PRICE T ROWE GROUP INC
Form 10-K
February 07, 2008

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K
ANNUAL REPORT PURSUANT TO SECTION 13 OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2007
Commission file number 000-32191
T. ROWE PRICE GROUP, INC.
(Exact name of registrant as specified in its charter)

State of incorporation Maryland IRS Employer Identification No. 52-2264646
Address, including zip code, of principal executive offices
100 East Pratt Street, Baltimore, Maryland 21202
Registrant s telephone number, including area code (410) 345-2000
Securities registered pursuant to Section 12(b) of the Act:

Common stock, $.20 par value per share	The NASDAQ Stock Market LLC
(Title of class)	(Name of exchange on which registered)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. þ Yes o No
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. o Yes þ No
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, and (2) has been subject to such filing requirements for the past 90 days. þ Yes o 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 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. þ
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company (as defined in Rule 12b-2 of the Exchange Act):
Large accelerated filer þ Accelerated filer o Non-accelerated filer o Smaller reporting company o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). o Yes þ No
The aggregate market value of the common equity (all voting) held by non-affiliates (excludes current executive officers and directors) at January 31, 2008, computed using $51.89 per share (the close/last price reported on The NASDAQ Stock Market for June 29, 2007, the last business day of the registrant s most recently completed second fiscal quarter) was $13.1 billion.
The number of shares outstanding of the registrant s common stock as of the latest practicable date, January 31, 2008, is 263,755,542.
DOCUMENTS INCORPORATED BY REFERENCE: In Part III, the Definitive Proxy Statement for the 2008 Annual Meeting of Stockholders to be filed pursuant to Regulation 14A.
Exhibit index begins on page 39.

PART I

Item 1. Business.

T. Rowe Price Group is a financial services holding company that derives its consolidated revenues and net income primarily from investment advisory services that its subsidiaries provide to individual and institutional investors in the sponsored T. Rowe Price mutual funds and other investment portfolios. Our investment advisory revenues depend largely on the total value and composition of assets under our management. Accordingly, fluctuations in financial markets and in the composition of assets under management impact our revenues and results of operations.

We operate our investment advisory business through our subsidiary companies, primarily T. Rowe Price Associates, T. Rowe Price International, and T. Rowe Price Global Investment Services. The late Thomas Rowe Price, Jr., began our advisory business in 1937, and the common stock of T. Rowe Price Associates was first offered to the public in 1986. The T. Rowe Price Group corporate holding company structure was established in late 2000.

Our assets under management are accumulated from a diversified client base across four primary distribution channels: third-party financial intermediaries that distribute our managed investment portfolios in the U.S. and other countries; individual U.S. investors on a direct basis; U.S. defined contribution retirement plans; and institutional investors in the U.S. and other countries.

We manage a broad range of U.S. and international stock, bond, blended asset, and money market mutual funds and other investment portfolios that are designed to meet the varied and changing needs and objectives of individual and institutional investors. Mutual fund shareholders can exchange balances among mutual funds as permitted when economic and market conditions and their investment needs change.

From time to time, we introduce new funds and other investment portfolios to complement and expand our investment offerings, respond to competitive developments in the financial marketplace, and meet the changing needs of our investment advisory clients. We will open a new mutual fund if we believe that its objective will be useful for investors over a long period. Conversely, we may also limit new investments into a mutual fund in order to maintain the integrity of the fund s investment strategy and to protect the interests of its existing shareholders. At present, the following funds are closed to new investors.

Fund	Date Closed
Small-Cap Value	May 24, 2002
Mid-Cap Growth	December 8, 2003
Institutional Mid-Cap Equity Growth	December 8, 2003
Small-Cap Stock	February 20, 2004
Institutional Small-Cap Stock	February 20, 2004
Mid-Cap Value	February 25, 2005

These funds continue to attract cash inflows from existing fund shareholders and direct rollovers from retirement plans into new IRA accounts that we offer.

Investment objectives for our managed investment portfolios, including the Price funds, accommodate a variety of strategies. Investors select from among the mutual funds based on the distinct objective that is described in each fund s prospectus. Investment management of other client portfolios includes approaches similar to those employed in the Price funds. Equity investment strategies may emphasize large-cap, mid-cap or small-cap investing; growth, value or core investing; and U.S., global, or international investing. We also offer systematic, tax-efficient, and blended equity investment strategies as well as active, systematic and municipal tax-free management strategies for fixed income investments. Our specialized advisory services include management of stable value investment contracts and a distribution management service for the disposition of equity securities received from third-party venture capital investment pools.

We employ fundamental and quantitative security analyses in the performance of the investment advisory function. We maintain substantial internal equity and fixed income investment research capabilities. We perform original industry and company research using such sources as inspection of corporate activities, management interviews, company-published financial and other information, financial newspapers and magazines, corporate rating services, and field checks with suppliers and competitors in the same industry and particular business sector. Our research staff operates primarily from offices located in the United States and Great Britain with additional staff resident in Argentina, Hong Kong, Japan, and Singapore. We also use research provided by brokerage firms in a supportive capacity and information received from private economists, political observers, commentators, government experts, and market and security analysts. Our stock selection process for some investment portfolios is based on quantitative analyses using computerized data modeling.

We also provide certain administrative services as ancillary services to our investment advisory clients. These administrative services are provided by several of our subsidiary companies, and include mutual fund transfer agent, accounting, and shareholder services; participant recordkeeping and transfer agent services for defined contribution retirement plans investing in our sponsored mutual funds; discount brokerage; and trust services. More than 90% of our administrative revenues in 2007 were determined based on the recovery of expenses incurred to provide the related services. Administrative revenues, therefore, do not significantly affect our net income.

Information concerning our revenues, results of operations, total assets, and investment assets under our management during the past three years is contained in our consolidated financial statements and in note 2 thereto, which are both included in Item 8 of this Form 10-K.

2007 DEVELOPMENTS.

Total assets under our management increased $65 billion over the course of 2007 and ended the year at an all-time record of $400 billion, including $275 billion held in retirement accounts and variable annuity investment portfolios. Our year-end assets under management include $322 billion in equity and blended asset investment portfolios and $78 billion in fixed income investment portfolios. The investment portfolios that we manage consist of $246 billion in the T. Rowe Price mutual funds distributed in the United States and $154 billion in other investment portfolios, including separately managed accounts, sub-advised funds, and other sponsored investment funds offered to investors outside the U.S. and through variable annuity life insurance plans in the U.S. Non-U.S. dollar denominated securities account for about $65 billion of our year-end assets under management.

The firm s investment advisory results relative to our peers remain strong, with at least 72% of the T. Rowe Price funds across their share classes surpassing their comparable Lipper averages on a total return basis for the three-, five-, and 10-year periods ended December 31, 2007, and 61% outperforming for the one-year period. In addition, 71 of the T. Rowe Price stock, bond and blended asset funds across their share classes, which account for more than 72% of our rated funds assets under management, ended the year with an overall rating of four or five stars from Morningstar. These four- and five-star-rated investments represent 58.2% of our rated funds and share classes, compared with 32.5% for the overall industry.

Our strong relative investment performance and brand awareness contributed significantly to investors entrusting a net of nearly $34 billion to our management in 2007. Third-party financial intermediaries, institutional investors around the world, and our target-date Retirement Funds were the most significant sources of these net inflows. Higher market valuations and income added more than $31 billion.

Assets under management in our series of target-date Retirement Funds, which provide fund shareholders with single, diversified portfolios that invest in underlying T. Rowe Price funds and automatically adjust fund asset allocations as investors age, increased 73% or $12.7 billion during 2007 to total $30 billion, or 12% of our mutual fund assets under management, at year end.

Six of the Price funds each had more than $10 billion of net assets at December 31, 2007. These funds Growth Stock, Equity Income, Mid-Cap Growth, Blue Chip Growth, Capital Appreciation and Equity Index 500 accounted for 25% of assets under management at the end of the year and 27.5% of 2007 investment advisory revenues.

Our international clients account for 9% of our total assets under management at December 31, 2007, up from 7% at the beginning of the year.

PRICE FUNDS. We provide investment advisory, distribution and other administrative services to the Price funds under various agreements. Investment advisory services are provided to each fund under individual investment management agreements that grant the fund the right to use the T. Rowe Price name. The boards of the respective funds, including a majority of directors who are not interested persons of the funds or of T. Rowe Price Group (as defined in the Investment Company Act of 1940), must approve the investment management agreements annually. Fund shareholders must approve material changes to these investment management agreements. Each agreement automatically terminates in the event of its assignment (as defined in the Investment Company Act) and, generally, either party may terminate the agreement without penalty after a 60-day notice. The termination of one or more of these agreements could have a material adverse effect on our results of operations.

Advisory Services. Investment advisory revenues are based upon the net assets managed daily in each fund. Additional revenues are earned for advisory-related administrative services as discussed below. Independent directors and trustees of the Price funds regularly review our fee structures.

The advisory fee paid by each of the Price funds generally is computed each day by multiplying a fund s net assets by a specific fee. For the majority of the Price funds, the fee is equal to the sum of an individual fund charge that is set based on the fund s specific investment objective and a group charge that is set based on the aggregate net assets of those funds. The individual fund charge for each of our four largest funds Growth Stock, Equity Income, Mid-Cap Growth, and Blue Chip Growth is a weighted average determined by applying a 15% reduction for net assets in excess of $15 billion to the base individual fund rate. The group charge is a tiered based schedule. The effective group charge when combined net assets exceed $220 billion is calculated based on a weighted-average fee across pricing tiers of almost 30.5 basis points for the first $220 billion of net assets plus 28.5 basis points for net assets in excess of $220 billion.

Our 2007 fee rates determined in the above manner varied from a low of 30 basis points for the U.S. Treasury funds to a high of 105 basis points for the Emerging Markets Stock, Emerging Europe & Mediterranean, International Discovery, and Latin America funds. To the extent that the combined net assets of the funds increase, the group charge component of a fund s advisory fee, and therefore the advisory fee paid by each fund, will decrease. Details of each fund s fee arrangement are available in its prospectus.

Each of the Price funds has a distinct investment objective that has been developed as part of our strategy to provide a broad, comprehensive selection of investing opportunities. The Investor class of all Price funds can be purchased in the United States on a no-load basis, without a sales commission or 12b-1 fee. No-load mutual fund shares offer investors a low-cost and relatively easy method of directly investing in a variety of stock and bond portfolios.

Certain of the T. Rowe Price mutual funds also offer Advisor and R classes of shares that are distributed to mutual fund shareholders and defined contribution retirement plans, respectively, through third-party financial intermediaries. These share classes incur 12b-1 fees of 25 and 50 basis points, respectively, for distribution, administration, and personal services. Our subsidiary, T. Rowe Price Investment Services, is the principal distributor of the T. Rowe Price mutual funds and enters into agreements with each intermediary. Payment of 12b-1 fees is made by each fund directly to the applicable intermediaries.

In accounting for 12b-1 fees, the applicable mutual fund share classes incur the related expense and we recognize the corresponding administrative revenue in our consolidated statement of income. We also recognize, as part of our other operating expenses in the consolidated statement of income, the corresponding payment of these fees from each fund to the third-party financial intermediaries. The revenue that we recognize from the funds and the expense that we recognize for the fees paid to third party intermediaries are equal in amount and, therefore, do not impact our net operating income.

We believe that our lower fund cost structure, distribution methods, and fund shareholder and administrative services help promote the stability of our fund assets under management through market cycles.

Each Price fund typically bears all expenses associated with its operation and the issuance and redemption of its securities. In particular, each fund pays investment advisory fees; shareholder servicing fees and expenses; fund accounting fees and expenses; transfer agent fees; custodian fees and expenses; legal and auditing fees; expenses of preparing, printing and mailing prospectuses and shareholder reports to existing shareholders; registration fees and expenses; proxy and annual meeting expenses; and independent trustee or director fees and expenses.

Several of the Price funds have different fee arrangements. The Equity Market Index funds and the Summit funds each have single, all-inclusive fees covering all investment management and operating expenses. Each of the funds in the series of Spectrum Funds and in the series of target-date Retirement Funds invest in a broadly diversified portfolio of other Price funds and have no separate investment advisory fee. However, they indirectly bear the expenses of the funds in which they invest. Mutual funds for institutional investors each have separate advisory fee arrangements.

We usually provide that a newly organized fund s expenses will not exceed a specified percentage of its net assets during an initial operating period. Generally, during the earlier portion of the period, we will waive advisory fees and absorb other mutual fund expenses in excess of the self-imposed limits. During the latter portion of the period, we may recover some or all of the waived fees and absorbed costs.

Except as noted above for 12b-1 fees, we bear all advertising and promotion expenses associated with our distribution of the Price funds. These costs are recognized currently, and include advertising and direct mail communications to potential fund shareholders as well as substantial staff and communications capabilities to respond to investor inquiries. Marketing and promotional efforts are focused in the print media, television, and the Internet. In addition, we direct considerable marketing efforts to defined contribution plans that invest in mutual funds. Advertising and promotion expenditures vary over time based on investor interest, market conditions, new investment offerings, and the development and expansion of new marketing initiatives, including enhancements to our web site.

Administrative Services. We provide advisory-related administrative services to the Price funds through our subsidiaries. T. Rowe Price Services provides mutual fund transfer agency and shareholder services, including maintenance of staff, facilities, and technology and other equipment to respond to inquiries from fund shareholders. T. Rowe Price Associates provides mutual fund accounting services, including maintenance of financial records, preparation of financial statements and reports, daily valuation of portfolio securities and computation of daily net asset values per share. T. Rowe Price Retirement Plan Services provides participant accounting, plan administration and transfer agent services for defined contribution retirement plans that invest in the Price funds. Plan sponsors and participants compensate us for some services while the Price funds compensate us for maintaining and administering the individual participant accounts for those plans that invest in the funds.

Our trustee services are provided by another subsidiary, T. Rowe Price Trust Company. Through this Maryland-chartered limited-service trust company, we offer common trust funds for investment by qualified retirement plans and serve as trustee for retirement plans and IRAs. T. Rowe Price Trust Company may not accept deposits and cannot make personal or commercial loans. Another subsidiary, T. Rowe Price Savings Bank, issues federally insured certificates of deposit.

We also provide advisory planning services to fund shareholders and potential investors through our subsidiary T. Rowe Price Advisory Services. These services are limited in scope and include retirement planning services, such as saving for retirement, transitioning into retirement, and income in retirement. An investment portfolio evaluation service is an integral part of these services. An ongoing checkup service is also available to assist an investor in remaining on track to achieve their financial goals.

Fund Assets. At December 31, 2007, assets under our management in the Price funds aggregated $246 billion, an increase of 19% or $39.5 billion from the beginning of the year. The following table presents the net assets (in billions) of our largest funds (net assets in excess of $.5 billion) and the year each fund was started. The Spectrum and Retirement series of funds are not listed in the table because their assets are included in the underlying funds.

	2006	2007
Stock funds:		
Growth Stock (1950)	$ 19.1	$ 26.1
New Horizons (1960)	7.0	7.2
New Era (1969)	4.4	6.9
International Stock (1980)	6.9	7.1
Growth & Income (1982)	1.7	1.4
Equity Income (1985)	23.5	23.3
New America Growth (1985)	.8	.9
Capital Appreciation (1986)	9.4	10.5
Science & Technology (1987)	3.2	3.1
International Discovery (1988)	2.3	3.0
Small-Cap Value (1988)	6.1	5.6
Equity Index 500 (1990)	7.8	10.2
European Stock (1990)	1.0	1.1
New Asia (1990)	2.2	5.6
Balanced (1991)	2.8	3.1
Japan (1991)	.5	.4
Dividend Growth (1992)	.9	.9
Mid-Cap Growth (1992)	15.3	17.7
Small-Cap Stock (1992)	7.7	6.6
Blue Chip Growth (1993)	9.7	12.8
Latin America (1993)	2.2	3.7
Media & Telecommunications (1993)	1.5	2.1
Personal Strategy Balanced (1994)	1.3	1.4
Personal Strategy Growth (1994)	1.1	1.2
Personal Strategy Income (1994)	.6	.7
Value (1994)	6.4	7.9
Emerging Markets Stock (1995)	2.6	4.8
Global Stock (1995)	.4	.9
Health Sciences (1995)	1.7	2.3
Institutional Mid-Cap Equity Growth (1996)	.4	.5
Mid-Cap Value (1996)	7.5	7.5
Real Estate (1997)	2.4	2.0
International Growth & Income (1998)	2.5	3.0
Total Equity Market Index (1998)	.4	.5
Emerging Europe & Mediterranean (2000)	1.6	1.8
Institutional Small-Cap Stock (2000)	.4	.5
International Equity Index (2000)	.3	.6

Institutional Large-Cap Growth (2001)	.5	1.4
Overseas Stock (2006)		1.5
Other funds	2.4	2.8
	168.5	200.6

	2006	2007
Bond and money market funds:		
New Income (1973)	4.7	7.6
Prime Reserve (1976)	5.4	6.0
Tax-Free Income (1976)	1.8	1.9
Tax-Exempt Money (1981)	.8	1.1
U.S. Treasury Money (1982)	1.0	1.2
Tax-Free Short-Intermediate (1983)	.5	.5
High Yield (1984)	4.9	5.2
Short-Term Bond (1984)	1.4	1.6
GNMA (1985)	1.3	1.3
Tax-Free High Yield (1985)	1.6	1.4
International Bond (1986)	2.2	2.8
Maryland Tax-Free Bond (1987)	1.4	1.4
U.S. Treasury Long-Term (1989)	.3	.5
Virginia Tax-Free Bond (1991)	.5	.6
Summit Cash Reserves (1993)	4.9	5.7
Summit Municipal Intermediate (1993)	.6	.6
Emerging Markets Bond (1994)	.6	.7
Institutional High Yield (2002)	.4	.5
Short-Term Income (2006)	.7	1.3
Other funds	3.0	3.5
	38.0	45.4
	$ 206.5	$ 246.0

We invest in many of the T. Rowe Price funds through our operating subsidiaries and our investments holding company subsidiary, TRP Finance.

OTHER INVESTMENT PORTFOLIOS. We managed $154 billion at December 31, 2007, in other client investment portfolios, up almost $26 billion from the beginning of the year. We provide investment advisory services to these clients through our subsidiaries on a separately managed or sub-advised account basis and through sponsored investment portfolios, such as common trust funds, Luxembourg-based mutual funds, and variable annuity life insurance plans. At December 31, these portfolios included the following investment assets:

	2006	2007
U.S. stocks	$ 80.4	$ 94.7
International stocks	18.1	26.3
Stable value assets	12.6	13.6
Other bonds and money market securities	17.1	19.4
	$ 128.2	$ 154.0

Our fees for managing these investment portfolios are computed using the value of assets under our management. In 2007, nearly 55% of these advisory fees were recognized based on daily valuations. The balance of these managed investment portfolios are generally billed quarterly. End of billing period valuations generated about 40% of the 2007 advisory fees from other managed portfolios while beginning of billing period values were the basis for about 5% of these fees.

We charge fees for investment management based on, among other things, the specific investment services to be provided. Our standard form of investment advisory agreement for client accounts provides that the agreement may be terminated at any time and that any unearned fees paid in advance will be refunded.

Our largest client account relationship, excluding the T. Rowe Price funds, is with a third-party financial intermediary that accounted for more than 3% of our investment advisory revenues in 2007.

REGULATION. T. Rowe Price Associates, T. Rowe Price International, T. Rowe Price Global Investment Services, T. Rowe Price Global Asset Management, T. Rowe Price (Canada), and T. Rowe Price Advisory Services are registered with the SEC as investment advisers under the Investment Advisers Act of 1940. T. Rowe Price Global Investment Services, T. Rowe Price Global Asset Management, and T. Rowe Price International are regulated by the Financial Services Authority (FSA) in Great Britain and, in certain cases, by other foreign regulators. Our transfer agent services subsidiaries are registered under the Securities Exchange Act of 1934, and our trust company is regulated by the State of Maryland, Commissioner of Financial Regulation. T. Rowe Price Savings Bank is regulated by the Office of Thrift Supervision, U.S. Department of the Treasury. T. Rowe Price (Canada) is also registered with several of the provincial securities commissions in Canada.

T. Rowe Price Investment Services is a registered broker-dealer and member of the National Association of Securities Dealers and the Securities Investor Protection Corporation. We provide discount brokerage services through this subsidiary primarily to complement the other services provided to shareholders of the Price funds. Pershing, a third-party clearing broker and affiliate of the Bank of New York, maintains all our discount brokerage s customer accounts and clears all their transactions.

All aspects of our business are subject to extensive federal and state laws and regulations. These laws and regulations are primarily intended to benefit or protect our clients and the Price funds shareholders. They generally grant supervisory agencies and bodies broad administrative powers, including the power to limit or restrict the conduct of our business in the event that we fail to comply with laws and regulations. Possible sanctions that may be imposed on us in the event that we fail to comply include the suspension of individual employees, limitations on engaging in certain business activities for specified periods of time, revocation of our investment adviser and other registrations, censures, and fines.

Certain of our subsidiaries are subject to net capital requirements including those of various federal, state, and foreign regulatory agencies. Our subsidiaries net capital, as defined, meets or exceeds all minimum requirements.

COMPETITION. As a member of the financial services industry, we are subject to substantial competition in all aspects of our business. A significant number of proprietary and other sponsors mutual funds are sold to the public by other investment management firms, broker-dealers, mutual fund companies, banks and insurance companies. We compete with brokerage and investment banking firms, insurance companies, banks, and other financial institutions in all aspects of our business and in every country in which we offer our advisory services. Many of these financial institutions have substantially greater resources than we do. We compete with other providers of investment advisory services primarily based on the availability and objectives of the investment portfolios offered, investment performance, and the scope and quality of investment advice and other client services.

We believe that competition within the investment management industry will increase as a result of consolidation and acquisition activity. In order to maintain and enhance our competitive position, we may review acquisition and venture opportunities and, if appropriate, engage in discussions or negotiations that could lead to acquisitions or new financial relationships.

EMPLOYEES. At December 31, 2007, we employed 5,081 associates, up 10.3% from the end of 2006. We may add additional temporary and part-time personnel to our staff from time to time to meet periodic and special project demands, primarily for technology and mutual fund administrative services.

SEC FILINGS. We make available free of charge through our Internet web site our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. To obtain any of this information, access our Internet home page at www.troweprice.com; select: Company Info or Company Info & Press; and then select: Financial Information.

Item 1A. Risk Factors.

An investment in our common stock involves various risks, including those mentioned below and those that are discussed from time-to-time in our periodic filings with the SEC. Investors should carefully consider these risks, along with the other information contained in this report, before making an investment decision regarding our common stock. There may be additional risks of which we are currently unaware, or which we currently consider immaterial. All of these risks could have a material adverse effect on our financial condition, results of operations, and value of our common stock.

RISKS RELATING TO OUR BUSINESS AND THE FINANCIAL SERVICES INDUSTRY

Our revenues are based on the market value and composition of the assets under our management, all of which are subject to fluctuation caused by factors outside of our control.

We derive our revenues primarily from investment advisory services provided by our subsidiaries to individual and institutional investors in the T. Rowe Price mutual funds and other investment portfolios. Our investment advisory fees typically are calculated as a percentage of the market value of the assets under our management. We generally earn higher fees on assets invested in our equity funds and equity investment portfolios than we earn on assets invested in our fixed income funds and portfolios. Among equity investments, there is a significant variation in fees earned from index-based investments at the low end and emerging markets funds and portfolios at the high end. Fees also vary across the fixed income funds and portfolios, though not as widely as equity investments, with money market securities at the low end and non-U.S. dollar denominated bonds at the high end. As a result, our revenues are dependent on the value and composition of the assets under our management, all of which are subject to substantial fluctuation due to many factors, including:

Investor Mobility. Our investors generally may withdraw their funds at any time, on very short notice and without any significant penalty.

General Market Declines. A general downturn in stock or bond prices would cause the value of assets under our management to decrease, and may also cause investors to withdraw their investments, thereby further decreasing the level of assets under our management.

Investment Performance. If the investment performance of our managed portfolios is less than that of our competitors or applicable third-party benchmarks, we could lose existing and potential customers and suffer a decrease in assets under management. Institutional investors in particular consider changing investment advisers based upon poor relative investment performance. Individual investors in contrast are more likely to react to poor absolute investment performance.

Global Economies. National and international political and economic events may cause financial market declines that lower the value of assets under our management, and may cause investors to withdraw funds.

Investing Trends. Changes in investing trends and, in particular, retirement savings trends may reduce interest in our funds and portfolios and may alter our mix of assets.

Interest Rate Changes. Investor interest in and the valuation of our fixed income investment funds and portfolios are affected by changes in interest rates.

Tax Regulation Changes. Changes in the status of tax deferred retirement plan investments and tax-free municipal bonds, the capital gains and corporate dividend tax rates, and other individual and corporate tax rates and regulations could adversely affect investor behavior and may cause investors to view certain investment offerings less favorably and withdraw their investment assets, thereby decreasing the level of assets under our management.

A decrease in the value of assets under our management, or an adverse change in their composition, could have a material adverse effect on our investment advisory fees and revenues. For any period in which revenues decline, net income and operating margins will likely decline by a greater proportion because certain expenses will be fixed over that finite period.

A significant majority of our revenues are based on contracts with the Price funds that are subject to termination without cause and on short notice.

We provide investment advisory, distribution and other administrative services to the Price funds under various agreements. Investment advisory services are provided to each Price fund under individual investment management agreements. The board of each Price fund must annually approve the terms of the investment management and service agreements and can terminate the agreement upon 60-day notice. If a Price fund seeks to lower the fees that we receive or terminate its contract with us, we would experience a decline in fees earned from the Price funds, which could have a material adverse effect on our revenues and net income.

We operate in an intensely competitive industry, which could cause a loss of customers and their assets, thereby reducing our assets under management and our revenues and net income.

We are subject to competition in all aspects of our business from:

- asset management firms,
- mutual fund companies,
- commercial banks and thrift institutions,
- insurance companies,
- hedge funds,
- exchange traded funds,
- brokerage and investment banking firms, and
- other financial institutions including multinational firms and subsidiaries of diversified conglomerates.

Many of these financial institutions have substantially greater resources than we do and may offer a broader range of financial products across more markets. Some operate in a different regulatory environment than we do which may give them certain competitive advantages in the investment products and portfolio structures that they offer. We compete with other providers of investment advisory services primarily based on the availability and objectives of the investment portfolios offered, investment performance, and the scope and quality of investment advice and other client services. Some institutions have proprietary products and distribution channels that make it more difficult for us to compete with them. We believe that competition within the investment management industry will increase as a result of consolidation and acquisition activity and because new competitors face few barriers to entry. Most of our investment portfolios are available without sales or redemption fees, which means that investors may be more willing to transfer assets to competing funds.

If current or potential customers decide to use one of our competitors, we could face a significant decline in market share, assets under management, revenues, and net income. If we are required to lower our fees in order to remain competitive, our net income could be significantly reduced because some of our expenses are fixed, especially over shorter periods of time, and others may not decrease in proportion to the decrease in revenues.

Our success depends on our key personnel and our financial performance could be negatively affected by the loss of their services.

Our success depends on our highly skilled personnel, including our portfolio and fund managers, investment analysts, management and client relationship personnel, and corporate officers, many of whom have specialized expertise and extensive experience in our industry. Financial services professionals are in high demand, and we face significant competition for qualified employees. Our key employees do not have employment contracts, and generally can terminate their employment with us at any time. We cannot assure that we will be able to retain or replace key personnel. In order to retain or replace our key personnel, we may be required to increase compensation, which would decrease net income. The loss of key personnel could damage our reputation and make it more difficult to retain and attract new employees and investors. Losses of assets from our client investors would decrease our revenues and net income, possibly materially.

Certain of the Price funds and other investment portfolios are vulnerable to market-specific risks that could adversely affect investment performance, our reputation and our revenues.

Several of the Price funds and investment portfolios (for example, emerging market investments) are subject to political and economic instability, wide exchange-rate fluctuations, illiquid and highly volatile markets, and other risks that could materially decrease the investment returns available in foreign markets. A significant decrease in the investment return or net asset value of any Price fund or investment portfolio could harm our reputation and cause a decrease in assets under management, including client asset withdrawals. The result could be a material decline in our revenues and net income.

Our operations are complex and a failure to perform operational tasks or the misrepresentation of products and services could have an adverse affect on our reputation and subject us to regulatory sanctions, fines, penalties, and litigation.

Operating risks include:

- failure to properly perform fund or portfolio recordkeeping responsibilities, including portfolio accounting, security pricing, corporate actions, investment restrictions compliance, daily net asset value computations, account reconciliations, and required distributions to fund shareholders to comply with tax regulations;
- failure to properly perform transfer agent and participant recordkeeping responsibilities, including transaction processing, tax reporting and record retention; and failure to identify excessive trading in mutual funds by our customers or plan participants;
- sales and marketing risks, including the intentional or unintentional misrepresentation of products and services in advertising materials, public relations information, or other external communications, and failure to properly calculate and present investment performance data accurately and in accordance with established guidelines and regulations.

Any damage to our reputation could harm our business and lead to a loss of revenues and net income.

We have spent many years developing our reputation for integrity, strong investment performance, and superior client services. Our brand is a valuable intangible asset, but it is vulnerable to a variety of threats that can be difficult or impossible to control, and costly or even impossible to remediate. Regulatory inquiries and rumors can tarnish or substantially damage our reputation, even if they are satisfactorily addressed. Any damage to our brand could impede our ability to attract and retain customers and key personnel, and reduce the amount of assets under our management, any of which could have a material adverse effect on our revenues and net income.

Our expenses are subject to significant fluctuations that could materially decrease net income.

Our operating results are dependent on the level of our expenses, which can vary significantly for many reasons, including:

- changes in the level of our advertising expenses, including the costs of expanding investment advisory services to investors outside of the United States and further penetrating U.S. distribution channels,
- variations in the level of total compensation expense due to, among other things, bonuses, stock option grants and other stock-based awards, changes in employee benefit costs due to regulatory or plan design changes, changes in our employee count and mix, and competitive factors,
- a future impairment of goodwill that is recognized in our balance sheet,
- material fluctuation in foreign currency exchange rates applicable to the costs of our operations abroad,
- expenses and capital costs incurred to enhance our administrative and operating services infrastructure, such as technology assets, depreciation, amortization, and research and development,
- unanticipated costs incurred to protect investor accounts and client goodwill, and
- disruptions of third-party services such as communications, power, and mutual fund transfer agent and accounting systems.

Under our agreements with our mutual funds, we charge our mutual funds certain administrative fees and related expenses based upon contracted terms. If we fail to accurately estimate our underlying expense levels or otherwise are required to incur expenses relating to the mutual funds that are not otherwise paid by the funds, our operating results will be adversely affected.

We have contracted with third-party financial intermediaries that distribute our investment portfolios, and such relationships may not be available or profitable to us in the future.

More than 30% of our assets under management are sourced from our largest distribution channel, third-party financial intermediaries that distribute our managed investment portfolios in the U.S. and abroad. These intermediaries generally offer their clients various investment products in addition to, and in competition with, our investment offerings, and have no contractual obligation to encourage investment in our portfolios. It would be difficult for us to acquire or retain the management of those assets without the assistance of the intermediaries, and we cannot assure that we will be able to maintain an adequate number of successful distribution relationships. In addition, some investors rely on third party financial planners, registered investment advisers, and other consultants or financial professionals to advise them on the choice of investment adviser and investment portfolio. These professionals and consultants can favor a competing investment portfolio as better meeting their particular client s needs. We cannot assure that our investment offerings will be among their recommended choices in the future. Further, their recommendations can change over time and we could lose their recommendation and their client assets under our management. Mergers, acquisitions, and other ownership or management changes could also adversely impact our relationships with these third party intermediaries. The presence of any of the adverse conditions discussed above would reduce revenues and net income, possibly by material amounts.

Natural disasters and other unpredictable events could adversely affect our operations.
Armed conflict, terrorist attacks, power failures, and natural disasters could adversely affect our revenues, expenses and net income by:
- decreasing investment valuations in, and returns on, the investment portfolios that we manage,
- causing disruptions in national or global economies that decrease investor confidence and make investment products generally less attractive,
- inflicting losses in human capital,
- interrupting our business operations,
- triggering technology delays or failures, and
- requiring substantial capital expenditures and operating expenses to remediate damage, replace our facilities, and restore our operations.

We have developed various backup systems and contingency plans but we cannot be assured that they will be adequate in all circumstances that could arise or that material interruptions and disruptions will not occur. In addition, we rely to varying degrees on outside vendors for disaster contingency support, and we cannot be assured that these vendors will be able to perform in an adequate and timely manner. If we lose any employees, or if we are unable to respond adequately to such an event in a timely manner, we may be unable to continue our business operations, which could lead to a tarnished reputation and loss of customers that results in a decrease in assets under management, lower revenues and materially reduced net income.

Our investment income and asset levels may be negatively impacted by fluctuations in our investment portfolio.
We currently have a substantial portion of our assets invested in our stock, bond, and blended asset mutual funds. All of these investments are subject to investment market risk and our income from these investments could be adversely affected by a decline in value. In addition, related investment income has fluctuated significantly over the years depending upon the performance of our corporate investments, including the impact of market conditions and the size of our corporate money market and longer-term mutual fund holdings. Fluctuations in other investment income can be expected to occur in the future.

The investment performance of our savings bank subsidiary could adversely affect our assets and results of operations.
We have a savings bank subsidiary that accepts time deposits from customers, pays a fixed rate of interest to them, and invests in asset-backed debt securities. Although we generally hold these investments to maturity on a basis which correlates to the maturities of our customer deposits, fluctuations in interest rates could result in other-than-temporary impairments among the fixed income investments and could result in a mismatch between the interest rate return on our investment portfolio and the interest paid on our customer deposits. To the extent that this occurs, our assets and results of operations could be adversely affected.

We may elect to pursue growth in the United States and abroad through acquisitions or joint ventures, which exposes us to risks inherent in assimilating new operations and in expanding into new jurisdictions.
In order to maintain and enhance our competitive position, we may review and pursue acquisition and venture opportunities. We cannot assure that we will identify and consummate any such transactions on acceptable terms or have sufficient resources to accomplish such a strategy. In addition, any strategic transaction can involve a number of risks, including additional demands on our staff; unanticipated problems regarding integration of investor account and investment security recordkeeping, operating facilities and technologies, and new employees; adverse effects in the event acquired intangible assets or goodwill become impaired; and the existence of liabilities or contingencies not disclosed to or otherwise known by us prior to closing a transaction.

LEGAL AND REGULATORY RISKS

Compliance within a complex regulatory environment imposes significant financial and strategic costs on our business, and non-compliance could result in fines and penalties.
We are subject to extensive regulation by foreign and domestic governments, regulatory agencies such as the SEC in the United States and the FSA in Great Britain, and self-regulatory organizations such as the Financial Industry Regulatory Authority (FINRA). The conduct of our business is in large part dictated by adherence to such regulation, including federal laws such as the Sarbanes-Oxley Act of 2002, the USA Patriot Act of 2001, the Employee Retirement Income Security Act of 1974 (ERISA), regulations relating to the mutual fund industry specifically and

securities laws generally, accounting standards, and banking and tax laws. Compliance with these complex regulations and our disclosure and financial reporting obligations requires significant investments of time and money and could limit our ability to enter into new lines of business. Further, the regulations imposed by one jurisdiction may conflict with the regulations imposed by another, and these differences may be difficult or impossible to reconcile.

Our regulatory environment is frequently altered by new regulations and by revisions to, and evolving interpretations of, existing regulations. Future changes could require us to modify or curtail our investment offerings and business operations.

If we are unable to maintain compliance with applicable laws and regulations, we could be subject to criminal and civil liability, the suspension of our employees, fines, penalties, sanctions, injunctive relief, exclusion from certain markets, or temporary or permanent loss of licenses or registrations necessary to conduct our business. A regulatory proceeding, even if it does not result in a finding of wrongdoing or sanctions, could consume substantial expenditures of time and capital. Any regulatory investigation, and any failure to maintain compliance with applicable laws and regulations, could severely damage our reputation, adversely affect our ability to conduct business, and decrease revenue and net income.

Legal and regulatory developments in the mutual fund and investment advisory industry could increase our regulatory burden, cause a loss of mutual fund investors, and reduce our revenues.

Because of trading abuses that were uncovered earlier this decade at several investment management firms, regulators have shown increasing interest in the oversight of the mutual fund and investment advisory industry. Federal agencies have adopted regulations designed to strengthen controls and restore investor confidence in the industry and more rules can be expected in the future that could place greater compliance and administrative burdens on us, which could increase our expenses without increasing revenues. In addition, new regulations could require the Price funds to reduce the level of certain mutual fund fees paid to us or require us to bear additional expenses, which would affect our operating results. Further, adverse results of regulatory investigations of mutual fund and investment advisory firms could tarnish the reputation of mutual funds and investment advisers generally, causing investors to avoid further fund investments or redeem their balances. Redemptions would decrease the assets under our management, which would reduce our advisory revenues and net income.

We may in the future be involved in legal and regulatory proceedings that may not be covered by insurance.

We are subject to regulatory and governmental inquiries and civil litigation. An adverse outcome of any such proceeding could involve substantial financial penalties. From time to time, various claims against us arise in the ordinary course of business, including employment-related claims. There also has been increased incidence of litigation and regulatory investigations in the financial services industry in recent years, including customer claims and class action suits alleging substantial monetary damages.

We carry insurance in amounts and under terms that we believe are appropriate. We cannot assure that our insurance will cover all liabilities and losses to which we may be exposed, or that our insurance policies will continue to be available on acceptable terms. Certain insurance coverage may not be available or may be prohibitively expensive in future periods. As our insurance policies come up for renewal, we may need to assume higher deductibles or co-insurance liabilities, or pay higher premiums, which would increase our expenses and reduce our net income.

Net capital requirements may impede the business operations of our subsidiaries.

Certain of our subsidiaries are subject to net capital requirements imposed by various federal, state, and foreign authorities. Our subsidiaries net capital meets or exceeds all minimum requirements; however, a significant operating loss or extraordinary charge against net capital could adversely affect the ability of our subsidiaries to expand or even maintain their operations if we were unable to make additional investments in them.

TECHNOLOGY RISKS

We require specialized technology to operate our business and would be adversely affected if our technology became inoperative or obsolete.

We depend on highly specialized and, in many cases, proprietary technology to support our business functions, including, among other functions:

- securities analysis,
- securities trading,
- portfolio management,
- customer service,
- accounting and internal financial processes and controls, and
- regulatory compliance and reporting.

All of our technology systems are vulnerable to disability or failures due to hacking, viruses, natural disasters, power failures, acts of war or terrorism, and other causes. Some of our software is licensed from and supported by outside vendors upon whom we rely to prevent operating system failure. A suspension or termination of these licenses or the related support, upgrades and maintenance could cause system delays or interruption. If our technology systems were to fail and we were unable to recover in a timely way, we would be unable to fulfill critical business functions, which could lead to a loss of customers and could harm our reputation. Technological breakdown could also interfere with our ability to comply with financial reporting and other regulatory requirements, exposing us to disciplinary action and to liability to our customers.

In addition, our continued success depends on our ability to effectively integrate operations across many countries, and to adopt new or adapt existing technologies to meet client, industry and regulatory demands. We might be required to make significant capital expenditures to maintain competitive technology. If we are unable to upgrade our technology in a timely fashion, we might lose customers and fail to maintain regulatory compliance, which could affect our results of operations and severely damage our reputation.

<u>We could be subject to losses if we fail to properly safeguard sensitive and confidential information.</u>
As part of our normal operations, we maintain and transmit confidential information about our clients as well as proprietary information relating to our business operations. Our systems could be victimized by unauthorized users or corrupted by computer viruses or other malicious software code, or authorized persons could inadvertently or intentionally release confidential or proprietary information. Such disclosure could, among other things:

- seriously damage our reputation,
- allow competitors access to our proprietary business information,
- subject us to liability for a failure to safeguard client data,
- result in the termination of contracts by our existing customers,
- subject us to regulatory action, and
- require significant capital and operating expenditures to investigate and remediate the breach.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

The lease on our corporate offices, which include almost 410,000 square feet at 100 East Pratt Street in Baltimore, expires in mid-2017. We are completing tenant improvements and expect to fully occupy this space early in the fourth quarter of 2008. Our London and other foreign offices as well as our customer service call center in Tampa, Florida are also leased.

Our operating and servicing facilities include owned properties in suburban campus settings comprising about 700,000 square feet in Owings Mills, Maryland and 294,000 square feet in Colorado Springs. We recently doubled the size of our Colorado Springs facilities by adding a second building that we occupied in mid-December 2007. Acreage that we own on which our campus facilities are located will accommodate additional future development. Our technology center of 122,000 square feet is on a separate parcel of owned land in Owings Mills in proximity to the campus facilities.

We presently maintain investor centers for walk-in traffic and investor meetings in leased facilities located in the Baltimore; Boca Raton, Florida; Boston (Wellesley, Massachusetts); Chicago (Oak Brook and Northbrook, Illinois); Los Angeles (Century City, California); New York City/New Jersey (Garden City, New York and Short Hills, New Jersey); San Francisco (Walnut Creek, California); Tampa; and Washington (Washington, D.C. and McLean, Virginia) areas. We also have investor centers in our owned facilities in Colorado Springs and Owings Mills. These investor centers allow us to be available in person to a large number of our investors.

Information concerning our anticipated capital expenditures in 2008 and our future minimum rental payments under noncancelable operating leases at December 31, 2007, is set forth in the capital resources and liquidity and contractual obligations discussions in Item 7 of this Form 10-K.

Item 3. Legal Proceedings.

In September 2003, a purported class action (T.K. Parthasarathy, et al., including Woodbury, v. T. Rowe Price International Funds, Inc., et al.) was filed in the Circuit Court, Third Judicial Circuit, Madison County, Illinois, against T. Rowe Price International and the T. Rowe Price International Funds with respect to the T. Rowe Price International Stock Fund. The basic allegations in the case were that the T. Rowe Price defendants did not make appropriate price adjustments to the foreign securities owned by the T. Rowe Price International Stock Fund prior to calculating the Fund s daily share prices, thereby allegedly enabling market timing traders to trade the Fund s shares in such a way as to disadvantage long-term investors. Following years of procedural litigation in State and Federal courts, the case has been remanded to the State Court. In the opinion of management, after consultation with counsel, the likelihood of a resolution of this matter that would have a material adverse effect on our financial position or results of operations is remote.

From time to time, various claims against us arise in the ordinary course of business, including employment-related claims. In the opinion of management, after consultation with counsel, the likelihood that an adverse determination in one or more pending claims would have a material adverse effect on our financial position or results of operations is remote.

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

None during the fourth quarter of 2007.

Item. Executive Officers of the Registrant.

The following information includes the names, ages, and positions of our executive officers. There are no arrangements or understandings pursuant to which any person serves as an officer. The first six individuals are members of our management committee.

James A.C. Kennedy (54), Chief Executive Officer and President since 2007. Mr. Kennedy was previously a Vice President from 1981-2006.

Brian C. Rogers (52), Chairman since 2007 and a Vice President since 1985.

Edward C. Bernard (51), Vice Chairman since 2007 and a Vice President since 1989.

Mary J. Miller (52), a Vice President since 1986.

William J. Stromberg (47), a Vice President since 1990.

David J.L. Warren (50), a Vice President since 2000.

For the three-month period ended March 31, 2006, the company recorded share-based compensation expense of $1,069,000. All such compensation is reflected in the accompanying condensed consolidated income statement within the selling, distribution and administrative expense line item. Share-based compensation expense recognized in the first quarter of 2006 is based on awards ultimately expected to vest; therefore, it has been reduced for estimated forfeitures. SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the pro forma information presented for periods prior to 2006, the company accounted for forfeitures as they occurred.

For the three months ended March 31, 2006, Apria s adoption of SFAS No. 123R reduced the company s operating income and income before taxes by $376,000 and net income was reduced by $251,000. Basic and diluted earnings per share were each reduced by $0.01. The adoption of SFAS No. 123R did not affect cash flow.

For the quarter ended March 31, 2006, cash received from the exercise of options totaled $2,802,000 and income tax benefits related to stock-based compensation arrangements amounted to $30,000.

The company estimates the fair value of stock options using the Black-Scholes valuation model. Key input assumptions used to estimate the fair value of stock options include the exercise price of the award, the expected option term, the expected volatility of the company s stock over the option s expected term, the risk-free interest rate over the option s term, and the company s expected annual dividend yield. Apria s management believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of the company s stock options granted in the three months ended March 31, 2006. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards.

The key input assumptions that were utilized in the valuation of the stock options granted during the three months ended March 31, 2006, are summarized in the table below. There were no stock option grants in the corresponding period in 2005.

	Three Months Ended March 31, 2006
Expected option term (1)	4.83 years
Expected volatility (2)	27.1%
Risk-free interest rate (3)	4.73%
Expected annual dividend yield	0%

(1) The expected option term is based on historical exercise and post-vesting termination patterns.
(2) Expected volatility represents a combination of historical stock price volatility and implied volatility from publicly-traded options on Apria s common stock.
(3) The risk-free interest rate is based on the implied yield on a U.S. Treasury zero coupon issue with a remaining term equal to the expected term of the option.

2003 Performance Incentive Plan: In July 2003, Apria s shareholders approved the 2003 Performance Incentive Plan (2003 Plan), which permits the grant of stock options, stock appreciation rights (SARs), stock bonuses, restricted stock, performance stock, stock units, phantom stock, dividend equivalents, or similar rights to purchase or acquire shares, and cash awards. Any award may be paid or settled in cash. The 2003 Plan is currently the only plan from which stock-based awards may be granted.

The maximum number of shares that may be issued as awards under the 2003 Plan equals the sum of (1) 6,500,000 shares, plus (2) the number of shares subject to stock options granted under previous plans, which expire or are cancelled or terminated without being exercised, after the effective date of the 2003 Plan.

The 2003 Plan also contains the following limits:

- grants of incentive stock options up to 2,000,000 shares,
- grants of options and SARs during any calendar year to any individual up to 500,000 shares,
- shares subject to all awards granted to an individual during any calendar year up to 1,000,000 shares,
- awards granted to non-employee directors up to 700,000 shares,
- awards granted, other than for stock options and SARs, up to 2,275,000 shares,
- performance-based awards, other than stock options and SARs, granted to an individual up to 500,000 shares in a calendar year, and
- performance-based awards, payable in cash, granted to an individual up to $10,000,000 in a calendar year.

The per share exercise price of an option or SAR (collectively referred to as options) generally may not be less than the per share fair market value on the date of grant. The maximum term of an option is ten years from the date of grant. Performance based awards may also be issued from the 2003 Plan. The vesting or payment of such awards will depend on the company s performance to established measurement criteria. The performance measurement period may range from three months to ten years. Performance based awards may be paid in stock or in cash. The company has historically issued new shares when options or stock-based awards are exercised.

The company believes that share-based awards better align the interests of its senior management and other key employees with those of its shareholders as well as serving as an effective tool to attract, retain and motivate plan participants.

Stock Options: Apria s incentive plan provides for the granting of stock options to employees and non-employee directors. Such grants may include non-qualified and incentive stock options. The exercise price of an option is established at the fair market value of a share of Apria common stock on the date of grant. Vesting of stock options is time-based and is generally over a three-year period.

The following table summarizes the activity for stock options for the three months ended March 31, 2006:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2006	4,076,705	$ 25.28		
Granted	630,000	22.75		
Exercised	(114,665)	23.20		
Forfeited	(40,002)	25.56		
Outstanding at March 31, 2006	4,552,038	$ 24.98	6.86	$ 6,260,061
Vested or expected to vest as of March 31, 2006	4,432,390	$ 25.04	6.83	$ 6,232,590
Exercisable at March 31, 2006	3,913,704	$ 25.34	6.37	$ 6,115,161

The weighted-average fair value of stock options granted during the three months ended March 31, 2006 was $7.39. There were no grants in the corresponding period in 2005. The total intrinsic value of options exercised was $120,000 and $3,255,000 for the three months ended March 31, 2006 and 2005, respectively.

As of March 31, 2006, total unrecognized stock-based compensation cost related to unvested stock options was $3,679,000, which is expected to be expensed over a weighted-average period of 1.91 years.

Restricted Stock Purchase Rights: In 2003 and 2004, Apria granted restricted stock purchase rights to certain members of executive management. The awards represented the right to purchase a certain number of shares of Apria common stock at a future date at a specified exercise price. The exercise price was established at 25% of the fair market value of a share of Apria common stock on the date of grant. Such awards generally require that certain performance conditions and service conditions be met before the awards will vest.

The following table summarizes the activity for restricted stock purchase rights for the three months ended March 31, 2006:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2006	546,000	$ 6.71		
Granted	-	-		
Exercised	(22,000)	6.46		
Forfeited	(34,000)	6.46		
Outstanding at March 31, 2006	490,000	$ 6.74	7.49	$ 7,957,010
Vested or expected to vest as of March 31, 2006	439,532	$ 6.72	7.48	$ 7,145,978
Exercisable at March 31, 2006	152,500	$ 6.49	7.38	$ 2,514,875

The total intrinsic value of restricted stock purchase rights exercised was $392,000 and $418,000 for the three months ended March 31, 2006 and 2005, respectively. No such awards were granted during these two periods.

As of March 31, 2006, total unrecognized stock-based compensation cost related to unvested restricted stock purchase rights was $4,340,000, which is expected to be expensed over a weighted-average period of 4.08 years.

Restricted Stock Awards and Units: Apria s incentive plan provides for the granting of restricted stock and restricted stock units to its non-employee directors and employees (limited to executive management). Such awards generally require that certain performance conditions and service conditions be met before the awards will vest.

The following table summarizes the activity for restricted stock awards and units for the three months ended March 31, 2006:

	Shares or Share Units	Weighted-Average Grant-Date Fair Value
Nonvested restricted stock awards and units at January 1, 2006	264,384	$34.01
Granted	255,000	22.75
Vested and released	-	-
Forfeited	(20,000)	33.40
Nonvested restricted stock awards and units at March 31, 2006	499,384	$28.28

The weighted-average fair value of restricted stock awards and units granted during the three months ended March 31, 2006 was $22.75. There were no grants in the corresponding period in 2005. No restricted stock awards or units were released during the periods presented in this report.

As of March 31, 2006, total unrecognized stock-based compensation cost related to unvested restricted stock awards and units was $10,623,000, which is expected to be expensed over a weighted-average period of 4.60 years.

Prior Period Pro Forma Presentation: Apria had previously adopted the provisions of SFAS No. 123 through disclosure only. The following table illustrates the effects on net income and earnings per share for the three months ended March 31, 2005 as if the company had applied the fair value recognition provisions of SFAS No. 123 to share-based employee awards.

(dollars in thousands, except per share data)	Three Months Ended March 31, 2005
Net income as reported	$ 25,170
Add: share-based compensation expense included in reported net income, net of related tax effects	807
Deduct: total share-based compensation expense determined for all awards under fair value-based	(3,083)

(dollars in thousands, except per share data)	Three Months Ended March 31, 2005
method, net of related tax effects	
Pro forma net income	$ 22,894
Basic net income per share:	
As reported	$ 0.52
Pro forma	$ 0.47
Diluted net income per share:	
As reported	$ 0.51
Pro forma	$ 0.46

NOTE G INCOME TAXES

Income taxes for the three months ended March 31, 2006 have been provided at a lower effective rate than is expected to be applicable for the entire year. The lower rate is due to the completion of a 2002 Internal Revenue Service audit, which resulted in the reduction of federal tax contingencies of $1,761,000 and a corresponding reduction in the tax provision for the quarter.

Income taxes for the three-month period ended March 31, 2005 were provided at a lower effective tax rate than applicable for that year. The lower rate was primarily due to state net operating loss carryforwards that became realizable based on a change in estimate of expected future earnings. This resulted in a decrease in the valuation allowance account of $2,597,000 and a corresponding reduction in the tax provision for the quarter.

At March 31, 2006, the company had various apportioned state net operating loss carryforwards which resulted in a deferred tax asset of $8,827,000, net of federal tax benefit.

NOTE H PER SHARE AMOUNTS

The following table sets forth the computation of basic and diluted per share amounts:

	Three Months Ended March 31,	
(in thousands, except per share data)	**2006**	**2005**
Numerator:		
Net income	$ 16,123	$ 25,170
Numerator for basic and diluted per share amounts net income available to common stockholders	$ 16,123	$ 25,170
Denominator:		
Denominator for basic per share amounts weighted average shares	42,379	48,818
Effect of dilutive securities:		
Employee stock options and awards dilutive potential common shares	575	967
Denominator for diluted per share amounts adjusted weighted average shares	42,954	49,785
Basic net income per common share	$ 0.38	$ 0.52
Diluted net income per common share	$ 0.38	$ 0.51

	Three Months Ended March 31,	
Employee stock options excluded from the computation of diluted per share amounts:		
Shares for which exercise price exceeds average market price of common stock	2,536	630
Average exercise price per share that exceeds average market price of common stock	$ 29.04	$ 33.40

NOTE I COMMITMENTS AND CONTINGENCIES

Apria is the defendant in a California class action lawsuit containing blanket claims of liability under various California employee protection statutes and regulations relating to payment of regular and overtime wages, the timeliness of such payments, the maintenance and provision of access to required payroll records, and the provision of meal and rest periods. *Venegas vs. Apria Healthcare, Inc.*, et al., was filed on February 21, 2006 in the California Superior Court for the County of San Francisco (Case No. CGC -- 06 -- 449669). No class has been certified at this time, but on behalf of a purported class consisting of all of the company s hourly employees in the State of California, the complaint seeks compensatory and punitive damages in an unspecified amount as well as other relief. The company has filed an answer to the complaint denying all material allegations and asserting a number of affirmative defenses. Based on the company s preliminary investigation of the allegations, management believes there are meritorious defenses to the claims and intends to vigorously defend the company. No assurance can be given, however, that the ultimate disposition of this case will not have a material adverse effect on the company s financial condition or results of operations. Management cannot estimate the possible loss or range of loss that may result from these proceedings and, therefore, has not recorded any related accruals.

Apria is also engaged in the defense of certain claims and lawsuits arising out of the ordinary course and conduct of its business, the outcomes of which are not determinable at this time. Apria has insurance policies covering such potential losses where such coverage is cost effective. In the opinion of management, any liability that might be incurred by Apria upon the resolution of these claims and lawsuits will not, in the aggregate, have a material adverse effect on the company s financial condition or results of operations.

Cautionary statement for purposes of the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995: Apria s business is subject to a number of risks which are partly or entirely beyond the company s control. The company has described certain of those risks in its Annual Report on Form 10-K/A for the fiscal year ended December 31, 2005, as filed with the Securities and Exchange Commission on March 23, 2006. This report may be used for purposes of the Private Securities Litigation Reform Act of 1995 as a readily available document containing meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in any forward-looking statements the company may make from time to time. Key factors that may have an impact on Apria include the following:

- trends and developments affecting the collectibility of accounts receivable;
- government legislative and budget developments that could continue to affect reimbursement levels;
- the effectiveness of Apria s operating systems and controls;
- healthcare reform and the effect of federal and state healthcare regulations;
- pricing pressures from large payors; and
- other factors described in Apria s filings with the Securities and Exchange Commission.

In addition, the military and national security activities in which the United States is currently engaged, and the federal government s financial commitments to disaster recovery efforts, have and could continue to have significant impacts on the economy and government spending priorities. Deficit spending by the government as the result of adverse developments in the economy and the continuing costs of military and national security activities and disaster assistance will most likely increase pressure to reduce government expenditures for other purposes, including government-funded programs such as Medicare and Medicaid.

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

Apria operates in the home healthcare segment of the healthcare industry and provides services in the home respiratory therapy, home infusion therapy and home medical equipment areas. In all three lines, Apria provides patients with a variety of clinical and administrative support services and related products and supplies, most of which are prescribed by a physician as part of a care plan. Apria provides these services to patients in the home through approximately 500 branch locations throughout the United States.

Apria s branch locations are organized into 15 geographic regions. Each region consists of a number of branches and a regional office that provides key administrative support services. Management evaluates operating results on a geographic basis and, therefore, views each region as an operating segment. All regions provide the same products and services, including respiratory therapy, infusion therapy and home medical equipment and supplies. Additional administrative and operational support services are provided at a corporate level. Management continues to evaluate opportunities to gain efficiencies and cost savings by consolidating regional functions. For financial reporting purposes, all the company s operating segments are aggregated into one reportable segment in accordance with the aggregation criteria of Statement of Financial Accounting Standards (SFAS) No. 131, Disclosures about Segments of an Enterprise and Related Information.

Strategy. Apria s mission is to be the first choice of patients and payors for their homecare needs. Apria has positioned itself in the marketplace as the low cost, quality provider of a broad range of home healthcare services to managed care customers and to Medicare. The specific elements of the company s strategy to achieve its mission and optimize its market position are as follows:

Growth - Apria s primary focus is to restore strong organic sales growth following a decline in revenue during the third and fourth quarters of 2005 and to increase market share in its core service lines. The company will continue to invest in service line extensions.

Productivity - Apria strives to leverage its nationwide infrastructure to reduce costs by enhancing best practices and by investing in systems improvements.

Service - Apria differentiates itself from the competition by setting a high standard for customer service.

People - Apria recruits, develops and advances individuals who are leaders in order to respond to changing market conditions and to maximize sales and earnings growth.

Critical Accounting Policies. Apria s management considers the accounting policies that govern revenue recognition and the determination of the net realizable value of accounts receivable to be the most critical in relation to the company s consolidated financial statements. These policies require management s most complex and subjective judgments. Additionally, the accounting policies related to goodwill, long-lived assets and income taxes require significant judgment. These policies are presented in detail in the Management s Discussion and Analysis of Financial Condition and Results of Operations section in Apria s Annual Report on Form 10-K/A for the fiscal year ended December 31, 2005.

Results of Operations

Net Revenues. Net revenues were $368.1 million in the first quarter of 2006, compared to $371.9 million in the first quarter of 2005. The decrease is primarily attributable to the Medicare reimbursement reductions that have been in effect since the first quarter of 2005. Reimbursement reductions for oxygen and oxygen equipment became effective April 8, 2005 and lower dispensing fees for respiratory drugs went into effect January 1, 2006. Further, the average sales price, or ASP, which is used as the basis for Medicare reimbursement of respiratory drugs is updated each quarter and, as a result, is now lower than it was one year ago. The combined effect of these Medicare reductions was $8.4 million in the first quarter of 2006 as compared to the first quarter of 2005. Additionally, reduced pricing for three of the company s larger managed care contracts caused revenues to decline by approximately $3.9 million, when comparing the first quarter of 2006 to the comparable period in 2005. These reductions were partially offset by the full period effect in 2006 of revenue from acquisitions that were closed in 2005, which is estimated at approximately $10 million. Also mitigating the reductions in the first quarter of 2006 was approximately $3.9 million in incremental revenues from the new CIGNA contract that went into effect February 1, 2006.

Management previously estimated that the CIGNA contract would contribute approximately $25 million in net revenues to 2006. Based on results to date, such revenues are now estimated to be at least $35 million.

Apria expects to continue to face pricing pressures from Medicare as well as from its managed care customers as these payors seek to lower costs by obtaining more favorable pricing from providers such as Apria. Managed care organizations are also evaluating alternative delivery models for certain products and services, which include those provided by Apria. This potential change may cause Apria to provide reduced levels of certain products and services in the future, resulting in a corresponding reduction in revenue.

The following table sets forth a summary of net revenues by service line:

	Three Months Ended March 31,			
	2006		**2005**	
(dollars in thousands)	**$**	**%**	**$**	**%**
Respiratory therapy	$253,148	68.8%	$257,488	69.2%
Infusion therapy	64,772	17.6%	61,703	16.6%

	Three Months Ended March 31,			
Home medical equipment/other	50,136	13.6%	52,672	14.2%
Total net revenues	$368,056	100.0%	$371,863	100.0%

Respiratory Therapy. Respiratory therapy revenues are derived primarily from the provision of oxygen systems, home ventilators, sleep apnea equipment, nebulizers, respiratory medications and related services. Revenues from the respiratory therapy service line declined by 1.7% in the first quarter of 2006 when compared to the corresponding period of 2005. The entire Medicare reduction of $8.4 million noted above was in the respiratory therapy line. Excluding the Medicare reduction, the respiratory line would have increased by 1.6%. Acquisitions of respiratory businesses effected in 2005 and revenues from the new CIGNA contract accounted for most of the growth in the respiratory therapy revenue line.

Growth between the first quarter of 2005 and the first quarter of 2006 in the largest respiratory categories is as follows: Excluding Medicare reductions, revenues from oxygen and oxygen systems were flat while revenues from respiratory medications increased by 4.1%. The CPAP/BiPAP line, which currently comprises 26% of total respiratory revenues, grew by 12.9%.

Infusion Therapy. The infusion therapy service line involves the administration of drugs or nutrients directly into the body intravenously through a needle or catheter. Infusion therapy services also include administering enteral nutrients directly into the gastrointestinal tract through a feeding tube. Infusion therapy revenues increased by 5.0% in the first quarter of 2006 when compared to the same period last year. Enteral nutrition, which represents just under half of the infusion therapy line, increased by 7.8%.

Home Medical Equipment/Other. Home medical equipment/other revenues are derived from the provision of equipment to assist patients with ambulation, safety and general care in and around the home. Home medical equipment/other revenues decreased by 4.8% in the first quarter of 2006 when compared to the first quarter of 2005. The home medical equipment line experienced a decline in the second half of 2005 largely due to decreases in hospital utilization rates for many of the company s managed care contractors as well as managed care pricing compression. However, when compared to the fourth quarter of 2005, the home medical equipment/other line has increased by 2.1%, an early indication that the downward trend may have reversed.

Medicare Reimbursement. There are a number of provisions contained within recent legislation or proposed legislation that affect or may affect Medicare reimbursement policies for items and services provided by Apria. Such provisions are outlined below in the chronological order of the associated legislation.

Still pending from the Balanced Budget Act of 1997 is the streamlined authority granted to the U.S. Department of Health and Human Services, or HHS, to increase or reduce the reimbursement for home medical equipment, including oxygen, by up to 15% each year under an inherent reasonableness authority. The Centers for Medicare and Medicaid Services, or CMS, issued a rule that established a process by which such adjustments may be made. The rule applies to all Medicare Part B services except those paid under a physician fee schedule, a prospective payment system, or a competitive bidding program. As of this date, neither CMS nor the durable medical equipment regional carriers, or DMERCs, have used the expedited authority.

In September 2003, the HHS Office of Inspector General, or OIG, issued a proposed rule intended to clarify terms and the application of program exclusion authority for submitting claims containing excessive charges. Under the rule, a provider could be excluded if its charges to Medicare or Medicaid are substantially in excess of the provider s usual charges, unless there is good cause. The proposed clarification defined substantially in excess as those charges that are 120% of the provider s usual charges. The company, along with many other providers and members of the public, submitted formal comments to the OIG regarding the proposed rule in the fall of 2003. Based upon recent statements of federal legislators, it is the company s understanding that the OIG is currently working on a final rule. Because the company is unaware of what changes the OIG may make to the proposed rule before it is made final, management cannot at this time quantify any negative impact that this rule, if and when issued, may have on the company.

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003, also referred to as the Medicare Modernization Act, became law. The provisions contained therein which are significant to Apria are as follows:

A freeze on annual payment increases for durable medical equipment The freeze commenced in 2004 and will continue through 2008.

Reimbursement reductions for five durable medical equipment categories, including oxygen Reimbursement for most of these categories is based on the median price paid for such items on behalf of beneficiaries of federal employee health benefit plans, or FEHBP. The new fee schedules for most products went into effect January 1, 2005. The revised pricing for oxygen and oxygen equipment was implemented on April 8, 2005.

Reimbursement reduction for inhalation drugs The previous reimbursement rate of 95% of the average wholesale price was reduced to 80% of the average wholesale price, effective January 1, 2004. Beginning in January 2005, reimbursement for these drugs was further reduced through a shift to the manufacturer-reported average sales price (subject to adjustment each quarter) plus 6%, plus a separate dispensing fee per patient episode. The dispensing fees for 2005 were $57.00 for a 30-day supply of medications and $80.00 for a 90-day supply. Effective January 1, 2006, the dispensing fees were established at $57.00 for a 30-day supply for a new patient and $33.00 for each 30-day supply thereafter. The 90-day dispensing fee has been lowered to $66.00.

Establishment of a competitive bidding program for Medicare Part B Such a program would require that suppliers wishing to provide certain items to beneficiaries submit bids to Medicare. The program, for as yet unspecified durable medical equipment items and services, is to be phased in as follows: (i) 10 of the largest metropolitan statistical areas in 2007; (ii) 80 of the largest metropolitan statistical areas in 2009; and (iii) additional areas after 2009. The legislation contains special provisions for rural areas.

On April 24, 2006, CMS issued its proposed rule for the competitive bidding program under Medicare Part B, related to durable medical equipment, prosthetics and supplies (DMEPOS) and other issues. The document outlines CMS general intent regarding competitive acquisition for DMEPOS beginning some time in 2007. However, it does not specify: (i) which DMEPOS products will be included in the 10 initial competitive acquisition program areas; (ii) which metropolitan statistical areas will be included in the initial round of competitive bidding, although it does explicitly exclude New York City, Chicago and Los Angeles from the first round; (iii) target cost savings; (iv) specific quality standards; or (v) specific provider guidelines for preparing, completing and implementing the bids in each area. The rule also introduced certain concepts not previously addressed. Such concepts require much more evaluation and consideration by all parties, including CMS and its legal advisors. CMS noted that it is seeking comments on all aspects of the rule, with a deadline of June 30, 2006. CMS also noted that it expects to issue the final quality standards, including product-specific standards, through a program instruction memo, later in the year. Given the evaluation that must still be performed, Apria cannot estimate the impact of the competitive bidding program at this time.

Incentives for expansion of Medicare Part C The Medicare Modernization Act includes financial incentives for managed care plans to expand their provision of Medicare Advantage plans in 2006 in a stated effort to attract more Medicare beneficiaries to managed care models. The company maintains contracts to provide respiratory, infusion and medical equipment and related services to a significant number of managed care plans nationwide, and believes that the Medicare Advantage expansion represents a growth opportunity in 2006.

Reimbursement for home infusion therapy under Medicare Part D Currently, a limited number of infusion therapies, supplies and equipment are covered by Medicare Part B. The Medicare Modernization Act provides expanded coverage for the drugs only, but excludes coverage for the supplies and clinical services needed to safely and effectively provide home infusion therapy services to patients in the home. In the fourth quarter of 2005, the company contracted with a limited number of Medicare Part D prescription drug plans in order to provide continuity of care for existing Medicare/Medicaid dual eligible patients in 2006. Due to nationwide Part D implementation issues experienced by home infusion providers in early 2006, the industry is continuing to work with CMS to rectify the coverage and payment policies that are causing implementation challenges.

The Deficit Reduction Act of 2005 was signed by the President in February 2006. However, a number of lawsuits were subsequently filed to prevent its implementation because the House and Senate approved different versions of the bill due to a clerical error. The matter is still pending, but should the legislation survive as written, it contains the following provisions that will impact reimbursement to Apria:

In 2007, durable medical equipment currently categorized in the capped rental category by CMS, such as hospital beds, wheelchairs, nebulizers, patient lifts and continuous positive airway pressure devices, will be considered purchased outright at the end of the maximum rental period and the ownership of such devices will transfer directly to the patients. The maximum rental period, which had been 15 months with an option for the patients to purchase the equipment in the tenth month, will be reduced to 13 months. The new 13-month rental period policy took effect on January 1, 2006, and therefore the first month in which the new policy will impact the company s revenue is February 2007. In addition, the service and maintenance fee that had been paid to suppliers twice yearly after the rental period ended will be eliminated. Suppliers will have the option of billing Medicare for any repairs and/or maintenance performed on the patient-owned equipment. The Deficit Reduction Act authorizes the Secretary of HHS to establish service and/or maintenance fees that at this time cannot be estimated or assured. It is, however, unlikely that Apria will continue in the repair and maintenance business. Management estimates that the annual reduction in rental revenue and the loss of the service and maintenance fee will be $4 million and $16 million, respectively. Management is currently evaluating the impact that this change will have on the corresponding cost of sales.

Reimbursement for oxygen equipment will convert from an ongoing rental method to a rent to purchase method. The Deficit Reduction Act mandates that oxygen equipment reimbursement will be limited to 36 months, after which time the ownership of the equipment will transfer to the patient, who will assume all responsibility for identifying when repairs or preventive maintenance are needed. Providers would continue to be reimbursed for delivering portable oxygen to those patients who require it. The Act applies to patients on service with suppliers from January 1, 2006 forward. Accordingly, the first month in which the new policy will impact the company is January 2009. The Act authorizes the Secretary of HHS to establish service and/or maintenance fees that at this time cannot be estimated or assured. Due to the bundled nature of the existing payment method, which includes the reimbursement for contents, and all applicable clinical, delivery, after-hours, billing/collection and other patient support services, the industry will work with CMS and the Secretary to establish fair and equitable fee schedules for such non-equipment services. The net impact of the changes cannot be estimated at this time.

The President s current budget proposal contains a provision to further reduce the maximum rental period for oxygen from the now-mandated 36 months to 13 months. No further information is available on the proposal and it is uncertain whether this provision will remain in the budget that is ultimately approved by Congress.

Other outstanding issues that will or could have an impact on Medicare reimbursement levels to Apria are summarized as follows:

In late December 2005, CMS issued the 2006 Health Care Procedure Coding System, or HCPCS, fee schedule for Medicare Part B medications and the new two-tiered dispensing fee for inhalation therapies. The fee schedule took effect on January 1, 2006, and included two HCPCS codes for commercially manufactured budesonide (Pulmicort®) and DuoNeb®. The fee schedule also included a revised definition for the HCPCS codes for commercially manufactured budesonide and budesonide compounded from a powder, and separated these products into two unique codes. Management estimates that the impact of this change is an annual revenue reduction of approximately $3 million.

In January 2006, CMS published a final regulation that would shift payment for certain respiratory assist devices from the current frequent and substantial payment category to the capped rental category. Under frequent and substantial payment, Medicare payment continues for the duration of time the beneficiary requires the device, while capped rental payment continues for 13 months (a reduction from 15 months, mandated by the recently enacted Deficit Reduction Act.) The change in the payment category became effective April 1, 2006. The policy applies to those respiratory assist devices (also known as BiPAP STs) that have a backup rate feature that delivers pressure whenever the user s spontaneous breathing efforts are insufficient. The first claims received for each Medicare beneficiary with a date of service on or after April 1, 2006, including beneficiaries with existing rental equipment, will be counted as the first rental month in the capped rental period. Thus, the first month in which the new categorization will impact the company s revenue will be May 2007. The estimate for this change in payment categories is a reduction in annual revenues of $4 million. Management is currently evaluating the impact that this change will have on the corresponding cost of sales.

In January 2006, CMS announced the designation of four specialty contractors, durable medical equipment Medicare administrative contractors, or DME MACs, which soon will be responsible for handling the administration of Medicare claims from suppliers of durable medical equipment. Thus, all applicable claims will be handled by these new entities. The four new DME MACs were originally scheduled to replace the existing DMERCs on July 1, 2006, however, two of the four will be delayed until October 1, 2006. It is difficult at this time to predict precisely how this transformation will affect the suppliers. The company cannot predict or estimate the potential impact of this change on collections of its accounts receivable.

On March 24, 2006, the three Program Safeguard Contractors, or PSCs, overseeing durable medical equipment issued a proposed Local Coverage Determination, or LCD, for nebulizer medications covered by Medicare Part B. In their respective geographic regions, the PSC medical directors are responsible for implementing medical policies that conform to Medicare rules, regulations, coverage guidelines and payment policies for Part B as mandated by law or other regulations. The LCD for nebulizer medications proposes to change the payment and coverage policies for certain inhalation therapies that are provided in conjunction with the durable medical equipment nebulizer. Specifically, four provisions were proposed: (i) payment for levalbuterol (commercially manufactured as brand-name Xopenex®) will be based on the allowance for generic albuterol sulfate; (ii) payment for commercially-manufactured, brand-name DuoNeb® will be based on the allowance for separate unit dose vials of albuterol sulfate and ipratropium bromide; (iii) coverage for a variety of other nebulizer drugs will be eliminated because the PSCs assert that there is inadequate support in the medical literature for administration using a DME nebulizer; and (iv) maximum monthly utilization limits for budesonide will be defined. The PSCs issued a deadline of May 8, 2006 by which formal comments from the public and interested parties must be submitted. In addition, the three PSCs scheduled public hearings on the subject, all of which will be completed by May 17, 2006.

Apria is participating along with numerous other industry representatives, manufacturers, providers, physician and patient advocacy groups in the public hearings and has also prepared formal written comments for submission to the PSCs and CMS. The company believes that the Medicare Modernization Act is clear in its intent to prescribe the Part B average sales price reimbursement formula for single-source drugs which applies to both DuoNeb® and Xopenex®. The company further believes that the PSCs do not have the legal authority to circumvent the average sales price methodology through the issuance of an LCD that invokes their authority to use the Least Costly Alternative as the basis for reimbursement for these drugs. Apria is working with industry representatives to further demonstrate to the PSCs that such a decision would have an unprecedented, extraordinary and negative impact on access to prescription medications used in the front-line treatment of chronic obstructive pulmonary disease. The company has determined that if the four provisions of the LCD are implemented as proposed in the March 24 document, it will generally not provide DuoNeb® and Xopenex® to existing or future patients, as the cost would far exceed the reimbursement rate. The company would undertake an effort to inform existing patients and physicians of the option to use the generic drugs that the PSCs have deemed to be therapeutically equivalent to these brand-name drugs. Such an effort would mitigate but not eliminate the full effect of the change in reimbursement;

the estimated annual gross profit reduction of providing the replacement medications in lieu of the brand name drugs is $13 million.

Further, the manufacturer of Xopenex® recently announced that it is attempting to negotiate a solution to this issue directly with CMS that would reduce the reimbursement rate while maintaining patient access to the drug within the Medicare Part B program. Apria does not have visibility to the particulars of such a proposal but believes that such a solution could also have an adverse affect on its revenues and results of operations.

Medicaid Reimbursement. In 2001, some states began adopting alternative pricing methodologies for certain drugs and biologicals under the Medicaid program. In at least 22 states, the changes reduced the level of reimbursement received by Apria without a corresponding offset or increase to compensate for the service costs incurred. In several of those states, Apria elected to stop accepting new Medicaid patient referrals for the affected drugs and biologicals. Further, in 2005, some states implemented other payment policy changes or changed coverage criteria altogether for medical equipment, enteral and infusion therapy. Currently, other states are considering reductions in Medicaid reimbursement as they work through their respective budget processes. Apria cannot predict the outcome of such budget negotiations or whether other states will consider reductions as well.

Gross Margin. The gross margin was 65.5% in the first quarter of 2006 and 67.8% in the same period last year. The principal causes of the decline are the Medicare reimbursement reductions of $8.4 million noted above, related cost increases of $1.2 million and the managed care pricing reductions of $3.9 million. Also affecting the comparison of the margin between the two first quarters is an increase in respiratory therapy labor and other operating expenses which represents about 0.3% of the margin decline.

Provision for Doubtful Accounts. The provision for doubtful accounts is based on management s estimate of the net realizable value of accounts receivable after considering actual write-offs of specific receivables. Accounts receivable which are not expected to be collected are estimated and provided for by applying specific percentages to each receivables aging category, which is determined by the number of days the receivable is outstanding. The provision for doubtful accounts, expressed as a percentage of net revenues, was 2.8% and 3.9% for the first quarter of 2006 and 2005, respectively. The improvement between the periods reflects improvements in cash collections and notably the success of a credit card program designed to collect patient receivables upon delivery and automatically on the rental due date thereafter. Also, the absence of acquisitions in recent months has allowed the revenue management teams to focus on basics and best practices.

Selling, Distribution and Administrative. Selling, distribution and administrative expenses are comprised of expenses incurred in direct support of operations and those associated with administrative functions. Expenses incurred by the operating locations include salaries and other expenses in the following functional areas: selling, distribution, intake, reimbursement, warehousing and repair. Many of these operating costs are directly variable with revenue growth patterns. Some are also very sensitive to market-driven price fluctuations such as facility lease and fuel costs. The administrative expenses include overhead costs incurred by the operating locations and corporate support functions. These expenses do not fluctuate with revenue growth as closely as operating costs.

Selling, distribution and administrative expenses, expressed as percentages of net revenues, were 53.7% in the first quarter of 2006 and 52.4% in the first quarter of 2005. The increase of 1.3% is attributable to the lower revenues resulting from the Medicare and managed care pricing changes noted above without a corresponding reduction in the company s actual cost of providing those products and services. These revenue pricing reductions had the effect of increasing the expense percentage by 1.6%. The annual salary increases that were processed at the end of the first quarter in 2005 and higher fuel prices offset other expense leveraging achieved by the company.

Share-based compensation is reflected within the selling, distribution and administrative expense line item. Effective January 1, 2006, Apria adopted the provisions of SFAS No. 123R, Share-Based Payment. Prior to 2006, the company accounted for share-based compensation in accordance with APB No. 25, Accounting for Stock Issued to Employees, and related interpretations. The company elected to employ the modified prospective transition method as provided by SFAS No. 123R and, accordingly, financial statement amounts for the prior periods presented have not been restated to reflect the fair value method of expensing share-based compensation.

For the three-month periods ended March 31, 2006 and 2005, share-based compensation expense was $1.1 million and $1.2 million, respectively. The adoption of SFAS No. 123R had little effect on the comparison between quarters primarily due to the November 2005 acceleration of the vesting of outstanding employee stock options with per share prices above $26.00, so that each such option became fully vested. That action eliminated the future compensation expense of the unvested portion of such options. The share-based compensation expense in both periods is comprised largely of expense associated with restricted stock awards and units for which expense recognition was previously required under the principles of APB No. 25.

Amortization of Intangible Assets. For the quarter ended March 31, 2006, amortization expense was $1.3 million. This compares to $1.6 million for the same period last year. The decrease in amortization expense between the two periods is directly attributable to the reduced level of acquisition activity in 2006 as compared to 2005. See Liquidity and Capital Resources Business Combinations.

Interest Expense and Income. Interest expense was $8.3 million for the first quarter of 2006 as compared to $7.6 million for the comparable period in 2005. Interest income was $972,000 and $341,000 for the three months ended March 31, 2006 and 2005, respectively. The increase in interest expense in 2006 is primarily attributable to the increase in long-term debt incurred to repurchase $175 million of Apria s common stock late in 2005. The increase in base interest rates during 2005 also contributed to the increase. See Liquidity and Capital Resources Long-term Debt and Treasury Stock.

Income Tax Expense. Income taxes for the three months ended March 31, 2006 have been provided at a lower effective rate than is expected to be applicable for the entire year. The lower rate is due to the completion of a 2002 Internal Revenue Service audit which resulted in the related reduction of federal tax contingencies of $1.8 million and a corresponding reduction in the tax provision for the quarter.

Income taxes for the three-month period ended March 31, 2005 were also provided at a lower effective tax rate than applicable for that year. The lower rate was primarily due to state net operating loss carryforwards that became realizable based on a change in estimate of expected future earnings. This resulted in a decrease in the valuation allowance account of $2.6 million and a corresponding reduction in the tax provision for the quarter.

At March 31, 2006, the company had various apportioned state net operating loss carryforwards which resulted in a deferred tax asset of $8.8 million, net of federal tax benefit.

Inflation. Apria experiences pricing pressures in the form of continued reductions in reimbursement rates, particularly from managed care organizations and from governmental payors such as Medicare and Medicaid. The company is also impacted by rising costs for certain inflation-sensitive operating expenses such as labor and employee benefits, facility and equipment leases, and vehicle fuel.

Liquidity and Capital Resources

Apria s principal source of liquidity is its operating cash flow, which is supplemented by a $500 million revolving credit facility. In recent years, Apria has generated operating cash flows in excess of its operating needs, which has afforded it the ability to pursue acquisitions and fund patient service equipment purchases to support revenue growth. Apria s management believes that its operating cash flow will continue to be sufficient to fund its operations and growth strategies. However, in late 2005, Apria drew upon its revolving credit facility for the $175 million common stock repurchase and in September 2008, the holders of the $250 million convertible senior notes will have an opportunity to require Apria to repurchase some or all of the notes. Accordingly, Apria management has begun to explore financing alternatives.

Further, Apria has initiated a project to implement a new enterprise-wide system. The overall objective of the project is to deliver the necessary technology and automation across the organization to enable service improvements, productivity and access to information. Management has completed the system selection phase and expects to progress to initial phases of development in the second quarter of 2006. The total cost of the project will be determined once the implementation roadmap and project planning are completed.

Cash Flow. Cash provided by operating activities was $38.2 million in the first three months of 2006 compared to $51.7 million in the corresponding period in 2005. The decrease in operating cash flow between the two periods is due primarily to the Medicare reimbursement reductions, the timing of the payment of payroll liabilities and an increase in accounts receivable caused by the first quarter 2006 revenue increase that trended upward toward the end of the quarter.

Cash used in investing activities decreased to $42.3 million for the first three months of 2006 compared to $63.3 million during the same period last year. A significant reduction in the level of business combinations executed during the first quarter of 2006 is the primary driver of this decrease. The increase in purchases of patient service and other equipment in 2006 is directly attributable to the new CIGNA contract. In order to accelerate the CIGNA transition, Apria not only increased purchases of new equipment, but also purchased from previous providers equipment that was already in place with existing patients.

Cash used in financing activities was $5.2 million during the first three months of 2006 compared to $261,000 for the first three months of 2005. Cash used in 2006 related primarily to the $5.0 million pay down on the revolver balance.

Contractual Cash Obligations. The following table summarizes Apria s long-term cash payment obligations to which the company is contractually bound. The years presented below represent 12-month rolling periods ending March 31.

(dollars in millions)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6+	Totals
Revolving loan	$ -	$ -	$ -	$ 385	$ -	$ -	$ 385
Convertible senior notes	-	-	-	-	-	250	250
Capital lease obligations	1	-	-	-	-	-	1
Other debt	1	1	-	-	-	-	2
Operating leases	55	43	31	23	14	22	188
Deferred acquisition payments	3	-	-	-	-	-	3

(dollars in millions)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6+	Totals
Total contractual cash obligations	$ 60	$ 44	$ 31	$ 408	$ 14	$ 272	$ 829

The holders of the convertible senior notes will first have the option to require Apria to repurchase all or a portion of their notes in September 2008.

Accounts Receivable. Accounts receivable before allowance for doubtful accounts increased to $270.6 million at March 31, 2006, from $268.0 million at December 31, 2005. Days sales outstanding (calculated as of each period-end by dividing accounts receivable, less allowance for doubtful accounts, by the 90-day rolling average of net revenues) were 56 days at March 31, 2006 compared to 57 at December 31, 2005. The decrease in days sales outstanding is a result of the increase in net revenues for the first quarter (or last 90 days) of 2006, when compared to the fourth quarter of 2005.

Accounts aged in excess of 180 days of total receivables for certain payor categories, and in total, are as follows:

	March 31, 2006	December 31, 2005
Total	20.6%	21.1%
Medicare	25.4%	22.8%
Medicaid	27.7%	28.7%
Self pay	32.3%	35.9%
Managed care/other	18.1%	19.4%

Unbilled Receivables. Included in accounts receivable are earned but unbilled receivables of $37.0 million and $41.6 million at March 31, 2006 and December 31, 2005, respectively. Delays, ranging from a day up to several weeks, between the date of service and billing can occur due to delays in obtaining certain required payor-specific documentation from internal and external sources. Earned but unbilled receivables are aged from date of service and are considered in Apria s analysis of historical performance and collectibility. The higher unbilled amount at December 31, 2005 is largely due to acquisitions effected throughout 2005. The time-consuming processes of converting patient files onto Apria s systems and obtaining provider numbers from governmental payors routinely delay billing of the newly acquired business.

Inventories and Patient Service Equipment. Inventories consist primarily of pharmaceuticals and disposable products used in conjunction with patient service equipment. Patient service equipment consists of respiratory and home medical equipment that is provided to in-home patients for the course of their care plan, normally on a rental basis, and subsequently returned to Apria for redistribution after cleaning and maintenance is performed.

The branch locations serve as the primary point from which inventories and patient service equipment are delivered to patients. Certain products and services, such as infusion therapy and respiratory medications, bypass the branches and are provided directly to patients from pharmacies or other central locations. The branches are supplied with inventory and equipment from central warehouses that service specific areas of the country. Such warehouses are also responsible for repairs and scheduled maintenance of patient service equipment, which adds to the frequent movement of equipment between locations. Further, the majority of Apria s patient service equipment is located in patients homes. While utilization varies widely between equipment types, on the average, approximately 80% of equipment is on rent at any given time. Inherent in this asset flow is the fact that losses will occur. Management has successfully instituted a number of controls over the company s inventories and patient service equipment to minimize such losses. Depending on the product type, the company performs physical inventories on an annual or quarterly basis. Inventory and patient service equipment balances in the financial records are adjusted to reflect the results of these physical inventories. Inventory and patient service equipment (pickups) and losses for the three months ended March 31, 2006 and 2005, were $(4,000) and $466,000, respectively.

Long-term Debt. *Revolving Credit Facility*. Borrowings under Apria s revolving credit facility were $385.0 million; outstanding letters of credit totaled $3.9 million; and credit available under the revolving facility was $111.1 million. The company continues to be in compliance with all of the covenants required by the credit agreement. The effective interest rate at March 31, 2006, after consideration of the effect of the swap agreements described below, was 5.89%. See Hedging Activities.

Convertible Senior Notes. At March 31, 2006, the fair value of the $250 million in convertible senior notes was $241.7 million, as determined by reference to quoted market prices.

Hedging Activities. Apria is exposed to interest rate fluctuations on its underlying variable rate long-term debt. Apria s policy for managing interest rate risk is to evaluate and monitor all available relevant information, including but not limited to, the structure of its interest-bearing assets and liabilities, historical interest rate trends and interest rate forecasts published by major financial institutions. The tools Apria may utilize to moderate its exposure to fluctuations in the relevant interest rate indices include, but are not limited to: (1) strategic determination of repricing periods and related principal amounts, and (2) derivative financial instruments such as interest rate swap agreements, caps or collars. Apria does not use derivative financial instruments for trading or other speculative purposes.

At March 31, 2006, Apria had three interest rate swap agreements in effect to fix its variable rate debt. One such agreement has a notional amount of $25 million, a fixed rate of 3.42% and expires in December 2006. The other two agreements were forward-starting contracts which became effective in January 2006. Both agreements have a three-year term and a notional amount of $25 million, with fixed rates of 4.38% and 4.44%. In 2005, Apria also had a swap agreement with an aggregate notional amount of $25 million that expired in December 2005.

The swap agreements are being accounted for under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. The difference between the interest received and interest paid is reflected as an adjustment to interest expense. For the three-month periods ended March 31, 2006 and 2005, Apria received (paid) net settlement amounts of $84,000 and $(84,000), respectively. The aggregate fair value of the swap agreements was an asset of $1.3 million and $769,000 at March 31, 2006 and December 31, 2005, respectively, and is reflected in the accompanying condensed consolidated balance sheets in other assets. Unrealized gains and losses on the fair value of the swap agreements are reflected in the condensed consolidated income statements as applicable. Apria s exposure to credit loss under the swap agreements is limited to the interest rate spread in the event of counterparty non-performance.

Treasury Stock. In November 2005, Apria purchased 7.3 million shares of its common stock for $175 million through an accelerated share repurchase program. Under the agreement, Apria s counterparty borrowed shares that were sold to Apria at an initial price of $23.83. The agreement contained a provision that subjected Apria to a purchase price adjustment based on the volume weighted average price of the company s common stock over the period during which the counterparty purchased the shares. Such provision resulted in an additional $242,000 owed to the counterparty that Apria elected to settle in cash in February 2006. This amount was recorded as a liability at December 31, 2005, with a corresponding charge to interest expense reflecting the change in the fair value of the settlement contract.

Business Combinations. Apria periodically acquires complementary businesses in specific geographic markets. Because of the potential for a higher gross margin, Apria targets respiratory therapy businesses. These transactions are accounted for as purchases and the results of operations of the acquired companies are included in the accompanying condensed consolidated income statements from the dates of acquisition. In accordance with SFAS No. 142, goodwill is no longer being amortized. Covenants not to compete are being amortized over the life of the respective agreements. Tradenames and customer lists are being amortized over the period of their expected benefit.

The aggregate consideration for acquisitions that closed during the first three months of 2006 was $1.1 million. Allocation of this amount was made to other intangible assets. Because Apria had already been servicing the existing patient bases on a subcontract basis, there was no patient service equipment acquired. Cash paid for acquisitions, which includes amounts deferred from prior periods, totaled $4.1 million and $28.9 million in the first three months of 2006 and 2005, respectively.

Off-Balance Sheet Arrangements

Apria is not a party to off-balance sheet arrangements as defined by the Securities and Exchange Commission. However, from time to time the company enters into certain types of contracts that contingently require the company to indemnify parties against third-party claims. The contracts primarily relate to: (i) certain asset purchase agreements, under which the company may provide customary indemnification to the seller of the business being acquired; (ii) certain real estate leases, under which the company may be required to indemnify property owners for environmental and other liabilities, and other claims arising from the company s use of the applicable premises; and (iii) certain agreements with the company s officers, directors and employees, under which the company may be required to indemnify such persons for liabilities arising out of their relationship with the company.

The terms of such obligations vary by contract and in most instances a specific or maximum dollar amount is not explicitly stated therein. Generally, amounts under these contracts cannot be reasonably estimated until a specific claim is asserted. Consequently, no liabilities have been recorded for these obligations on the company s balance sheets for any of the periods presented.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Apria is exposed to interest rate fluctuations on its underlying variable rate long-term debt. Apria utilizes interest rate swap agreements to moderate such exposure. Apria does not use derivative financial instruments for trading or other speculative purposes.

At March 31, 2006, Apria s revolving credit facility borrowings totaled $385.0 million. The bank credit agreement governing the revolver provides interest rate options based on the following indices: Federal Funds Rate, the Bank of America prime rate or the London Interbank Offered Rate (LIBOR). All such interest rate options are subject to the application of an interest margin as specified in the bank credit agreement. At March 31, 2006, all of Apria s outstanding revolving debt was tied to LIBOR.

During the first quarter of 2006, Apria had three interest rate swap agreements in effect to fix its LIBOR-based variable rate debt. One of the agreements, which will expire in December 2006, has a notional amount of $25 million and a fixed rate of 3.42%. The other two agreements, which were forward-starting contracts with three-year terms, became effective in January 2006. Each contract has a notional amount of $25 million and fixed rates of 4.38% and 4.44%.

Based on the revolving debt outstanding and the swap agreements in place at March 31, 2006, a 100 basis point change in the applicable interest rates would increase or decrease Apria s annual cash flow and pretax earnings by approximately $3.1 million. See Management s Discussion and Analysis of Financial Condition and Results of Operations Long-term Debt Hedging Activities.

ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, the company s management, including the company s principal executive officer and principal financial officer, carried out an evaluation of the effectiveness of the company s disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act). Based upon that evaluation, the company s principal executive officer and principal financial officer each concluded that the company s disclosure controls and procedures were effective as of the end of the period covered by this report.

During the period covered by this report, there have been no changes to the company s internal control over financial reporting (as such term is defined in Rules 13a-15(d) and 15d-15(d) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, the company s internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Apria is the defendant in a California class action lawsuit containing blanket claims of liability under various California employee protection statutes and regulations relating to payment of regular and overtime wages, the timeliness of such payments, the maintenance and provision of access to required payroll records, and the provision of meal and rest periods. *Venegas vs. Apria Healthcare, Inc.*, et al., was filed on February 21, 2006 in the California Superior Court for the County of San Francisco (Case No. CGC -- 06 -- 449669). No class has been certified at this time, but on behalf of a purported class consisting of all of the company s hourly employees in the State of California, the complaint seeks compensatory and punitive damages in an unspecified amount as well as other relief. The company has filed an answer to the complaint denying all material allegations and asserting a number of affirmative defenses. Based on the company s preliminary investigation of the allegations, management believes there are meritorious defenses to the claims and intends to vigorously defend the company. No assurance can be given, however, that the ultimate disposition of this case will not have a material adverse effect on the company s financial condition or results of operations.

Apria is also engaged in the defense of certain claims and lawsuits arising out of the ordinary course and conduct of its business, the outcomes of which are not determinable at this time. Apria has insurance policies covering such potential losses where such coverage is cost effective. In the opinion of management, any liability that might be incurred by Apria upon the resolution of these claims and lawsuits will not, in the aggregate, have a material adverse effect on Apria s financial condition or results of operations.

ITEM 1A. RISK FACTORS

The risk factors presented in Apria s Annual Report on Form 10–K/A, as filed with the Securities and Exchange Commission on March 23, 2006, are updated by reference to the Medicare Reimbursement section included in Management s Discussion and Analysis of Financial Condition and Results of Operations in this Quarterly Report on Form 10-Q. There were no material changes to any of the other risk factors previously disclosed in the Form 10K/A.

ITEM 5. OTHER INFORMATION

As of May 5, 2006, the company entered into Amended and Restated Employment Agreements with Lawrence M. Higby, the company s Chief Executive Officer, and Lawrence A. Mastrovich, the company s President and Chief Operating Officer, as well as Amended and Restated Executive Severance Agreements with Amin I. Khalifa, the company s Executive Vice President and Chief Financial Officer, W. Jeffrey Ingram, the company s Executive Vice President, Sales, and Daniel J. Stark, the company s Executive Vice President, Customer Services. The amendments conformed certain defined terms used in each of the agreements, contain certain provisions related to compliance with Section 409A of the Internal Revenue Code of 1986, as amended (the Code), and made a number of other immaterial changes. The form of compensation related to certain executive perquisites to be paid to Messrs. Higby and Mastrovich was changed pursuant to their amended agreements, which resulted in modest increases in their base salaries (2.8% and 2.4%, respectively), in lieu of receiving the perquisites to which they were previously entitled. In addition, the provision regarding golden parachute excise taxes under Mr. Khalifa s Executive Severance

Agreement was modified to provide that in the event any payments to Mr. Khalifa would trigger the golden parachute excise tax under Section 4999 of the Code, such payments will only be reduced if such reduction would result in a better after tax result for Mr. Khalifa.

As of May 5, 2006, the company also entered into Noncompetition Agreements with Messrs. Khalifa, Ingram and Stark. Pursuant to these agreements, Messrs. Khalifa, Ingram and Stark each agree not to compete with the company for a period of one year following a termination of employment in connection with a Change in Control, as defined in their respective Amended and Restated Severance Agreements. The Noncompetition Agreements provide that if the employment of any of those executives is terminated, other than for disability or Cause, as defined in their Amended and Restated Severance Agreements, in connection with or within two years following such a Change in Control, the company shall make payments to such executive totaling $750,000.

The complete text of each Amended and Restated Employment Agreement, Amended and Restated Executive Severance Agreement and Noncompetition Agreement is filed as an exhibit to this quarterly report on Form 10-Q, and the foregoing summaries are qualified in their entirety by reference thereto.

ITEM 6. EXHIBITS

Exhibits:

Exhibit Number	Reference
10.1	Deferred Compensation Plan, effective July 17, 2003.
10.2	Form of Restricted Stock Unit Award Agreement as granted under the Registrant s 2003 Performance Incentive Plan.
10.3	Amended and Restated Employment Agreement dated as of May 5, 2006, between Registrant and Lawrence M. Higby.
10.4	Amended and Restated Employment Agreement dated as of May 5, 2006, between Registrant and Lawrence A. Mastrovich.
10.5	Amended and Restated Executive Severance Agreement dated as of May 5, 2006, between Registrant and Amin I. Khalifa.
10.6	Amended and Restated Executive Severance Agreement dated as of May 5, 2006, between Registrant and Daniel J. Starck.
10.7	Amended and Restated Executive Severance Agreement dated as of May 5, 2006, between Registrant and W. Jeffrey Ingram.
10.8	Noncompetition Agreement dated as of May 5, 2006, between Registrant and Amin I. Khalifa.
10.9	Noncompetition Agreement dated as of May 5, 2006, between Registrant and Daniel J. Starck.
10.10	Noncompetition Agreement dated as of May 5, 2006, between Registrant and W. Jeffrey Ingram.
31.1	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rule 13a-14(a).
31.2	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rule 13a-14(a).
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

APRIA HEALTHCARE GROUP INC.
Registrant

May 10, 2006

/s/ AMIN I. KHALIFA
Amin I. Khalifa
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)

TD align="right">41.7 $1,697.3
Common stock-based compensation plans activity

Shares issued
38 .0 2.8 2.8
Shares issued upon option exercises
3,301 .7 99.6 100.3
Restricted shares issued
31 .0 2.0 $(2.0)
Stock-based compensation expense
.3 .3
Common shares repurchased
(1,300) (.3) (75.5) (75.8)
Comprehensive income

Net income
431.0
Change in unrealized security holding gains, net of taxes
6.8
Total comprehensive income
437.8
Dividends declared
(126.6) (126.6)

Balances at December 31, 2005
131,678 26.3 279.7 1,683.3 48.5 (1.7) 2,036.1
Reclassification at adoption of SFAS 123R
(1.7) 1.7
Common stock-based compensation plans activity

Shares issued upon option exercises
1,403 .3 49.7 50.0
Restricted shares forfeited
(1) .0 .0 .0
Common shares repurchased
(1,533) (.3) (117.4) (117.7)
Common shares issued in 2 for 1 split
131,547 26.3 (26.3)

Balances after split on June 23, 2006
263,094 52.6
Common stock-based compensation plans activity

Shares issued upon option exercises
3,227 .7 55.4 56.1
Restricted shares issued
74 .0 .0
Income tax benefit at vesting of restricted shares
.1 .1
Stock-based compensation expense
61.0 61.0
Common shares repurchased
(1,435) (.3) (53.0) (53.3)
Comprehensive income

Net income
529.6
Change in unrealized security holding gains, net of taxes
20.8
Total comprehensive income
550.4
Dividends declared
(155.8) (155.8)

Balances at December 31, 2006
264,960 53.0 247.5 2,057.1 69.3 2,426.9
Common stock-based compensation plans activity

Shares issued upon option exercises
5,508 1.1 92.7 93.8
Shares issued upon vesting of restricted stock units
27 .0 (.4) (.4)
Restricted shares issued
289 .0 .0
Shares withheld and tax effects at vesting of restricted shares
(8) .0 .1 .1
Restricted shares forfeited
(8) .0 (.1) .0 (.1)
Stock-based compensation expense
79.9 79.9
Common shares repurchased
(6,163) (1.2) (124.0) (195.5) (320.7)
Comprehensive income

Net income
670.6
Change in unrealized security holding gains, net of taxes
25.7

Total comprehensive income							696.3
Dividends declared and related tax benefits			.1	(198.8)			(198.7)
Balances at December 31, 2007	264,605	$52.9	$295.8	$2,333.4	$95.0	$	$2,777.1

The accompanying summary of significant accounting policies and notes to consolidated financial statements are an integral part of these statements.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

T. Rowe Price Group derives its consolidated revenues and net income primarily from investment advisory services that its subsidiaries provide to individual and institutional investors in the sponsored T. Rowe Price mutual funds and other investment portfolios. We also provide our investment advisory clients with related administrative services, including mutual fund transfer agent, accounting and shareholder services; participant recordkeeping and transfer agent services for defined contribution retirement plans; discount brokerage; and trust services. While investors that we serve are primarily domiciled in the United States of America, investment advisory clients outside the United States account for 9% of our assets under management at December 31, 2007.

Investment advisory revenues depend largely on the total value and composition of assets under our management. Accordingly, fluctuations in financial markets and in the composition of assets under management impact our revenues and results of operations.

BASIS OF PREPARATION.

These consolidated financial statements have been prepared by our management in accordance with accounting principles generally accepted in the United States, which require the use of estimates. Actual results may vary from our estimates. We have reclassified certain prior year amounts to be comparative with and conform to the presentation of our 2007 financial statements.

Our financial statements include the accounts of all subsidiaries in which we have a majority or controlling interest. All material intercompany accounts and transactions are eliminated in consolidation.

We are not the primary beneficiary, and do not consolidate the accounts, of a high-yield collateralized bond obligation (CBO) that held assets of less than $50 million at December 31, 2007. This variable interest entity is a non-recourse, limited liability company for which we are the collateral manager and receive related investment advisory fees. We recognized the full impairment of this CBO investment in our 2002 statement of income and do not expect to recognize any future gains or losses from this investment.

STOCK SPLIT.

At the close of business on June 23, 2006, we effected a two-for-one split of our common stock by issuing additional $.20 par value shares and reclassifying the par value of the additional shares issued among our paid-in stockholders equity accounts. All per-share and share data in the accompanying consolidated statements of income, in these significant accounting policies, and in the accompanying notes have been adjusted to give retroactive effect to this stock split.

CASH EQUIVALENTS.

Cash equivalents consist primarily of short-term, highly liquid investments in our sponsored money market mutual funds. The cost of these funds is equivalent to fair value.

INVESTMENTS.

Investments in debt securities held by our savings bank subsidiary are classified as available-for-sale and are reported at fair value. We value our investments in sponsored mutual funds at the quoted closing net asset values, or NAVs, per share of each mutual fund on the balance sheet date and generally classify these holdings as available-for-sale. Changes in net unrealized security holding gains on available-for-sale securities are recognized in accumulated other comprehensive income.

We classify marketable equity securities other than sponsored mutual funds and some investments in sponsored mutual funds made at fund formation as trading because they are expected to be held for only a short period of time. Other investments are recognized using the cost or equity methods of accounting, as appropriate.

We review the carrying amount of each investment on a quarterly basis and recognize an impairment in our statement of income whenever an unrealized loss is considered other than temporary.

CONCENTRATIONS OF RISK.

Concentration of credit risk in accounts receivable is believed to be minimal in that our clients generally have substantial assets, including those in the investment portfolios that we manage for them.

Our investments in sponsored mutual funds expose us to market risk in the form of equity price risk; that is, the potential future loss of value that would result from a decline in the fair values of the mutual funds. Each fund and its underlying net assets are also subject to market risk, which may arise from changes in equity prices, credit ratings,

foreign currency exchange rates, and interest rates.
Investments by our savings bank subsidiary in debt securities expose us to market risk, which may arise from changes in credit ratings and interest rates.

PROPERTY AND EQUIPMENT.

Property and equipment is stated at cost net of accumulated depreciation and amortization computed using the straight-line method. Provisions for depreciation and amortization are based on the following weighted average estimated useful lives: computer and communications software and equipment, 3.5 years; buildings, 33.5 years; leasehold improvements, 9.1 years; furniture and other equipment, 6.4 years; and leased land, 99 years.

GOODWILL.

We evaluate the $665.7 million carrying amount of goodwill in our balance sheet for possible impairment on an annual basis in the third quarter of each year using a fair value approach. Our evaluations have indicated that no impairment exists.

We internally conduct, manage and report our operations as one investment advisory business. We do not have distinct operating segments or components that separately constitute a business. Accordingly, we attribute goodwill to a single reportable business segment and reporting unit our investment advisory business.

REVENUE RECOGNITION.

Fees for investment advisory services, which are based on assets under management, and related administrative services that we provide to investment advisory clients are recognized in the period that our services are provided. Taxes billed to our clients based on our fees for services rendered are not included in revenues. Administrative revenues from distribution of our sponsored mutual funds Advisor and R class shares, and the corresponding operating expense for payments to third-party financial intermediaries that distribute those share classes, are recognized in the period that they are earned, which is the same period that the related mutual funds recognize their expense.

ADVERTISING.

Costs of advertising are expensed the first time that the advertising takes place.

EARNINGS PER SHARE.

Basic earnings per share does not include the dilutive effect of outstanding stock options, nonvested restricted common shares, and outstanding stock units, and is computed by dividing net income by the weighted average common shares outstanding of 260.5 million in 2005, 263.8 million in 2006, and 264.8 million in 2007. Diluted earnings per share reflects the potential dilution that could occur if outstanding stock options were exercised, restricted common shares vest, and stock units are converted to common shares. It is computed by increasing the denominator of the basic calculation by potential dilutive common shares, determined using the treasury stock method, of 12.7 million in 2005, 14.9 million in 2006, and 14.4 million in 2007.

COMPREHENSIVE INCOME.

Total comprehensive income is reported in our consolidated statements of stockholders equity and includes net income and the change in unrealized security holding gains, net of income taxes.

STOCK AWARDS AND OPTIONS.

Our stockholders have approved the 2001 and 2004 Stock Incentive Plans under which we may make stock awards in the form of unrestricted common shares, restricted common shares, and restricted stock units that convert to shares after vesting. Under these plan provisions, we issued 76,000 unrestricted common shares to our employees in 2005 at the grant date fair value of $37.365 per share. We have also issued restricted shares and restricted stock units at the grant date fair value that vest over graded schedules of up to four years.

Under the 2001 and 2004 Stock Incentive Plans and six other stockholder approved plans (the 1990, 1993 and 1996 Stock Incentive Plans and the 1995, 1998 and 2007 plans for non-employee directors), we have granted qualified incentive and nonqualified fixed stock options with a maximum term of 10 years to employees and directors. Vesting of our annual employee option grants is based solely on the individual continuing to render service and generally occurs over a five-year graded schedule. The exercise price of each option granted is equivalent to the market price of the common stock at the date of grant. Under the 2007 Non-Employee Director Equity Plan, we also grant restricted common shares and stock units that vest over one year. Vested stock units are issued in lieu of dividends on outstanding stock units.

We recognized compensation expense for stock-based awards other than stock options of $3.2 million in 2005, $1.8 million in 2006, and $8.0 million in 2007.

On January 1, 2006, we adopted the provisions of SFAS 123R and began recognizing stock option-based compensation expense in our consolidated statements of income using the fair value based method, including provision for estimated future forfeitures of our stock option awards. Prior to 2006, our stock option grants were accounted for using the intrinsic value based method and no compensation expense related to our option grants was recognized in our consolidated statements of income.

Because we adopted SFAS 123R on a modified prospective basis, financial statements for 2005 have not been restated. The following table compares our 2006 and 2007 net income (in millions) and earnings per share with pro forma results as if we had applied the fair value based method in 2005. For purposes of this disclosure, forfeitures of options during 2005 were recognized as they occurred.

	2005	2006	2007
Net income, as reported	$ 431.0	$ 529.6	$ 670.6
Additional stock option-based compensation expense estimated using the fair value based method	(59.8)		
Related income tax benefits	19.5		
Pro forma net income	$ 390.7	$ 529.6	$ 670.6
Earnings per share			
Basic as reported	$ 1.65	$ 2.01	$ 2.53
Basic pro forma	$ 1.50	$ 2.01	$ 2.53
Diluted as reported	$ 1.58	$ 1.90	$ 2.40
Diluted pro forma	$ 1.43	$ 1.90	$ 2.40

Net income, as reported, includes a charge for stock option-based compensation expense of $59.2 million in 2006 and $71.8 million in 2007, including $6.1 million and $8.6 million, respectively, for reload option grants. Related income tax benefits recognized in net income, as reported, were $19.4 million in 2006 and $24.3 million in 2007. The recognition of stock-option based compensation expense reduced our diluted earnings per share by approximately $.14 in 2006 and $.17 in 2007. In recognizing 2006 and 2007 stock-option based compensation expense and in preparing the pro forma 2005 information, we used the Black-Scholes option-pricing model to estimate the fair value of each option grant, including reloads, as follows:

		Weighted-average		Range
	2005	2006	2007	2007
Grant-date fair value per option awarded, including reload grants	$9.57	$12.42	$12.31	$.91 to 22.00
Assumptions used:				
Expected life in years	5.5	5.5	5.4	.1 to 8.3
Expected volatility	29%	26%	23%	6 to 38%
Dividend yield	1.7%	1.7%	1.7%	1.7%
Risk-free interest rate	4.2%	4.6%	4.3%	2.9 to 5.1%

Our expected life assumptions are based on the vesting period for each option grant and our historical experience with respect to the average holding period from vesting to option exercise. The assumptions for expected volatility and dividend yield are based on recent historical experience over the same periods as our expected lives. Risk-free interest rates are set using grant-date U.S. Treasury yield curves for the same periods as our expected lives.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 CASH EQUIVALENTS.

Cash equivalent investments in our sponsored money market mutual funds aggregate $739.1 million at December 31, 2006, and $710.0 million at December 31, 2007. Dividends earned on these investments totaled $14.9 million in 2005, $35.4 million in 2006, and $38.0 million in 2007.

NOTE 2 INFORMATION ABOUT RECEIVABLES, REVENUES, AND SERVICES.

Accounts receivable from our sponsored mutual funds for advisory fees and advisory-related administrative services aggregate $122.9 million at December 31, 2006, and $144.6 million at December 31, 2007.

Revenues (in millions) from advisory services provided under agreements with our sponsored mutual funds and other investment clients include:

	2005	2006	2007
Sponsored mutual funds in the U.S.			
Stock and blended asset	$ 758.3	$ 937.5	$ 1,168.7
Bond and money market	142.1	155.6	184.6
	900.4	1,093.1	1,353.3
Other portfolios	335.1	415.4	525.8
Total investment advisory fees	$ 1,235.5	$ 1,508.5	$ 1,879.1

The following table summarizes the various investment portfolios and assets under management (in billions) on which we earn investment advisory fees.

	Average during			December 31,	
	2005	2006	2007	2006	2007
Sponsored mutual funds in the U.S.					
Stock and blended asset	$124.1	$152.2	$191.1	$168.5	$200.6
Bond and money market	32.1	35.4	41.7	38.0	45.4
	156.2	187.6	232.8	206.5	246.0
Other portfolios	90.9	112.1	141.4	128.2	154.0
	$247.1	$299.7	$374.2	$334.7	$400.0

Fees for advisory-related administrative services provided to our sponsored mutual funds were $211.3 million in 2005, $239.9 million in 2006, and $273.9 million in 2007. We provide all services to the sponsored U.S. mutual funds under contracts that are subject to periodic review and approval by each of the funds boards. Regulations require that the funds shareholders also approve material changes to investment advisory contracts.

NOTE 3 INVESTMENTS IN SPONSORED MUTUAL FUNDS.

Our other mutual fund investments (in millions) at December 31 include:

	Aggregate cost	Unrealized holding gains	Aggregate fair value
<u>2006</u>			
Stock and blended asset funds	$ 325.5	$ 84.3	$ 409.8
Bond funds	120.6	24.0	144.6

Total available-for-sale holdings	$	446.1	$	108.3	$	554.4
2007						
Stock and blended asset funds	$	427.0	$	114.3	$	541.3
Bond funds		197.2		32.7		229.9
Total available-for-sale holdings	$	624.2	$	147.0		771.2
Fund investments held as trading						1.8
					$	773.0

Dividends earned on our investments in sponsored mutual funds totaled $7.2 million in 2005, $12.5 million in 2006, and $30.4 million in 2007. There were no fund holdings with an unrealized loss at December 31, 2006, and two mutual fund holdings with a total unrealized temporary loss of $.4 million at December 31, 2007.

NOTE 4 DEBT SECURITIES HELD BY AND CUSTOMER DEPOSITS AT SAVINGS BANK SUBSIDIARY.
Our savings bank subsidiary holds investments in marketable debt securities, including mortgage- and other asset-backed securities, which are accounted for as available-for-sale. The following table (in millions) details the components of these investments at year end.

	2006		2007	
	Fair value	Unrealized gain (loss)	Fair value	Unrealized gain (loss)
Investments with temporary impairment				
Of less than 12 months (17 securities in 2007)	$ 25.3	$ (.1)	$ 10.9	$ (.1)
Of 12 months or more (52 securities in 2007)	63.9	(1.5)	42.6	(.5)
	89.2	(1.6)	53.5	(.6)
Investments with unrealized holding gains	37.0	.1	73.4	.6
Balance at December 31	$ 126.2	$ (1.5)	$ 126.9	$
Aggregate cost	$ 127.7		$ 126.9	

The unrealized losses in these investments were generally caused by interest rate increases and not changes in credit quality. We have the ability and intent to hold these securities to their maturities, which generally correlate to the maturities of our customer deposits, and to collect all contractual cash flows. Accordingly, impairment of these investments is considered temporary.
The estimated fair value of our customer deposit liability, based on discounting expected cash outflows at maturity dates that range up to five years, using current interest rates offered for deposits with the same dates of maturity, was $114.8 million at December 31, 2006, and $115.8 million at December 31, 2007.
NOTE 5 OTHER INVESTMENTS.
Other investments include U.S. Treasury Notes that will yield 4.7% to 5.2% through their maturities in 2008 to 2012. These holdings are accounted for as held-to-maturity securities and are recognized at the amortized cost of the notes plus accrued interest. The status of the U.S. Treasury investments (in millions) at December 31 is:

	2006	2007
Recognized amount	$55.6	$70.6
Fair value	$55.8	$72.5
Face amount	$55.0	$70.0

Investments accounted for under the cost method total $25.3 million at December 31, 2006, and $31.5 million at December 31, 2007. Our remaining investments aggregate $.9 million at December 31, 2006, and $.2 million at December 31, 2007.
We had outstanding commitments to fund additional investments totaling $29.1 million at December 31, 2007.
NOTE 6 PROPERTY AND EQUIPMENT.
Property and equipment (in millions) at December 31 consists of:

	2006	2007
Computer and communications software and equipment	$ 216.6	$ 251.5
Buildings and leasehold improvements	222.3	270.0
Furniture and other equipment	67.7	97.0
Land owned and leased	21.5	21.5

	528.1	640.0
Less accumulated depreciation and amortization	263.2	281.7
	$ 264.9	$ 358.3

Compensation and related costs attributable to the development of computer software for internal use totaling $6.2 million in 2005, $7.7 million in 2006, and $8.9 million in 2007 have been capitalized.

NOTE 7 ACQUISITIONS OF INTANGIBLE ASSETS.

In 2006, we acquired customer relationships and assets under management of $.1 billion in separate accounts and $.8 billion in mutual fund accounts from two fund groups that merged into twelve of our sponsored mutual funds. We paid $4.1 million as part of these three transactions and recognized intangible assets that are being amortized on a straight-line basis over 2.5 years for the acquired separate account customer relationships and over 8 years for the acquired mutual fund customer relationships.

NOTE 8 INCOME TAXES.
The provision for income taxes (in millions) consists of:

	2005	2006	2007
Current income taxes			
U.S. federal and foreign	$ 228.1	$ 301.9	$ 368.6
State and local	27.4	45.8	53.3
Deferred income tax benefits	(7.1)	(19.0)	(15.7)
	$ 248.4	$ 328.7	$ 406.2

Our accounting policy with respect to interest and penalties arising from income tax settlements is to recognize them as part of our provision for income taxes.
Deferred income taxes arise from temporary differences between taxable income for financial statement and income tax return purposes. Significant temporary differences in 2005 include deferred tax benefits of $5.3 million related to property and equipment offset by deferred taxes of $1.5 million related to accrued compensation. Deferred benefits in 2005 also include $3.8 million arising from foreign net operating loss carryforwards, including $2.4 million from 2005 operations and $1.4 million from the reversal of a previously provided valuation allowance on prior year losses. During 2005, we developed a tax-planning strategy that made it more likely than not that we would be able to realize a substantial portion of this deferred tax benefit.
Deferred tax benefits include $17.8 million in 2006 and $24.9 million in 2007 resulting from stock option-based compensation expense recognized in our operating results in accordance with SFAS 123R. Partially offsetting the deferred tax benefits in 2007 were deferred taxes of $8.1 million from the reversal of temporary differences related to property and equipment and the use of foreign net operating loss carryforwards.
The net deferred tax asset recognized in our balance sheet in other assets includes the following (in millions) at December 31.

	2006	2007
Deferred tax liabilities		
Arising from net unrealized holding gains	$ (37.5)	$ (52.0)
Other	(3.8)	(4.7)
	(41.3)	(56.7)
Deferred tax assets		
Related to stock-based compensation	18.6	44.3
Related to investment income	5.4	5.4
Related to property and equipment	7.3	3.3
Related to accrued compensation	4.7	4.5
Foreign net operating loss carryforwards that do not expire	6.3	2.2
Other	3.0	2.2
	45.3	61.9
Net deferred tax asset	$ 4.0	$ 5.2

Cash outflows from operating activities include income taxes paid of $188.0 million in 2005, $272.8 million in 2006, and $329.6 million in 2007.

Cash flows from operating activities include income tax benefits of $52.3 million in 2005, $66.8 million in 2006, and $96.9 million in 2007 arising from stock option exercises and the vesting of stock-based grants that reduced the amount of income taxes that would have otherwise been payable. As a result of the adoption of SFAS 123R and our election to use the alternative transition method to account for tax benefits recognized in additional paid-in capital, operating cash outflows from payables and accrued liabilities and financing cash inflows from common share issuances under stock-based compensation plans include tax benefits of $65.7 million in 2006 and $94.9 million in 2007. These tax benefits have been recognized in stockholders equity as additional capital in excess of par value. The following table reconciles the statutory federal income tax rate to the effective income tax rate.

	2005	2006	2007
Statutory U.S. federal income tax rate	35.0%	35.0%	35.0%
State income taxes for current year, net of federal income tax benefits	2.4	2.7	3.0
Other items	(.8)	.6	(.3)
Effective income tax rate	36.6%	38.3%	37.7%

The adoption of FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes*, on January 1, 2007, did not affect our financial position.

The following table reconciles our unrecognized tax benefits (in millions) during the year:

Balance at adoption on January 1, 2007	$ 3.0
Additions for tax positions related to	
2007	1.5
2006 and prior years	.3
Balance at December 31, 2007	$ 4.8

If recognized, this amount would affect our effective tax rate; however, we do not expect that unrecognized tax benefits for tax positions taken with respect to 2007 and prior years will significantly change in 2008. Our United States federal tax obligations have been settled through the year 2000. Net interest recoverable recognized in our balance sheets was $1.8 million at December 31, 2006, and $3.1 million at December 31, 2007. Interest recognized as part of our provision for income taxes was not material in 2007.

NOTE 9 COMMON STOCK AND STOCK-BASED COMPENSATION PROGRAMS.

REPURCHASE AUTHORIZATION.

As of December 31, 2007, the Board of Directors has authorized the future repurchase of up to 12,627,467 common shares. At December 31, 2007, accounts payable and accrued expenses includes $8.6 million representing the unsettled liability for common stock repurchases.

DIVIDENDS.

Cash dividends declared per share were $.485 in 2005, $.59 in 2006, and $.75 in 2007.

SHARES AUTHORIZED FOR STOCK-BASED COMPENSATION PROGRAMS.

At December 31, 2007, 62,792,227 shares of unissued common stock were reserved for issuance under our stock-based compensation plans. Additionally, 3,360,000 shares are reserved for issuance under a plan whereby substantially all employees may acquire common stock through payroll deductions at prevailing market prices. We believe that our stock-based compensation programs align the interests of our employees and directors with those of our common stockholders.

STOCK OPTIONS.

The following table summarizes the status of and changes in our stock option grants during 2007.

	Options	Weighted-average exercise price	Weighted-average remaining contractual term (in years)
Outstanding at beginning of 2007	43,770,758	$25.97	
Annual grants	5,202,000	$50.02	
New hire grants	111,000	$52.68	
Reload grants	1,363,082	$53.74	
Exercised	(8,814,196)	$20.15	
Forfeited or cancelled	(602,469)	$33.15	
Outstanding at end of 2007	41,030,175	$31.16	6.2
Exercisable at end of 2007	24,287,935	$24.59	4.7

The total intrinsic value of options exercised was $165.4 million in 2005, $213.1 million in 2006, and $300.1 million in 2007. At December 31, 2007, the aggregate intrinsic value of options outstanding was $1.2 billion and of options exercisable was $.9 billion.

STOCK AWARDS.

The following table summarizes the status of and changes in our nonvested restricted shares and restricted stock units during 2007.

	Restricted shares	Restricted stock units	Weighted-average grant-date fair value
Nonvested at beginning of 2007	104,500	36,000	$43.01
Granted to employees	284,650	133,050	$50.53
Granted to directors	4,800	7,222	$55.69
Vested (value at vest date was $6.4 million)	(67,000)	(36,022)	$42.59
Forfeited	(7,650)		$45.74
Nonvested at end of 2007	319,300	140,250	$50.23

FUTURE STOCK-BASED COMPENSATION EXPENSE.
The following table presents the compensation expense (in millions) to be recognized over the separate vesting periods of the 16,742,240 nonvested options and 459,550 restricted shares and restricted stock units outstanding at December 31, 2007. Estimated future compensation expense will change to reflect future option grants, including reloads; future awards of unrestricted shares, restricted shares, and restricted stock units; changes in estimated forfeitures; and adjustments for actual forfeitures.

First quarter 2008	$ 17.8
Second quarter 2008	17.7
Third quarter 2008	17.3
Fourth quarter 2008	12.7
2009 through 2012	67.8
Total	$ 133.3

NOTE 10 OTHER COMPREHENSIVE INCOME.
The following table reconciles our unrealized holding gains and losses (in millions) to that recognized in other comprehensive income.

	2005	2006	2007
Unrealized holding gains on our investments in sponsored mutual funds	$ 12.1	$ 38.0	$ 43.9
Less gains on mutual fund investments realized in other investment income, using average cost	.0	6.3	5.2
	12.1	31.7	38.7
Unrealized holding gains (losses)on debt securities held by our savings bank subsidiary	(1.5)	.5	1.5
	10.6	32.2	40.2
Deferred income taxes	(3.8)	(11.4)	(14.5)
Unrealized holding gains, recognized in other comprehensive income	$ 6.8	$ 20.8	$ 25.7

The components of accumulated other comprehensive income (in millions) at December 31, 2007, are presented below.

Unrealized holding gains on	
Investments in sponsored mutual funds	$ 147.0
Debt securities held by savings bank subsidiary	
	147.0
Deferred income taxes	(52.0)
	$ 95.0

NOTE 11 OTHER DISCLOSURES.
We occupy certain office facilities and rent computer and other equipment under noncancelable operating leases. Related rental expense was $23.5 million in 2005, $24.1 million in 2006, and $25.6 million in 2007. Future minimum payments under these leases aggregate $27.1 million in 2008, $24.3 million in 2009, $23.0 million in 2010 and in

2011, $21.5 million in 2012, and $104.7 million in later years.
In the second quarter of 2006, we voluntarily terminated our $300 million bank-syndicated credit facility.
Our consolidated stockholders equity at December 31, 2007, includes $64 million that is restricted as to use by various regulations and agreements arising in the ordinary course of our business.
From time to time, various claims against us arise in the ordinary course of business, including employment-related claims. In the opinion of management, after consultation with counsel, the likelihood that an adverse determination in one or more pending claims would have a material adverse effect on our financial position or results of operations is remote.
Compensation expense recognized for our defined contribution retirement plans was $35.7 million in 2005, $38.8 million in 2006, and $44.1 million in 2007.

NOTE 12 SUPPLEMENTARY QUARTERLY FINANCIAL DATA (Unaudited).

	Net revenues	Net income	Basic earnings per share	Diluted earnings per share
	(in millions)			
2006				
1st quarter	$429.3	$116.7	$.44	$.42
2nd quarter	$446.0	$135.7	$.51	$.49
3rd quarter	$450.6	$128.3	$.49	$.46
4th quarter	$489.1	$148.9	$.56	$.53
2007				
1st quarter	$508.4	$142.9	$.54	$.51
2nd quarter	$551.1	$162.2	$.61	$.58
3rd quarter	$571.0	$174.8	$.66	$.63
4th quarter	$597.8	$190.7	$.72	$.68

The sum of quarterly earnings per share may not equal annual earnings per share because the computations are done independently.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
T. Rowe Price Group, Inc.:

We have audited the accompanying consolidated balance sheets of T. Rowe Price Group, Inc. and subsidiaries (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of income, stockholders equity, and cash flows for each of the years in the three-year period ended December 31, 2007. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of T. Rowe Price Group, Inc. and subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

As discussed in the summary of significant accounting policies accompanying the consolidated financial statements, effective January 1, 2006, the Company changed its method of accounting for stock-based compensation with the adoption of Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company s internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 6, 2008, expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

/s/ KPMG LLP
Baltimore, Maryland
February 6, 2008

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

Item 9A. Controls and Procedures.

Our management, including our principal executive and principal financial officers, has evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2007. Based on that evaluation, our principal executive and principal financial officers have concluded that our disclosure controls and procedures as of December 31, 2007, are effective at the reasonable assurance level to ensure that the information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934, including our Form 10-K annual report, is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission s rules and forms, and to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Our management, including our principal executive and principal financial officers, has evaluated any change in our internal control over financial reporting that occurred during the fourth quarter of 2007, and has concluded that there was no change during the fourth quarter of 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Management s report on our internal control over financial reporting and the attestation report of KPMG LLP follow.

Report of Management on Internal Control Over Financial Reporting

To the Stockholders of T. Rowe Price Group, Inc.:

We, together with other members of management of T. Rowe Price Group, are responsible for establishing and maintaining adequate internal control over the company s financial reporting. Internal control over financial reporting is the process designed under our supervision, and effected by the company s board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the company s financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

There are inherent limitations in the effectiveness of internal control over financial reporting, including the possibility that misstatements may not be prevented or detected. Accordingly, even effective internal controls over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Furthermore, the effectiveness of internal controls can change with circumstances.

Management has evaluated the effectiveness of internal control over financial reporting as of December 31, 2007, in relation to criteria described in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on management s assessment, we believe that the company s internal control over financial reporting was effective as of December 31, 2007.

KPMG LLP, an independent registered public accounting firm, has audited our financial statements that are included in this annual report and expressed an unqualified opinion thereon. KPMG has also expressed an unqualified opinion on the effective operation of our internal control over financial reporting as of December 31, 2007.

February 6, 2008

/s/ James A.C. Kennedy

Chief Executive Officer and President

/s/ Kenneth V. Moreland

Vice President and Chief Financial Officer

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
T. Rowe Price Group, Inc.:

We have audited T. Rowe Price Group, Inc. and subsidiaries (the Company) internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report of Management on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, T. Rowe Price Group, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of T. Rowe Price Group, Inc. and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of income, stockholders equity, and cash flows for each of the years in the three-year period ended December 31, 2007, and our report dated February 6, 2008, expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP
Baltimore, Maryland
February 6, 2008

Item 9B. Other Information.
None**.**

PART III

Item 10. Directors, Executive Officers and Corporate Governance.
Information required by this item as to the identification of our executive officers is furnished in a separate item at the end of Part I of this Report. Other information required by this item is incorporated by reference from the definitive proxy statement required to be filed pursuant to Regulation 14A for the 2008 Annual Meeting of our stockholders.

Item 11. Executive Compensation.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

Item 14. Principal Accounting Fees and Services.
Information required by these items is incorporated by reference from the definitive proxy statement required to be filed pursuant to Regulation 14A for the 2008 Annual Meeting of our stockholders.

PART IV

Item 15. Exhibits, Financial Statement Schedules.
The following documents are filed as part of this report.

(1) Financial Statements: See Item 8 of Part II of this report.

(2) Financial Statement Schedules: None.

(3) The following exhibits required by Item 601 of Regulation S-K are filed herewith, except for Exhibit 32 that is furnished herewith. Management contracts and compensatory plans and arrangements are filed as Exhibits 10.06 through 10.21.

3(i) Amended and Restated Charter of T. Rowe Price Group, Inc. as of March 9, 2001. (Incorporated by reference from Form 10-K for 2000; Accession No. 0001113169-01-000003.)

3(ii) Amended and Restated By-Laws of T. Rowe Price Group, Inc. as of December 13, 2007. (Incorporated by reference from Form 8-K Current Report as of December 13, 2007; Accession No. 0000950133-07-005002.)

10.01.1 Representative Investment Management Agreement with most of the T. Rowe Price mutual funds. (Incorporated by reference from Form 485BPOS; Accession No. 0000216907-05-000006.)

10.01.2 Amendment to representative Investment Management Agreement with most of the T. Rowe Price mutual funds. (Incorporated by reference from Form 485BPOS; Accession No. 0001267862-05-000006.)

10.02 Representative Underwriting Agreement between a T. Rowe Price mutual funds and T. Rowe Price Investment Services, Inc. (Incorporated by reference from Form N-1A/A; Accession No. 0001368135-06-000014.)

10.03 Transfer Agency and Service Agreement dated as of January 1, 2007, between T. Rowe Price Services, Inc. and the T. Rowe Price Funds. (Incorporated by reference from Form 485BPOS; Accession No. 0000871839-07-000078.)

10.04 Agreement dated January 1, 2007, between T. Rowe Price Retirement Plan Services, Inc. and certain of the T. Rowe Price Funds. (Incorporated by reference from Form 485BPOS; Accession No. 0000871839-07-000078.)

10.05 Second Amended, Restated and Consolidated Lease Agreement dated November 9, 2004, between East Pratt Street Associates Limited Partnership and T. Rowe Price Associates, Inc. (Incorporated by reference from Form 10-K for 2004; Accession No. 0000950133-05-000815.)

10.06 1995 Director Stock Option Plan. (Incorporated by reference from Form DEF 14A; Accession No. 0000933259-95-000009.)

10.07 1998 Director Stock Option Plan, as Amended and Restated effective December 16, 2004, including forms of option agreements. (Incorporated by reference from Form 10-K for 2004; Accession No. 0000950133-05-000815.)

10.08 2007 Non-Employee Director Equity Plan. (Incorporated by reference from Form DEF 14A; Accession No. 0001113169-07-000018.)

10.09 Form of option agreement available for awards issued under the 2007 Non-Employee Director Equity Plan (Incorporated by reference from Form S-8; Accession No. 0000950133-07-001664.)

10.10	Form of restricted stock agreement available for awards issued under the 2007 Non-Employee Director Equity Plan (Incorporated by reference from Form S-8; Accession No. 0000950133-07-001664.)
10.11	Form of restricted stock units agreement available for awards issued under the 2007 Non-Employee Director Equity Plan (Incorporated by reference from Form S-8; Accession No. 0000950133-07-001664.)
10.12	Schedule of Non-Employee Director Compensation, as amended April 12, 2007. (Incorporated by reference from Form 10-Q for the quarterly period ended March 31, 2007; Accession No. 0000950133-07-001865.)
10.13	T. Rowe Price Group, Inc. Outside Directors Deferred Compensation Plan. (Incorporated by reference from Form 10-K for 2004; Accession No. 0000950133-05-000815.)
10.14	1993 Stock Incentive Plan. (Incorporated by reference from Form S-8 Registration Statement [File No. 33-72568].)
10.15	1996 Stock Incentive Plan. (Incorporated by reference from Form DEF 14A; Accession No. 0001006199-96-000031.)
10.16.1	2001 Stock Incentive Plan. (Incorporated by reference from Form DEF 14A; Accession No. 0001113169-01-000002.)
10.16.2	First Amendment to 2001 Stock Incentive Plan dated April 8, 2004. (Incorporated by reference from Form DEF 14A; Accession No. 0001113169-04-000023.)
10.17	2004 Stock Incentive Plan. (Incorporated by reference from Form DEF 14A; Accession No. 0001113169-04-000023.)
10.18	Forms of agreements available for stock-based awards issued under the 2001 and 2004 Stock Incentive Plans.
10.19	Annual Incentive Compensation Pool. (Incorporated by reference from Form DEF 14A; Accession No. 0001113169-03-000001.)
10.20	Consulting Agreement dated January 23, 2007, with George A. Roche. (Incorporated by reference from Form 8-K Current Report as of January 23, 2007; Accession No. 0000950133-07-000205.)
10.21	Consulting Agreement dated January 31, 2006, with James S. Riepe. (Incorporated by reference from Form 8-K Current Report as of January 31, 2006; Accession No. 0000950133-06-000434.)
14	Code of Ethics for Principal Executive Officer and Senior Financial Officers of T. Rowe Price Group, Inc. under the Sarbanes-Oxley Act of 2002.
21	Subsidiaries of T. Rowe Price Group, Inc.
23	Consent of Independent Registered Public Accounting Firm, KPMG LLP.

31(i).1 Rule 13a-14(a) Certification of Principal Executive Officer.

31(i).2 Rule 13a-14(a) Certification of Principal Financial Officer.

32 Section 1350 Certifications.

SIGNATURES

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on February 7, 2008.

T. Rowe Price Group, Inc.

By: /s/ James A.C. Kennedy, Chief Executive Officer and President

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on February 7, 2008.

/s/ James A.C. Kennedy, Chief Executive Officer and President, Director
/s/ Kenneth V. Moreland, Vice President and Chief Financial Officer
/s/ Joseph P. Croteau, Vice President and Treasurer (Principal Accounting Officer)
/s/ Brian C. Rogers, Chairman of the Board of Directors
/s/ Edward C. Bernard, Vice Chairman of the Board of Directors
/s/ James T. Brady, Director
/s/ J. Alfred Broaddus, Jr., Director
/s/ Donald B. Hebb, Jr., Director
/s/ Alfred Sommer, Director
/s/ Dwight S. Taylor, Director
/s/ Anne Marie Whittemore, Director