qualify for hedge accounting. Apria's exposure to credit loss under the swap agreement is limited to the interest rate spread in the event of counterparty nonperformance. Apria does not anticipate losses due to counterparty nonperformance as its counterparties to the swap agreement are nationally recognized financial institutions with strong credit ratings.

Total interest paid on debt totaled \$7,700,000 and \$9,270,000 for the three-month periods ended March 31, 2007 and 2006, respectively.

NOTE F STOCKHOLDERS EQUITY

For the three months ended March 31, 2007, changes to stockholders' equity were comprised of the following amounts:

| | <i>(dollars in thousands)</i> |
|--|-------------------------------|
| Net income | \$ 19,144 |
| Issuances of common stock | 13,297 |
| Tax benefit related to share-based compensation | 3,364 |
| Tax effect of canceled options | (39) |
| Restricted stock retained in treasury upon vesting | (835) |
| Stock-based compensation | 1,436 |
| Cumulative effect adjustment for FIN No. 48 adoption | (4,232) |
| Other comprehensive loss, net of taxes | (45) |
| | \$ 32,090 |

Net income and total comprehensive income differ by other comprehensive loss, net of taxes. Such loss represents the amortization of a balance in accumulated other comprehensive income that was previously recorded in connection with certain interest rate swap agreements. For the three months ended March 31, 2007 and 2006, total comprehensive income was \$19,099,000 and \$16,123,000 respectively.

NOTE G SHARE-BASED COMPENSATION

For the three month periods ended March 31, 2007 and 2006, the company recorded share-based compensation expense of \$1,436,000 and \$1,069,000, respectively. All such compensation is reflected in the accompanying condensed consolidated income statement within the selling, distribution and administrative expense line item. The related awards were granted to administrative personnel or members of the company's Board of Directors and therefore no portion of the share-based compensation has been classified within cost of net revenues. Share-based compensation expense recognized in the periods presented is based on awards ultimately expected to vest; therefore, it has been reduced for estimated forfeitures.

For the three months ended March 31, 2007 and 2006, cash received from the exercise of options totaled \$13,297,000 and \$2,802,000, respectively.

The company estimates the fair value of stock options using the Black-Scholes valuation model. Key input assumptions used to estimate the fair value of stock options include the exercise price of the award, the expected option term, the expected volatility of the company's stock over the option's expected term, the risk-free interest rate over the option's term, and the company's expected annual dividend yield. Apria's management believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of the company's stock options granted in the three-month periods ended March 31, 2007 and 2006. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards. The key input assumptions that

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were utilized in the valuation of the stock options granted during the three months ended March 31, 2007 and 2006, are summarized in the table below.

| | Three Months Ended March 31, | |
|--|---------------------------------|-----------|
| | 2007 | 2006 |
| Expected option term ⁽¹⁾ | 4.6 years | 4.8 years |
| Expected volatility ⁽²⁾ | 29.9% | 27.1% |
| Risk-free interest rate ⁽³⁾ | 4.6% | 4.7% |
| Expected annual dividend yield | 0% | 0% |

⁽¹⁾ The expected option term is based on historical exercise and post-vesting termination patterns.

⁽²⁾ Expected volatility represents a combination of historical stock price volatility and implied volatility from publicly-traded options on Apria's common stock.

⁽³⁾ The risk-free interest rate is based on the implied yield on a U.S. Treasury zero coupon issue with a remaining term equal to the expected term of the option.

Stock Options: Apria's incentive plan provides for the granting of stock options to employees and non-employee directors. Such grants to employees may include non-qualified and incentive stock options. The exercise price of an option is established at the fair market value of a share of Apria common stock on the date of grant. Vesting of stock options is time-based and is generally over a three-year period.

The following table summarizes the activity for stock options for the three months ended March 31, 2007:

| | Options | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (in Years) | Aggregate Intrinsic Value |
|---|-----------|------------------------------------|---|---------------------------------|
| Outstanding at January 1, 2007 | 4,056,314 | \$ 24.59 | | |
| Granted | 576,830 | 32.12 | | |
| Exercised | (677,245) | 19.56 | | |
| Forfeited | (26,667) | 29.72 | | |
| Outstanding at March 31, 2007 | 3,929,232 | \$ 26.53 | 6.97 | \$22,995,269 |
| Vested or expected to vest as of March 31, 2007 | 3,690,921 | \$ 26.49 | 6.81 | \$21,772,350 |
| Exercisable at March 31, 2007 | 2,679,061 | \$ 26.12 | 5.79 | \$16,929,861 |

The weighted-average fair value of stock options granted during the three months ended March 31, 2007 and 2006 was \$10.67 and \$7.39, respectively. There were 630,000 stock options granted in the corresponding period in 2006. The total intrinsic value of options exercised was \$8,021,000 and \$120,000 for the three months ended March 31, 2007 and 2006, respectively.

As of March 31, 2007, total unrecognized stock-based compensation cost related to unvested stock options was \$8,916,000, which is expected to be expensed over a weighted-average period of 2.54 years.

Restricted Stock Purchase Rights: In 2003 and 2004, Apria granted restricted stock purchase rights to certain members of executive management. The awards represented the right to purchase a certain number of shares of Apria common stock at a future date at a specified exercise price. The exercise price was established at 25% of the fair market value of a share of Apria common stock on the date of grant. Such awards generally require that certain performance conditions and service conditions be met before the awards will vest.

The following table summarizes the activity for restricted stock purchase rights for the three months ended March 31, 2007:

| Restricted Stock Purchase Rights | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (in Years) | Aggregate Intrinsic Value |
|---|------------------------------------|---|---------------------------------|
|---|------------------------------------|---|---------------------------------|

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| | Restricted Stock Purchase Rights | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (in Years) | Aggregate Intrinsic Value |
|---|---|------------------------------------|---|---------------------------------|
| Outstanding at January 1, 2007 | 300,000 | \$ 6.79 | | |
| Granted | - | - | | |
| Exercised | (8,000) | 6.46 | | |
| Forfeited | - | - | | |
| Outstanding at March 31, 2007 | 292,000 | \$ 6.80 | 6.52 | \$ 7,431,500 |
| Vested or expected to vest as of March 31, 2007 | 226,478 | \$ 6.77 | 6.51 | \$ 5,770,145 |
| Exercisable at March 31, 2007 | 8,000 | \$ 6.46 | 6.37 | \$ 206,320 |

The total intrinsic value of restricted stock purchase rights exercised was \$200,000 and \$392,000 for the three months ended March 31, 2007 and 2006, respectively. No such awards were granted during these two periods.

As of March 31, 2007, total unrecognized stock-based compensation cost related to unvested restricted stock purchase rights was \$2,725,000, which is expected to be expensed over a weighted-average period of 3.06 years.

Restricted Stock Awards and Units: Apria's incentive plan provides for the granting of restricted stock and restricted stock units to its non-employee directors and employees (limited to executive management). Such awards generally require that certain performance conditions and service conditions be met before the awards will vest.

The following table summarizes the activity for restricted stock awards and units for the three months ended March 31, 2007:

| | Shares or Share Units | Weighted-Average Grant-Date Fair Value |
|--|-----------------------------|--|
| Nonvested restricted stock awards and units at January 1, 2007 | 486,922 | \$27.16 |
| Granted | 346,710 | \$30.33 |
| Vested and released | (69,230) | \$22.42 |
| Forfeited | (14,873) | \$22.42 |
| Nonvested restricted stock awards and units at March 31, 2007 | 749,529 | \$29.16 |

The weighted-average fair value of restricted stock awards and units granted during the three months ended March 31, 2007 and 2006 was \$30.33 and \$22.75, respectively. There were 255,000 awards granted in the corresponding period in 2006. Restricted stock awards or units released during the three months ended March 31, 2007 were 69,230 shares and the total intrinsic value was \$2,206,000. No restricted stock awards or units were released during the three months ended March 31, 2006.

As of March 31, 2007, total unrecognized stock-based compensation cost related to unvested restricted stock awards and units was \$14,994,000, which is expected to be expensed over a weighted-average period of 2.20 years.

NOTE H INCOME TAXES

The effective income tax rate was 39.0% for the three months ended March 31, 2007 compared with 34.6% for the three months ended March 31, 2006. The change in the effective tax rate was primarily due to the recognition of a \$1,761,000 favorable adjustment in March 31, 2006 which related to the settlement of tax issues.

The company adopted FIN No. 48, Accounting for Uncertainty in Income Taxes, as of January 1, 2007. In conjunction with its FIN No. 48 adoption, the company increased its liability for unrecognized tax benefits by recording a cumulative effect adjustment of \$4,232,000. This cumulative effect adjustment was recorded as a reduction to opening retained earnings.

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As of January 1, 2007, the company has provided for a liability of \$16,948,000 for unrecognized tax benefits, all of which, if ultimately recognized, could favorably affect the effective tax rate in a future period.

As of March 31, 2007, the company believes it is reasonably possible that certain unrecognized tax benefits, related to state tax uncertainties, could be realized within the succeeding 12 months. The company estimates that these unrecognized tax benefits could be up to \$2,000,000 and ultimate realization is dependent upon the occurrence of certain events (including the expiration of the applicable statute of limitations).

The company recognizes interest expense and penalties related to unrecognized tax benefits as part of its provision for income taxes. As of January 1, 2007, the company has provided \$3,844,000 in accrued interest and penalties within its liability for unrecognized tax benefits.

The company's calendar 2003 through 2005 tax years remain open to examination by the Internal Revenue Service. The company's calendar 2001 through 2005 tax years remain open to examination by various state tax agencies.

The company is currently under examination by the Internal Revenue Service for its calendar 2005 tax year and by certain state tax agencies for its calendar tax years 2001 through 2004.

Net income taxes paid for the three-month periods ended March 31, 2007 and 2006, were \$3,000,000 and \$361,000, respectively.

NOTE I 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> | Three Months Ended March 31, | |
|---|---|-------------|
| | 2007 | 2006 |
| Numerator: | | |
| Net income | \$ 19,144 | \$ 16,123 |
| Numerator for basic and diluted per share amounts — net income available to common stockholders | \$ 19,144 | \$ 16,123 |
| Denominator: | | |
| Denominator for basic per share amounts — weighted average shares | 43,112 | 42,379 |
| Effect of dilutive securities: | | |
| Employee stock options and awards — dilutive potential common shares | 876 | 575 |
| Denominator for diluted per share amounts — adjusted weighted average shares | 43,988 | 42,954 |
| Basic net income per common share | \$ 0.44 | \$ 0.38 |
| Diluted net income per common share | \$ 0.44 | \$ 0.38 |
| Employee stock options excluded from the computation of diluted per share amounts: | | |
| Shares for which exercise price exceeds average market price of common stock | 986 | 2,536 |
| Average exercise price per share that exceeds average market price of common stock | \$ 31.80 | \$ 29.04 |

NOTE I PER SHARE AMOUNTS

NOTE J COMMITMENTS AND CONTINGENCIES

Litigation: Apria is the defendant in a California class action lawsuit asserting blanket claims of liability under various California employee protection statutes and regulations relating to payment of regular and overtime wages, the timeliness of such payments, the maintenance and provision of access to required payroll records, and the provision of meal and rest periods. *Venegas vs. Apria Healthcare, Inc., et al.*, was filed on February 21, 2006 in the California Superior Court for the County of San Francisco (Case No. CGC 06 449669). No class has been certified at this time but, the complaint seeks compensatory and punitive damages in an unspecified amount as well as other relief on behalf of a purported class consisting of certain hourly employees of the company in the State of California. The company has filed an answer to the complaint denying all material allegations and asserting a number of affirmative defenses. To date, plaintiff has not filed a motion for class certification. The court has set the case for trial beginning November 26, 2007. Based on the company's preliminary investigation of the allegations, management believes there are meritorious defenses to the claims and the company intends to vigorously defend the lawsuit. No assurance can be given, however, that the ultimate disposition of this case will not have a material adverse effect on the company's financial condition or results of operations.

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 financial condition or results of operations.

Medicare Reimbursement: There are a number of provisions contained within recent legislation or proposed legislation that affect or may affect Medicare reimbursement policies for items and services provided by Apria. The company cannot be certain of the ultimate impact of all legislated and contemplated changes, and therefore, cannot provide assurance that these changes will not have a material adverse effect on Apria's results of operations.

Supplier Concentration: Apria currently purchases approximately 63% of its patient service equipment and supplies from four vendors. Although there are a limited number of suppliers, management believes that other vendors could provide similar products on comparable terms. However, a change in suppliers could cause delays in service delivery and possible losses in revenue, which could adversely affect operating results.

Guarantees and Indemnities: From time to time Apria enters into certain types of contracts that contingently require the company to indemnify parties against third party claims. These 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 or 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 relationship with the company.

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.

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 and administrative support 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 through approximately 470 branch locations throughout the United States.

Strategy. Apria's strategy is to position itself in the marketplace as the low cost, quality provider of a broad range of home healthcare services to managed care and Medicare customers. The specific elements of its strategy are to:

- achieve strong sales growth;
- leverage its nationwide infrastructure to reduce costs and expand profits;
- deliver superior customer service; and
- attract, develop and advance leaders within the company.

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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 year ended December 31, 2006.

Government Reimbursement Update. On April 10, 2007, the Centers for Medicare and Medicaid Services, or CMS, published the final rule (Final Rule) implementing the Medicare Part B competitive bidding program for certain items of Durable Medical Equipment, Prosthetics, Orthotics and Supplies, or DMEPOS. By statute, CMS must phase in the program over time, with the first phase establishing competitive bidding in 10 of the largest metropolitan statistical areas (MSAs) for 2008, with 80 additional markets added in 2009, and full implementation in 2010. Competitive bidding imposes a new and significant risk to suppliers of DMEPOS. If a DMEPOS supplier operating in a Competitive Bidding Area, or CBA, is not awarded a contract for that CBA, the supplier generally will no longer be able to bill and collect from Medicare for most DMEPOS supplied in that CBA. A DMEPOS supplier awarded one of the winning bids for the CBA is likely to receive lower Medicare payment levels than those in existence prior to competitive bidding. Finally, there is a risk that the new competitive bidding prices will become a new benchmark for reimbursement from private payors. As competitive bidding is phased in across the country, there is likely to be a substantial reduction in reimbursement earned by all DMEPOS suppliers, including Apria.

The Final Rule listed both the 10 MSAs and product categories that CMS selected for the initial phase of the program. Apria services all nine of the domestic markets included in the list of initial 10 CBAs (Puerto Rico markets excluded). Nine of the 10 product categories selected for the first phase are common to all nine domestic markets. The tenth product category is specific to the Miami and Puerto Rico markets only. CMS will accept bids from suppliers for the following product categories: Oxygen Supplies and Equipment; Standard Power Wheelchairs, Scooters and Related Accessories; Complex Rehabilitative Power Wheelchairs and Related Accessories; Mail-Order Diabetic Supplies; Enteral Nutrients, Equipment and Supplies; Continuous Positive Airway Pressure Devices, Respiratory Assist Devices and Related Supplies and Accessories; Hospital Beds and Related Accessories; Negative Pressure Wound Therapy Pumps and Related Supplies and Accessories; Walkers and Related Accessories; and (Miami and Puerto Rico only) Support Surfaces (group 2 mattresses and overlays).

The deadline for suppliers to submit bids for participation in the program is 60 days after issuance of the Request for Bids (RFB). While CMS and its Competitive Bidding Implementing Contractor expect the deadline for bid submission to be early July 2007, the RFB had not been issued as of May 9, 2007. CMS has posted on its website the following key targeted dates for implementation of the first phase of the program: December 2007 final selection of winning contract suppliers; April 1, 2008 new payment levels go into effect for the selected product categories in the 10 selected CBAs.

The Final Rule, among other things, generally requires Medicare beneficiaries who live in a CBA to receive equipment and services that are included within the competitive bidding program exclusively from suppliers who are awarded contracts by CMS, with a few exceptions. The reimbursement rate for the items and services will be the single payment rate that is determined through the bid process. Apria's Medicare-reimbursed revenue for the selected products in the applicable markets during the initial year of competitive bidding represents less than 2% of the company's total net revenue. If Apria becomes a winning contract supplier in each of the nine initial CBAs serviced by Apria and the subject revenue were impacted by a 10% to 15% payment reduction as estimated by CMS, it would represent less than 0.3% of Apria's total net revenue during the initial year of competitive bidding. In the second and subsequent years of competitive bidding, the adverse financial impact will increase substantially in amounts that cannot immediately be determined. Apria intends to submit a bid for participation in the competitive bidding program in each of the nine CBAs and is evaluating available data to determine the product categories on which it will bid. If Apria is selected as a winning contract supplier, it believes that its geographic coverage and purchasing strength in particular provides advantages to maintain and enhance market share, but at lower reimbursement rates. However, there is no guarantee that Apria will be selected as a winning contract supplier and be awarded a competitive bidding contract by CMS. If Apria is not selected as a contract supplier for a particular CBA, it will generally not be allowed to supply Medicare beneficiaries with products subject to competitive bidding within that CBA, unless it elects to continue providing service to existing patients under the grandfathering provision of the Final Rule. Because of Apria's combination of both managed care and traditional business, Apria believes it can nevertheless maintain a strong overall market position.

For detailed disclosure on other legislative and regulatory activities that affect or may affect Medicare and Medicaid reimbursement policies for products and services provided by Apria, please refer to the Business Government Regulation section in Apria's Annual Report on Form 10-K for the year ended December 31, 2006.

Results of Operations

Net Revenues and Gross Margin. Net revenues were \$389.3 million in the first quarter of 2007, compared to \$368.1 million for the same quarter of 2006. This represents an increase of 5.8% which is primarily volume-based as pricing increases have been negligible. Net revenue was reduced in the first quarter by approximately \$651,000 due to a change in Medicare reimbursement methodology for certain durable medical equipment items previously categorized as capped rental. Such equipment previously had a maximum rental period of 15 months with a patient purchase option, but currently rental payments cease at the 13th month with transfer of ownership to the patient. The change was mandated by

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the Deficit Reduction Act of 2005 and became effective for patients commencing service on or after January 1, 2006 for this particular set of items. February 2007 is the first month in which the change impacted Apria's revenues.

Gross margins were stable at 65.4% in the first quarter of 2007 compared to 65.5% in the same period last year.

Apria expects to continue to face pricing pressures from Medicare as well as from its managed care customers as these payors 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 potential change may cause Apria to provide reduced levels of certain products and services in the future, resulting in a corresponding reduction in revenue.

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

| <i>(dollars in thousands)</i> | Three Months Ended March 31, | | | |
|-------------------------------|-------------------------------------|--------|-------------|--------|
| | 2007 | | 2006 | |
| | \$ | % | \$ | % |
| Respiratory therapy | \$268,272 | 68.9% | \$253,148 | 68.8% |
| Infusion therapy | 68,968 | 17.7% | 64,772 | 17.6% |
| Home medical equipment/other | 52,050 | 13.4% | 50,136 | 13.6% |
| Total net revenues | \$389,290 | 100.0% | \$368,056 | 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. Revenues from the respiratory therapy service line increased by 6.0% in the first quarter of 2007 when compared to the corresponding period in 2006. The largest respiratory categories grew between the three-month periods in 2007 and 2006 as follows: revenues from oxygen and oxygen systems increased by 2.9% and revenues from respiratory drugs grew by 9.4%. Revenues from the continuous positive and bi-level airway pressure devices and related supplies, which currently comprise approximately 28% of total respiratory revenues, grew by 13.6%. Much of this growth is attributable to a program the company has instituted to provide via mail the necessary supplies to patients already utilizing the airway pressure devices. Approximately \$376,000 of the aforementioned Medicare revenue reduction impacted the respiratory therapy line.

Infusion Therapy. The infusion therapy service line involves the administration of drugs or nutrients 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 by 6.5% in the three months ended March 31, 2007 when compared to the same period last year. The growth was generated primarily by the enteral nutrition offering, which represents just under half of the infusion therapy line. Enteral nutrition revenues increased by 14.5% for the three months ended March 31, 2007.

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 increased by 3.8% for the three months ended March 31, 2007 when compared to the corresponding period in 2006. Approximately \$275,000 of the Medicare revenue reduction noted above impacted the home medical equipment/other line.

Provision for Doubtful Accounts. The provision for doubtful accounts is based on management's estimate of the net realizable value of accounts receivable after considering actual write-offs of specific receivables. Accounts receivable which are not expected to be collected are estimated and provided for by applying specific percentages to each receivables aging category, which is determined by the number of days the receivable is outstanding. The provision for doubtful accounts, expressed as a percentage of net revenues, was 2.5% and 2.8% for the first quarter of 2007 and 2006, respectively. The improvement between the periods reflects improvements in cash collections and notably the success of a credit card program designed to collect patient receivables upon delivery and automatically on the rental due date thereafter.

Selling, Distribution and Administrative. Selling, distribution and administrative expenses are comprised of expenses incurred in direct 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, intake, reimbursement, warehousing and repair. Many of these operating costs are directly variable with revenue growth patterns. Some are also very sensitive to market-driven price fluctuations such as facility leases and fuel costs. The administrative expenses include overhead costs incurred by the operating locations and corporate support functions. These expenses do not fluctuate with revenue growth as closely as operating costs.

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Selling, distribution and administrative expenses, expressed as percentages of net revenues, were 53.1% in the first quarter of 2007 and 53.7% in the first quarter of 2006. The comparison between the reported periods reflects expense leveraging achieved through the successful implementation of a number of cost saving initiatives. Such initiatives include those in the revenue management area whereby productivity and efficiencies have been enhanced by consolidating and centralizing certain functions. Billing and collection activities for several of the company's larger payors have been centralized as have certain other related functions. Also, in the logistics area, the routing of deliveries has been automated which has resulted in decreased miles per delivery stop and increased stops per driver. The company has been successful in converting these productivity improvements to cost savings.

Share-based compensation is reflected within the selling, distribution and administrative expense line item. For the three-month periods ended March 31, 2007 and 2006, share-based compensation expense was \$1.4 million and \$1.1 million, respectively.

Amortization of Intangible Assets. For the quarters ended March 31, 2007 and 2006, amortization expense was \$1.0 million and \$1.3 million, respectively. See Liquidity and Capital Resources Business Combinations.

Interest Expense and Income. Interest expense was \$6.3 million for the first quarter of 2007 as compared to \$8.3 million for the comparable period in 2006. The decrease in interest expense in 2007 is primarily attributable to the decrease in long-term debt as a result of the continued pay down of the revolving credit line. For the first quarter of 2007 and 2006, interest income was \$494,000 and \$972,000, respectively. During the first three months of 2007, interest costs in the amount of \$111,000 were capitalized in conjunction with software development. See Liquidity and Capital Resources Long-term Debt.

Income Tax Expense. The effective income tax rate was 39.0% for the three months ended March 31, 2007 compared with 34.6% for the three months ended March 31, 2006. The change in the effective tax rate was primarily due to the recognition of a \$1.8 million favorable adjustment in March 31, 2006 which related to the settlement of tax issues.

Apria's effective tax rate is based on expected income, statutory tax rates and tax planning opportunities available to it in the various jurisdictions in which the company operates. Significant management estimates and judgments are required in determining the company's effective tax rate. Apria is routinely under audit by federal, state or local authorities regarding the timing and amount of deductions, allocation of income among various tax jurisdictions and compliance with federal, state and local tax laws. Tax assessments related to these audits may not arise until several years after tax returns have been filed. Although predicting the outcome of such tax assessments involves uncertainty, Apria believes that the recorded tax liabilities appropriately reflect the company's potential obligations under FIN No. 48.

Inflation. Apria is impacted by rising costs for certain inflation-sensitive operating expenses such as vehicle fuel, labor and employee benefits and facility and equipment leases.

Liquidity and Capital Resources

Apria's principal source of liquidity is its operating cash flow, which is supplemented by a \$500 million revolving credit facility. In recent years, Apria has generated operating cash flows in excess of its operating needs, which has afforded it the ability to pursue acquisitions and fund patient service equipment purchases to support revenue growth. Apria's management believes that its operating cash flow will continue to be sufficient to fund its operations and growth strategies. In September 2008, the holders of the \$250 million convertible senior notes will have an opportunity to require Apria to repurchase some or all of the notes. Accordingly, Apria management continues to evaluate its financing alternatives regarding its ability to repurchase these notes to the extent required by the holders.

Further, Apria has initiated a project to implement a new enterprise-wide information system. The overall objective of the project is to deliver the necessary technology and automation across the organization to enable improvements in service, productivity and access to information. Development on certain modules commenced in 2006. The overall project plan is being designed and developed and is expected to be implemented over several years.

Cash Flow. Cash provided by operating activities was \$44.9 million in the first three months of 2007 compared to \$38.2 million in the corresponding period in 2006. The increase in operating cash flow between the two periods is due primarily to improved profitability, strong cash collections of receivables and favorable timing for expense disbursements.

Cash used in investing activities decreased to \$32.6 million for the first three months of 2007 compared to \$42.3 million during the same period last year. The decrease in 2007 was due to an absence of acquisitions and to a reduction in capital expenditures resulting from better equipment utilization.

Cash used in financing activities was \$10.4 million during the first three months of 2007 compared to \$5.2 million for the first three months of 2006. As a result of the strong operating cash flow and cash proceeds received upon the issuance of common stock, the company reduced the

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amount owed on its revolving line of credit by \$25 million during the first quarter of 2007.

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 March 31.

| <i>(dollars in millions)</i> | 2008 | 2009 | 2010 | 2011 | 2012 | There- after | Totals |
|---|-------|-------|-------|-------|--------|-----------------|--------|
| Revolving loan ⁽¹⁾ | \$ - | \$ - | \$ - | \$ - | \$ 210 | \$ - | \$ 210 |
| Convertible senior notes (3.375%) ⁽²⁾ | - | - | - | - | - | 250 | 250 |
| Interest on convertible senior notes ⁽³⁾ | 8 | 8 | 8 | 8 | 8 | 182 | 222 |
| Other debt | 1 | - | - | - | - | - | 1 |
| Operating leases | 54 | 46 | 36 | 27 | 18 | 23 | 204 |
| Software licenses and related maintenance | 1 | - | - | - | - | - | 1 |
| | \$ 64 | \$ 54 | \$ 44 | \$ 35 | \$ 236 | \$ 455 | \$ 888 |

⁽¹⁾ Interest on outstanding borrowings is payable quarterly.

⁽²⁾ 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.

⁽³⁾ Interest on these notes is paid bi-annually in March and September. Unless the notes are earlier converted, redeemed or repurchased, such interest payments will total \$8.4 million annually until the notes mature in 2033. Amounts presented above assume notes are not earlier converted, redeemed or repurchased.

Accounts Receivable. Accounts receivable before allowance for doubtful accounts was \$238.4 million at March 31, 2007, which was consistent with December 31, 2006. 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 49 days at March 31, 2007 and December 31, 2006.

Accounts aged in excess of 180 days expressed as percentages of total receivables for certain payor categories are as follows:

| | March 31, 2007 | December 31, 2006 |
|--------------------|-------------------|----------------------|
| Medicare | 17.3% | 19.2% |
| Medicaid | 29.1% | 28.6% |
| Self pay | 28.1% | 36.5% |
| Managed care/other | 18.2% | 19.1% |
| Total | 19.0% | 19.8% |

Unbilled Receivables. Included in accounts receivable are earned but unbilled receivables of \$28.9 million and \$30.0 million at March 31, 2007 and December 31, 2006, respectively. Delays, ranging from a day up to several weeks, between the date 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.

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 patients. Certain products and services, such as infusion therapy and respiratory medications, bypass the branches and are provided directly to patients from pharmacies or other central locations. The branches are supplied with inventory and equipment from central warehouses that service specific areas of the country. Such warehouses are also responsible for repairs and scheduled maintenance of patient service equipment, which adds to the frequent movement of equipment between locations. Further, the majority of Apria's patient service equipment is located in patients' homes. While utilization varies widely between equipment types, on the average, approximately 83% of equipment is on rent at any given time. Inherent in this asset flow is the fact that losses will occur. Depending on the product type, the company performs physical inventories on an annual or quarterly basis. Inventory and patient service equipment balances in the financial records are adjusted to reflect the results of these physical

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inventories. Inventory and patient service equipment losses for the three months ended March 31, 2007 were \$248,000 and in the first quarter of 2006, the company adjusted its related assets upward by \$4,000.

Long-term Debt. At March 31, 2007, borrowings under the revolving credit facility were \$210 million; outstanding letters of credit totaled \$3.9 million; credit available under the revolving facility was \$286.1 million; and Apria was in compliance with all covenants required by the credit agreement. The effective interest rate at March 31, 2007, after consideration of the effect of the swap agreement described below, was 6.32%. See *Hedging Activities* below.

Convertible Senior Notes. At March 31, 2007, the fair value of the \$250 million in convertible senior notes was \$275.0 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: (1) strategic determination of repricing periods and related principal amounts, and (2) derivative financial instruments such as interest rate swap agreements, caps or collars. Apria does not use derivative financial instruments for trading or other speculative purposes.

At March 31, 2007, Apria had one interest rate swap agreement in effect which will expire in January 2009 and has a notional amount of \$25 million with a fixed rate of 4.44%. Apria also had an interest swap agreement which expired in December 2006 that had a notional amount of \$25 million with a fixed rate of 3.42%.

The swap agreements are being accounted for under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The difference between the interest received and interest paid is reflected as an adjustment to interest expense. Apria paid a net settlement amount of \$58,000 for the three-month period ended March 31, 2007 and \$84,000 for the same three-month period in 2006. The aggregate fair value of the swap agreement was an asset of \$264,000 and \$356,000 at March 31, 2007 and December 31, 2006, respectively, and is reflected in the accompanying condensed consolidated balance sheets in other assets. Unrealized gains and losses on the fair value of the swap agreements are reflected, net of taxes, in operating income, as the transactions no longer qualify for hedge accounting. Apria's exposure to credit loss under the swap agreement is limited to the interest rate spread in the event of counterparty nonperformance. Apria does not anticipate losses due to counterparty nonperformance as its counterparties to the swap agreement are nationally recognized financial institutions with strong credit ratings.

Treasury Stock. In the first quarter of 2007, 26,215 shares of employee restricted stock shares, valued at \$835,000 were tendered back to the company to satisfy the related tax obligation. In 2006 a similar transaction for 7,672 shares of employee restricted stock shares, valued at \$141,000, were also tendered back to the company to satisfy the related tax obligation.

Business Combinations. Apria periodically acquires complementary businesses in specific geographic markets. Given the potential for a higher gross margin, Apria targets respiratory therapy businesses. These transactions are accounted for as purchases and 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. Tradenames and customer lists are being amortized over the period of their expected benefit.

During the three months ended March 31, 2007 Apria did not effect any acquisitions, nor were payments made for amounts deferred from prior periods. For the first three months of 2006, \$4.1 million was paid for acquisitions, which includes amounts deferred from prior periods.

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 relationship with the company.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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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 March 31, 2007, Apria's revolving credit facility borrowings totaled \$210.0 million. The bank credit agreement governing the revolver provides interest rate options based on the following indices: Federal Funds Rate, the Bank of America prime rate or the London Interbank Offered Rate, or LIBOR. All such interest rate options are subject to the application of an interest margin as specified in the bank credit agreement. At March 31, 2007 all of Apria's outstanding revolving debt was tied to LIBOR.

During the first quarter of 2007, Apria had one interest rate swap agreement in effect to fix its LIBOR-based variable rate debt. The agreement became effective in January 2006 for a three-year term, and has a notional amount of \$25 million that fixes an equivalent amount of the company's variable rate debt at 4.44%.

Based on the revolving debt outstanding and the swap agreements in place at March 31, 2007, a 100 basis point change in the applicable interest rates would increase or decrease Apria's annual cash flow and pretax earnings by approximately \$1.85 million. See Management's Discussion and Analysis of Financial Condition and Results of Operations Long-term Debt Hedging Activities.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures. As of the end of the period covered by this report, the company carried out an evaluation, 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 each concluded that the company's disclosure controls and procedures are effective as of the end of the period covered by this report.

Changes in Internal Control Over Financial Reporting. During the period covered by this report, there have been no significant changes to the company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Apria is the defendant in a California class action lawsuit asserting blanket claims of liability under various California employee protection statutes and regulations relating to payment of regular and overtime wages, the timeliness of such payments, the maintenance and provision of access to required payroll records, and the provision of meal and rest periods. *Venegas vs. Apria Healthcare, Inc., et al.*, was filed on February 21, 2006 in the California Superior Court for the County of San Francisco (Case No. CGC 06 449669). No class has been certified at this time but the complaint seeks compensatory and punitive damages in an unspecified amount as well as other relief on behalf of a purported class consisting of certain hourly employees of the company in the State of California. The company has filed an answer to the complaint denying all material allegations and asserting a number of affirmative defenses. To date, plaintiff has not filed a motion for class certification. The court has set the case for trial beginning November 26, 2007. Based on the company's preliminary investigation of the allegations, management believes there are meritorious defenses to the claims and the company intends to vigorously defend the lawsuit. No assurance can be given, however, that the ultimate disposition of this case will not have a material adverse effect on the company's financial condition or results of operations.

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 financial condition or results of operations.

ITEM 1A. RISK FACTORS

The risk factors presented in Apria's Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 1, 2007, are incorporated herein by reference with the exception of the risk factor titled Medicare/Medicaid Reimbursement Rates which is presented below in its entirety. For further information, see Part I Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations, Government Reimbursement Update in this Quarterly Report on this Form 10-Q.

Medicare/Medicaid Reimbursement Rates Continued reductions in Medicare and Medicaid reimbursement rates could have a material adverse effect on Apria's results of operations and financial condition.

Medicare Reimbursement Reductions. There are a number of provisions contained within recent legislation and proposed regulations that adversely affect or may adversely affect reimbursement for products and services provided by Apria. For example, in December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003, also referred to as the Medicare Modernization Act, or MMA, became law. The MMA and related rules issued by the Centers for Medicare and Medicaid Services, or CMS, implemented reimbursement reductions for a number of products and services provided by Apria and established a proposed competitive bidding program for Medicare Part B. Further, the Deficit Reduction Act of 2005, or DRA, was signed into law in February 2006. Once fully implemented, the DRA and related rules issued by CMS will result in reduced reimbursement rates for certain durable medical equipment, including home oxygen equipment and services provided by Apria, a reduced period for rental revenue, and potential increased costs associated with replacement of certain patient-owned equipment.

In addition to these laws, certain other proposed legislative and regulatory activities may affect reimbursement policies for other items and services provided by Apria. These recently enacted reductions and pending proposed reductions in Medicare reimbursement rates could have a material adverse effect on Apria's net revenues, net income, cash flow and capital resources.

Medicaid Reimbursement Reductions. For a number of years, some states began adopting alternative pricing methodologies for certain drugs and biologicals under the Medicaid program. In a number of states, the changes 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 elected to stop accepting new Medicaid patient referrals for the affected drugs and biologicals. Further, some states are considering other reductions in Medicaid reimbursement as they work through their respective budget processes.

Apria cannot estimate the ultimate impact of all legislated and contemplated Medicare and Medicaid reimbursement changes or provide assurance to investors that additional reimbursement reductions will not be made or will not have an adverse effect on the company's operations and financial condition.

PART II OTHER INFORMATION

ITEM 2. UNREGISTERED SALE OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibits:

Exhibit

Number Reference

10.1 # Apria Healthcare Group Inc. 2007 Executive Bonus Plan.

10.2 # Form of Restricted Stock Unit Award Agreement as granted under the Registrant's 2003 Performance Incentive Plan.

10.3 # Form of Employee Stock Option Agreement as granted under the Registrant's 2003 Performance Incentive Plan.

10.4 #

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Noncompetition and Nonsolicitation Agreement as dated March 7, 2007, between Registrant and Lawrence M. Higby.

- 10.5 # Noncompetition and Nonsolicitation Agreement as dated March 7, 2007, between Registrant and Lawrence Mastrovich.
 - 10.6 # Amended and Restated Noncompetition Agreement as dated March 7, 2007, between Registrant and Chris A. Karkenny.
 - 10.7 # Amended and Restated Noncompetition Agreement as dated March 7, 2007, between Registrant and William J. Ingram.
 - 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.
- # Management contract or compensatory plan or arrangement.

SIGNATURES

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

APRIA HEALTHCARE GROUP INC.

Registrant

May 10, 2007

/s/ CHRIS A. KARKENNY

Chris A. Karkenny
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)