APRIA HEALTHCARE GROUP INC
Form 10-Q
August 10, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2011

or

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

For the transition period from to .

Commission file number 333-168159

APRIA HEALTHCARE GROUP INC.

(Exact name of Registrant as specified in its charter)

Delaware	**33-0488566**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
26220 Enterprise Court Lake Forest, CA	**92630**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (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 x

Note: As a voluntary filer not subject to the filing requirements of Section 13 or 15(d) of the Exchange Act, the registrant has filed all reports pursuant to Section 13 or 15(d) as if the registrant was subject to such filing requirements.

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer , accelerated filer , and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	x (Do not check if a smaller reporting company)	Smaller reporting company	¨

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

As of July 29, 2011, there were 100 shares of the issuer s common stock, par value $0.01 per share, issued and outstanding.

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FORM 10-Q

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This quarterly report on Form 10-Q includes forward-looking statements regarding, among other things, our plans, strategies and prospects, both business and financial. These statements are based on the beliefs and assumptions of our management. Although we believe that our plans, intentions and expectations reflected in or suggested by these forward-looking statements are reasonable, we cannot assure you that we will achieve or realize these plans, intentions or expectations. Forward-looking statements are inherently subject to risks, uncertainties and assumptions. Generally, statements that are not historical facts, including statements concerning our possible or assumed future actions, business strategies, events or results of operations, are forward-looking statements. These statements may be preceded by, followed by or include the words believes , expects , anticipates , intends , plans , estimates or similar expressions.

Forward-looking statements are not guarantees of performance. You should not put undue reliance on these statements. You should understand that various important factors, in addition to those discussed elsewhere in this quarterly report on Form 10-Q, could affect our future results and could cause those results or other outcomes to differ materially from those expressed or implied in our forward-looking statements:

- trends and developments affecting the collectability 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 our 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
- the items discussed under Risk Factors in this quarterly report on Form 10-Q.

All forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the foregoing cautionary statements. We undertake no obligations to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

As used in this report, unless otherwise noted or the context otherwise requires, references to Company, we, us, and our are to Apria Healthcare Group Inc., a Delaware corporation, and its subsidiaries; references to Apria and the Issuer are to Apria Healthcare Group Inc., exclusive of its subsidiaries; references to Merger Sub are to Sky Merger Sub Corporation, a Delaware corporation; references to Holdings are to Apria Holdings LLC, a Delaware limited liability company, exclusive of its subsidiaries; references to Sky Acquisition are to Sky Acquisition LLC , a Delaware limited liability company, exclusive of its subsidiaries; references to Blackstone and the Sponsor are to Blackstone Capital Partners V L.P.; references to the Investor Group are, collectively, to Blackstone and certain funds affiliated with Blackstone, Dr. Norman C. Payson and certain other members of our management; and references to home medical equipment, durable medical equipment and DME are used synonymously. On October 28, 2008, the Company was acquired by private investment funds affiliated with the Sponsor via a merger of the Merger Sub with and into Apria (the Merger), with Apria being the surviving corporation following the Merger. As a result of the Merger, the Investment Group beneficially owns all of Apria s issued and outstanding common stock. The Merger and the related financing and refinancing transactions, including, but not limited to, the equity investment by the Sponsor, the borrowings under the Company s senior secured bridge credit agreement dated October 28, 2008 (the senior secured bridge credit agreement) and the use of proceeds therefrom, the offerings of $700.0

million of the Company s 11.25% Senior Secured Notes due 2014 (Series A-1) (the Series A-1 Notes) and $317.5 million of the Company s 12.375% Senior Secured Notes due 2014 (Series A-2) (the Series A-2 Notes), the repayment of all outstanding borrowings under the Company s senior secured bridge credit agreement, and the payment of related fees and expenses, are collectively referred to in this Quarterly Report as the Transactions.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

APRIA HEALTHCARE GROUP INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	June 30, 2011	December 31, 2010
	(in thousands, except share data)	
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 27,144	$ 109,137
Accounts receivable, less allowance for doubtful accounts of $58,419 and $56,559 at June 30, 2011 and December 31, 2010, respectively	328,983	282,798
Inventories	55,400	73,894
Deferred income taxes	58,847	58,028
Deferred expenses	3,410	3,061
Prepaid expenses and other current assets	21,913	20,221
TOTAL CURRENT ASSETS	495,697	547,139
PATIENT SERVICE EQUIPMENT, less accumulated depreciation of $167,345 and $144,074 at June 30, 2011 and December 31, 2010, respectively	199,612	169,878
PROPERTY, EQUIPMENT AND IMPROVEMENTS, NET	87,130	83,893
GOODWILL	765,245	760,088
INTANGIBLE ASSETS, NET	577,106	578,957
DEFERRED DEBT ISSUANCE COSTS, NET	47,730	53,659
OTHER ASSETS	9,178	7,523
TOTAL ASSETS	$ 2,181,698	$ 2,201,137
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 107,683	$ 86,637
Accrued payroll and related taxes and benefits	57,643	59,073
Other accrued liabilities	92,286	90,447
Deferred revenue	29,748	26,504
Current portion of long-term debt	695	1,323
TOTAL CURRENT LIABILITIES	288,055	263,984
LONG-TERM DEBT, net of current portion	1,017,926	1,018,098
DEFERRED INCOME TAXES	207,658	222,743
INCOME TAXES PAYABLE AND OTHER NON-CURRENT LIABILITIES	32,625	31,000
TOTAL LIABILITIES	1,546,264	1,535,825
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY		
Common stock, $0.01 par value: 1,000 shares authorized; 100 shares issued at June 30, 2011 and December 31, 2010		
Additional paid-in capital	689,041	688,458
Accumulated deficit	(53,607)	(23,146)

TOTAL STOCKHOLDERS EQUITY	635,434	665,312
	$ 2,181,698	$ 2,201,137

See notes to unaudited condensed consolidated financial statements.

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APRIA HEALTHCARE GROUP INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
	(in thousands)			
Net revenues:				
Fee for service arrangements	$ 534,229	$ 477,699	$ 1,029,913	$ 947,535
Capitation	42,119	40,479	83,178	79,519
TOTAL NET REVENUES	576,348	518,178	1,113,091	1,027,054
Costs and expenses:				
Cost of net revenues:				
Product and supply costs	190,882	164,234	368,322	321,067
Patient service equipment depreciation	24,077	23,693	45,882	48,749
Home respiratory therapy services	6,130	8,022	12,103	16,215
Nursing services	10,596	8,912	20,527	18,000
Other	3,747	3,271	6,474	6,893
TOTAL COST OF NET REVENUES	235,432	208,132	453,308	410,924
Provision for doubtful accounts	16,578	12,933	36,842	28,820
Selling, distribution and administrative	303,070	258,843	599,698	516,581
Amortization of intangible assets	1,121	1,085	2,198	2,742
TOTAL COSTS AND EXPENSES	556,201	480,993	1,092,046	959,067
OPERATING INCOME	20,147	37,185	21,045	67,987
Interest expense	33,026	32,663	65,930	65,235
Interest income and other	(39)	(222)	(290)	(305)
(LOSS) INCOME BEFORE TAXES	(12,840)	4,744	(44,595)	3,057
Income tax (benefit) expense	(3,403)	1,378	(14,134)	494
NET (LOSS) INCOME	$ (9,437)	$ 3,366	$ (30,461)	$ 2,563

See notes to unaudited condensed consolidated financial statements.

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APRIA HEALTHCARE GROUP INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
	(in thousands)	
OPERATING ACTIVITIES		
Net (loss) income	$ (30,461)	$ 2,563
Items included in net (loss) income not requiring cash:		
Provision for doubtful accounts	36,842	28,820
Depreciation	63,625	62,439
Amortization of intangible assets	2,198	2,742
Amortization of deferred debt issuance costs	5,928	5,198
Deferred income taxes	(15,903)	2,470
Profit interest compensation	1,583	2,203
Loss on disposition of assets and other	8,202	9,099
Changes in operating assets and liabilities, exclusive of effects of acquisitions:		
Accounts receivable	(83,027)	(76,257)
Inventories	8,324	7,855
Prepaid expenses and other assets	(3,134)	(3,672)
Accounts payable, exclusive of book-cash overdraft	19,692	(7,226)
Accrued payroll and related taxes and benefits	(1,621)	1,649
Income taxes payable	396	(768)
Deferred revenue, net of related expenses	2,895	462
Accrued expenses	3,067	(2,859)
NET CASH PROVIDED BY OPERATING ACTIVITIES	18,606	34,718
INVESTING ACTIVITIES		
Purchases of patient service equipment and property, equipment and improvements, exclusive of effects of acquisitions	(76,415)	(55,783)
Purchases of short-term investments		(8,087)
Maturities of short-term investments		25,685
Proceeds from disposition of assets	153	101
Cash paid for acquisitions	(22,538)	(1,960)
NET CASH USED IN INVESTING ACTIVITIES	(98,800)	(40,044)
FINANCING ACTIVITIES		
Payments on other long-term debt	(799)	(867)
Change in book-cash overdraft included in accounts payable		(32,533)
Debt issuance costs		(2,887)
Cash paid on profit interest units	(1,000)	(78)
NET CASH USED IN FINANCING ACTIVITIES	(1,799)	(36,365)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(81,993)	(41,691)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	109,137	158,163
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 27,144	$ 116,472

SUPPLEMENTAL DISCLOSURES See Note 5 and Note 8 for a discussion of cash paid for interest and income taxes, respectively.

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 when paid. Unpaid purchases were $10.5 million and $7.6 million at June 30, 2011 and December 31, 2010, respectively.

See notes to unaudited condensed consolidated financial statements.

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APRIA HEALTHCARE GROUP INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. These 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.

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 notes thereto for the fiscal year ended December 31, 2010.

On October 28, 2008, the Company completed a merger (the Merger) with Sky Merger Sub Corporation (Merger Sub), a Delaware corporation and wholly-owned subsidiary of Sky Acquisition LLC, a Delaware limited liability company (Buyer or Sky LLC). Buyer is controlled by private investment funds affiliated with The Blackstone Group (Sponsor).

Company Background: Apria operates in the home healthcare segment of the healthcare industry, providing a variety of high-quality clinical patient care management programs, related products and supplies as prescribed by a physician and/or authorized by a case manager as part of a care plan. Essentially all products and services offered by the Company are provided through the Company s network of approximately 550 locations, which are located throughout the United States. We provide services and products in two operating segments and within these two operating segments there are three core service lines: home respiratory therapy, home medical equipment and home infusion therapy. Both segments provide products and services in the home setting to patients and are primarily paid for by a third-party payor, such as Medicare, Medicaid, managed care or other third-party insurer. Sales for both segments are primarily derived from referral sources such as hospital discharge planners, medical groups or independent physicians.

Use of Accounting Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Among the significant estimates affecting the consolidated financial statements are those related to revenue recognition and the resulting accounts receivable, share-based compensation, income taxes, goodwill and long-lived assets.

Revenue Recognition and Concentration of Credit Risk: Revenues are recognized under fee for service/product arrangements for equipment the Company rents to patients, sales of equipment, supplies, pharmaceuticals and other items the Company sells to patients and under capitation arrangements with third party payors for services and equipment the Company provides to the patients of these payors. Revenue generated from equipment that the Company rents to patients is recognized over the rental period, typically one month, and commences on delivery of the equipment to the patients. Revenue related to sales of equipment, supplies and pharmaceuticals is recognized on the date of delivery to the patients. Revenues derived from capitation arrangements were approximately 7% of total net revenues for the three and six months ended June 30, 2011 and 8% of total net revenues for the three and six months ended June 30, 2010. Capitation revenue is earned as a result of entering into a contract with a third party to provide its members certain services without regard to the actual services provided, therefore revenue is recognized in the period that the beneficiaries are entitled to health care services. All revenues are recorded at amounts estimated to be received under reimbursement arrangements with third-party payors, including private insurers, prepaid health plans, Medicare and Medicaid. Revenues reimbursed under arrangements with Medicare and Medicaid were approximately 30% and 29% of total net revenues for the three and six months ended June 30, 2011 and June 30, 2010, respectively. In the six months ended June 30, 2011 and June 30, 2010, no other third-party payor group represented more than 8% of the Company s revenues.

Rental and sale revenues in the fee for service/product arrangement revenue line item were:

	Three Months Ended June 30,				**Six Months Ended June 30,**			
(dollars in millions)	**2011**		**2010**		**2011**		**2010**	
Rental	$ 163.6	30.6%	$ 154.2	32.3%	$ 316.4	30.7%	$ 312.4	33.0%
Sale	370.6	69.4	323.5	67.7	713.5	69.3	635.1	67.0

Total fee for service	$ 534.2	100.0%	$ 477.7	100.0%	$ 1,029.9	100.0%	$ 947.5	100.0%

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

In the Company s business, there are multiple services and products delivered to patients. These arrangements involve equipment that is rented and related supplies that may be sold that cannot be returned. In arrangements with multiple deliverables, revenue is recognized when each deliverable is provided to the patient. For example, revenues from equipment rental supplies sales are recognized upon of delivery of the products, as the supplies sold are considered a separate unit of accounting.

Cash and Cash Equivalents: Cash is maintained with various financial institutions. These financial institutions are located throughout the United States and the Company s cash management practices limit exposure to any one institution. Management considers all highly liquid instruments purchased with a maturity of less than three months to be cash equivalents.

Accounts Receivable: Included in accounts receivable are earned but unbilled receivables of $77.9 million and $55.2 million at June 30, 2011 and December 31, 2010, 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. Unbilled receivables can also be impacted by the transition of patients during the integration of acquisitions and overall revenue growth. Earned but unbilled receivables are aged from date of service and are considered in the analysis of historical performance and collectability.

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

Management performs periodic analyses to evaluate accounts receivable balances to ensure that recorded amounts reflect estimated net realizable value. Specifically, management considers historical realization data, accounts receivable aging trends, other operating trends, 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. Additionally, focused reviews of certain large and/or problematic payors are performed. Due to continuing changes in the healthcare industry and third-party reimbursement, it is possible that management s 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.

Deferred Revenue and Deferred Expense: A lessor is required to recognize rental income over the lease term. Rental of patient equipment is billed on a monthly basis beginning on the date the equipment is delivered. Since deliveries can occur on any day during a month, the amount of billings that apply to the next month are deferred. Only the direct costs associated with the initial rental period are deferred.

Inventories: Inventories are stated at the lower of cost (first-in, first-out method) or market and consist primarily of pharmaceuticals and items used in conjunction with patient service equipment. Inventories are reduced by a reserve for slow moving or obsolete inventory.

Patient Service Equipment: Patient service equipment is stated at cost and consists of medical equipment rented to patients on a month-to-month basis. Depreciation is provided using the straight-line method over the estimated useful lives of the equipment, which range from one to ten years.

Property, Equipment and Improvements: Property, equipment and improvements are stated at cost. Depreciation is provided using the straight-line method over the estimated useful lives of the assets.

Capitalized Software: Included in property, equipment and improvements are costs related to internally developed and purchased software that are capitalized and amortized over periods that the assets are expected to provide benefit. Capitalized costs include direct costs of materials and services incurred in developing or obtaining internal-use software and payroll and benefit costs for employees directly involved in the development of internal-use software. Additions to capitalized internally developed software totaled $2.2 million and $3.2 million for the three months ended June 30, 2011 and 2010, respectively, and $4.5 million and $6.1 million for the six months ended June 30, 2011 and 2010, respectively.

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APRIA HEALTHCARE GROUP INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

Goodwill and long-lived assets: Goodwill is recorded as the difference, if any, between the aggregate consideration paid for an acquisition and the fair value of the net tangible and intangible assets acquired. The amounts and useful lives assigned to intangible assets acquired, other than goodwill, impact the amount and timing of future amortization.

Goodwill and indefinite-lived intangible assets are not amortized but instead tested at least annually for impairment, or more frequently when events or changes in circumstances indicate that the assets might be impaired. Goodwill is tested for impairment by comparing the carrying value to the fair value of the reporting unit to which the goodwill is assigned. A two-step test is used to identify the potential impairment and to measure the amount of impairment, if any. The first step is to compare the fair value of the reporting unit with its carrying amount, including goodwill. If the fair value of the reporting unit exceeds its carrying amount, goodwill is considered not impaired; otherwise, goodwill is impaired and the loss is measured by performing step two. Under step two, the impairment loss is measured by comparing the implied fair value of the reporting unit with the carrying amount of goodwill. Management has determined that our two operating segments are reporting units. As such, the Company has two reporting units: home respiratory therapy/home medical equipment and home infusion therapy. The Company performs the annual test for impairment as of the first day of its fourth quarter and determines fair value based on a combination of the income approach and the market approach. The income approach is based on discounted cash flows. The market approach uses a selection of comparable companies in determining market value. During the annual goodwill impairment test in 2010, the Company completed step one and determined that there was no impairment of goodwill since the fair value of the reporting units substantially exceeded the carrying value; therefore, we are not at risk of failing step one based upon our current assumptions. Our annual indefinite-lived intangible assets impairment test in 2010 also resulted in no impairment as the fair value of the assets exceeded the carrying value. The goodwill amounts for the March 4, 2011 acquisition of Praxair assets (see Note 3 Business Combinations for details of the Praxair acquisition), are based upon preliminary estimates that are subject to change in 2011 upon completion of the final valuation analysis. Final determination of these estimates could result in an adjustment to the purchase price allocation with an offsetting adjustment to goodwill.

Long-lived assets, including property and equipment and purchased intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable. Significant judgment is required in determining whether a potential indicator of impairment of long-lived assets exists and in estimating future cash flows for any necessary impairment tests. Recoverability of assets to be held and used is measured by the comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such an asset is considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

Purchased intangible assets consist primarily of trade names, patient backlog, capitated relationships and payor relationships resulting from the Merger. Purchased intangible assets that have definite lives are amortized over the estimated useful lives of the related assets, generally ranging from one to twenty years. The intangible assets resulting from the March 4, 2011 acquisition of Praxair assets are based upon preliminary estimates that are subject to change in 2011 upon completion of the final valuation analysis.

Deferred Debt Issuance Costs: Capitalized debt issuance costs include those associated with the Company s Series A-1 Notes, Series A-2 Notes and Asset Based Revolving Credit Facility (ABL Facility). Such costs are classified as non-current assets. Costs relating to the ABL Facility are being amortized through the maturity date of October 2013. Costs relating to the Series A-1 Notes and Series A-2 Notes are amortized from the issuance date through October 2014. See Note 5 Long-term Debt.

Fair Value of Financial Instruments: The carrying value of debt approximates fair value because the underlying instruments are variable notes that reprice frequently. The fair values of cash and cash equivalents, short-term investments and the Series A-1 Notes and Series A-2 Notes are determined based upon Level 1 inputs, consisting of quoted prices in active markets for identical items. The fair value of the Series A-1 Notes and Series A-2 Notes was $721.0 million and $328.6 million at June 30, 2011, respectively. The carrying amounts of cash and cash equivalents, accounts receivable, trade payables and accrued expenses approximate fair value due to their short maturity.

Product and Supply Costs: Product and supply costs presented within cost of total net revenues are comprised primarily of the cost of supplies and equipment provided to patients, infusion drug costs and enteral product costs.

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APRIA HEALTHCARE GROUP INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

Home Respiratory Therapy Expenses: Home respiratory therapy expenses presented within cost of total net revenues are comprised primarily of employee salary and benefit costs or contract fees paid to respiratory therapists and other related professionals who are deployed to service a patient. Home respiratory therapy personnel are also engaged in a number of administrative and marketing tasks, and accordingly, these costs are classified within selling, distribution and administrative expenses and amounted to $11.0 million and $6.7 million in the three months ended June 30, 2011 and June 30, 2010, respectively, and $21.4 million and $13.1 million in the six months ended June 30, 2011 and June 30, 2010, respectively.

Distribution Expenses: Distribution expenses are included in selling, distribution and administrative expenses and totaled $48.5 million and $39.9 million in the three months ended June 30, 2011 and June 30, 2010, respectively, and $94.1 million and $78.9 million in the six months ended June 30, 2011 and June 30, 2010, respectively. Such expense represents the cost incurred to coordinate and deliver products and services to the patients. Included in distribution expenses are leasing, maintenance, licensing and fuel costs for the vehicle fleet; salaries and other costs related to drivers and dispatch personnel; and amounts paid to courier and other outside shipping vendors. Such expenses fall within the definition of shipping and handling costs and are classified within selling and administrative expenses and may not be comparable to other companies.

Self-Insurance: Coverage for certain employee medical claims and benefits, as well as workers compensation, professional and general liability, and vehicle liability are self-insured. Amounts accrued for costs of workers compensation, medical, professional and general liability, and vehicle are classified in other accrued liabilities as follows:

(in thousands)	**June 30, 2011**	**December 31, 2010**
Workers compensation	$ 22,884	$ 21,694
Professional and general liability/vehicle	11,067	10,552
Medical insurance	6,768	6,477
Total	$ 40,719	$ 38,723

Income Taxes: The Company s provision for income taxes is based on expected income, permanent book/tax differences and statutory tax rates in the various jurisdictions in which the Company operates. Significant management estimates and judgments are required in determining the provision for income taxes.

Deferred income tax assets and liabilities are computed for differences between the carrying amounts of assets and liabilities for financial statement and tax purposes. Deferred income tax assets are required to be reduced by a valuation allowance when it is determined that it is more likely than not that all or a portion of a deferred tax assets will not be realized.

Profit Interest Units: We measure and recognize compensation expense for all profit interest unit awards made to employees based on estimated fair values on the date of grant. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service period in our consolidated financial statements. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Profit interest unit expense is recognized on a straight-line basis over the requisite service period. The estimate of fair value of profit interest unit awards on the date of grant is determined through the allocation of all outstanding securities to a business enterprise valuation. The enterprise valuation is based upon a combination of the income approach and the market approach. The income approach is based on discounted cash flows. The market approach uses a selection of comparable companies in determining value. This determination of fair value is affected by assumptions regarding a number of highly complex and subjective variables. Changes in the subjective assumptions can materially affect the estimate of their fair value.

Recent Accounting Pronouncements: In June 2011, the Emerging Issues Task Force (EITF) issued EITF 09-H, *Health Care Entities: Presentation of the Provision for Bad Debts and Disclosures of Net Revenues and the Allowance for Doubtful Accounts* (EITF 09-H). EITF 09-H requires certain entities to present bad debt as an offset to revenue in the statement of operations. This issue will be effective for fiscal years beginning after December 15, 2011 and interim periods within those fiscal years. We are currently evaluating the impact of EITF 09-H on our financial position, results of operations, cash flows and disclosures.

NOTE 2 RECENT DEVELOPMENTS

Amended and Restated ABL Facility: On August 8, 2011, we entered into a senior secured asset-based revolving credit facility, or ABL Facility, with Bank of America, N.A., as administrative agent and collateral agent and a syndicate of financial institutions and institutional lenders. Merrill Lynch, Pierce, Fenner & Smith Incorporated and Barclays Capital, the investment banking division of Barclays Bank PLC joint bookrunners. The ABL Facility amended and restated our prior senior secured asset-based revolving credit facility dated October 28, 2008, which provided for a revolving credit financing of up to $150.0 million.

The ABL Facility provides for revolving credit financing of up to $250.0 million, subject to borrowing base availability, with a maturity of the earlier of (a) five years and (b) 90 days prior to the earliest maturity of our outstanding Series A-1 Notes and Series A-2 Notes, and includes both a letter of credit and swingline loan sub-facility. The borrowing base at any time is equal to the sum (subject to certain reserves and other adjustments) of (i) 85% of eligible receivables, (ii) the least of (a) 85% of eligible self-pay accounts, (b) 10% of the borrowing base, (c) $25,000,000 and (d) the aggregate amount of self-pay accounts collected within the previous 90 days, (iii) the lesser of (a) 85% of eligible accounts invoiced but unpaid for more than 180 days but less than 360 days and (b) 10% of eligible accounts invoiced but unpaid for 180 days or less and (iv) the lesser of (a) 85% of the net orderly liquidation value of eligible inventory and (b) $35.0 million.

Borrowings under our ABL Facility bear interest at a rate per annum equal to, at our option, either (a) a base rate determined by reference to the higher of (1) the prime rate of Bank of America, N.A. and (2) the federal funds effective rate plus 1/2 of 1% (Base Rate), plus an applicable margin (currently 1.25%) or (b) a LIBOR rate determined by reference to LIBOR, adjusted for statutory reserve requirements, plus an applicable margin (currently 2.25%). The applicable margin for borrowings under our ABL Facility is subject to (a) 25 basis points step ups and step downs based on average excess availability under the ABL Facility and (b) a step down of 25 basis points based on achieving a consolidated fixed charge coverage ratio greater than 1.75 to 1.00. In addition to paying interest on outstanding amounts under our ABL Facility, we are required to pay a commitment fee, in respect of the unutilized commitments thereunder, ranging from 0.375% to 0.50% per annum, which fee will be determined based on utilization of our ABL Facility (increasing when utilization is low and decreasing when utilization is high). We also pay customary letter of credit fees equal to the applicable margin on LIBOR loans and other customary letter of credit and agency fees.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

From time to time, we issue letters of credit in connection with our business, including commercial contracts, leases, insurance and workers compensation arrangements. If the holders of our letters of credit draw funds under such letters of credit, it would increase our outstanding senior secured indebtedness.

As of June 30, 2011, there were no outstanding borrowings under the ABL Facility, outstanding letters of credit totaled $21.1 million and additional availability under the ABL Facility, subject to the borrowing base, was $128.9 million. As of June 30, 2011, the available borrowing base did not constrain our ability to borrow the entire $128.9 available borrowing capacity under our ABL Facility. At June 30, 2011, we were in compliance with all of the financial covenants required by the credit agreement governing the ABL Facility.

As of August 8, 2011, there were no outstanding borrowings under the ABL Facility, outstanding letters of credit totaled $21.1 million and additional availability under the ABL Facility, subject to the borrowing base, was $228.9 million. As of August 8, 2011, the available borrowing base did not constrain our ability to borrow the entire remaining available borrowing capacity under our ABL Facility.

Realignment of Management. On July 11, 2011, the Company announced the realignment of management responsibility for certain functions, including those related to revenue management and information technology. In connection with these changes, James G. Gallas, who has served as the Company s Executive Vice President and Chief Administrative Officer, will cease to oversee revenue management, information technology and certain related functions. Management of those functions will be assumed by other members of the Company s senior management team, and Mr. Gallas will assume a special projects role during a transitional period, which is presently expected to conclude on or prior to February 28, 2012. At the conclusion of this transitional period, Mr. Gallas employment is expected to terminate in accordance with the terms of his Amended and Restated Executive Severance Agreement dated as of March 10, 2009.

NOTE 3 BUSINESS COMBINATIONS

The Company periodically acquires complementary businesses in specific geographic markets. The results of operations of the acquired companies are included in the accompanying condensed consolidated statements of operations from the dates of acquisition. On March 4, 2011, the Company completed its previously announced asset acquisition of Praxair, Inc. s (NYSE: PX) and Praxair Healthcare Services, Inc. s (collectively, Praxair) United States homecare business. The Company expects this business to contribute approximately $85 to $95 million to its revenue in 2011. This estimate and the acquired business s contribution in future periods will be subject to decreases as a result of the impact of Medicare competitive bidding and other factors.

During the six months ended June 30, 2011 and 2010, the Company purchased certain assets and businesses for total consideration of $22.4 million and $2.3 million, respectively. The 2011 total is comprised primarily of the asset acquisition of Praxair, Inc. s U.S. homecare business.

NOTE 4 GOODWILL AND INTANGIBLE ASSETS

Changes in goodwill by segment are as follows:

(in thousands)	Home Infusion Therapy	Home Respiratory Therapy and Home Medical Equipment	Total
Balance, December 31, 2010	$ 257,823	$ 502,265	$ 760,088
Acquisition	547	4,610	5,157
Balance, June 30, 2011	$ 258,370	$ 506,875	$ 765,245

Intangible assets consist of the following:

(dollars in thousands)	Average Life in Years	June 30, 2011 Gross Carrying Amount	June 30, 2011 Accumulated Amortization	June 30, 2011 Net Book Value	December 31, 2010 Gross Carrying Amount	December 31, 2010 Accumulated Amortization	December 31, 2010 Net Book Value
Intangible assets subject to amortization:							
Capitated relationships	20.0	$ 40,000	$ (5,333)	$ 34,667	$ 40,000	$ (4,333)	$ 35,667
Payor relationships	20.0	11,000	(1,467)	9,533	11,000	(1,192)	9,808
Net favorable leasehold interest	3.5	3,210	(2,446)	764	3,553	(2,325)	1,228
Customer list	1.2	248	(106)	142	710	(456)	254
Subtotal		54,458	(9,352)	45,106	55,263	(8,306)	46,957
Intangible assets not subject to amortization:							
Trade names		525,000		525,000	525,000		525,000
Accreditations with commissions		7,000		7,000	7,000		7,000
Subtotal		532,000		532,000	532,000		532,000
Total		$ 586,458	$ (9,352)	$ 577,106	$ 587,263	$ (8,306)	$ 578,957

For the six months ended June 30, 2011, the net increase in the carrying amount of goodwill of $5.2 million is the result of the acquisition of Praxair assets on March 4, 2011. Most of the goodwill recorded in conjunction with business combinations for the periods presented is expected to be deductible for tax purposes. Goodwill and intangible assets from our Praxair acquisition are based upon preliminary estimates that are subject to change in 2011 upon completion of the final valuation analysis.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amortization expense amounted to $2.2 million and $2.7 million for the six months ended June 30, 2011 and 2010, respectively. Estimated amortization expense for each of the fiscal years ending December 31 is presented below:

Year Ending December 31,	(in thousands)
2011	$ 4,038
2012	2,891
2013	2,550
2014	2,550
2015	2,550

NOTE 5 LONG-TERM DEBT

Series A-1 Notes and Series A-2 Notes. Series A-1 Notes and Series A-2 Notes were issued by the Company in May 2009 and August 2009, respectively. The Series A-1 Notes and the Series A-2 Notes bear interest at a rate equal to 11.25% per annum and 12.375% per annum, respectively. The indenture governing the Series A-1 Notes and the Series A-2 Notes, among other restrictions, limits the Company s ability and the ability of its restricted subsidiaries to:

- incur additional debt;
- pay dividends and make other distributions;
- make certain investments;
- repurchase our stock;
- incur certain liens;
- enter into transactions with affiliates;
- merge or consolidate;
- enter into agreements that restrict the ability of our subsidiaries to make dividends or other payments to us; and
- transfer or sell assets.

Subject to certain exceptions, the indenture governing the Series A-1 Notes and the Series A-2 Notes permits Apria and its restricted subsidiaries to incur additional indebtedness, including senior indebtedness and secured indebtedness. The Series A-1 Notes are entitled to a priority of payment over the Series A-2 Notes in certain circumstances, including upon any acceleration of the obligations under the Series A-1 Notes, the Series A-2 Notes or any bankruptcy or insolvency event or default with respect to Apria or any guarantor of the Series A-1 Notes and the Series A-2 Notes.

The Series A-1 Notes and Series A-2 Notes will mature on November 1, 2014. On and after November 1, 2011, we may redeem the Series A-1 Notes and Series A-2 Notes, in whole or in part, at the redemption prices described below:

Series A-1 Notes

	Percentage
November 1, 2011	105.625%
November 1, 2012	102.813%
November 1, 2013 and thereafter	100.000%

Series A-2 Notes

	Percentage
November 1, 2011	106.188%
November 1, 2012	103.094%
November 1, 2013 and thereafter	100.000%

ABL Facility: In connection with the Merger on October 28, 2008, the Company entered into the ABL Facility with Banc of America Securities LLC and Wachovia Capital Markets, LLC, as joint lead arrangers, Banc of America Securities LLC, Wachovia Capital Markets, LLC and Barclays Capital, the investment banking division of Barclays Bank PLC, as joint bookrunners and Bank of America, N.A., as administrative agent and collateral agent, and a syndicate of financial institutions and institutional lenders.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

The ABL Facility provides for revolving credit financing of up to $150.0 million, subject to borrowing base availability, with a maturity of five years, including both a letter of credit and swingline loan sub-facility. The borrowing base at any time is equal to the sum (subject to certain reserves and other adjustments) of 85% of eligible receivables and the lesser of (a) 85% of the net orderly liquidation value of eligible inventory and (b) $20.0 million.

Borrowings under our ABL Facility bear interest at a rate per annum equal to, at our option, either (a) a base rate determined by reference to the higher of (1) the prime rate of Bank of America, N.A. and (2) the federal funds effective rate plus 1/2 of 1% (Base Rate), plus an applicable margin (currently 2.0%) or (b) a LIBOR rate determined by reference to LIBOR, adjusted for statutory reserve requirements, plus an applicable margin (currently 3.0%). The applicable margin for borrowings under our ABL Facility is subject to step ups and step downs based on average excess availability under the ABL Facility. In addition to paying interest on outstanding amounts under our ABL Facility, we are required to pay a commitment fee, in respect of the unutilized commitments thereunder, ranging from 0.50% to 1.00% per annum, which fee will be determined based on utilization of our ABL Facility (increasing when utilization is low and decreasing when utilization is high). We also pay customary letter of credit fees equal to the applicable margin on LIBOR loans and other customary letter of credit and agency fees.

From time to time, we issue letters of credit in connection with our business, including commercial contracts, leases, insurance and workers compensation arrangements. If the holders of our letters of credit draw funds under such letters of credit, it would increase our outstanding senior secured indebtedness.

As of June 30, 2011 there were no borrowings under the ABL Facility, outstanding letters of credit totaled $21.1 million and additional availability under the ABL Facility subject to the borrowing base was $128.9 million. As of June 30, 2011, the available borrowing base did not constrain our ability to borrow the entire $128.9 million of available borrowing capacity under our ABL Facility. At June 30, 2011, we were in compliance with all of the financial covenants required by the credit agreement governing the ABL Facility.

In August 2011, we amended and restated the ABL Facility. See Note 2 Recent Developments.

Interest paid on debt totaled $59.5 million for each of the three months ended June 30, 2011 and 2010, and $60.0 million for each of the six months ended June 30, 2011 and 2010. Interest expense for the three months ended June 30, 2011 and 2010 was $33.0 million and $32.7 million, respectively, and $65.9 million and $65.2 million for the six months ended June 30, 2011 and 2010, respectively.

NOTE 6 STOCKHOLDERS EQUITY

For the six months ended June 30, 2011, changes to stockholders equity were comprised of the following amounts (in thousands):

Net loss	$ (30,461)
Cash paid on profit interest units	(1,000)
Profit interest compensation	1,583
	$ (29,878)

NOTE 7 PROFIT INTEREST UNITS

In November and December of 2008, BP Healthcare Holdings LLC (BP Holdings) and Sky LLC, parent entities of the Company affiliated with the Sponsor, granted equity units to the Company s Chief Executive Officer and the Company s Chief Financial Officer for purposes of retaining them and enabling such individuals to participate in the long-term growth and financial success of the Company. In addition, in 2009 and 2010, Sky LLC (and following our reorganization in March 2010, Apria Holdings LLC) granted equity units to certain management employees for purposes of retaining them and enabling such individuals to participate in the long-term growth and financial success of the Company. Profit interest units are measured at the grant date, based on the calculated fair value of the award, and are recognized as an expense over the employee s requisite service period. These equity awards were issued in exchange for services to be performed.

BP Holdings granted the Company s Chief Executive Officer 38,697,318 Class B units, all of which are subject to vesting terms based on either (i) continued service to BP Holdings or its subsidiaries and/or (ii) performance/market conditions.

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Time-Vesting Units. The portion of the Class B units that vest based on continued service represent 80% of the total Class B units. These units vest over four years starting on October 28, 2008 based on continued service, but will become fully vested on an accelerated basis either (x) upon a change in control while the Company s Chief Executive Officer continues to provide services to BP Holdings or its subsidiaries or (y) if affiliates of the Sponsor receive cash proceeds in respect to 50% of their units in BP Holdings equal to at least 200% of their aggregate capital contributions in respect of such units while the Company s Chief Executive Officer continues to provide services to BP Holdings or its subsidiaries. In addition, if the Company s Chief Executive Officer s services are terminated (a) by the Company without cause or (b) by the Chief Executive Officer as a result of constructive termination, an additional number of these time-vesting Class B units will vest equal to the number that would have vested over the 24-month period following the applicable termination date. Any of these time-vested Class B units that are unvested on termination of the executive s services will be forfeited.

Performance-Vesting Units. The remaining portion of the Class B units that vest based on performance/market conditions represent 20% of the total Class B units. One-half of these units will vest if affiliates of the Sponsor receive cash proceeds equal to at least 200% of their aggregate capital contributions in respect of all of their units in BP Holdings, with the other half eligible to vest if they receive cash proceeds equal to at least 300% of their aggregate capital contributions in respect of all of their units in BP Holdings. Any of these performance-vesting units that are unvested upon a termination of the Company s Chief Executive Officer s services (x) by the Company without cause, (y) by the executive as a result of constructive termination or (z) by the executive for any reason on or following October 28, 2012, will remain outstanding until the second anniversary of the applicable termination date (unless they vest prior to that date). If the units do not vest by such anniversary, then any unvested performance-vesting units shall be immediately forfeited.

Assumptions used were as follows:

Expected Asset Volatility (1)	23.0%
Risk Free Interest Rate (2)	2.24%
Expected Life (3)	5.0 years

(1) The expected asset volatility is derived from the asset volatilities of comparable publicly traded companies.
(2) The risk free interest rate is interpolated from the constant maturity treasury rate (CMT Rate) as of the valuation date with the maturity matching the expected life.
(3) The expected life is based on management s estimate.

The following table summarizes activity for profit interest units for the period December 31, 2010 to June 30, 2011:

	Class B Units
Balance at December 31, 2010	38,697,318
Granted	
Forfeited	
Exercised	
Balance at June 30, 2011	38,697,318
Vested units at June 30, 2011	19,348,659

There is no stated contractual life for the B units.

Sky LLC granted the Company s Chief Financial Officer 500,000 Class A-2 units, 6,675,287 Class B units and 2,225,096 Class C units, all of which are subject to vesting terms based on either (i) continued service to Sky LLC or its subsidiaries or (ii) performance/market conditions.

Class A-2 Units. The Class A-2 units vest if an initial public offering (IPO) or change of control occurs and the valuation of Class A-1 units of Sky LLC implied by the transaction exceeds 110% of the aggregate capital contributions of affiliates of the Sponsor for the Class A-1 units. The Company s Chief Financial Officer does not need to be employed at the time of the IPO or change in control to vest. The Class A-2 Units will be forfeited if an IPO or change of control occurs at a valuation that does not result in vesting.

Time-Vesting Units. The portion of the Class B units that vest based on continued service represent 66 2/3% of the total Class B units. These units vest over 57 months starting on October 28, 2008 based on continued service, but will become fully vested on an accelerated basis upon a change in control while the Company s Chief Financial Officer continues to provide services to Sky LLC or its subsidiaries. Any of these time-vested Class B units that are unvested on termination of the executive s services will be forfeited.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

Performance-Vesting Units. The remaining portion of the Class B units and all of the Class C units vest based on performance/market conditions. These units will vest if affiliates of the Sponsor receive cash proceeds equal to at least 200% of their aggregate capital contributions in respect of 25% of their units in Sky LLC while the Company s Chief Financial Officer continues to provide services to Sky LLC or its subsidiaries.

Assumptions used were as follows:

Expected Asset Volatility (1)	23.0%
Risk Free Interest Rate (2)	1.35%
Expected Life (3)	5.0 years

(1) The expected asset volatility is derived from the asset volatilities of comparable publicly traded companies.
(2) The risk free interest rate is interpolated from the CMT Rate as of the valuation date with the maturity matching the expected life.
(3) The expected life is based on management s estimates.

The following table summarizes activity for profit interest units for the period December 31, 2010 to June 30, 2011:

	Class A-2 Units	Class B Units	Class C Units
Balance at December 31, 2010	500,000	6,675,287	2,225,096
Granted			
Forfeited			
Exercised			
Balance at June 30, 2011	500,000	6,675,287	2,225,096
Vested units at June 30, 2011		2,447,360	

There are no stated contractual lives for the A-2, B or C units.

Sky LLC (and following our reorganization in March 2010, Apria Holdings LLC) granted certain management employees 44,116,448 Class B units and 15,189,198 Class C units, all of which are subject to vesting terms based on either (i) continued service to Sky LLC or its subsidiaries or (ii) performance/market conditions.

Time-Vesting Units. The portion of the Class B units that vest based on continued service represent 66 2/3% of the total Class B units. These units vest over five years starting on the later of (x) October 28, 2008 and (y) the date the employee commenced employment based on continued service, but will become fully vested on an accelerated basis upon a change in control while the employee continues to provide services to Sky LLC or its subsidiaries. Any of these time-vested Class B units that are unvested on termination of the employee s services will be forfeited.

Performance-Vesting Units. The remaining portion of the Class B units and all of the Class C units vest based on performance/market conditions. These units will vest if affiliates of the Sponsor receive cash proceeds equal to at least 200% of their aggregate capital contributions in respect of 25% of their units in Sky LLC while the employee continues to provide services to Sky LLC or its subsidiaries.

Notwithstanding the vesting terms described above, if the employee voluntarily resigns (in the absence of constructive termination) then Sky LLC may require the forfeiture of any vested Class B or C units.

Assumptions used were as follows for the 2011 grants:

Expected Asset Volatility (1)	25.0%
Risk Free Interest Rate (2)	2.01%
Expected Life (3)	5.0 years

Assumptions used were as follows for the 2010 grants:

Expected Asset Volatility (1)	25.0%
Risk Free Interest Rate (2)	2.39%
Expected Life (3)	5.0 years

(1) The expected asset volatility is derived from the asset volatilities of comparable publicly traded companies.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(2) The risk free interest rate is interpolated from the CMT Rate as of the valuation date with the maturity matching the expected life.

(3) The expected life is based on management s estimate.

The following table summarizes activity for profit interest units for the period December 31, 2010 to June 30, 2011:

	Class A-2 Units	Class B Units	Class C Units
Balance at December 31, 2010	2,075,000	35,341,831	12,635,175
Granted			
Forfeited	(1,000,000)	(2,118,678)	(706,226)
Exercised			
Balance at March 31, 2011	1,075,000	33,223,153	11,928,949
Granted		1,189,943	396,648
Forfeited		(435,345)	(145,115)
Exercised			
Balance at June 30, 2011	1,075,000	33,977,751	12,180,482
Vested units at June 30, 2011		9,407,023	

There are no stated contractual lives for the A-2, B or C units.

Pursuant to a reorganization we conducted in March 2010, units of Sky LLC were converted or exchanged into units of Apria Holdings LLC, its parent entity.

Expense recorded related to profit interest units was $0.7 million and $1.1 million in the three months ended June 30, 2011 and 2010, respectively, and $1.6 million and $2.2 million in the six months ended June 30, 2011 and 2010, respectively. As of June 30, 2011, total unrecognized profit interest compensation cost related to unvested profit interest units was $3.4 million, which is expected to be expensed over a weighted average period of 3.2 years.

NOTE 8 INCOME TAXES

The Company s effective tax rate was 26.5% for the three months ended June 30, 2011, compared to 29.1% for the three months ended June 30, 2010. The Company s effective tax rate was 31.7% for the six months ended June 30, 2011, compared to 16.2% for the six months ended June 30, 2010.

Deferred income tax assets and liabilities are computed for differences between the carrying amounts of assets and liabilities for financial statement and tax purposes. Deferred income tax assets are required to be reduced by a valuation allowance when it is determined that it is more likely than not that all or a portion of a deferred tax asset will not be realized.

In determining the necessity and amount of a valuation allowance, all available information (both positive and negative) is considered and analysis is performed to determine the appropriate weight that should be afforded to available objective and subjective evidence. Cumulative losses in recent years are considered significant negative evidence which could result in the accrual of a valuation allowance against deferred tax assets.

The Company has not sustained a cumulative book loss over the three-year period ended June 30, 2011 (after adjusting for the impact of certain non-recurring historical items which are not indicative of the Company s ability to generate future income).

Based on available information, the Company concluded that a valuation allowance against federal deferred tax assets was not required at June 30, 2011. The Company will continue to assess the need for a valuation allowance as additional information becomes available.

The Company accounts for its tax uncertainties under generally accepted accounting principles. Accordingly, the Company is required to disclose, within its interim financial statements, material changes to the following five disclosure categories: (1) gross unrecognized tax benefits recorded on the balance sheet; (2) total unrecognized tax benefits that, if recognized, would affect the effective tax rate; (3) interest and penalties related to tax uncertainties; (4) amounts and relevant

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

information concerning unrecognized tax benefits for which it is reasonably possible that an increase or decrease could occur during the 12-month rolling period ending June 30, 2012 and (5) disclosure of tax years and major tax jurisdictions which remain subject to examination by taxing authorities.

As of June 30, 2011, the Company does not expect any material increases to its unrecognized tax benefits for the 12-month rolling period ending June 30, 2012. However, as of June 30, 2011, it is reasonably possible that unrecognized tax benefits could decrease by $9.0 million within the 12-month rolling period ending June 30, 2012. This decrease primarily relates to the timing uncertainty for when certain deductions should be recognized for tax return purposes, allocation of expenses between affiliates, and state tax uncertainties. Ultimate realization of this decrease is dependent upon the occurrence of certain events (including the completion of audits by tax agencies and expiration of statutes of limitations).

For the six months ended June 30, 2011, no other material changes occurred with respect to the Company s tax uncertainties and the other four disclosure categories discussed above.

As of June 30, 2011, federal net operating loss (NOLs) carryforwards of approximately $364.0 million were available to offset future federal taxable income. Such NOLs will expire at various times and in varying amounts during the Company s calendar 2015 through 2031 tax years. A significant portion of these NOLS are subject to an annual utilization limitation as required by Section 382 of the Internal Revenue Code of 1986, as amended.

Net income tax refunds received for the six-month period ended June 30, 2011 and 2010 amounted to $0.4 million and $0.2 million, respectively.

NOTE 9 COMMITMENTS AND CONTINGENCIES

Litigation: The Company is 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. Insurance policies covering such potential losses, where such coverage is cost effective, are maintained. In the opinion of management, any liability that might be incurred upon the resolution of these claims and lawsuits will not, in the aggregate, have a material adverse effect on the Company s financial condition or results of operations, cash flows and liquidity.

Medicare and Medicaid Reimbursement: There are a number of provisions contained within recent, proposed or contemplated legislation that affect or may affect Medicare and Medicaid reimbursement policies for items and services provided. 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 the Company s financial condition or results of operations.

Supplier Concentration: Currently, approximately 60.0% of purchases for patient service equipment and supplies are from five 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 the Company s financial condition or operating results.

Guarantees and Indemnities: From time to time, certain types of contracts are entered into that contingently require indemnification of parties against third party claims. These contracts primarily relate to (i) certain asset purchase agreements, under which indemnification may be provided to the seller of the business being acquired; (ii) certain real estate leases, which may require indemnification to property owners for environmental or other liabilities and other claims arising from use of the applicable premises; and (iii) certain agreements with officers, directors and employees, which may require indemnification of 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 balance sheets for any of the periods presented.

NOTE 10 SEGMENTS

The Company has two reportable operating segments (1) home respiratory therapy and home medical equipment and (2) home infusion therapy. Within these two operating segments there are three core service lines: home respiratory therapy, home medical equipment and home infusion therapy. The home respiratory therapy and home medical equipment segment provides services and equipment to assist patients with oxygen systems, sleep apnea, ambulation and general care around the home, as well as to provide respiratory medications and related services. The home infusion therapy segment primarily provides patients with pharmaceuticals and services prescribed in conjunction with the administration of nutrients or medication intravenously or through a gastrointestinal tube.

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APRIA HEALTHCARE GROUP INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

	Net Revenues			
	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	2011	2010	2011	2010
Operating Segment				
Home Respiratory Therapy and Home Medical Equipment	$ 292,609	$ 273,127	$ 568,670	$ 551,443
Home Infusion Therapy	283,739	245,051	544,421	475,611
Total	$ 576,348	$ 518,178	$ 1,113,091	$ 1,027,054

	EBIT			
	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	2011	2010	2011	2010
Operating Segment				
Home Respiratory Therapy and Home Medical Equipment	$ (14,550)	$ 8,692	$ (32,212)	$ 13,307
Home Infusion Therapy	34,694	28,684	53,104	54,758
Total	$ 20,144	$ 37,376	$ 20,892	$ 68,065

	Depreciation and Amortization			
	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	2011	2010	2011	2010
Operating Segment				
Home Respiratory Therapy and Home Medical Equipment	$ 29,484	$ 28,243	$ 57,635	$ 57,956
Home Infusion Therapy	4,141	3,700	8,188	7,225
Total	$ 33,625	$ 31,943	$ 65,823	$ 65,181

Our Chief Operating Decision Maker (CODM) does not review assets assigned to segments. Therefore, such items are not reflected in the table above.

Earnings before interest and taxes (EBIT). EBIT is a measure used by our management to measure operating performance. EBIT is defined as net income (loss) plus interest expense and income taxes. EBIT is not a recognized term under Generally Accepted Accounting Principles (GAAP) and does not purport to be an alternative to net income as a measure of operating performance or to cash flows from operating activities as a measure of liquidity.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

The following table provides a reconciliation from net (loss) income to EBIT:

	Three Months Ended June 30, 2011			Three Months Ended June 30, 2010		
(in thousands)	Home Respiratory Therapy and Home Medical Equipment	Home Infusion Therapy	Total	Home Respiratory Therapy and Home Medical Equipment	Home Infusion Therapy	Total
Net (loss) income			$ (9,437)			$ 3,366
Interest expense, net (a)			32,984			32,632
Income tax (benefit) expense			(3,403)			1,378
EBIT	$ (14,550)	$ 34,694	$ 20,144	$ 8,692	$ 28,684	$ 37,376

	Six Months Ended June 30, 2011			Six Months Ended June 30, 2010		
(in thousands)	Home Respiratory Therapy and Home Medical Equipment	Home Infusion Therapy	Total	Home Respiratory Therapy and Home Medical Equipment	Home Infusion Therapy	Total
Net (loss) income			$ (30,461)			$ 2,563
Interest expense, net (b)			65,487			65,008
Income tax (benefit) expense			(14,134)			494
EBIT	$ (32,212)	$ 53,104	$ 20,892	$ 13,307	$ 54,758	$ 68,065

(a) Reflects $33.0 million of interest expense, net of $0.0 million of interest income for the three months ended June 30, 2011. Reflects $32.7 million of interest expense, net of $0.1 million of interest income for the three months ended June 30, 2010.

(b) Reflects $65.9 million of interest expense, net of $0.4 million of interest income for the six months ended June 30, 2011. Reflects $65.2 million of interest expense, net of $0.2 million of interest income for the six months ended June 30, 2010.

The Company allocates certain expenses that are not directly attributable to a product line based upon segment headcount.

NOTE 11 CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS

Transaction and Management Fee Agreement: In connection with the Merger, Merger Sub entered into a transaction and management fee agreement with Blackstone Management Partners V L.L.C. (BMP). The Company succeeded to and assumed the rights and obligations of Merger Sub pursuant to the transaction and management fee agreement upon the closing of the Merger. Under the transaction and management fee agreement, Merger Sub agreed to pay BMP, at the closing of the Merger, an $18.7 million transaction fee in consideration for BMP undertaking financial and structural analysis, due diligence and other assistance in connection with the Merger. In addition the Company agreed to reimburse BMP for any out-of-pocket expenses incurred by BMP and its affiliates in connection with the Merger and the provision of services under the transaction and management fee agreement.

In addition, under this agreement, BMP (including through its affiliates) agreed to provide services, including without limitation, (a) advice regarding the structure, distribution and timing of debt and equity offerings and advice regarding relationships with the Company s lenders and bankers, (b) advice regarding the business and strategy of the Company, including compensation arrangements, (c) advice regarding dispositions and/or acquisitions and (d) such advice directly related or ancillary to the above financial advisory services as may be reasonably requested by the Company. In consideration for the services, the Company pays BMP at the beginning of each fiscal year a management fee equal to the greater of $7.0 million or 2.0% of the Company s consolidated EBITDA, as defined in the agreement, for the immediately preceding fiscal year. BMP shall have no obligation to provide any other services to the Company absent express agreement. In addition, in the absence of an express agreement to provide investment banking or other financial advisory services to the Company, and without regard to whether such services were provided, BMP is entitled to receive a fee equal to 1.0% of the aggregate transaction value upon the consummation of any acquisition, divestiture, disposition, merger, consolidation, restructuring, refinancing, recapitalization, issuance of private or public debt of equity securities (including an initial public offering of equity securities), financing or similar transaction by the Company.

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APRIA HEALTHCARE GROUP INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

At any time in connection with or in anticipation of a change of control of the Company, a sale of all or substantially all of the Company s assets or an initial public offering of common equity of the Company or its successor, BMP may elect to receive, in consideration of BMP s role in facilitating such transaction and in settlement of the termination of the services, a single lump sum cash payment equal to the then-present value of all then-current and future annual management fees payable under the transaction and management fee agreement, assuming a hypothetical termination date of the agreement to be the twelfth anniversary of such election. The transaction and management fee agreement will continue until the earlier of the twelfth anniversary of the date of the agreement or such date as the Company and BMP may mutually determine. The Company has agreed to indemnify BMP and its affiliates, directors, officers, employees, agents and representatives from and against all liabilities relating to the services contemplated by the transaction and management fee agreement and the engagement of BMP pursuant to, and the performance of BMP and its affiliates of the services contemplated by, the transaction and management fee agreement.

Intelenet Agreement: In May 2009, the Company entered into the Master Service Agreement (Intelenet Agreement) with Intelenet Global Services Private Limited (Intelenet), an Indian company affiliated with the Sponsor, regarding the outsourcing of certain functions relating to billing, collections and other administrative and clerical services. On May 31, 2011, it was announced that an affiliate of the Sponsor, along with other shareholders of Intelenet, agreed to sell Intelenet to Serco Group PLC, an international services company. The transaction closed in July 2011. As of June 30, 2011, the Company expects to make payments to Intelenet of approximately $100.0 million over a seven-year period that began in the second quarter of 2009. This amount is expected to be reduced in the future as we continue to refine the scope of our outsourcing needs. One of the members of our board of directors, Mr. Patrick Bourke, is an employee of the Sponsor who also served on the board of directors of Intelenet. During the six months ended June 30, 2011, the Company paid approximately $11.7 million to Intelenet.

Equity Healthcare Agreement: Effective as of January 1, 2010, the Company entered into an employer health program agreement with Equity Healthcare LLC (Equity Healthcare), an affiliate of the Sponsor, pursuant to which Equity Healthcare will provide to the Company certain negotiating, monitoring and other services in connection with our health benefit plans. In consideration for Equity Healthcare s services, the Company pays Equity Healthcare a fee of $2 per participating employee per month. As of June 30, 2011, the Company had approximately 8,100 employees enrolled in Equity Healthcare health benefit plans.

NOTE 12 FINANCIAL GUARANTEES

The Company conducts substantially all of its business through its subsidiaries. Substantially all of the Company s wholly-owned domestic subsidiaries (the Guarantors) fully and unconditionally guarantee the Series A-1 Notes and Series A-2 Notes on a senior secured basis. The Guarantors also guarantee our ABL Facility. See also Note 5 Long-Term Debt.

The following unaudited condensed consolidated financial statements quantify the financial position as of June 30, 2011 and December 31, 2010, the operations for the three and six months ended June 30, 2011 and 2010, and the cash flows for the six months ended June 30, 2011 and 2010. These condensed consolidated financial statements present financial information for the parent issuer, the guarantor subsidiaries, the non-guarantor subsidiaries and consolidating adjustments, consisting of the entries that eliminate the investment in subsidiaries and intercompany balances and transactions.

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APRIA HEALTHCARE GROUP INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

CONDENSED CONSOLIDATED BALANCE SHEETS

June 30, 2011

(Unaudited)

	Issuer	Guarantor Subsidiaries	Non-Guarantor Subsidiaries (in thousands)	Consolidating Adjustments	Consolidated
ASSETS					
CURRENT ASSETS					
Cash and cash equivalents	$ 38,026	$	$ 651	$ (11,533)	$ 27,144
Accounts receivable less allowance for doubtful accounts		328,010	973		328,983
Inventories, net		55,124	276		55,400
Deferred income taxes	5,094	53,753			58,847
Deferred expenses		3,410			3,410
Intercompany	241,410	467,683		(709,093)	
Prepaid expenses and other current assets	1,021	20,880	12		21,913
Intercompany loan	710,000			(710,000)	
TOTAL CURRENT ASSETS	995,551	928,860	1,912	(1,430,626)	495,697
PATIENT SERVICE EQUIPMENT, less accumulated depreciation		199,601	11		199,612
PROPERTY, EQUIPMENT AND IMPROVEMENTS, NET	39,857	47,003	270		87,130
GOODWILL		765,245			765,245
INTANGIBLE ASSETS, NET	460,000	117,106			577,106
DEFERRED DEBT ISSUANCE COSTS, NET	47,730				47,730
INVESTMENT IN SUBSIDIARIES	390,803	730		(391,533)	
INTERCOMPANY LOAN					
OTHER ASSETS	4,343	4,835			9,178
TOTAL ASSETS	$ 1,938,284	$ 2,063,380	$ 2,193	$ (1,822,159)	$ 2,181,698
LIABILITIES AND STOCKHOLDERS EQUITY					
CURRENT LIABILITIES					
Accounts payable	$	$ 118,793	$ 423	$ (11,533)	$ 107,683
Accrued payroll and related taxes and benefits	11,365	46,140	138		57,643
Other accrued liabilities	19,962	71,422	902		92,286
Deferred revenue		29,748			29,748
Intercompany	81,990	627,103		(709,093)	
Current portion of long-term debt		710,695		(710,000)	695
TOTAL CURRENT LIABILITIES	113,317	1,603,901	1,463	(1,430,626)	288,055
LONG-TERM DEBT, net of current portion	1,017,500	426			1,017,926
DEFERRED INCOME TAXES	162,057	45,601			207,658
INCOME TAXES PAYABLE & OTHER NON-CURRENT LIABILITIES	9,976	22,649			32,625

TOTAL LIABILITIES	1,302,850	1,672,577	1,463	(1,430,626)	1,546,264
COMMITMENTS AND CONTINGENCIES					
STOCKHOLDERS EQUITY					
Additional paid-in capital	689,041	488,716		(488,716)	689,041
(Accumulated deficit) retained earnings	(53,607)	(97,913)	730	97,183	(53,607)
TOTAL STOCKHOLDERS EQUITY	635,434	390,803	730	(391,533)	635,434
	$ 1,938,284	$ 2,063,380	$ 2,193	$ (1,822,159)	$ 2,181,698

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APRIA HEALTHCARE GROUP INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

CONDENSED CONSOLIDATED BALANCE SHEETS

December 31, 2010

(Unaudited)

	Issuer	Guarantor Subsidiaries	Non-Guarantor Subsidiaries (in thousands)	Consolidating Adjustments	Consolidated
ASSETS					
CURRENT ASSETS					
Cash and cash equivalents	$ 125,137	$	$ 407	$ (16,407)	$ 109,137
Accounts receivable less allowance for doubtful accounts		281,917	881		282,798
Inventories, net		73,547	347		73,894
Deferred income taxes	5,012	53,016			58,028
Deferred expenses		3,061			3,061
Intercompany	344,992	256,742		(601,734)	
Prepaid expenses and other current assets	2,757	17,313	151		20,221
Intercompany loan	360,000			(360,000)	
TOTAL CURRENT ASSETS	837,898	685,596	1,786	(978,141)	547,139
PATIENT SERVICE EQUIPMENT, less accumulated depreciation		169,858	20		169,878
PROPERTY, EQUIPMENT AND IMPROVEMENTS, NET	38,818	44,887	188		83,893
GOODWILL		760,088			760,088
INTANGIBLE ASSETS, NET	460,000	118,957			578,957
DEFERRED DEBT ISSUANCE COSTS, NET	53,659				53,659
INTERCOMPANY RECEIVABLE					
INVESTMENT IN SUBSIDIARIES	362,248	702		(362,950)	
INTERCOMPANY LOAN	350,000			(350,000)	
OTHER ASSETS	3,340	4,183			7,523
TOTAL ASSETS	$ 2,105,963	$ 1,784,271	$ 1,994	$ (1,691,091)	$ 2,201,137
LIABILITIES AND STOCKHOLDERS EQUITY					
CURRENT LIABILITIES					
Accounts payable	$	$ 102,858	$ 186	$ (16,407)	$ 86,637
Accrued payroll and related taxes and benefits	12,173	46,771	129		59,073
Other accrued liabilities	20,049	69,421	977		90,447
Deferred revenue		26,504			26,504
Intercompany	202,901	398,833		(601,734)	
Current portion of long-term debt		361,323		(360,000)	1,323
TOTAL CURRENT LIABILITIES	235,123	1,005,710	1,292	(978,141)	263,984
LONG-TERM DEBT, net of current portion	1,017,500	350,598		(350,000)	1,018,098
DEFERRED INCOME TAXES	178,603	44,140			222,743
	9,425	21,575			31,000

INCOME TAXES PAYABLE & OTHER NON-CURRENT LIABILITIES					
TOTAL LIABILITIES	1,440,651	1,422,023	1,292	(1,328,141)	1,535,825
COMMITMENTS AND CONTINGENCIES					
STOCKHOLDERS EQUITY					
Additional paid-in capital	688,458	447,926		(447,926)	688,458
(Accumulated deficit) retained earnings	(23,146)	(85,678)	702	84,976	(23,146)
TOTAL STOCKHOLDERS EQUITY	665,312	362,248	702	(362,950)	665,312
	$ 2,105,963	$ 1,784,271	$ 1,994	$ (1,691,091)	$ 2,201,137

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APRIA HEALTHCARE GROUP INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

Three Months Ended June 30, 2011

(Unaudited)

	Issuer	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
			(in thousands)		
Operating net revenue	$	$ 573,944	$ 2,404	$	$ 576,348
Income from subsidiaries	45,593			(45,593)	
TOTAL NET REVENUES	45,593	573,944	2,404	(45,593)	576,348
TOTAL COST OF NET REVENUES		234,201	1,231		235,432
Provision for doubtful accounts		16,418	160		16,578
Selling, distribution and administrative	52,275	295,694	694	(45,593)	303,070
Amortization of intangible assets	230	891			1,121
TOTAL COSTS AND EXPENSES	52,505	547,204	2,085	(45,593)	556,201
OPERATING (LOSS) INCOME	(6,912)	26,740	319		20,147
Interest expense	33,110	(84)			33,026
Interest income and other	(15,857)	15,662	156		(39)
(LOSS) INCOME BEFORE TAXES	(24,165)	11,162	163		(12,840)
Income tax (benefit) expense	(7,267)	3,864			(3,403)
NET (LOSS) INCOME	(16,898)	7,298	163		(9,437)
Equity in income of subsidiaries, net of tax	7,461	163		(7,624)	
NET (LOSS) INCOME	$ (9,437)	$ 7,461	$ 163	$ (7,624)	$ (9,437)

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APRIA HEALTHCARE GROUP INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

Six Months Ended June 30, 2011

(Unaudited)

	Issuer	Guarantor Subsidiaries	Non-Guarantor Subsidiaries (in thousands)	Consolidating Adjustments	Consolidated
Operating net revenue	$	$ 1,108,264	$ 4,827	$	$ 1,113,091
Income from subsidiaries	71,765			(71,765)	
TOTAL NET REVENUES	71,765	1,108,264	4,827	(71,765)	1,113,091
TOTAL COST OF NET REVENUES		450,837	2,471		453,308
Provision for doubtful accounts		36,608	234		36,842
Selling, distribution and administrative	109,136	560,912	1,415	(71,765)	599,698
Amortization of intangible assets	459	1,739			2,198
TOTAL COSTS AND EXPENSES	109,595	1,050,096	4,120	(71,765)	1,092,046
OPERATING (LOSS) INCOME	(37,830)	58,168	707		21,045
Interest expense	65,701	229			65,930
Interest income and other	(31,713)	31,077	346		(290)
(LOSS) INCOME BEFORE TAXES	(71,818)	26,862	361		(44,595)
Income tax (benefit) expense	(23,498)	9,364			(14,134)
NET (LOSS) INCOME	(48,320)	17,498	361		(30,461)
Equity in income of subsidiaries, net of tax	17,859	361		(18,220)	
NET (LOSS) INCOME	$ (30,461)	$ 17,859	$ 361		