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APRIA HEALTHCARE GROUP INC
Form 10-Q
November 14, 2001

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, 2001

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)

3560 HYLAND AVENUE, COSTA MESA, CA
(Address of principal executive offices)

92626
(Zip Code)

Registrant's telephone number, including area code: (714) 427-2000

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 54,496,817 shares of common stock, \$.001 par value, outstanding at November 5, 2001.

APRIA HEALTHCARE GROUP INC.

FORM 10-Q

FOR THE PERIOD ENDED SEPTEMBER 30, 2001

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

APRIA HEALTHCARE GROUP INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(dollars in thousands)	SEPTEMBER 30, 2001	DEC 2000
		(unaudited)
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 17,552	\$
Accounts receivable, less allowance for doubtful accounts of \$35,790 and \$39,787 at September 30, 2001 and December 31, 2000, respectively ...	161,200	1
Inventories, net	21,838	
Deferred income taxes	33,321	
Prepaid expenses and other current assets	12,568	
	-----	-----
TOTAL CURRENT ASSETS	246,479	2

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PATIENT SERVICE EQUIPMENT, less accumulated depreciation of \$335,561 and \$310,741 at September 30, 2001 and December 31, 2000, respectively	160,441	1
PROPERTY AND EQUIPMENT, NET	43,621	
DEFERRED INCOME TAXES	53,188	
INTANGIBLE ASSETS, NET	175,284	1
OTHER ASSETS	8,268	
	-----	-----
	\$ 687,281	\$ 6
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$ 54,283	\$
Accrued payroll and related taxes and benefits	38,277	
Accrued insurance	9,941	
Income taxes payable	14,448	
Other accrued liabilities	30,479	
Current portion of long-term debt	26,594	
	-----	-----
TOTAL CURRENT LIABILITIES	174,022	1
LONG-TERM DEBT, net of current portion	293,067	3
COMMITMENTS AND CONTINGENCIES (Note H)		
STOCKHOLDERS' EQUITY Preferred stock, \$.001 par value:		
10,000,000 shares authorized; none issued	-	
Common stock, \$.001 par value:		
150,000,000 shares authorized; 54,479,917 and 53,153,890 shares issued at September 30, 2001 and December 31, 2000, respectively; 54,393,817 and 53,067,790 outstanding at September 30, 2001 and December 31, 2000, respectively	54	
Additional paid-in capital	365,642	3
Accumulated deficit	(144,543)	(1
Treasury stock, at cost; 86,100 shares at September 30, 2001 and December 31, 2000	(961)	
	-----	-----
	220,192	1
	-----	-----
	\$ 687,281	\$ 6
	=====	=====

See notes to condensed consolidated financial statements.

APRIA HEALTHCARE GROUP INC.

CONDENSED CONSOLIDATED INCOME STATEMENTS
(unaudited)

(dollars in thousands, except per share data)	THREE MONTHS ENDED SEPTEMBER 30,		NINE SE
	2001	2000	2001
Net revenues	\$ 284,025	\$ 252,588	\$ 838,8
Costs and expenses:			

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Cost of net revenues:			
Product and supply costs	50,376	45,230	152,0
Patient service equipment depreciation	23,127	19,172	66,5
Nursing services	194	467	8
Other	2,780	2,541	8,8
	-----	-----	-----
TOTAL COST OF NET REVENUES	76,477	67,410	228,3
Selling, distribution and administrative	158,750	140,115	465,2
Provision for doubtful accounts	9,873	6,767	29,0
Amortization of intangible assets	3,244	2,601	9,2
	-----	-----	-----
TOTAL COSTS AND EXPENSES	248,344	216,893	731,8
OPERATING INCOME	35,681	35,695	106,9
Interest expense, net	5,093	10,167	21,5
	-----	-----	-----
INCOME BEFORE TAXES AND EXTRAORDINARY CHARGE	30,588	25,528	85,4
Income taxes	11,455	10,722	32,0
	-----	-----	-----
INCOME BEFORE EXTRAORDINARY CHARGE	19,133	14,806	53,4
Extraordinary charge on debt refinancing, net of taxes	1,528	-	1,5
	-----	-----	-----
NET INCOME	\$ 17,605	\$ 14,806	\$ 51,9
	=====	=====	=====
Basic income per common share:			
Income before extraordinary charge	\$ 0.35	\$ 0.28	\$ 0.
Extraordinary charge on debt refinancing, net of taxes...	(0.03)	-	(0.
	-----	-----	-----
Net income	\$ 0.32	\$ 0.28	\$ 0.
	=====	=====	=====
Diluted income per common share:			
Income before extraordinary charge	\$ 0.34	\$ 0.28	\$ 0.
Extraordinary charge on debt refinancing, net of taxes...	(0.03)	-	(0.
	-----	-----	-----
Net income	\$ 0.31	\$ 0.28	\$ 0.
	=====	=====	=====

See notes to condensed consolidated financial statements.

APRIA HEALTHCARE GROUP INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

(dollars in thousands)	NINE MONTHS ENDED SEPTEMBER 30,	
	2001	2000
-----	-----	-----
OPERATING ACTIVITIES		

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Net income	\$ 51,928	\$ 41,658
Items included in net income not requiring cash:		
Extraordinary charge on debt refinancing	2,443	-
Provision for doubtful accounts	29,092	25,785
Depreciation and amortization	87,676	78,091
Amortization of deferred debt costs	1,552	2,025
Deferred income taxes and other	28,415	27,037
Changes in operating assets and liabilities, exclusive of effects of acquisitions:		
Accounts receivable	(44,773)	(18,202)
Inventories, net	729	155
Prepaid expenses and other assets	(5,173)	998
Accounts payable	33	(858)
Accrued payroll and related taxes and benefits	9,828	5,895
Other accrued liabilities	4,350	(3,594)
	-----	-----
NET CASH PROVIDED BY OPERATING ACTIVITIES	166,100	158,990
INVESTING ACTIVITIES		
Purchases of patient service equipment and property and equipment, exclusive of effects of acquisitions	(99,775)	(66,553)
Proceeds from disposition of assets	235	482
Cash paid for acquisitions and payments of contingent consideration.....	(49,745)	(15,400)
	-----	-----
NET CASH USED IN INVESTING ACTIVITIES	(149,285)	(81,471)
FINANCING ACTIVITIES		
Proceeds from revolving credit facilities, net	16,000	-
Proceeds from term loans	300,000	-
Payments on term loans	(140,000)	(30,062)
Payment on redemption of senior subordinated notes	(200,000)	-
Payments on other long-term debt	(1,653)	(3,402)
Capitalized debt costs, net	(5,597)	(983)
Repurchases of common stock	-	(958)
Issuances of common stock	15,123	2,766
	-----	-----
NET CASH USED IN FINANCING ACTIVITIES	(16,127)	(32,639)
NET INCREASE IN CASH AND CASH EQUIVALENTS	688	44,880
Cash and cash equivalents at beginning of period	16,864	20,493
	-----	-----
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 17,552	\$ 65,373
	=====	=====

See notes to condensed consolidated financial statements.

APRIA HEALTHCARE GROUP INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE A - BASIS OF PRESENTATION

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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, 2000, included in the company's 2000 Form 10-K.

For all periods presented herein, there were no differences between net income and comprehensive income.

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 generally accepted accounting principles 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: During the first quarter of 2001, Apria adopted Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities", which was amended by SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of SFAS No. 133" and further amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities". SFAS No. 133, as amended, establishes accounting and reporting standards for hedging activities and for derivative instruments, including certain derivative instruments embedded in other contracts. It requires that an entity recognize all derivatives as either assets or liabilities in the statements of financial position and measure those instruments at fair value. Changes in the fair value of derivatives must be recorded each period. SFAS No. 133 also requires formal documentation, designation at the time the hedge transaction is initiated and assessment of the effectiveness of the transactions that receive hedge accounting. At adoption and at September 30, 2001, Apria had no derivative instruments that require fair value measurement under SFAS No. 133. Accordingly, adoption of SFAS No. 133 did not have a material effect on the consolidated financial statements.

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets". SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for under the purchase method and eliminates the pooling of interests method. Adoption of SFAS No. 141 did not have a significant effect on the company's consolidated financial statements.

SFAS No. 142 requires that an intangible asset that is acquired shall be initially recognized and measured based on its fair value. The statement also provides that goodwill should not be amortized, but shall be tested for impairment annually, or more frequently if circumstances indicate potential impairment, through a comparison of fair value to its carrying amount. Existing goodwill will continue to be amortized through the remainder of 2001 at which time amortization will cease and the company will perform a transitional goodwill impairment test. Goodwill and intangible assets acquired in business

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combinations completed after June 30, 2001 must comply with this statement. Adoption of SFAS No. 142 in its entirety is required for fiscal periods beginning after December 15, 2001. Apria management is currently evaluating the impact of the new accounting standard on existing goodwill and other intangible assets. The ultimate impact of the new accounting standard has yet to be determined. Goodwill amortization expense for the nine months ended September 30, 2001 was \$7,301,000.

In August 2001, the FASB issued 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 similar 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. The provisions of SFAS No. 144 are effective for financial statements issued for years beginning after December 15, 2001. The adoption of this statement will not have a material effect on Apria's 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, managed care organizations, Medicare and Medicaid.

Due to the nature of the industry and the reimbursement environment in which Apria operates, net revenues and accounts receivable are recorded at their expected net realizable values. Inherent in this process is the risk that the expected amounts 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, operating statistics and relevant business conditions. Also, focused reviews of certain large and/or problematic payors are performed. Because of 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.

NOTE D - BUSINESS COMBINATIONS

Apria periodically makes acquisitions of complementary businesses in specific geographic markets. The transactions are accounted for as purchases and the results of operations of the acquired companies are included in the accompanying income statements from the date of acquisition. During the nine-month period ended September 30, 2001, cash paid for acquisitions was \$49,745,000. Included in this amount is contingent consideration of \$1,868,000. At September 30, 2001 outstanding contingent consideration totaled \$5,001,000.

For the acquisitions that closed during the nine-month period ended September 30, 2001, \$46,699,000 was allocated to intangible assets, which includes amounts not yet paid. The majority of such intangible assets represents goodwill from business combinations completed prior to June 30, 2001, which is being amortized

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over 20 years, and covenants not to compete which are being amortized over the life of the respective agreements.

NOTE E - LONG-TERM DEBT

On July 20, 2001, Apria closed a new \$400,000,000 senior secured credit agreement with a syndicate of lenders led by Bank of America, N.A. The company's previous credit agreement and the \$200,000,000 9 1/2% senior subordinated notes, both of which were scheduled to mature in late 2002, were repaid in full concurrent with the closing of the new senior secured credit agreement. In connection with the early retirement of its debt, Apria wrote-off the unamortized balance of deferred financing fees attributable to the subordinated notes and the previous credit agreement. Accordingly, Apria recorded an extraordinary charge of \$1,528,000, net of tax, in the quarter ended September 30, 2001.

The senior secured credit facilities consist of: a \$100,000,000 five-year revolving credit facility; a \$125,000,000 five-year term loan; and a \$175,000,000 six-year term loan. On September 30, 2001, borrowings under the revolving credit facility were \$16,000,000, outstanding letters of credit totaled \$1,000,000 and credit available under the revolving facility was \$83,000,000.

Borrowings under the senior secured credit facilities are collateralized by substantially all of the assets of Apria. The credit agreement contains numerous restrictions, including but not limited to, covenants requiring the maintenance of certain financial ratios, limitations on additional borrowings, capital expenditures, mergers, acquisitions and investments and, restrictions on cash dividends, loans and other distributions. The agreement also permits Apria to expend a maximum of \$100,000,000 per year on acquisitions. At September 30, 2001, the company was in compliance with all of the financial covenants required by the agreement.

The senior secured credit agreement permits Apria to select one of two variable interest rates. One option is the base rate which is expressed as the higher of (a) the Federal Funds rate plus 0.50% and (b) the Prime Rate. The other option is the Eurodollar rate which is based on the London Interbank Offered Rate. Interest on outstanding balances under the senior secured credit agreement are determined by adding a margin to the Eurodollar rate or base rate existing at each interest calculation date. Prior to September 30, 2001, margins on initial borrowings under the revolving credit facility and the \$125,000,000 term loan were 1.75% for Eurodollar loans and 0.75% for base rate loans. Commencing on September 30, 2001, the applicable margins for the revolving credit facility and the \$125,000,000 term loan are based on Apria's leverage ratio, which is the ratio of its funded debt to its last four quarters of EBITDA, as defined. The applicable margin ranges from 1.50% to 2.25% for Eurodollar loans and from 0.50% to 1.25% for base rate loans. For the \$175,000,000 term loan, the margins are fixed at 3.00% for Eurodollar loans and at 2.00% for base rate loans. The senior credit agreement also requires payment of commitment fees ranging from 0.25% to 0.50% (also based on Apria's leverage ratio) on the unused portion of the revolving credit facility.

The \$125,000,000 term loan is repayable in 20 consecutive quarterly installments of \$5,500,000 to \$7,000,000 each, commencing December 31, 2001. The \$175,000,000 term loan is repayable in 20 consecutive quarterly installments of \$437,500 each, commencing December 31, 2001, and four installments of \$41,562,500 each, three of which are payable on the last business day of each calendar quarter commencing December 31, 2006 and the last of which is payable on July 20, 2007.

NOTE F - EQUITY

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The change in stockholders' equity, other than from net income, is attributable to the exercise of stock options and the tax benefit associated with the exercise of nonqualified stock options. For the nine months ended September 30, 2001, proceeds from the exercise of stock options amounted to \$15,123,000 and the related tax benefit amounted to \$6,899,000.

NOTE G - INCOME TAXES

Income taxes for the nine months ended September 30, 2001 and 2000 have been provided at the effective tax rates expected to be applicable for the respective year.

At December 31, 2000, Apria's federal net operating loss carryforwards ("NOLs") approximated \$174,500,000, which will begin expiring in varying amounts in the years 2003 through 2013. Apria also has various state NOLs which began expiring in 1997. Additionally, the company's alternative minimum tax credit carryforward approximated \$7,600,000 at December 31, 2000. As a result of an ownership change in 1992, which met specified criteria of Section 382 of the Internal Revenue Code, future use of a portion of the federal and state NOLs 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 NOLs may expire unused. The company excludes the \$57,000,000 of potentially expiring NOLs from its deferred tax assets. In 2001, for federal tax purposes, NOLs are being utilized to the extent of the company's federal taxable income.

NOTE H - COMMITMENTS AND CONTINGENCIES

Apria and certain of its present and former officers and/or directors are 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). This case is a consolidation of three similar class actions filed in March and April, 1998. Pursuant to a court order dated May 27, 1998, the plaintiffs in the original three class actions filed a Consolidated Amended Class Action Complaint on August 6, 1998. The amended complaint purports to establish a class of plaintiff shareholders who purchased Apria's common stock between May 22, 1995 and January 20, 1998. No class has been certified at this time. The amended complaint alleges, 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. The amended complaint seeks compensatory and punitive damages as well as other relief.

Two similar class actions were filed during July 1998 in the Superior Court for the State of California for the County of Orange: Schall v. Apria Healthcare Group Inc., et. al. (Case No. 797060) and Thompson v. Apria Healthcare Group Inc., et al. (Case No. 797580). These two actions were consolidated by a court order dated October 22, 1998 (Master Case No. 797060). On June 14, 1999, the plaintiffs filed a Consolidated Amended Class Action Complaint asserting claims founded on state law and on Sections 11 and 12(2) of the 1933 Securities Act.

Apria and its Chief Executive Officer are also defendants in a class action lawsuit, J.E.B. Capital Partners, LP v. Apria Healthcare Group Inc. and Philip L. Carter, filed on August 27, 2001 in the U.S. District Court for the Central District of California, Southern Division (Case No. SACV01-813 GLT). Among other things, this complaint alleges 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.

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Apria believes that, in all of these class action cases, it has meritorious defenses to the plaintiffs' claims, and it intends to vigorously defend itself. In the opinion of Apria's management, the ultimate disposition of these class actions 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, all of which 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 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

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effect on Apria's results of operations or financial condition.

NOTE I - 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,	
	2001	2000

NUMERATOR:		
Net income	\$17,605	\$14,806
Numerator for basic and diluted per share amounts - net income available to common stockholders	\$17,605	\$14,806
DENOMINATOR:		
Denominator for basic per share amounts - weighted average shares	54,231	52,324
Effect of dilutive securities:		
Employee stock options	1,737	1,380
Total dilutive potential common shares	1,737	1,380
	-----	-----
Denominator for diluted per share amounts - adjusted weighted average shares	55,968	53,704
	=====	=====
BASIC NET INCOME PER COMMON SHARE	\$ 0.32	\$ 0.28
	=====	=====
DILUTED NET INCOME PER COMMON SHARE	\$ 0.31	\$ 0.28
	=====	=====
Employee stock options excluded from the computation of diluted per share amounts:		
Exercise price exceeds average market price of common stock	1,827	2,650
Average exercise price per share that exceeds average market price of common stock	\$ 27.08	\$ 18.31
	=====	=====

NOTE J - SUBSEQUENT EVENTS

During the fourth quarter of 2001, Apria entered into two interest rate swaps with a total notional amount of \$100,000,000 to fix its LIBOR-based variable rate debt at 3.07% (before the applicable margin). The swap agreements became effective October 30, 2001 and terminate on October 30, 2003. The swaps will be accounted for as cash flow hedges under SFAS No. 133. See "Note E".

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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, 2000, as filed with the Securities and Exchange Commission on March 22, 2001 and Amendment No. 3 to Form S-3 Registration Statement, as filed on August 7, 2001. 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: whether the company will be able to resolve issues pertaining to the collectibility of its accounts receivable, healthcare reform and the effect of federal and state healthcare regulations, the ongoing government investigations regarding patients covered by Medicare and other federal programs, pricing pressures from large payors and changes in governmental reimbursement levels, the effectiveness of the company's operating systems and controls, and the successful implementation of the company's acquisition strategy. 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 United States 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.

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

RESULTS OF OPERATIONS

NET REVENUES. Net revenues were \$284.0 million and \$838.9 million in the third quarter and first nine months of 2001, respectively, compared to \$252.6 million and \$755.9 million for the corresponding periods in 2000. The increases in net revenues are primarily due to new contracts with regional and national payors, the acquisition of complementary businesses and price increases in certain managed care contracts.

(dollars in thousands)	THREE MONTHS ENDED SEPTEMBER 30,				NINE MONTHS ENDED	
	2001		2000		2001	
	\$	%	\$	%	\$	%
Respiratory therapy.....	\$186,069	65.5%	\$162,394	64.3%	\$549,480	65.5%
Infusion therapy.....	54,570	19.2%	49,532	19.6%	161,829	19.2%
HME/other.....	43,386	15.3%	40,662	16.1%	127,550	15.3%
Total net revenues	\$284,025	100.0%	\$252,588	100.0%	\$838,859	100.0%
	=====	=====	=====	=====	=====	=====

Recording of Net Revenues. Substantially all of Apria's revenues are reimbursed by third party payors, including private insurers, Medicare, Medicaid and managed care organizations. Due to the nature of the industry and the

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reimbursement environment in which Apria operates, net revenues are recorded at their expected net realizable values. Inherent in this process is the risk that the expected amounts will have to be revised or updated as additional information becomes available.

Medicare Reimbursement Update. The Medicare, Medicaid and SCHIP Benefits Improvement and Protection Act of 2000 provides reinstatement of the Consumer Price Index-based reimbursement increase in 2001 for certain durable medical equipment products and services. The increase, which went into effect July 1, 2001 and continues through December 31, 2001, includes a transitional allowance that will effectively compress a full year's Consumer Price Index update into six months.

GROSS MARGIN. Gross margins for the third quarter of 2001 and the nine months ended September 30, 2001 were 73.1% and 72.8%, respectively, compared to 73.3% and 72.4% for the same periods last year. The improvement in the year-to-date margin is attributable to better utilization of inventory and patient service equipment, the increase in the share of higher-margin respiratory revenues to total net revenues and the price increases reflected in net revenues.

SELLING, DISTRIBUTION AND ADMINISTRATIVE. Selling, distribution and administrative expenses, as percentages of net revenue, were 55.9% and 55.5% for the third quarter and the nine months ended September 30, 2001, respectively, versus 55.5% and 54.4% for the corresponding periods in 2000. The increases are mainly attributable to merit and other compensation increases.

PROVISION FOR DOUBTFUL ACCOUNTS. The provision for doubtful accounts was 3.5% of net revenues for the third quarter and the first nine months of 2001 compared to 2.7% and 3.4% for the corresponding periods in 2000. The provision percentage in the third quarter of 2000 was positively impacted by higher than normal collections. See "Liquidity and Capital Resources - Accounts Receivable".

AMORTIZATION OF INTANGIBLE ASSETS. Amortization expense was \$3.2 million and \$9.2 million for the third quarter and first nine months of 2001, respectively, compared to \$2.6 million and \$7.5 million in the corresponding periods of 2000. The increases are directly attributable to intangible assets that were recorded in conjunction with acquisitions consummated after the subject periods of 2000.

INTEREST EXPENSE. Interest expense was \$5.1 million for the third quarter of 2001, down from \$10.2 million in the third quarter of 2000. For the nine months ended September 30, 2001 interest expense was \$21.5 million compared to \$31.1 million in the same period in 2000. The decreases are due to the reduction in long-term debt and decreases in interest rates between the periods.

INCOME TAXES. Income taxes for the nine months ended September 30, 2001, and in the corresponding period of 2000, have been provided at the effective tax rates expected to be applicable for the respective year.

At December 31, 2000, Apria's federal net operating loss carryforwards ("NOLs") approximated \$174.5 million, which will begin expiring in varying amounts in the years 2003 through 2013. Apria also has various state NOLs which began expiring in 1997. Additionally, the company's alternative minimum tax credit carryforward approximated \$7.6 million at December 31, 2000. As a result of an ownership change in 1992, which met specified criteria of Section 382 of the Internal Revenue Code, future use of a portion of the federal and state NOLs 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 NOLs may expire unused. Apria excludes the \$57 million of potentially expiring NOLs from its deferred tax assets. In 2001, for federal tax purposes, NOLs are being utilized to the extent of the company's federal taxable income.

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LIQUIDITY AND CAPITAL RESOURCES

CASH FLOW. Operating cash flow was \$166.1 million in the first nine months of 2001 compared with \$159.0 million in the corresponding period of 2000. The cash flow increase was primarily attributable to the increase in net income before items not requiring cash. The larger increase in accounts receivable in the first nine months of 2001, when compared to the same period in 2000, was partially offset by decreases in other working capital requirements.

Cash used in investing activities increased to \$149.3 million for the first nine months of 2001, compared to \$81.5 million during the same period last year. The increase is attributable to an increase in patient service equipment purchases to support the revenue growth and increased acquisition activity.

Cash used in financing activities was \$16.1 million during the first nine months of 2001 compared to \$32.6 million during the corresponding period of 2000. The long-term debt refinancing is reflected in the financing activities section of the 2001 statement of cash flows, but the net decrease in cash used between the periods presented is primarily attributable to the following two items: (1) Apria made no scheduled term loan payments on the former credit agreement in 2001 prior to the refinancing due to large prepayments made in the latter part of 2000, and (2) in 2001, proceeds from the exercise of stock options increased. See "Long-term Debt".

ACCOUNTS RECEIVABLE. Accounts receivable, before allowance for doubtful accounts, was \$197.0 million at September 30, 2001 and \$185.3 million at December 31, 2000. The increase is due to continued quarter-over-quarter net revenue increases. Days sales outstanding (calculated as of each period-end by dividing net accounts receivable by the 90-day rolling average of net revenues) were 51 days at September 30, 2001 and at December 31, 2000. Accounts aged in excess of 180 days as a percentage of total accounts receivable decreased to 21.1% at September 30, 2001 from 23.8% at December 31, 2000.

Evaluation of Net Realizable Value. Management performs various analyses to evaluate the net realizable value of accounts receivable. Specifically, management considers historical realization data, accounts receivable aging trends, operating statistics and relevant business conditions. Also, focused reviews of certain large and/or problematic payors are performed. Because of 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.

Unbilled Receivables. Delays between the date of service and billing can occur due to delays in obtaining certain required payor-specific documentation from internal and external sources. Such earned but unbilled receivables are aged from date of service and are considered in Apria's analysis of historical performance and collectibility. Earned but unbilled receivables were \$27.5 million and \$17.9 million at September 30, 2001 and December 31, 2000, respectively. The increase is largely due to the acquisitions effected during 2001. 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.

LONG-TERM DEBT. On July 20, 2001, Apria closed a new \$400 million senior secured credit agreement with a syndicate of lenders led by Bank of America, N.A. The previous credit agreement and Apria's \$200 million 9 1/2% senior subordinated notes, both of which were scheduled to mature in late 2002, were repaid in full concurrent with the closing of the new credit agreement. In connection with the early retirement of its debt, Apria wrote-off the

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unamortized balance of deferred financing fees attributable to the subordinated notes and the previous credit agreement, resulting in an extraordinary charge of \$1.5 million, net of tax.

The senior secured credit facilities consist of: a \$100 million five-year revolving credit facility; a \$125 million five-year term loan; and a \$175 million six-year term loan. On September 30, 2001, borrowings under the revolving credit facility were \$16 million, outstanding letters of credit totaled \$1 million and credit available under the revolving facility was \$83 million.

During the fourth quarter of 2001, Apria entered into two interest rate swaps with a total notional amount of \$100 million to fix its LIBOR-based variable rate debt at 3.07% (before the applicable margin). The swap agreements became effective October 30, 2001 and terminate on October 30, 2003. The swaps will be accounted for as cash flow hedges under SFAS No. 133. See "Note E to the Condensed Consolidated Financial Statements".

BUSINESS COMBINATIONS. Apria periodically makes acquisitions of complementary businesses in specific geographic markets. The transactions are accounted for as purchases and the results of operations of the acquired companies are included in the accompanying income statements from the date of acquisition. During the nine-month period ended September 30, 2001, cash paid for acquisitions was \$49.7 million. Included in this amount is contingent consideration of \$1.9 million. Outstanding contingent consideration at September 30, 2001 totaled \$5.0 million.

For acquisitions that closed during the first nine months of 2001, approximately \$46.7 million was allocated to intangible assets, which includes amounts not yet paid. The majority of such intangible assets represents goodwill from business combinations completed prior to June 30, 2001, which is being amortized over 20 years, and covenants not to compete which are being amortized over the life of the respective agreements.

FEDERAL INVESTIGATIONS. The U.S. Attorney's office in Los Angeles is conducting an investigation of Apria's billing documentation. The U.S. Attorney's office has informed Apria that this investigation is the result of qui tam litigation filed by one or more individuals on behalf of the government, but has not yet informed Apria whether it will intervene in the qui tam actions; however, it could reach a decision with respect to intervention at any time. If the U.S. Attorney were to intervene in the qui tam cases, or if qui tam actions were to proceed without such intervention, the amount of the claim could be highly material. 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. Although Apria believes that such assertions are unwarranted, and is prepared to vigorously defend against any attempt to impose material liabilities or penalties, Apria can provide no assurance as to the outcome of these proceedings. In the event Apria was found liable or otherwise reached settlement on any such claim in a material amount, Apria's liquidity and capital resources could be adversely affected. See "Note H to the Condensed Consolidated Financial Statements".

RECENT ACCOUNTING PRONOUNCEMENTS. During the first quarter of 2001, Apria adopted Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities", which was amended by SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of SFAS No. 133" and further amended

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by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities". SFAS No. 133, as amended, establishes accounting and reporting standards for hedging activities and for derivative instruments, including certain derivative instruments embedded in other contracts. It requires that an entity recognize all derivatives as either assets or liabilities in the statements of financial position and measure those instruments at fair value. Changes in the fair value of derivatives must be recorded each period. SFAS No. 133 also requires formal documentation, designation at the time the hedge transaction is initiated and assessment of the effectiveness of the transactions that receive hedge accounting. At adoption and at September 30, 2001, Apria had no derivative instruments that require fair value measurement under SFAS No. 133. Accordingly, adoption of SFAS No. 133 did not have a material effect on the consolidated financial statements.

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets". SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for under the purchase method and eliminates the pooling of interests method. Adoption of SFAS No. 141 did not have a significant effect on the company's consolidated financial statements.

SFAS No. 142 requires that an intangible asset that is acquired shall be initially recognized and measured based on its fair value. The statement also provides that goodwill should not be amortized, but shall be tested for impairment annually, or more frequently if circumstances indicate potential impairment, through a comparison of fair value to its carrying amount. Existing goodwill will continue to be amortized through the remainder of 2001 at which time amortization will cease and the company will perform a transitional goodwill impairment test. Goodwill and intangible assets acquired in business combinations completed after June 30, 2001 must comply with this statement. Adoption of SFAS No. 142 in its entirety is required for fiscal periods beginning after December 15, 2001. Apria management is currently evaluating the impact of the new accounting standard on existing goodwill and other intangible assets. The ultimate impact of the new accounting standard has yet to be determined. Goodwill amortization expense for the nine months ended September 30, 2001 was \$7.3 million.

In August 2001, the FASB issued 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 similar 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. The provisions of SFAS No. 144 are effective for financial statements issued for years beginning after December 15, 2001. The adoption of this statement will not have a material effect on Apria's financial statements.

OTHER. Apria's management believes that cash provided by operations together with cash invested in its money market account and amounts available under its existing credit facility will be sufficient to finance its current operations for at least the next year.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Apria is subject to interest rate changes on its variable rate term loans under the company's bank credit agreement. Based on the term debt outstanding at September 30, 2001 and the current market perception, a 100 basis point change in the applicable interest rates would increase or decrease Apria's annual cash

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flow and pretax earnings by approximately \$3.0 million. At September 30, 2001, Apria did not have any derivative financial instruments.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Apria and certain of its present and former officers and/or directors are 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). This case is a consolidation of three similar class actions filed in March and April, 1998. Pursuant to a court order dated May 27, 1998, the plaintiffs in the original three class actions filed a Consolidated Amended Class Action Complaint on August 6, 1998. The amended complaint purports to establish a class of plaintiff shareholders who purchased Apria's common stock between May 22, 1995 and January 20, 1998. No class has been certified at this time. The amended complaint alleges, 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. The amended complaint seeks compensatory and punitive damages as well as other relief.

Two similar class actions were filed during July 1998 in the Superior Court for the State of California for the County of Orange: Schall v. Apria Healthcare Group Inc., et. al. (Case No. 797060) and Thompson v. Apria Healthcare Group Inc., et al. (Case No. 797580). These two actions were consolidated by a court order dated October 22, 1998 (Master Case No. 797060). On June 14, 1999, the plaintiffs filed a Consolidated Amended Class Action Complaint asserting claims founded on state law and on Sections 11 and 12(2) of the 1933 Securities Act.

Apria and its Chief Executive Officer are also defendants in a class action lawsuit, J.E.B. Capital Partners, LP v. Apria Healthcare Group Inc. and Philip L. Carter, filed on August 27, 2001 in the U.S. District Court for the Central District of California, Southern Division (Case No. SACV01-813 GLT). Among other things, this complaint alleges 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.

Apria believes that, in all of these class action cases, it has meritorious defenses to the plaintiffs' claims, and it intends to vigorously defend itself. In the opinion of Apria's management, the ultimate disposition of these class actions 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, all of which 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

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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 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.

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ITEMS 2-3. NOT APPLICABLE

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

(a) Annual Meeting of Stockholders of the company on July 18, 2001.

(b) Directors re-elected at the Annual Meeting for a term of one year:

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

(c) Matters Voted Upon at Annual Meeting:

Election of Directors

The company's Board of Directors consists 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	49,541,275	440,828
Philip L. Carter	49,541,275	440,828
David L. Goldsmith	49,541,275	440,828
Richard H. Koppes	49,541,275	440,828
Philip R. Lochner, Jr.	49,541,275	440,828
Beverly Benedict Thomas	49,541,275	440,828
Ralph V. Whitworth	49,541,275	440,828

ITEM 5. NOT APPLICABLE

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

Exhibit Number -----	Reference -----
10.1	Building Lease, dated December 6, 2000 and commencing on December 1, 2001, between MSGW California I, LLC and Apria Healthcare, Inc. for two buildings within the MSGW/Pacific Commercentre Business Park, Lake Forest, California.
10.2	Credit Agreement dated July 20, 2001, among Registrant and certain of its subsidiaries, Bank of America National Association and other financial institutions party to the Credit Agreement.
10.3	Underwriting Agreement dated August 9, 2001, between Registrant and Relational Investors, LLC.

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(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, 2001

/s/ JAMES E. BAKER

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