RESPIRONICS INC
Form 10-K
September 13, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

FORM 10-K

(Mark One)

x **Annual Report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934**
For the fiscal year ended June 30, 2005

or

¨ **Transition Report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from _____ to _____

Commission File No. 000-16723

RESPIRONICS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**25-1304989**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**
1010 Murry Ridge Lane	
Murrysville, Pennsylvania	**15668-8525**
(Address of principal executive offices)	**(Zip Code)**

(Registrant s Telephone Number, including area code) 724-387-5200

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**
None	

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value $.01 per share

(Title of Class)

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 periods that the registrant was required to file such reports) and (2) has been subject to such filing requirements for at least the past 90 days. Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes x No ¨

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

As of December 31, 2004, the aggregate market value of the registrant s voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant s most recently completed second fiscal quarter was approximately $1,708,000,000. (All directors, executive officers, and 10% shareholders of the registrant are considered affiliates).

As of August 31, 2005, there were 79,000,782 shares of Common Stock of the registrant outstanding, of which 6,990,359 were held in treasury. These amounts have been adjusted to reflect the two-for-one stock split effected in the form of a 100% stock dividend that was declared on April 20, 2005 and distributed on June 1, 2005.

Documents incorporated by reference: Portions of the Proxy Statement for the registrant s Annual Meeting of Shareholders to be held on November 15, 2005 are incorporated by reference into Part III of this Annual Report on Form 10-K.

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PART I

CAUTIONARY STATEMENT FOR PURPOSES OF THE SAFE HARBOR PROVISIONS OF THE PRIVATE SECURITIES REFORM ACT OF 1995.

The statements contained in this Annual Report on Form 10-K, including those contained in Item 1 Business and Item 7 Management s Discussion and Analysis of Results of Operations and Financial Condition, and statements incorporated by reference in this Form 10-K from the 2005 Annual Report to Shareholders, along with statements in other reports filed with the Securities and Exchange Commission, external documents and oral presentations which are not historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21B of the Securities Exchange Act of 1934, as amended. These forward-looking statements represent the Company s present expectations or beliefs concerning future events. The Company cautions that such statements are qualified by important factors that could cause actual results to differ materially from the expected results included in the forward-looking statements. Those factors include, but are not limited to, the following: developments in the healthcare industry; the success of the Company s marketing, sales, and promotion programs; future sales and acceptance of the Company s products and programs; the timing and success of new product introductions; new product development; anticipated cost savings; U.S. Food and Drug Administration (FDA) and other regulatory requirements and enforcement actions; future results from acquisitions; growth rates in foreign markets; regulations and other factors affecting operations and sales outside the United States (including potential future effects of the change in sovereignty of Hong Kong); the effects of a major earthquake, cyber-attack or other catastrophic event that results in the destruction or disruption of any of our critical business or information technology systems; foreign currency fluctuations; expiration of intellectual property rights; customer consolidation and concentration; increasing price competition and other competitive factors in the sale of products; interest rate fluctuations; intellectual property and related litigation; other litigation; future levels of earnings and revenues; the number of equity awards granted to employees and changes in the Company s stock price; and third party reimbursement; all of which are subject to change.

Item 1. Business

Respironics Inc. is a Delaware corporation with executive offices located at 1010 Murry Ridge Lane, Murrysville, PA 15668-8525. Unless the context indicates otherwise, reference in this Annual Report to the Company or Respironics refers to Respironics, Inc. and its domestic and foreign subsidiaries. Unless the context indicates otherwise, reference in this Annual Report to fiscal year refers to the twelve-month period ending on June 30 of the year indicated.

Respironics maintains an internet website at the following address: www.respironics.com. The information on the Company s website is not incorporated by reference in this Annual Report on Form 10-K.

Copies of the Company s Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, current reports on Form 8-K, and all amendments to these reports as filed with the Securities and Exchange Commission (the SEC) are available on or through the Company s website without charge as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. Copies are also available, without charge, upon written request to Dorita Pishko, Corporate Secretary, Respironics, Inc., 1010 Murry Ridge Lane, Murrysville, PA 15668-8525.

General

Respironics is a leading designer, developer, manufacturer and marketer of medical devices used primarily for the treatment of patients suffering from sleep and respiratory disorders. The Company s products are designed to reduce costs while improving the effectiveness of patient care and are used primarily in the home, in hospitals, in alternative care facilities and in emergency medical settings. The Company s primary product lines are:

(i) Homecare products, including: (a) sleep apnea products, including continuous positive airway pressure (CPAP) devices and bi-level positive airway pressure devices used in the home for the treatment of obstructive sleep apnea (OSA), a serious disorder characterized by the repeated cessation of

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breathing during sleep (a CPAP device provides continuous air pressure into a patient s airway, whereas a bi-level device provides higher air pressure into a patient s airway during inhalation and lower pressure during exhalation); (b) respiratory devices, including bi-level non-invasive ventilation products that provide positive airway pressure into a patient s airway to supplement (but not replace) the patient s own breathing; (c) invasive portable volume ventilation products used in the home; and (d) home oxygen products.

(ii) Hospital products, including: (a) therapeutic devices that assist or control a patient s ventilation, such as bi-level non-invasive ventilation products and critical care ventilation products that can deliver both non-invasive and invasive ventilation; (b) cardio-respiratory monitoring products that provide information about a patient s condition, all of which are used in hospital or institutional settings; (c) traditional respiratory drug delivery products; and

(iii) Other emerging product lines, including respiratory drug delivery products, Children s Medical Ventures infant management and developmental care products, and products aimed at offering solutions to sleep disorders beyond OSA. Consistent with the Company s strategy to broaden its scope and the breadth of its products and services, the Company established these individual product groups within its Homecare and Hospital product groups to meet the current and emerging needs of the sleep and respiratory markets.

Respironics markets its products through homecare, hospital, respiratory drug delivery and international sales organizations, which consist of approximately 756 direct and independent sales representatives and sales management personnel who sell to a network of over 5,000 medical product service providers and dealers (commonly referred to as dealers) and, in some cases, directly to hospitals and other institutions. The Company also rents certain of its products to dealers and, in limited cases, directly to end-users. With over 80% of its sales currently reaching the global homecare market, Respironics believes that it is well positioned to take advantage of the growing preference for in-home treatment of patients suffering from respiratory disorders.

Recent Acquisitions

Fiscal Year Ended June 30, 2005

Mini-Mitter On April 1, 2005, the Company acquired 100% of the outstanding shares of Mini-Mitter Company, Inc. (Mini-Mitter). The base cash purchase price approximated $10,500,000, with provisions for up to $7,500,000 of additional payments to be made based on Mini-Mitter s operating performance over the next two years. Mini-Mitter, located in Bend, Oregon, develops and sells sleep and physiological monitoring products to commercial sleep laboratories and other medical, pharmaceutical and health research institutions involved in clinical trials. The acquisition of Mini-Mitter broadens the Company s presence in the sleep market beyond its core OSA business through innovative technologies that will enable the Company to expand its current position and access new markets that have been identified as key in the broader sleep market. The results of operations of Mini-Mitter are included in the Company s Consolidated Statement of Operations beginning on the acquisition date, April 1, 2005.

Profile On July 1, 2004, the Company s offer to acquire 100% of the outstanding shares of Profile Therapeutics plc (Profile) was declared unconditional, and the Company paid 50.9 British Pence for each share of Profile, representing a total purchase price of 26,309,000 British Pounds (or approximately $43,524,000 net of $4,675,000 of cash acquired in the transaction). Profile, which is based in the United Kingdom (UK), distributes, develops and commercializes specialty products to improve the treatment of sleep and respiratory patients. The acquisition of Profile expands the Company s presence in the global sleep and respiratory markets, and enhances the breadth of its products and services with Profile s new innovative technologies for respiratory drug delivery. Prior to the acquisition, Profile was a distributor of the Company s sleep and ventilation products in the UK; the acquisition therefore expands the Company s distribution channel in the UK. Profile s core respiratory drug delivery system is an innovative platform that utilizes intelligent inhalation technology called Adaptive Aerosol Delivery (AAD). This delivery system is designed to automatically respond to individual patients breathing patterns to deliver a precise dose synchronized with a patient s inhalation cycle.

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The technology has the potential to benefit patients by ensuring a uniform drug dose and reproducible therapy, and in addition, allows for smaller fill volumes of drug to be used compared to conventional nebulizers. Profile s second generation AAD system, Prodose, is approved for use in the UK and various markets in Europe, and it has received 510(k) clearance from the FDA. The results of operations of Profile are included in the Company s Consolidated Statement of Operations beginning on the acquisition date, July 1, 2004.

During the year ended June 30, 2005, the Company also acquired distribution channels in Italy and Switzerland as well as an independent sales organization that previously sold the Company s products in certain U.S. territories. These acquisitions did not materially affect the Company s financial condition or results of operations, individually or in the aggregate.

Fiscal Year Ended June 30, 2004

Caradyne On February 27, 2004, the Company acquired 100% of the outstanding capital stock of Western Biomedical Technologies (WBT), an Ireland-based company, which owns 100% of the outstanding capital stock of Caradyne Limited, now known as Respironics (Ireland) Limited , for a base purchase price of $5,970,000 (including transaction costs), of which $4,470,000 was paid at closing and up to $1,500,000 is scheduled to be paid at the end of a two-year retention period. The Company may also be required to make up to $2,500,000 of additional future payments based on the achievement of various performance milestones following the acquisition through December 31, 2005 (as amended), of which $2,000,000 was paid as of June 30, 2005 as a result of the successful achievement of performance milestones. WBT and Respironics (Ireland) Limited are collectively referred to herein as Caradyne. Caradyne is involved in the development, manufacturing and marketing of proprietary technologies that are complementary with the Company s ventilation product portfolio, which are primarily used in hospital settings and pre-hospital applications. The results of operations of Caradyne are included in the Company s Consolidated Statement of Operations beginning on the acquisition date, February 27, 2004.

BiliChek On March 6, 2003, the Company acquired certain assets related to the BiliChek Non-invasive Bilirubin Analyzer product line from SpectRx, Inc. for a base purchase price of $4,000,000 and up to $7,250,000 of additional future payments based on the achievement of various performance milestones following the acquisition through December 31, 2007. As of June 30, 2005, the Company accrued (on a cumulative basis since the acquisition date) $3,381,000 for milestones achieved during the period (of which $3,030,000 was paid as of June 30, 2005). Additionally, in June 2005 the Company advanced $1,000,000 to SpectRx, Inc. as a prepayment for performance milestones expected to be achieved during the 2006 fiscal year. The acquisition expands the Company s involvement with the acquired product line from U.S. marketing and sales under a prior exclusive license agreement, to worldwide marketing and sales and also to the future development and manufacturing of the BiliChek product. The results of operations of BiliChek are included in the Company s Consolidated Statement of Operations beginning on the acquisition date, March 6, 2003.

See Note Q to the Consolidated Financial Statements for more information about these acquisitions.

Products

The following are registered trademarks of the Company as used in this document: Respironics, REMstar, Encore, Encore SmartCard, Tranquility, Smart Monitor, Wallaby, Inspiration, Esprit, BiPAP, BiPAP Vision, PLV, Synchrony, Alice, Stardust, BiliChek, AAD, Bi-Flex, Flow-TRAK, NICO, Prodose, BiPAP Harmony, Sleepware and WhisperFlow. The following are trademarks of the Company as used in this document: Respironics Millennium, Profile Lite, Simplicity, Comfort Series, ComfortSelect, ComfortClassic, ComfortLite, ComfortGel, ComfortFull, ComfortCurve, SleepLink, Contour Deluxe, Performa Trak, I-neb, and NeoPAP.

The trademark C-Flex is used under license.

The Company s principal products can be divided into two categories: homecare products and hospital products, both of which are used in the diagnosis and treatment of patients suffering from sleep and respiratory disorders.

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Homecare Products

The Company s homecare products can be separated into the following major subcategories: sleep apnea diagnosis and therapy products; non-invasive ventilation products; invasive portable volume ventilation products; and oxygen products.

Sleep Apnea Products. Respironics believes it is the worldwide market share leader in OSA therapy devices. The Company s primary OSA products include the REMstar CPAP Series and the BiPAP Series and Tranquility bi-level units, and related accessories such as humidifiers, masks, tubes, filters and headgear.

The Company s CPAP devices consist of a small, portable air pressurization device, an air pressure control and a mask worn by the patient at home during sleep. The REMstar Series CPAP systems (REMstar Plus, REMstar Pro and REMstar Auto) are low-cost, innovative OSA therapy devices that meet the Company s strategy of offering units at all key price points and represent state-of-the-art CPAP systems that provide high-quality treatment options at an economical price. The REMstar Auto CPAP system utilizes innovative technology to monitor the patient s airway and adjust output automatically in order to deliver the appropriate pressure. The REMstar Pro and REMstar Auto also feature built-in memory to record patient usage and quality of life data. The Company s Encore SmartCard is a device used to retrieve this patient data, update air pressure settings, and change modes of operations for certain of the Company s CPAP and bi-level devices by utilizing specially developed data management software that is programmed onto a credit card sized Encore SmartCard. The C-Flex technology provides OSA sufferers with a more comfortable treatment for sleep apnea when compared to traditional CPAP treatment by tracking the patient s breathing to ensure the optimal amount of pressure is delivered at exhalation. The C-Flex technology is currently available on the Company s REMstar Pro (released during the 2003 fiscal year), REMstar Pro II (released during the 2005 fiscal year), REMstar Plus (released during the 2004 fiscal year), and REMstar Auto (released during the 2005 fiscal year).

The BiPAP Pro, BiPAP Plus and Tranquility Bi-level System are the Company s primary bi-level OSA units. These units sense the patient s breathing cycle and adjust the pressure accordingly. The BiPAP Pro unit also contains advanced leak-sensing technology, which improves the unit s pressure adjustment capability. Bi-level units are used to treat severe OSA and are useful in improving acceptance of therapy by patients as an alternative to CPAP.

The Company also offers both integrated and stand-alone humidifiers as accessories to support its strategy of enhancing patient adherence to the therapy provided by its CPAP and bi-level devices. Humidifying the air that flows into the patient s airway provides more comfortable therapy for certain patients.

The Company also provides masks used with CPAP and bi-level devices, primarily from its Comfort Series including the Respironics Profile Lite, ComfortSelect, ComfortClassic, ComfortLite, ComfortGel, ComfortFull Face, ComfortCurve and Respironics Simplicity masks. The Company believes that its nasal mask products were the first masks to adequately seal on a patient s face for nasal CPAP delivery, thereby minimizing patient discomfort and promoting increased patient compliance with prescribed usage. The Company s nasal mask products are designed to enhance patient comfort by utilizing a variety of shapes and designs and a variety of cushion materials to create a comfortable mask seal around the contours of the face while delivering effective CPAP and bi-level therapy. Full face masks address the needs of specific patient groups for whom CPAP and bi-level therapy is delivered most effectively and comfortably through masks that cover the mouth and nose.

Respironics also manufactures and distributes a wide range of technologically advanced computer-based products for use in the diagnosis of sleep related disorders. The Company provides advanced, technically proficient clinical products for use in sleep disorders laboratories (commonly known as sleep labs). The Company also provides products for patient testing in the home that allow clinicians to expand the

number of patients who can be served by a traditional sleep lab.

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The Company s primary sleep diagnostic product is the Alice System. Alice is a computer-based system for use in sleep labs and other clinical settings. With the release of the Alice 5 sleep diagnostic unit during the 2005 fiscal year, the device is capable of recording up to 25 channels of physiological data, which are stored on either a desktop or portable computer prior to permanent storage on optical cartridges. In addition to acquiring and storing the patient s physiological data, the Alice System utilizes physician input and internal algorithms to provide a comprehensive range of reports for clinical analysis. Alice can be used on infants or adults, and separate software programs were developed specifically for each type of patient.

The Company also manufactures and markets Stardust II, a palm-sized portable sleep system that monitors up to seven channels of physiological data for up to ten hours per patient and features pre-programmed host software that simplifies data analysis. Among other factors, Stardust is distinguished by its physiological sensors that are specifically designed for use in the home. These sensors record a variety of patient data and the information is subsequently sent to the sleep lab or other clinical setting where it is diagnosed by a trained clinician.

The Synchrony Sleep Lab System, consisting of the Synchrony pressure generator and a palm-sized remote control unit, is used by clinicians in prescribing therapy for the treatment of adult OSA once a diagnosis has been made.

The Company estimates that in the U.S. there are currently more than 2,500 sleep labs located at hospitals, other medical centers and freestanding sites where pulmonologists, technicians and other medical professionals diagnose OSA (as well as other sleep disorders) and then prescribe the appropriate treatment. Sleep labs provide the most frequent source of patient introductions to the Company s sleep and home respiratory sleep products.

OSA patients can purchase or rent the Company s OSA therapy products from home medical equipment service provider and dealer locations throughout most of the world. Personnel at each of these locations are generally equipped to train the patient in the product s use and to maintain and service the product. See Sales, Distribution, and Marketing. The retail price for a CPAP unit ranges from $1,200 to $1,700, depending on the type of unit, geographical market and whether certain accessories are purchased. The retail price for a bi-level OSA unit generally ranges from $2,400 to $3,000, depending on which model is purchased. The Company s sleep diagnostic products are sold through dealers and directly to clinical sites.

Non-invasive Ventilation Products. The Company believes it is the leading manufacturer and marketer of non-invasive ventilation products in the U.S. These products are intended to augment the ventilation of a spontaneously breathing patient, but are not intended to satisfy the total ventilation requirements of the patient.

The Company s principal non-invasive ventilation product for home use is the BiPAP Synchrony Ventilatory Support System. This device is a low-pressure, electrically-driven flow generator with an electronic pressure control designed to augment patient breathing by supplying pressurized air to the patient. This device senses the patient s breathing and adjusts its output to assist in inhalation and exhalation. Additionally, the device compensates for mask leaks, which often occur in the delivery of ventilatory support to the patient, thereby providing what the Company believes is a more efficient and consistent non-invasive therapy than competing ventilators. The face masks described above are also used with the non-invasive ventilatory support units.

The Company believes that its non-invasive ventilation products have the potential for increasing patient comfort by adapting to the patient s breathing cycles as opposed to requiring the patient to adapt his or her breathing to the ventilator cycles and by delivering therapy effectively with a patient mask rather than requiring intubation. Non-invasive ventilation products are generally less expensive than invasive ventilators.

Invasive Portable Volume Ventilation Products. The Company manufactures and markets invasive portable volume ventilators that are used in the home by individuals who are typically dependent on ventilators for continuous life support.

The Company s principal invasive portable volume ventilator is the PLV-100, a microprocessor-controlled, electrically powered unit specifically designed for long-term use in the home and also suitable for transport,

short-term and institutional use. The PLV-100 can be used to ventilate a wide range of patients. The small, lightweight unit delivers volume ventilation through the operation of a piston inside the unit, and it can be powered by normal AC power or DC battery power and be operated in three different ventilation modes depending on the patient s needs. The unit features a variety of alarms and displays to alert clinicians and caregivers to changes in the patient s pulmonary status or to possible unit malfunction. The Company manufactures and distributes different versions of the PLV-100 for international markets based on language differences, and it also manufactures and distributes a variety of accessories for use with the PLV-100. The PLV-100 unit and related accessories reach end-user patients primarily through the Company s network of medical product dealers who purchase or rent the unit from the Company and resell or rent it to end-users. In certain limited cases, the Company rents these units directly to end-users. The Company s next generation invasive portable volume ventilator, the PLV-C, was released in August 2005.

Oxygen Products. The Company s principal oxygen products are oxygen concentrators, which provide a continuous flow of oxygen by separating it from room air with a molecular sieve composed of an inorganic silicate. Oxygen concentrators are generally used in the home by patients who require supplemental oxygen. Supplemental oxygen is prescribed for people with a variety of chronic pulmonary disorders, such as lung cancer, emphysema, bronchitis or acute pneumonia. These individuals generally rent an oxygen delivery system from a home medical equipment dealer.

The Company s primary oxygen concentrator product is the Respironics Millennium. This unit is designed to be easy to maintain and service and is suitable for chronic patients in the advanced stages of illness and for the less severe respiratory patient. The Respironics Millennium also features a low sound level and is mobile, both of which are important features for a device that is used in the home. In 2004, the Company introduced the Respironics Millennium M10 concentrator (M10), which was engineered to reduce the cost of providing oxygen at higher liter flows.

The Company also manufactures and markets oximeter products for use in the home. The units, which allow the caregiver to take readings of the patient s blood oxygen levels and pulse rate, feature the capability to store up to 18 hours of data. This data can be later downloaded via the Company s software, which prints reports for oximetry analysis.

Hospital Products

The Company has three primary hospital product groups: (a) therapeutic products that assist or control a patient s ventilation, (b) cardio-respiratory monitoring products that provide clinical information about a patient s condition, and (c) traditional respiratory drug delivery products.

Therapeutic Products. The Company s primary therapeutic products are the BiPAP Vision and the Esprit. The BiPAP Vision is a non-invasive ventilatory support device designed specifically for hospital use which features an oxygen module, provides higher flow and pressure functions than the Company s other non-invasive units, and is designed to be easily upgraded. The BiPAP Vision also includes integrated airway pressure monitoring, an integrated display screen, a disposable circuit and a mounting stand, all of which are designed to allow the unit to be used more easily in delivering non-invasive ventilation support in the hospital environment.

The Company also manufactures and markets the Esprit, a ventilator designed for use in the hospital and other institutional settings. Esprit is designed to effectively deliver both invasive and noninvasive ventilation, thus eliminating the need to use two separate ventilators for one patient and allowing it to be used throughout the continuum of patient care. With invasive ventilation, the ventilator delivers a mixture of room air and oxygen into a patient s lungs via a tube inserted into the patient s airway. These patients are typically dependent on the ventilator for life support. Esprit features a graphical user interface with an infrared touch screen, alarm and status indicators designed to allow rapid assessment of alarm

conditions and patient status, volume and pressure control, and is designed to be easily upgraded. The Company developed and released several software and other

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product enhancements to the Esprit ventilator, including Flow-TRAK and Trending, aimed at increasing its capabilities and ease of use. Flow-TRAK provides a new breathing mode for the Esprit, whereby the volume of gas delivery can be increased or decreased based on the patient s requirements. Trending provides the clinician with the ability to review patient data, alarm occurrences and ventilator settings from the previous seventy-two hour period. The Esprit has a graphics option available, designed to provide clinicians with immediate, real time feedback in order to optimize ventilator settings. Also available is a color screen option, designed to enhance the clinicians ability to identify displays and facilitate the Esprit s already easy-to-use graphical user interface.

The Company s February 2004 acquisition of Caradyne provided new innovative noninvasive devices for use in hospitals and pre-hospital applications. The WhisperFlow product line provides a comprehensive noninvasive ventilation treatment solution effective for treating a wide range of adult and pediatric respiratory conditions. Most notably, it is designed to reduce the patient s work of breathing, improve oxygen uptake and is highly portable and easy to use.

The Company also manufactures, distributes and rents several other hospital ventilation products, including a version of the PLV-100 designed more specifically for institutional use, and a variety of masks, tubing and headgear similar to those used in the sleep and home respiratory market described above along with certain other accessories specifically designed for hospital and institutional use.

Cardio-Respiratory Monitoring Products. The Company manufactures and markets cardio-respiratory monitors, sensors and related disposable accessories. These electronic devices provide the measurements and continuous display of a patient s cardiac output, carbon dioxide, oxygen saturation and respiratory mechanics parameters. The sensors for the Company s devices are designed so that this patient data can be gathered non-invasively. Noninvasive monitoring offers advantages over invasive monitoring, including a reduced likelihood of infection and other associated complications that can result from invasive monitoring. The Company s cardio-respiratory monitoring devices are used in hospital operating rooms, intensive care units, emergency departments, and while transporting patients to or within hospitals.

Traditional Respiratory Drug Delivery Products. The Company provides respiratory drug delivery products that are used in both the home and hospital settings, including nebulizers, peak flow meters, and spacers. The Company distributes several models of medication nebulizers, which dispense medication in a fine mist for inhalation deep into the lungs, under the trade name Inspiration. The primary uses for nebulizers have been in the treatment of respiratory diseases, such as emphysema and chronic bronchitis, and conditions such as asthma. The Company s models utilize a compressor to direct a flow of air through the nebulizer chamber that contains medication in liquid form. An increase in the number of available respiratory medications in recent years, coupled with the cost and efficacy of aerosol delivery methods, has contributed to the growth of this market. A peak flow meter provides an objective measure of lung function and is used by the patient at home to assist in the management of asthma. A spacer, when used with a metered dose inhaler (MDI), facilitates the delivery of asthma medications.

Profile also develops and sells traditional nebulizers and compressors that are complimentary to the Company s existing nebulizer product family.

Other Emerging Product Lines

The Company has also established other product groups that represent potential emerging growth drivers, including respiratory drug delivery products, Children s Medical Ventures infant management and developmental care products, and products aimed at offering solutions to sleep disorders beyond OSA. Consistent with the Company s strategy to broaden its scope and the breadth of its products and services, the Company established these individual product groups within its Homecare and Hospital product groups to meet the current and emerging needs of the sleep and respiratory markets.

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Respiratory Drug Delivery Products. Through its July 1, 2004 acquisition of Profile, the Company added Profile s core respiratory delivery technology, an intelligent inhalation platform called Adaptive Aerosol Delivery (AAD). This delivery system is designed to automatically respond to individual patients breathing patterns to deliver a precise dose synchronized with the patient s inhalation cycle. The technology has the potential to benefit patients by ensuring a uniform drug dose and reproducible therapy, and in addition, allows for smaller fill volumes of drug to be used and faster treatment times compared to conventional nebulizers. The Company s second generation AAD system, Prodose, is approved for use in the UK, various markets in Europe and has received 510K clearance from the U.S. Food and Drug Administration. During the 2005 fiscal year, the Company reached agreement with a customer to supply the AAD system for delivery of the pulmonary arterial hypertension drug, Ventavis (iloprost) Inhalation Solution, which recently received FDA approval for marketing in the U.S. The Company also provides, via a third party contract manufacturer, its own branded antibiotic, Promixin, which treats chronic infections associated with cystic fibrosis. Promixin, launched by Profile in 2003 in the UK and marketed in the European Community primarily in combination with the Company s AAD device, is a branded generic antibiotic designed to be delivered directly to the site of infection in the lungs. A new handheld, portable and silent version of AAD technology called I-neb is approved for use in the European market and is currently awaiting FDA approval.

Children s Medical Ventures Infant Management and Developmental Care Products. Children s Medical Ventures is a leading provider of developmentally supportive products for premature babies, healthy newborns and older hospitalized infants. The Company s primary infant management products are monitoring devices designed for infants at risk for sudden infant death syndrome or SIDS. SIDS is the sudden unexpected death of an infant that remains unexplained after investigation and is one of the leading causes of death in the U.S. of infants between one month and one year of age. Despite extensive research, the causes of SIDS remain unknown. High-risk infants who are prescribed home monitors include infants with low birth weight, those who are premature, those who survive serious cardio-respiratory episodes and those born to a family with a SIDS incident history. A limited number of alternative monitoring technologies are generally available.

The Company s primary infant monitor is the Smart Monitor, a fifth-generation microprocessor-based design that incorporates many aspects of a physiological recorder into the traditional monitor. In addition to sounding an alarm to alert the infant s caregiver, the Smart Monitor documents patient episodes with an internal electronic memory system, enabling physicians to study up to six channels of patient waveforms in order to assess the medical significance of the alarm episodes and determine the need for continued monitoring or possible hospitalization. The data collected by the Smart Monitor can be transmitted from the home to a clinical center over phone lines or can be extracted from the Smart Monitor using a memory transfer device such as a computer.

The Company also manufactures and markets the Wallaby II Phototherapy System, a cost-effective, home-based alternative to conventional overhead phototherapy lights for treating newborn jaundice, a condition which is caused by elevated levels of bilirubin in the blood and which, in severe cases, can result in brain damage.

The Company also manufactures and markets the BiliChek Non-Invasive Bilirubin Analyzer, a non-invasive device that measures the level of bilirubin in the blood of infants. The historical method of measuring bilirubin levels to diagnose jaundice in infants, the heel stick, involves drawing blood from the infant and is a painful, costly and time consuming procedure. BiliChek replaces the heel stick by analyzing reflected light shined on an infant s forehead to generate immediate and painless test results at a low cost. The Company acquired the BiliChek line of products from SpectRx, Inc. on March 6, 2003. Prior to the acquisition, the Company had exclusive distribution rights in the United States and Canada for the BiliChek. The device has received clearance to market from the FDA for infants before, during and after phototherapy treatment.

The Company also markets developmental care products and services designed to improve the quality of care for premature infants. These developmental care products are designed to meet the unique needs of premature

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infants, including appropriately sized infant care products, safety equipment and specialty feeding and skin care products. The Company also offers related education products and programs. The Company s developmental care products are used in the home and in neonatal and pediatric intensive care units of hospitals.

Sleep Well Ventures. Sleep Well Ventures was established to become the worldwide leader at providing innovative and highly valued sleep and wake solutions beyond OSA. Sleep Well Ventures gained several active product lines and development initiatives with the acquisition of Mini-Mitter on April 1, 2005. Current products are in the field of Actigraphy, and includes device used to determine energy expenditure, sleep/wake patterns, sleep quality and evaluate circadian rhythms. Additionally, Biotelemetry products are used to monitor body temperature, heart rate and variability and stress responses.

* * * * * * * * * *

Sales of homecare products and all related accessories and replacement parts accounted for 82% (domestic 60%; international 22%), 81% (62%; 19%) and 81% (62%; 19%), of the Company s net sales for its fiscal years 2005, 2004, and 2003, respectively. Sales of hospital products and accessories accounted for 18% (domestic 11%; international 7%), 19% (13%; 6%), and 19% (13%, 6%) of the Company s net sales for fiscal years 2005, 2004 and 2003, respectively.

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Manufacturing and Properties

The Company owns or leases its manufacturing, office and warehouse facilities. The Company s major facilities and their primary uses are summarized below:

	Square Feet	Owned/Leased
United States:		
Murrysville, Pennsylvania (offices)	55,000	Owned
Murrysville, Pennsylvania (offices)	23,000	Leased
Murrysville, Pennsylvania (offices and manufacturing)	127,000	Owned
Monroeville, Pennsylvania (offices)	138,000	Owned
Plum Borough, Pennsylvania (offices and warehouse)	17,000	Leased
Kennesaw, Georgia (offices and manufacturing)	129,000	Leased
Carlsbad, California (offices and manufacturing)	85,000	Leased
Wallingford, Connecticut (offices and manufacturing)	53,000	Leased
Cedar Grove, New Jersey (offices)	10,000	Leased
Youngwood, Pennsylvania (warehouse)	104,000	Leased
Edison, New Jersey (warehouse)	6,800	Leased
Houston, Texas (warehouse)	6,000	Leased
Concord, California (warehouse)	6,400	Leased
La Mirada, California (warehouse)	6,400	Leased
Bend, Oregon (offices and manufacturing)	9,300	Leased
Thornton, Colorado (offices and warehouse)	9,000	Leased
International:		
Hong Kong (offices)	10,000	Leased
Shenzhen, China (manufacturing)	100,000	Leased
Subic Bay, Philippines (manufacturing)	2,300	Leased
Tokyo, Japan (offices)	5,400	Leased
Saitama City, Japan (warehouse)	26,300	Leased
Herrsching, Germany (offices and warehouse)	19,000	Leased
Nantes, France (offices and warehouse)	7,800	Leased
Paris, France (offices)	3,400	Leased
Galway, Ireland (offices and manufacturing)	14,000	Leased
West Sussex, United Kingdom (offices and manufacturing)	36,000	Leased
Zofingen, Switzerland (offices)	600	Leased
Desio, Italy (offices)	1,200	Leased

The Company also has approximately 75 sales and service centers throughout Japan, each of which is approximately 950 square feet in size and is leased.

Operations in the Far East and Europe are subject to the risks normally associated with foreign operations including, but not limited to, foreign currency fluctuations, possible changes in export or import restrictions and the modification or introduction of governmental policies with potentially adverse effects.

The Company believes that its present facilities are suitable and adequate for its current and presently anticipated future needs. While several facilities are extensively utilized, additional productive capacity is available through a variety of means including augmenting the current partial

second shift work schedule at the United States facilities. Rental space, which the Company believes is readily available and reasonably priced near each current location, could be utilized as well. The Company s current and prior year acquisitions did not create any material excess or unused capacity. The Company also owns undeveloped land near its existing Murrysville facilities that can be used for future expansion, if needed.

The Company generally performs all major assembly work on all of its products. It manufactures many of the plastic components for its face mask products and uses subcontractors to supply certain other components. The Company purchases the component parts for its major products from a number of different suppliers. The raw materials used in the Company s components have historically been readily available. However, loss of a key supplier or access to certain raw materials could have a material adverse impact on the Company.

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Sales, Distribution and Marketing

The Company sells and, in some cases, rents its products primarily to home medical equipment service providers (also referred to herein as homecare dealers or providers) and hospital distributors. These parties in turn resell and rent the Company s products to end-users. The Company also sells certain of its products directly to hospitals. The Company initiated a change in the third quarter of fiscal year 2005 related to the distribution of its BiPAP Vision Non-invasive Ventilation system for hospital applications. During the third and fourth quarters of fiscal year 2005 the Company has been transitioning from distributor-based sales to a direct-sales model for this product line. Effective July 1, 2005 the Company began selling the Vision ventilator directly to its domestic hospital customers.

The Company s products reach its customers in the United States through the direct sales force, comprised of 40 national account and regional sales managers that direct the activities of 212 direct sales representatives and sales support specialists, as well as 38 independent manufacturers representatives. The Company s sales management team includes leadership positions across all major product groups and geographical regions, including the U.S. and Canada, South and Central America, Europe and Middle East, and Far East and Asia Pacific. The Company s international sales organization includes approximately 300 individuals, including management, account managers, sales support specialists, and direct sales representatives. The Company s international sales organization sells products from both the Homecare and Hospital product groups. International sales accounted for approximately 29%, 25% and 25% of the Company s net sales for fiscal years 2005, 2004 and 2003, respectively.

The Company s solutions-oriented approach to doing business with customers incorporates specific products with a package of diagnostic tools and other educational materials. This approach is designed to support a provider s desire to offer the finest care possible while assisting the provider in growing its business.

The Company s marketing organization is currently staffed by Product Managers, who are assigned to each of the Company s principal product groups. The Product Managers stay abreast of changes in the marketplace, with an emphasis on product use specifications, features, price, promotions, education, training and distribution.

The Company has relationships with a variety of key customers. Some of these relationships are based on written supply agreements, while others are not. The Company extended its supply agreements with several key customers during the 2005 fiscal year. These agreements generally represent the right to sell to customers, often at stated prices and terms. However, often this access is shared and the Company (and its competitors) must compete for new business. Most of these relationships are terminable at will or upon short notice periods. Maintaining positive relationships with these customers is a key element of the Company s sales and marketing strategy. Failure to maintain customer relationships could adversely affect the Company s future results of operations.

The Company s U.S. homecare dealer customer base (which ranges in size from large, publicly held dealers with several hundred branch locations to small, owner-operated dealers with one location) continues to undergo consolidation, particularly among dealers specializing in homecare products. The impact on the Company of this customer consolidation is likely to continue to be reduced selling prices for the Company s products as a result of greater purchasing power and market dominance enjoyed by larger customers.

During the fiscal year ended June 30, 2005, no individual customer accounted for 10% or more of the Company s net sales. However, in the aggregate homecare dealer customers constitute an important market for the Company s products.

The Company offers leasing programs to certain of its customers through arrangements with independent leasing companies. In some cases, these arrangements make the Company contingently liable, in the event of a customer default, to the leasing companies for certain unpaid installment receivables initiated by or transferred to the

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leasing companies. The Company s total exposure for unpaid installment receivables under these leasing programs was approximately $16,835,000 and $14,999,000 at June 30, 2005 and 2004, respectively. Approximately 8% of the Company s net sales were made under these financing arrangements during the years ended June 30, 2005 and 2004, of which a portion was made with recourse. The Company is not dependent on these off-balance sheet arrangements. See Note K to the Consolidated Financial Statements for additional information.

The majority of the Company s revenue in Japan is derived from renting devices to hospitals that in turn provide these devices to patients for use in their homes, with the Company providing product service and support to these patients. The hospital pays monthly fees under month-to-month rental contracts for the patients product use and other services and support the Company provides. In these cases, the hospitals receive reimbursement from the Japanese government for providing devices to the patients. The Company also sells products to hospitals and to a network of distributors who resell to other distributors.

Competition

The Company believes that the principal competitive factors in all of its markets are product and service performance and innovation, efficient distribution and competitive price. Price competition has become more intense in the last several years. In the case of a number of the Company s and its competitors products, patent protection is becoming more prevalent and of increasing competitive importance. The Company competes on a product-by-product basis with various other companies, some of which have significantly greater financial and marketing resources and broader product lines than the Company.

The Company believes that it maintains a strong market presence in several of the major markets and product groups in which it competes. However, other manufacturers, including other larger and more experienced manufacturers of home healthcare products, are active in these markets and the Company expects competition to increase. In its major product lines, the Company competes with two principal competitors, divisions of Tyco International Ltd. (Tyco) and ResMed, Inc. (ResMed). Tyco, which is the Company s largest major competitor and has the greatest financial resources of the Company s competitors, offers an array of products that compete with many of the Company s major products. ResMed competes with the Company in OSA and noninvasive ventilation. The Company also competes with Invacare Corp., Viasys Healthcare Inc., Dräger AG, Getinge AG, Vital Signs, Inc., Monaghan Medical Corp., Fisher & Paykel Healthcare Corp. Ltd., and with divisions of Sunrise Medical, Inc. Additionally, the Company competes with a number of smaller foreign medical device manufacturers and healthcare providers, primarily in local overseas markets and, to a lesser extent, in the U.S.

The Company s customer base and the medical device manufacturing industry are undergoing consolidation. Several of the Company s competitors have been involved in acquisitions. The impact on the Company of this competitor consolidation is likely to be greater competition from medical device manufacturers that can utilize the financial and technical resources that may be made available as a result of the consolidation.

Research and Development

The Company believes that its ability to identify product opportunities, to respond to the needs of physicians, healthcare providers, and their patients in the treatment of sleep and respiratory and other disorders and to incorporate the latest technological innovations into its products has been and will continue to be important to its success. The Company s research and development efforts are focused on understanding the problems faced by physicians and healthcare providers and their patients needs and on maintaining the Company s technological leadership in its core product areas. The Company maintains both formal and informal relationships with physician practitioners and researchers to supplement its research and development efforts. The Company s research and development efforts enable it to capitalize on opportunities in the sleep and

respiratory medical product market by upgrading its current products as well as developing new products. In addition to the ongoing research and development work in the Company s existing product areas and existing sleep and respiratory

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markets, the Company continues to invest in research and development to identify opportunities in, and potential solutions to other patient needs in the sleep and respiratory markets.

The Company conducts the vast majority of its research and development for existing and potential new products in the U.S. Through the acquisitions of Caradyne and Profile, the Company also conducts certain research and development activities in Ireland and the UK, respectively. The Company currently employs approximately 450 engineers, technicians and support personnel in these activities. The research and development staff performs overall conceptual design work for all products and the design work related to the manufacturing, engineering and tooling for products manufactured by the Company. The Company spent approximately $45,625,000 (5% of net sales) in fiscal year 2005, $29,478,000 (4% of net sales) in fiscal year 2004 and $24,048,000 (4% of net sales) in fiscal year 2003, to support product enhancement and new product development.

The Company introduced new products in all of its core product areas during fiscal years 2005, 2004 and 2003. New product introductions in 2005 included the REMstar Auto with C-Flex CPAP device; REMstar Pro II; BiPAP Harmony S/T and BiPAP S/T; new masks, including the ComfortCurve and Disposable Lab masks; product software enhancements to the Encore Pro Patient Data Management Software; Alice 5 Diagnostic unit and Sleepware software; and Stardust II portable diagnostic device; NeoPAP; and software and functional enhancements to the Esprit ventilation system and cardio-respiratory monitoring devices, among others. Significant product development efforts are ongoing and new product launches in many of the Company s major product lines are scheduled for the next six to eighteen months. Additional development work and clinical trials are being conducted in certain product areas and markets outside the Company s current core products and patient groups.

In addition to its development efforts in its core product areas, the Company is actively pursuing product development activities in a variety of new markets. The Company continues to invest in research and development related to other sleep disorders and in respiratory drug delivery applications. The Company continues to explore the area of congestive heart failure (CHF) and the potential co-morbidities that exist between CHF and sufferers of OSA. An additional related opportunity is the use of positive airway pressure to improve cardiovascular function.

Patents, Trademarks and Licenses

The Company seeks protection for certain of its products through the prosecution and acquisition of patents and exclusive licensing arrangements. In addition, the Company aggressively defends its patents and other rights when infringed by other companies. The Company currently has approximately 471 U.S. and foreign patents (compared to 437 as of June 30, 2004) and has additional U.S. and foreign patent applications pending. Some of these patents and patent applications relate to significant aspects and features of the Company s products. Thirty-nine of these patents expire in the next five years as follows: three expire in fiscal year 2006, nine expire in fiscal year 2007, three expire in fiscal year 2008, ten expire in fiscal year 2009 and fourteen expire in fiscal year 2010. The Company has an increasingly diverse portfolio of products that should help to mitigate the impact that expiring patents could have on its business. However, the expiration of the Company s intellectual property rights may have a future adverse impact on the Company.

The Company also has approximately 279 registered U.S. and foreign trademarks (compared to 256 as of June 30, 2004) and has additional U.S. and foreign trademark applications pending.

Regulatory Matters

The Company s products are subject to regulation by, among other governmental entities, the FDA and corresponding foreign agencies. The FDA regulates the introduction, manufacture, advertising, labeling, packaging, marketing and distribution of and recordkeeping for such products in the U.S. The Company must comply with statutory requirements and FDA regulations and is subject to various FDA recordkeeping and

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reporting requirements and to inspections by the FDA. The testing for and preparation of required applications can be expensive, and subsequent FDA review can be lengthy and the results uncertain. The FDA also regulates the clinical testing of medical devices. Moreover, FDA clearance or approval, if granted, can include significant limitations on the indicated uses for which a product may be marketed. Failure to comply with applicable FDA requirements can result in fines, civil penalties, suspensions or revocation of clearances or approvals, recalls or product seizures, operating restrictions or criminal penalties. Delays in receipt of, or failure to receive, FDA clearances or approvals for the Company s products for which such clearances or approvals have not yet been obtained would adversely affect the marketing of such products in the U.S. and could adversely affect the results of future operations.

The Company must obtain FDA or foreign regulatory approval or clearance for marketing the Company s new devices prior to their release for commercial distribution. There are two primary means by which the FDA permits a medical device to be marketed in the U.S. A manufacturer may seek clearance for the device by filing a 510(k) premarket notification with the FDA. To obtain such clearance, the 510(k) premarket notification must establish that the device is substantially equivalent to a predicate device that has been legally marketed under a 510(k) notification or was marketed before May 28, 1976. In some situations, a device also may be cleared by a 510(k) premarket notification through de novo classification even though there is no predicate device. The manufacturer may not place the device into commercial distribution in the U.S. until a substantial equivalence determination notice is issued by the FDA. The FDA, however, may determine that the proposed device is not substantially equivalent, or require further information, such as additional test data or clinical data, or require the Company to modify its product labeling, before it will make a finding of substantial equivalence. The process of obtaining FDA clearance of a 510(k) premarket notification, including testing, preparation of the 510(k) premarket notification and subsequent FDA review, can take a number of years and require the expenditure of substantial resources.

If a manufacturer cannot establish, to the FDA s satisfaction, that a new device is substantially equivalent to a legally marketed device, it will have to seek approval to market the device through the premarket approval application (PMA) process. This process involves preclinical studies and clinical trials. The process of completing clinical trials, submitting a PMA and obtaining FDA clearance takes a number of years and requires the expenditure of substantial resources. In addition, there can be no assurance that the FDA will approve a PMA. The Company s export activities and clinical investigations also are subject to the FDA s jurisdiction and enforcement.

Foreign regulatory approvals vary widely depending on the country. The Company s business in Japan is subject to government regulation generally similar to that in the U.S. The Japanese Ministry of Health requires registration and review of new products prior to granting approval to distribute such products in Japan and also requires product recalls and corrective actions when circumstances warrant. The Company has received ISO 9001 certification for its Murrysville, Kennesaw, Bend, Carlsbad, Wallingford, Cedar Grove, Nantes, Herrsching, Subic Bay and Shenzhen facilities based on criterion developed by the International Organization for Standardization, a quality standards organization with headquarters in Geneva, Switzerland. The Company has also received authorization for the same facilities, under the European Union s Medical Devices Directive, to affix the CE Mark to the Company s products marketed throughout the world. The primary component of the certification process was an audit of the facilities quality systems conducted by an independent agency authorized to perform conformity assessments under ISO guidelines and the Medical Devices Directive. Since receiving their original ISO 9001 certification, these facilities have undergone periodic update audits by such independent agencies.

Pharmaceutical products are controlled in the European Community (EC) primarily through the system of licensing and conditional exemptions from licensing set forth in EC legislation, the Medicines Act of 1968 and in relevant subordinate legislation. This legislation covers the systems by which licenses to manufacture, market, distribute, sell and supply medicinal products are granted by Ministers (the Licensing Authority) (or, in the new centralized system, by the relevant EC institutions), once they are satisfied about the safety, efficacy and quality of the product.

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Third Party Reimbursement

The cost of a significant portion of medical care in the U.S. is funded by government and private insurance programs, such as Medicare, Medicaid and corporate health insurance programs including health maintenance organizations and managed care organizations. Countries outside of the U.S. also have government and private insurance medical reimbursement programs that vary on a country-by-country basis, with varying levels of reimbursement and degrees of sophistication. Except for amounts representing an insignificant portion of the Company s annual revenues (less than 1%), the Company does not file claims or bill governmental programs and other third-party payers directly for reimbursement for its products sold in the United States. However, the Company is still subject to laws and regulations relating to governmental programs, and violation of these laws and regulations could result in civil and criminal penalties, including fines. The Company believes that its businesses and operations do not violate these laws. The Company s future results of operations and financial condition could also be negatively affected by adverse changes made in the reimbursement policies for medical products under these insurance programs. If such changes were to occur, the ability of the Company s customers to obtain adequate reimbursement for the resale or rental of the Company s products could be reduced. In recent years, limitations imposed on the levels of reimbursement by both government and private insurance programs have become more prevalent.

The Company has obtained procedure codes for its homecare products from the Centers for Medicare and Medicaid Services (CMS) (formerly known as the Healthcare Financing Administration). These procedure codes enhance the ability of medical product distributors and dealers to obtain reimbursement for providing products to patients covered by Medicare and other insurance payers. However, reimbursement levels can be reduced after a procedure code has been established.

The amount of reimbursement that a hospital can obtain under the Medicare diagnosis related group (DRG) payment system for utilizing the Company s products in treating patients is a primary determinant of the revenue that can be realized by medical product distributors and dealers who resell or rent the Company s hospital products. Many private insurance programs also utilize the Medicare DRG system. The various uses of the Company s hospital products to treat patients are provided within the DRG system. The levels of reimbursement under the DRG system are also subject to review and change.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) was signed into law on December 8, 2003. The Act reduced medical reimbursement for respiratory drugs and home oxygen to homecare providers and placed a freeze on current reimbursement levels for durable medical equipment (DME) through 2008, including certain of the Company s products. In 2007, Medicare will begin competitively bidding certain DME products and services in specified Metropolitan areas. Although the specific DME products and services affected by competitive bidding have not yet been determined, it is possible that some of the Company s product offerings could be included. CMS is expected to publish a proposed rule in the Federal Register and solicit public comments about how competitive bidding of DME may be implemented. These changes in medical reimbursement may have a future adverse impact on the Company s results of operations, although the Company believes that its product breadth and diversification and manufacturing efficiencies will help to mitigate the potential financial impact of the medical reimbursement reductions.

Both the federal government and numerous state legislatures are considering options for containing growth in the Medicaid program. Certain states including California, Missouri, and Pennsylvania have discussed adjusting the payment for DME which could result in reimbursement reductions or non-coverage of some DME. Medicaid payment for products and services are determined by each state and are subject to review and change.

Employees

The Company currently has approximately 3,900 employees, including approximately 970 hourly employees in the U.S. and 824 hourly employees in the Far East. None of the Company s employees are covered by collective

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bargaining agreements. The Company considers its labor relations to be good and has never suffered a work stoppage as a result of a labor conflict.

Financial Information About Foreign and Domestic Operations and Export Sales

Financial information concerning foreign and domestic operations and export sales is discussed in Item 1, Business - Sales, Distribution and Marketing, and set forth in Note N of the Consolidated Financial Statements included in this Annual Report.

Item 2. Properties

Information with respect to the location and general character of the principal properties of the Company is included in Item 1, Business - Manufacturing and Properties.

Item 3. Legal Proceedings

Invacare Litigation

On March 5, 2004, the Company filed a lawsuit against Invacare Corporation (Invacare) in the United States District Court for the Western District of Pennsylvania alleging that Invacare s manufacture, sale and marketing of a new CPAP device infringes one or more of eleven U.S. patents of the Company. In its complaint, the Company has sought preliminary and permanent injunctive relief, damages and an award of three times actual damages because of Invacare s willful infringement of its patents. In its answer to the complaint, Invacare has denied the infringement allegations of the complaint. Currently, trial on liability issues is scheduled for February 2006.

On August 10, 2004, Invacare filed a lawsuit against the Company in the United States District Court in the Northern District of Ohio alleging that the Company has engaged in monopolization, restraint of trade and unfair competition in the sale and distribution of sleep apnea products. The lawsuit s claims include allegations that the Company s actions and alleged market power have foreclosed competitors from alleged markets and have created markets where there has not been competitive pricing or availability of competitive product offerings. In the lawsuit, Invacare seeks damages in an unspecified amount and to treble such damages pursuant to the antitrust laws, as well as attorney s fees and punitive damages. Invacare also seeks injunctive relief as to certain marketing practices. The Company is vigorously defending itself in this suit.

Other

The Company is, as a normal part of its business operations, a party to other legal proceedings in addition to those described above. Legal counsel has been retained for each proceeding, and none of these proceedings is expected to have a material adverse impact on the Company s results of operations or financial condition.

Item 4. Submission of Matters to a Vote of Security Holders

During the fourth quarter of the fiscal year 2005, no matters were submitted to a vote of security holders.

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PART II

Item 5. Market for Registrant s Common Equity, Related Shareholder Matters, and Issuer Purchases of Equity Securities

As of June 30, 2005, 78,689,442 shares of the Company s common stock were issued, of which 6,990,529 were held in treasury. The common stock is traded in the over-the-counter market and is reported on the NASDAQ National Market System under the symbol RESP. As of September 7, 2005, there were approximately 2,500 holders of record of the Company s common stock.

On April 20, 2005, the Company declared a two-for-one stock split effected in the form of a 100% stock dividend that was distributed on June 1, 2005. Accordingly, all share price information has been adjusted to reflect the stock split.

The Company has never paid a cash dividend with respect to its common stock. While the Company periodically reviews its policies with respect to dividends, it does not intend to pay cash dividends in the immediate future.

High and low sales price information for the Company s common stock for the applicable quarters is shown below.

Fiscal year ended June 30, 2005:

	First	Second	Third	Fourth
High	$ 29.48	$ 28.45	$ 30.76	$ 37.40
Low	$ 25.08	$ 21.88	$ 26.08	$ 29.13

Fiscal year ended June 30, 2004:

	First	Second	Third	Fourth
High	$ 21.79	$ 23.50	$ 27.37	$ 29.38
Low	$ 18.98	$ 20.00	$ 21.94	$ 25.27

The Company did not repurchase any shares of its common stock during the years ended June 30, 2005, 2004 or 2003. On a cumulative basis since inception of a previously disclosed stock repurchase plan that was initially approved by the Company s Board of Directors in August 1998, through June 30, 2005 the Company repurchased 7,600,000 shares at an average price per share of approximately $5.75. A maximum of 8,000,000 shares may be repurchased under this program (from which 400,000 shares remain available for repurchase as of June 30, 2005), for which there is no expiration date. The Company may continue to repurchase shares of its common stock for cash in the open market, or in negotiated block transactions, from time to time as market and business conditions warrant.

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Item 6. Selected Financial Data

The information set forth below is not necessarily indicative of the results of future operations and should be read in conjunction with the Company s consolidated financial statements and related notes as well as the section of the report titled Item 7. Management s Discussion and Analysis of Results of Operations and Financial Condition.

The results of operations of acquired entities, including Mini-Mitter, acquired in April 2005; Profile acquired in July 2004; Caradyne, acquired in February 2004; BiliChek; acquired in March 2003; Fuji RC Kabushiki Kaisha (now known as Fuji Respironics Kabushiki Kaisha and referred to herein as Fuji), acquired in May 2002; and Novametrix Medical Systems Inc. (now known as Respironics Novametrix, LLC and referred to herein as Novametrix), acquired in April 2002, have been included in the Company s Consolidated Statements of Operations beginning on their respective acquisition dates.

Income Statement Data:

	Year Ended June 30				
	2005(1)	2004(1)	2003(1)	2002(2)(4)	2001(3)(4)
	(Amounts in thousands except per share data)				
Net sales	$ 911,497	$ 759,550	$ 629,817	$ 494,919	$ 422,438
Cost of goods sold	413,215	356,625	310,385	260,795	224,087
	498,282	402,925	319,432	234,124	198,351
General and administrative expenses, excluding acquisition earn-out expenses	123,040	100,232	83,731	60,719	50,126
Acquisition earn-out expenses	3,493	8,533	2,036		
Sales, marketing and commission expenses	182,796	147,740	116,300	86,189	72,428
Research and development expenses	45,625	29,478	24,047	17,317	15,281
Contribution to Foundation	3,000	2,844			
Restructuring and acquisition-related expenses (credits)	6,415	10,942	17,789	2,288	(1,909)
Impairment charge				2,006	
Other (income) expense, net	(1,806)	(2,078)	639	1,569	6,517
Income before income taxes	135,719	105,234	74,890	64,036	55,908
Income taxes	51,363	40,214	28,309	25,619	22,337
Net income	$ 84,356	$ 65,020	$ 46,581	$ 38,417	$ 33,571
Diluted earnings per share	$ 1.17	$ 0.92	$ 0.68	$ 0.60	$ 0.54
Diluted shares outstanding	72,255	70,619	68,688	64,016	61,772

(1) Refer to Item 7. Management s Discussion and Analysis of Results of Operations and Financial Condition.
(2)

Includes the impact of a non-recurring purchase accounting adjustment related to reversing acquisition date inventory fair market value adjustments as inventory was sold subsequent to the acquisition of Novametrix ($1,653,000), restructuring and acquisition-related expenses related to the integration of Novametrix ($2,288,000), and an asset impairment charge ($2,006,000).

(3) Includes a $2,000,000 gain from the sale of the Company s Westminster, Colorado facility.

(4) Includes $3,507,000 of goodwill amortization expense in both fiscal years 2002 and 2001. As of July 1, 2002, the Company ceased amortizing goodwill due to the adoption of Financial Accounting Standards Board (FASB) No. 142, Goodwill and Other Intangible Assets.

Balance Sheet Data:

	June 30				
	2005	2004	2003	2002	2001
Working capital	$ 334,997	$ 301,032	$ 212,787	$ 198,966	$ 171,985
Total assets	878,446	711,139	582,196	550,911	367,295
Total long-term obligations	29,241	26,897	16,513	59,502	80,055
Shareholders equity	627,646	519,053	426,869	367,720	235,268

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There were no cash dividends declared or paid during any of the periods presented in the above table.

All share information has been adjusted to reflect the two-for-one stock split effected in the form of a 100% stock dividend that was declared on April 20, 2005 and distributed on June 1, 2005.

Item 7. Management s Discussion and Analysis of Results of Operations and Financial Condition

EXECUTIVE SUMMARY

The Company reported record financial results in fiscal year 2005. The year was marked by the Company s continued successful leadership in the global OSA marketplace, further acceptance and adoption of the Company s ventilation therapies in various geographic markets, successful international expansion and the emergence of Children s Medical Ventures as a growth driver for the Company. Additionally, during fiscal year 2005 the Company made significant progress in fostering the development of new growth drivers for its business, including advanced respiratory drug delivery and the screening, diagnosing and treatment of other sleep disorders. Listed below are some of the individual measures of the Company s performance in 2005 and other significant highlights:

The Company achieved 20% revenue growth in fiscal year 2005 compared to fiscal year 2004, led by global sleep therapy growth of $87,348,000, or 22% (domestic - 19%; international - 31%). The Company s growth in OSA therapy products was achieved through the success of recent product introductions and the Company s overall product breadth in OSA therapy, continued acceptance and recognition of C-Flex technology among patients and providers, strong sales channels with sleep labs, thought leaders, and homecare providers, strength of the sales force and the success of customer programs, and growth of the domestic sleep apnea therapy market (estimated to be approximately 15% - 20%). Global home ventilation revenues increased by $14,252,000 or 18%. The Company s Global Children s Medical Ventures revenue exceeded the $55,000,000 mark during the 2005 fiscal year, representing 24% growth compared to the prior year. Overall global hospital ventilation growth was $10,795,000, or 11% compared to fiscal year 2004, as the Company s Esprit critical care ventilator continued to gain market acceptance. The primary geographic locations experiencing organic revenue increases were the U.S., Europe and the Far East/Asia Pacific, where the Company has made significant investments in sales force and marketing programs.

The Company completed several business acquisitions during fiscal year 2005, enabling the Company to expand its presence in the global sleep and respiratory markets by enhancing the breadth of products and services into the drug delivery and sleep and physiological monitoring areas, and through international expansion in key markets. Overall, $36,168,000 of incremental sales were contributed by acquired companies in fiscal year 2005, which represents 5% acquired growth. The acquisition of Profile on July 1, 2004 expanded the Company s presence in the global sleep and respiratory markets, and enhanced the breadth of its products and services with Profile s new innovative technologies for respiratory drug delivery. Caradyne, which was acquired on February 27, 2004, offers proprietary technologies that are complementary with the Company s ventilation product portfolio, used in hospital and pre-hospital applications. The Company acquired Mini-Mitter on April 1, 2005, which enabled the Company to expand its presence in diagnosing and treating sleep disorders through Mini-Mitter s sleep and physiological monitoring products.

The Company achieved earnings of $1.17 per diluted share in fiscal year 2005, compared to $0.92 per diluted share in fiscal year 2004. The improved earnings were primarily driven by the 20% revenue growth described above. The Company also improved its gross margins to 55% of net sales for the year ended June 30, 2005, compared to 53% of net sales for the year ended June 30, 2004. The increase in gross profit percentage was due to higher revenues, positive product and geographic mix, and material cost reductions achieved through the Company s successful negotiations with suppliers and product design changes.

The Company spent approximately $45,625,000 on research and development activities in fiscal year 2005, which represents 5% of net sales. During fiscal year 2005 the Company introduced a number of

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new products across all major product groups, including REMstar Auto with C-Flex, REMstar Pro II, BiPAP Harmony S/T and BiPAP S/T, new masks including the ComfortCurve and Disposable Lab masks, product software enhancements to the Encore Pro Patient Data Management Software, Alice 5 Diagnostic unit and Sleepware software, Stardust II portable diagnostic device, NeoPAP, and software and functional enhancements to the Esprit ventilation system and cardio-respiratory monitoring devices.

During the 2005 fiscal year the Company contributed $3,000,000 to the Respironics Sleep and Respiratory Research Foundation, which was formed for scientific, educational, and charitable purposes and is used to promote awareness of and research into the medical consequences of sleep and respiratory problems.

The Company generated $135,078,000 in cash from operations during the 2005 fiscal year and made continued improvements in working capital management, including reductions in days sales outstanding from 61 days as of June 30, 2004 to 55 days as of June 30, 2005. After spending $63,097,000 for business acquisitions during the 2005 fiscal year, the Company added $42,186,000 to its cash balance during the year. As of June 30, 2005, the Company has $234,632,000 of cash and cash equivalents and $149,066,000 in borrowing capacity under its Revolving Credit Agreement available for future expansion.

During fiscal year 2005 the Company repatriated $37,500,000 from certain foreign subsidiaries, of which $22,500,000 was repatriated in order to take advantage of temporary incentives under the American Jobs Creation Act of 2004.

On April 20, 2005 the Company declared a two-for-one stock split effected in the form of a 100% stock dividend. The stock dividend was distributed on June 1, 2005 to shareholders of record on May 9, 2005.

RESULTS OF OPERATIONS

Fiscal Year Ended June 30, 2005, Compared to Fiscal Year Ended June 30, 2004:

Year ended June 30	2005	2004	Percent Increase (Decrease)
Net sales	$ 911,496,811	$ 759,549,845	20%
Cost of goods sold	413,214,533	356,625,125	16%
	498,282,278	402,924,720	24%
General and administrative expenses (excluding acquisition earn-out expenses)	123,040,210	100,231,728	23%
Acquisition earn-out expenses	3,492,699	8,533,000	(59%)
Sales, marketing and commission expenses	182,796,568	147,739,729	24%
Research and development expenses	45,625,059	29,477,699	55%
Contribution to foundation	3,000,000	2,844,475	5%
Restructuring and acquisition-related expenses	6,415,363	10,942,352	(41%)
Other (income) expense, net	(1,806,475)	(2,078,417)	(13%)
	362,563,424	297,690,566	22%
INCOME BEFORE INCOME TAXES	135,718,854	105,234,154	29%
Income taxes	51,362,800	40,214,309	28%
NET INCOME	$ 84,356,054	$ 65,019,845	30%

Diluted earnings per share	$ 1.17	$ 0.92	27%
Diluted shares outstanding	72,254,509	70,618,700	

All share and per share information has been adjusted to reflect the two-for-one stock split effected in the form of a 100% stock dividend that was declared on April 20, 2005 and distributed on June 1, 2005.

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Net sales Net sales for the year ended June 30, 2005 were $911,497,000 representing a 20% increase over sales of $759,550,000 recorded for the year ended June 30, 2004. The Company s sales growth occurred across all product groups, summarized as follows.

	Year Ended June 30				Dollar Increase	Percent Increase
	2005		2004			
Domestic Homecare Products	$ 545,453,000	60%	$ 471,645,000	62%	$ 73,808,000	16%
Domestic Hospital Products	102,549,000	11%	95,876,000	13%	6,673,000	7%
International Products	263,495,000	29%	192,029,000	25%	71,466,000	37%
	$ 911,497,000	100%	$ 759,550,000	100%	$ 151,947,000	20%

Domestic homecare product sales for the year ended June 30, 2005 were driven primarily by growth in sales of sleep apnea therapy devices, masks, and accessories (the Company s largest product line), which represented $62,850,000 of the increase over the prior year, or 19% growth. The Company s growth in OSA therapy products was achieved through the success of recent product introductions and the Company s overall product breadth in OSA therapy, continued acceptance and recognition of C-Flex technology among patients and providers, strong sales channels with sleep labs, thought leaders, and homecare providers, strength of the sales force and the success of customer programs, and growth of the domestic OSA therapy market (estimated to be approximately 15% 20%). Sales of Children s Medical Ventures developmental infant care products constituted the majority of the remainder of the sales increase over the prior year.

Within domestic hospital product sales, ventilation growth was 5% during the year ended June 30, 2005. During fiscal year 2005 the Company initiated a change related to the distribution of its BiPAP Vision Non-invasive Ventilation system, whereby the Company transitioned from distributor-based sales to a direct-sales model for this product line. Effective July 1, 2005 the Company began selling the Vision ventilator directly to its domestic hospital customers. During the transition, this change resulted in lower overall hospital ventilation growth in fiscal year 2005. The Company s Esprit critical care ventilator continued to gain market acceptance in 2005, evidencing the growing acceptance of the Company s approach to the management of ventilated patients in the hospital setting.

The Company s international growth during the year ended June 30, 2005 included increased sales of both homecare and hospital products; the most significant increases coming from sleep therapy devices and accessories ($24,498,000 increase over the prior year, representing 31% growth), home ventilation systems and accessories ($14,423,000 over the prior year, representing 33% growth), and international hospital ventilation products (7,769,000 increase over the prior year, representing 21% growth). The Company s recent acquisitions, including Profile and Caradyne, contributed $27,238,000 of international sales during the year ended June 30, 2005. The primary geographic locations experiencing organic revenue increases were Europe and the Far East/Asia Pacific, where the Company has made significant investments in sales force and marketing programs. Changes in foreign currency exchange rates contributed $4,500,000 of revenues during the year ended June 30, 2005 (less than 1% of net sales) compared to the prior year.

Gross Profit The Company s gross profit was 55% of net sales for the year ended June 30, 2005, compared to 53% of net sales for the year ended June 30, 2004. The increase in gross profit percentage was primarily due to higher revenue, product sales mix (between sales of electro-mechanical devices and masks and accessories, domestic and international sales, and product groups) and material cost reductions achieved through the Company s successful negotiations with suppliers and product design changes.

General and Administrative Expenses (excluding acquisition earn-out expenses) General and administrative expenses were $123,040,000 (13% of net sales) for the year ended June 30, 2005 as compared to $100,232,000 (13% of net sales) for the year ended June 30, 2004. The increase for the year ended June 30, 2005

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was due primarily to higher employee compensation, consistent with the growth of the Company s business and the financial performance achieved during the year, increases in information technology, legal and product warranty costs, and general and administrative expenses at recently acquired companies (which constituted $9,133,000 of the increase).

Acquisition Earn-out Expenses During the years ended June 30, 2005 and 2004, the Company incurred acquisition earn-out expenses related to the Company s May 2002 Fuji acquisition of $3,493,000 (less than 1% of net sales) and $8,533,000 (1% of net sales), respectively. Included in the prior year amount was the impact of a revision to the estimated earn-out obligation due to Fuji s positive financial performance since the acquisition date. See Note Q to the Consolidated Financial Statements for additional information regarding the Fuji acquisition.

Sales, Marketing and Commission Expenses Sales, marketing and commission expenses were $182,797,000 (20% of net sales) for the year ended June 30, 2005 as compared to $147,740,000 (19% of net sales) for the year ended June 30, 2004. The increase was driven by higher variable sales force compensation, consistent with the increase in sales levels from the prior year, sales, marketing and commission expenses incurred at recently acquired companies (which contributed $8,850,000 of the increase), costs associated with the Company s change in distribution of the BiPAP Vision Non-Invasive Ventilation System, as well as the Company s continued investments in sales and marketing programs and sales force, especially in international markets.

Research and Development Expenses Research and development expenses were $45,625,000 (5% of net sales) for the year ended June 30, 2005 as compared to $29,478,000 (4% of net sales) for the year ended June 30, 2004. The increases were due to the Company s continuing commitment to research, development and new product introductions, as well as research and development expenses incurred at recently acquired companies (which contributed $5,048,000 of the increase). Significant product development efforts are ongoing and new product launches in many of the Company s major product lines are scheduled over the next eighteen months. Additional development work and clinical trials are being conducted in certain product areas within the sleep and respiratory markets outside the Company s current core products and patient groups.

Contribution to Foundation During the years ended June 30, 2005 and 2004, respectively, the Company made contributions totaling $3,000,000 (less than 1% of net sales) and $2,844,000 (less than 1% of net sales) to the Respironics Sleep and Respiratory Research Foundation (the Foundation). The Foundation was formed for scientific, educational and charitable purposes and is used to promote awareness of and research into the medical consequences of sleep and respiratory problems.

Restructuring and Acquisition-Related Expenses During the year ended June 30, 2005, the Company incurred restructuring and acquisition-related expenses of $6,415,000, related primarily to the restructuring of operations at the Wallingford, Connecticut manufacturing facility ($4,701,000) and the integration of recently acquired companies ($2,611,000), offset by a reduction to the reserve for idle facility lease obligation at the Kennesaw, Georgia manufacturing facility based on increased utilization ($897,000 credit). During the year ended June 30, 2004, the Company incurred restructuring and acquisition-related expenses of $10,942,000, related primarily to the restructuring of operations at the Wallingford, Connecticut manufacturing facility. See Note P to the Consolidated Financial Statements for additional information regarding restructuring and acquisition-related expenses.

Other (Income) Expense, Net Other (income) expense, net was $(1,806,000) for the year ended June 30, 2005 as compared to $(2,078,000) for the year ended June 30, 2004. Other (income) expense, net in all periods presented is comprised of interest income on cash and cash equivalents (net of interest expense on long-term debt), realized and unrealized foreign currency exchange (gains) losses, partially offset by recognized losses (gains) on designated cash flow hedges that are more fully described in Note I to the Consolidated Financial Statements.

Income Taxes The Company s effective income tax rate was approximately 38% for the years ended June 30, 2005 and 2004. The income tax benefits associated with various on-going tax planning, primarily in the state and

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international tax areas, were offset by additional income tax expense from the repatriation of foreign earnings during the year ended June 30, 2005 (partially offset by foreign tax credits and other items) that is more fully described in Note L to the Consolidated Financial Statements, and higher non-deductible acquisition earn-out expenses during the year ended June 30, 2004.

Except as disclosed in Note L to the Consolidated Financial Statements, the Company has not provided a valuation allowance for deferred income tax assets because it has determined that it is more likely than not that these assets can be realized, at a minimum, through carrybacks to prior years in which taxable income was generated.

Net Income As a result of the factors described above, the Company s net income was $84,356,000 (9% of net sales) or $1.17 per diluted share for the year ended June 30, 2005 as compared to net income of $65,020,000 (9% of net sales) or $0.92 per diluted share for the year ended June 30, 2004. The restructuring and acquisition-related expenses described above constituted a reduction of $0.05 and $0.10 per diluted share on an after-tax basis, respectively, for the years ended June 30, 2005 and 2004.

Fiscal Year Ended June 30, 2004, Compared to Fiscal Year Ended June 30, 2003:

Year ended June 30	2004	2003	Percent Increase (Decrease)
Net sales	$ 759,549,845	$ 629,817,447	21%
Cost of goods sold	356,625,125	310,385,469	15%
	402,924,720	319,431,978	26%
General and administrative expenses (excluding acquisition earn-out expenses)	100,231,728	83,730,678	20%
Acquisition earn-out expenses	8,533,000	2,036,000	319%
Sales, marketing and commission expenses	147,739,729	116,299,669	27%
Research and development expenses	29,477,699	24,047,538	23%
Contribution to foundation	2,844,475		
Restructuring and acquisition-related expenses	10,942,352	17,788,719	(38%)
Other (income) expense, net	(2,078,417)	639,520	
	297,690,566	244,542,124	22%
INCOME BEFORE INCOME TAXES	105,234,154	74,889,854	41%
Income taxes	40,214,309	28,308,365	42%
NET INCOME	$ 65,019,845	$ 46,581,489	40%
Diluted earnings per share	$ 0.92	$ 0.68	35%
Diluted shares outstanding	70,618,700	68,688,006	

Net sales Net sales for the year ended June 30, 2004 were $759,550,000 representing a 21% increase over sales of $628,817,000 recorded for the year ended June 30, 2003. The Company s sales growth occurred across all product groups, summarized as follows.

	Year Ended June 30				Dollar Increase	Percent Increase
	2004		2003			
Domestic Homecare Products	$ 471,645,000	62%	$ 388,166,000	62%	$ 83,479,000	22%
Domestic Hospital Products	95,876,000	13%	79,776,000	13%	16,100,000	20%
International Products	192,029,000	25%	161,875,000	25%	30,154,000	19%
Total	$ 759,550,000	100%	$ 629,817,000	100%	$ 129,733,000	21%

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Domestic homecare sales for the year ended June 30, 2004 were driven primarily by growth in sales of sleep apnea therapy devices, masks, and accessories (the Company s largest product line), which represented $66,880,000 of the increase over the prior year, or 26% growth. The Company s growth in obstructive sleep apnea therapy products was achieved through the success of recent product introductions and the Company s overall product breadth in obstructive sleep apnea therapy, strength of the sales force and the success of customer programs, and growth of the domestic obstructive sleep apnea therapy market (estimated to be approximately 15% - 20%). Sales of developmental infant care products and oxygen products constituted the majority of the remainder of the sales increase over the prior year.

Sales of domestic hospital products for the year ended June 30, 2004 were driven primarily by growth in sales of hospital ventilators and accessories, which represented $13,439,000 of the increase over the prior year, or 30% growth, evidencing the growing acceptance of the Company s approach to the management of ventilated patients in the hospital setting.

The Company s international growth included sales from both homecare and hospital products; the most significant increases coming from homecare sleep apnea therapy devices and accessories ($19,901,000 of the increase over the prior year) and hospital ventilation systems and accessories ($6,395,000 of the increase over the prior year). The primary geographic drivers for these revenue gains were Europe and the Far East/Asia Pacific, where the Company has made significant investments in sales force and marketing programs. In Japan, in particular, the Company has experienced continued growth from the May 2002 acquisition of Fuji. Changes in foreign currency exchange rates contributed $6,808,000 of revenues during the year ended June 30, 2004 (less than 1% of net sales) compared to the prior year. Included in net sales for the year ended June 30, 2003 is approximately $10,000,000 in revenues resulting from the demand for ventilation products associated with the treatment of SARS (Severe Acute Respiratory Syndrome) during the fourth quarter of fiscal year 2003 that did not recur during the year ended June 30, 2004.

Gross Profit The Company s gross profit was 53% of net sales for the year ended June 30, 2004 compared to 51% of net sales for the year ended June 30, 2003. The increase in gross profit percentage was primarily due to higher revenue, product sales mix (between sales of electro-mechanical devices and masks and accessories, and between domestic and international sales), material cost reductions (achieved through the Company s successful negotiations with suppliers and product design changes), and reduced indirect manufacturing costs resulting from the Company s restructuring of operations at its Kennesaw, Georgia manufacturing facility. See Note P to the Consolidated Financial Statements for additional information regarding the restructuring.

General and Administrative Expenses (excluding acquisition earn-out expenses) General and administrative expenses were $100,232,000 (13% of net sales) for the year ended June 30, 2004 as compared to $83,731,000 (13% of net sales) for the year ended June 30, 2003. The increase for the year ended June 30, 2004 was due primarily to higher employee compensation, consistent with the growth of the Company s business and the strong financial performance achieved during the year, increases in product warranty costs and an impairment loss on a specific investment that experienced an other than temporary decline in fair market value (as of June 30, 2004 the total remaining carrying value of the investment is $1,254,000).

Acquisition Earn-out Expenses During the years ended June 30, 2004 and 2003, the Company incurred acquisition earn-out expenses related to the Company s May 2002 Fuji acquisition of $8,533,000 (1% of net sales) and $2,036,000 (less than 1% of net sales), respectively. The increase in this expense compared to the prior year was due to Fuji s positive financial performance during the year ended June 30, 2004. See Note Q to the Consolidated Financial Statements for additional information regarding the Fuji acquisition.

Sales, Marketing and Commission Expenses Sales, marketing and commission expenses were $147,740,000 (19% of net sales) for the year ended June 30, 2004 as compared to $116,300,000 (18% of net sales) for the year ended June 30, 2003. The increase was driven by higher variable sales force compensation consistent with the increase in sales levels from the prior year. Also during the year ended June 30, 2004, the Company made significant investments in sales and marketing programs and sales force, especially in international markets.

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Research and Development Expenses Research and development expenses were $29,478,000 (4% of net sales) for the year ended June 30, 2004 as compared to $24,047,000 (4% of net sales) for the year ended June 30, 2003. The increases were due to the Company s continuing commitment to research, development and new product introductions. New product introductions in 2004 included the REMstar Plus with C-Flex CPAP device; BiPAP Pro II with Bi-Flex and BiPAP Plus bi-level obstructive sleep apnea therapy unit; new masks, including the ComfortLite, ComfortGel, Contour Deluxe, Performa Classic, and Performa Trak; product software enhancements to the Encore Pro Patient Data Management Software, SleepLink, and Esprit ventilation system; the NICO version 5.0 cardiac output monitoring system; and the Millennium M10 Concentrator.

Contribution to Foundation During the year ended June 30, 2004, the Company contributed $2,844,000 (less than 1% of net sales) to the Foundation. The Foundation was formed for scientific, educational, and charitable purposes and will be used to promote awareness of and research into the medical consequences of sleep and respiratory problems.

Restructuring and Acquisition-Related Expenses During the year ended June 30, 2004, the Company incurred restructuring and acquisition-related expenses of $10,942,000, related primarily to the restructuring of operations at the Wallingford, Connecticut manufacturing facility. See Note P to the Consolidated Financial Statements for additional information regarding restructuring and acquisition-related expenses.

During the year ended June 30, 2003, the Company incurred restructuring and acquisition-related expenses of $18,144,000, related to the integration of Novametrix and restructuring of operations at the Kennesaw, Georgia and Wallingford, Connecticut manufacturing facilities, and other acquisition-related costs. Of this amount, $17,789,000 is included in restructuring and acquisition-related expenses, and $355,000 is included in cost of goods sold in the Consolidated Statement of Operations for the year ended June 30, 2003.

Other (Income) Expense, Net Other (income) expense, net was $(2,078,000) for the year ended June 30, 2004 as compared to $640,000 for the year ended June 30, 2003. The change was due to realized and unrealized foreign currency exchange gains primarily caused by the strengthening Japanese Yen and Euro against the U.S. Dollar during the year ended June 30, 2004, offset by recognized losses on designated cash flow hedges that are more fully described in Note I to the Consolidated Financial Statements. Also contributing to the change were lower interest expenses resulting from a reduction in the amount of outstanding borrowings under the Company s Revolving Credit Agreement and larger cash balances, offset by higher amounts of long-term equipment financing (and related interest expense) at Fuji.

Income Taxes The Company s effective income tax rate was approximately 38% for the years ended June 30, 2004 and 2003. The income tax benefits associated with various on-going tax planning, primarily in the state and international tax areas, were offset by higher acquisition earn-out expenses, which are not deductible for income tax purposes.

The Company has not provided a valuation allowance for deferred income tax assets because it has determined that it is more likely than not that such assets can be realized, at a minimum, through carrybacks to prior years in which taxable income was generated.

Net Income As a result of the factors described above, the Company s net income was $65,020,000 (9% of net sales) or $0.92 per diluted share for the year ended June 30, 2004 as compared to net income of $46,581,000 (7% of net sales) or $0.68 per diluted share for the year ended June 30, 2003. The restructuring and acquisition-related expenses described above constituted a reduction of $0.10 and $0.16 per diluted share on an after-tax basis, respectively, for the years ended June 30, 2004 and 2003.

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FINANCIAL CONDITION, LIQUIDITY, AND CAPITAL RESOURCES

The Company had working capital of $334,997,000 at June 30, 2005 and $301,032,000 at June 30, 2004. Net cash provided by operating activities for the year ended June 30, 2005 was $135,078,000, compared to $140,937,000 for the year ended at June 30, 2004 and $124,293,000 for the year ended June 30, 2003. Cash provided by operating activities for all years included increasing amounts of net income before the impact of depreciation and amortization expense. During the year ended June 30, 2005, this increase was offset by deferred income tax benefits and working capital changes, including an increase in inventories that affected operating cash flows to support the Company s growth and various pending product releases as well as the transition of inventories to the Company s Carlsbad, California manufacturing facility in association with the restructuring of operations at the Wallingford, Connecticut manufacturing facility.

Net cash used by investing activities was $128,215,000, $62,386,000 and $47,444,000, for fiscal years 2005, 2004 and 2003, respectively. During the year ended June 30, 2005, the Company paid $63,097,000 to acquire businesses, including: $43,524,000 to acquire Profile, net of cash acquired in the transaction of $4,675,000 on July 1, 2004; $10,085,000 to acquire Mini-Mitter on April 1, 2005; and $9,488,000 to acquire other businesses and representing additional purchase price payments and transaction costs for previously acquired businesses. During the years ended June 30, 2005, 2004 and 2003 cash used by investing activities included capital expenditures of $61,900,000, $51,391,000 and $42,075,000, respectively, including the purchase of leasehold improvements, production equipment, computer hardware and software, telecommunications and office equipment, and the production of equipment leased to customers. Current fiscal year capital expenditures also included the purchase of a 138,000 square foot facility near the Company s current Murrysville, Pennsylvania, campus for a purchase price of $5,500,000 (net of rent that was prepaid by the seller for a transitional rental period that is recorded in accrued expenses and other current liabilities in the consolidated balance sheet). Cash used by investing activities in all three years included the acquisition of intangible assets and additional purchase price payments and transaction costs for previously acquired businesses. These acquisition-related payments are more fully described in Note Q to the consolidated financial statements. In the prior fiscal year, cash used by investing activities included the Company s acquisition of Caradyne that is more fully described in Note Q to the Consolidated Financial Statements. In the year ended June 30, 2003 cash used by investing activities also included transaction costs related to the Novametrix acquisition and the Company s acquisition of the BiliChek Non-invasive Bilirubin Analyzer product line from SpectRx, Inc. that are more fully described in Note Q to the Consolidated Financial Statements.

Net cash provided (used) by financing activities was $35,323,000, $17,995,000 and ($43,284,000) during the years ended June 30, 2005, 2004 and 2003, respectively. These amounts include proceeds from the issuance of common stock under the Company s stock option plans of $24,971,000, $18,070,000, and $10,243,000, respectively, during the years ended June 30, 2005, 2004, and 2003. The Company also received proceeds from equipment financing at its Fuji subsidiary in Japan, in the amount of $16,415,000 and $10,419,000 during the years ended June 30, 2005 and 2004, respectively. These proceeds were partially offset by payments on these equipment financing arrangements and other long-term borrowings in each year. Fiscal year 2004 debt pay-downs included the remaining $10,000,000 balance that was outstanding under the Company s revolving credit facility in August 2003. During the fiscal year ended June 30, 2003 the Company also made $53,527,000 of payments under long-term borrowing arrangements.

On August 1, 2002 one of the Company s significant sleep and home respiratory dealer customers announced that it filed a voluntary petition to reorganize under Chapter 11 of the U.S. Bankruptcy Code in order to restructure its bank debt. On July 1, 2003, the U.S. Bankruptcy Court approved the customer s reorganization plan. The confirmed plan allowed the customer to continue its business operations uninterrupted, and all creditors and vendors were to be paid 100% of all amounts they were owed, either immediately or over time with interest. The Company received all scheduled installment payments on its pre-petition balance during the years ended June 30, 2005 and 2004 based on the reorganization plan.

The Company believes that its sources of funding consisting of projected positive cash flow from operating activities, the availability of additional funds under its revolving credit facility (totaling approximately

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$149,066,000 at June 30, 2005), and its accumulated cash and cash equivalents will be sufficient to meet its current and presently anticipated short-term and long-term needs for operating activities, investing activities and financing activities (primarily consisting of scheduled payments on long-term debt).

CONTRACTUAL OBLIGATIONS AND OFF-BALANCE SHEET ARRANGEMENTS

The Company has contractual financial obligations and commercial financial commitments consisting primarily of long-term debt, capital lease obligations, and non-cancelable operating leases. See Notes G and J to the Consolidated Financial Statements for additional information about these obligations and commitments. The composition and nature of these obligations and commitments have not changed materially since June 30, 2004.

On August 19, 2002 and as subsequently amended, the Company entered into a revolving credit agreement with a group of banks under which a total of $150,000,000 is available through August 31, 2009. The revolving credit agreement is unsecured and contains certain financial covenants with which the Company must comply. The Company is currently in compliance with these covenants. The interest rate on the revolving credit facility is based on a spread over the London Interbank Offered Rate (LIBOR). As of June 30, 2005, no borrowings are outstanding under the revolving credit agreement.

The following table summarizes significant contractual obligations and commercial commitments of the Company as of June 30, 2005:

Contractual Obligations and Commercial Commitments

		Payments Due by Period			
Contractual Obligations	**Total**	**Up to 1 Year**	**1-3 Years**	**3-5 Years**	**Over 5 Years**
Long-Term Debt	$ 3,233,000	$ 1,952,000	$ 1,281,000	$	$
Capital Lease Obligations	43,419,000	15,459,000	21,528,000	6,432,000	
Operating Leases	33,262,000	8,442,000	11,485,000	7,325,000	6,010,000
Amounts payable to selling parties of previously acquired businesses	12,360,000	7,949,000	4,411,000		
Total Contractual Obligations	$ 92,274,000	$ 33,802,000	$ 38,705,000	$ 13,757,000	$ 6,010,000

		Amount of Commitment Expiration Per Period			
Other Commercial Commitments	**Total Amounts Committed**	**Up to 1 Year**	**1-3 Years**	**3-5 Years**	**Over 5 Years**

Letters of Credit	$ 934,000	$ 934,000	$	$	$

In addition to the amounts payable to the selling parties of previously acquired businesses that are set forth in the contractual obligations and commercial commitments table above, the Company may be obligated to make additional future payments under earn-out provisions pertaining to the acquisitions of Fuji, BiliChek, Caradyne, and Mini-Mitter for which the total amount of the obligations will not be known until the occurrence of future events. The amounts reflected in the contractual obligations and commercial commitments table above include the future payments that are accrued as of June 30, 2005 in accordance with the earn-out provisions and the Company s other fixed obligations under the acquisition agreements. See Note Q to the Consolidated Financial Statements for additional information about these obligations.

The contractual obligations and commercial commitments table above does not reflect obligations under purchase orders that arise in the ordinary course of business and that are typically fulfilled within ninety days. In addition to ordinary course purchase orders, the Company enters into supply agreements and distribution agreements in the ordinary course of business, some of which make the purchase of minimum quantities of products a condition to exclusivity or to obtaining or retaining more favorable pricing. Since failure to purchase the minimum amounts under these agreements generally does not result in a breach of contract, but only to an

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option on the part of the vendor to terminate the Company s exclusivity or increase the product prices the Company pays to the vendor, they are not included in the contractual obligations and commercial commitments table above.

In connection with customer leasing programs, the Company uses independent leasing companies for the purpose of providing financing to certain customers for the purchase of the Company s products. The Company is contingently liable, in the event of a customer default, to the leasing companies within certain limits for unpaid installment receivables initiated by or transferred to the leasing companies. The transfer of certain of these installment receivables meets the criteria of FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities, and therefore are not recorded on the Company s financial statements. The total exposure for unpaid installment receivables meeting these criteria and not recorded on the Company s financial statements was approximately $16,087,000 at June 30, 2005 as compared to $13,950,000 at June 30, 2004. The estimated fair value of the Company s contingent recourse guarantee is $1,765,000 and $581,000 as of June 30, 2005 and 2004, respectively. Approximately 8% of the Company s net sales were made under these financing arrangements during the years ended June 30, 2005 and 2004, of which a portion was made with recourse. The Company is not dependent on these off-balance sheet arrangements.

The remainder of these installment receivables (consisting of installment receivables acquired as part of the Novametrix acquisition) do not meet the criteria of FASB No. 140 and therefore are recorded as collateralized borrowing arrangements. Accordingly, at June 30, 2005 and 2004, the Company has included $748,000 and $1,049,000 of receivables sold with recourse in prepaid expenses and other current assets, and has recorded offsetting amounts at those dates in accrued expenses and other current liabilities. Effective March 31, 2003, the Company entered into an agreement with the third party financing company that is counter-party to these receivables. The terms of the agreement placed a cap on the Company s recourse obligation at $1,049,000. The third party financing company can exercise its rights under this recourse provision and require the Company to repurchase accounts receivables up to the cap amount.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

The Company is exposed to market risk from changes in foreign exchange rates.

Interest Rates Interest rates have not had a significant effect on the Company s business during the periods discussed. All of the Company s long-term obligations are subject to fixed interest rates, and the Company has no interest rate hedging agreements.

Foreign Exchange Rates The Company s functional currency is the U.S. Dollar, and a substantial majority of the Company s sales, expenses and cash flows are transacted in U.S. Dollars. The Company also conducts business in various foreign currencies, primarily the Japanese Yen, the Euro, the British Pound, the Canadian Dollar, the Hong Kong Dollar, and the Chinese Yuan. As part of the Company s risk management strategy, the Company put in place a hedging program under which the Company enters into foreign currency option and forward contracts to hedge a portion of cash flows denominated in Japanese Yen and British Pounds. These contracts are entered into to reduce the risk that the Company s earnings and cash flows, resulting from certain forecasted and recognized currency transactions, will be affected by changes in foreign currency exchange rates. See Note I to the Consolidated Financial Statements for additional information about the Company s foreign currency hedging activities.

For the year ended June 30, 2005, sales denominated in currencies other than the U.S. Dollar totaled $169,066,000, or approximately 19% of net sales (compared to 14% in the prior year). An adverse change of 10% in exchange rates would have resulted in a decrease in sales of $15,370,000 for the year ended June 30, 2005. Foreign currency losses included in the determination of the Company s net income, net of gains related to designated cash flow hedges, were $636,000 for the year ended June 30, 2005.

Inflation Inflation has not had a significant effect on the Company s business during the periods discussed.

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NEW ACCOUNTING PRONOUNCEMENTS

In June 2005, the FASB issued Statement No. 154, Accounting Changes and Error Corrections , a replacement of APB Opinion No. 20, Accounting Changes, and FASB No. 3, Reporting Accounting Changes in Interim Financial Statements. FASB No. 154 changes the requirements for the accounting and reporting of a change in accounting principles. Previously, most voluntary changes in accounting principles required recognition via a cumulative effect adjustment within net income of the period of the change. FASB No. 154 requires retrospective application to prior periods financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. FASB No. 154 is effective for accounting changes made in fiscal years beginning in the Company s fiscal 2007 first quarter; however, the Statement does not change the transition provisions of any existing accounting pronouncements. The Company is not currently aware of any accounting changes to which FASB No. 154 would apply, but will continue to evaluate FASB No. 154 through its effective date.

In December 2004, the FASB issued Statement No. 123 (R), Share-Based Payment, which is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation. As permitted by FASB No. 123, the Company currently accounts for share-based payments to employees using APB No. 25 s intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of FASB No. 123(R) s fair value method will have a significant impact on the Company s result of operations, although it will have no impact on the Company s overall financial position or cash flows. During the 2006 fiscal year, the Company expects to incur approximately $13,500,000 to $15,500,000 of stock compensation expense on a pre-tax basis, or $0.12 to $0.13 per share after tax. The Company is in the process of finalizing the methods by which it will value and attribute stock compensation expense. The actual expenses recorded during the 2006 fiscal year may fluctuate based on factors such as the actual number of equity awards granted to employees, changes in the Company s stock price, and the valuation methods and assumptions used in determining the fair value of share-based payments. Had the Company adopted FASB No. 123(R) in prior periods, the impact of that standard for years ended June 30, 2005 and 2004 would have approximated the impact of FASB No. 123 as described in the disclosure of pro forma net income and earnings per share in Note A to the Consolidated Financial Statements. FASB No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. While the Company cannot estimate what those amounts will be in the future (because they depend on, among other things, when employees exercise stock options), the amount of operating cash flows recognized for such excess tax deductions were $4,598,000, $5,077,000 and $3,164,000 during the years ended June 30, 2005, 2004 and 2003, respectively. The accounting provisions of SFAS No.123(R) are effective beginning in the Company s fiscal 2006 first quarter.

In March 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 107, which expressed views of the SEC regarding the interaction between FASB Statement No. 123 (Revised 2004), Share-Based Payment and certain SEC rules and regulations and provides the staff s views regarding the valuation of share-based payment arrangements for public companies.

In December 2004, the FASB issued Statement No. 153, Exchanges of Non-monetary Assets, an Amendment of APB Opinion No. 29, Accounting for Non-monetary Transactions . The amendments made by FASB No. 153 are based on the principle that exchanges of non-monetary assets should be measured based on the fair value of the assets exchanged. Further, the amendments eliminate the narrow exception for non-monetary exchanges of similar productive assets and replace it with a broader exception for exchanges of non-monetary assets that do not have commercial substance. FASB No. 153 is effective for non-monetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The provisions of this statement will be applied prospectively. The Company has not historically entered into material exchanges of non-monetary assets.

In November 2004, the FASB issued Statement No. 151, Inventory Costs, which is an amendment of ARB No. 43, Chapter 4, Inventory Pricing. FASB No. 151 clarifies the accounting for abnormal amounts of idle facility

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expense, freight, handling costs, and spoilage and requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. FASB No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company believes the impact of FASB No. 151 on its financial position and results of operations will not be material.

CRITICAL ACCOUNTING POLICIES

The Company s Consolidated Financial Statements are prepared in accordance with accounting principles generally accepted in the United States, which require the Company to make estimates and assumptions that may affect the reported financial condition and results of operations should actual results differ. The Company bases its estimates and assumptions on the best available information and believes them to be reasonable under the circumstances. The Company believes that of its significant accounting policies, the following may involve a higher degree of judgment and complexity.

Revenue Recognition The Company s revenues are recognized when title to product passes to the customer, which generally occurs upon shipment to a customer location and, in the case of rental revenue and long-term service contracts, is recognized ratably over the period the product is rented or service is performed. For those sales shipped FOB destination, revenue is recognized upon receipt by the customer. The Company s standard conditions of sale do not include customer acceptance, installation, price protection agreements, or other post-shipment obligations. At times, the Company performs installation and/or training after certain products are shipped as a service to customers (at their request). As of June 30, 2005 and 2004 the amounts of deferred service revenue for post shipment obligations were immaterial in relation to the Company s financial condition and results of operations. The Company s revenue transactions are sometimes made pursuant to standard terms and conditions included in distributor agreements and customer contracts. These contracts generally include price lists that apply to specified products shipped to customers during the terms of their agreement. These contracts also generally include rights of return provisions that only permit customers to return sold product in the case of a defective product or order entry, shipping, or similar error made by the Company. Product returns, which are recorded as a reduction of net sales and cost of sales, are generally insignificant in relation to net sales. The Company accrues for estimated sales returns and allowances based on historical trends, adjusted for specific product programs and individual transactions where appropriate. The Company does not offer variable sales prices for subsequent events; all prices are fixed when customers orders are received. Certain customers and group purchasing organizations contracts provide customers with price rebates based on their level of purchases from the Company. Rebates are accrued by the Company as a reduction in net sales as they are earned by customers. Price discounts that may be awarded to customers for payment of invoices within specified periods are recorded as reductions to net sales at the time of payment and are generally insignificant in relation to net sales. As part of the Company s sales process, pricing discounts may be provided for large orders to support sales initiatives, including new product introductions. In the Company s domestic sales activities, a number of independent manufacturers representatives are used to sell the Company s products. These independent representatives are paid a direct commission on sales made to customers in their respective territories and are an integral component of the Company s domestic sales force. The Company does not ship or sell its products to these representatives, and therefore does not recognize any revenue from transactions with these independent representatives. The SEC s SAB Nos. 101 and 104, Revenue Recognition, provides guidance on the application of generally accepted accounting principles to selected revenue recognition issues. The Company has concluded that its revenue recognition policy is appropriate and in accordance with generally accepted accounting principles and SAB Nos. 101 and 104.

Allowance for Uncollectible Accounts Receivable Accounts receivable are reduced by an allowance for amounts that may become uncollectible in the future. Provisions to increase the allowance for uncollectible accounts receivable are recorded as a component of general and administrative expenses in the Company s Consolidated Statements of Operations during the fiscal years ended June 30, 2005, 2004 and 2003. Substantially all of the Company s receivables are due from healthcare product providers, distributors, hospitals, and independent leasing companies. The Company s customers are located throughout the United States and around

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the world. A significant portion of products sold to providers, distributors and hospitals, both foreign and domestic, is ultimately funded through government reimbursement programs or through private insurance programs. As a consequence, changes in these programs can have an adverse impact on distributor and hospital liquidity and profitability. In addition, because a concentration of market share exists in the sleep and home respiratory product industry in the United States among national and large regional providers, the Company experiences a comparable concentration of credit risk with these customers. The estimated allowance for uncollectible amounts is based primarily on the Company s evaluation of the payment pattern, financial condition, cash flows, and credit history of its customers as well as current industry and economic conditions. Adverse changes in these factors may impair the ability of the Company s customers to make payments; as a consequence, additional allowances for uncollectible accounts receivable may be required. The Company is also contingently liable, within certain limits, in the event of a customer default on unpaid installment receivables initiated by or transferred to several independent leasing companies in connection with customer leasing programs. The Company monitors the collection status of these installment receivables and provides amounts necessary for estimated losses in the allowance for doubtful accounts.

Inventories and Related Allowance for Obsolete and Excess Inventory Inventories are valued at the lower of cost or market value and have been reduced by an allowance for excess and obsolete inventories. Provisions to increase the allowance for obsolete and excess inventory are recorded as a component of cost of goods sold in the Company s Consolidated Statements of Operations during the fiscal years ended June 30, 2005, 2004 and 2003. The estimated allowance is based on the Company s review of inventories on hand compared to historical and estimated future usage and sales. If it is determined that inventory on hand is in excess of estimated future usage and sales because of changes in competitive conditions, new product introductions, product obsolescence, changes in customer demand, or other reasons, additional allowances for obsolete and excess inventory may need to be provided. The establishment of these additional allowances may have an adverse impact on earnings, depending on the extent and amount of inventory affected.

Intangible Assets Intangible assets are comprised primarily of intellectual property rights, patent registration costs, product technology, customer contracts and relationships, and employee agreements. Intangible assets are amortized to expense over their useful lives, which are based on the Company s estimates of the period that the assets will generate positive cash flows. Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. If such carrying amounts are determined to be unrecoverable because of changes in technology, extended delays in obtaining regulatory approval, competition, significant changes in the Company s strategic business objectives, utilization of the asset, or other reasons, the carrying amounts would be written down to their fair market values. These adjustments may have an adverse impact on earnings, depending on the significance of the carrying amounts and the extent of the required adjustments.

Contingencies As a normal part of its business operations, the Company incurs liabilities that may be difficult to quantify precisely, such as future warranty obligations, potential liabilities relating to legal or regulatory matters, and tax exposures. The Company follows the requirements of Statement of Financial Accounting Standards No. 5, Accounting for Contingencies, which dictate when a charge to income should be taken to accrue for a loss contingency. These requirements necessitate the application of judgment regarding the likelihood and amount of the liability.

CAUTIONARY STATEMENT FOR PURPOSES OF THE SAFE HARBOR PROVISIONS OF THE PRIVATE SECURITIES REFORM ACT OF 1995.

The statements contained in this Annual Report, including those contained in Management s Discussion and Analysis of Results of Operations and Financial Condition, along with statements in reports filed with the SEC, external documents and oral presentations which are not historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21B of the Securities Exchange Act of 1934, as amended. These forward-looking statements represent the Company s present expectations or

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beliefs concerning future events. The Company cautions that such statements are qualified by important factors that could cause actual results to differ materially from the expected results included in the forward-looking statements. Those factors include, but are not limited to, the following: developments in the healthcare industry; the success of the Company s marketing, sales, and promotion programs; future sales and acceptance of the Company s products and programs; the timing and success of new product introductions; new product development; anticipated cost savings; FDA and other regulatory requirements and enforcement actions; future results from acquisitions; growth rates in foreign markets; regulations and other factors affecting operations and sales outside the United States (including potential future effects of the change in sovereignty of Hong Kong); the effects of a major earthquake, cyber-attack or other catastrophic event that results in the destruction or disruption of any of our critical business or information technology systems; foreign currency fluctuations; expiration of intellectual property rights; customer consolidation and concentration; increasing price competition and other competitive factors in the sale of products; interest rate fluctuations; intellectual property and related litigation; other litigation; future levels of earnings and revenues; the number of equity awards granted to employees and changes in the Company s stock price; and third party reimbursement; all of which are subject to change.

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Item 8. Consolidated Financial Statements

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Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders

Respironics, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Respironics, Inc. and subsidiaries as of June 30, 2005 and 2004, and the related consolidated statements of operations, shareholders equity, and cash flows for each of the three years in the period ended June 30, 2005. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Respironics, Inc. and subsidiaries at June 30, 2005 and 2004, and the consolidated results of their operations and their cash flows for each of the three years in the period ended June 30, 2005, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company s internal control over financial reporting as of June 30, 2005, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated September 7, 2005 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Pittsburgh, Pennsylvania

September 7, 2005

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CONSOLIDATED BALANCE SHEETS

RESPIRONICS, INC. AND SUBSIDIARIES

At June 30	2005	2004
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 234,632,280	$ 192,445,866
Trade accounts receivable	153,479,117	140,633,793
Inventories	96,314,972	85,539,100
Prepaid expenses and other current assets	11,930,547	8,621,042
Deferred income tax benefits	39,767,465	25,373,010
TOTAL CURRENT ASSETS	536,124,381	452,612,811
PROPERTY, PLANT AND EQUIPMENT		
Land	4,387,557	3,214,679
Buildings	23,088,982	17,258,260
Production and office equipment	279,156,393	245,978,933
Leasehold improvements	9,386,856	7,989,040
	316,019,788	274,440,912
Less allowances for depreciation and amortization	188,643,863	163,383,655
	127,375,925	111,057,257
OTHER ASSETS	48,318,790	37,466,117
GOODWILL	166,627,295	110,003,068
TOTAL ASSETS	$ 878,446,391	$ 711,139,253
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 57,474,169	$ 52,789,363
Accrued expenses and other current liabilities	126,242,043	88,255,213
Current portion of long-term obligations	17,411,475	10,536,473
TOTAL CURRENT LIABILITIES	201,127,687	151,581,049
LONG-TERM OBLIGATIONS	29,240,901	26,896,842
OTHER NON-CURRENT LIABILITIES	20,432,192	13,608,331
SHAREHOLDERS EQUITY		
Common Stock, $.01 par value; authorized 100,000,000 shares; issued 78,689,442 shares at June 30, 2005 and 76,957,022 shares at June 30, 2004; outstanding 71,698,913 shares at June 30, 2005 and 69,966,538 at June 30, 2004	786,894	769,570
Additional capital	278,764,548	249,209,760
Accumulated other comprehensive income (loss)		