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APRIA HEALTHCARE GROUP INC
Form 10-Q
November 14, 2002

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 period ended September 30, 2002

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 X No

There were 54,882,530 shares of common stock, \$.001 par value, outstanding at November 7, 2002.

APRIA HEALTHCARE GROUP INC.

FORM 10-Q

FOR THE PERIOD ENDED SEPTEMBER 30, 2002

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Chief Executive Officer
Chief Financial Officer

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS (UNAUDITED)

APRIA HEALTHCARE GROUP INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited)

(DOLLARS IN THOUSANDS)

SEPTEMBER 30,
2002

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ASSETS

CURRENT ASSETS

| | |
|---|-----------|
| Cash and cash equivalents | \$ 12,732 |
| Accounts receivable, less allowance for doubtful accounts of \$33,764 and \$32,073 at September 30, 2002 and December 31, 2001, respectively | 176,656 |
| Inventories, net | 22,823 |
| Deferred income taxes | 28,476 |
| Prepaid expenses and other current assets | 13,407 |
| | ----- |
| TOTAL CURRENT ASSETS | 254,094 |

| | |
|--|------------|
| PATIENT SERVICE EQUIPMENT, less accumulated depreciation of \$367,394 and \$342,010 at September 30, 2002 and December 31, 2001, respectively | 181,304 |
| PROPERTY, EQUIPMENT AND IMPROVEMENTS, NET | 54,002 |
| DEFERRED INCOME TAXES | 2,198 |
| GOODWILL | 239,365 |
| INTANGIBLE ASSETS, NET | 6,489 |
| OTHER ASSETS | 7,027 |
| | ----- |
| | \$ 744,479 |
| | ===== |

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES

| | |
|--|-----------|
| Accounts payable | \$ 55,513 |
| Accrued payroll and related taxes and benefits | 41,361 |
| Accrued insurance | 10,280 |
| Income taxes payable | 3,638 |
| Other accrued liabilities | 36,857 |
| Current portion of long-term debt | 28,093 |
| | ----- |
| TOTAL CURRENT LIABILITIES | 175,742 |

| | |
|--|---------|
| LONG-TERM DEBT, net of current portion | 257,468 |
|--|---------|

COMMITMENTS AND CONTINGENCIES (Note I)

STOCKHOLDERS' EQUITY

| | |
|--|------------|
| Preferred stock, \$.001 par value: 10,000,000 shares authorized; none issued | - |
| Common stock, \$.001 par value: 150,000,000 shares authorized; 56,296,149 and 54,690,267 shares issued at September 30, 2002 and December 31, 2001, respectively; 54,758,849 and 54,604,167 outstanding at September 30, 2002 and December 31, 2001, respectively | 56 |
| Additional paid-in capital | 392,928 |
| Treasury stock, at cost; 1,537,300 and 86,100 shares at September 30, 2002 and December 31, 2001, respectively | (32,485) |
| Accumulated deficit | (48,936) |
| Accumulated other comprehensive (loss) income | (294) |
| | ----- |
| | 311,269 |
| | ----- |
| | \$ 744,479 |
| | ===== |

See notes to condensed consolidated financial statements.

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APRIA HEALTHCARE GROUP INC.

CONDENSED CONSOLIDATED INCOME STATEMENTS
(unaudited)

| (DOLLARS IN THOUSANDS, EXCEPT PER SHARE DATA) | THREE MONTHS ENDED SEPTEMBER 30, | |
|--|-------------------------------------|------------|
| | 2002 | 2001 |
| Net revenues | \$ 312,046 | \$ 284,025 |
| Costs and expenses: | | |
| Cost of net revenues: | | |
| Product and supply costs | 56,004 | 50,300 |
| Patient service equipment depreciation | 24,826 | 23,127 |
| Nursing services | 221 | 270 |
| Other | 3,182 | 2,780 |
| TOTAL COST OF NET REVENUES | 84,233 | 76,477 |
| Selling, distribution and administrative | 169,797 | 158,750 |
| Provision for doubtful accounts | 11,476 | 9,873 |
| Amortization of goodwill and intangible assets | 667 | 3,244 |
| TOTAL COSTS AND EXPENSES | 266,173 | 248,344 |
| OPERATING INCOME | 45,873 | 35,681 |
| Interest expense, net | 3,528 | 5,093 |
| INCOME BEFORE TAXES AND EXTRAORDINARY CHARGE | 42,345 | 30,588 |
| Income tax expense | 15,880 | 11,455 |
| INCOME BEFORE EXTRAORDINARY CHARGE | 26,465 | 19,133 |
| Extraordinary charge on debt refinancing, net of taxes | - | 1,528 |
| NET INCOME | \$ 26,465 | \$ 17,605 |
| Basic net income per common share: | | |
| Income before extraordinary charge | \$ 0.48 | \$ 0.35 |
| Extraordinary charge on debt refinancing, net of taxes | - | (0.03) |
| Net income | \$ 0.48 | \$ 0.32 |
| Diluted net income per common share: | | |
| Income before extraordinary charge | \$ 0.48 | \$ 0.34 |
| Extraordinary charge on debt refinancing, net of taxes | - | (0.03) |
| Net income | \$ 0.48 | \$ 0.31 |

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See notes to condensed consolidated financial statements.

APRIA HEALTHCARE GROUP INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

| | NINE MONTH SEPTEMBER |
|---|---|
| (DOLLARS IN THOUSANDS) | 2002 |
| <hr style="border-top: 1px dashed black;"/> | |
| OPERATING ACTIVITIES | |
| Net income | \$ 75,618 |
| Items included in net income not requiring cash: | |
| Extraordinary charge on debt refinancing | - |
| Provision for doubtful accounts | 34,534 |
| Depreciation and amortization | 87,569 |
| Amortization of deferred debt issuance costs | 967 |
| Deferred income taxes and other | 41,130 |
| Changes in operating assets and liabilities, exclusive of effects of acquisitions: | |
| Accounts receivable | (49,407) |
| Inventories, net | 3,232 |
| Prepaid expenses and other assets | (3,694) |
| Accounts payable, exclusive of outstanding checks | (8,829) |
| Accrued payroll and related taxes and benefits | 7,454 |
| Income taxes payable | 3,572 |
| Accrued expenses | (3,289) |
| | <hr style="border-top: 1px dashed black;"/> |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 188,857 |
| INVESTING ACTIVITIES | |
| Purchases of patient service equipment and property, equipment and improvements, exclusive of effects of acquisitions | (88,857) |
| Proceeds from disposition of assets | 239 |
| Cash paid for acquisitions, including payments of deferred consideration | (59,566) |
| | <hr style="border-top: 1px dashed black;"/> |
| NET CASH USED IN INVESTING ACTIVITIES | (148,184) |
| FINANCING ACTIVITIES | |
| Proceeds from revolving credit facilities | 141,000 |
| Payments on revolving credit facilities | (146,100) |
| Proceeds from term loans | - |
| Payments on term loans | (6,812) |
| Payment on redemption of senior subordinated notes | - |
| Payments on other long-term debt | (2,239) |
| Outstanding checks included in accounts payable | (6,856) |
| Capitalized debt issuance costs | (666) |
| Repurchases of common stock | (31,524) |
| Issuances of common stock | 15,897 |
| | <hr style="border-top: 1px dashed black;"/> |

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| | |
|--|-----------|
| NET CASH USED IN FINANCING ACTIVITIES | (37,300) |
| | ----- |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 3,373 |
| Cash and cash equivalents at beginning of period | 9,359 |
| | ----- |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 12,732 |
| | ===== |

See notes to condensed consolidated financial statements.

APRIA HEALTHCARE GROUP INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE A - 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 the opinion of management, 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 for the year ended December 31, 2001, included in the company's 2001 Form 10-K.

NOTE B - RECLASSIFICATIONS, ACCOUNTING ESTIMATES AND RECENT ACCOUNTING PRONOUNCEMENTS

Reclassifications: 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 assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Recent Accounting Pronouncements: Effective January 1, 2002, Apria adopted Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets" in its entirety. SFAS No. 142 addresses the financial accounting and reporting for goodwill and other intangible assets. The statement provides that goodwill or other intangible assets with indefinite lives will no longer be amortized, but shall be tested for impairment annually, or more frequently if circumstances indicate potential impairment. The effect of adoption of SFAS No. 142 on the consolidated financial statements is shown in Note E - Goodwill and Intangible Assets.

Effective January 1, 2002, Apria was required to adopt SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This statement supercedes SFAS No. 121 "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" and amends other guidance related to the accounting and reporting of long-lived assets. SFAS No. 144 requires that one

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accounting model be used for long-lived assets to be disposed of by sale. Discontinued operations will be measured similarly to other long-lived assets classified as held for sale at the lower of its carrying amount or fair value less cost to sell. Future operating losses will no longer be recognized before they occur. SFAS No. 144 also broadens the presentation of discontinued operations to include a component of an entity when operations and cash flows can be clearly distinguished, and establishes criteria to determine when a long-lived asset is held for sale. Adoption of this statement did not have a material effect on Apria's consolidated financial statements.

In April 2002, SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections" was issued. SFAS No. 145 updates and clarifies existing accounting pronouncements related to gains and losses from the extinguishment of debt and requires that certain lease modifications be accounted for in the same manner as sale-leaseback transactions. Apria will be required to adopt the provisions of SFAS No. 145 for its fiscal year beginning January 1, 2003. Adoption of this statement is not expected to have a material effect on the company's consolidated financial statements.

In July 2002, SFAS No. 146, "Accounting for Costs Associated With Exit or Disposal Activities" was issued. This statement addresses the financial accounting and reporting for costs associated with exit or disposal activities and requires that a liability for such costs be recognized when the liability is incurred rather than at the date of an entity's commitment to an exit plan. SFAS No. 146 also establishes that the liability should be measured and recorded at fair value. Apria will be required to adopt the provisions of SFAS No. 146 for exit and disposal activities that are initiated after December 31, 2002. Adoption of this statement is not expected to have a material effect on the company's consolidated financial statements.

NOTE C - REVENUE RECOGNITION AND CONCENTRATION OF CREDIT RISK

Net 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 33% of the company's revenues are reimbursed under arrangements with Medicare and Medicaid. No other third-party payor group represents 10% or more 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 less than 10% 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 various analyses to evaluate the net realizable value of accounts receivable. Specifically, management considers historical realization data, accounts receivable aging trends, other operating trends and relevant business conditions. Management also performs focused reviews of certain large and/or problematic payors. Because of continuing changes in the healthcare industry and third-party reimbursement, management's estimates may change from time to time, which could have a material impact on operations and cash flows.

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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.

NOTE D - 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 date of acquisition. During the nine-month period ended September 30, 2002, cash paid for acquisitions was \$59,566,000, which included amounts deferred from prior years of \$2,523,000. At September 30, 2002, outstanding deferred consideration totaled \$8,103,000 and is included on the balance sheet in other accrued liabilities.

For the 13 transactions that were completed during the nine-month period ended September 30, 2002, \$46,844,000 was allocated to goodwill, \$3,172,000 to other intangible assets and \$12,529,000 to patient service equipment. 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, 2002, as if the acquisitions had occurred at the beginning of the periods presented. The pro forma information is based on the historical financial statements of Apria and those of the acquired businesses. Amounts are not necessarily indicative of the results that may have been obtained had the combinations been in effect at the beginning of the periods presented or that may be achieved in the future.

| (IN THOUSANDS) | NINE MONTHS ENDED SEPTEMBER 30, | |
|--|------------------------------------|------------|
| | 2002 | 2001 |
| Net revenues..... | \$ 953,472 | \$ 887,387 |
| Income before extraordinary charge..... | \$ 75,551 | \$ 49,141 |
| Net income..... | \$ 75,551 | \$ 47,613 |
| Diluted income per common share: | | |
| Income before extraordinary charge..... | \$ 1.36 | \$ 0.88 |
| Extraordinary charge on debt refinancing, net of taxes..... | - | (0.03) |
| Net income..... | \$ 1.36 | \$ 0.85 |
| | ===== | ===== |

NOTE E - GOODWILL AND INTANGIBLE ASSETS

In July 2001, Apria adopted SFAS No. 141, "Business Combinations", which requires that the purchase method of accounting be applied to all business combinations completed after June 30, 2001 and which also addresses the criteria for initial recognition of intangible assets and goodwill. Effective January 1, 2002, the company adopted SFAS No. 142, "Goodwill and Other Intangible Assets", in its entirety. SFAS No. 142 addresses the financial accounting and reporting for goodwill and other intangible assets. The statement provides that goodwill and other intangible assets with indefinite lives will no longer be amortized, but shall be tested for impairment annually, or more frequently if circumstances indicate potential impairment. If the carrying value of goodwill or an intangible asset exceeds its fair value, an impairment loss shall be recognized.

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In the year of adoption, SFAS No. 142 requires that a transitional goodwill impairment test be performed and that the results be measured as of the beginning of the year. The test is conducted at a "reporting unit" level and compares each reporting unit's fair value to its carrying value. The company has determined that its geographic regions are reporting units under SFAS No. 142. The measurement of fair value for each region was based on an evaluation of future discounted cash flows and was further tested using a multiple of earnings approach. The transitional test, which has been completed, indicated that no impairment exists and, accordingly, no loss was recognized.

In conjunction with the transitional impairment test and based on the criteria established in SFAS No. 141, management reviewed the useful lives and the amounts previously recorded for intangible assets and determined that no adjustments were necessary.

The following table sets forth the reconciliation of net income and earnings per share as adjusted for the non-amortization provisions of SFAS No. 142:

| (IN THOUSANDS, EXCEPT PER SHARE DATA) | THREE MONTHS ENDED SEPTEMBER 30, | | NINE MONTHS ENDED SEPTEMBER 30, | |
|---|-------------------------------------|-----------|------------------------------------|-----------|
| | 2002 | 2001 | 2002 | 2001 |
| Reported net income | \$ 26,465 | \$ 17,605 | \$ 75,618 | \$ 51,920 |
| Add: goodwill amortization, net of taxes | - | 1,626 | - | 4,560 |
| Adjusted net income | \$ 26,465 | \$ 19,231 | \$ 75,618 | \$ 56,490 |
| BASIC INCOME PER COMMON SHARE: | | | | |
| Reported net income | \$ 0.48 | \$ 0.32 | \$ 1.39 | \$ 0.90 |
| Goodwill amortization, net of taxes | - | 0.03 | - | 0.00 |
| Adjusted net income | \$ 0.48 | \$ 0.35 | \$ 1.39 | \$ 1.00 |
| DILUTED INCOME PER COMMON SHARE: | | | | |
| Reported net income | \$ 0.48 | \$ 0.31 | \$ 1.36 | \$ 0.90 |
| Goodwill amortization, net of taxes | - | 0.03 | - | 0.00 |
| Adjusted net income | \$ 0.48 | \$ 0.34 | \$ 1.36 | \$ 1.00 |

For the nine months ended September 30, 2002, the net change in the carrying amount of goodwill of \$45,907,000 is the result of business combinations. All of the goodwill recorded in conjunction with business combinations completed after June 30, 2001 is expected to be deductible for tax purposes.

Intangible assets consist of the following:

(DOLLARS IN THOUSANDS)

SEPTEMBER 30, 2002

| Intangible assets subject to amortization: | AVERAGE LIFE IN YEARS | GROSS CARRYING AMOUNT | ACCUMULATED AMORTIZATION | NET BOOK VALUE | GROSS CARRYING AMOUNT |
|---|-----------------------------|-----------------------------|-----------------------------|-------------------|-----------------------------|
| | | | | | |

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| | | | | | |
|-------------------------------|------|----------|------------|----------|------|
| Covenants not to compete..... | 4.5 | \$ 9,595 | \$ (4,320) | \$ 5,275 | \$16 |
| Tradename..... | 2.0 | 1,324 | (110) | 1,214 | --- |
| | ---- | ----- | ----- | ----- | --- |
| | 3.9 | \$10,919 | \$ (4,430) | \$ 6,489 | \$16 |
| | ==== | ===== | ===== | ===== | ==== |

Amortization expense amounts to \$2,003,000 for the nine months ended September 30, 2002. Estimated amortization expense for each of the fiscal years ending December 31, is presented below:

| (DOLLARS IN THOUSANDS) | FOR THE YEAR ENDING DECEMBER 31, |
|------------------------|-------------------------------------|
| ----- | ----- |
| 2002..... | \$ 2,693 |
| 2003..... | 2,566 |
| 2004..... | 1,869 |
| 2005..... | 731 |
| 2006..... | 488 |
| 2007..... | 145 |

NOTE F - LONG-TERM DEBT

Apria's credit agreement with Bank of America and a syndicate of lenders was amended and restated effective June 7, 2002. The amendment extended the maturity date, reduced the applicable interest rate margins and modified the repayment schedule for the company's \$175,000,000 six-year term loan. The term loan, which was amended to mature in seven years, had a balance of \$173,250,000 at September 30, 2002. It is now repayable in 20 remaining consecutive quarterly installments of \$437,500 each, followed by three consecutive quarterly installments of \$41,125,000 each, and a final payment of \$41,125,000 due on July 20, 2008.

Interest rates on outstanding balances under the credit agreement are determined by adding a margin to the Eurodollar or base rate existing at each interest calculation date. Applicable margins for the seven-year term loan were lowered and are currently fixed at 2.0% for Eurodollar loans and at 1.0% for base rate loans.

At September 30, 2002, borrowings under the revolving credit facility were \$2,700,000, outstanding letters of credit totaled \$5,155,000, credit available under the revolving facility was \$92,145,000, and Apria was in compliance with all of the financial covenants required by the credit agreement.

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 September 30, 2002, Apria had two interest rate swap agreements with a total notional amount of \$100,000,000 that fix its LIBOR-based variable rate debt at 2.58% (before the applicable margin). The swap agreements, which terminate March 2003, are being accounted for as cash flow hedges under SFAS No. 133. 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, 2002, Apria paid a net settlement amount of \$478,000. The swap agreements are recorded as a liability at their fair value of \$469,000 and unrealized losses of \$321,000 on their fair value are reflected, net of taxes, in other comprehensive loss. Apria's exposure to credit loss under the swap agreements is limited to the interest rate spread in the event of counterparty non-performance.

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NOTE G - STOCKHOLDERS' EQUITY

For the nine months ended September 30, 2002, changes to stockholders' equity are comprised of the following amounts:

(DOLLARS IN THOUSANDS)

| | |
|---|-----------|
| Net income..... | \$ 75,618 |
| Proceeds from the exercise of stock options..... | 15,897 |
| Tax benefit related to the exercise of stock options..... | 8,801 |
| Other comprehensive loss, net of taxes..... | (321) |
| Repurchased common shares held in treasury..... | (31,524) |
| | ----- |
| | \$ 68,471 |
| | ===== |

For the nine months ended September 30, 2002, net income and comprehensive income differed by \$321,000 which is attributable to unrealized losses on two interest rate swap agreements. There was no difference between net income and comprehensive income for the same period of the previous year.

Pursuant to its credit agreement, Apria can repurchase up to \$35,000,000 worth of its outstanding common stock during this calendar year. The company repurchased 1,451,200 shares for \$31,524,000, during the nine-month period ended September 30, 2002. Subsequently, the company purchased 145,800 shares for \$3,476,000, thereby reaching its maximum for the year.

NOTE H - INCOME TAXES

Income taxes for the nine months ended September 30, 2002 and 2001 have been provided at the effective tax rates expected to be applicable for the respective year.

At December 31, 2001, Apria had federal net operating loss carryforwards of approximately \$98,000,000, expiring in varying amounts in the years 2003 through 2018, and various state net operating loss carryforwards that began to expire in 1997. Additionally, the company has an alternative minimum tax credit carryforward of approximately \$7,600,000. As a result of an ownership change in 1992 that met specified criteria of Section 382 of the Internal Revenue Code, future use of a portion of the federal and state operating loss carryforwards generated prior to 1992 are each limited to approximately \$5,000,000 per year. Because of the annual limitation, approximately \$57,000,000 of each of Apria's federal and state operating loss carryforwards may expire unused. The net operating loss carryforward amount in the related deferred tax asset excludes such amount. In 2002, for federal tax purposes, the company expects to utilize its entire net operating loss carryforward amount not subject to limitation.

NOTE I - COMMITMENTS AND CONTINGENCIES

Apria and certain of its present and former officers and/or directors were defendants in a class action lawsuit, In Re Apria Healthcare Group Securities Litigation, filed in the U.S. District Court for the Central District of California, Southern Division (Case No. SACV98-217 GLT). The complaint alleged, among other things, that the defendants made false and/or misleading public statements regarding Apria and its financial condition in violation of federal securities laws. Two similar class actions were filed during July 1998 in the Superior Court for the State of California for the County of Orange, which were

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consolidated by a court order dated October 22, 1998 (Master Case No. 797060). Following a series of settlement discussions, the parties reached an agreement to settle both the federal and state class actions for \$42 million. Under the terms of the settlement, Apria has paid \$1 million and its insurance carriers have paid \$41 million. Pursuant to the settlement: (1) the State Court class actions were concluded on August 20, 2002 by entry of an Order and Final Judgment; and (2) the District Court class action was dismissed on August 21, 2002 by entry of an Order dismissing the action with prejudice.

On August 27, 2001, a class action lawsuit was filed against Apria and its former Chief Executive Officer in the U.S. District Court for the Central District of California, Southern Division (Case No. SACV01-5160 PA), entitled *J.E.B. Capital Partners, LP v. Apria Healthcare Group Inc. and Philip L. Carter*. Among other things, the complaint alleged that the defendants made false and/or misleading public statements by not announcing until July 16, 2001 the amount of potential damages asserted by the U.S. Attorney's office in Los Angeles and counsel for the plaintiffs in the qui tam actions referred to below. The defendants' motion to dismiss the complaint was granted with leave to amend on June 14, 2002. Plaintiff elected not to amend its complaint, but filed a notice of appeal on July 15, 2002. The appeal was dismissed as premature. On October 10, 2002, the District Court entered a judgment in favor of the defendants and dismissed the action with prejudice. On November 8, 2002, the plaintiff filed an appeal of the Order of dismissal. Apria believes that it has meritorious defenses to the plaintiff's claims and it intends to vigorously defend itself. In the opinion of Apria's management, the ultimate disposition of this class action will not have a material adverse effect on Apria's results of operations or financial condition.

As previously reported, since mid-1998 Apria has been the subject of investigations conducted by several U.S. Attorneys' offices and the U.S. Department of Health and Human Services. These investigations concern the documentation supporting Apria's billing for services provided to patients whose healthcare costs are paid by Medicare and other federal programs. Apria is cooperating with the government in connection with these investigations and is responding to various document requests and subpoenas. A criminal investigation conducted by the U.S. Attorney's office in Sacramento was closed in mid-1999 with no charges being filed. Potential claims resulting from an investigation by the U.S. Attorney's office in San Diego were settled in mid-2001 in exchange for a payment by Apria of \$95,000.

Apria has been informed by the U.S. Attorney's office in Los Angeles that the investigation being conducted by that office is the result of civil qui tam litigation filed on behalf of the government against Apria. The complaints in the litigation are under seal, however, and the government has not informed Apria of either the identities of the plaintiffs, the court or courts where the proceedings are pending, the date or dates instituted or the factual bases alleged to underlie the proceedings. To date, the U.S. Attorney's office has not informed Apria of any decision to intervene in the qui tam actions; however, it could reach a decision with respect to intervention at any time.

On July 12, 2001, government representatives and counsel for the plaintiffs in the qui tam actions asserted that, by a process of extrapolation from a sample of 300 patient files to all of Apria's billings to the federal government during the three-and-one-half year sample period, Apria could be liable to the government under the False Claims Act for more than \$9 billion, consisting of extrapolated overpayment liability, plus treble damages and penalties of up to \$10,000 for each allegedly false claim derived from the extrapolation.

Apria has acknowledged that there may be errors and omissions in supporting documentation affecting a portion of its billings. However, it considers the assertions and amounts described in the preceding paragraph to be unsupported both legally and factually and believes that most of the alleged documentation

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errors and omissions should not give rise to any liability, for overpayment refunds or otherwise. Accordingly, Apria believes that the claims asserted are unwarranted and that it is in a position to assert numerous meritorious defenses. Nevertheless, Apria cannot provide any assurances as to the outcome of these proceedings. Management cannot estimate the possible loss or range of loss that may result from these proceedings and therefore has not recorded any related accruals.

If a judge, jury or administrative agency were to determine that false claims were submitted to federal healthcare programs or that there were significant overpayments by the government, Apria could face civil and administrative claims for refunds, sanctions and penalties for amounts that would be highly material to its business, results of operations and financial condition, including the exclusion of Apria from participation in federal healthcare programs.

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

NOTE J - PER SHARE AMOUNTS

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

| (IN THOUSANDS, EXCEPT PER SHARE DATA) | THREE MONTHS ENDED SEPTEMBER 30, | | NINE MONTHS SEPTEMBER | |
|--|-------------------------------------|----------|--------------------------|----------|
| | 2002 | 2001 | 2002 | 2001 |
| NUMERATOR: | | | | |
| Net income | \$26,465 | \$17,605 | \$75,618 | \$75,618 |
| Numerator for basic and diluted per share amounts - income available to common stockholders | \$26,465 | \$17,605 | \$75,618 | \$75,618 |
| DENOMINATOR: | | | | |
| Denominator for basic per share amounts - weighted average shares | 54,745 | 54,231 | 54,490 | |
| Effect of dilutive securities: | | | | |
| Employee stock options - dilutive potential common shares | 623 | 1,737 | 979 | |
| Denominator for diluted per share amounts - adjusted weighted average shares | 55,368 | 55,968 | 55,469 | |
| Basic net income per common share | \$ 0.48 | \$ 0.32 | \$ 1.39 | \$ 1.39 |
| Diluted net income per common share | \$ 0.48 | \$ 0.31 | \$ 1.36 | \$ 1.36 |

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Employee stock options excluded from the computation
of diluted per share amounts:

| | | | |
|---|----------|----------|----------|
| Shares for which exercise price exceeds average market price of common stock | 2,595 | 1,827 | 2,560 |
| Average exercise price per share that exceeds average market price of common stock | \$ 25.29 | \$ 27.08 | \$ 25.32 |
| | ===== | ===== | ===== |

=====

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 Form 10-K for the fiscal year ended December 31, 2001, as filed with the Securities and Exchange Commission on April 1, 2002. This report may be used for purposes of the Private Securities Litigation Reform Act of 1995 as a readily available document containing meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in any forward-looking statements the company may make from time to time. Those risks include:

- trends and developments affecting the collectibility of accounts receivable;
- the effectiveness of the company's operating systems and controls;
- healthcare reform and the effect of federal and state healthcare regulations;
- government legislative and budget developments which could affect reimbursement levels for products and services provided by Apria;
- the ongoing government investigations regarding patients covered by Medicare and other federal programs;
- pricing pressures from large payors; and
- the successful implementation of the company's acquisition strategy and integration of acquired businesses.

In addition, the terrorist attacks of September 11, 2001 and the military and security activities which followed, their impacts on the United States economy and government spending priorities, and the effects of any further such developments pose risks and uncertainties to all U.S.-based businesses, including Apria. Among other things, deficit spending by the government as the result of adverse developments in the economy and costs of the government's response to the terrorist attacks could lead to the increased pressure to reduce government expenditures for other purposes, including governmentally-funded programs such as Medicare.

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

Apria operates in the home healthcare segment of the healthcare industry and provides services in the home respiratory therapy, home infusion therapy and home medical equipment areas. In all three lines, Apria provides patients with a variety of clinical services and related products and supplies, most of which are prescribed by a physician as part of a care plan. Apria provides these services to patients in the home throughout the United States through approximately 405 branch locations.

CRITICAL ACCOUNTING POLICIES. Apria's management considers the accounting policies that govern revenue recognition and the determination of the net realizable value of accounts receivable to be the most critical in relation to the company's consolidated financial statements. These policies require

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management's most complex and subjective judgments. Other accounting policies requiring significant judgment are those related to goodwill and income taxes. These policies are presented in detail in Apria's 2001 Form 10-K - Management's Discussion and Analysis of Financial Condition and Results of Operations.

SEGMENT REPORTING. Apria's branch locations are organized into geographic regions. Each region consists of a number of branches and a regional office that provides key support services, such as billing, purchasing, patient service equipment maintenance, repair and warehousing. Management evaluates operating results on a geographic basis, and therefore views each region as an operating segment. All regions provide the same products and services, including respiratory therapy, infusion therapy and home medical equipment and supplies. For financial reporting purposes, all the company's operating segments are aggregated into one reportable segment in accordance with the aggregation criteria in paragraph 17 of Statement of Financial Accounting Standards ("SFAS") No. 131, "Disclosures about Segments of an Enterprise and Related Information."

RECENT ACCOUNTING PRONOUNCEMENTS. Effective January 1, 2002, Apria adopted SFAS No. 142, "Goodwill and Other Intangible Assets", in its entirety. SFAS No. 142 addresses the financial accounting and reporting for goodwill and other intangible assets. The statement provides that goodwill or other intangible assets with indefinite lives will no longer be amortized, but shall be tested for impairment annually, or more frequently if circumstances indicate potential impairment. Upon adoption, a transitional goodwill impairment test must be performed. The test is conducted at the "reporting unit" level and compares each reporting unit's fair value to its carrying value. Apria's management has determined that its geographic regions are reporting units under SFAS No. 142. Apria's transitional goodwill impairment test utilized a discounted cash flow approach in determining fair value, which was further tested by a multiple of earnings approach. The transitional test has been completed; no goodwill impairment is indicated at any of Apria's reporting units. See "Amortization of Goodwill and Intangible Assets."

Effective January 1, 2002 Apria adopted SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 requires that one accounting model be used for long-lived assets to be disposed of by sale. Discontinued operations will be measured similarly to other long-lived assets classified as held for sale at the lower of its carrying amount or fair value less cost to sell. Future operating losses will no longer be recognized before they occur. SFAS No. 144 also broadens the presentation of discontinued operations to include a component of an entity when operations and cash flows can be clearly distinguished, and establishes criteria to determine when a long-lived asset is held for sale. Adoption of this statement did not have a material effect on Apria's financial statements.

In April 2002, SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections" was issued. SFAS No. 145 updates and clarifies existing accounting pronouncements related to gains and losses from the extinguishment of debt and requires that certain lease modifications be accounted for in the same manner as sale-leaseback transactions. Apria will be required to adopt the provisions of SFAS No. 145 for its fiscal year beginning January 1, 2003. Adoption of this statement is not expected to have a material effect on the company's consolidated financial statements.

In July 2002, SFAS No. 146, "Accounting for Costs Associated With Exit or Disposal Activities" was issued. This statement addresses the financial accounting and reporting for costs associated with exit or disposal activities and requires that a liability for such costs be recognized when the liability is incurred rather than at the date of an entity's commitment to an exit plan. SFAS No. 146 also establishes that the liability should be measured and recorded at fair value. Apria will be required to adopt the provisions of SFAS No. 146 for

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exit and disposal activities that are initiated after December 31, 2002. Adoption of this statement is not expected to have a material effect on the company's consolidated financial statements.

RESULTS OF OPERATIONS

NET REVENUES. Net revenues were \$312.0 million and \$923.8 million in the third quarter and first nine months of 2002, respectively, compared to \$284.0 million and \$838.9 million for the corresponding periods in 2001. This represents increases of 9.9% and 10.1% for the three and nine month periods, respectively. The growth is due to volume increases, new contracts with regional and national payors, the acquisition of complementary businesses and price increases in certain managed care agreements.

Apria's acquisition strategy generally results in the rapid integration of acquired businesses into existing operating locations. This limits management's ability to separately track the amount of revenue generated by an acquired business. Estimating the revenue contribution from acquisitions therefore requires certain assumptions. Based on its analyses, Apria's management estimates that approximately one-third of the revenue growth between the nine month periods presented was derived from acquisitions.

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

| (DOLLARS IN THOUSANDS) | THREE MONTHS ENDED SEPTEMBER 30, | | | | NINE MONTHS ENDED | |
|--------------------------|----------------------------------|--------|-----------|--------|-------------------|--------|
| | 2002 | | 2001 | | 2002 | |
| | \$ | % | \$ | % | \$ | % |
| Respiratory therapy..... | \$205,319 | 65.8% | \$186,069 | 65.5% | \$613,814 | 66.4% |
| Infusion therapy..... | 58,785 | 18.8% | 54,570 | 19.2% | 170,204 | 18.5% |
| HME/other..... | 47,942 | 15.4% | 43,386 | 15.3% | 139,798 | 15.1% |
| Total net revenues | \$312,046 | 100.0% | \$284,025 | 100.0% | \$923,816 | 100.0% |
| | ===== | ===== | ===== | ===== | ===== | ===== |

Home 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. The respiratory therapy service line increased by 10.3% and 11.7% in the third quarter and first nine months of 2002, respectively, as compared to the same periods in 2001. Apria's focus on acquiring respiratory therapy businesses contributed to this growth.

Home Infusion Therapy. The infusion therapy service line involves the administration of a drug or nutrient directly into the body intravenously through a needle or catheter. Examples include: parenteral nutrition, anti-infectives, pain management, chemotherapy and other medications and related services. The infusion line also includes enteral nutrition, which is the administration of nutrients directly into the gastrointestinal tract through a feeding tube. Infusion therapy revenues increased by 7.7% and 5.2% in the third quarter and first nine months of 2002, respectively, when compared to the corresponding periods in 2001. The nine month 2002 period reflects the effect of a 12.8% increase in enteral nutrition attributable to a renewed focus on this product offering, that resulted from a program initiated in mid-2001 that centralized the enteral intake and distribution functions at the regional level.

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Home Medical Equipment/Other. Home medical equipment/other revenues are derived from the provision of patient safety items, ambulatory and patient room equipment. Home medical equipment/other revenues increased by 10.5% and 9.6% in the third quarter and first nine months of 2002, respectively, as compared to the same periods in 2001. The increase between periods is partially due to the fact that the full Medicare cost of living adjustment (COLA) for certain durable medical equipment products and services was restored in 2001. The COLA had been frozen since 1998 pursuant to the Balanced Budget Act of 1997. Substantially all of this adjustment was provided through a transitional allowance applied to amounts reimbursed during the second half of the year. The 2002 reimbursement amounts incorporate the 2001 adjustments as if they had been applied evenly throughout the year. Medicare reimbursement amounts for 2002 include only minimal increases which are significantly below the cost of living increase.

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

Approximately 33% of Apria's revenues are reimbursed under arrangements with Medicare and Medicaid. No other third-party payor represents 10% or more 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 less than 10% of total net revenues for all periods presented.

Medicare and Medicaid Reimbursement. The Balanced Budget Act of 1997 significantly reduced the Medicare reimbursement rates for home oxygen therapy and included other provisions that have impacted or may impact reimbursement rates in the future, such as potential reimbursement reductions under an inherent reasonableness procedure and competitive bidding. Also currently at issue is the potential adoption of an alternative pricing methodology for certain drugs and biologicals.

In June 2002, the U.S. House of Representatives passed the Medicare Modernization and Prescription Drug Act of 2002. The bill provides for a nationwide competitive bidding program for an as-yet-undetermined list of durable medical equipment ("DME") items covered by Medicare Part B. A Senate bill providing for a version of competitive bidding different than what was introduced in the House was proposed by Senators Baucus and Grassley but not introduced for Senate consideration prior to recess for the November 2002 elections. It is unclear whether competitive bidding for DME or other issues that may have an impact on Apria will be passed by the Senate in a "lame duck" session scheduled to convene November 22, 2002.

GROSS PROFIT. Gross margins for the third quarter of 2002 and the first nine months of 2002 were 73.0% and 72.8%, respectively, compared to 73.1% and 72.8% for the corresponding periods in the prior year. These margins reflect the general period-to-period consistency of product costs and reimbursement levels of products and services.

PROVISION FOR DOUBTFUL ACCOUNTS. The provision for doubtful accounts was 3.7% of net revenues for both the third quarter of 2002 and for the first nine months of 2002 compared to 3.5% for both corresponding periods in 2001. The provision for doubtful accounts results from management's estimate of the net realizable value of accounts receivable after considering actual write-offs of

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specific receivables. The increase in the provision between the years can be largely attributed to the impact of acquisitions; specifically two large fourth quarter acquisitions and those acquisitions effected to date in 2002. Such acquisitions result in the integration of a significant amount of patient information into Apria's information systems and document files which can delay the billing and collection process.

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, clinical, intake, reimbursement, warehousing and repair. Many of these operating costs are directly variable with revenue growth patterns. Certain expenses, such as facility lease and fuel costs, are also very sensitive to market-driven price fluctuations. The administrative expenses include overhead costs incurred by the operating locations and corporate support functions. These expenses do not vary as closely with revenue growth as do the operating costs. Selling, distribution and administrative expenses, expressed as percentages of net revenues, were 54.4% and 54.5% for the third quarter and first nine months of 2002, respectively, versus 55.9% and 55.5% for the corresponding periods in 2001. In 2002, the first quarter included \$2.6 million in contract termination costs related to the departure of the former Chief Executive Officer and the second quarter included approximately \$2.2 million in merit compensation increases. Despite these additional expenses, management was able to leverage its expense structure against the revenue growth.

AMORTIZATION OF GOODWILL AND INTANGIBLE ASSETS. Amortization of intangible assets for the third quarter and the nine months ended September 30, 2002 were \$667,000 and \$2.0 million, respectively, compared to \$3.2 million and \$9.2 million for the same periods last year (which included goodwill amortization). Upon adoption of SFAS No. 142 on January 1, 2002, goodwill amortization ceased. Amortization of goodwill was \$2.6 million for the third quarter and \$7.3 million for the first nine months of 2001. The effect of adding this amount back as though SFAS No. 142 were adopted at the beginning of the prior year would have resulted in net income increases of \$1.6 million and \$4.6 million and increases in diluted income per common share of \$0.03 and \$0.08 for the third quarter and first nine months of 2001, respectively. See "Recent Accounting Pronouncements", "Business Combinations" and Note C to the Condensed Consolidated Financial Statements.

INTEREST EXPENSE. Interest expense was \$3.5 million for the third quarter of 2002, down from \$5.1 million in the third quarter of 2001. For the nine months ended September 30, 2002 interest expense was \$11.6 million compared to \$21.5 million in the same period in 2001. The significant decrease between the periods is due to several factors. From September 30, 2001 to September 30, 2002, long-term debt decreased by \$34.1 million. The July 2001 refinancing replaced the 9 1/2% senior subordinated notes with debt at significantly more favorable interest rates and resulted in lower rates on the bank loans. In connection with the refinancing, deferred debt issuance costs on the 9 1/2% notes and former bank debt were written off; the issuance costs incurred upon refinancing resulted in a lower monthly amortization expense. Also, the June 2002 credit agreement amendment included a reduction in the applicable interest rate margin for the \$175 million term loan. Finally, the decreases in market-driven interest rates over the course of 2001 contributed to the overall decrease in Apria's interest expense. See "Long-Term Debt."

INCOME TAXES. Income taxes for the nine months ended September 30, 2002 and in the corresponding period of 2001, have been provided at the effective tax rates expected to be applicable for the respective year.

At December 31, 2001, Apria had federal net operating loss carryforwards of

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approximately \$98 million, expiring in varying amounts in the years 2003 through 2018 and various state net operating loss carryforwards that began to expire in 1997. Additionally, the company has an alternative minimum tax credit carryforward of approximately \$7.6 million. As a result of an ownership change in 1992 that met specified criteria of Section 382 of the Internal Revenue Code, future use of a portion of the federal and state operating loss carryforwards generated prior to 1992 are each limited to approximately \$5 million per year. Because of the annual limitation, approximately \$57 million of each of Apria's federal and state operating loss carryforwards may expire unused. The net operating loss carryforward amount in the related deferred tax asset excludes such amount. In 2002, for federal tax purposes, the company expects to utilize its entire net operating loss carryforward not subject to limitation.

LIQUIDITY AND CAPITAL RESOURCES

Apria's principal source of liquidity is its operating cash flow, which is supplemented by a \$100 million revolving credit facility. Apria's ability to generate operating cash flows in excess of its operating needs has afforded it the ability, among other things, to pursue its acquisition strategy and fund patient service equipment expenditures to support revenue growth. Apria's management believes that its operating cash flow and revolving credit line will continue to be sufficient to fund its operations and growth strategies. However, sustaining the current cash flow levels is dependent on many factors, some of which are not within Apria's control, such as government reimbursement levels and the financial health of its payors.

CASH FLOW. Cash provided by operating activities was \$188.9 million in the first nine months of 2002 compared with \$166.7 million in the corresponding period in 2001. The increase between periods in net income (before items not requiring cash) was partially offset by the increase in accounts receivable and increases in payments against accounts payable and other expense accruals.

Cash used in investing activities decreased to \$148.2 million for the first nine months of 2002 compared to \$149.3 million during the same period last year. The reduction in patient service and other equipment purchases between the periods was largely offset by the increase in acquisition activity.

Cash used in financing activities was \$37.3 million during the first nine months of 2002 compared to \$16.7 million during the same period last year. The difference is mainly due to the repurchase of the company's stock in 2002. The activity in 2002 and 2001 in the revolving credit facility and term loan line items reflects the June 2002 credit agreement amendment and the July 2001 refinancing, respectively. See "Long-term Debt" and "Treasury Stock."

CONTRACTUAL CASH OBLIGATIONS. The following table summarizes Apria's long term cash payment obligations to which the company is contractually bound (the years presented below represent twelve-month rolling periods ending September 30):

| (DOLLARS IN MILLIONS) | YEAR 1 | YEAR 2 | YEAR 3 | YEAR 4 | YEAR 5 |
|---------------------------------------|--------|--------|--------|--------|--------|
| Term loans..... | \$ 26 | \$ 26 | \$ 29 | \$ 32 | \$ |
| Capitalized lease obligations..... | 2 | 3 | 2 | - | - |
| Operating leases..... | 53 | 44 | 35 | 28 | - |
| Deferred acquisition payments..... | 8 | - | - | - | - |
| | ---- | ---- | ---- | ---- | ---- |
| Total contractual cash obligations... | \$89 | \$73 | \$66 | \$60 | \$ |
| | ==== | ==== | ==== | ==== | ==== |

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ACCOUNTS RECEIVABLE. Accounts receivable before allowance for doubtful accounts increased to \$210.4 million at September 30, 2002 from \$194.2 million at December 31, 2001, which is attributable to the revenue increases. 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 51 at September 30, 2002, and 50 at December 31, 2001. Accounts aged in excess of 180 days decreased to 19.4% at September 30, 2002 from 19.8% at December 31, 2001. See "Provision for Doubtful Accounts."

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

Unbilled Receivables. Included in accounts receivable are earned but unbilled receivables of \$27.2 million and \$26.9 million at September 30, 2002 and December 31, 2001, 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 net realizable value. The increase is partially due to acquisitions made in late 2001 and during 2002. The time-consuming processes of converting patient files onto Apria's systems and obtaining provider numbers from government payors routinely delay billing of the newly acquired business.

INVENTORIES AND PATIENT SERVICE EQUIPMENT. Inventories consist primarily of pharmaceuticals and disposable articles 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 and subsequently returned to Apria for reuse. Continued revenue growth is directly dependent on Apria's ability to fund its inventory and patient service equipment requirements.

LONG-TERM DEBT. Apria's credit agreement with Bank of America and a syndicate of lenders was amended and restated effective June 7, 2002. The amendment extended the maturity date, reduced the applicable interest rate margins and modified the repayment schedule for the company's \$175 million six-year term loan. The term loan, which was amended to mature in seven years, had a balance of \$173.3 million at September 30, 2002. It is now repayable in 20 remaining consecutive quarterly installments of \$437,500 each, followed by three consecutive quarterly installments of \$41.1 million each, and a final payment of \$41.1 million due on July 20, 2008.

Interest rates on outstanding balances under the credit agreement are determined by adding a margin to the Eurodollar or base rate existing at each interest calculation date. Applicable margins for the seven-year term loan were lowered to 2.0% for Eurodollar loans and 1.0% for base rate loans.

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On September 30, 2002, total borrowings under the credit agreement were \$279.0 million. Outstanding letters of credit totaled \$5.2 million and credit available under the revolving facility was \$92.1 million. At September 30, 2002, the company was in compliance with all of the financial covenants required by the credit agreement.

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.

Apria has two interest rate swap agreements with a total notional amount of \$100 million that fix its LIBOR-based variable rate debt at 2.58% (before the applicable margin). The swap agreements terminate March 2003. The swaps are being accounted for as cash flow hedges under SFAS No. 133. Accordingly, the difference between the interest received and interest paid is reflected as an adjustment to interest expense. For the first nine months of 2002, Apria paid a net settlement amount of \$478,000. At September 30, 2002, the swap agreements are reflected in the accompanying consolidated balance sheet in other accrued liabilities at their fair value of \$469,000. Unrealized losses on the fair value of the swap agreements are reflected, net of taxes, in other comprehensive loss.

Apria does not anticipate losses due to counterparty nonperformance, as its counterparty to the swap agreements is a nationally-recognized financial institution with a strong credit rating.

TREASURY STOCK. Apria's credit agreement limits common stock repurchases to \$35 million in any fiscal year and \$100 million in the aggregate. During the first nine months of 2002, Apria repurchased 1.5 million shares of its outstanding common stock for \$31.5 million. Subsequently, the company purchased additional shares for \$3.5 million thereby reaching its maximum for the year. All repurchased common shares are being held in treasury.

BUSINESS COMBINATIONS. Pursuant to one of its primary growth strategies, Apria periodically acquires complementary businesses in specific geographic markets. The results of operations of the acquired companies are included in the accompanying consolidated income statements from the dates of acquisition. Effective with the adoption of SFAS No. 142, goodwill is no longer being amortized. Covenants not to compete are being amortized over the life of the respective agreements.

The aggregate consideration for acquisitions that closed during the first nine months of 2002 was \$64.7 million. Allocation of this amount includes \$46.8 million to goodwill, \$3.2 million to intangible assets and \$12.5 million to patient service equipment. During the first nine months of 2001, the aggregate consideration for acquisitions was \$51.7 million. Cash paid for acquisitions, which includes amounts deferred from prior year acquisitions, totaled \$59.6 million and \$49.7 million in the first nine months of 2002 and 2001, respectively.

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

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FEDERAL INVESTIGATIONS. As previously reported, since mid-1998 Apria has been the subject of investigations conducted by several U.S. Attorneys' offices and the U.S. Department of Health and Human Services. These investigations concern the documentation supporting Apria's billing for services provided to patients whose healthcare costs are paid by Medicare and other federal programs. Apria is cooperating with the government in connection with these investigations and is responding to various document requests and subpoenas. A criminal investigation conducted by the U.S. Attorney's office in Sacramento was closed in mid-1999 with no charges being filed. Potential claims resulting from an investigation by the U.S. Attorney's office in San Diego were settled in mid-2001 in exchange for a payment by Apria of \$95,000.

Apria has been informed by the U.S. Attorney's office in Los Angeles that the investigation being conducted by that office is the result of civil qui tam litigation filed on behalf of the government against Apria. The complaints in the litigation are under seal, however, and the government has not informed Apria of either the identities of the plaintiffs, the court or courts where the proceedings are pending, the date or dates instituted or the factual bases alleged to underlie the proceedings. To date, the U.S. Attorney's office has not informed Apria of any decision to intervene in the qui tam actions; however, it could reach a decision with respect to intervention at any time.

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Apria has acknowledged that there may be errors and omissions in supporting documentation affecting a portion of its billings. However, it considers the assertions and amounts described in the preceding paragraph to be unsupported both legally and factually and believes that most of the alleged documentation errors and omissions should not give rise to any liability, for overpayment refunds or otherwise. Accordingly, Apria believes that the claims asserted are unwarranted and that it is in a position to assert numerous meritorious defenses. Nevertheless, Apria cannot provide any assurances as to the outcome of these proceedings. Management cannot estimate the possible loss or range of loss that may result from these proceedings and therefore has not recorded any related accruals.

If a judge, jury or administrative agency were to determine that false claims were submitted to federal healthcare programs or that there were significant overpayments by the government, Apria could face civil and administrative claims for refunds, sanctions and penalties for amounts that would be highly material to its business, results of operations and financial condition, including the exclusion of Apria from participation in federal healthcare programs.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

At September 30, 2002, Apria's term loan borrowings totaled \$276.3 million. The bank credit agreement governing the term loans provides interest rate options based on the following indices: Federal Funds Rate, Prime Rate or LIBOR.

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All such interest rate options are subject to the application of an interest margin as specified in the bank credit agreement. At September 30, 2002, all of Apria's outstanding term debt was tied to LIBOR. Apria has two interest rate swap agreements with a total notional amount of \$100 million that fix its LIBOR-based debt at 2.58% (before application of the interest margin). Both agreements expire March 2003.

Based on the term debt outstanding and the swap agreements in place at September 30, 2002, a 100 basis point change in LIBOR would increase or decrease Apria's annual cash flow and pretax earnings by approximately \$1.8 million.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of disclosure controls and procedures. Within the 90 days prior to the date of this report, the company carried out an evaluation, under the supervision and with the participation of the company's management, including the company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the company's disclosure controls and procedures. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the company's disclosure controls and procedures are effective in timely alerting them to material information relating to the company that is required to be included in the company's periodic Securities and Exchange Commission filings.

(b) Changes in internal controls. No significant changes to the company's internal controls, or in other factors that could significantly affect these controls subsequent to the date of their evaluation, have been made during the periods covered by this report.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Apria and certain of its present and former officers and/or directors were defendants in a class action lawsuit, In Re Apria Healthcare Group Securities Litigation, filed in the U.S. District Court for the Central District of California, Southern Division (Case No. SACV98-217 GLT). The complaint alleged, among other things, that the defendants made false and/or misleading public statements regarding Apria and its financial condition in violation of federal securities laws. Two similar class actions were filed during July 1998 in the Superior Court for the State of California for the County of Orange, which were consolidated by a court order dated October 22, 1998 (Master Case No. 797060). Following a series of settlement discussions, the parties reached an agreement to settle both the federal and state class actions for \$42 million. Under the terms of the settlement, Apria has paid \$1 million and its insurance carriers have paid \$41 million. Pursuant to the settlement: (1) the State Court class actions were concluded on August 20, 2002 by entry of an Order and Final Judgment; and (2) the District Court class action was dismissed on August 21, 2002 by entry of an Order dismissing the action with prejudice.

On August 27, 2001, a class action lawsuit was filed against Apria and its former Chief Executive Officer in the U.S. District Court for the Central District of California, Southern Division (Case No. SACV01-5160 PA), entitled J.E.B. Capital Partners, LP v. Apria Healthcare Group Inc. and Philip L. Carter. Among other things, the complaint alleged that the defendants made false and/or misleading public statements by not announcing until July 16, 2001 the amount of potential damages asserted by the U.S. Attorney's office in Los Angeles and counsel for the plaintiffs in the qui tam actions referred to below. The defendants' motion to dismiss the complaint was granted with leave to amend on

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June 14, 2002. Plaintiff elected not to amend its complaint, but filed a notice of appeal on July 15, 2002. The appeal was dismissed as premature. On October 10, 2002, the District Court entered a judgment in favor of the defendants and dismissed the action with prejudice. On November 8, 2002, the plaintiff filed an appeal of the Order of dismissal. Apria believes that it has meritorious defenses to the plaintiff's claims and it intends to vigorously defend itself. In the opinion of Apria's management, the ultimate disposition of this class action will not have a material adverse effect on Apria's results of operations or financial condition.

As previously reported, since mid-1998 Apria has been the subject of investigations conducted by several U.S. Attorneys' offices and the U.S. Department of Health and Human Services. These investigations concern the documentation supporting Apria's billing for services provided to patients whose healthcare costs are paid by Medicare and other federal programs. Apria is cooperating with the government in connection with these investigations and is responding to various document requests and subpoenas. A criminal investigation conducted by the U.S. Attorney's office in Sacramento was closed in mid-1999 with no charges being filed. Potential claims resulting from an investigation by the U.S. Attorney's office in San Diego were settled in mid-2001 in exchange for a payment by Apria of \$95,000.

Apria has been informed by the U.S. Attorney's office in Los Angeles that the investigation being conducted by that office is the result of civil qui tam litigation filed on behalf of the government against Apria. The complaints in the litigation are under seal, however, and the government has not informed Apria of either the identities of the plaintiffs, the court or courts where the proceedings are pending, the date or dates instituted or the factual bases alleged to underlie the proceedings. To date, the U.S. Attorney's office has not informed Apria of any decision to intervene in the qui tam actions; however, it could reach a decision with respect to intervention at any time.

On July 12, 2001, government representatives and counsel for the plaintiffs in the qui tam actions asserted that, by a process of extrapolation from a sample of 300 patient files to all of Apria's billings to the federal government during the three-and-one-half year sample period, Apria could be liable to the government under the False Claims Act for more than \$9 billion, consisting of extrapolated overpayment liability, plus treble damages and penalties of up to \$10,000 for each allegedly false claim derived from the extrapolation.

Apria has acknowledged that there may be errors and omissions in supporting documentation affecting a portion of its billings. However, it considers the assertions and amounts described in the preceding paragraph to be unsupported both legally and factually and believes that most of the alleged documentation errors and omissions should not give rise to any liability, for overpayment refunds or otherwise. Accordingly, Apria believes that the claims asserted are unwarranted and that it is in a position to assert numerous meritorious defenses. Nevertheless, Apria cannot provide any assurances as to the outcome of these proceedings. Management cannot estimate the possible loss or range of loss that may result from these proceedings and therefore has not recorded any related accruals.

If a judge, jury or administrative agency were to determine that false claims were submitted to federal healthcare programs or that there were significant overpayments by the government, Apria could face civil and administrative claims for refunds, sanctions and penalties for amounts that would be highly material to its business, results of operations and financial condition, including the exclusion of Apria from participation in federal healthcare programs.

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

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

ITEM 2. Not applicable

ITEM 3. Not applicable

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

(a) Annual Meeting of Stockholders of the company on July 18, 2002.

(b) Directors reelected at the Annual Meeting for a term of one year:

David H. Batchelder
David L. Goldsmith
Lawrence M. Higby
Richard H. Koppes
Philip R. Lochner, Jr.
Beverly Benedict Thomas
Ralph V. Whitworth

(c) Matters Voted Upon at Annual Meeting:

Election of Directors

As of July 18, 2002, the company's Board of Directors consisted of seven members who will serve for one year or until the election and qualification of their successors. The results of the stockholder voting were as follows:

| | FOR | WITHHOLD |
|-------------------------|------------|----------|
| | ----- | ----- |
| David H. Batchelder | 50,598,611 | 822,462 |
| David L. Goldsmith | 50,615,489 | 805,584 |
| Lawrence M. Higby | 51,058,494 | 362,579 |
| Richard H. Koppes | 51,056,490 | 364,583 |
| Philip R. Lochner, Jr. | 50,573,489 | 847,584 |
| Beverly Benedict Thomas | 51,058,494 | 362,579 |
| Ralph V. Whitworth | 51,056,612 | 364,461 |

ITEM 5. OTHER INFORMATION

Apria's bylaws were amended, effective September 3, 2002, to increase the number of directors from seven to eight. Vicente Anido, Jr. was elected to the open director position effective with the amendment of the bylaws. He will serve on the Board of Directors until the next annual meeting of stockholders or until his successor is elected and qualified.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

| Exhibit Number | Reference |
|-------------------|---|
| ----- | ----- |
| 3.1 | Amended and Restated Bylaws of registrant, as amended on September 3, 2002. |
| 10.1 | Amended and Restated Employment Agreement effective |

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February 12, 2002, between registrant and Lawrence M. Higby.

(b) Reports on Form 8-K:

No reports on Form 8-K were filed during the quarter for which this report is filed.

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

November 14, 2002

/s/ JAMES E. BAKER

James E. Baker
Chief Financial Officer
(Principal Financial and Accounting Officer)

CERTIFICATION - CHIEF EXECUTIVE OFFICER

I, Lawrence M. Higby, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Apria Healthcare Group Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this

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quarterly report (the "Evaluation Date"); and

- c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors:
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
 6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 14, 2002

/s/ LAWRENCE M. HIGBY

Lawrence M. Higby
Chief Executive Officer

CERTIFICATION - CHIEF FINANCIAL OFFICER

I, James E. Baker, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Apria Healthcare Group Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated

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subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

- b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors:
- a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 14, 2002

/s/ JAMES E. BAKER

James E. Baker
Chief Financial Officer