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**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

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**FORM 10-Q**

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

For The Quarterly Period Ended June 30, 2004

Commission File Number 333-100750

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**ROTECH HEALTHCARE INC.**

(Exact Name of Registrant as Specified in Its Charter)

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**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)

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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 August 16, 2004, the registrant had 25,192,058 shares of common stock outstanding.

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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)

	<u>June 30, 2004</u>	<u>December 31, 2003</u>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 39,764	\$ 20,980
Accounts receivable, net	78,799	81,862
Other accounts receivable	823	892
Inventories	8,234	7,989
Prepaid expenses	4,207	4,328
Income taxes receivable	—	2,531
Deferred tax asset	12,721	12,721
	<u>144,548</u>	<u>131,303</u>
Property and equipment, net	135,349	150,752
Identifiable intangible assets, net	17,102	17,684
Other goodwill	11,256	11,256
Reorganization value in excess of value of identifiable assets—goodwill	668,347	668,347
Other assets	12,725	13,941
	<u>\$989,327</u>	<u>\$ 993,283</u>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 14,750	\$ 16,652
Accrued expenses	18,851	27,034
Accrued interest	9,085	9,873
Deferred revenue	13,568	13,768
Income taxes payable	11,119	—
Current portion of long-term debt	439	692
	<u>67,812</u>	<u>68,019</u>
Deferred tax liabilities	25,905	25,905
Priority tax claim	7,091	8,352
Long-term debt, less current portion	342,451	367,308
Series A Convertible Redeemable Preferred Stock	6,377	6,101
Stockholders' equity:		
Common stock	3	3
Additional paid-in capital	498,543	495,881
Retained earnings	41,145	21,714
	<u>539,691</u>	<u>517,598</u>
	<u>\$989,327</u>	<u>\$ 993,283</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)

	Three months ended June 30,		Six months ended June 30,	
	2004	2003 (As restated)	2004	2003 (As restated)
Net revenues	\$ 133,400	\$ 145,707	\$ 267,411	\$ 298,284
Cost of net revenues				
Product and supply costs	17,583	18,990	33,316	40,352
Patient service equipment depreciation	16,156	43,168	33,141	57,235
Total cost of net revenues	33,739	62,158	66,457	97,587
Gross profit	99,661	83,549	200,954	200,697
Costs and expenses:				
Provision for doubtful accounts	3,497	5,378	8,776	9,938
Selling, distribution and administrative	70,163	80,194	141,595	173,012
Interest expense, net	8,392	9,824	17,624	20,630
Total costs and expenses	82,052	95,396	167,995	203,580
Earnings (loss) before income taxes	17,609	(11,847)	32,959	(2,883)
Federal and state income tax expense (benefit)	7,220	(5,168)	13,526	(1,201)
Net Earnings (loss)	10,389	(6,679)	19,433	(1,682)
Accrued dividends on redeemable preferred stock	—	113	—	225
Net earnings (loss) available for common stockholders	\$ 10,389	\$ (6,792)	\$ 19,433	\$ (1,907)
Net earnings (loss) per common share—basic	\$ 0.41	\$ (0.27)	\$ 0.78	\$ (0.08)
Net earnings (loss) per common share—diluted	\$ 0.40	\$ (0.27)	\$ 0.75	\$ (0.08)
Weighted average shares outstanding—basic	25,082,338	24,999,998	25,062,183	24,999,998
Weighted average shares outstanding—diluted	26,005,129	24,999,998	25,861,056	24,999,998

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Three months ended June 30,		Six months ended June 30,	
	2004	2003 (As restated)	2004	2003 (As restated)
Net Earnings (loss)	\$ 10,389	\$ (6,679)	\$ 19,433	\$ (1,682)
Adjustments to reconcile net earnings to net cash provided by operating activities:				
Provision for doubtful accounts	3,497	5,378	8,776	9,938
Depreciation and amortization	19,697	46,245	40,115	63,164
Loss on disposal of fixed assets	125	—	265	—
Changes in operating assets and liabilities:				
(Increase) in accounts receivable	(3,625)	(1,482)	(5,713)	(4,281)
Decrease (increase) in other receivables	366	(1,132)	69	(152)
Decrease (increase) in inventories	433	6,663	(244)	11,441
(Increase) decrease in prepaid expenses	(228)	(1,356)	121	(796)
(Increase) decrease in income taxes receivable	—	(6,722)	2,531	(6,722)
(Decrease) increase in accounts payable and accrued expenses	(4,334)	1,815	(10,088)	(574)
(Decrease) increase in accrued interest	(7,496)	(7,288)	(512)	63
Increase (decrease) in income taxes payable	6,103	(1,447)	11,119	(6,787)
Decrease in deferred revenue	(211)	(325)	(200)	(569)
Net cash provided by operating activities	<u>24,716</u>	<u>33,670</u>	<u>65,672</u>	<u>63,043</u>
Cash flows from investing activities:				
Purchases of property and equipment	(12,422)	(17,618)	(24,394)	(32,656)
Business acquisitions-net of cash acquired	—	—	—	(1,873)
Decrease in other assets	551	2,546	1,215	3,601
Net cash used in investing activities	<u>(11,871)</u>	<u>(15,072)</u>	<u>(23,179)</u>	<u>(30,928)</u>
Cash flows from financing activities:				
Payments of long term borrowings	(110)	(20,063)	(25,110)	(30,513)
Payments of liabilities subject to compromise/priority tax claim	(1,253)	(13)	(1,261)	(306)
Proceeds from stock option exercises	2,662	—	2,662	—
Net cash provided (used) by financing activities	<u>1,299</u>	<u>(20,076)</u>	<u>(23,709)</u>	<u>(30,819)</u>
Increase (decrease) in cash and cash equivalents	14,144	(1,478)	18,784	1,296
Cash and cash equivalents, beginning of period	25,620	30,786	20,980	28,012
Cash and cash equivalents, end of period	<u>\$ 39,764</u>	<u>\$ 29,308</u>	<u>\$ 39,764</u>	<u>\$ 29,308</u>

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 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, 2003.

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. 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.

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

**(2) Accounting Policies and Recent Accounting Pronouncements**

**Restatements:** Subsequent to the issuance of the Company's unaudited condensed consolidated financial statements as of and for each of the quarterly periods in 2003, the Company determined that amortization related to approximately \$3.5 million of deferred financing costs associated with its \$200 million senior secured term loan had not appropriately reflected the effect which the Company's accelerated prepayments would have had on the computation of amortization for these deferred financing costs during 2003. As a result, interest expense has been restated from the amounts previously reported to account for an increase in the amortization of the deferred financing costs in accordance with the effective interest method to take into account the accelerated prepayments. The results for the three months and six months ended June 30, 2003 include a reduction of net earnings of approximately \$216 and \$562, respectively, for the effect of the difference in amortization of deferred financing costs that was expensed versus what should have been recognized in fiscal 2003.

A summary of the unaudited effect of the restatement on the three and six months ended June 30, 2003 (as previously reported and as restated) is as follows (dollars in thousands):

	Three months ended June 30, 2003		Six months ended June 30, 2003	
	(As previously reported)	(As restated)	(As previously reported)	(As restated)
Interest expense, net	\$ 9,464	\$ 9,824	\$ 19,693	\$20,630
Net (loss)	\$ (6,463)	\$ (6,679)	\$ (1,120)	\$ (1,682)

**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, SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure" ("SFAS No. 148") was issued by the Financial Accounting Standards Board ("FASB"). This standard amends SFAS No. 123 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 has implemented SFAS No. 148 effective January 1, 2003 regarding disclosure requirements for condensed financial statements. The Company has elected to not implement the fair value based method of accounting for stock-based employee compensation as permitted by SFAS No. 148.

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

In January 2003, the FASB issued FIN No. 46, *Consolidation of Variable Interest Entities*, and a revised interpretation of FIN No. 46 (“FIN No. 46-R”) in December 2003, in an effort to expand upon existing accounting guidance that addresses when a company should consolidate the financial results of another entity. FIN No. 46 requires “variable interest entities,” as defined, to be consolidated by a company if that company is subject to a majority of expected losses of the entity or is entitled to receive a majority of expected residual returns of the entity, or both. A company that is required to consolidate a variable interest entity is referred to as the entity’s primary beneficiary. The interpretation also requires certain disclosures about variable interest entities that a company is not required to consolidate, but in which it has a significant variable interest. The consolidation and disclosure requirements apply immediately to variable interest entities created after January 31, 2003. The Company is not the primary beneficiary of any variable interest entity created after January 31, 2003 nor does the Company have a significant variable interest in a variable interest entity created after January 31, 2003. For variable interest entities that existed before February 1, 2003, the consolidation requirements of FIN No. 46-R are effective as of March 31, 2004. The adoption of FIN No. 46-R does not have a material impact 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* (“SFAS No. 150”). 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 the Company’s Series A Convertible Redeemable Preferred Stock as a liability on the Company’s consolidated financial statements. As a result of adopting SFAS No. 150, the Company has recorded accrued dividends to interest expense subsequent to June 30, 2003.

**(3) Earnings Per Common Share**

Basic earnings per share (“EPS”) are computed by dividing earnings 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 shares and common equivalent shares outstanding. Common stock equivalent shares totaling 117,500 and 297,500 for the three months and six months ended June 30, 2004, respectively, and 1,335,000 and 3,250,000 for the same periods in 2003 were excluded from the computation of diluted EPS 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:

	Three Months ended June 30,		Six Months ended June 30,	
	2004	2003	2004	2003
Weighted average basic shares	25,082,338	24,999,998	25,062,183	24,999,998
Effect of dilutive securities:				
Weighted options outstanding	722,791		598,873	
Conversion of convertible redeemable preferred stock	200,000		200,000	
Weighted average diluted shares	26,005,129	24,999,998	25,861,056	24,999,998

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

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:

	Three Months ended June 30,		Six Months ended June 30,	
	2004	2003 (As restated)	2004	2003 (As restated)
<b>Net Earnings (loss) available for common stockholders:</b>				
As reported	\$10,389	\$ (6,792)	\$19,433	\$ (1,907)
SFAS 123 pro forma compensation expense net of tax	\$ 319	\$ 364	\$ 645	\$ 607
Pro forma	\$10,070	\$ (7,156)	\$18,788	\$ (2,514)
<b>Basic net earnings (loss) available for common stockholders per share:</b>				
As reported	\$ 0.41	\$ (0.27)	\$ 0.78	\$ (0.08)
Pro forma	\$ 0.40	\$ (0.29)	\$ 0.75	\$ (0.10)
<b>Diluted net earnings (loss) available for common stockholders per share:</b>				
As reported	\$ 0.40	\$ (0.27)	\$ 0.75	\$ (0.08)
Pro forma	\$ 0.39	\$ (0.29)	\$ 0.73	\$ (0.10)

Options to purchase approximately 3,180,751 share of common stock at prices ranging from \$14.55 to \$26.00 per share were outstanding as of June 30, 2004. Options to purchase approximately 3,225,000 shares of common stock at prices ranging from \$14.55 to \$20.00 per share were outstanding as of June 30, 2003.

**(4) 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. During 2003, an additional \$1,000 was paid in cash as part of the purchase price.

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	8,940
Assumption of liabilities	(66)
	<hr/>
Fair value of purchased net assets	\$ 9,964
Loan and management fees payable to the Company	(6,964)
	<hr/>
Cash paid for acquisition	\$ 3,000

The purchase price is subject to adjustment if certain targets are met until December 31, 2005, the date the earn-out period expires.

**(5) Restructuring Accruals**

The Company implemented certain restructuring activities that include head count reduction and real estate consolidation to

improve operating effectiveness and efficiencies. During the three month period ended June 30, 2003, \$468 of restructuring related charges were recognized for severances, all of which was paid in cash. During the six month period ended June 30, 2003, \$6,274 of restructuring related charges were recognized, which consisted of severance and lease cancellation charges. Of the \$6,274 in charges, \$4,899 was paid in cash. As of June 30, 2003, the Company had approximately \$2,775 recorded in accrued expenses related to restructuring charges. The restructuring related charges are included in selling, distribution and

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

administrative expenses in the condensed consolidated statements of operations. The Company terminated approximately 15% of its employees during the six months ended June 30, 2003. The terminated employees consisted of corporate and administrative personnel, and field staff in a variety of capacities. During the six month period ended June 30, 2004, there were no restructuring related charges recognized. During the three and six month periods ended June 30, 2004, the Company paid \$240 and \$883, respectively, in cash for restructuring related charges. As of June 30, 2004 and December 31, 2003, the Company had approximately \$793 and \$1,676, respectively, recorded in accrued expenses related to restructuring charges.

**(6) 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 following table reflects the components of other identifiable intangible assets:

	June 30, 2004		December 31, 2003	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
<b>Amortizable identifiable intangible assets:</b>				
Customer/physician relationship	\$12,000	\$ 1,350	\$12,000	\$ 1,050
Computer software	5,000	750	5,000	583
Other	1,004	802	1,004	687
Subtotal	18,004	2,902	18,004	2,320
<b>Non-amortizable identifiable intangible assets:</b>				
Trade name	1,000	—	1,000	—
Medicare licenses	1,000	—	1,000	—
Subtotal	2,000	—	2,000	—
<b>Total identifiable intangible assets</b>	<b>\$20,004</b>	<b>\$ 2,902</b>	<b>\$20,004</b>	<b>\$ 2,320</b>

Amortization expense for the three months and six months ended June 30, 2004 was approximately \$246 and \$582, respectively, and was approximately \$334 and \$665 for the three months and six months ended June 30, 2003, respectively.

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

	Amount
2004	\$1,072
2005	984
2006	984
2007	966
2008	944

**(7) 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, 2003.

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:

	Three months ended June 30,		Six months ended June 30,	
	2004	2003	2004	2003
Respiratory therapy equipment and services	\$116,240	\$121,847	\$232,226	\$248,030
Durable medical equipment	15,725	22,074	32,280	45,872
Other health care products	1,435	1,786	2,905	4,382
	\$133,400	\$145,707	\$267,411	\$298,284

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

**(8) Other 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 11, 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, cash flows or results of operations.

**(9) 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 71.5% and 71.0% of the Company's patient revenue for the three and six months ended June 30, 2004, respectively, and represented 71.1% and 70.5% of the Company's patient revenue for the three and six months ended June 30, 2003, respectively.

Recent legislation continues to impact and reduce Medicare payment levels. Under the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 ("MMA"), additional reductions have been imposed. Changes under MMA include a freeze in payments for certain medical devices from 2004 through 2008, competitive bidding requirements, new clinical conditions for payment and quality standards. The changes affect the Company's products generally, although specific products may be affected by some but not all of the MMA provisions. Medicare payments for home medical equipment ("HME") including oxygen and nebulizers, are set at the 2003 level for 2004 through 2008, unless they are subject to competitive bidding. Furthermore, MMA may further reduce payments in 2005 for these products based on a percentage of the median payments for the items under the Federal Employee Health Benefits Program and freeze them at that reduced level through 2008. MMA also reduces payments for drugs delivered through nebulizer equipment to 80% of average wholesale price ("AWP") in 2004 and beginning in 2005, an amount based on 106% of average sales price for most inhalation drugs. Reductions in Medicare reimbursement for oxygen, nebulizers and inhalation medications could have a material, adverse effect on the Company's revenues and profitability.

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

Currently, Medicare payments to the Company for its HME products are based on the lesser of the actual charge for the item or the applicable Medicare fee schedule amount. Under MMA, beginning in 2004 through 2008, most payments for HME will not be adjusted upward by a cost of living index and, therefore, will be “frozen,” unless the item becomes subject to competitive bidding. Further, beginning in 2005, certain items of HME, including wheelchairs, nebulizers, oxygen and oxygen equipment, will experience a further reduction in the fee schedule amount. That further reduction will be based on the percentage difference between the amount of payment otherwise determined for 2002 and the median amount of payment under the Federal Employee Health Benefits Program, as that amount is determined by the Office of Inspector General of The Department of Health and Human safety (“DHHS”). The adjusted payments would remain “frozen” through 2008 unless the particular item becomes subject to competitive bidding.

MMA also revises the payment methodology for certain drugs, including inhalation drugs dispensed through nebulizers. Prior to MMA, Medicare paid for these drugs based on AWP, as reported by drug manufacturers. Beginning January 1, 2004, Medicare payments were reduced for most of the Company’s Part B inhalation drugs to 80% of AWP from 95% of AWP, a reduction of approximately 15%. Beginning in 2005, payments for drugs delivered through nebulizer equipment will be based on 106% of average sales price (“ASP”). ASP is defined statutorily as the volume weighted average of manufacturers’ average sales prices, calculated by adding the products of manufacturers’ average sales prices for the drug in the fiscal quarter and the number of units sold and then dividing by the total number of units sold for all national drug codes assigned to the product. Under the ASP methodology, Medicare generally will pay 106% of ASP for multiple source drugs and 106% of the lesser of ASP or wholesale acquisition cost for single source drugs. The ASP for many drugs may be significantly less than the AWP, resulting in reduced Medicare payments for these drugs. In addition, if the ASP exceeds the widely available market price by more than 5%, the Centers for Medicare and Medicaid studies (“CMS”) (the federal agency responsible for administering the Medicare program) may substitute the widely available market price for the ASP, further reducing payment levels for those drugs. In 2003, Medicare covered inhalation drugs accounted for approximately one fifth of the Company’s recorded revenues. While the net payment amounts for inhalation drugs under the ASP methodology have not yet been determined, the Company believes that the ASP provision, if implemented, could result in payment amounts in 2005 that are dramatically lower than payment amounts in 2004. Such reductions in Medicare reimbursement for inhalation medications could have a material, adverse effect on the Company’s revenues and profitability.

Recently, CMS conducted competitive bidding demonstrations for certain Medicare services. Under MMA, starting in 2007, Medicare will begin a nationwide competitive bidding program in ten high-population metropolitan services areas (“MSAs”) for certain high cost and high utilization items. The program will expand to cover 80 MSAs in 2009 and additional areas thereafter. Competitive bidding will require suppliers to compete for the exclusive or limited rights to provide items to beneficiaries in a defined region. Only a limited number of suppliers will be selected in any given MSA, resulting in restricted supplier choices for beneficiaries. Competitive bidding may result in lower reimbursement or the loss of the Company’s ability to provide services in certain regions. MMA permits certain exemptions from competitive bidding, including exemptions for rural areas and areas with low population density within urban areas that are not competitive, unless there is a significant national market through mail order for the particular item. A large number of the Company’s facilities are located in such areas. However, the criteria for how the exemption will be applied have not yet been determined. Therefore, the impact on the Company’s business is uncertain.

On August 5, 2004, CMS published in the Federal Register proposed rules implementing certain MMA provisions relating to inhalation drugs. CMS published preliminary estimates for two inhalation drugs: albuterol sulfate and ipratropium bromide. The payment amounts under the ASP payment methodology for these two drugs represented approximately 90% reductions from 2004 payment levels. The agency also indicated that given the overall reduction in payment for inhalation drugs, there are concerns about beneficiary access to these drugs and noted that the 6% above ASP would generally not be sufficient to meet the costs for shipping, handling, and other pharmacy activities. Therefore, CMS indicated that it is appropriate to continue to pay a separate dispensing fee to pharmacies that furnish inhalation drugs and seeks comments on the appropriate dispensing fee amount to cover that shipping, handling, compounding and other pharmacy activities required to get the medications to Medicare beneficiaries. Additionally, CMS recognized that most patients use inhalation drugs for extended periods of time and often for the rest of their lives. Under CMS’s current guidelines, a pharmacist generally may not fill a prescription for inhalation drugs for more than a month’s supply for the patient. CMS proposed that 90-day prescriptions could be filled, and expects that refills would be for this time period and also acknowledged that mail order prescription drug models work well for 90 day prescriptions. A final rule is expected to be published by November 1, 2004. The Company recognizes that, if the pricing changes become effective, it could have a materially adverse effect on the Company’s revenues and profitability.

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

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 federal health care program patients, including Medicare and Medicaid patients. Stark prohibits, with limited exceptions, a physician from referring Medicare or Medicaid patients for certain designated health services to an entity with which the physician has a financial relationship. Stark also prohibits the submission of a claim to Medicare or Medicaid by the entity for designated health services furnished pursuant to a prohibited referral. 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 non-compliance with Medicare and Medicaid regulations. 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.

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.

**(10) Long-Term Debt**

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

	<b>June 30, 2004</b>	<b>December 31, 2003</b>
Senior Secured Term Loan; \$110 payable quarterly through March 31, 2007 with remainder due quarterly through March 31, 2008, interest payable at LIBOR plus 3%, payable quarterly	\$ 42,890	\$ 68,000
9 1/2% Senior Subordinated Notes, due April 1, 2012, interest payable semi-annually on April 1 and October 1	300,000	300,000
<b>Sub-total</b>	<b>342,890</b>	<b>368,000</b>
Less: current portion	439	692
<b>Total long-term debt</b>	<b>\$342,451</b>	<b>\$ 367,308</b>



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

In addition to the above, as of June 30, 2004, the Company has a \$75 million five-year revolving credit facility available. No debt is outstanding under this facility at June 30, 2004; however, the Company has issued letters of credit totaling \$11.2 million under this facility to guaranty the Company's payments on future insurance claims. Effective August 3, 2004, the Company repurchased \$13.0 million of its 9½% senior subordinated notes and paid a premium of \$0.9 million associated with the retirement of such notes.

**(11) Significant Events**

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 from the United States Attorney's Office for the Northern District of Illinois for information relating to Medicare and Medicaid billing and VA contracting. The Company is cooperating fully with the investigation; however, 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. In addition, the Company received informal requests for information on March 7, 2003 and April 17, 2003 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 the Company has provided documents in response to such requests. 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.

**(12) Supplemental Statements of Cash Flow Information**

	Three months ended June 30,		Six months ended June 30,	
	2004	2003	2004	2003
Cash payments for:				
Interest	\$15,435	\$16,548	\$16,600	\$18,899
Income taxes	\$ 1,138	\$ 2,519	\$ 1,325	\$ 3,035

**Supplemental Schedule of Noncash Investing and Financing Activities**

During the six months ended June 30, 2003, 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 at the time of acquisition for the net assets acquired	(2,000)
Loan and management fees payable to the Company	(6,808)
Liabilities assumed	\$ 66

## 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, 2003 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. Management’s discussion and analysis has been revised to give effect of the restatement as described in Note 2 to the unaudited condensed consolidated financial statements.*

### Executive Overview

*Background.* We provide home medical equipment and related products and services in the United States, with a comprehensive offering of respiratory therapy and durable home medical equipment and related services. We provide equipment and services in 48 states through approximately 500 operating centers located primarily in non-urban markets.

Our revenues are principally derived from respiratory equipment rental and related services, which accounted for 87.1% and 83.6% of our revenues for the three months ended June 30, 2004 and June 30, 2003, respectively and 86.8% and 83.2% for the six months ended June 30, 2004 and June 30, 2003, respectively. Revenues from respiratory rental and related services include the rental of oxygen concentrators, liquid oxygen systems, portable oxygen systems, ventilator therapy systems, nebulizer equipment and sleep disorder breathing therapy systems, and the sale of nebulizer medications. We also generate revenues from the rental and sale of durable medical equipment accounting for 11.8% and 15.1% of net revenues for the three months ended June 30, 2004 and June 30, 2003, respectively and 12.1% and 15.4% for the six months ended June 30, 2004 and June 30, 2003, respectively. Revenues from the rental and sale of durable medical equipment include the rental and sale of items such as hospital beds, wheelchairs, walkers, patient aids and ancillary supplies.

We have engaged in an ongoing series of activities to strengthen our organizational structure and reposition us for future growth. These actions have included selective reduction in headcount, renegotiation of certain vendor contracts, substantial reduction in the number of billing centers, discontinuation of certain product lines and branch locations, centralization of certain administrative functions (including billing and purchasing), development and implementation of an advanced information and billing system, and enhancement of regulatory compliance programs. We expect to continue to review our operations in order to improve operating efficiencies.

*Reimbursement by Third Party Payors.* We derive a majority of our revenues from reimbursement by third party payors, including Medicare, Medicaid, the Veterans Administration and private insurers. Our business has been, and may continue to be, significantly impacted by changes mandated by Medicare legislation. With the passage of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, or MMA, a number of changes have been mandated to the Medicare payment methodology and conditions for coverage for our products. These changes include a freeze in payments for home medical equipment from 2004 to 2008, competitive bidding requirements, new clinical conditions for payment and quality standards. MMA also revises the payment methodology for certain drugs, including inhalation drugs dispensed through nebulizers. Prior to MMA, Medicare paid for these drugs based on average wholesale price, or AWP, as reported by drug manufacturers. Beginning January 1, 2004, Medicare payments were reduced for most of our Part B inhalation drugs to 80% of AWP from 95% of AWP, a reduction of approximately 15%. Beginning in 2005, payments for drugs delivered through nebulizer equipment will be based on 106% of average sales price, or ASP. ASP is defined statutorily as the volume weighted average of manufacturers’ average sales prices, calculated by adding the products of manufacturers’ average sales prices for the drug in the fiscal quarter and the number of units sold and then dividing by the total number of units sold for all national drug codes assigned to the product. Under the ASP methodology, Medicare generally will pay 106% of ASP for multiple source drugs and 106% of the lesser of ASP or wholesale acquisition cost for single source drugs. The ASP for many drugs may be significantly less than the AWP, resulting in reduced Medicare payments for these drugs. In addition, if the ASP exceeds the widely available market price by more than 5%, the Centers for Medicare and Medicaid Services may substitute the widely available market price for the ASP, further reducing payment levels for those drugs. In 2003, Medicare covered inhalation drugs accounted for approximately one fifth of our recorded revenues. While the net payment amounts for inhalation drugs under the ASP methodology have not yet been determined, we believe that the ASP provision, if implemented, could result in payment amounts in 2005 that are dramatically lower than payment amounts in 2004. Such reductions in Medicare reimbursement for oxygen, nebulizers and inhalation medications could have a material, adverse effect on our revenues and profitability.

The following table shows our results of operations for the three and six months ended June 30, 2004 and June 30, 2003.

	Three months ended June 30,		Six months ended June 30,	
	2004	2003	2004	2003
Net revenues	\$133,400	\$145,707	\$267,411	\$298,284
Cost of net revenues				
Product and supply costs	17,583	18,990	33,316	40,352
Patient service equipment depreciation	16,156	43,168	33,141	57,235
Total cost of net revenues	33,739	62,158	66,457	97,587
Gross profit	99,661	83,549	200,954	200,697
Costs and expenses:				
Provision for doubtful accounts	3,497	5,378	8,776	9,938
Selling, distribution and administrative	70,163	80,194	141,595	173,012
Interest expense, net	8,392	9,824	17,624	20,630
Total costs and expenses	82,052	95,396	167,995	203,580
Earnings (loss) before income taxes	17,609	(11,847)	32,959	(2,883)
Federal and state income tax expense (benefit)	7,220	(5,168)	13,526	(1,201)
Net earnings (loss)	10,389	(6,679)	19,433	(1,682)
Accrued dividends on redeemable preferred stock	—	113	—	225
Net earnings available for common stockholders	\$ 10,389	\$ (6,792)	\$ 19,433	\$ (1,907)

The following table shows our results of operations as a percentage of our net revenues for the three and six months ended June 30, 2004 and June 30, 2003.

	Three months ended June 30,		Six months ended June 30,	
	2004	2003	2004	2003
Net revenues	100.0%	100.0%	100.0%	100.0%
Cost of net revenues				
Product and supply costs	13.2%	13.0%	12.5%	13.5%
Patient service equipment depreciation	12.1%	29.6%	12.4%	19.2%
Total cost of net revenues	25.3%	42.6%	24.9%	32.7%
Gross profit	74.7%	57.4%	75.1%	67.3%
Costs and expenses:				
Provision for doubtful accounts	2.6%	3.7%	3.3%	3.3%
Selling, distribution and administrative	52.6%	55.0%	53.0%	58.0%
Interest expense, net	6.3%	6.7%	6.5%	6.9%
Total costs and expenses	61.5%	65.4%	62.8%	68.2%
Earnings before income tax expense (benefit)	13.2%	(8.0)%	12.3%	(0.9)%
Federal and state income tax expense (benefit)	5.4%	(3.5)%	5.1%	(0.4)%
Net Earnings (loss)	7.8%	(4.5)%	7.2%	(0.5)%

## Results of Operations

### Three months ended June 30, 2004 as compared to the three months ended June 30, 2003

Total net revenues for the three months ended June 30, 2004 were \$133.4 million as compared to \$145.7 million for the comparable period in 2003. 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 and the impact of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 on our respiratory medication sales.

Cost of net revenues for the three months ended June 30, 2004 decreased \$28.5 million, or 45.7%, to \$33.7 million, from the comparable period in 2003. Cost of net revenues as a percentage of net revenue was 25.3% for the three months ended June 30, 2004 as compared to 42.6% for the comparable period in 2003. The results of operations for the three months ended June 30, 2004 included a decrease of \$27.0 million or approximately 63.0% in patient service equipment depreciation as compared to the comparable period of 2003. The decrease in patient service equipment depreciation was primarily attributable to the revision of depreciable lives during the three months ended June 30, 2003. 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, Rotech Medical Corporation. Based on information then available, we have changed 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 \$138.0 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 this change we recognized approximately \$27.8 million in additional depreciation expense for the three months ended June 30, 2003. In addition, our product and supply costs declined by approximately \$1.4 million during the three months ended June 30, 2004, which is primarily attributable to the change in the revenue composition from lower gross margin durable medical equipment to higher margin respiratory therapy equipment and services.

Selling, distribution and administrative expenses for the three months ended June 30, 2004 decreased by \$10.0 million, or 12.5%, to \$70.2 million, from the comparable period in 2003. This decrease in selling, distribution and administrative expenses resulted primarily from reduced costs for salaries and benefits, which were accomplished through a reduction in our employee head count. Selling, distribution and administrative expenses as a percentage of net revenues decreased to 52.6% for the three months ended June 30, 2004 from 55.0% for the three months ended June 30, 2003.

Interest expense for the three months ended June 30, 2004 decreased \$1.4 million from the comparable period in 2003. The decrease is primarily attributable to the repayment of approximately \$105.1 million of long-term bank debt principal over the past twelve months.

Federal and state income taxes for the three months ended June 30, 2004 increased \$12.4 million to an expense of \$7.2 million from the comparable period in 2003. The increase in federal and state income taxes was primarily due to increased taxable income for the three month period ended June 30, 2004.

Net earnings were \$10.4 million for the three months ended June 30, 2004 as compared to net loss of \$6.7 million for the same period in 2003. The increase in the current period resulted primarily from the reduction in depreciation expense as compared to the comparable period in 2003. In addition certain selling, distribution and administrative expenses also decreased as a result of our reduction of head count during the same period of 2003.

For the three months ended June 30, 2004, earnings from continuing operations before interest, income taxes, depreciation and amortization (EBITDA) was \$45.7 million as compared to \$44.2 million for the three months ended June 30, 2003. Set forth below is a comparable reconciliation of our net earnings to EBITDA:

*Comparable Reconciliation of Net Earnings to EBITDA*

	Three Months Ended June 30,	
	2004	2003
Net earnings	\$10,389	\$(6,679)
Income tax expense (benefit)	7,220	(5,168)
Interest expense, net	8,392	9,824
Depreciation & amortization	19,697	46,245
EBITDA	\$45,698	\$44,222

We view 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.

**Six months ended June 30, 2004 as compared to the six months ended June 30, 2003**

Total net revenues for the six months ended June 30, 2004 were \$267.4 million as compared to \$298.3 million for the comparable period in 2003. 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 and the impact of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 on our respiratory medication sales.

Cost of net revenues for the six months ended June 30, 2004 decreased \$31.1 million, or 31.9%, to \$66.5 million, from the comparable period in 2003. Cost of net revenues as a percentage of net revenue was 24.9% for the six months ended June 30, 2004 as compared to 32.7% for the comparable period in 2003. The results of operations for the six months ended June 30, 2004 included a decrease of \$24.0 million or approximately 42.1% in patient service equipment depreciation as compared to the comparable period of 2003. The decrease in patient service equipment depreciation was primarily attributable to the revision of depreciable lives during the six months ended June 30, 2003. 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, Rotech Medical Corporation. Based on

information then available, we have changed 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 \$138.0 million of rental property was necessary to more closely match the replacement rates of rental property acquired with its specific remaining useful life. The increase in net earnings for the six months ended June 30, 2004 is a result, primarily, of the reduction in patient service equipment depreciation expense as described in management's discussion and analysis for the three months ended June 30, 2004. In addition, our product and supply costs declined by approximately \$7.0 million during the six months ended June 30, 2004, which is primarily attributable to the change in the revenue composition from lower gross margin durable medical equipment to higher margin respiratory therapy equipment and services.

Selling, distribution and administrative expenses for the six months ended June 30, 2004 decreased by \$31.4 million, or 18.2%, to \$141.6 million, from the comparable period in 2003. This decrease in selling, distribution and administrative expenses resulted primarily from reduced costs for salaries and benefits, which were accomplished through a reduction in our employee head count. Selling, distribution and administrative expenses as a percentage of net revenues decreased to 53.0% for the six months ended June 30, 2004 from 58.0% for the six months ended June 30, 2003.

Interest expense for the six months ended June 30, 2004 decreased \$3.0 million from the comparable period in 2003. The decrease is primarily attributable to the repayment of approximately \$105.1 million of long-term bank debt principal over the past twelve months.

Federal and state income taxes for the six months ended June 30, 2004 increased \$14.7 million to an expense of \$13.5 million from the comparable period in 2003. The increase in federal and state income taxes was primarily due to increased taxable income for the six month period ended June 30, 2004.

Net earnings were \$19.4 million for the six months ended June 30, 2004 as compared to net loss of \$1.7 million for the same period in 2003. The increase in the current period resulted primarily from the reduction in depreciation expense as compared to the comparable period in 2003. In addition certain selling, distribution and administrative expenses also decreased as a result of our reduction of head count during the same period of 2003.

For the six months ended June 30, 2004, earnings from continuing operations before interest, income taxes, depreciation and amortization (EBITDA) was \$90.7 million as compared to \$80.9 million for the six months ended June 30, 2003. Set forth below is a comparable reconciliation of our net earnings to EBITDA:

*Comparable Reconciliation of Net Earnings to EBITDA*

	Six Months Ended June 30,	
	2004	2003
Net earnings	\$19,433	\$(1,682)
Income tax expense (benefit)	13,526	(1,201)
Interest expense, net	17,624	20,630
Depreciation & amortization	40,115	63,164
	\$90,698	\$80,911

We view 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 June 30, 2004. Management also believes that seasonality generally only applies to the use of respiratory medications.

## **Liquidity and capital resources**

Net cash provided by operating activities and reorganization items was \$24.7 million and \$65.7 million for the three months and six months ended June 30, 2004, respectively, as compared to \$33.7 million and \$63.0 million for the same periods in 2003. Cash flows in both periods were sufficient to fund capital expenditures and required repayments of debt.

Accounts receivable before allowance for doubtful accounts decreased \$6.1 million from \$104.4 million at December 31, 2003 to \$98.3 million at June 30, 2004. 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 53 days at June 30, 2004 compared to 52 days at December 31, 2003.

Included in accounts receivable are earned but unbilled receivables of \$10.9 million at June 30, 2004 and \$14.8 million at December 31, 2003. Delays, ranging from a day to several weeks, between the dates 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.

Net cash used in investing activities was \$11.9 million and \$23.2 million for the three months and six months ended June 30, 2004, respectively, as compared to \$15.1 million and \$30.9 million for the same periods in 2003. Activity in the three and six months ended June 30, 2004 included net investment in capital equipment of \$12.4 million and \$24.4 million, respectively, as compared to \$17.6 million and \$32.7 million for the three and six months ended June 30, 2003, respectively.

Cash flows from financing activities primarily relate to debt facilities entered into on the effective date of our predecessor's plan of reorganization on March 26, 2002. We currently have the following debt facilities and outstanding debt:

- a five-year \$75 million senior secured revolving credit facility for general corporate purposes including working capital, capital expenditures and acquisitions, which the Company has not drawn upon. Included in this facility is the issuance of \$9.9 million and \$11.2 million in stand by letters of credit resulting in \$65.1 million and \$63.8 million remaining available under this facility as of December 31, 2003 and June 30, 2004, respectively.
- 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 the Eurodollar rate plus 3.00% or the prime rate plus 2.00%. The term loan was advanced as a Eurodollar rate advance. The Company, as of December 31, 2003 and June 30, 2004, had balances of \$68.0 million and \$42.9 million outstanding, respectively.
- an aggregate principal amount of \$300 million of 9 1/2% senior subordinated notes, the proceeds of which were used to repay certain pre-petition claims owed to the creditors of our predecessor as part of its plan of reorganization. The notes mature on April 1, 2012. Interest of 9 1/2% is payable semi-annually in arrears on April 1 and October 1 of each year. As of the date of this report, an aggregate amount of \$287 million of the Company's 9 1/2% senior subordinated notes was outstanding.

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 June 30, 2004, we were in compliance with such covenants.

Accrued interest on our borrowings was \$7.1 million and \$7.9 million at June 30, 2004 and December 31, 2003, respectively. During the three months ended June 30, 2004, we made our regularly scheduled principal payments with respect to the term loan in the aggregate amount of approximately \$0.1 million. At June 30, 2004, the outstanding balance on our term loan was \$42.9 million, which bore interest at the rate of 4.59% per annum.

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.

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 three-month periods ended June 30, 2004 and June 30, 2003, our capital expenditures were \$12.4 million and \$17.6 million, respectively, representing 9.3% and 12.1% 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.

Our capital and debt structure was determined upon the transfer to us of substantially all of the assets of our predecessor, Rotech Medical Corporation, when it emerged from bankruptcy on March 26, 2002. We expect to review our capital and debt structure during 2004. This review will include, but not be limited to, consideration of a primary and/or secondary stock offering, a stock exchange listing, and a restructuring of our debt. We have no present plans to take any of such actions, and any decisions will necessarily depend upon market and business conditions at the applicable time.

Effective June 7, 2004, we were granted a waiver of certain provisions of our credit agreement in order to permit us to repurchase, prior to March 31, 2005, up to \$50.0 million in aggregate of our capital stock and/or our obligations under our 9½% senior subordinated notes due 2012. Effective August 3, 2004, we repurchased \$13.0 million of our 9½% senior subordinated notes and paid a premium of \$0.9 million associated with the retirement of such notes.

#### **Off-balance Sheet Arrangements and Contractual Obligations**

We do not have off-balance sheet arrangements (as that term is defined in Item 303(a)(4)(ii) of Regulation S-K) that have or are reasonably likely to have a current or future effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. There are no material changes with respect to contractual obligations as presented in our Annual Report on Form 10-K for the year ended December 31, 2003.

#### **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, 2003.

#### *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. However, we defer revenue for the rental of equipment and amortize it over the period such revenue is earned.

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.

#### *Property and Equipment*

Property and equipment are stated at cost. The cost of the assets on hand at March 31, 2002 was adjusted to their fair values based on the fresh start reporting requirements. Patient service equipment represents medical equipment rented or held for rental to in-home patients. Depreciation is provided on the straight-line method over the estimated useful lives of the assets, five years for patient service equipment, seven years for furniture and office equipment, five years for vehicles, three years for computer equipment, and the shorter of the remaining lease term or the estimated useful life for leasehold improvements.

Effective April 1, 2003, we changed our estimated useful life on certain long-lived assets acquired from our predecessor, Rotech Medical Corporation. The estimated useful life of certain acquired rental property was changed from an aggregate of four years from the date acquired from our predecessor to a five-year useful life from the original acquisition date by our predecessor. The change was made to more closely match the replacement rates of rental property acquired with its specific remaining useful life.

Included in property, equipment and improvements are costs related to internally developed and purchased software that are capitalized and amortized over periods not exceeding three years. Capitalized costs include direct costs of materials and services incurred in developing or obtaining internal-use software and payroll and payroll-related costs for employees directly involved in the development of internal-use software. The carrying value of capitalized software is reviewed if the facts and circumstances suggest that it may be impaired. Indicators of impairment may include a subsequent change in the extent or manner in which the software is used or expected to be used, a significant change to the software is made or expected to be made or the cost to develop or modify internal-use software exceeds that expected amount.

### *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.

### *Income Taxes*

We account for income taxes under SFAS No. 109, Accounting for Income Taxes (“SFAS 109”). Deferred tax assets and liabilities are determined based upon differences between financial reporting and the tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred income tax assets to amounts expected to be realized.

### *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.

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 “Risk Factors” contained in our Annual Report on Form 10-K for the year ended December 31, 2003 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 variable debt facilities. Variable interest rates may rise, which could increase the amount of interest expense. 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 June 30, 2004, the \$75 million senior secured revolving credit facility had not been drawn upon, although standby letters of credit totaling approximately \$11.2 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 \$42.9 million is outstanding as of June 30, 2004), we would incur approximately \$0.4 million in additional interest expense for the period January 1, 2004 through December 31, 2004.

### **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 our 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**

During the second quarter of fiscal 2004, there have been no changes to our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

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. Accordingly, 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 undergoing a comprehensive effort in preparation for compliance with Section 404 of the Sarbanes-Oxley Act of 2002. This effort includes the documentation, testing and review of our internal controls under the direction of senior management. During the course of these activities, we have identified certain internal control issues which senior management believes need to be improved. As a result, we have made improvements to our internal controls over financial reporting and will continue to do so. These improvements include further formalization of policies and procedures, improved segregation of duties, and improved controls over the recording and tracking of fixed assets.

**ITEM 1—Legal Proceedings**

Information required for Part II, Item 1 is incorporated by reference to the discussion under the heading “Significant Events” in Note 11 of the Condensed Consolidated Financial Statements in Part I, Item 1 of this Form 10-Q.

**ITEM 2—Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities***Recent Sales of Unregistered Securities*

During the three months ended June 30, 2004, we issued to employees and directors 139,404 shares of common stock upon the exercise of stock options at a weighted average exercise price of \$24.53 per share. During the same period, we granted options to purchase 105,000 shares of common stock at a weighted average exercise price of \$22.20 per share.

The issuance of stock options and the common stock issuable upon the exercise of such options as described above were issued pursuant to written compensatory plans or arrangements with our employees and directors, in reliance upon the exemption provided by Rule 701 promulgated under the Securities Act of 1933, as amended. Employees and directors that receive options to purchase our common stock may exercise such options in accordance with the terms of our stock option plan and individual option agreements. Unless a registration statement is effective with respect to shares issued upon the exercise of such options, such shares currently will be restricted securities under the Securities Act of 1933, as amended, and may not be sold absent registration or an exemption from such registration requirement.

**ITEM 3—Defaults upon Senior Securities**

Not applicable.

**ITEM 4—Submission of Matters to Vote of Security Holders**

The Company’s annual meeting of stockholders was held on June 29, 2004. At the meeting, the stockholders:

(1) elected the following seven persons to serve as directors of the Company: William Wallace Abbott, Philip L. Carter, Edward L. Kuntz, William J. Mercer, Arthur J. Reimers, Guy P. Sansone and Arthur Siegel; and

(2) ratified the selection of Deloitte & Touche LLP as the Company’s independent auditors for the fiscal year ending December 31, 2004.

The number of votes cast for, against or withheld, and the number of abstentions with respect to each such matter is set forth below. There were no broker non-votes with respect to any of the matters voted upon.

<b>MATTER</b>	<b>FOR</b>	<b>AGAINST/WITHHELD</b>	<b>ABSTAINED</b>
(1) Election of Directors:			
William Wallace Abbott	17,980,250	2,200	—
Philip L. Carter	17,980,250	2,200	—
Edward L. Kuntz	17,871,565	110,885	—
William J. Mercer	17,980,250	2,200	—
Arthur J. Reimers	17,980,250	2,200	—
Guy P. Sansone	17,980,250	2,200	—
Arthur Siegel	17,094,800	887,650	—
(2) Ratification of Auditors	17,980,450	0	2,000

## **ITEM 5—Other Information**

Effective as of June 7, 2004, we entered into a second amendment and waiver to the Credit Agreement dated March 26, 2002 relating to our senior secured credit facilities in order to, among other things, permit the Company to (i) pay dividends on our Series A Convertible Preferred Stock and (ii) repurchase, prior to March 31, 2005, up to \$50.0 million in the aggregate of our obligations under our 9 1/2% Senior Subordinated Notes due 2012 or of our capital stock. A copy of the second amendment and waiver to our Credit Agreement is attached as Exhibit 10.1 hereto.

## **ITEM 6—Exhibits and Reports on Form 8-K**

### (a) Exhibits:

10.1 Second Amendment and Waiver, dated as of June 7, 2004, to the Company's \$275,000,000 Credit Agreement dated as of March 26, 2002.

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 April 16, 2004, the Company furnished a Current Report on Form 8-K to the Securities and Exchange Commission, dated April 16, 2004, disclosing under Item 12 that the Company filed its Annual Report on Form 10-K for the year ended December 31, 2003.

On May 3, 2004, the Company furnished a Current Report on Form 8-K to the Securities and Exchange Commission, dated May 3, 2004, disclosing under Item 12 its financial results for the quarter ended March 31, 2004.



## **EXHIBIT INDEX**

<u>Exhibit No.</u>	<u>Description</u>
10.1	Second Amendment and Waiver, dated as of June 7, 2004, to the Company's \$275,000,000 Credit Agreement dated as of March 26, 2002.
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.

EXECUTION VERSION

SECOND AMENDMENT AND WAIVER, dated as of June 7, 2004

(this "Amendment"), to the Credit Agreement, dated as of March 26, 2002 (as amended by the Amendment dated as of December 31, 2002 and as further amended, supplemented or modified from time to time, the "Credit Agreement"), among ROTECH HEALTHCARE INC., a Delaware corporation (the "Borrower"), the Lenders parties thereto, UBS WARBURG LLC and GOLDMAN SACHS CREDIT PARTNERS L.P., as joint lead arrangers and joint bookrunners (the "Arrangers"), GOLDMAN SACHS CREDIT PARTNERS L.P., as Syndication Agent, THE BANK OF NOVA SCOTIA, DEUTSCHE BANK SECURITIES INC. (formerly known as Deutsche Banc Alex. Brown Inc.) and GENERAL ELECTRIC CAPITAL CORPORATION, as Co-Documentation Agents, GENERAL ELECTRIC CAPITAL CORPORATION, as Collateral Agent, and UBS AG, STAMFORD BRANCH, as Administrative Agent.

WITNESSETH:

WHEREAS, the Borrower has requested that certain provisions of the Credit Agreement be amended and waived upon the terms and subject to the conditions set forth herein; and

WHEREAS, the Lenders have agreed to such amendments and waivers upon the terms and subject to the conditions set forth herein;

NOW, THEREFORE, in consideration of the premises and mutual covenants contained herein and in the Credit Agreement, the parties hereto hereby agree as follows:

SECTION 1. DEFINITIONS.

Unless otherwise defined herein, terms used herein and defined in the Credit Agreement are used herein as therein defined.

SECTION 2. AMENDMENT.

2.1 Amendment to Section 2.10 (Mandatory Prepayments and Commitment Reductions). Section 2.10 of the Credit Agreement is hereby amended by adding the following new paragraph (g) at the end thereof:

“(g) If any Revolving Credit Loans shall be outstanding on December 31, 2004, the Borrower shall, without notice or demand, prepay all such Revolving Credit Loans in their entirety and any interest accrued thereon, and shall cause the aggregate outstanding principal amount of all Revolving Credit Loans to be zero for the following five consecutive Business Days. Following such time period, the Borrower may resume borrowing under the Revolving Credit Facility as otherwise provided herein.”

2.2 Amendment to Section 7.6 (Restricted Payments). Section 7.6 of the Credit Agreement is hereby amended by (i) inserting the term “(a)” directly following the phrase “except that” set forth therein, (ii) deleting the period at the end of such Section, and (iii) adding the following at the end thereof:

“and (b) the Borrower may pay dividends on its Series A Convertible Preferred Stock in an aggregate amount not exceeding \$500,000 during any fiscal year of the Borrower or \$1,000,000 for any period of two fiscal years of the Borrower.”

### SECTION 3. WAIVER.

3.1 Waiver of Sections 4.16(b) and Section 7.9(a). The Lenders hereby waive until March 31, 2005 (but not beyond such date) compliance with Section 4.16(b) and Section 7.9(a) of the Credit Agreement in each case to the extent, but only to the extent, necessary to permit the Borrower to repurchase up to \$50,000,000 in the aggregate of its obligations under its Senior Subordinated Notes or of its Capital Stock and, at the option of the Borrower, use the proceeds of borrowings under the Revolving Credit Loans, subject to availability under Section 2.4 of the Credit Agreement, to finance such repurchase, provided that (a) availability under Section 2.4 of the Credit Agreement (excluding outstanding Letters of Credit) shall be no less than \$35,000,000 immediately prior and after giving effect to such repurchase, (b) no Default or Event of Default shall have occurred and be continuing immediately prior and after giving effect to such repurchase, and (c) if any repurchase is consummated on or after January 1, 2005, no Revolving Credit Loans shall be outstanding immediately prior and after giving effect to such repurchase.

3.2 Waiver of Event of Default. The Lenders hereby waive the Event of Default arising from (i) the Borrower's failure to deliver the Appraisal required by Section 6.3(e) of the Credit Agreement which was to have been delivered concurrently with the financial statements for the Borrower's fiscal year ended December 31, 2003 (the "2003 Appraisal") and (ii) the Borrower's failure to cure such Default pursuant to Section 8(d) of the Credit Agreement; provided that, the Borrower shall deliver the 2003 Appraisal by no later than June 15, 2004.

### SECTION 4. MISCELLANEOUS.

4.1 Conditions to Effectiveness. This Amendment shall become effective on the date the Administrative Agent shall have received: (a) an executed counterpart of this Amendment duly executed and delivered by the Borrower and each of the Required Lenders and (b) an Acknowledgement and Consent in the form attached hereto as Exhibit A duly executed and delivered by each Guarantor.

4.2 Representations and Warranties. As of the date hereof and after giving effect to the amendments contained herein, the Borrower hereby confirms, reaffirms and restates the representations and warranties made by it in Section 4 of the Credit Agreement, except to the extent any of such representations and warranties relate to a specific earlier date, in which case such representations and warranties shall be deemed true and correct on and as of such earlier date; provided, that each reference therein to the Credit Agreement shall be deemed to be a reference to the Credit Agreement after giving effect to this Amendment.

4.3 Payment of Expenses. The Borrower agrees to pay or reimburse the Administrative Agent for all of its out-of-pocket costs and expenses incurred in connection with this Amendment, any other documents prepared in connection herewith and the transactions

contemplated hereby, including, without limitation, the reasonable fees and disbursements of counsel to the Administrative Agent.

4.4 Continuing Effect. Except as expressly provided hereby, all of the terms and provisions of the Credit Agreement and the other Loan Documents are and shall remain in full force and effect. The amendments, waivers and acknowledgement contained herein shall not be construed to as an amendment or waiver of any other provision of the Credit Agreement or the other Loan Documents or for any purpose except as expressly set forth herein or a consent to any further or future action on the part of the Borrower that would require the waiver or consent of the Administrative Agent or the Lenders.

4.5 Counterparts. This Amendment may be executed by one or more of the parties hereto in any number of separate counterparts and all of said counterparts taken together shall be deemed to constitute one and the same instrument. Any executed counterpart delivered by facsimile transmission shall be effective as for all purposes hereof.

4.6 **GOVERNING LAW. THIS AMENDMENT AND THE RIGHTS AND OBLIGATIONS OF THE PARTIES HERETO SHALL BE GOVERNED BY, AND CONSTRUED AND INTERPRETED IN ACCORDANCE WITH, THE LAWS OF THE STATE OF NEW YORK.**

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be duly executed and delivered by their respective proper and duly authorized officers as of the day and year first above written.

ROTECH HEALTHCARE INC.

By: \_\_\_\_\_

Name:

Title:

UBS AG, STAMFORD BRANCH, as  
Administrative Agent and a Lender

By: \_\_\_\_\_

Name:

Title:

By: \_\_\_\_\_

Name:

Title:

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[LENDER]

By:

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Name:

Title:

**Ratio of Earnings to Fixed Charges**  
**Rotech Healthcare Inc.**  
(In thousands)

	Predecessor Company (1)				Successor Company (1)		
	Year ended December 31,			Three months ended March 31, 2002	Nine months ended December 31, 2002	Twelve Months ended December 31, 2003	Six months ended June 30, 2004
	1999	2000	2001				
<b>Ratio of Earnings to Fixed Charges</b>							
Pretax income (loss) from continuing operations	\$71,151	\$ 3,314	\$40,030	\$ (153,944)	\$ 24,775	\$ 15,217	\$ 32,959
Add fixed charges	8,363	8,251	7,832	1,900	40,333	50,171	22,529
<b>Total Earnings (Loss) (A)</b>	<b>\$79,514</b>	<b>\$11,565</b>	<b>\$47,862</b>	<b>\$ (152,044)</b>	<b>\$ 65,108</b>	<b>\$ 65,388</b>	<b>\$ 55,488</b>
Interest Expense	\$ 490	\$ 108	\$ 74	\$ 14	\$ 33,556	\$ 42,056	\$ 18,960
Estimate of the interest within rental expense (33% of total)	7,873	8,143	7,758	1,886	6,777	8,115	3,570
<b>Total Fixed Charges (B)</b>	<b>\$ 8,363</b>	<b>\$ 8,251</b>	<b>\$ 7,832</b>	<b>\$ 1,900</b>	<b>\$ 40,333</b>	<b>\$ 50,171</b>	<b>\$ 22,529</b>
<b>Ratio (A/B)</b>	<b>9.51x</b>	<b>1.40x</b>	<b>6.11x</b>	<b>(80.03)x(2)</b>	<b>1.61x</b>	<b>1.30x</b>	<b>2.46x</b>

- (1) Our predecessor, Rotech Medical Corporation, emerged from bankruptcy on March 26, 2002 and subsequently 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 "Predecessor Company" refers to the business and operations of Rotech Medical Corporation and its subsidiaries for all periods prior to April 1, 2002 and "Successor Company" refers to the business and operations of Rotech Healthcare Inc. and its subsidiaries for all periods after March 31, 2002.
- (2) 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 Company's assets to fair market value.

**CERTIFICATION**

I, Philip L. Carter, certify that:

1. I have reviewed this quarterly report on Form 10-Q for the quarter ended June 30, 2004 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 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 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 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: August 16, 2004

/s/ PHILIP L. CARTER

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**Philip L. Carter**  
**President and Chief Executive Officer**

**CERTIFICATION**

I, Barry E. Stewart, certify that:

1. I have reviewed this quarterly report on Form 10-Q for the quarter ended June 30, 2004 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 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 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 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: August 16, 2004

/s/ Barry E. Stewart

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**Barry E. Stewart**  
**Chief Financial Officer**

**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 June 30, 2004 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 Barry E. Stewart, 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

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Name: **Philip L. Carter**  
Title: **President and Chief Executive Officer**  
Date: **August 16, 2004**

/s/ Barry E. Stewart

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Name: **Barry E. Stewart**  
Title: **Chief Financial Officer**  
Date: **August 16, 2004**

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.