
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For The Quarterly Period Ended September 30, 2003

Commission File Number 333-100750

ROTECH HEALTHCARE INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware

(State or Other Jurisdiction of Incorporation or Organization)

030408870

(IRS Employer Identification No.)

2600 Technology Drive, Suite 300, Orlando, Florida

(Address of Principal Executive Offices)

32804

(Zip Code)

(407) 822-4600

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

As of November 1, 2003, the registrant had 25,039,529 shares of common stock outstanding.

ROTECH HEALTHCARE INC.
Quarterly Report for the Period Ended September 30, 2003

EXPLANATORY NOTE

Rotech Medical Corporation emerged from bankruptcy on March 26, 2002 and transferred to Rotech Healthcare Inc. substantially all of its assets used by it in connection with its businesses and operations (including the stock of substantially all of its subsidiaries), in a restructuring transaction. The financial statements included herein reflect these transactions effective as of March 31, 2002. As used in this quarterly report, unless otherwise specified or the context otherwise requires, references to the "Company" refer to the business and operations of Rotech Healthcare Inc. and its subsidiaries for all periods subsequent to March 31, 2002 and to the business and operations of Rotech Medical Corporation and its subsidiaries for all periods prior to April 1, 2002. References to the "Predecessor" refer to Rotech Medical Corporation and its subsidiaries. References to the "Successor" refer to Rotech Healthcare Inc. and its subsidiaries. Readers should refer to the discussion under "The bankruptcy case" and "Restructuring transaction and related transactions" contained in our Annual Report on Form 10-K for the year ended December 31, 2002 for information regarding the bankruptcy of our Predecessor and the restructuring transactions related thereto. This quarterly report contains forward-looking statements based upon current expectations that involve risks and uncertainties. When used in this quarterly report, the words "intend," "anticipate," "believe," "estimate," "plan" and "expect" and similar expressions as they relate to Rotech Healthcare Inc. are included to identify forward-looking statements. Our actual results and the timing of certain events could differ materially from those anticipated in these forward-looking statements as a result of certain factors.

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PART I—FINANCIAL INFORMATION
ITEM 1—Condensed Consolidated Financial Statements

ROTECH HEALTHCARE INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

	December 31, 2002	September 30, 2003
Assets		
Current assets:		
Cash and cash equivalents	\$ 28,012	\$ 17,389
Accounts receivable, net	97,418	89,423
Other accounts receivable	2,066	1,928
Inventories	21,447	9,629
Prepaid expenses	3,629	3,975
Income taxes receivable	—	4,337
Deferred tax asset	4,775	4,775
	<u>157,347</u>	<u>131,456</u>
Total current assets	157,347	131,456
Property and equipment, net	217,364	166,394
Identifiable intangible assets, net	18,966	18,018
Other goodwill	2,316	10,100
Reorganization value in excess of value of identifiable assets—goodwill	668,923	668,938
Other assets	26,290	16,064
	<u>\$1,091,206</u>	<u>\$ 1,010,970</u>
	<u>\$1,091,206</u>	<u>\$ 1,010,970</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 21,071	\$ 17,814
Accrued expenses	21,955	24,330
Accrued interest	10,281	17,154
Deferred revenue	15,157	14,035
Income taxes payable	6,413	—
Current portion of long-term debt	1,799	995
	<u>76,676</u>	<u>74,328</u>
Total current liabilities	76,676	74,328
Deferred tax liabilities	14,987	14,987
Priority tax claim	8,957	8,494
Long-term debt, less current portion	476,714	397,005
Series A Convertible Redeemable Preferred Stock	5,346	5,744
Stockholders' equity:		
Common stock	2	3
Additional paid-in capital	494,998	495,384
Retained earnings	13,526	15,025
	<u>508,526</u>	<u>510,412</u>
Total stockholders' equity	508,526	510,412
	<u>\$1,091,206</u>	<u>\$ 1,010,970</u>
	<u>\$1,091,206</u>	<u>\$ 1,010,970</u>

See accompanying notes to unaudited condensed consolidated financial statements.

ROTECH HEALTHCARE INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands except share and per share data)

	Predecessor	Successor			
	Three months ended March 31, 2002	Six months ended September 30, 2002	Three months ended September 30, 2002	Three months ended September 30, 2003	Nine months ended September 30, 2003
Net revenues	\$ 154,750	\$ 308,133	\$ 153,140	\$ 142,353	\$ 440,637
Cost of net revenues					
Product and supply costs	22,513	45,557	22,416	17,378	57,730
Patient service equipment depreciation	12,147	25,736	12,873	28,188	85,423
Total cost of net revenues	34,660	71,293	35,289	45,566	143,153
Gross profit	120,090	236,840	117,851	96,787	297,484
Costs and expenses:					
Provision for doubtful accounts	3,661	8,407	4,596	4,368	14,305
Selling, distribution and administrative	88,099	184,792	94,872	77,420	250,432
Interest expense on preferred stock	—	—	—	121	121
Interest (income) expense, net	(17)	22,468	10,745	9,665	29,358
Total costs and expenses	91,743	215,667	110,213	91,574	294,216
Earnings before reorganization items, income taxes, extraordinary items and cumulative effect of a change in accounting principle	28,347	21,173	7,638	5,213	3,268
Reorganization items	182,291	1,494	250	—	—
(Loss) earnings before income taxes, extraordinary items and cumulative effect of a change in accounting principle	(153,944)	19,679	7,388	5,213	3,268
Federal and state income tax (benefit) expense	(203)	7,871	2,955	2,341	1,515
(Loss) earnings before extraordinary items and cumulative effect of a change in accounting principle	(153,741)	11,808	4,433	2,872	1,753
Cumulative effect of change in accounting principle for mandatorily redeemable financial instruments	—	—	—	(30)	(30)
Extraordinary gain on debt discharge	20,441	—	—	—	—
Net (loss) earnings	(133,300)	11,808	4,433	2,842	1,723
Accrued dividends on redeemable preferred stock	—	233	113	—	225
Net (loss) earnings available for common stockholders	\$ (133,300)	11,575	4,320	2,842	1,498
Net earnings per common share—basic		0.46	0.17	0.11	0.06
Net earnings per common share—diluted		0.46	0.17	0.11	0.06
Weighted average shares outstanding—basic		25,000,000	25,000,000	25,003,894	25,001,303
Weighted average shares outstanding—diluted		25,200,000	25,200,000	25,766,396	25,181,725

See accompanying notes to unaudited condensed consolidated financial statements.

ROTECH HEALTHCARE INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)

	Predecessor	Successor			
	Three months ended March 31, 2002	Six months ended September 30, 2002	Three months ended September 30, 2002	Three months ended September 30, 2003	Nine months ended September 30, 2003
Net (loss) earnings	\$ (133,300)	\$ 11,808	4,433	\$ 2,842	\$ 1,723
Adjustments to reconcile net (loss) earnings to net cash provided by operating activities:					
Reorganization items	182,291	1,494	250	—	—
Provision for doubtful accounts	3,661	8,407	4,596	4,368	14,305
Depreciation and amortization	14,986	30,823	15,087	31,579	94,745
Deferred income taxes	—	(4,447)	(1,887)	—	(16)
Extraordinary gain on debt discharge	(20,441)	—	—	—	—
Changes in operating assets and liabilities:					
(Increase) decrease in accounts receivable	(7,998)	10,382	3,053	(1,730)	(6,010)
Decrease (increase) in other receivables	1,146	(3,425)	(2,647)	290	138
(Increase) decrease in inventories	(2,045)	104	1,432	377	2,354
Decrease (increase) in prepaid expenses	124	(427)	746	450	(346)
Decrease (increase) in income taxes receivable	—	—	—	2,385	(4,337)
Increase (decrease) in accounts payable and accrued expenses	(5,086)	632	6,768	(389)	(947)
Increase (decrease) in accrued interest	—	3,207	(4,778)	6,983	7,046
Increase (decrease) in income taxes payable	—	120	—	—	(6,413)
Decrease in deferred revenue	—	—	(380)	(553)	(1,122)
Net cash provided by operating activities	33,338	58,678	26,673	46,602	101,120
Net cash used by reorganization items	(8,848)	(1,494)	(250)	—	—
Net cash provided by operating activities and reorganization items	24,490	57,184	26,423	46,602	101,120
Cash flows from investing activities:					
Purchases of property and equipment	(15,299)	(30,965)	(14,626)	(9,506)	(32,700)
Business acquisitions	—	(2,903)	(1,520)	—	(1,873)
(Increase) decrease in other assets	(6,929)	(363)	1,133	754	3,418
Net cash used in investing activities	(22,228)	(34,231)	(15,013)	(8,752)	(31,155)
Cash flows from financing activities:					
Net proceeds from long term borrowings	483,040	—	—	—	—
Debt issuance costs	16,960	—	—	—	—
Payments of long term borrowings	—	(6,000)	(5,500)	(50,000)	(80,513)
Payments of liabilities subject to compromise/priority tax claim	(27,932)	—	—	(157)	(463)
Net proceeds from stock option exercises	—	—	—	388	388
Net proceeds from sale/lease back of vehicles	10,191	—	—	—	—
Distributions to parent company, net	(487,804)	—	—	—	—
Net cash used in financing activities	(5,545)	(6,000)	(5,500)	(49,769)	(80,588)
(Decrease) increase in cash and cash equivalents	(3,283)	16,953	5,910	(11,919)	(10,623)
Cash and cash equivalents, beginning of period	4,970	1,687	12,730	29,308	28,012
Cash and cash equivalents, end of period	\$ 1,687	18,640	18,640	17,389	17,389



See accompanying notes to unaudited condensed consolidated financial statements.

ROTECH HEALTHCARE INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(In thousands, except share and per share data)

(1) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of Rotech Healthcare Inc. and its subsidiaries, and its predecessor, Rotech Medical Corporation and its subsidiaries, and have been prepared in accordance with the instructions to Form 10-Q and, therefore do not include all information and footnotes necessary for a fair presentation of consolidated financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America. Interim results are not necessarily indicative of results to be expected for the full year. For further information, refer to the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

Rotech Medical Corporation emerged from bankruptcy on March 26, 2002 and transferred to Rotech Healthcare Inc. substantially all of its assets used by it in connection with its businesses and operations (including the stock of substantially all of its subsidiaries), in a restructuring transaction. The financial statements included herein reflect these transactions effective as of March 31, 2002. As used in these notes, unless otherwise specified or the context otherwise requires, references to the "Company" refer to the business and operations of Rotech Healthcare Inc. and its subsidiaries for all periods subsequent to March 31, 2002 and to the business and operations of Rotech Medical Corporation and its subsidiaries for all periods prior to April 1, 2002. References to the "Predecessor" refer to Rotech Medical Corporation and its subsidiaries. References to the "Successor" refer to Rotech Healthcare Inc. and its subsidiaries.

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

(2) Accounting Policies 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: In December 2002, Statement of Financial Accounting Standards ("SFAS") No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure" was issued by the Financial Accounting Standards Board ("FASB"). This standard amends SFAS No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, this standard amends the disclosure requirements of SFAS No. 123 to require prominent disclosure in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS No. 148 is effective for financial statements for fiscal years ending after December 15, 2002. The Company implemented SFAS No. 148 effective January 1, 2003 regarding disclosure requirements for condensed financial statements for interim periods. The Company has not yet determined whether it will voluntarily change to the fair value based method of accounting for stock-based employee compensation.

In January 2003, the FASB issued FASB Interpretation No. 46 "Consolidation of Variable Interest Entities", an interpretation of Accounting Research Bulletin ("ARB") No. 51, Consolidated Financial Statements ("FIN 46"). FIN 46 clarifies the application of ARB No. 51 to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. The adoption of FIN 46, as it relates to variable interest entities created after January 31, 2003, did not impact the Company's condensed consolidated financial statements. Additional provisions of FIN 46, which became effective for the Company beginning on July 1, 2003, have not had a material effect on the Company's consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." This statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires the issuer to classify a financial instrument that is within the scope of the standard as a liability if such financial instrument embodies an obligation of the issuer. It is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The Company has adopted SFAS No. 150 and therefore has classified and accounted for

ROTECH HEALTHCARE INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

its Series A Convertible Redeemable Preferred Stock as a liability on the Company's condensed consolidated financial statements.

(3) Change in Accounting Estimate

Effective April 1, 2003, the Company changed its estimated useful life on certain long-lived assets acquired from its predecessor, Rotech Medical Corporation. The estimated useful life was changed from an aggregate of four years from the date acquired from the predecessor to a five year useful life from the original acquisition date. The change decreased net income in the three months and nine months ended September 30, 2003, by \$12,600, or \$0.49 per share and \$40,400, or \$1.60 per share, respectively. The change was made to more closely match the replacement rates of rental property acquired with its specific remaining useful life.

(4) Earnings Per Common Share and Stock Based Compensation

Basic earnings per share ("EPS") is computed by dividing earnings (losses) attributable to common stockholders by the weighted average number of common shares outstanding for the periods. Diluted EPS reflects the potential dilution of securities that could share in the earnings, including stock options, and are based upon the weighted average number of common and common equivalent shares outstanding during the year. Common equivalent shares are excluded from the computation of diluted EPS in periods where they have an anti-dilutive effect. The Company uses the treasury stock method to compute the dilutive effects of outstanding options.

A reconciliation of the number of common shares used in the calculation of basic and diluted EPS is presented below:

	Successor			
	Six months ended September 30, 2002	Three months ended September 30, 2002	Three months ended September 30, 2003	Nine months ended September 30, 2003
Weighted average basic shares	25,000,000	25,000,000	25,003,894	25,001,303
Effect of dilutive securities:				
Weighted options outstanding	—	—	762,502	180,422
Conversion of convertible redeemable preferred stock	200,000	200,000	—	—
Weighted average diluted shares	25,200,000	25,200,000	25,766,396	25,181,725

As permitted under SFAS No. 148 and 123, the Company has elected to follow Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, which prescribes the intrinsic value method of accounting for its stock-based awards issued to employees and directors. Accordingly, the Company does not currently recognize compensation expense for its stock-based awards to employees in the condensed consolidated statements of operations. Had compensation cost been determined on the basis of fair value pursuant to SFAS No. 123, the Company's net earnings and basic and diluted earnings per share would have been as follows:

	Successor			
	Six months ended September 30, 2002	Three months ended September 30, 2002	Three months ended September 30, 2003	Nine months ended September 30, 2003
Net earnings available for common stockholders:				
As reported	\$ 11,575	\$ 4,320	\$ 2,842	\$ 1,498
Pro forma	\$ 10,468	\$ 3,548	\$ 2,456	\$ 505
Basic net earnings available for common stockholders per share:				
As reported	\$ 0.46	\$ 0.17	\$ 0.11	\$ 0.06
Pro forma	\$ 0.42	\$ 0.14	\$ 0.10	\$ 0.02
Diluted net earnings available for common stockholders per share:				
As reported	\$ 0.46	\$ 0.17	\$ 0.11	\$ 0.06
Pro forma	\$ 0.42	\$ 0.14	\$ 0.10	\$ 0.02

ROTECH HEALTHCARE INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Options to purchase approximately 3,413,125 shares of common stock at prices ranging from \$14.55 to \$24.95 per share were outstanding as of September 30, 2003. No earnings per share data is provided for the Predecessor, since the Predecessor was a wholly owned subsidiary of Integrated Health Services, Inc. ("IHS").

(5) Acquisitions

On February 6, 2003, the Company entered into an asset purchase agreement with Daniels Investment, Inc. d/b/a Northern Kentucky Respiratory Care ("NKR") to acquire its principal operating assets and certain liabilities (including a loan and outstanding management fees owed to the Company) for a cash purchase price of up to \$5,000.

Pursuant to the asset purchase agreement, the Company paid \$2,000 in cash on the closing date, with the remaining cash purchase price to be paid out based on an earn-out provision in the agreement.

The business combination of NKR was accounted for by the purchase method of accounting. The results of the operations of the acquired business are included in the condensed consolidated financial statements from the purchase date. The Company acquired the following assets and liabilities in the NKR acquisition:

Cash	\$ 127
Accounts receivable	300
Property and equipment	613
Intangible assets	50
Goodwill	7,784
Assumption of liabilities	(66)
	<hr/>
Fair value of purchased assets	\$ 8,808
Loan and management fees payable to the Company	(6,808)
	<hr/>
Cash paid for acquisition	\$ 2,000
	<hr/>

The purchase price is preliminary until December 31, 2005, the date the earn-out period expires. The unaudited pro forma effect of the acquisition of NKR on the Company's revenues, net income (loss) and net income (loss) per share, for the nine months ended September 30, 2002 and 2003, had the acquisition occurred on January 1, 2002, are not material to the Company's condensed consolidated statements of operations.

(6) Restructuring Accruals

The Company is implementing certain restructuring activities that include head count reduction and real estate consolidation to improve operating effectiveness and efficiencies. During the three month period ended September 30, 2003, \$456 of restructuring related charges were recognized for severances and lease cancellation charges. For the three months ended September 30, 2003, the Company paid \$1,179 in cash for restructuring related charges. During the nine month period ended September 30, 2003, \$6,730 of restructuring related charges were recognized, which consisted of severance and lease cancellation charges. Of the \$6,730 in charges, \$6,078 was paid in cash. As of September 30, 2003, the Company had approximately \$2,052 recorded in accrued expenses related to restructuring charges. At January 1, 2003 the Company had approximately \$1.4 million recorded in accrued expenses related to restructuring charges. The restructuring related charges are included in selling, distribution and administrative expenses in the condensed consolidated statements of operations. The Company terminated approximately 15% of its employees during the nine months ended September 30, 2003. The terminated employees consisted of corporate and administrative personnel, and field staff in a variety of capacities.

(7) Goodwill and Other Identifiable Intangible Assets

For impairment testing purposes, the Company has determined that it has one reporting unit in the distribution business. Management further has determined that the distribution reporting unit should be reported in the aggregate based upon similar economic characteristics within each company within that unit. Management will perform the required annual impairment test during the fourth quarter, unless indicators of impairment are present and suggest earlier testing is warranted.

The carrying value of goodwill increased by approximately \$7,784 for the nine months ended September 30, 2003 related to the acquisition of NKR on February 6, 2003.

ROTECH HEALTHCARE INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

The changes in the carrying amount of goodwill for the nine months ended September 30, 2003, are as follows:

Balance as of January 1, 2003	\$ 2,316
Goodwill acquired during the nine months ended September 30, 2003	7,784
	<hr/>
Balance as of September 30, 2003	\$10,100
	<hr/>

The following table reflects the components of other identifiable intangible assets:

	December 31, 2002		September 30, 2003	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortizable identifiable intangible assets:				
Customer/physician relationship	\$12,000	\$ 450	\$12,000	\$ 900
Computer software	5,000	250	5,000	500
Other	954	288	1,004	586
	<hr/>	<hr/>	<hr/>	<hr/>
Subtotal	17,954	988	18,004	1,986
Non-amortizable identifiable intangible assets:				
Trade name	1,000	—	1,000	—
Medicare licenses	1,000	—	1,000	—
	<hr/>	<hr/>	<hr/>	<hr/>
Subtotal	2,000	—	2,000	—
	<hr/>	<hr/>	<hr/>	<hr/>
Total identifiable intangible assets	\$19,954	\$ 988	\$20,004	\$ 1,986
	<hr/>	<hr/>	<hr/>	<hr/>

Amortization expense for the three months ended March 31, 2002 and the three months and six months ended September 30, 2002 and the three months and nine months ended September 30, 2003 was approximately \$0, \$331, \$658, \$334 and \$998, respectively.

Estimated amortization expense for each of the fiscal years ended December 31, is as follows:

	Amount
2003	\$1,333
2004	1,072
2005	984
2006	984
2007	966

(8) Segment Data

The Company has determined that it has one reportable segment because all distribution locations have similar economic characteristics, such as margins, products, customers, distribution networks and regulatory oversight. The accounting policies of the operating segment are those discussed in the Company's consolidated financial statements included in its Annual Report on Form 10-K for the year ended December 31, 2002.

This one line of business represents 100% of consolidated revenues from the distribution of health care products. The distribution business is comprised of three primary product lines: respiratory therapy equipment and services, durable medical equipment, and other health care products. The following table presents net revenues from distribution by each of the Company's three primary product lines:

	Predecessor	Successor			
	Three months ended March 31, 2002	Six months ended September 30, 2002	Three months ended September 30, 2002	Three months ended September 30, 2003	Nine months ended September 30, 2003
Respiratory therapy equipment and services	\$ 120,618	\$ 243,253	\$ 121,921	\$ 119,097	\$ 367,126

Durable medical equipment	30,745	58,185	27,687	21,576	67,438
Other health care products	3,387	6,695	3,532	1,680	6,073
	<u>154,750</u>	<u>308,133</u>	<u>153,140</u>	<u>142,353</u>	<u>440,637</u>

ROTECH HEALTHCARE INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(9) Petitions for Reorganization under Chapter 11 and Other Information

The Predecessor was incorporated on September 1, 1981. In 1997, the Predecessor entered into a definitive merger agreement pursuant to which the Predecessor became a wholly-owned subsidiary of IHS effective as of October 21, 1997.

On February 2, 2000, IHS and substantially all of its subsidiaries, including the Predecessor and its subsidiaries, filed separate voluntary petitions for relief under Chapter 11 (“Chapter 11”) of the United States Bankruptcy Code with the United States Bankruptcy Court in the District of Delaware (the “Bankruptcy Court”). On November 23, 2001, IHS filed a plan of reorganization (the “Plan”) for the Predecessor and its subsidiaries, which was approved by the creditors and confirmed by the Bankruptcy Court on February 13, 2002. The Plan became effective on March 26, 2002. On the effective date, the Predecessor transferred to the Company substantially all of the assets used by it in connection with its businesses and operations (including the stock of substantially all of its subsidiaries).

In February 2002, the Predecessor settled all outstanding government litigation and pre-petition and certain post-petition claims arising from Medicare payments made to certain of the Company’s operating centers as well as claims in unliquidated amounts for a cash settlement of \$17 million. The settlement became effective on March 26, 2002, upon the effectiveness of the Plan.

In addition, on February 13, 2002, IHS and its subsidiaries, including the Predecessor, entered into a stipulation with the Centers for Medicare and Medicaid Services (“CMS”), whereby CMS was permitted to set off certain underpayments to IHS with certain overpayments to the Predecessor in exchange for a full release of all CMS overpayment claims against IHS and its subsidiaries, including the Predecessor, to the effective date of the stipulation. The Bankruptcy Court signed the stipulation on April 12, 2002.

In accordance with the Company’s emergence from bankruptcy, the following expenses were recorded as reorganization items:

	<u>Predecessor</u>	<u>Successor</u>
	Three months ended March 31, 2002	Three months ended September 30, 2002
Severance and terminations	\$ 837	\$ —
Legal, accounting and consulting fees	175	497
Loss on sale/leaseback of vehicles	4,686	169
Priority tax claim allowed	9,000	—
Contribution of convertible redeemable preferred stock to an employee profit sharing plan	5,000	—
Administrative expense claims allowed	7,800	—
Fresh-start reporting adjustments	153,197	—
Loss on closure of discontinued branch operations, long term incentive compensation and other charges resulting from reorganization and restructuring	1,596	828
	<u>\$ 182,291</u>	<u>\$ 1,494</u>

(10) Other Commitments and Contingencies

The Company is subject to workers’ compensation and employee health benefit claims, which are primarily self-insured. The Company does, however, maintain certain stop-loss and other insurance coverage which management believes to be appropriate. Provisions for estimated settlements relating to the workers’ compensation and health benefit plans are provided in the period of the related claim on a case-by-case basis plus an amount for incurred but not reported claims. Differences between the amounts accrued and subsequent settlements are recorded in operations in the period of settlement.

From time to time, the Company and its subsidiaries have been parties to various legal proceedings in the ordinary course of business. For more information regarding the Company’s recent legal proceedings, see Footnote 14, Significant Events. In the opinion of management there are currently no proceedings which individually, after taking into account the insurance coverage maintained by the Company, would have a material adverse effect on the Company’s financial position or results of operations.

ROTECH HEALTHCARE INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(11) Certain Significant Risks and Uncertainties

The Company and others in the health care business are subject to certain inherent risks, including the following:

- Substantial dependence on revenues derived from reimbursement by the federal Medicare and state Medicaid programs which have been reduced in recent years and which entail exposure to various health care fraud statutes;
- Government regulations, government budgetary constraints and proposed legislative and regulatory changes; and
- Lawsuits alleging general and professional liability and related claims.

Such inherent risks require the use of certain management estimates in the preparation of the Company's financial statements and it is reasonably possible that a change in such estimates may occur.

The Company receives payment for a significant portion of services rendered to patients from the federal government under Medicare and other federally funded programs (including the Veterans Administration) and from the states in which its facilities and/or services are located under Medicaid. Revenue derived from Medicare, Medicaid and other federally funded programs represented 67.9%, 68.1% and 71.3% of the Company's patient revenue for the three months ended March 31, 2002, six months ended September 30, 2002 and three months ended September 30, 2003, respectively, and 70.8% of the Company's patient revenue for the nine months ended September 30, 2003. The Company's operations are subject to a variety of federal, state and local legal and regulatory risks, including, without limitation, federal Medicare and Medicaid fraud and abuse laws (sometimes referred to as the "Anti-Kickback Statute") and the federal Ethics in Patient Referral Act of 1989 ("Stark I") as amended by the Omnibus Budget and Reconciliation Act of 1993 ("Stark II" and together with Stark I, "Stark") many of which apply to virtually all companies engaged in the health care services industry. The Anti-Kickback Statute prohibits, among other things, the offer, payment, solicitation or receipt of any form of remuneration in return for the referral of Medicare and Medicaid patients. Stark prohibits, with limited exceptions, financial relationships between certain designated health service providers and referring physicians. Many states in which the Company operates have laws and regulations similar to Stark and the Anti-Kickback Statute with which the Company must comply. Other regulatory risks assumed by the Company and other companies engaged in the health care industry are as follows:

- False Claims—The federal False Claims Act imposes civil liability on individuals or entities that submit false or fraudulent claims for payment to the federal government. The False Claims Act also includes a number of "whistleblower" provisions that allow private individuals to bring actions on behalf of the government alleging violations of the False Claims Act. Violations of the False Claims Act may result in treble damages, civil monetary penalties, and exclusion from the Medicare and Medicaid programs. A number of other federal statutes give rise to criminal penalties (including fines and imprisonment) for individuals or entities that present false or fraudulent claims or documentation to the government.
- Regulatory Requirement Deficiencies—In the ordinary course of business, health care facilities receive notices of deficiencies for failure to comply with various regulatory requirements. In some cases, the reviewing agency may take adverse actions against a facility, including the imposition of fines, temporary suspension or decertification from participation in the Medicare and Medicaid programs and, in extreme cases, revocation of a facility's license.
- Changes in laws and regulations—Changes in laws and regulations could have a material adverse effect on licensure, eligibility for participation in government programs, permissible activities, operating costs and the levels of reimbursement from governmental and other sources.

The Company has formed a Corporate Compliance Department to help identify, prevent and deter instances of Medicare, Medicaid and other noncompliance. Although the Company strives to manage these regulatory risks, there can be no assurance that federal and/or state regulatory agencies that currently have jurisdiction over matters including, without limitation, Medicare, Medicaid and other government reimbursement programs, will take the position that the Company's business and operations are in compliance with applicable law or with the standards of such regulatory agencies.

While the Company believes it complies in all material respects with all applicable regulatory requirements, an adverse determination in the governmental investigations, whether currently asserted or arising in the future, could have a material adverse effect on the Company.

ROTECH HEALTHCARE INC. AND SUBSIDIARIES
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The Company is also subject to general and professional liability and related claims, which arise in the normal course of business and which could have a significant effect on the Company. As a result, the Company maintains occurrence based professional and general liability insurance with coverage and deductibles which management believes to be appropriate.

The Company is also subject to certain inherent risks related to the acquisition of businesses. Since its inception, the Company has grown through acquisitions, and realization of acquisition costs, including intangible assets of businesses acquired, is dependent initially upon the consummation of the acquisitions and subsequently upon the Company's ability to successfully integrate and manage acquired operations.

The Company believes that adequate provision for the aforementioned items has been made in the accompanying condensed consolidated financial statements and that their ultimate resolution will not have a material effect on the consolidated financial statements.

(12) Fresh-Start Reporting

The Company adopted fresh-start reporting upon its emergence from Chapter 11, effective March 31, 2002. Under fresh-start reporting, the reorganization value of the Company is allocated to the Company's assets based on their respective fair values in conformity with a method similar in nature to the purchase method of accounting for business combinations; any portion not attributed to specific tangible or identifiable intangible assets is reported as an intangible asset referred to as "reorganization value in excess of value of identifiable assets—goodwill." In adopting fresh-start reporting, the Company engaged an independent financial advisor to assist in the determination of the reorganization value or fair value of the entity. The estimate of reorganization value was based upon the Company's cash flows, selected comparable market multiples of publicly traded companies, lease obligations, and other applicable valuation techniques.

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A reconciliation of fresh-start reporting recorded as of March 31, 2002 follows (in thousands):

	<u>Predecessor</u>	<u>Reorganization Adjustments</u>	<u>Fresh-Start Adjustments</u>	<u>Successor</u>
Assets				
Current assets:				
Cash and cash equivalents	\$ 14,687	\$ (13,000) ⁽¹⁾	\$ —	\$ 1,687
Accounts receivable, net	121,742	—	—	121,742
Other accounts receivable	1,137	—	—	1,137
Inventories	23,908	—	—	23,908
Prepaid expenses	2,831	—	—	2,831
Deferred tax asset	24,705	(24,705) ⁽²⁾	—	—
	<u>189,010</u>	<u>(37,705)</u>	<u>—</u>	<u>151,305</u>
Total current assets				
Property and equipment, net	242,774	—	(21,482) ⁽⁷⁾	221,292
Intangible assets	783,529	—	(783,529) ⁽⁸⁾	—
Reorganization value in excess of value of identifiable assets—goodwill	—	—	651,814 ⁽¹⁰⁾	651,814
Other assets	13,625	6,460 ⁽³⁾	—	20,085
	<u>\$1,228,938</u>	<u>\$ (31,245)</u>	<u>\$ (153,197)</u>	<u>\$1,044,496</u>
Liabilities and Stockholders' Equity				
Current liabilities:				
Accounts payable	\$ 15,497	\$ —	\$ —	\$ 15,497
Accrued expenses	19,999	—	—	19,999
Current portion of long term debt	—	2,000 ⁽⁵⁾	—	2,000
	<u>35,496</u>	<u>2,000</u>	<u>—</u>	<u>37,496</u>
Total current liabilities				
Liabilities subject to compromise	47,441	(47,441) ⁽¹⁾	—	—
Due to parent company, net	378,287	(438,086) ⁽⁴⁾	59,799 ⁽⁸⁾	—
Deferred tax liabilities	58,359	(58,359) ⁽²⁾	—	—
Priority tax claim	—	9,000 ⁽¹⁾	—	9,000
Long-term debt, less current portion	—	498,000 ⁽⁵⁾	—	498,000
Series A Convertible Redeemable Preferred Stock	—	5,000 ⁽⁹⁾	—	5,000
Stockholders' equity:				
Common Stock—Predecessor	1	—	(1) ⁽⁹⁾	—
Common Stock—Successor	—	—	2 ⁽⁹⁾	2
Additional paid-in capital Predecessor	565,893	—	(565,893) ⁽⁸⁾	—
Additional paid-in capital Successor	—	—	494,998 ⁽⁹⁾	494,998
Retained earnings	143,461	(1,359) ⁽⁶⁾	(142,102) ⁽⁸⁾	—
	<u>709,355</u>	<u>(1,359)</u>	<u>(212,996)</u>	<u>495,000</u>
Total stockholders' equity				
	<u>\$1,228,938</u>	<u>\$ (31,245)</u>	<u>\$ (153,197)</u>	<u>\$1,044,496</u>

(1) Represents estimated plan of reorganization claims allowed and paid.

(2) Represents estimated effect of Internal Revenue Code Section 338(h)(10) election.

(3) Represents the following:

Estimated value of non-core assets retained by Predecessor	\$(10,500)
Deferred debt issue costs	16,960
	<u>6,460</u>

\$ 6,460

- (4) Represents settlement with IHS.
- (5) Represents the sale of senior secured term loan and senior subordinated notes.
- (6) Represents priority tax claim allowed of \$9,000, plus contribution of Series A Convertible Redeemable Preferred Stock of \$5,000 to an employee profit sharing plan, plus administrative expense claims allowed of \$7,800, less gain on debt discharge of \$20,441.
- (7) Represents reduction of property and equipment to estimated fair market value under fresh-start reporting.
- (8) Represents elimination of our Predecessor's intangible assets, equity accounts and retained earnings under fresh-start reporting.

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(9) Represents reorganization value of capital stock as follows:

Series A Convertible Redeemable Preferred Stock	\$ 5,000
Common Stock	2
Additional paid-in capital	494,998
	<u>\$500,000</u>

(10) Represents allocation of reorganization value under fresh-start reporting as follows:

Cash and cash equivalents	\$ 1,687
Accounts receivable	121,742
Other current assets	27,876
Property and equipment	221,292
Other assets	20,085
Accounts payable and accrued expenses	(35,496)
Priority tax claim	(9,000)
	<u>348,186</u>
Reorganization value in excess of value of identifiable assets—goodwill	651,814
	<u>\$1,000,000</u>

Subsequent to March 31, 2002 and during the period ended December 31, 2002, the following adjustments were made to reorganization value in excess of value of identifiable assets—goodwill as the Company completed and finalized the valuations required under fresh-start reporting to determine the fair value of the Company's assets and liabilities:

Reduction of property and equipment to estimated fair market value	\$ 4,683
Finalization of additional taxes due related to the Internal Revenue Code Sections 338(h)(10) election	18,194
Finalization of estimates made to recognize cumulative deferred revenue upon emergence	15,157
Allocation of goodwill to specifically identifiable intangible assets	(19,803)
Miscellaneous	(1,122)
	<u>\$ 17,109</u>

(13) Long-Term Debt

The Company's long-term debt consists of the following:

	<u>December 31, 2002</u>	<u>September 30, 2003</u>
Senior Secured Term Loan; \$249 payable quarterly through March 31, 2007 with remainder due quarterly through March 31, 2008, interest payable at LIBOR plus 3%, payable quarterly	\$ 178,513	\$ 98,000
9 ½% Senior Subordinated Notes, due April 1, 2012, interest payable semi-annually on April 1 and October 1	300,000	300,000
	<u>478,513</u>	<u>398,000</u>
Sub-total	478,513	398,000
Less current portion	1,799	995
	<u>\$ 476,714</u>	<u>\$ 397,005</u>

In addition to the above, as of September 30, 2003, the Company has a \$75 million five-year revolving credit facility available. No debt is outstanding under this facility at September 30, 2003; however, the Company has issued letters of credit totaling

\$9,990 under this facility to guaranty the Company's payments on future insurance claims.

(14) Significant Events

Due to the nature of its business, the Company is involved from time to time in lawsuits that arise in the ordinary course of business. The Company does not believe that any lawsuit it is a party to, if resolved adversely, would have a material adverse effect on its financial condition or results of operations.

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On April 30, 2003, federal agents served search warrants at the Company's corporate headquarters and four other facilities in three states and were provided access to a number of current and historical financial records and other materials. The Company has also received subpoenas on behalf of the United States Attorney's Office for the Northern District of Illinois relating to the same information including information relating to Medicare billing and VA contracting. The Company is cooperating fully with the investigation; however, it has not been informed by the government of the specific subject matter of the inquiry. The Company can give no assurances as to the duration of the investigation or as to whether or not the government will institute proceedings against the Company or any of its employees or as to the violations that may be asserted. The Company previously received informal requests for information from the Division of Enforcement of the Securities and Exchange Commission related to matters that were the subject of the Company's previously disclosed internal investigation regarding VA contracts, and has already provided documents in response. As a health care provider, the Company is subject to extensive government regulation, including numerous laws directed at preventing fraud and abuse and laws regulating reimbursement under various government programs. The marketing, billing, documentation and other practices of health care companies are all subject to government scrutiny. To ensure compliance with Medicare and other regulations, regional carriers often conduct audits and request patient records and other documents to support claims submitted by the Company for payment of services rendered to patients. Similarly, government agencies periodically open investigations and obtain information from health care providers pursuant to legal process. Violations of federal and state regulations can result in severe criminal, civil and administrative penalties and sanctions, including disqualification from Medicare and other reimbursement programs.

(15) Supplemental Statements of Cash Flow Information

	Predecessor	Successor			
	Three months ended March 31, 2002	Six months ended September 30, 2002	Three months ended September 30, 2002	Three months ended September 30, 2003	Nine months ended September 30, 2003
Cash payments for:					
Interest	\$ 14	\$ 18,416	\$ 15,211	\$ 2,262	\$ 21,161
Income taxes	\$ —	\$ 558	\$ 368	\$ 655	\$ 3,690

Supplemental Schedule of Noncash Investing and Financing Activities

The Company purchased the principal operating assets and assumed certain liabilities of a provider of home health care products and services. In conjunction with this purchase, liabilities were assumed as follows:

Fair value of assets acquired	\$ 8,874
Cash paid for the net assets acquired	(2,000)
Loan and management fees payable to the Company	(6,808)
	<hr/>
Liabilities assumed	\$ 66
	<hr/>

ITEM 2—Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of our financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and the notes thereto included elsewhere in this Quarterly Report on Form 10-Q and our consolidated financial statements for the year-ended December 31, 2002 and the notes thereto included in our Annual Report on Form 10-K previously filed with the Securities and Exchange Commission. As used herein, unless otherwise specified or the context otherwise requires, references to the “Company”, “we”, “our” and “us” refer to the business and operations of Rotech Healthcare Inc. and its subsidiaries for all periods subsequent to March 31, 2002 and to the business and operations of Rotech Medical Corporation and its subsidiaries for all periods prior to April 1, 2002. The tables below include a summary of our unaudited pro forma statement of operations data for the nine months ended September 30, 2002 which combines the results of operations of our Predecessor for the three months ended March 31, 2002 and our results of operations, as Successor, for the six months ended September 30, 2002. The pro forma financial data do not purport to be indicative of our operating results.

The following table shows the results of operations for the Predecessor for the three months ended March 31, 2002, and for the Company for the three months ended September 30, 2002 and September 30, 2003, the six months ended September 30, 2002, the nine months ended September 30, 2003, and the combined results for the Predecessor and the Successor for the nine months ended September 30, 2002.

	Successor		Predecessor	Successor	Proforma Combined	Successor
	Three months ended September 30, 2002	Three month ended September 30, 2003	Three months ended March 31, 2002	Six months ended September 30, 2002	Nine months ended September 30, 2002	Nine months ended September 30, 2003
Net revenues	\$ 153,140	\$ 142,353	\$ 154,750	\$ 308,133	\$ 462,883	\$ 440,637
Cost of net revenues:						
Product and supply costs	22,416	17,378	22,513	45,557	68,070	57,730
Patient service equipment depreciation	12,873	28,188	12,147	25,736	37,883	85,423
Total cost of net revenues	35,289	45,566	34,660	71,293	105,953	143,153
Gross profit	117,851	96,787	120,090	236,840	356,930	297,484
Costs and expenses:						
Provision for doubtful accounts	4,596	4,368	3,661	8,407	12,068	14,305
Selling, distribution and administrative	94,872	77,420	88,099	184,792	272,891	250,432
Interest (income) expense, net	10,745	9,786	(17)	22,468	22,451	29,479
Total costs and expenses	110,213	91,574	91,743	215,667	307,410	294,216
Earnings before reorganization items, income taxes, extraordinary items and cumulative effect of a change in accounting principle	7,638	5,213	28,347	21,173	49,520	3,268
Reorganization items	250	—	182,291	1,494	183,785	—
(Loss) earnings before income taxes and extraordinary items and cumulative effect of a change in accounting principle	7,388	5,213	(153,944)	19,679	(134,265)	3,268
Federal and state income tax (benefit) expense	2,955	2,341	(203)	7,871	7,668	1,515
(Loss) earnings before extraordinary items and cumulative effect of a change in accounting principle	4,433	2,872	(153,741)	11,808	(141,933)	1,753
Cumulative effect of a change in accounting principle for mandatorily redeemable financial instruments	—	30	—	—	—	30

Extraordinary gain on debt discharge	—	—	20,441	—	20,441	—
Net (loss) earnings	\$ 4,433	\$ 2,842	\$ (133,300)	\$ 11,808	\$ (121,492)	\$ 1,723

The following table shows the results of operations for the Company as a percentage of its net revenues for the three months ended September 30, 2002 and 2003, the nine months ended September 30, 2003, and the combined results for the Predecessor and the Successor for the nine months ended September 30, 2002.

	Successor		Proforma Combined	Successor
	Three months ended September 30, 2002	Three months ended September 30, 2003	Nine months ended September 30, 2002	Nine months ended September 30, 2003
Net revenues	100%	100%	100%	100%
Cost of net revenues:				
Product and supply costs	14.6%	12.2%	14.7%	13.1%
Patient service equipment depreciation	8.4%	19.8%	8.2%	19.4%
Total cost of net revenues	23.0%	32.0%	22.9%	32.5%
Gross profit	77.0%	68.0%	77.1%	67.5%
Costs and expenses:				
Provision for doubtful accounts	3.0%	3.1%	2.6%	3.2%
Selling, distribution and administrative	62.0%	54.4%	59.0%	56.8%
Interest expense, net	7.0%	6.9%	4.9%	6.7%
Total costs and expenses	72.0%	64.3%	66.4%	66.8%
Earnings before reorganization items, income taxes, extraordinary items and cumulative effect of a change in accounting principle	5.0%	3.7%	10.7%	0.7%
Reorganization items	0.2%	0.0%	39.7%	0.0%
(Loss) earnings before income taxes and extraordinary items and cumulative effect of a change in accounting principle	4.8%	3.7%	(29.0)%	0.7%
Federal and state income tax expense	1.9%	1.6%	1.7%	0.3%
(Loss) earnings before extraordinary items and cumulative effect of a change in accounting principle	2.9%	2.0%	(30.7)%	0.4%
Cumulative effect of a change in accounting principle for mandatorily redeemable financial instruments	0.0%	0.0%	0.0%	0.0%
Extraordinary gain on debt discharge	0.0%	0.0%	4.4%	0.0%
Net (loss) earnings	2.9%	2.0%	(26.2)%	0.4%

Results of Operations

Three months ended September 30, 2003 as compared to the three months ended September 30, 2002

Total net revenues for the three months ended September 30, 2003 were \$142.4 million as compared to \$153.1 million for the comparable period in 2002. The decrease in revenue is consistent with the previously announced plan of exiting product lines, business units, and contracts that are inconsistent with the Company's profit objectives. In addition, some revenues have been lost as a result of significant employee turnover within the sales force.

Cost of net revenues for the three months ended September 30, 2003 increased \$10.3 million, or 29.1%, to \$45.6 million, from the comparable period in 2002. The increased cost of revenues resulted primarily from an increase in our patient service equipment depreciation costs. During the three month period ended June 30, 2003, we completed an assessment of the depreciation estimates previously made on April 1, 2002 related to long lived assets acquired from our Predecessor. Based on information then available, we have revised our depreciation policy for these assets from an aggregate of four years from the date acquired from our Predecessor, to depreciating the assets over a period ending five years from the date the assets were originally acquired by our Predecessor. The

revised estimates on depreciable lives for approximately \$138 million of rental property was necessary to more closely match the replacement rates of rental property acquired with its specific remaining useful life. As a result of that change in depreciation estimate, we recognized approximately \$12.6 million in additional depreciation expense for the three months ended September 30, 2003. This increase in patient service depreciation costs was offset by a decline in our product and supply costs, which is attributable to the change in the revenue composition from lower gross margin durable medical equipment to respiratory therapy equipment and services. Cost of net revenues as a percentage of net revenue was 32.0% for the three months ended September 30, 2003 as compared to 23.0% for the comparable period in 2002.

The provision for doubtful accounts for the three months ended September 30, 2003 decreased by \$0.2 million, or 5.0%, from the comparable period in 2002. The provision for doubtful accounts as a percentage of net revenue increased to 3.1% for the three months ended September 30, 2003 as compared to 3.0% for the same period in 2002.

Selling, distribution and administrative expenses for the three months ended September 30, 2003 decreased by \$17.5 million, or 18.4%, to \$77.4 million, from the comparable period in 2002. This decrease in selling, distribution and administrative expenses resulted primarily from reduced costs for salaries and benefits which was accomplished through a reduction in our employee head count. Selling, distribution and administrative expenses as a percentage of net revenues decreased to 54.4% for the three months ended September 30, 2003 from 62.0% for the three months ended September 30, 2002.

Interest expense for the three months ended September 30, 2003 decreased \$1.0 million from the comparable period in 2002. The decrease is primarily attributable to the repayment of approximately \$96 million of long-term bank debt in the past twelve months.

No reorganization items related to our Predecessor's bankruptcy were incurred for the three months ended September 30, 2003, as compared to \$0.3 million of such reorganization items incurred during the comparable period in 2002. The reorganization items incurred for the three months ended September 30, 2002 consisted of compensation and other charges.

Federal and state income taxes for the three months ended September 30, 2003 decreased \$0.6 million from the comparable period in 2002 to an expense of \$2.3 million. The decrease in federal and state income taxes was primarily due to decreased taxable income for the three month period ended September 30, 2003.

Net earnings were \$2.8 million for the three months ended September 30, 2003 as compared to net earnings of \$4.4 million for the same period in 2002. The decrease in the current period resulted primarily from the additional \$12.6 million of depreciation expense that was recognized in the current period as a result of a change in estimate during the quarter ended June 30, 2003.

For the three months ended September 30, 2003, earnings from continuing operations before interest, income taxes, depreciation and amortization (EBITDA) was \$46.6 million as compared to \$33.2 million for the three months ended September 30, 2002. Set forth below is a comparable reconciliation of the Company's net earnings to EBITDA:

Comparable Reconciliation of Net Earnings to EBITDA

	Three Months Ended September 30,	
	2002	2003
Net earnings	\$ 4,433	\$ 2,842
Cumulative effect of a change in accounting principle	—	30
Income tax expense	2,955	2,341
Interest expense, net	10,745	9,786
Depreciation & amortization	15,087	31,579
EBITDA	\$33,220	\$46,578

The Company views EBITDA as a commonly used analytic indicator within the health care industry, which management believes serves as a measure of leverage capacity and debt service ability. This performance measure should not be considered as a measure of financial performance under generally accepted accounting principles, and the items excluded from this benchmark are significant components in understanding and assessing financial performance. EBITDA should not be considered in isolation or as an alternative to net income, cash flows generated by operating, investing or financing activities or other financial statement data presented in the condensed consolidated financial statements as an indicator of financial performance or liquidity. Because EBITDA is not a measurement determined in accordance with generally accepted accounting principles and is thus susceptible to varying calculations, the benchmarks as presented may not be comparable to other similarly titled measures of other companies.

Results of Operations

Nine months ended September 30, 2003 as compared to the nine months ended September 30, 2002

Total net revenues for the nine months ended September 30, 2003 were \$440.6 million as compared to \$462.9 million for the comparable period in 2002. The decrease in revenue is consistent with the previously announced plan of exiting product lines, business units, and contracts that are inconsistent with the Company's profit objectives. In addition, some revenues have been lost as a result of significant employee turnover within the sales force.

Cost of net revenues for the nine months ended September 30, 2003 increased \$37.2 million, or 35.1%, to \$143.2 million, from the comparable period in 2002. The increased cost of revenues resulted primarily from an increase in our patient service equipment depreciation costs. During the three months ended June 30, 2003, we completed an assessment of the depreciation estimates previously made on April 1, 2002 related to long lived assets acquired from our Predecessor. Based on information then available, we have revised our depreciation policy for these assets from an aggregate of four years from the date acquired from our Predecessor, to depreciating the assets over a period ending five years from the date the assets were originally acquired by our Predecessor. The revised estimates on depreciable lives for approximately \$138 million of rental property was necessary to more closely match the replacement rates of rental property acquired with its specific remaining useful life. As a result of that change in depreciation estimate, we recognized approximately \$40.4 million in additional depreciation expense. This increase in patient service depreciation costs was offset by a decline in our product and supply costs, which is attributable to the change in the revenue composition from lower gross margin durable medical equipment to respiratory therapy equipment and services. Cost of net revenues as a percentage of net revenue was 32.5% for the nine months ended September 30, 2003 as compared to 22.9% for the comparable period in 2002.

The provision for doubtful accounts for the nine months ended September 30, 2003 increased by \$2.2 million, or 18.5%, from the comparable period in 2002. The provision for doubtful accounts expense as a percentage of net revenue increased to 3.2% for the nine months ended September 30, 2003 as compared to 2.6% for the same period in 2002.

Selling, distribution and administrative expenses for the nine months ended September 30, 2003 decreased by \$22.5 million, or 8.2%, to \$250.4 million, from the comparable period in 2002. This decrease in selling, distribution and administrative expenses resulted primarily from reduced costs for salaries and benefits, which was accomplished through a reduction in our employee head count. This decline in salaries and benefits was offset by charges for location closures and severance, which were related to our continuing efforts to consolidate various operating units and billing centers. Selling, distribution and administrative expenses as a percentage of net revenues decreased to 56.8% for the nine months ended September 30, 2003 from 59.0% for the nine months ended September 30, 2002.

Interest expense for the nine months ended September 30, 2003 increased \$7.0 million from the comparable period in 2002. The increase is primarily attributable to interest costs incurred on the \$200 million senior secured term loan outstanding under our senior secured credit facilities and on the \$300 million of our 9½% Senior Subordinated Notes due 2012 issued in connection with our Predecessor's emergence from bankruptcy in March of 2002.

No reorganization expenses related to our Predecessor's bankruptcy were incurred for the nine months ended September 30, 2003, as compared to \$183.8 million of such reorganization items incurred during the comparable period in 2002. The majority of reorganization items incurred for the nine months ended September 30, 2002 resulted from our adoption of fresh-start reporting, effective March 31, 2002.

Federal and state income taxes for the nine months ended September 30, 2003 decreased \$6.2 million from the comparable period in 2002 to an expense of \$1.5 million. The decrease in federal and state income taxes is primarily due to the change in depreciation estimate and the resulting additional depreciation during the nine months ended September 30, 2003.

Net earnings were \$1.7 million for the nine months ended September 30, 2003 as compared to a net loss of \$121.5 million for the same period in 2002. The large loss in the prior period resulted from the \$183.8 million of reorganization items, the majority of which related to the fresh-start reporting adjustments recorded by our Predecessor.

For the nine months ended September 30, 2003, EBITDA was \$127.5 million as compared to (\$45.6) million for the nine months ended September 30, 2002. EBITDA for the nine months ended September 30, 2002, includes \$163.3 million of charges consisting of

costs associated with the reorganization, the extraordinary gain on debt discharge and inventory losses related to the previously disclosed instance of falsified bulk sales to the Veterans Administration (“VA”). Set forth below is a comparable reconciliation of the Company’s net (loss) earnings to EBITDA:

Comparable Reconciliation of Net(loss) Earnings to EBITDA

	Nine months ended September 30,	
	2002	2003
Net (loss) earnings	\$(121,492)	\$ 1,723
Cumulative effect of change in accounting principle	—	30
Income tax expense	7,668	1,515
Interest expense, net	22,451	29,479
Depreciation & amortization	45,809	94,745
EBITDA	\$ (45,564)	\$127,492

The Company views earnings from continuing operations before interest, income taxes, depreciation and amortization (EBITDA) as a commonly used analytic indicator within the health care industry, which management believes serves as a measure of leverage capacity and debt service ability. This performance measure should not be considered as a measure of financial performance under generally accepted accounting principles, and the items excluded from this benchmark are significant components in understanding and assessing financial performance. EBITDA should not be considered in isolation or as an alternative to net income, cash flows generated by operating, investing or financing activities or other financial statement data presented in the condensed consolidated financial statements as an indicator of financial performance or liquidity. Because EBITDA is not a measurement determined in accordance with generally accepted accounting principles and is thus susceptible to varying calculations, the benchmarks as presented may not be comparable to other similarly titled measures of other companies.

Inflation and Seasonality

Management believes that there was no material effect on operations or the financial condition of the Company as a result of inflation for the three months ended September 30, 2002 and 2003. Management also believes that its business is not seasonal.

Liquidity and capital resources

Net cash provided by operating activities and reorganization items was \$101.1 million for the nine months ended September 30, 2003, as compared to \$81.7 million for the same period in 2002. Cash flows in both periods were sufficient to fund capital expenditures and required repayments of debt.

Accounts receivable before allowance for doubtful accounts decreased \$18.8 million from \$131.4 million at December 31, 2002 to \$112.6 million at September 30, 2003. Accounts receivable decreased as a result of continued strong cash collections combined with a decline in sales for the period. Days sales outstanding (calculated as of each period end by dividing accounts receivable, less allowance for doubtful accounts, by the 90-day rolling average of net revenue) were 57 days at September 30, 2003 compared to 56 days at December 31, 2002.

Included in accounts receivable are earned but unbilled receivables of \$20.1 million at September 30, 2003 and \$18.4 million at December 31, 2002. Delays, ranging from a day to several weeks, between the date of service and billing can occur due to delays in obtaining certain required payor-specific documentation from internal and external sources. Earned but unbilled receivables are aged from date of service and are considered in our analysis of historical performance and collectibility.

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

Management performs analyses to evaluate the net realizable value of accounts receivable. Specifically, management considers historical realization data, accounts receivable aging trends, other operating trends and relevant business conditions. Because of continuing changes in the health care industry and third-party reimbursement, it is possible that management’s estimates could change, which could have an impact on operations and cash flows.

Inventories decreased \$11.8 million from \$21.4 million at December 31, 2002 to \$9.6 million at September 30, 2003. The decrease resulted primarily from our efforts to reduce inventory levels that had grown as a result of the previously disclosed instance of

falsified bulk sales to the VA.

Net cash used in investing activities was \$31.2 million for the nine months ended September 30, 2003 as compared to \$56.5 million for the nine months ended September 30, 2002. Activity in the nine months ended September 30, 2003 included investment in capital equipment of \$32.7 million. In addition we entered into an asset purchase agreement with a provider of home health care products and services to acquire its principal operating assets and certain of its liabilities (including a loan and outstanding management fees owed to us, which were a component of other assets at December 31, 2002) for a cash purchase price of up to \$5.0 million. We paid \$2.0 million in cash, with the remaining cash purchase price to be paid to the sellers based upon an earn-out provision in the asset purchase agreement relating to such acquisition.

Cash flows from financing activities primarily relate to our Predecessor's emergence from bankruptcy, which was reflected in the three months ended March 31, 2002. In March 2002, we entered into:

- A five-year \$75 million senior secured revolving credit facility that will constitute a working capital facility for general corporate purposes including working capital, capital expenditures and acquisitions. Interest is payable based upon a consolidated leverage ratio grid with an option of a margin plus the Eurodollar rate or a margin plus a Base prime rate. The range of margin rates based on the Eurodollar rate is 3.25% to 2.25%. The range of margin rates based on the prime rate is 2.25% to 1.25%.
- A six-year \$200 million senior secured term loan, the proceeds of which were used to repay certain pre-petition claims owed to our Predecessor's creditors as part of its plan of reorganization. The term loan is repayable in an aggregate annual amount equal to 1% of the principal amount each year for the first five years with the balance due in year six. Interest is payable based on the election of either the Eurodollar rate plus 3.00% or the Base prime rate plus 2.00%.
- 9½% Senior Subordinated Notes due 2012 in an aggregate principal amount of \$300 million, the proceeds of which were used to repay certain pre-petition claims owed to our Predecessor's creditors as part of its plan of reorganization. The notes mature on April 1, 2012. Interest of 9½% is payable semi-annually in arrears on April 1 and October 1 of each year.

Borrowings under the revolving credit facility and term loan are secured by substantially all of our assets and the agreements impose numerous restrictions, including, but not limited to, covenants requiring the maintenance of certain financial ratios, limitations on additional borrowing, capital expenditures, acquisitions and investments. As of September 30, 2003, we are in compliance with such covenants.

Accrued interest on our borrowings was \$10.3 million and \$17.2 million at December 31, 2002 and September 30, 2003. During the nine months ended September 30, 2003, we made our regularly scheduled amortization payments with respect to the term loan in the aggregate amount of approximately \$1.3 million and made voluntary prepayments of principal on the term loan in the amount of approximately \$79.2 million. At September 30, 2003, the outstanding balance on our term loan was \$98.0 million, which bore interest at the rate of 4.2% per annum.

Upon our Predecessor's emergence from bankruptcy, settlement agreements that it had entered into with IHS and with the United States Government became effective. Pursuant to the settlement agreement with IHS, our Predecessor and IHS have fully and finally satisfied the claims they have against each other by an allocation of \$40 million in cash and a \$5 million promissory note and the remainder of the cash on hand (approximately \$40 million) was retained by IHS. Pursuant to the terms of the settlement agreement with the United States Government, our Predecessor paid to the federal government \$17 million in cash, in full settlement and satisfaction of its claims against our Predecessor and us for the conduct covered in the agreement.

Our working capital requirements relate primarily to the working capital needed for general corporate purposes and our desire to grow through internal growth supplemented by selective acquisitions primarily in non-urban markets. We have historically satisfied our working capital requirements and capital expenditures from operating cash flow, except with respect to acquisitions by our Predecessor during the time it was a subsidiary of IHS, which were principally funded by IHS.

We currently have no commitments for capital expenditures over the next twelve months other than to acquire equipment as needed to supply our patients. Our business requires us to make significant capital expenditures relating to the purchase and maintenance of the medical equipment used in our business. In the nine month periods ended September 30, 2002 and September 30, 2003, our capital expenditures were \$46.3 million and \$32.7 million, respectively, representing 10.0% and 7.4% of our net revenues for each period, respectively. We believe that the cash generated from our operations, together with amounts available under our \$75 million revolving credit facility, will be sufficient to meet our working capital, capital expenditure and other cash needs for the foreseeable future.

The Company's capital and debt structure was determined when it emerged from bankruptcy in March 2002. The Company expects to review its capital and debt structure during 2004. This review may include, but not be limited to, consideration of a secondary stock offering, a stock exchange listing, and a restructuring of our debt. The Company has no present plans to take any of such actions and any decisions will necessarily depend upon many factors.

Critical accounting policies

The preparation of our financial statements in accordance with accounting principles generally accepted in the United States of America requires us to make assumptions that affect the reported amounts of assets, liabilities and disclosure of contingencies as of the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting periods. Critical accounting policies are those that require the most complex or subjective judgments often as a result of the need to make estimates about the effects of matters that are inherently uncertain. Thus, to the extent that actual events differ from our estimates and assumptions, there could be a material impact to our financial statements. We believe that the critical accounting policies for the Company are those related to revenue recognition, accounts receivable, goodwill and other identifiable intangible assets.

The below listing is not intended to be a comprehensive list of all our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by generally accepted accounting principles with limited or no need for management's judgment. There are also areas in which management's judgment in selecting available alternatives may or may not produce a materially different result. For more information, see our audited consolidated financial statements and notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2002.

Revenue Recognition and Accounts Receivable

Revenues are recognized when services and related products are provided to patients and are recorded at amounts estimated to be received under reimbursement arrangements with third-party payors. Revenues derived from capitation arrangements are insignificant.

Our rental arrangements generally provide for fixed monthly payments established by fee schedules (subject to capped rentals in some instances) for as long as the patient is using the equipment and medical necessity continues. Once initial delivery is made to the patient ("initial setup"), a monthly billing is established based on the initial setup service date. No separate revenue is earned from the initial setup process. We have no lease with the patient or third-party payor, no continuing service obligation (other than oxygen refills and servicing equipment based on manufacturers' recommendations) after the initial setup, and no refund obligation for the return of equipment after the monthly billing date. At each month end, we defer revenue for the balance of the remaining portion of the thirty day rental period.

Revenues for the sale of durable medical equipment and related supplies, including oxygen equipment, ventilators, wheelchairs, hospital beds and infusion pumps, are recognized at the time of delivery. Revenues for the sale of nebulizer medications, which are generally dispensed by our pharmacies and shipped directly to the patient's home, are recognized at the time of shipment.

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

Management performs analyses to evaluate the net realizable value of accounts receivable. Specifically, management considers historical realization data, accounts receivable aging trends, other operating trends and relevant business conditions. Because of continuing changes in the healthcare industry and third-party reimbursement, it is possible that management's estimates could change, which could have an impact on operations and cash flows.

Asset lives and depreciation methods:

The Company's primary business involves the purchase and subsequent lease of long-lived patient service equipment. Management has chosen asset lives that it believes correspond to the economic life of the related asset. Management has chosen a depreciation method that it believes matches the benefit to the Company from the asset with the associated costs. These judgments have been made based on Management's expertise and historical results in the industry in which the Company operates. If the asset life and depreciation method chosen do not reduce the book value of the asset to at least the potential future cash flows from the asset to the Company, the Company would be required to record an impairment loss. Likewise, if the net book value of the asset was reduced by an amount greater than the economic value has deteriorated, the Company may record a gain on sale upon final disposition of the asset.

Reorganization Value in Excess of Value of Identifiable Assets—Goodwill and Identifiable Intangible Assets

Reorganization value in excess of value of identifiable assets—goodwill, represents the portion of our reorganization value at March 31, 2002 that could not be attributable to specific tangible or identifiable intangible assets recorded in connection with the implementation of fresh-start reporting.

Goodwill and identifiable intangible assets prior to March 31, 2002, represent the excess of cost over the fair value of assets acquired and liabilities assumed in business combinations. Prior to January 1, 2002, such assets were amortized on a straight-line basis over an estimated life of approximately 20 years.

Effective January 1, 2002, we adopted the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually in accordance with the provisions of SFAS No. 142. Management has determined that branch locations have similar economic characteristics and should be aggregated into one reporting unit for assessing fair value. If the carrying amount of the goodwill and intangible asset exceeds its fair value, an impairment loss is recognized. Fair values for goodwill and intangible assets are determined based upon discounted cash flows, market multiples or appraised values as appropriate. As a result of adopting SFAS No. 142, goodwill and a portion of our identifiable intangible assets are no longer amortized.

Contingencies

Our business is subject to extensive laws and government regulations, including those related to the Medicare and Medicaid programs. We are also subject to a Corporate Integrity Agreement with the Department of Health and Human Services. Non-compliance with such laws and regulations or the Corporate Integrity Agreement could subject us to severe sanctions, including penalties and fines.

In 1999, we recorded a provision of \$15 million based on a preliminary evaluation of the government's estimated claims against us arising from Medicare payments made to certain of our operating centers. We revised this estimate and recorded an additional provision of \$2 million in 2001. Legal costs incurred in connection with the government claims were approximately \$2 million in 2000 and \$0.5 million in 2001.

In February 2002, we settled all outstanding government litigation and pre-petition and certain post-petition claims arising from Medicare payments made to certain of our operating centers as well as claims in unliquidated amounts for a cash settlement of \$17 million.

SFAS No. 5, *Accounting for Contingencies*, provides guidance on the application of generally accepted accounting principles related to these matters. We evaluate and record liabilities for contingencies based on known claims and legal actions when it is probable a liability has been incurred and the liability can be reasonably estimated. We believe that our accrued liabilities related to such contingencies are appropriate and in accordance with generally accepted accounting principles.

Forward-Looking Statements

This report contains certain statements that constitute forward-looking statements. These forward-looking statements include all statements regarding the intent, belief or current expectations regarding the matters discussed in this report (including statements as to "beliefs," "expectations," "anticipations," "intentions" or similar words) and all statements which are not statements of historical fact.

These forward-looking statements involve known and unknown risks, uncertainties, contingencies and other factors that could cause results, performance or achievements to differ materially from those stated in this report. The following are some but not all of such risks, uncertainties, contingencies, assumptions and other factors, many of which are beyond our control, that could cause results, performance or achievements to differ materially from those anticipated: general economic, financial and business conditions; issues relating to reimbursement by government and third party payors for our products and services; the costs associated with government regulation of the health care industry; the effects of competition and industry consolidation; and the costs and effects of legal proceedings. Readers should refer to the discussion under "Factors that may affect future results of operations" contained in our Annual Report on Form 10-K for the year ended December 31, 2002 for a description of additional risks and uncertainties. Should one or more of these risks or uncertainties materialize or should underlying assumptions prove incorrect, our actual results, performance or achievements could differ materially from those expressed in, or implied by, such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date thereof. When you consider these forward-looking statements, you should keep in mind these risk factors and other cautionary statements. We do not undertake any obligation to publicly release any revisions to these forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

ITEM 3—Quantitative and Qualitative Disclosures about Market Risk

In March 2002, we entered into (i) a five-year \$75 million senior secured revolving credit facility and (ii) a six-year \$200 million senior secured term loan. Our earnings may be affected by changes in interest rates relating to these debt facilities. Variable interest rates may rise, which could increase the amount of interest expense. We did not incur any interest expense in the three month period ended March 31, 2002. In March 2002, we borrowed the entire amount of the \$200 million term loan and transferred the proceeds of that loan to our Predecessor to fund a portion of the cash distributions made by our Predecessor in connection with its plan of reorganization. As of September 30, 2003, the \$75 million senior secured revolving credit facility had not been drawn upon, although standby letters of credit totaling approximately \$10.0 million have been issued under this credit facility. Assuming a hypothetical increase of one percentage point for the variable interest rate applicable to the \$200 million term loan (of which \$98.0 million is outstanding as of September 30, 2003), we would incur approximately \$1.5 million in additional interest expense for the period January 1, 2003 through December 31, 2003.

ITEM 4—Controls and Procedures

Disclosure Controls and Procedures

Our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, (the "Exchange Act")) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on such evaluation, our principal executive officer and principal financial officer have concluded, as of the end of such period, that our disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in our reports that we file or submit under the Exchange Act.

Internal Control Over Financial Reporting

We evaluate our internal control over financial reporting on a regular basis. If we identify a problem in our internal control over financial reporting during the course of our evaluations, we consider what revision, improvement and/or correction to make in order to ensure that our internal controls are effective. We are currently in the process of enhancing our internal controls to address issues identified through these evaluations, including the implementation of a multi-tiered reporting structure pursuant to which our regional managers are required to report material events to our division managers who are, in turn, required to report such events to senior management at our corporate headquarters. We anticipate that implementation of these enhancements may continue through the end of the year. Pending full implementation of these enhancements, we have instituted additional procedures and policies to preserve our ability to accurately record, process and summarize financial data and prepare financial statements for external purposes that fairly present our financial condition, results of operations and cash flows. Our principal executive and financial officers recognize that any set of controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. We intend to continue to refine our internal control over financial reporting on an ongoing basis as we deem appropriate with a view towards making improvements.

We have made no other changes during the fiscal quarter covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II—OTHER INFORMATION

ITEM 1—Legal Proceedings

Due to the nature of our business, we are involved from time to time in lawsuits that arise in the ordinary course of our business. We do not believe that any lawsuit that we are a party to, if resolved adversely, would have a material adverse effect on our financial condition or results of operations.

On April 30, 2003, federal agents served search warrants at our corporate headquarters and four other facilities in three states and were provided access to a number of current and historical financial records and other materials. The Company has also received subpoenas on behalf of the United States Attorney's Office for the Northern District of Illinois relating to the same information including information relating to Medicare billing and VA contracting. We are cooperating fully with the investigation; however, we have not been informed by the government of the specific subject matter of the inquiry. We can give no assurances as to the duration of the investigation or as to whether or not the government will institute proceedings against us or any of our employees or as to the violations that may be asserted. We previously received informal requests for information from the Division of Enforcement of the Securities and Exchange Commission related to matters that were the subject of our previously disclosed internal investigation regarding VA contracts, and have already provided documents in response. As a health care provider, we are subject to extensive government regulation, including numerous laws directed at preventing fraud and abuse and laws regulating reimbursement under various government programs. The marketing, billing, documentation and other practices of health care companies are all subject to government scrutiny. To ensure compliance with Medicare and other regulations, regional carriers often conduct audits and request

patient records and other documents to support claims submitted by us for payment of services rendered to patients. Similarly, government agencies periodically open investigations and obtain information from health care providers pursuant to legal process. Violations of federal and state regulations can result in severe criminal, civil and administrative penalties and sanctions, including disqualification from Medicare and other reimbursement programs.

ITEM 2—Changes in Securities and Use of Proceeds

Not applicable.

ITEM 3—Defaults upon Senior Securities

Not applicable.

ITEM 4—Submission of Matters to Vote of Security Holders

Not applicable.

ITEM 5—Other Information

Effective as of August 26, 2003, we amended our common stock option plan to provide for one hundred percent (100%) vesting of all options issued under our stock option plan upon a “change in control” (as defined in the stock option plan). A copy of the amendment to the stock option plan is attached hereto as Exhibit 4.1.

ITEM 6—Exhibits and Reports on Form 8-K

(a) Exhibits:

- 4.1 Amendment No. 2 to the Rotech Healthcare Inc. Common Stock Option Plan.
- 12.1 Ratio of Earnings to Fixed Charges.
- 31.1 Certification of principal executive officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of principal financial officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K:

On July 22, 2003, the Company furnished a Current Report on Form 8-K, dated July 22, 2003, disclosing under Item 9 and Item 12 in accordance with guidance provided by Securities and Exchange Commission its financial results for the quarter ended June 30, 2003.

On October 24, 2003, the Company furnished a Current Report on Form 8-K, dated October 23, 2003, disclosing under Item 12 its financial results for the quarter ended September 30, 2003.

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.

ROTECH HEALTHCARE INC.

Dated: November 14, 2003

By: /s/ PHILIP L. CARTER

Philip L. Carter
President and Chief Executive Officer

Dated: November 14, 2003

By: /s/ JANET L. ZIOMEK

Janet L. Ziomek
Chief Financial Officer

EXHIBIT INDEX

Exhibit No.	Description
4.1	Amendment No. 2 to the Rotech Healthcare Inc. Common Stock Option Plan.
12.1	Ratio of Earnings to Fixed Charges.
31.1	Certification of principal executive officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of principal financial officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Exhibit 4.1

**AMENDMENT NO. 2 TO THE
ROTECH HEALTHCARE INC.
COMMON STOCK OPTION PLAN**

WHEREAS, Rotech Healthcare Inc. (the “Company”) has established and maintains the Rotech Healthcare Inc. Common Stock Option Plan (the “Plan”); and

WHEREAS, pursuant to Section 7(b) of the Plan, the Company’s Board of Directors (the “Board”) may at any time amend the Plan, subject to certain limitations;

WHEREAS, the Board deems it to be in the best interests of the Company to amend the Plan to provide for one hundred percent (100%) vesting of all options outstanding upon a Change in Control (as defined in the Plan);

WHEREAS, on June 24, 2003, the Board approved such amendment to the Plan;

WHEREAS, for purposes of clarification the Board deems it to be in the best interests of the Company to amend the Plan to provide that the Plan will be administered by the Board or a committee thereof;

WHEREAS, on August 26, 2003, the Board approved such amendment to the Plan; and

NOW, THEREFORE, the Plan is hereby amended, effective as of August 26, 2003 as follows:

FIRST: Section 5(a)(iv)(b) of the Plan is hereby amended to read in its entirety as follows:

“(b) one hundred percent (100%) of the Shares under such Option upon a Change in Control, and “

SECOND: The first sentence of Section 6 of the Plan is hereby amended to read in its entirety as follows:

“The Plan shall be administered by the Board or a committee thereof appointed by the Board.”

THIRD: Except to the extent hereinabove set forth, the Plan shall remain in full force and effect without change or modification.

IN WITNESS WHEREOF, and as evidence of the adoption of the foregoing, the Company has caused this Amendment No. 2 to be executed by a duly authorized officer this 26th day of August 26, 2003.

ROTECH HEALTHCARE INC.

By: _____

Name: _____

Title: _____

Exhibit 12.1

Ratio of Earnings to Fixed Charges
Rotech Healthcare Inc.

	Predecessor Company					Successor Company				
	Year ended December 31,					Three months ended September 30, 2002	Nine months ended December 31, 2002	Three months ended September 30, 2003	Nine months ended September 30, 2003	
	1998	1999	2000	2001	Three months ended March 31, 2002					
Ratio of Earnings to Fixed Charges										
Pretax income (loss) from continuing operations	\$112,754	\$71,151	\$ 3,314	\$40,030	\$ (153,944)	\$ 7,388	\$ 24,775	\$ 5,213	\$ 3,268	
Add fixed charges	6,589	8,363	8,251	7,832	1,900	13,072	40,333	11,790	36,311	
Total Earnings (Loss) (A)	\$119,343	\$79,514	\$11,565	\$47,862	\$ (152,044)	\$ 20,460	\$ 65,108	\$ 16,823	\$ 39,579	
Interest Expense	\$ 221	\$ 490	\$ 108	\$ 74	\$ 14	\$ 10,745	\$ 33,556	\$ 9,966	\$ 30,167	
Estimate of the interest within rental expense (33% of total)	6,368	7,873	8,143	7,758	1,886	2,327	6,777	1,824	6,144	
Total Fixed Charges (B)	\$ 6,589	\$ 8,363	\$ 8,251	\$ 7,832	\$ 1,900	\$ 13,072	\$ 40,333	\$ 11,790	\$ 36,311	
Ratio (A/B)	18.11x	9.51x	1.40x	6.11x	(80.03)x(1)	1.57x	1.61x	1.44x	1.09x	

(1) The dollar amount of the deficiency for the three months ended March 31, 2002 was \$153,944. Such amount includes approximately \$153,197 of reorganization expense to write-down the Predecessor's assets to fair market value.

Exhibit 31.1**CERTIFICATION**

I, Philip L. Carter, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Rotech Healthcare Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation;

c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2003

/s/ PHILIP L. CARTER

Philip L. Carter
President and Chief Executive Officer

Exhibit 31.2**CERTIFICATION**

I, Janet L. Ziomek, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Rotech Healthcare Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation;

(c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2003

/s/ JANET L. ZIOMEK

Janet L. Ziomek
Chief Financial Officer

Exhibit 32.1

**Certification Pursuant to
18 U.S.C. Section 1350,
As Adopted Pursuant to
Section 906 of the Sarbanes-Oxley Act of 2002**

In connection with the Quarterly Report on Form 10-Q of Rotech Healthcare Inc. (the "Company") for the quarterly period ended September 30, 2003 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Philip L. Carter, as President and Chief Executive Officer of the Company, and Janet L. Ziomek, as Chief Financial Officer of the Company, each hereby certifies, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that, to the best of each such officer's knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ PHILIP L. CARTER

Name: **Philip L. Carter**
Title: **President and Chief Executive Officer**
Date: **November 14, 2003**

/s/ JANET L. ZIOMEK

Name: **Janet L. Ziomek**
Title: **Chief Financial Officer**
Date: **November 14, 2003**

This certification accompanies the Report pursuant to Section 906 of the Sarbanes-Oxley of 2002 and shall not, except to extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

A signed original of this written statement required by Section 906 of the Sarbanes-Oxley Act of 2002 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.